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One Size Does Not Fit All: Corporate Governance for Controlled Companies

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One Size Does Not Fit All: Corporate Governance for Controlled Companies

Cover Page Footnote

International Law; Commercial Law; Law

One Size Does Not Fit All: Corporate Governance for “Controlled Companies”

Karl Hofstetter[†]

Abstract

Corporate governance discussions focus mostly on widely held firms. Controlled companies, such as family companies or listed subsidiaries, pose different challenges. Where a company is under the control of a large active shareholder, the “agency” conflict between shareholders and managers is less pronounced. Yet, the power of controlling shareholders gives rise to another “agency” issue: the potential conflicts of interest with minority shareholders. Thus, corporate governance rules that were developed for widely held firms may overshoot or undershoot in the context of controlled companies. Specifically adjusted rules might therefore be called for.

This paper analyzes the particular corporate governance issues faced by controlled companies with a functional, efficiency-based perspective. It conceptualizes the pros and cons of controlled company structures and tries to draw normative conclusions. Looking at regulatory regimes in the United States, the United Kingdom, Germany, and Switzerland, it argues for the flexibility of regulatory regimes to allow controlled companies to choose specific corporate governance structures where this is in the interest of shareholders as a class. Furthermore, it posits that control premiums and dual class shares have a potential to efficiently promote controlling shareholder structures. Allowing controlling shareholders to recoup some of their costs of control as shareholders (“external costs of control”) through control premiums (“external private benefits of control”) adds to their incentive to produce benefits of control for all shareholders (“shared benefits of control”).

[†] John Harvey Gregory Lecturer on World Organization, Harvard Law School, Spring 2005; Professor Zurich University; Member of the Board of Directors & General Counsel, Schindler Holding AG, Switzerland. The author would like to thank the members of the “corporate law group” at Harvard Law School—in particular, Reinier Kraakman, Lucian Bebchuk, Guhan Subramanian, Mark Roe, and Allen Ferrell—for their valuable input on the whole or on parts of this paper.

Dual class share structures, in turn, allow controlling shareholders to protect (external) private and shared benefits of control when new financing needs arise.

I. Biases in Corporate Governance Discussions	599
II. No End of History in Corporate Ownership Structures.....	603
A. Corporate Ownership Around the World.....	603
B. The Dynamics of Convergence and Path Dependencies in Corporate Ownership.....	605
III. Comparing Performance: Controlled versus Dispersed Ownership Structures	608
A. Empirical Studies	608
1. Studies Showing Positive Relative Performance by Controlled Companies	609
2. Studies Showing Negative or Mixed Relative Performance by Controlled Companies.....	611
B. Interpreting the Results	614
IV. Identifying the Potentials, Costs and Risks of Controlling Shareholder Structures	614
A. The Potential of Shared Benefits of Control	614
1. Monitoring Advantages of Controlling Shareholders	614
2. "Soft Factor" Advantages of Founder and Family Companies.....	615
B. Private Benefits of Control	616
1. Internal Benefits of Control	617
2. External Benefits of Control.....	618
C. Private Costs of Control.....	619
1. Internal Costs of Control	619
2. External Costs of Control	620
D. Entrenchment Risks	620
E. Legal Tradeoffs	621
V. Curbing Internal Private Benefits of Control.....	622
A. Disclosure.....	622
1. Financial and Operational Disclosure.....	622
2. Corporate Governance Disclosure.....	623
3. Disclosure of Conflict of Interest Transactions	625
4. Compensation Disclosure	625
B. Board of Directors and Board Committees.....	627
1. Board of Directors	627
2. Board Committees	630
C. Auditors and Other Gatekeepers	632
1. Auditors	632
2. Additional Gatekeepers	632
D. Specific Rules Against Self-Dealing.....	633

VI. Monitoring External Private Benefits of Control	635
A. Corporate and Market Activities	635
B. Evaluating Control Premiums	636
1. Standard Explanations for Control Premiums	636
2. Control Premiums as a Potentially Efficient Compensation Device	639
3. Looking at the Buyer’s Side	640
4. Bargaining Power as a Tool to Extract a Control Premium	641
5. Where Does the Control Premium Come From?... ..	642
6. Quantitative Links Between Control Premiums and External Private Costs of Control	644
7. Alternatives to Control Premiums	644
C. Reassessing Mandatory Bid Rules	646
D. Extending the Control Protection Strategy	648
E. Dual Class Share Structures	648
1. Efficiency Potential	648
2. Differentiating <i>Ex Ante</i> and <i>Ex Post</i> : Introductions of Dual Class Share Structures	649
3. Additional Observations	650
F. Pyramids	651
1. Efficiency Potential	651
2. <i>Ex Ante</i> Investments in Pyramids	652
3. <i>Ex Post</i> Pyramiding	653
G. Freeze-Out Transactions	654
1. Issues	654
2. Rules	655
VII. Mitigating Entrenchment Risks	658
A. Management v. Shareholder Entrenchment	658
B. Exit Measures	659
VIII. Conclusions	661

I. Biases in Corporate Governance Discussions

The United States has had a heavy influence on the global discussion of corporate governance. One example of this is the fact that the term “corporate governance” was coined in the United States and is now being used around the world.¹ The U.S.-inspired debate has unquestionably raised the sensitivity for the typical

¹ Karl Hofstetter, *Corporate Governance in Switzerland*, Final Report of the Panel of Experts on Corporate Governance, at 4 (published by economiesuisse, Zurich 2002), <http://www.economiesuisse.ch/d/content.cfm?upid=0420B48A-8FC9-4630-810935FA3F7F83F7&type=pdf&filetype=pdf> (English version).

principal and agency conflicts in listed companies everywhere. It has greatly contributed to the emergence of more sophisticated rules and practices designed to help cope with these conflicts. In addition, it has also given the debate a particular American focus.

The landscape of listed companies in the United States is homogenous in at least one sense: most companies have dispersed shareholder structures.² This means that they do not have large groups of majority shareholders who actively manage them.³ The situation is similar in the United Kingdom, but rather different in the rest of the world.⁴ For example, in Continental Europe, a much larger number of listed firms are "controlled companies"—under the control of founders, families, parent companies, or shareholder groups.⁵ In other words, shareholders have, at least potentially, a much greater influence on the course of these firms. It also means that the "agency" conflict between shareholders and managers that stands at the core of the corporate governance debate is less pronounced. However, the power of controlling shareholders gives rise to another "agency" issue: the potential conflicts of interest with minority shareholders.

For a long time, the U.S.-led corporate governance discussion took little note of the particular situation of controlled companies.⁶ This is understandable, given the salience of dispersed shareholder structures among listed companies in the United States. It is also understandable given the fact that most of the highly publicized corporate governance scandals in recent years shook companies that did not have a controlling shareholder.⁷ Yet, comparative

² The first to point this out were Adolph Berle and Gardiner Means. See ADOLF AUGUSTUS BERLE & GARDINER COIT MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (Transaction Publishers New Brunswick (1932)).

³ See BERLE & MEANS, *supra* note 2; Yoser Gadhoun et al., *Who Controls US?* (2005), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=399801.

⁴ See generally Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999).

⁵ *Id.* "Controlled companies" can be defined as companies in which the management is in the hands or under the control of one group of shareholders, with the rest of the shareholders being in a minority position. In practice, listed companies can often be controlled with less than 50% of the votes. Depending on the circumstances, a company can be controlled with as little as 30%, sometimes even with 20% or less.

⁶ Compare the American Law Institute's Corporate Governance Project in the 1980s, the Blue Ribbon Report in the 1990s, or the Sarbanes-Oxley Act in 2002, which all centered on widely held corporations.

⁷ Such companies include Enron, Tyco, and WorldCom. There were also major scandals involving companies with controlling shareholders, such as Adelphia, Hollinger

studies have shown that shareholder structures of listed companies are different outside the United States, with the United Kingdom being a notable exception. One could therefore expect the normative corporate governance debate to extend to the different issues faced by controlled companies. This has not really happened—at least not on a large scale.⁸

A major part of the legal and economic research has concentrated on explaining the development of ownership patterns in the United States and the United Kingdom as opposed to Continental Europe and the rest of the world. The underlying assumption often was that the dispersed shareholder structures in the United States and the United Kingdom are a reflection of more advanced laws and markets.⁹ Moreover, except for path dependency effects, the efficiency pressures of globalization were said to ultimately lead to a convergence of worldwide ownership patterns along U.S./U.K. lines.¹⁰ As a result, controlling shareholder structures were often explicitly or implicitly portrayed as second best.¹¹

In the terminology of behavioral economics, the described current in this U.S.-dominated debate can arguably be

and Parmalat in Italy.

⁸ There are important exceptions: THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH (Reinier Kraakman et al. eds., 2004); Allen Ferrell, *The Case for Mandatory Disclosure in Securities Regulation Around the World*, HARVARD LAW SCHOOL, 2004, 32, http://www.law.harvard.edu/programs/olin_center/; Brian R. Cheffins, *Corporate Law and Ownership Structure: A Darwinian Link?* (2002), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=317661; Lucian Arye Bebchuk, *Efficient and Inefficient Sales of Corporate Control*, Q.J. ECON. 957 (1994); Lucian Arye Bebchuk & Mark Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127 (1999).

⁹ E.g., Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L. J. 439 (2001).

¹⁰ *Id.*

¹¹ La Porta, et al., *supra* note 4; Randall Morck, *How to Eliminate Pyramidal Business Groups—The Double Taxation of Inter-Corporate Dividends and Other Incisive Uses of Tax Policy* (Nat'l Bureau of Econ. Research, Working Paper No. W10944, 2005), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=629586; John Coffee, *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U.L. REV. 641 (1999); John Coffee, *The Rise of Dispersed Ownership: The Roles of the Law and the State in the Separation of Ownership and Control*, 111 YALE L. J. 1 (2001) [hereinafter Coffee, *Dispersed Ownership*].

explained by “availability heuristics” and “endowment effects.”¹² “Availability heuristic” refers to the tendency among human beings to judge things based on mental availability; for example, their tendency to overestimate what is present and visible or what they have experienced recently.¹³ “Endowment effect” refers to the tendency among human beings to value a good that belongs to them more highly than the same good if it does not belong to them.¹⁴ Given the perceived prevalence of dispersed structures in the United States and their presumed contribution to the country’s successful economy, there is perhaps a tendency to focus corporate governance discussions on them and to see them as the ultimate stage in corporate ownership.

This article approaches the corporate governance of controlled companies from another angle. Part II details the results of recent research on the patterns of international ownership and critically assesses the various attempts to explain them. In Part III, the article provides an overview of some recent empirical research on the relative performance of controlled companies. In Part IV, the article conceptualizes the particular advantages and disadvantages of controlled companies from a corporate governance perspective. There are three main categories of agency issues: internal private benefits of control, external private benefits of control, and entrenchment. Parts V through VII will analyze various rules that have been devised to address these issues. The main focus will be on the United States and Europe—specifically, the United Kingdom, Germany, and Switzerland. The article will be particularly critical with regard to mandatory bid rules as they threaten to undercut the potential efficiency of control premiums. In the same vein, dual class share structures and even pyramids deserve regulatory tolerance. Both can be seen as devices that efficiently perpetuate shared and private benefits of control in controlled company structures. It will also be argued that rules developed to address the particular agency risks of widely held firms do not necessarily have the same merits for controlled companies. As a consequence, such rules would have to be sufficiently flexible to allow for adjustments. Part VIII

¹² See Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471 (1998).

¹³ *Id.*

¹⁴ *Id.*

finally concludes with suggestions for an improved approach to the corporate governance of controlled companies.

II. No End of History in Corporate Ownership Structures

A. *Corporate Ownership Around the World*

Although corporate ownership structures around the world share much in common, they also differ in significant ways. The corporate form with its five basic features—legal personality, limited liability, transferable shares, board and management separation, and investor ownership¹⁵—dominates the landscape of large enterprise almost everywhere. In practically all economies an important segmentation between listed and non-listed companies has taken root. The largest companies tend to be listed, but the overwhelming majority—mainly the smaller and medium-sized firms—stay private.¹⁶ The number of listed firms is particularly significant in the United States and the United Kingdom.¹⁷ This correlates with the high market capitalization in these two countries as a percentage of gross domestic product (GDP).¹⁸

With regard to listed companies, some striking features have been discovered by scholarship in recent years. Rafael La Porta and other researchers looked at ownership data in twenty-seven wealthy economies.¹⁹ Using twenty percent of the voting rights as a proxy for control, they found that thirty-six percent of the firms overall were widely held, thirty percent were family-controlled, eighteen percent were state-controlled and fifteen percent were controlled in other ways.²⁰ The authors therefore concluded that “by far the dominant form of controlling ownership around the world is not by banks and other corporations, but rather by families.”²¹ They also found stark differences between concentrations of ownership in the investigated countries. A

¹⁵ Kraakman et al., *supra* note 8, at 5-15.

¹⁶ *Id.*

¹⁷ Coffee, *Dispersed Ownership*, *supra* note 11, at 17.

¹⁸ However, market capitalization as a percentage of GDP is not the highest in the United States or the United Kingdom. It is even higher in Switzerland. *Id.* at 18.

¹⁹ La Porta et al., *supra* note 4.

²⁰ *Id.* These different ways include control by another widely held corporation, a voting trust, or a group with no single controlling investor.

²¹ *Id.* at 496.

regression analysis showed a correlation between the degree of concentration and the so-called "Anti-Director Index,"²² which was intended to capture the quality of the minority shareholder protection in the various jurisdictions. Countries with a common law history fared better on average in the "Anti-Director Index" and had significantly higher ownership dispersion.²³ Countries with a civil law background scored comparatively lower on the "Anti-Director Index" and showed higher concentrations of ownership.²⁴ The paper therefore concluded that since common law countries protect minority shareholders better than civil law countries, dispersed ownership could develop in the United States and the United Kingdom, but has been lagging in the civil law countries of Continental Europe. The logical implication was that if minority shareholder protection could be improved in civil law countries, ownership structures would develop in the direction of the United States and the United Kingdom.

Subsequent academic research confirmed the differences between ownership structures in the United States and the United Kingdom as opposed to other countries.²⁵ Marco Becht and Alisa Roell depicted an "extraordinarily high degree of concentration of shareholder voting power in Continental Europe relative to the [United States] and the [United Kingdom]."²⁶

In a study of 5,232 publicly traded corporations in thirteen Western European countries, Mara Faccio and Larry Lang²⁷ found

²² The index ranged from zero to six and was formed by adding one point if any of the following criteria were fulfilled: (1) the country allows shareholders to mail their proxy vote to the firm; (2) shareholders are not required to deposit their shares prior to a shareholders meeting; (3) cumulative voting or proportional representation of minorities in the board of directors is allowed; (4) an oppressed minorities mechanism is in place; (5) the minimum percentage of share capital that entitles a shareholder to call an extraordinary shareholders meeting is less than or equal to 10%; (6) shareholders have preemptive rights that can only be waived by a shareholders vote. *Id.* at 478, tbl.I.

²³ La Porta et al., *supra* note 4, at 478.

²⁴ *Id.* The first group included the United States and the United Kingdom, while the second group included Continental Europe.

²⁵ The fact that ownership structures in the United States and the United Kingdom are different from Continental Europe had been noted and discussed before. *See, e.g.,* Kaufmann et al., *Besitzverhältnisse von Schweizer Aktien, Studie Bank Baer, Zurich* (1991).

²⁶ Marco Becht & Alisa Roell, *Blockholdings in Europe: An International Comparison*, 43 EUR. ECON. REV. 1049 (1999).

²⁷ Mara Faccio & Larry H.P. Lang, *The Ultimate Ownership of Western European Corporations*, <http://www2.owen.vanderbilt.edu/marafaccio/JFE/pdf>.

that 36.93% were widely held and 44.29% were family-controlled.²⁸ They, too, drew a clear line between the United Kingdom (including Ireland) and Continental Europe. They also found that financial and large firms are more likely to be widely held, while non-financial and small firms are more likely to be family-controlled.²⁹ State control was found to be important for larger firms in certain countries.³⁰

In the United States and the United Kingdom, there are also a number of companies with large shareholders. Aside from institutional shareholders who play a particularly prominent role in the United Kingdom, there are numerous companies in both countries, particularly smaller ones, with dominant shareholders.³¹ Even sizeable, well-known companies—Microsoft, Wal-Mart, Ford, Berkshire Hathaway, Anheuser-Busch, Google, Marriott, or Genentech being examples in the United States—sometimes have dominant shareholders.³² In contrast, many companies listed in Continental Europe have dispersed shareholder structures. These companies are often the largest in their countries, as can be shown for Germany³³ and Switzerland.³⁴

B. The Dynamics of Convergence and Path Dependencies in Corporate Ownership

Globalization has unleashed very powerful forces of competition that not only affect factors of production, but may also impact corporate as well as political structures. It is therefore not

²⁸ The study used a control threshold of 20%. *Id.* at 26, tbl. 3.

²⁹ *Id.* at 13-14.

³⁰ Significant discrepancies between equity ownership and voting rights were noted in only a few countries. *Id.* at 15.

³¹ *Cf.* Gadhoum et al., *supra* note 3.

³² See *id.* (pointing out that even Berle and Means had evidence of only 44 out of 200 listed companies to be "management controlled," i.e., strictly widely held). Their own data of all listed U.S. companies for the year 1996, using 10% of the voting rights as a control threshold, shows 59.74% as "controlled" (79.72% for Asia, 86.28% for Europe). Using a 20% threshold, the authors get 28.11% "controlled companies" for the United States (56.40% for Asia, 63.07% for Europe). *Id.* at 7.

³³ Becht & Roell, *supra* note 26, at 1052. In their research, Becht and Roell show that the concentration among the DAX 30 companies (i.e., the thirty largest companies listed in Germany) is notably lower than the concentration among all listed German companies. *Id.*

³⁴ Examples include Nestle, Novartis, UBS, or Credit Suisse.

surprising that a lot of scholarly energy has been spent on speculations about the future of corporate governance around the world. Advocates of convergence, the most prominent being Henry Hansmann and Reinier Kraakman,³⁵ predicted the possible end of history for corporate law along Anglo-American lines. This would include the retraction of insider-dominated ownership structures.³⁶ The results of the analysis by La Porta and other researchers lend themselves to similar predictions.³⁷ Other scholars also sympathize with this line of thought, even though their reasoning sometimes differs. For example, Coffee³⁸ sees private action at work that includes bonding through cross-listings in U.S. securities markets. In contrast, Gordon³⁹ emphasizes the role of widely held corporate ownership in overcoming economic nationalism. He sees such mechanisms as being particularly active in the context of the European integration project. Thomsen,⁴⁰ on the other hand, posits that convergence is simultaneously moving in two different directions: he finds decreasing ownership concentration in Continental Europe and increasing ownership concentration in the United States and the United Kingdom.⁴¹

The convergence thesis has its critics. Bebchuk and Roe⁴² and Roe⁴³ individually have put forward the notion of path dependence in various forms as a crucial factor in determining the directions of corporate ownership and governance in different countries. The

³⁵ Hansmann & Kraakman, *supra* note 9.

³⁶ *Id.* at 463; Fausto Panunzi, Mike Burkart & Andrei Shleifer, *Family Firms* (Harvard Inst. of Econ. Res. Paper No. 1944, 2003), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=298631, predict the emergence of the widely held professional corporation as the equilibrium outcome in an environment where law successfully limits the expropriation of minority shareholders.

³⁷ La Porta et al., *supra* note 4.

³⁸ Coffee, *Dispersed Ownership*, *supra* note 11.

³⁹ Jeffrey Gordon, *An International Relations Perspective on the Convergence of Corporate Governance: German Shareholder Capitalism and the European Union, 1999-2000* (2003), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=374620.

⁴⁰ Steen Thomsen, *Convergence of Corporate Governance Systems to European and Anglo-American Standards*, 4 EUR. BUS. ORG. L. REV. 31 (2003).

⁴¹ Cf. also Ronald Gilson, *Globalizing Corporate Governance: Convergence of Form or Function, and Other Contributions*, in CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE 128-158 (Jeffrey N. Gordon & Mark J. Roe eds., 2004).

⁴² Bebchuk & Roe, *supra* note 8.

⁴³ See generally MARK ROE, POLITICAL DETERMINATION OF CORPORATE GOVERNANCE (2003).

argument put forward under this line of thought is that embedded structures of ownership perpetuate themselves on efficiency as well as political grounds. Existing ownership structures face exit barriers in the form of switching costs and therefore might efficiently survive in the face of strong convergence pressures. Dominant ownership structures may also entail vested political interests that can stop or drag legal changes towards different ownership constellations.⁴⁴ Consequently, mechanisms of path dependencies offer a "historic" explanation for persisting patterns of corporate ownership. This explanation is quite different from La Porta's theory, which is based on the civil and common law dichotomy.⁴⁵

The latter theory has taken a toll as a result of various studies showing that changes in ownership structures in the United Kingdom took root in the first half of the 20th century—prior to the legal changes that decisively affected the protection of minority shareholders.⁴⁶ The changes in the ownership structures of companies in the United Kingdom were apparently driven by intense merger and acquisition activities that developed in an environment of high trust.⁴⁷ Accordingly, cultural factors also have to be taken into account when evaluating ownership structures.⁴⁸ Looking at the results of a wide range of recent research, it is clear that corporate ownership structures are influenced by many factors, including business performance, law, political environments, culture, and history.⁴⁹

⁴⁴ Bebchuk & Roe, *supra* note 8.

⁴⁵ La Porta et al., *supra* note 4.

⁴⁶ Julian R. Franks et al., *Spending Less Time with the Family: The Decline of Family Ownership in the UK* (ECGI-Finance Working Paper No. 35/2004, 2004), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=493504; Julian R. Franks & Colin Mayer, *Ownership: Evolution and Regulation* (ECGI-Finance Working Paper No. 09/2003, 2005), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=354381; Brian Cheffins, *Does Law Matter? The Separation of Ownership and Control in the United Kingdom* (ERSC Centre for Bus. Res., Working Paper, 2000), <http://www.cbr.cam.ac.uk/pdf/wp172.pdf>; Brian Cheffins, *History and the Global Governance Revolution: The UK Perspective* (Working Paper, 2001), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=262805.

⁴⁷ Franks & Mayer, *Ownership: Evolution and Regulation*, *supra* note 46.

⁴⁸ Amir N. Licht et al., *Culture, Law and Finance: Cultural Dimensions of Corporate Governance Laws* (Working Paper, 2001), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=267190.

⁴⁹ Randall Morck & Lloyd Steier, *The Global History of Corporate Governance:*

The multi-causality of ownership structures suggests that it is difficult to predict any clear or linear evolution in corporate ownership. Observations of the actual market dynamics do not seem to reveal a clear pattern either. Trends towards more dispersed ownership certainly do exist as a consequence of privatization, as well as growth, merger, and acquisition activities of existing companies.⁵⁰ Even so, trends towards ownership concentration can also be observed. They may happen as a consequence of new initial public offerings, takeovers of dispersed companies by raiders,⁵¹ private equity investments in listed companies, spin-offs, or the build-up of concentrated share blocks by institutional investors and management.⁵² To be sure, not all such concentrations will lead to an increase in shareholder activity comparable to the traditional family company. This is particularly true for institutional investors, whose relative apathy remains one of the hotly debated topics in modern corporate governance. Nevertheless, the dynamics in the market place—including the rise of private equity and leveraged buy-outs around the world⁵³—call for caution in predicting the convergence of corporate ownership structures along any pattern.

III. Comparing Performance: Controlled versus Dispersed Ownership Structures

A. Empirical Studies

The lively debate about convergence has sparked a heightened interest in the performance of controlled versus dispersed ownership structures. A number of empirical studies have been carried out in recent years that look at the relative operational and stock

An Introduction (Nat'l Bureau of Econ. Research, Working Paper No. 11062, 2005), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=652361.

⁵⁰ *Id.* at 14. One example is the privatization of the telecommunications sector in Europe, such as Deutsche Telekom in Germany. See <http://www.telekom3.de/>.

⁵¹ Compare, for example, the build-up of a significant (and potentially growing) stake in GM by the investor Kirk Kerkorian. Danny Hakim, *Kerkorian Seeking to Buy 9% Stake in G.M.*, N.Y. TIMES, May 5, 2005, at C1.

⁵² Compare, for example, the tender offers of Blackstone Group, a private equity firm, for the German chemical maker Celanese. *Business Brief: Celanese Shareholders Approve Takeover by Blackstone*, N.Y. TIMES May 21, 2005, at C2; see also *Business Digest: Blackstone Group to Acquire Wyndham Hotel Chain*, N.Y. TIMES, June 15, 2005, at C2.

⁵³ *Id.*

performances of controlled companies. A particular focus has been placed on the most frequent form, the family company.

*1. Studies Showing Positive Relative Performance by
Controlled Companies*

Various studies of the Standard & Poor (S&P) 500 companies by Anderson et al. indicate strong positive correlations between family ownership and firm performance.⁵⁴ They found that, among the S&P 500, families were present in about one-third of the firms with an average holding of about nineteen percent.⁵⁵ The authors further demonstrated that family firms were, on average, better performers than non-family firms.⁵⁶ Additionally, family firms enjoyed a lower cost of debt than non-family firms.⁵⁷ They used less diversification than non-family firms and were not limited to low-risk businesses or industries.⁵⁸ The authors found no evidence that continued family ownership in public firms leads to minority shareholder wealth expropriation.⁵⁹ However, moderate family board representation, combined with a strong presence of independent directors, significantly improves family firm performance.⁶⁰ Finally, minority shareholders benefit overall from the presence of founding families.⁶¹

Ehrhardt et al. identified sixty-two German family-controlled companies founded before 1913 and still in existence in 2003 with

⁵⁴ Wharton Business School found similar positive performance results after testing 132 companies with a family ownership of at least 10% over a period of twenty years. These firms showed a return of 14% per annum over the whole period as opposed to the S&P 500 returning 11%. See Lisa Munoz, *Money Grows on Family Trees*, FORTUNE MAGAZINE, Apr. 2, 2001, at 78.

⁵⁵ Ronald C. Anderson et al., *Founding Family Ownership and the Agency Cost of Debt*, at 1 (2002), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=303864.

⁵⁶ Ronald C. Anderson & David M. Reeb, *Founding Family Ownership and Firm Performance: Evidence from the S&P 500* (2003), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=365260; Ronald C. Anderson & David M. Reeb, *Who Monitors the Family?* (2003), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=369620.

⁵⁷ Anderson et al., *supra* note 55.

⁵⁸ Ronald C. Anderson & David M. Reeb, *Founding Family Ownership, Corporate Diversification, and Firm Leverage*, 46 J. L. & ECON. 653 (2003).

⁵⁹ *Id.*

⁶⁰ Ronald C. Anderson & David M. Reeb, *Board Composition: Balancing Family Influence in S&P 500 Firms*, 49 ADMIN. SCI. Q. 209 (2004).

⁶¹ Anderson & Reeb, *supra* note 58.

sales of more than 50 million Euro.⁶² They then constructed a matching sample of sixty-two non-family owned firms and compared them over a period of one hundred years. According to their results, family businesses seem to outperform non-family firms in terms of operating performance; yet family firms are shown to also grow more slowly, and their performance decreases over time.⁶³

Edwards and Weichenrieder tested a sample of 102 listed companies from Germany for the years 1990-1992 and found positive correlations between concentrated ownership and performance, except in cases where the largest shareholder was a non-bank enterprise or a public sector body.⁶⁴ This suggests the necessity to differentiate between family-companies, subsidiaries in corporate groups, and state controlled enterprises.

A recent study analyzed the relative share performance of family companies and non-family companies listed on the Swiss Stock Exchange.⁶⁵ It demonstrated that the former outperformed the latter by a significant margin of more than five to three in the period between 1990 and 2004.⁶⁶ Looking at 103 initial public offerings (IPO) in Germany and fifty in Switzerland, Gleissberg identified a robust correlation between ownership structure and company performance: the faster the controlling shareholder sold off his shares or diluted his ownership after the IPO, the worse the

⁶² Olaf Ehrhardt, Eric Nowak, & Felix Weber, *Running in the Family: The Evolution of Ownership, Control, and Performance in German Family-owned Firms 1903-2003*, Paper prepared for the Review of Finance/CEPR Conference on Early Securities Markets, Version Dec. 31, 2004.

⁶³ An earlier German study expresses doubts about the conclusiveness of measuring performance links between ownership structures and performance for various reasons, one of them being the role of banks. Ekkehart Boehmer, *Corporate Governance in Germany: Institutional Background and Empirical Results* (Soc. Sci. Res. Network eLibrary Working Paper Series, 2005), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=149774.

⁶⁴ Jeremy Edwards & Alfons J. Weichenrieder, *Ownership Concentration and Share Valuation: Evidence from Germany* (CESifo Working Paper No. 193, 1999), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=175333.

⁶⁵ Urs Frey, Frank Halter, & Thomas Zellweger, *Bedeutung und Struktur von Familienunternehmen in der Schweiz*, Universitaet St. Gallen, Schweizerisches Institut fuer Klein- und Mittelunternehmen, Sommer 2004.

⁶⁶ *Id.* An article in the business journal BILANZ (February 2005) looked at the best performing companies on the Swiss Stock Exchange over the last thirty years and had three family companies among the top five: Schindler (2nd), Lindt & Spruengli (3rd), Sika (5th); the two other companies are widely held: Novartis (1st), Nestle (4th).

performance of the company.⁶⁷ Sraer and Thesmar reported very positive performance results in listed family companies for France from 1994 to 2000.⁶⁸ The authors found that family firms largely outperformed widely held corporations. The result held for both founder-managed firms and heir-managed companies.⁶⁹

Ben-Amar and Andre analyzed 238 acquisitions by 183 companies in Canada where a large proportion of public companies have controlling shareholders.⁷⁰ They found positive abnormal returns for family controlled firms and did not find negative impacts of separations of ownership and control through dual class shares or pyramids.⁷¹ In turn, Gompers et al. showed a positive correlation between the concentration of cash flow rights in the hands of controlling shareholders and firm value as well as performance, but a negative correlation if voting rights are disproportionate, as is the case for dual class shares.⁷²

2. *Studies Showing Negative or Mixed Relative Performance by Controlled Companies*

There are also studies showing that controlling shareholders can have negative performance implications. In a paper from 1988, Holderness and Sheehan posited that firms under family ownership create less economic value than non-family firms.⁷³

⁶⁷ Ralf Gleissberg, Boersengaenge vermindern oft die Rentabilitaet, *Neue Zuercher Zeitung*, July 8, 2003, 25. Of course, it could be suspected that the sell-off (in at least some cases) took place because the controlling shareholders knew about the worsening prospects of their company. Gleissberg seems to interpret the results of his study differently, however.

⁶⁸ David Sraer & David Thesmar, *Performance and Behavior of Family Firms: Evidence from the French Stock Market* (CEPR Discussion Paper No. 4520, 2004), <http://www.cepr.org/pubs/dps/dp4520.asp>.

⁶⁹ *Id.*

⁷⁰ Walid Ben-Amar & Paul Andre, *Separation of Ownership from Control and Acquiring Firm Performance: The Case of Family Ownership in Canada*, (Soc. Sci. Res. Network eLibrary Working Paper Series, 2005), <http://www.lums.lancs.ac.uk/files/accounting/5490/download/>.

⁷¹ *Id.*

⁷² Paul A. Gompers, Joy L. Ishii & Andrew Metrick, *Incentives vs. Control: An Analysis of U.S. Dual-Class Companies* (Nat'l Bureau of Econ. Research, Working Paper No. W10240, 2004), <http://www.nber.org/papers/w10290.pdf>.

⁷³ Clifford G. Holderness & Dennis P. Sheehan, *The Role of Majority Shareholders in Publicly Held Corporations*, 20 J. FIN. ECON. 317, 345 (1988); see also Clifford G. Holderness & Dennis P. Sheehan, *Constraints on Large-Block Shareholders* (Nat'l

More recently, Grant and Kirchmaier,⁷⁴ testing data on the 100 largest firms in five major European economies indicated mixed but overall rather negative correlations between ownership concentration and performance.⁷⁵

Using proxy data on all Fortune 500 firms during 1994-2000, Villalonga and Amit found a marked contrast between family firms where the founder served as CEO or Chairman and family firms with a CEO belonging to the heir-generation.⁷⁶ The first category performed better than non-family firms, while the second category performed worse.⁷⁷ In analyzing 192 successions in family-dominated companies listed in the United States Perez-Gonzalez found large relative declines in returns on assets and market-to-book ratios where CEOs related to the family were promoted.⁷⁸ The declines were particularly significant in firms with CEOs who did not attend a selective college.⁷⁹

Galve Gorriz and Salas Fumas tested the relative performance of listed family firms in Spain during the period from 1990 to 2004.⁸⁰ They found that family firms grew at a smaller rate and chose less capital-intensive productive technologies, but were

Bureau of Econ. Research, Working Paper No. W6765, Oct. 1998), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=138218 [hereinafter Holderness & Sheehan, *Large-Block Shareholders*].

⁷⁴ Tom Kirchmaier & Jeremy Grant, *Corporate Ownership Structure and Performance in Europe* (CEP Discussion Paper No. 0631, 2005), <http://www.cep.lse.ac.uk/pubs/download/dp0631.pdf>.

⁷⁵ The five major economies are Germany, United Kingdom, France, Italy, and Spain.

⁷⁶ Helen Villalonga & Raphael H. Amit, *How Do Family Ownership, Control, and Management Affect Firm Value?* Working Paper, June 7, 2004, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=556032.

⁷⁷ *Id.* Cf. also David Hillier & Patrick M.L. McColgan, *Firm Performance, Entrenchment and Managerial Succession in Family Firms* (Soc. Sci. Res. Network eLibrary Working Paper Series, 2005), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=650161. They report similar "entrenchment effects" from a sample of 683 U.K. companies showing that family CEOs were less likely to be removed after poor performance than non-family CEOs.

⁷⁸ Francisco Perez-Gonzalez, *Inherited Control and Firm Performance* (Soc. Sci. Res. Network eLibrary Working Paper Series, 2002), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=320888.

⁷⁹ *Id.*

⁸⁰ Carmen Galve Górriz & Vincente Salas Fumás, *Family Ownership and Performance: The Net Effect of Productive Efficiency and Growth Constraints* (ECGI-Fin. Working Paper No. 66/2005, 2005), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=664538.

more efficient in production than non-family firms.⁸¹

B. Interpreting the Results

Naturally, all described empirical results would have to be interpreted and controlled for various industries, market characteristics, laws, and other factors.⁸² Several of the aforementioned studies tried to do this.⁸³ Other studies looked specifically at market characteristics and their correlation with ownership concentration and performance. For example, Koeke and Renneboog⁸⁴ identified a positive relationship between productivity increases in markets subject to little discipline and control by insiders.⁸⁵ Analyzing data from 19,000 companies from sixty-one countries, Gugler et al. found that performance differences related to a country's legal system were much more significant than performance differences related to ownership structures.⁸⁶

Given the focus of this paper, the crucial question is what normative conclusions we can draw from these various studies. If nothing else, we recognize that there is no empirical basis for discriminating legally against controlled ownership structures. Instead, it seems plausible that controlled structures, like dispersed structures, have their benefits and drawbacks. Therefore, the

⁸¹ *Id.*

⁸² See Randall Morck & Bernard Yin Yeung, *Special Issues Relating to Corporate Governance and Family Control* (World Bank Pol. Research Working Paper No. 3406, 2004), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=625283 (with a highly critical perspective towards controlling shareholders).

⁸³ E.g., Górriz & Salas Fumás, *supra* note 80 (explaining their relatively lower scores for family companies in Spain as compared to family companies in the United States, *inter alia*, with the differences in minority shareholder protections in these two countries).

⁸⁴ Jens F. Koke & Luc Renneboog, *Do Corporate Control and Product Market Competition Lead To Stronger Productivity Growth? Evidence From Market-Oriented and Blockholder Based Governance Regimes* (ECGI-Fin. Working Paper No. 14/2003, 2003), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=389000.

⁸⁵ Similarly, Palmer showed that firms controlled by strong owners generated higher profits when the firms had market power, but ordinary profits when the firms had none. John Palmer, *The Profit-Performance Effects of the Separation of Ownership from Control in Large U.S. Industrial Corporations*, 4 BELL J. ECON. 293 (1973).

⁸⁶ Klaus Peter Gugler, Dennis C. Mueller & B. Burcin Yurtoglu, *Corporate Governance and the Returns on Investment* (ECGI-Fin. Working Paper No. 06/2003, 2004), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=299520.

normative challenge is to devise a level regulatory playing field that will allow both categories of ownership to compete on equal footing.⁸⁷ This requires that the specific potentials and risks of controlled companies first be specified in order to address them properly with legal rules.

IV. Identifying the Potentials, Costs and Risks of Controlling Shareholder Structures

A. The Potential of Shared Benefits of Control

Controlling shareholders offer specific advantages to the governance of corporations. These advantages have the potential to generate significant benefits for all shareholders. We can call them "shared benefits of control."

1. Monitoring Advantages of Controlling Shareholders

In their seminal work heralding the onset of the widely held corporation, Berle and Means assessed the presence of a controlling shareholder in these terms:

Presumably many, if not most of the interests of a minority owner run parallel to those of the controlling majority and are in the main protected by the self interest of the latter. So far as such interests of the minority are concerned, this loss of control is not serious. Only when the interests of majority and minority are in a measure opposed and the interests of the latter are not protected by enforceable law are the minority holders likely to suffer. This, however, is a risk which the minority must run; and since it is an inevitable counterpart of group enterprise, the problems growing out of it, though they may be most acute in isolated cases, have not taken on major social significance.⁸⁸

There is no question that the most obvious advantage of a controlling shareholder lies in the fact that he has interests that are generally aligned with those of the shareholders as a class.⁸⁹ Given the large stake that the controlling shareholder has typically invested himself, he also has the incentive to monitor the corporation and/or management closely and carefully. His voting

⁸⁷ This would allow capital markets to choose value maximizing structures on a case-by-case basis. See Harold Demsetz & Kenneth Lehn, *The Structure of Corporate Ownership*, 93 J. POL. ECON. 1155 (1985).

⁸⁸ BERLE & MEANS, *supra* note 2, at 68.

⁸⁹ *Id.*

power will allow him to intervene in a timely and forceful fashion if the company's performance is sub par. In addition, a controlling shareholder has the incentive and power to implement strategic and management changes even before dark clouds begin to move in.⁹⁰ "Creative destruction" is, after all, the hallmark of the controller-entrepreneur. In addition, given the controlling shareholders' usual long-term investment horizon, strategies can be devised and defended with a higher degree of patience than would be possible in companies that are at the mercy of short-term oriented and arguably inefficient capital markets.⁹¹ Likewise, parent companies with a controlling stake in listed subsidiaries may be able to create synergies in monitoring subsidiary management, giving them similar comparative advantages in monitoring costs.⁹² Therefore, in comparison to the board and management members in widely held companies, a controlling shareholder can have an edge in managing or supervising the company's performance due to his superior incentives, power, quality, horizon, and costs in regards to monitoring.

2. "Soft Factor" Advantages of Founder and Family Companies

The "hard" monitoring advantages are the most salient and perhaps also the most effective advantages of having a controlling shareholder. However, there might be other, less visible advantages. For family owners, anecdotal and empirical evidence indicates strong value attachments to the long-term success of family companies over several generations. Interviewing twenty-one of sixty-four Spanish family-companies that are thirty years old or more and among the Spanish top 1000, Gallo and Cappuyns found in all of them a business culture dominated by what they called "ELISA" values.⁹³ These values are: *Excellence, Labor*

⁹⁰ Given his power, the controlling shareholder is not subject to the collective action and "hold up" problems that exist in dispersed ownership structures.

⁹¹ See, e.g., ANDREI SHLEIFER, *INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE* (2000).

⁹² See, e.g., Karl Hofstetter, *Multinational Enterprise Parent Liability: Efficient Legal Regimes in a World Market Environment*, 15 N.C. J. OF INT'L LAW & COMM. REG. 301 (1990).

⁹³ M.Á. Gallo & Kristin Cappuyns, *Characteristics of Successful Family Businesses* (IESE Business School Working Paper No. 542, 2005), <http://www.iesc.edu/research/pdfs/D1-0542-E.pdf>.

ethic, Initiative for innovation, Simplicity in lifestyle and Austerity.⁹⁴

Shared values may breed trust. In their study indicating the superior performance of French family companies, Sraer and Thesmar posit that heir-managed firms have a comparative advantage in trust relationships with their labor force.⁹⁵ In return for more job security, workers accept being paid less.⁹⁶ The authors refer to this phenomenon as “implicit insurance contracts.”⁹⁷ The importance of cultural and other soft factors for the success of founder and family firms seems plausible. They capture what can be referred to as the “entrepreneurial spirit.”⁹⁸ Entrepreneurship might, in turn, be explained by long-term economic incentives including reputation, but could also be rooted in other psychological and social drivers of human action.⁹⁹

B. Private Benefits of Control

The power of controlling shareholders potentially reduces agency risks that exist in companies with dispersed shareholder structures; however, the same power also creates particular agency risks that would not exist in widely held companies.¹⁰⁰ The term often invoked to refer to those risks is “private benefits of control.”¹⁰¹ Even though it is not defined in a strict legal sense, this catch-all term seems to be commonly understood as including everything that controlling shareholders are able to get out of their

⁹⁴ *Id.*

⁹⁵ Sraer & Thesmar, *supra* note 68.

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ For example, it is said that there are about 450 “world champions” among German family companies—i.e., companies that are the global leaders in their respective markets.

⁹⁹ In particular, behavioral economics has shown that economic action is not only driven by rational utility maximization, but also by social and other human factors. See Ernst Fehr & Gerhard Schwarz, *PSYCHOLOGISCHE GRUNDLAGEN DER OEKONOMIE* (2002); Bruno S. Frey & Margit Osterloh, *Yes, Managers Should Be Paid Like Bureaucrats* (Inst. for Empirical Research in Econ. University of Zurich, Working Paper July 2004, Series No. 1379, 2005), <http://www.ideas.repec.org/p/cra/wpaper/2005=03.html>; Margit Osterloh & Bruno S. Frey, *Shareholders Should Welcome Employees as Directors* (Inst. for Empirical Res. in Econ. Working Paper No. 228, 2005), <http://www.ideas.repec.org/p/zur/iewwp/228.html>.

¹⁰⁰ Kraakman et al., *supra* note 8.

¹⁰¹ Bebchuk, *supra* note 8; Ferrell, *supra* note 8.

position without minority shareholders receiving a proportionate share.¹⁰² However, there are two categories of such "private benefits of control" that this paper proposes to strictly separate from each other: "internal" and "external" private benefits of control.

1. Internal Benefits of Control

Capital investments by shareholders in the company are assets of the company.¹⁰³ As a consequence, they are taken away from the free disposal of the shareholders. Their use and ultimate payback to the shareholders is subject to the constraints of corporate law.¹⁰⁴ The same is true for any proceeds generated by such investments. The corporation's reach also includes invisible assets that are the result of its ongoing operation, in particular, information and opportunities.¹⁰⁵ To be sure, the demarcation line between what belongs to the company and what belongs to its shareholders can be difficult to discern. For example, this is the case where shareholder assets and company assets have been jointly put to work, as is common in corporate groups.¹⁰⁶ Separating the two spheres can therefore become a conundrum and is part of the explanation for the emergence of corporate group laws in Germany.¹⁰⁷

At least conceptually, however, there is a pool of capitalized and non-capitalized assets that are subject to the decision and payout rules of the corporation. Controlling shareholders can theoretically, and sometimes practically, extract such assets for themselves disregarding applicable rules.¹⁰⁸ These internal private

¹⁰² *Id.*

¹⁰³ ROBERT CLARK, CORPORATE LAW 593 (1986).

¹⁰⁴ *Id.*

¹⁰⁵ *Id.* at 223.

¹⁰⁶ Hofstetter, *supra* note 92.

¹⁰⁷ *Id.*

¹⁰⁸ Such extractions can take on different forms, such as: (1) outright "stealing" by siphoning off cash and other assets without any business justification whatsoever (e.g., looting of a company's bank accounts); (2) transfer of assets to the controlling shareholders or to companies controlled by them under circumstances or at terms which violate the "arm's length" principle (e.g., unsecured low-interest loans or excessive salaries to controlling shareholders in management positions, transfer pricing in corporate groups, including use of intellectual property and know-how without proper consideration); (3) implementing transactions in the interests of the controlling

benefits of control can be defined to include all the benefits a controlling shareholder can extract from the company as an insider with access to the company's assets, information and opportunities, at prices or conditions more favorable to him than in an arm's length transaction.

2. *External Benefits of Control*

In principle, we may perceive shareholders as pursuing interests "outside" the company. They are only acting "inside" the company—and therefore, are bound to the interests of the company—to the extent that they are members of a company organ, such as the board of directors. Such activities are subject to fiduciary obligations and other constraints. Yet the situation is quite different for the activities of the shareholders as shareholders. In that capacity they have wide latitude, and justifiably so, since this is basically the realm of the free employment and movement of capital.¹⁰⁹

As a consequence, controlling shareholders rightfully have large discretion in creating value for themselves as shareholders. This includes the use of voting rights to make choices that minority shareholders might consider sub-optimal.¹¹⁰ Examples of the exercise of voting rights include electing the board of directors, changing the company's articles of association or capital structure, and deciding on mergers. Similarly, controlling shareholders can sell their shares in the market or as a block. They may also choose to increase their stake in the company. Minority shareholders may disagree with such decisions. However, except for specifically designed legal restrictions,¹¹¹ such decisions are merely subject to

shareholders that do not affect the company directly, but impose liability risks on it without a concomitant benefit (e.g., tax evasion schemes in the interest of controlling shareholders); (4) allocating without proper basis or approval business opportunities to shareholders that arose in the sphere of the company and were a result of the activities of the company; or (5) use of insider information in connection with the sale or purchase of shares in the market (e.g., purchase of shares prior to an imminent takeover bid by a third party, going private/freeze out transactions that take advantage of insider information about the "real" value of the company).

¹⁰⁹ CLARK, *supra* note 103, at 93.

¹¹⁰ Ultimately, the majority rule in corporations is a concession to the collective choice problems that would otherwise exist. In that regard, there is no basic difference between controlled companies and dispersed companies. If there were a unanimity rule, the risk of minority hold-ups would exist in both.

¹¹¹ Such legal restrictions include mandatory bid rules. *See infra* § VI.C.

market forces.¹¹²

It is not always easy to separate the "internal" from "external" benefits of a controlling shareholder. At least conceptually, it is obvious that there are private benefits for a controlling shareholder in his capacity as a shareholder—that is, benefits that he would not receive if he were in a mere minority position. Such private benefits include the non-financial benefits he can extract through the prestige of being publicly recognized as the founder or heir of an important enterprise.¹¹³

C. Private Costs of Control

As a counterpart to the private benefits of control, there are "private costs of control." Such costs are incurred by controlling shareholders, but not by minority shareholders. To mirror the categorization of private benefits proposed in this paper, these costs should also be subdivided into internal and external costs of control.

1. Internal Costs of Control

Internal costs of control arise in connection with the particular contributions of a controlling shareholder as a manager or inside monitor of the company. These contributions can, in principle, be properly compensated. Founders or family members in management positions can get market-clearing compensation packages.¹¹⁴ The same is true for board members representing controlling shareholders. Similarly, management and other shared services supplied by parent companies in corporate groups can be benchmarked against market prices.¹¹⁵ Internal costs of control can, therefore, be properly compensated in specific and tailor-made arrangements. Hence, they are no justification for any additional private benefits of control.

¹¹² CLARK, *supra* note 103, at 93.

¹¹³ Cf. Ronald Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Taxonomy* (Oct. 2004) (unpublished manuscript, on file with the North Carolina Journal of International Law and Commercial Regulation).

¹¹⁴ Of course, such compensation can be higher than compensation paid to a third-party manager in the same position if the controlling shareholder, by virtue of his "entrepreneurial input," is able to manage the company better than third parties would. The determination of such premium, if any, is within the authority of the board compensation committee. Cf. *infra* § V.B.2.

¹¹⁵ CLARK, *supra* note 103, at 159.

2. *External Costs of Control*

The situation is different for external costs of control. These are the specific risks and costs that a controlling shareholder assumes and incurs as a shareholder, independent of his involvement as a manager, board member, or other service provider. They include the risk associated with the under-diversification of an entrepreneur who has a disproportionately large part of his wealth invested in the company, the stewardship costs of a parent company, or the costs associated with the diminished liquidity of control blocks. These costs might be difficult to measure. However, their incurrence could be crucial for the generation of shared benefits of control for all shareholders.¹¹⁶ Therefore, efficiency considerations favor any solutions that would allow these costs to be recouped; one possibility is non-financial benefits of control,¹¹⁷ while another is control premiums.¹¹⁸

D. Entrenchment Risks

Entrenchment by controlling shareholders can occur in at least three different instances: in a corporate crisis, in connection with a succession to the founder or another family member, or in connection with strategic decisions.¹¹⁹ In all three instances, the potential that the controlling shareholder will destroy value or refuse to go along with value-enhancing proposals exists. Of course, in practice it is debatable whether a decision taken by the controlling shareholder will destroy or enhance value. In principle, the entrenchment risks are similar to, e.g., those in takeover situations involving the boards of widely held target companies. However, there is one important difference: the controlling shareholder will gain or lose the most in any decision with regard to the future direction of the company. It can, therefore, at least be assumed that his incentives are more appropriately aligned with the interests of the shareholders as a class than are the incentives of the board in a widely held target company. Nonetheless, there is a lingering risk of negative

¹¹⁶ *Supra* § IV.A.

¹¹⁷ *Supra* § IV.B.2.

¹¹⁸ *Infra* § VI.B.2.

¹¹⁹ For example, a decision to issue new equity for the financing of growth (leading to the dilution of control) or a decision to sell the company to a third party.

entrenchment effects.

E. Legal Tradeoffs

The potential "shared benefits of control" associated with controlling shareholders and the risks of these shareholders reaping "private benefits of control" or entrenching themselves are two sides of the same coin. They both grow out of the fact that controlling shareholders have the power to make decisions and that these decisions can be beneficial or harmful from the point of view of shareholders as a class.¹²⁰ Therefore, the question is to what extent legal rules can reduce improper "private benefits of control" without sacrificing desirable "shared benefits of control."

The described tradeoff reflects the two functions of corporate governance that this paper proposes to call the "promotional" and the "preventive" functions. The promotional function aims at creating room and incentives for corporate actors to create long-term value for shareholders. The preventive function aims at precluding corporate actors from doing the opposite: destroying value or diverting it to themselves.

In dispersed ownership structures, the promotional function is inherent in rules favoring incentive compensation for management, but also in rules aimed at the strategic value contributions of the board of directors. The preventive function is at the core of a whole panoply of corporate governance rules that serve as checks on management and the board. This includes mandatory disclosure, independence requirements for board members, board committees and auditors, rules about conflicts of interest, takeovers, and the rights of shareholders to vote and to sue.¹²¹

In controlled companies, the promotional function of corporate governance arguably starts at the stage of ownership formation. Assuming that concentrated ownership offers value potentials that dispersed structures do not, legal impediments to the formation or preservation of controlled company structures deserve to be questioned. It is in this light that control premiums or dual class share structures will have to be broached.¹²²

The preventive role of corporate governance rules is also

¹²⁰ CLARK, *supra* note 103, at 141.

¹²¹ *Cf. infra* § V.

¹²² *See infra* § VI.B-E.

somewhat different in controlled ownership structures. Given the alignment of interests among the controlling shareholder and the minority shareholders in their relationship with third party managers, corporate governance rules that were designed for dispersed ownership structures and concentrate on the agency problem between shareholders and managers are not always the most appropriate. They might overshoot and thereby impose unnecessary costs on controlled companies.¹²³ However, there is also a potential for them to undershoot to the extent that they do not capture the agency-issues that can arise between controlling and minority shareholders.¹²⁴ This particular agency-conflict might require separate rules such as those existing for “freeze out” transactions.¹²⁵

There are various possible regulatory approaches with regard to the idiosyncratic corporate governance issues in companies with controlling shareholders. Different jurisdictions have chosen different paths. The following chapters will try to evaluate them, with a particular emphasis on the United States and European jurisdictions like Germany, the United Kingdom, and Switzerland. The assessment will be done using the three main categories of agency-issues in controlled companies identified earlier:¹²⁶ (1) internal private benefits of control; (2) external private benefits of control; and (3) entrenchment.¹²⁷

V. Curbing Internal Private Benefits of Control

A. *Disclosure*

There are three principal areas of disclosure that matter for shareholders. The first includes financial disclosure and management reporting on strategy and operations. The second relates to corporate governance. The third covers conflicts of interest transactions and compensation.

1. *Financial and Operational Disclosure*

Disclosure of financial performance and disclosure on strategy

¹²³ Cf. *infra* § V.

¹²⁴ *Id.*

¹²⁵ *Infra* § VI.G.

¹²⁶ *Supra* § IV.B-D.

¹²⁷ *Infra* §§ V, VI, and VII, respectively.

and operations¹²⁸ have a great importance in dispersed ownership structures.¹²⁹ These disclosures serve as the main basis for the assessment of management and of share value.¹³⁰ Both can be considered as having a similarly important function in controlled companies. Even though one could argue that the control of management performance by minority shareholders is less crucial in controlled companies, the valuation of minority shares is equally important.

Ferrell argues that mandatory financial disclosure for controlled companies also increases competition in capital and product markets.¹³¹ Competition for capital will be enhanced because some firms will find their access to external finance improved as a result of being able to credibly commit to higher disclosure levels.¹³² That, in turn, can be expected to also promote competition in the product markets.

In addition, disclosure helps mitigate the potential of insider trading; a risk that exists to similar degrees in widely held and controlled companies. Accordingly, financial and management reporting requirements are usually the same for both types of companies,¹³³ which is justifiable.¹³⁴

2. Corporate Governance Disclosure

The second area of disclosure relating to corporate governance

¹²⁸ Such disclosures may occur in annual reports, at annual press conferences, at road shows, during conference calls with analysts, or through press releases (ad hoc disclosures) on important events.

¹²⁹ Ferrell, *supra* note 8.

¹³⁰ *Id.*

¹³¹ *Id.*

¹³² *Id.* at 39. Ferrell maintains that they would not be able to do that individually, because they have no way to commit credibly *ex ante* without a perceived high risk of them reversing their disclosure policy later.

¹³³ Sometimes, stock exchanges have separate segments for smaller companies with lower disclosure requirements. These segments might have higher numbers of controlled companies, but this can be explained by the fact that smaller companies are more likely to have controlling shareholders.

¹³⁴ A potential argument could be made that given the presumable long-term horizon of family companies, quarterly reporting requirements are an inappropriate and costly overkill for them, as has been maintained by the German family company Porsche. One possibility would be to grant opt-out rights from certain disclosure rules to companies having received the approval of a qualified majority of their shareholders. See *infra* § V.A.4.

has seen a significant rise in importance during the last years. The Combined Code in the United Kingdom,¹³⁵ the Sarbanes-Oxley Act in the United States,¹³⁶ and various corporate governance codes and stock market regulations in other countries¹³⁷ have dramatically enhanced the requirements that listed companies periodically report their governance structures and policies. The legitimate interest of minority shareholders in receiving information about corporate governance is the same for widely held and controlled companies. However, the relative importance of specific pieces of information could differ. Information on major shareholders, board composition and board committees, auditor independence, or shareholder rights has similar importance in both cases. Information on the compensation of third party managers or on takeover defenses has higher relative importance in dispersed ownership structures, whereas information on the percentage of ownership of the controlling shareholders¹³⁸ or on related-party transactions takes on a particular significance in controlled companies. Yet, the differences are such that uniform disclosure rules are justified for the sake of simplicity and comparability. This does not exclude that specific opting out rules¹³⁹ or a general rule of “comply or explain” are being applied to certain disclosure requirements.¹⁴⁰

¹³⁵ The Combined Code on Corporate Governance (July 2003).

¹³⁶ Sarbanes-Oxley Act of 2002 (*Public Company Accounting Reforms and Investor Protection Act*), Pub. L. No. 107-204, 116 Stat. 745 (codified primarily in Chapters 15 and 18 U.S.C.) [hereinafter SOX].

¹³⁷ Hofstetter, *supra* note 1.

¹³⁸ What matters is the percentage of votes held by the controlling shareholder(s) overall. In other words, if there is cooperation among several of them, what matters is the total of all votes held by them. Internal facts of the group, including the individual stake held by each group member, have secondary meaning at best. This favors rules that give as much privacy protection as possible to, for example, a family's internal ownership arrangements.

¹³⁹ As in the new German law on the disclosure of individual compensation for managers in listed companies. See *infra* § V.A.4.

¹⁴⁰ The principle applies to corporate governance disclosure under the rules of the Swiss Stock Exchange, except for disclosure on compensation, which is mandatory. Compare SWISS EXCHANGE, Directive on Information Relating to Corporate Governance (Corporate Governance Directive, DCG), (July 2002), http://www.swx.com/download/admission/regulation/guidelines/swx_guideline_20020701_en.pdf; Hofstetter, *supra* note 1.

3. *Disclosure of Conflict of Interest Transactions*

The third area of disclosure is concerned with conflict of interest transactions. This has a particular significance for controlled companies, perhaps most notably with regard to transfer pricing in corporate groups. Given the power and influence of controlling shareholders and the concomitant risk of them "tunneling" cash or other assets to themselves or to entities belonging entirely to them, disclosure of all material related party transactions are pertinent.¹⁴¹ For corporate groups there might even be more specific rules, such as the dependence report to the supervisory board under German corporate group law or the parent/subsidiary report as had been proposed under the former draft for a Ninth Directive in the EU.¹⁴²

A particular form of conflicts of interest transaction is the use of insider information in the stock market.¹⁴³ This risk is identical in controlled and widely held companies.¹⁴⁴ Accordingly, trading restrictions apply indiscriminately to managers and controlling shareholders who have access to insider information. In principle, the same is true for the disclosure of stock market transactions by insiders.¹⁴⁵

4. *Compensation Disclosure*

A hotly debated topic in many jurisdictions, although not so much in the United States, is the disclosure of management compensation. It is located halfway between corporate governance and conflicts of interest disclosure. The reporting of management compensation has two aspects: it gives shareholders the possibility to convince themselves that management has appropriate financial incentives and that compensation is not used as a tool to loot the company. In the presence of a controlling shareholder, the

¹⁴¹ Cf. CLARK, *supra* note 103, at 166.

¹⁴² Karl Hofstetter, *Parent Responsibility for Subsidiary Corporations: Evaluating European Trends*, 39 INT'L & COMP. LAW Q. 588 (1990).

¹⁴³ CLARK, *supra* note 103, at 263.

¹⁴⁴ *Id.*

¹⁴⁵ To be sure, differentiations may be justified. Where transactions take place privately among insiders (e.g., by way of inheritance, gifts or other trades within a family pool acting as one controlling shareholder), disclosure would seem to have no compelling function. This could favor exemptions in the interest of protecting the privacy of controlling shareholder groups.

functionality of such disclosure could be questioned. It could be argued that the controlling shareholder, due to his own significant interest, has the right incentives to negotiate efficient management compensation arrangements. Therefore, disclosure might be considered unnecessary. As a consequence, the negative fallout of the publicity of management salaries could be prevented.¹⁴⁶ Yet, there may be reasons for requiring disclosure even in those situations. For one, disclosure allows minority shareholders to better assess the supervision over management by the controlling shareholder.¹⁴⁷ In addition, disclosure is justified if the controlling shareholder is himself a part of management. Even though his basic incentives to manage the company in the shareholders' interests are hardly questionable, the potential of excessive compensation is almost the same as for managers in widely held corporations.¹⁴⁸ Consequently, the argument for applying identical compensation disclosure rules to widely held and controlled companies is quite strong.

Nonetheless, there is an intriguing new German statute which allows listed companies to opt out of individual compensation disclosure by way of a shareholders' resolution.¹⁴⁹ One alternative is to see this law as a political concession to German family companies, in particular Porsche, which had been critical about other disclosure requirements of the German Stock Exchange.¹⁵⁰

¹⁴⁶ This includes the potential spiraling-effect the publication of salaries has on other managers within and outside the firm. This psychological factor, very plausible to common sense, has been recognized by behavioral economics and boils down to the fact that people are as much concerned about their income relative to their group of reference as about their income in absolute terms. See Bruno S. Frey & Alois Stutzer, *Economics and Psychology: From Imperialistic to Inspired Economics*, in *PHILOSOPHIE ECONOMIQUE* 16 (2001).

¹⁴⁷ E.g., through the disclosure of the structure and amount of total compensation received by management overall.

¹⁴⁸ The fact that the controlling shareholder in a family corporation also controls the board of directors through his election votes in the shareholders meeting arguably aggravates the situation; conversely, the fact that such a person has a significant part of his own wealth at stake and that management compensation has perhaps less of a relative importance for him mitigates it.

¹⁴⁹ See *Individualisierte Offenlegung der Gehälter von Vorstandsmitgliedern von Aktiengesellschaften*, Eckpunkte eines Gesetzesentwurfs, (Newsletter German Justice Department), Mar. 11, 2005.

¹⁵⁰ Porsche refused to issue quarterly reports. Cf. *Porsche receives distinguished award for financial market communication*, "Best Communication of Shareholder Value," Aumotaive Intelligence News,

Yet, the law is more persuasive for other reasons. The requirement of a seventy-five percent approval rate by the shareholders is quite high, and the opt-out only applies to individual disclosure. The disclosure of total management compensation remains mandatory. Accordingly, the decision of the shareholders is limited to a choice between the risks of the controlling shareholder camouflaging excessive compensation to himself or his representatives in the overall amount of management compensation and the risks associated with the potential upward spiraling effects of disclosing individual compensation packages.¹⁵¹ It is certainly possible to argue that shareholders will be better off long-term by opting for the former.

B. Board of Directors and Board Committees

1. Board of Directors

The task of the board of directors as the "first line of defense" for shareholder interests in corporations has again a promotional and a preventive side.¹⁵² The promotional side aims at contributing to the creation of value for shareholders. The preventive side sets its sight on the risks of value destruction and value diversion.¹⁵³ The legal tasks of boards of directors and supervisory boards sometimes differ as to the relative emphasis on those two aspects. For example, the German supervisory board has less of a promotional role and more of a preventive one. On the other hand, boards in the United Kingdom and Switzerland have pronounced promotional roles.¹⁵⁴ The broad authorities and strong fiduciary duties of boards in the United States include both aspects.

The promotional role of the board requires familiarity with the company's business, market, and management. This gives an edge to current and former insiders. The preventive role of the

<http://www.autointell-news.com/News-2001/November-2001/November-2001-1/November-07-01-p07.htm>.

¹⁵¹ Cf. Frey & Stutzer, *supra* note 146, at 5.

¹⁵² *Supra* § IV.E.

¹⁵³ *Id.*

¹⁵⁴ The board's task of formulating the strategy is even considered a non-delegable task under Swiss law. Swiss Code of Obligation, § 716a (1991) [hereinafter Swiss Code of Obligation].

board, on the other hand, stresses the need for independence. This role favors outsiders, such as non-executive or independent directors.¹⁵⁵ Recent corporate scandals and the subsequent wave of corporate governance regulations put the spotlight on the preventive role of the board. Legal rules, listing requirements, and corporate governance codes have therefore shown a tendency to increase the required number of non-executives and independents on boards of directors.¹⁵⁶ Particularly stringent independence rules apply to the various board committees, i.e., the audit committee, the compensation committee, and the nomination committee.¹⁵⁷

So far, empirical research has not been able to establish a clear, positive link between the presence of independents on boards of directors and company performance.¹⁵⁸ In addition, firms like Enron and WorldCom had boards with majorities of "independent" directors. Proposals have therefore been put forward in the United States to increase the influence of shareholders on board nominations.¹⁵⁹ Their rationale is based on the notion that

¹⁵⁵ The fact that the German supervisory board has mainly preventive tasks, explains the mandatory legal rule that no members of the management board may at the same time be members of the supervisory board. Section A.3 of the U.K. Combined Code, on the other hand, stresses the need for a good mix of insiders and outsiders on the board of directors. FIN. REPORTING COUNCIL, THE COMBINED CODE ON CORPORATE GOVERNANCE, http://www.fsa.gov.uk/pubs/ukla/lr_comcode2003, §A.3 (July 2003) [hereinafter THE COMBINED CODE].

¹⁵⁶ The NYSE listing rules require a majority of independents. NYSE, LISTED COMPANY MANUAL (2003), §303A.1, <http://www.nyse.com/Frameset.html?displayPage=/listed/1022221393251.html> [hereinafter NYSE MANUAL]. The Combined Code recommends a "balance" of executive and non-executive directors, meaning that at least half should be non-executives. THE COMBINED CODE, *supra* note 155, §A.3. Lastly, the Swiss Code of Best Practice recommends a majority of non-executives. SWISS BUSINESS FEDERATION, SWISS CODE OF BEST PRACTICE FOR CORPORATE GOVERNANCE, §12 (2002), http://www.kpmg.ch/CG/Swiss_code_of_Best_Practice_english.pdf [hereinafter SWISS CODE OF BEST PRACTICE].

¹⁵⁷ The Sarbanes-Oxley Act requires that all members of the audit committee be independent, the NYSE rules also require the members of the compensation and the nomination committees to be independent. NYSE MANUAL, *supra* note 156 §§ 301.3A, 303.4 and 5; SOX, *supra* note 136.

¹⁵⁸ Robert Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too*, 36-37 (John M. Olin School of Business and Economics, Discussion Paper No. 525, 2005), http://www.law.harvard.edu/programs/olin_center/corporate_governance/papers/2005_Clark_525.pdf.

¹⁵⁹ Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, in SHAREHOLDER ACCESS TO THE CORPORATE BALLOT 59 (Lucian Arye Bebchuk ed., Harvard Univ. Press 2005); *see also* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004).

"independence" as a requirement for board and board committee membership is, in fact, a mere proxy for the alignment with shareholder interests. All other things being equal, independent directors are, therefore, just the second best solution to having the shareholders themselves being represented on the board.

This insight has ramifications for companies with controlling shareholders. First of all, the presence of a controlling shareholder and his representatives on the board of directors must be welcomed. His direct representation can strengthen the board in the sense that it will align the board with shareholder interests. Accordingly, there is no strong case for requiring that the board be composed of a majority of independent directors with no ties to either the company or the controlling shareholder.¹⁶⁰ The exemption from the independence requirements for "controlled companies"¹⁶¹ in the NYSE listing rules is therefore pertinent. The same is true for Section 28 of the Swiss Code of Best Practice, which explicitly provides for proper adjustments to the corporate governance of companies with controlling shareholders.¹⁶²

Having the founder or the corporate parent dominate the board of directors of a controlled company can move the company's agenda swiftly and decisively towards the interests of shareholders as a class. On the other hand, looking at the promotional side of the board's task, a controlling shareholder can benefit as much as anybody else from the input of persons with different backgrounds and fresh ideas. Hence, outside board members can also add value to the board of a controlled company. Empirical research strongly supports this view.¹⁶³

Looking at the preventive role of the board, the potential of diverging interests between the controlling and the minority shareholders—such as in the case of conflict-of-interest transactions—calls for a proper counterweight. Outside directors,

¹⁶⁰ The situation is likely different in companies where the state has a majority stake. The danger of political goals affecting the objectives pursued by the controlling shareholder militate in favor of strong independent membership on the board.

¹⁶¹ In the NYSE listing rules, "controlled companies" are defined as companies with a shareholder holding more than 50% of the votes. NYSE MANUAL, *supra* note 156, § 303A.

¹⁶² These proper adjustments include the composition of the board and its committees. SWISS CODE OF BEST PRACTICE, *supra* note 156, § 28.

¹⁶³ Andersen & Reeb, *supra* note 60.

independent from the controlling shareholders, can fulfill that function.¹⁶⁴ In sum, independent board members have their role cut out for them in controlled companies, too; however, there is a strong case to be made for granting controlled companies more flexibility with regard to the composition of the board.

2. Board Committees

Flexibility seems equally justified in regards to the composition of board committees. Conceptually, the audit committee, the compensation committee, and the nomination committee are strengthened if the controlling shareholder or his representatives participate in them. Alignment with shareholder interests, and not independence, are the primary concerns. To be sure, the situation becomes more differentiated to the extent that the controlling shareholder is himself involved in management. The implications are not identical for the three committees.

Assuming that the audit committee's function is the monitoring of major risks—including financial disclosure and the relationship with the outside auditor—the case for oversight by independent directors becomes stronger, the more the controlling shareholder is himself managing such risks. Still, given the fact that the controlling shareholder has the most to lose if these risks materialize, his credentials to actively participate in the board's audit committee remain intact. Accordingly, in a company controlled by its founder, the participation of the controlling shareholder in the audit committee could be justified on the grounds of his strong shareholder orientation and competence. However, transactions and risk areas involving potential conflicts of interest between the controlling shareholder and the company would consequently have to be monitored by independents.¹⁶⁵

The compensation committee is basically strengthened by the participation of the controlling shareholder, except when it comes

¹⁶⁴ Of course, outside directors sometimes fail in it, as the *Hollinger* case demonstrates: well-known independent directors had repeatedly (and perhaps unknowingly) rubberstamped illegal diversions by the controlling shareholder. See, e.g., *Hollinger Int'l, Inc. v. Black*, 844 A. 2d 1022 (Del. Ch. 2004); RICHARD BREEDEN, REPORT OF THE INVESTIGATION BY THE SPECIAL COMMITTEE OF THE BOARD OF DIRECTORS OF HOLLINGER INTERNATIONAL INC. (2004), <http://www.sec.gov/>.

¹⁶⁵ Such monitoring might be conducted through a committee consisting exclusively of independents. All transactions between the founder and the company would have to be approved by it. In addition, the committee would have to get proper assurance that all relevant transactions were presented to it.

to his own compensation and the compensation of persons close to him. That favors a wholly independent compensation committee in family companies where family members are participating in management. On the other hand, it should be possible in a corporate group to have the compensation committee of the parent also deal with the compensation packages of subsidiary management. The subsidiary board would, of course, still be ultimately responsible for approving the parent's recommendations with a view to the interests of subsidiary shareholders in general; however, with regard to management salaries, the interests of the controlling shareholder and the minority are the same.

The role of the nomination committee basically always warrants the participation of the controlling shareholder. There is no fundamental conflict of interest between him and the minority shareholders as far as nominations to the board are concerned. Minority shareholders can have different preferences for candidates. This may be particularly pronounced in situations of crisis or succession of leadership, with the risk of entrenchment on the part of the controller.¹⁶⁶ That creates one argument in favor of a mixed composition of the nomination committee: allowing independents to air different proposals early in the nomination process. On the other hand, in corporate groups the nomination process can be orchestrated on the parent level, with the subsidiary board having the last word before nominations go to the shareholders meeting.

As a result, the optimal composition of board committees depends highly on the specific circumstances of a controlled company. This favors broad flexibility, which is in fact what the NYSE listing rules,¹⁶⁷ the Swiss Code of Best Practice,¹⁶⁸ or other European codes using the "comply or explain" concept provide.¹⁶⁹

¹⁶⁶ See *infra* § VII.

¹⁶⁷ NYSE MANUAL, *supra* note 156, § 303.A.

¹⁶⁸ SWISS CODE OF BEST PRACTICE, *supra* note 156, § 28.

¹⁶⁹ Flexibility is the hallmark of European corporate governance codes (e.g., the Combined Code). See Floyd Norris, *Corporate Rules in Europe Have Been Flexible, but Change is Coming*, N.Y. TIMES, April 8, 2005, at C1; see also Colin Mayer, *Corporate Governance: A Policy for Europe*, Paper presented at the 2003 Annual Congress of the Swiss Society of Economics and Statistics at the University of Bern (Mar. 21 2003) (strongly advocating the European approach and the Swiss in particular).

C. Auditors and Other Gatekeepers

1. Auditors

There are other gatekeepers besides the board of directors, the most important being the external auditor. The role and independence of the external auditor has become a central issue in the aftermath of recent corporate scandals. Sarbanes-Oxley and its counterparts in other jurisdictions have established new standards of independence for external auditors. While auditor independence from management is an undisputed necessity in widely held companies, it is debatable whether, and to what extent, auditors also have to be independent from controlling shareholders. This is reminiscent of the issue of board independence. At the outset, it is clear that the auditor is accountable to the shareholders as a class. This certainly includes the controlling shareholder. To the extent that a controlling shareholder holds an investment passively, independence from him should therefore not matter.

On the other hand, there is the potential that controlling shareholders may use their position to extract improper private benefits of control. In cases such as Parmalat, Hollinger, or Adelphia, this has had dire consequences.¹⁷⁰ Transfer pricing in corporate groups is another known area of potential improper benefit extraction. These risks favor rules requiring the independence of auditors not just from management, but also from controlling shareholders. This is in fact what rules generally provide.¹⁷¹

2. Additional Gatekeepers

Additional gatekeepers include banks, creditors, credit rating agencies, and other capital market participants like financial

¹⁷⁰ Guido Alessandro Ferrarini & Paolo Giudici, *Financial Scandals and the Role of Private Enforcement: The Parmalat Case* (ECGI-Law Working Paper No. 40/2005, 2005), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=730403; BREEDEN, *supra* note 164; Press Release, Securities Exchange Commission, SEC and US Attorney Settle Massive Financial Fraud Case Against Adelphia and Rigas Family for \$715 Million, (Apr. 25, 2005) [hereinafter Financial Fraud Case].

¹⁷¹ There is, of course, a question of whether these independence requirements work. Coffee doubts it and suggests the idea of auditors appointed by minority shareholders only. John C. Coffee Jr., *The Theory of Corporate Scandals: Why the US and Europe Differ*, http://www.law.columbia.edu/center_program/law_economics/wp_listing_1/wp_author?exclusive=filemgr.download&file_id=94915&rtcontentdisposition=filename%3DWP274.pdf.

analysts, the business media or transactional lawyers. The role they play with regard to controlled companies does not seem to be entirely different from their role in widely held firms. To be sure, where controlling shareholders resort to increased credit financing to prevent dilution of their control, creditors may assume a particularly significant risk position and a concomitant monitoring role. That such a role is not always carried out successfully is evidenced by recent scandals such as Parmalat in Italy or Erb in Switzerland.¹⁷² However, data collected by Holderness and Sheehan for the United States showed that the leverage of controlled companies was on average lower than that of widely held companies.¹⁷³ Accordingly, it does not seem that creditors play a systematically more important monitoring role in controlled companies.

D. Specific Rules Against Self-Dealing

Regardless of whether they are controlling shareholders or managers, insiders have special access to company assets, company information, and company opportunities. Accordingly, there is a risk that they will appropriate such goods to themselves instead of using them in the interest of all shareholders.¹⁷⁴ This risk exists in both controlled and widely held firms. Of course, it could be argued that it is a greater concern in controlled companies, because controlling shareholders hold ultimate sway over the board of directors, making the board a less effective monitor of their conduct.¹⁷⁵ By the same token, it could be argued that managers have a greater incentive to extract private benefits because they have less at stake in the company.¹⁷⁶ In addition, it could be said that managers are perhaps more inclined to

¹⁷² Erb, a non-listed conglomerate with sales of more than US\$3 billion, crumbled under a mountain of debt.

¹⁷³ Holderness & Sheehan, *Large-Block Shareholders*, *supra* note 73.

¹⁷⁴ La Porta et al., *supra* note 4.

¹⁷⁵ This is why Coffee suspects "private benefits of control" to be the major corporate governance issue in controlled companies. Coffee, *supra* note 171, at 11.

¹⁷⁶ It is interesting in that context to look at a survey of 200 CEOs in the N.Y. Times of April 3, 2005, which shows that the two CEOs with the lowest total compensation (below US\$1 million) were also the two CEOs with by far the largest wealth invested in their companies: Steven Ballmer of Microsoft and Warren Buffet of Berkshire Hathaway. Claudia Deutsch, *EXECUTIVE PAY; My Big Fat C.E.O. Paycheck*, N.Y. TIMES, April 3, 2005, at Sec. 3, 1.

"creatively adjust" the numbers in order to protect their stock options.¹⁷⁷ That can, of course, be even more damaging to shareholder interests overall, as recent scandals like Enron, WorldCom, and others have demonstrated.¹⁷⁸

There are no systematic data on the relative frequency and seriousness of self-dealing in controlled as opposed to widely held companies. Anecdotal evidence suggests that serious self-dealing can happen in both models. Parmalat in Italy,¹⁷⁹ Hollinger,¹⁸⁰ and Adelphia¹⁸¹ in the United States epitomize the risks in controlled companies. Enron, Tyco, and WorldCom have become symbols of the risks of self-dealing by managers in companies with dispersed ownership structures. In any case, it is evident that the potential of self-dealing inefficiently distorts rewards and incentive systems everywhere. The prevention of self-dealing is therefore one of the main tasks of corporate law and corporate governance in general.

Legal systems have developed various specific rules in regards to self-dealing, including restrictions on loans to insiders, insider trading rules,¹⁸² or procedural rules for transactions between companies and their insiders.¹⁸³ These rules tend to be applicable to all categories of insiders. Accordingly, there are few differences in their application to controlled and widely held firms.¹⁸⁴

Special rules in regard to the potential self-dealing of controlling shareholders do exist for corporate groups. The most prominent ones are those on transfer pricing. They have their roots in tax laws and tend to be highly sophisticated. Since their aim is to simulate arm's-length transactions, they are, *mutatis*

¹⁷⁷ Coffee, *supra* note 171, at 2.

¹⁷⁸ *Id.*

¹⁷⁹ Ferrarini & Giudici, *supra* note 170.

¹⁸⁰ BREEDEN, *supra* note 164.

¹⁸¹ SEC, Financial Fraud Case, *supra* note 170.

¹⁸² E.g., Exchange Act of 1934, 15 U.S.C. § 78(j) [Act §§ 10b-5 (1934)].

¹⁸³ Examples of such procedural rules are abstention rules and rules requiring the approval by special committees composed of disinterested persons. Exchange Act of 1934, 15 U.S.C. § 78n(a) [Act §§ 14(a)(3)-14(a)(13)].

¹⁸⁴ Differences could abound in connection with their enforcement, where rules are privately enforceable through derivative actions requiring board approval. Special rules are needed under these circumstances, preventing a board dominated by the controlling shareholder to suppress the action from going forward; U.K. law, in particular, has grappled with that problem. PAUL DAVIS, INTRODUCTION TO COMPANY LAW 236 (2002).

mutandis, applicable in corporate law as well.¹⁸⁵

VI. Monitoring External Private Benefits of Control

A. Corporate and Market Activities

External private benefits of control come out of the activities of controlling shareholders as shareholders.¹⁸⁶ These activities can be separated into corporate and market activities. Corporate activities occur in the context of shareholders' meetings. They are, therefore, subject to the general rules and restrictions applicable to shareholder resolutions. Shareholder resolutions are governed by proxy rules and other procedural standards aimed at optimal decision-making with a view to the interests of all shareholders.¹⁸⁷ Shareholder resolutions may also be subject to certain substantive standards, such as those provided for in German or Swiss law. In both jurisdictions, resolutions can be challenged on the grounds that they were arbitrary or that they violated the general principle of equal treatment among shareholders.¹⁸⁸ Such restrictions, even though much looser than fiduciary duties imposed on insider conduct, can be understood as generic protections against ex post opportunism by controlling shareholders as shareholders and, as such, have efficiency potential.

There may be additional rules that apply specifically in the context of shareholder resolutions in controlled companies. Examples include preemption rights and other legal safeguards protecting minority shareholders against dilution.¹⁸⁹ These rules tend to be particularly strict in civil law countries like Germany or Switzerland, where the procedure of issuing new shares is highly regulated and, with few exceptions, in the mandatory domain of the shareholders' meeting. This has the benefit of allowing minority shareholders to challenge such decisions both in the open forum of the shareholders meeting and before courts.¹⁹⁰ The same rationale applies to other fundamental decisions, which European

¹⁸⁵ Cf. CLARK, *supra* note 103, at 159.

¹⁸⁶ *Supra* § IV.B.2.

¹⁸⁷ CLARK, *supra* note 103, at 93.

¹⁸⁸ Under U.S. law, legal controls and remedies would typically be limited to liability actions by minority shareholders.

¹⁸⁹ CLARK, *supra* note 103, at 719.

¹⁹⁰ Cf. Hofstetter, *supra* note 1, at 10.

laws¹⁹¹ assign to the shareholders meeting. This includes, for example, dividend payouts and all changes of constitutional documents, including by-laws.¹⁹² To be sure, such laws typically leave the controlling shareholder wide discretion in taking decisions through majority votes. This seems appropriate as long as such decisions are within the range of expectations the minority shareholders had implicitly agreed to when the shares were issued to them. This can be assumed to be the case as long as the decisions meet certain basic tests of economic rationality within the limits of the law.

In addition, there might be shareholder resolutions where the controlling shareholder has a conflict of interest with his parallel position as a corporate insider. In these cases a "majority of minority rule" might apply; that is, the controlling shareholder would be prohibited from voting. Examples are shareholder approvals of derivative actions under U.K. law,¹⁹³ "discharge" resolutions under Swiss law, or "freeze out" mergers.

The market activities of controlling shareholders are subject to the general market rules that are applicable to all market participants. In addition, there is a question of whether specific legal rules should apply to the market conduct of controlling shareholders. One principal area of debate concerns control premiums in connection with the sale of share blocks.

B. Evaluating Control Premiums

1. Standard Explanations for Control Premiums

The conventional wisdom among scholars has been that control premiums are a proxy for the private benefits of controlling shareholders.¹⁹⁴ No distinction is usually made between the

¹⁹¹ Unlike U.S. law, which generally does not assign such decisions to the shareholders meeting.

¹⁹² Other minority shareholder rights might affect board elections giving the holders of shares with voting or dividend rights that are different from the shares of the controlling shareholder a right to appoint a board member. Swiss Code of Obligation, *supra* note 154, § 709. Cumulative voting, as known in some U.S. states, can have similar effects.

¹⁹³ DAVIS, *supra* note 184, at 225-26.

¹⁹⁴ Michael J. Barclay & Clifford G. Holderness, *Private Benefits From Control of Public Corporations*, 25 J. FINANCIAL ECON. 373 (1989); Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, J. FINANCE 541 (Apr. 2004); Ferrell, *supra* note 8, at 12; Coffee, *Dispersed Ownership*, *supra* note 11, at

different categories of private benefits.¹⁹⁵ In addition, the general assumption is that the existence of control premiums reflects an inability by legal systems to prevent private benefits of control. This implies that control premiums are, in principle, undesirable and inefficient or, at best, neutral.¹⁹⁶

A recent empirical study by Alexander Dyck and Luigi Zingales measured control premiums in thirty-nine countries based on data drawn from 393 sales of controlling blocks.¹⁹⁷ The control premium was defined as the difference between the price for the controlling block and the post-sale market price of the shares. The study found on average premiums of fourteen percent. Brazil was highest with sixty-five percent, Japan lowest with negative four percent.¹⁹⁸ Countries on the higher end included the Czech Republic, Italy, and Mexico.¹⁹⁹ On the lower end, the United States and United Kingdom both had on average a one percent control premium, while France exhibited a two percent premium. South Korea, Germany, and Switzerland fell in between, with premiums of sixteen, ten, and six percent, respectively.²⁰⁰ The authors tested several regressions and found, among other things, that higher premiums and benefits are associated with less developed capital markets and more concentrated ownership. However, they were reluctant to render any judgment on the efficiency of control premiums.²⁰¹

In contrast, Bebchuk has modeled a "rent-protection theory" for the decision by a company's founder to keep control upon going public.²⁰² This model indicates that the founder's decision

10; Lucian Bebchuk, *A Rent Protection Theory of Corporate Ownership and Control*, at 24 (Harvard Law and Econ. Discussion Paper No. 260, 1999).

¹⁹⁵ Gilson, *supra* note 113, at 22, at least differentiates between pecuniary and non-pecuniary private benefits of control.

¹⁹⁶ Dyck & Zingales, *supra* note 194; see also FRANK EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 109 (1991) (important exceptions arguing strongly in favor of control premiums on efficiency grounds).

¹⁹⁷ Dyck & Zingales, *supra* note 194.

¹⁹⁸ *Id.*

¹⁹⁹ The percentage numbers for the Czech Republic, Italy, and Mexico are 58%, 37%, and 38%, respectively. *Id.*

²⁰⁰ *Id.*

²⁰¹ Dyck & Zingales, *supra* note 194 (mentioning that they might merely have distributional consequences).

²⁰² Bebchuk, *supra* note 194.

is a function of the size of the private benefits of control he can extract from the company.²⁰³ When private benefits of control are large, leaving control up for grabs attracts rivals.²⁰⁴ Furthermore, keeping control allows the founder to capture a control premium.²⁰⁵ Hence, Bebchuk predicts that "in countries in which private benefits of entrenched control are large, . . . ownership choices will be distorted" in favor of controlled company structures.²⁰⁶

Bebchuk's policy conclusions are two-fold. First, he inferred that given the perceived distorting effect of private benefits of control on ownership structures, "a corporate policy that lowers private benefits of control would bring us closer to efficient choices of ownership structures."²⁰⁷ Second, Bebchuk concluded that since the benefits of control cannot be completely prevented, prohibiting or discouraging controlled company structures altogether would not be desirable, since this could lead companies not to go public at all. In addition, he recognized that it might not be "desirable to reduce private benefits all the way to zero," based on the fact that "when the pressure of blockholders can improve incentives, having some private benefits of control might be necessary to induce them to hold a block and forego some benefits of diversification."²⁰⁸

As shown earlier,²⁰⁹ and in line with Bebchuk's analysis, certain private benefits of control are desirable in that they will induce controlling shareholders to bear specific private costs of control. Indeed this is the basis for the potential efficiency of control premiums. A clear differentiation between internal and external private costs and benefits of control will be helpful in developing that argument.²¹⁰

²⁰³ *Id.*

²⁰⁴ *Id.* at 1.

²⁰⁵ *Id.*

²⁰⁶ *Id.* at 30.

²⁰⁷ *Id.*

²⁰⁸ *Id.* at 31.

²⁰⁹ *Supra* § IV.

²¹⁰ *Cf. supra* § IV.B-C.

2. *Control Premiums as a Potentially Efficient Compensation Device*

The external costs of control for a controlling shareholder are significant and increase markedly during the period in which he holds a controlling stake. They are likely to differ substantially depending on the type of control structure—for example, single founder, family, or corporate group—and can encompass the following: risks associated with the typical under-diversification of founders and families;²¹¹ risks associated with the diminished liquidity of control blocks;²¹² costs of keeping a shareholder group or family together; monitoring costs and costs of other activities as a shareholder, such as, stewardship costs;²¹³ liability risks as a controlling shareholder, as a "deep pocket" or through "piercing the corporate veil" concepts; and costs and risks associated with the increased publicity as a controlling shareholder including hassle costs, and personal safety risks.²¹⁴

If a controlled company is being sold, there are specific contributions the controlling shareholder may make to the transaction, all of which can be added to the account of his external costs of control. These contributions include: timing, promoting, and setting up the deal in order to get the maximum price for the company; negotiating the deal;²¹⁵ assuming liability risks in connection with the sale, especially if the controlling shareholder grants specific representations and warranties to the

²¹¹ Under-diversification should not be an issue in corporate groups with regard to subsidiaries, assuming the shareholders diversify themselves.

²¹² The "block discounts" that sometimes have to be accepted if large blocks are being traded in the market reflect this risk.

²¹³ This is a term typically used in tax law and marks the costs that a parent company may not pass on to the subsidiary for tax purposes, another indication that these are external control costs.

²¹⁴ Taxes, too, could be a private cost of control to the extent they would be higher as a consequence of the block concentration (e.g., if capital gains taxes were levied on large control blocks only, as has been discussed for some time in Switzerland, where individuals do, in principle, not have to pay capital gains taxes). On the other hand, if taxes were lower as a consequence of the block-holding (as can be the case for dividend deductions on income taxes) the tax reductions would enter the other side of the ledger as an external private benefit of control.

²¹⁵ Compensation for the fees of outside counsel (e.g., lawyers) might, to the extent they work on the transaction as a whole and not just for the controlling shareholders, be charged to the company.

acquirer.²¹⁶

How are these external costs of control compensated? Principles of non-discrimination and equal treatment generally prevent higher dividend payments to a controlling shareholder, unless he owns some type of preferred shares. Direct payments for external costs of control are not allowed across jurisdictions and would be considered illegal self-dealing. Hence, a controlling shareholder's compensation options include the following: he may negotiate a preferred status (e.g., preferred shares) upon going public; obtain non-financial satisfaction from the reputation and prestige as the major shareholder of an important company, particularly if the company bears his name; or be paid a control premium upon the sale of the controlling block.

Control premiums are often treated skeptically by legal academics.²¹⁷ They, nonetheless, appear as a potentially efficient deferred compensation device for the external costs of control of controlling shareholders. How can this be explained in terms of market dynamics?

3. *Looking at the Buyer's Side*

The buyer who wants to buy one hundred percent of the shares typically values the company as a whole. That includes the synergies he hopes to make from the acquisition. He, of course, tries to minimize the price, but will always look at the total price he pays for all shares of the company. The distribution between the controlling shareholder and the minority does not concern him. In a functioning market environment, the buyer will only pay the equilibrium price, meaning that every additional dollar he pays to the controller will be deducted from the price paid to the minority. Therefore, for the buyer, a premium to the controlling shareholder comes down to the same thing as a "golden parachute" or a "bonus" to the target management in a widely held firm.²¹⁸ It is part of the overall purchase price and that price is determined by the market.

²¹⁶ The verdict of over \$1 billion against Morgan Stanley in connection with an M&A transaction in which it was a mere advisor reflects the high risks at stake. See *Morgan Stanley's Comeuppance*, N.Y. TIMES, May 20, 2005, at A24.

²¹⁷ CLARK, *supra* note 103, at 494-98; Coffee, *Dispersed Ownership*, *supra* note 11; Bebchuk, *supra* note 8; Bebchuk, *supra* note 194; Ferrell, *supra* note 8.

²¹⁸ The Mannesmann takeover by Vodafone is an example. See Gordon, *supra* note 39, at 37.

There are legitimate doubts in regards to golden parachutes and bonuses for target management in takeovers of widely held firms. One important consideration ought to be the existence of a contractual basis for such payment. If this is the case,²¹⁹ an efficiency argument can be made that it was the result of a market arrangement. The counterargument could be made as to whether the arrangement was really made under free market conditions or whether there was an element of coercion involved. However, that could potentially be said about executive compensation in general.²²⁰

The argument for control premiums is less contestable. Assuming the controlling shareholder never made any explicit or implicit promises to the contrary, it can be assumed that minority shareholders investing in a company with a controlling shareholder accept, and perhaps discount, the possibility of him selling out at some stage at a premium. Given his otherwise uncompensated external costs of control, allowing him to collect a control premium, therefore, appears as a potentially efficient solution.

4. Bargaining Power as a Tool to Extract a Control Premium

The external costs of control are, for the most part, sunk costs. Hence, in order to recover them in the form of a control premium, the controlling shareholder needs bargaining power to deal with the potential acquirer. This bargaining power exists by virtue of the voting block the controlling shareholder brings to the table, without which an acquirer could not get a hold of the company. Therefore, the controlling shareholder is in the driver's seat selling the company and can, accordingly, extract a premium from the acquirer.

Given his bargaining power, there is a danger that the controlling shareholder may use his discretion in the negotiation process to overcharge for his costs of control. However, there are at least three factors acting as important counterweights. First, assuming the acquirer extends an offer to the minority shareholders, it can be refused. As long as the minority shareholders do not consider the offered price to be at least slightly

²¹⁹ *Id.*

²²⁰ *Cf. BEBCHUK & FRIED, supra* note 159, at 61.

higher than the net present value of their current claims on the future cash flows of the company, they will reject the offer. That puts a first limit on the control premium the controlling shareholder can charge. Second, to the extent the minority shareholders are not accepting an offer, because it did not properly reflect their expected future cash flow claims, the acquirer will, in principle, be overpaying for the controlling shares, assuming his price calculation is, as it has to be, based on the value of the company as a whole. A third limit is put on the control premium through reputational markets for all actors involved in a sales transaction, including the controlling shareholders themselves, the acquirer, the banks, the transaction lawyers, and others.²²¹ Thus, the dangers of overcharging are, at least to some extent, controlled by market factors.

5. *Where Does the Control Premium Come From?*

Assuming that no internal private benefits of control will flow to the acquirer through transfer pricing and other techniques, the size of the control premium he will be prepared to pay depends on two factors. These factors are the bargaining power of the controlling shareholder and the value the acquirer expects to generate in excess of the value that would be generated by the current controlling shareholder. This includes first of all the synergies that the acquirer expects to be able to generate in his current sphere of activities.²²² It may also include part of the synergies the acquirer expects to generate in the target company.²²³ Of course, if minority shareholders assessed these synergies in the same way as the acquirer, they would raise the price of their shares accordingly.²²⁴ However, the acquirer will not disclose all his

²²¹ The relative importance of this limit will arguably be greater the greater trust levels and the tighter social controls are in a society.

²²² If the acquirer is a corporation, e.g., synergies in the acquiring company; if the acquirer is an individual, e.g., the (non-pecuniary) benefits of owning the company (like the prestige that goes with ownership in a sports team).

²²³ The demarcation between the spheres of the target company and the acquirer might be difficult in practice. Conceptually, if the synergies accrue within the sphere of the target company, the new controlling shareholder or his representatives on the board would be obliged to leave the benefits to the target or to organize proper compensation, in which case the minority shareholders would receive a proportionate share.

²²⁴ If they stayed on as minority shareholders, they would participate fully in the synergies.

expected synergies in the target.²²⁵ He will perhaps also assess the synergies' likelihood differently than the minority shareholders.²²⁶ He might therefore be able to buy the shares from the minority shareholders below their value to him, giving him surplus to be used to pay the control premium.²²⁷ Accordingly, even in a world with no internal private benefits of control, there will be sufficient resources out of which a rational acquirer might be able and willing to pay a control premium.²²⁸

To the extent the control premium indeed reflects the potential of controlling shareholders "looting" a company, the efficient answer to this is not a legal restriction of control premiums, but a strengthening of legal protections against "internal" benefit extractions by insiders.²²⁹ Curbing control premiums would in no way prevent such improper benefit extractions from happening. Instead, it might suppress potentially efficient control transactions.²³⁰

²²⁵ See also EASTERBROOK & FISCHER, *supra* note 196, at 117-19.

²²⁶ An empirical study about Union Bank of Switzerland (UBS) in 1994 exemplifies this situation. BK Vision, in an attempt to get control over the strategy of the former UBS, had heavily bought registered shares with five times the voting rights of bearer shares and brought their premiums up to around twenty percent. Nonetheless, the majority of the registered shareholders voted with the board of directors of UBS to repeal their voting privileges by converting their shares into bearer shares. In other words, these shareholders did not attach additional value to their registered shares because they did not believe in any benefits of UBS and its strategy being controlled by BK Vision. They, accordingly, voted to discard the premium on their shares. Claudio Loderer & Pius Zraggen, *When Shareholders Choose Not to Maximize Value: The Union Bank of Switzerland's 1994 Proxy Fight*, 12 J. APPLIED CORP. FIN. (BANK OF AM.) 91 (1999).

²²⁷ The potential sharing of insider information between the controlling shareholder and the acquirer is, of course, a different issue. However, this can be dealt with through insider trading laws and a proper concept of fiduciary duties for insiders.

²²⁸ A study based on a sample of 661 dual-class firms in eighteen countries, using data for 1997, showed significant price premiums for voting rights between 0% for Denmark and 50% for Mexico. Again, as in the case of control premiums, these value differentials can reflect the potentials of extracting internal private benefits of control. Yet these premiums may also be interpreted as reflecting the expected synergy potentials as described above and, perhaps, the fact that voting privileged shares allow control to be built up faster and with a smaller equity investment. Tatiana Nenova, *The Value of Corporate Votes and Control Benefits: A Cross-country Analysis* (Social Sci. Res. Network eLibrary Working Paper Series, 2003), <http://www.law.harvard.edu/programs.olin-center/corporate-governance/papers/No380.02.Roe.pdf>.

²²⁹ *Supra* § V.

²³⁰ This is because private benefit extractions would supposedly continue under the current controlling shareholder. Clark's suggestion to put a rule restricting control

6. *Quantitative Links Between Control Premiums and External Private Costs of Control*

Except for the mechanisms and limits set out above, there are no other necessary links between the size of the control premium a controlling shareholder is able to negotiate and the size of the external private costs of control for which the control premium can be considered a deferred compensation. For lack of better alternatives,²³¹ this still renders control premiums potentially efficient. There are also two additional implications. First, control premiums as a compensation device carry a random element. Controlling shareholders do not know exactly how large the control premium will be. This allows the conceptualization of the control premium as a flexible bonus for the controlling shareholder that may or may not materialize, but still has the desired incentive effects. Second, it could be that the prospect of a control premium is not sufficient to induce a controlling shareholder to invest in external private costs of control.²³² It might therefore be argued that in such case it could be efficient to let the controlling shareholder also collect internal private benefits of control.²³³ This is doubtful, however, since such a "blank check" would totally blur the concept of fiduciary duties and could give rise to uncontrollable abuses.

7. *Alternatives to Control Premiums*

Accepting the fact that control premiums have efficiency potential, the question remains why they are not made an explicit part of the corporate contract at the time of the issuance of shares to minority shareholders and why controlling shareholders do not always issue some type of preferred shares to themselves before selling stock to public shareholders. In fact, control premiums do at least become an implicit part of the corporate contract upon the

premiums on top of self-dealing prohibitions would therefore "throw the baby out with the bathwater." CLARK, *supra* note 103, at 497.

²³¹ Cf. *infra* § VI.B.7.

²³² This applies, for example, in a country with very high political risks and therefore very high risks associated with the under-diversification of the controlling shareholder. These risks might indeed be alternative explanations for the very high control premiums measured in emerging economies like Brazil. Dyck & Zingales, *supra* note 194, at 537.

²³³ That is perhaps implied in Bebchuk's theory. Bebchuk, *supra* note 194, at 30-31.

issuance of shares to minority shareholders. Minority shareholders have to reckon with the possibility that the controlling shareholder might sell his stake at a premium so long as no other promises were made. As a consequence, minority shareholders have to factor this contingency into their calculus. This could lead to a discount in the price the minority shareholders are willing to pay for the shares of the company.

Under Swiss law, where the mandatory bid rule is a default provision for listed firms, the possibility of a control premium requires a specific clause in the articles of the company and may therefore become an explicit part of the corporate contract. Many companies with controlling shareholders opted out of the mandatory bid rule in their articles of association.²³⁴

Still, why do controlling shareholders simply choose not to issue preferred shares to themselves and thereby secure a proper return on their external private costs of control instead of taking bets on an uncertain control premium? There are several possible reasons. First, uncertainty about the future private costs of control might advise against presenting a "fixed invoice" to minority shareholders *ex ante*. In view of the mechanisms that have a limiting effect on control premiums, leaving the price for control open until the sale of a block could be in the interests of the controlling and of the minority shareholders alike. Second, issuing preferred shares creates two classes of shares, reducing the liquidity of the shares of the controlling shareholder such that he might not be able to sell his shares in the market. Third, in a given share structure with only one class of shares, a controlling shareholder, faced with the choice of incurring specific external private costs of control, will not be able to convert his shares into preferred shares anymore.²³⁵ Nonetheless, potentials for substantial shared benefits of control might exist. In this situation, the prospect of a later control premium could tip the scale in favor of the controlling shareholder incurring specific private costs of control. As a result, there are good reasons to leave the possibility

²³⁴ Cf. *infra* § VI.C. The Swiss experience also indicates that control premiums are on the minds of controlling shareholders who go public. Interestingly, it could not be shown that the shares of such companies are discounted in any way, indicating that the net effect of control premiums for minority shareholders may at worst be neutral.

²³⁵ Examples of such a controlling shareholder might include an heir or a buyer having taken over from the founder.

of control premiums to market forces.

C. Reassessing Mandatory Bid Rules

Against this background, mandatory bid rules that force the acquirer of a control block to also buy out the minority shareholders at a certain price appear questionable. These rules have their origin in the United Kingdom, but have spread to Continental Europe. Mandatory bid rules are now part of the European Union's 13th Directive on Takeovers.²³⁶

Section 5 of the Takeover Directive requires an acquirer of securities in a company that give him "control" to extend a bid to all minority shareholders at an "equitable price."²³⁷ The definition of the percentage of voting rights that confer "control" is left to the member states.²³⁸ The "equitable price" is defined as the highest price paid by the acquirer or the parties acting in concert with him during a period of between six to twelve months prior to the bid.²³⁹ The member states may define the exact period and may also provide for upward or downward price adjustments by the supervisory authorities.²⁴⁰ However, the mandatory bid provisions do not apply if the acquirer obtains control as part of a voluntary offer.²⁴¹

The strict mandatory bid rule in the United Kingdom was a linchpin of the City Code on Takeovers and Mergers, a voluntary code among capital market participants that was followed across the board.²⁴² The new EU Directive required the rule to be transferred into formal statutory law by May 20, 2006.

The EU and U.K. rules appear overly rigid in the context of controlled companies. They may be justified in the case in which a new shareholder is building up a controlling position in a widely

²³⁶ Council Directive 2002/0240(COD), art. 13, 2004 O.J. (L 517) (EC) [hereinafter 13th Directive].

²³⁷ *Id.* art. 5.

²³⁸ *Id.*

²³⁹ *Id.*

²⁴⁰ *Id.*

²⁴¹ *Id.*

²⁴² It defined "control" as being achieved once the acquirer holds 33.33% of the voting rights. The price to be offered to the minority shareholders was defined as the higher of: (i) the market price at the time of the bid and the (ii) the highest price paid for the shares of the target during the last twelve months, with the takeover panel having discretion to grant proper adjustments in exceptional cases.

held firm. In this case it could be argued that the minority shareholders are faced with a hitherto unknown controlling shareholder and the risk that he will extract improper "internal" private benefits of control. They might therefore be given an option to exit or to stay on, depending on whether they anticipate net benefits for themselves in the new constellation.

If applied to companies that already have a controlling shareholder, the rule seems over-inclusive, since it interferes with a market-mechanism that balances external private costs with external private benefits of control. One of the potential consequences of that could be a suboptimal level of entrepreneurship or a suboptimal level of initial public offerings by entrepreneurs, hindering innovation and the efficiency of capital allocation.²⁴³

From this point of view, the flexible mandatory bid rule under Swiss law trumps the rigid EU rule.²⁴⁴ The Swiss rule provides for a bid to all shareholders after a threshold of 33.33% has been passed.²⁴⁵ The offer price has to be at least equal to the current market price and not less than twenty-five percent lower than the highest price paid for the shares of the company during the last twelve months.²⁴⁶ Even so, the rule allows companies to adopt a clause in their articles of association providing for an opt-out.²⁴⁷ This requires a majority vote by the shareholders, subject to the legal challenge that it was lacking legitimate justification.²⁴⁸ Therefore, the Swiss rule requires controlled companies to clearly signal to their minority shareholders that the controlling shareholder might fetch a control premium if he decides to sell his

²⁴³ In a country like the United Kingdom, where the equal opportunity rule in connection with the sale of shares in acquisitions has had a long, market-developed tradition the mandatory bid rule appears in a different light than in a country where market structures had not developed nor anticipated such a rule. See Franks et al., *supra* note 46.

²⁴⁴ Art. 32 of the [Swiss Stock and Securities Exchange Act], Mar. 24, 1995. Cf. Hofstetter, *supra* note 1, at 35-37.

²⁴⁵ *Id.*

²⁴⁶ *Id.*

²⁴⁷ *Id.*

²⁴⁸ In accordance with § 706 of the Swiss Code of Obligation, giving courts means to intervene if legitimate expectations of minority shareholders were ignored without a concomitant benefit for the corporation or the shareholders as a class. *Id.*

block at any stage.²⁴⁹

D. Extending the Control Protection Strategy

Faced with the necessity to expand the company's equity base in order to finance further growth, a controlling shareholder might have to choose between several alternatives in connection with an initial public offering or thereafter.²⁵⁰ Starting from the assumption that the alternatives of leveraging, not growing, or growing more slowly are second-best for the company, the issue culminates with the choice between dilution on the one side and a dual class or a pyramid structure on the other.²⁵¹ Dilution might be unattractive for the controlling shareholder because it would discard his option of collecting a control premium in the future. The potential implication of this lost prospect could be that investments in future private costs of control will not be made. Along with that goes the loss of future shared benefits of control for all shareholders.²⁵² The question, therefore, is whether dual class share structures or pyramids offer efficient solutions to prevent these potential losses.

E. Dual Class Share Structures

1. Efficiency Potential

Dual class share structures²⁵³ can be used as devices to protect external private benefits of control, including control premiums.

²⁴⁹ An opt-out prior to a listing may not be challenged for lack of a legitimate reason, which makes sense since no expectations of minority shareholders could have built up by then. Applying the same reasoning, the Swiss rule also provided for a two-year transition period after its adoption. During this period, an opt-out provision could be chosen without the risk of a legal challenge by minority shareholders. *Id.*

²⁵⁰ The shareholder may choose to: (1) dilute his control position by issuing new shares to the market; (2) finance growth with higher leverage; (3) opt for lower growth, financed internally with profits; (4) issue equity with lesser voting rights (i.e., switch to a dual class share structure); or (5) use a pyramid system that allows him to finance the new equity issue without introducing a dual class share structure. *See infra* § V.I.E, F.

²⁵¹ *Id.*

²⁵² *See supra* § IV.

²⁵³ Dual class share structures can take on many forms and involve, for example, multiple voting rights for a certain class of shares, non-voting stock or—as possible under Swiss law—voting restrictions for shareholders at a certain percentage level, with controlling shareholders being exempt. Hofstetter, *supra* note 1, at 24-27; cf. Deminor-study, Association of British Insurers, *Application of the one share-one vote principle in Europe*, March 2005.

They have efficiency potential to the extent that they promote shared benefits of control²⁵⁴ that outweigh the costs associated with dual class shares. The potential costs of dual class share structures are threefold: (1) weakened incentives of control: the larger the rift between the equity investment of the controlling shareholder and his voting rights becomes, the more his incentives will weaken to the level of third party managers,²⁵⁵ (2) increased entrenchment risks: in conjunction with the loosened alignment between the controlling shareholder's interests and those of the shareholders at large, the risk of entrenchment becomes potentially more serious, and (3) higher risk of internal private benefit extractions: to the extent control can be used to extract internal private benefits of control, dual class share structures may amplify the incentives to do so. Looking at the described potential costs of dual class shares, it is plausible that the higher the "wedge" between the relative equity investment of a controlling shareholder and his voting rights, the more such costs will materialize.²⁵⁶

These costs notwithstanding, dual class share structures can be expected to be efficient where the benefits of control for shareholders as a class are high.²⁵⁷ This could be the case where a company has to thrive in a highly dynamic "entrepreneurial" environment. The information-technology sector is one example. Therefore, it is not surprising that a company like Google is listed with a dual class share structure. This could also explain why dual class listings in the United States are on the rise, given the high share of initial public offerings coming from entrepreneurial sectors.²⁵⁸

2. *Differentiating Ex Ante and Ex Post: Introductions of Dual Class Share Structures*

The normative conclusions that can be drawn from the above analysis are twofold. First, there is no efficiency basis for prohibiting dual class share structures via mandatory "one share

²⁵⁴ See *supra* § IV.A.

²⁵⁵ Cf. Gompers et al., *supra* note 72.

²⁵⁶ *Id.*

²⁵⁷ The potential efficiency of dual class shares in at least certain instances are confirmed in economic models. See OLIVER HART, *CONTRACTS AND FINANCIAL STRUCTURE* 191 (Clarendon Press 1995).

²⁵⁸ In the year 2003, 16.5% of IPOs in the United States involved dual class shares.

one vote" rules.²⁵⁹ To the contrary, dual class share structures have a potential to serve as powerful devices with which to exploit the potentials of concentrated control structures and entrepreneurship. It is most sensible to leave the choice of whether to use dual class share structures to market forces. This poses few problems where companies list with such structures already in place. In such a case, minority shareholders can assess costs and *benefits ex ante* and price the shares they acquire accordingly.

The situation is more difficult when companies issue dual class shares subsequent to a listing. In such a case, there is an obvious potential for opportunism and entrenchment that the minority shareholders cannot counter properly with either voice or exit. This is an area where law may legitimately intervene. The SEC's disenfranchisement rule²⁶⁰ seems optimal from that point of view. The same can be said about corporation laws that allow minority shareholders to challenge shareholder resolutions as discriminatory if they increase the relative voting power of the controlling shareholders through the issuance of dual class shares without proper justification.²⁶¹

3. Additional Observations

Given the increasing costs of dual class share structure, as the divide between equity investments and voting rights becomes greater, it seems justifiable to set a legal maximum beyond which dual class share structures may not develop. Some corporate laws have in fact done this.²⁶² Furthermore, the favorable view of dual class share structures in controlled companies has to give way to a more skeptical view in dispersed ownership structures, where privileged voting rights are issued *ex post* as a defensive measure against potential takeovers.

²⁵⁹ German law, which basically prohibits dual class shares, would not seem optimal from that point of view. Sec. 2.A.2 of the German Corporate Governance Code of May 21, 2003, provides: "[i]n principle, each share carries one vote. There are no shares with multiple voting rights, preferred voting rights (golden shares) or maximum voting rights."

²⁶⁰ Cf. 17 CFR § 420.

²⁶¹ Hofstetter, *supra* note 1, at 26.

²⁶² Swiss law, for example, provides that privileged shares may grant a maximum of ten times the votes of common stock. Swiss Code of Obligation, *supra* note 154, § 693.

F. Pyramids

1. Efficiency Potential

Pyramids are corporate group structures which may incorporate several levels and allow a shareholder to control a corporate organization with only a small percentage of the equity of the group. For example, if such a shareholder wanted to control just above fifty percent of the equity at every company in a six-level pyramid, he would only have to own about two percent of the overall equity. Therefore, pyramid structures can be used as alternatives to dual class share structures in companies with controlling shareholders. In fact, pyramids are more common around the world than dual class shares.²⁶³ They are not widespread for tax reasons in the United States,²⁶⁴ but are an important phenomenon in European countries, where several companies of a pyramid may be listed.²⁶⁵

Pyramids tend to be judged very critically.²⁶⁶ The conventional wisdom is that they are merely an instrument with which to extract internal private benefits of control and therefore are widespread in countries with lax shareholder protection.²⁶⁷ An additional explanation is that pyramidal structures grow if external funds are more costly than internal funds, allowing a controlling shareholder to invest in a project through his existing structure where an independent entrepreneur would not be able to raise funds.²⁶⁸ This might explain why pyramids sometimes exist even

²⁶³ La Porta et al., *supra* note 4.

²⁶⁴ Morck & Yin Yeung, *supra* note 82.

²⁶⁵ High Level Group of Company Experts, *A Modern Regulatory Framework for Company Law in Europe* (Nov. 4, 2002), http://europa.eu.int/comm/internal_market/company/docs/modern/report_en.pdf [hereinafter High Level Group].

²⁶⁶ See Lucian Bebchuk et al., *Stock Pyramids, Cross Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash Flow Rights*, in CONCENTRATED CORPORATE OWNERSHIP (Robert Morck ed., 2000); see also Heitor Almeida & Daniel Wolfenzon, *A Theory of Pyramidal Ownership and Agency Costs of Debt* (Nat'l Bureau of Econ. Research, Working Paper No. W11368, 1998) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=147590.

²⁶⁷ Almeida & Wolfenzon, *supra* note 266, at 1; see also Bebchuk et al., *supra* note 266, at 312.

²⁶⁸ Almeida & Wolfenzon, *supra* note 266; cf. also Tarun Khanna & Krishna Palepu, *The Right Way to Restructure Conglomerates in Emerging Markets*, 77 HARV. BUS. REV. 125 (1999) (arguing that business groups arise to substitute for missing markets).

though the wedge between the equity investment of the controlling shareholder and his voting rights is small.²⁶⁹

Given the doubt about any fundamental efficiency merits of pyramid structures, there are worldwide pressures to restrict or even dismantle such structures.²⁷⁰ In the EU, there have been proposals put forward to limit the listing of holding companies that serve as financing vehicles for pyramids, unless "a strong case is made as to the economic value" of the listing.²⁷¹ Taxation of inter-company dividends in line with U.S. legislation is touted as another alternative.²⁷²

2. *Ex Ante Investments in Pyramids*

In principle, the case for structural freedom in connection with pyramids is similar to dual class shares. Pyramid structures allow a controlling shareholder to protect private and shared benefits of control.²⁷³ Once more, this militates in favor of a market approach, in which choices are left to the shareholders investing into a particular corporate structure. This requires a separation of *ex ante* and *ex post* situations.

When minority shareholders decide to invest into a pyramid structure, the main requirement should be disclosure. As long as minority shareholders are familiar with the controlling shareholder and the extent of his equity exposure and voting power, an appropriate assessment of the potential risks and opportunities should be possible. It does not appear to matter whether the buy-in is at the top or somewhere further down the pyramid; as long as the whole pyramid structure is fully transparent *ex ante*, capital markets can basically be expected to assess it properly.

However, there is one possible caveat. As the equity investment of the controlling shareholder in a pyramidal group gets smaller, his incentives will begin to resemble those of an independent manager. Accordingly, there is a turning point when the risks of control start to outweigh the benefits of control from the point of view of minority investors. Hence, it seems justified to limit pyramid structures in a similar manner as dual class share

²⁶⁹ Almeida & Wolfenzon, *supra* note 266, at 4.

²⁷⁰ Cf. Bebchuk et al., *supra* note 266, at 313-14.

²⁷¹ High Level Group, *supra* note 265, at 99.

²⁷² Morck & Yin Yeung, *supra* note 82.

²⁷³ *Supra* § IV.

structures.

Technically, this is more difficult. One possibility is a tax law that requires a minimum percentage of inter-corporate share ownership in order to be able to deduct dividend payments within the group.²⁷⁴ To be sure, such laws are over-inclusive as they also discourage potentially efficient group structures with less equity interface than is provided for in the tax rules. Another possibility would be laws prohibiting the listing of finance companies which are part of pyramids.²⁷⁵ If combined with a sufficiently detailed but also flexible catalogue of exceptions, such rules could perhaps be tailored optimally.²⁷⁶

3. Ex Post *Pyramiding*

One can make a stronger case for limiting the introduction of pyramid structures ex post. "Upward" pyramiding, the "leveraging" of voting control on the shareholder level, is similar to expanding the voting privileges of controlling shareholders in dual class share structures.²⁷⁷ However, since this is happening on the shareholder level outside the shareholders' meeting, minority shareholders can devise no proper veto rights. In addition, any intervention would gravely endanger the ability of controlling shareholders to finance themselves efficiently. Practically speaking, this favors regulatory restraint, relying on the effectiveness of general legal restrictions in connection with the establishment of pyramids, such as tax laws or listing requirements.²⁷⁸

On the other hand, "downward" pyramiding involves the same risks for minority shareholders as created by the acquisition of a majority stake in a company or the spin-off into a new majority-

²⁷⁴ This is the U.S. approach stemming from the 1930s. Cf. Morck & Yin Yeung, *supra* note 82.

²⁷⁵ High Level Group, *supra* note 265.

²⁷⁶ The problem is always that such laws would have to differentiate between "pyramiding" and economically efficient group structures. This is, of course, difficult in practice and can lead to great complexities posing a problem in their own right, like the South Korean laws trying to curb certain chaebol structures.

²⁷⁷ For example, by bringing a control bloc of a first company into a second company as a contribution in kind, it allows the controlling shareholder to get control of such second company and to use the cash funds of the second company for subscribing to a new share issue in the first company.

²⁷⁸ See *supra* § VI.F.2.

owned subsidiary. Furthermore, these risks are not limited to controlled companies—they are equally relevant in companies under the de facto control of independent managers. In addition, the agency risks of such acts from the point of view of minority shareholders are not different from any other acts of the company, except that they may be of a particular magnitude. They could therefore warrant specific shareholder veto rights; this is the case under the *Holzmueller* doctrine in German law.²⁷⁹

G. Freeze-Out Transactions

1. Issues

Freeze-out transactions can take two basic forms: tender offers or mergers. Both involve the risk of the controlling shareholder “coercing” the minority shareholders into selling their shares for too low a price. Freeze-outs became particularly popular after the decline of the stock markets in the beginning of the 21st century. They are major legal issues on both sides of the Atlantic.²⁸⁰

Freeze-out transactions, by their nature, make economic sense.²⁸¹ They allow the efficient total integration of a parent company and its subsidiary. They also solve the potential problems of delay a controlling shareholder can face from dissenting minority shareholders. In addition, they may give a controlling shareholder the chance to delist a company and save

²⁷⁹ The doctrine refers to the *Holzmueller* decision by the German High Court. Bundesgerichtshof [BGH] [Federal Court of Justice] Feb 25, 1982, 83 Entscheidungen des Bundesgerichtshofes in Zivilsachen [BGHZ] 122 (F.R.G.). Cf. Marc Loebbe, *Corporate Groups: Competences of the Shareholders' meeting and minority protection—The German Federal Court of Justice's recent Gelatine and Macrotron cases Redefine the Holzmueller doctrine*, 5 GERMAN L.J. 1057 (2004), <http://www.germanlawjournal.com/article.php?id=491>.

²⁸⁰ Cf. *id.* at 1069-71; Guhan Subramanian, *Fixing Freezeouts* (Harvard Law and Economics Discussion Paper No. 501, 2005), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=634268; Guhan Subramanian, *Post-Silicon Freeze-Outs: Theory, Evidence & Policy* (Harvard Law and Economics Discussion Paper No. 472, 2005), <http://www.law.harvard.edu/programs/plp/PDFS/subramanian-paper.pdf>; see also, the *Macrotron* decision in Germany, Bundesgerichtshof [BGH] [Federal Court of Justice] Nov 26, 2002, 133 Entscheidungen des Bundesgerichtshofes in Zivilsachen 1 [BGHZ] (F.R.G.).

²⁸¹ THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH, *supra* note 8, at 142.

the significant costs required to be public.²⁸² Modern laws, therefore, specifically provide for freeze-outs in case the controlling shareholder owns a very high percentage—ninety percent or more—of the shares of a company.²⁸³

The most contested issue in freeze-out transactions is the price at which the minority shareholders can sell their shares in a tender offer or are cashed out in a merger. The problem stems from the fact that, typically, the controlling shareholder has access to superior information and therefore is in a better position to assess the value of his shares. Conceptually, the issue is one of potentially extracting internal private benefits of control, since the controlling shareholder can use information that he acquired as an insider. The same constellation exists in management buy-out transactions. Therefore, the question is how can law efficiently cope with this potential opportunism?

2. Rules

The United States has developed a myriad of ways to protect shareholders. With regard to freeze-out tender offers, SEC Rule 13e-3 requires, among other things, the disclosure of independent fairness opinions about the offered price.²⁸⁴ In addition, courts will review the fairness of the price under the limited appraisal test.²⁸⁵ The rules are more stringent for mergers.²⁸⁶ If the controlling shareholder owns less than ninety percent of the shares, a majority vote by the shareholders is required and courts can thereupon assess the price under the entire fairness test applicable to related party transactions.²⁸⁷ This means that the company has to prove the fairness of the price and of the process by which it was determined.²⁸⁸ However, the burden of proof can be shifted to the minority shareholders²⁸⁹ if the price determination was done

²⁸² *Id.*

²⁸³ Sometimes referred to as "squeeze out" laws.

²⁸⁴ *Cf.* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH, *supra* note 8, at 147.

²⁸⁵ *Id.*

²⁸⁶ *Id.*

²⁸⁷ *Id.*

²⁸⁸ *Id.*

²⁸⁹ Although the burden shifts to minority shareholders, "entire fairness" (fairness of the price and process by which it was determined) remains the relevant test.

within a structure that approximates an "arm's-length" transaction.²⁹⁰ Another possibility to shift the burden of proof is to seek formal approval by the majority of the minority shareholders.²⁹¹ On the other hand, if the controlling shareholder owns more than ninety percent of the shares, no shareholder vote is required and courts apply a mere appraisal test.²⁹²

The laws in other jurisdictions have evolved in similar directions. In Germany, the *Macrotron* decision by the Federal High Court has set a new standard for going private or delisting transactions by requiring a tender offer to the minority shareholders at a price that is subject to an appraisal review by the courts, and a majority decision by the company's shareholders.²⁹³ In Switzerland, the Takeover Panel requires controlling shareholders in going private tender offers to attach an independent fairness opinion and to disclose certain key assumptions underlying the opinion, such as the discount rate.²⁹⁴ From an efficiency point of view, freeze-out transactions have two problematic aspects: the informational advantage given to insiders and the possibility of coercion. Their ramifications are slightly different for tender offers and mergers.²⁹⁵

With regard to tender offers, insider advantages can be minimized by restrictions on insider trading for controlling shareholders and through disclosure obligations. It is appropriate to request a heightened degree of disclosure in going private transactions as opposed to open market purchases by controlling shareholders. Going private transactions are potentially coercive. Faced with the choice of selling the shares to the controlling shareholder or being left in a market with very low liquidity and perhaps no listing, minority shareholders are caught in a

²⁹⁰ For example, leaving the decision to a special committee of independent directors will help create an "arms-length" transaction.

²⁹¹ THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH, *supra* note 8, at 147.

²⁹² *Id.*

²⁹³ The *Altana* case gives an explanation for the standards to be applied in the appraisal. See Bundesverfassungsgericht [BverfG] [Federal Constitutional Court] Apr 27, 1999, 1 The Bundesverfassungsgericht [BVR] 1613 (94).(F.R.G.).

²⁹⁴ Recommendation of the Swiss Takeover Panel of August 21, 2003, in re Alpine Select AG, Zug.

²⁹⁵ See Subramanian, *supra* note 280.

"prisoners' dilemma."²⁹⁶ This could lead them to sell at a suboptimal price, justifying countermeasures in the form of more disclosure or other procedural protection devices, including shareholder votes or independent fairness opinions.

With regard to mergers, the potential coercion is particularly pronounced since the controlling shareholder can, in principle, cash out the minority shareholders at a price set by majority vote. This justifies deepened scrutiny of the "fairness" of the cash-out price and additional procedural standards, like approvals by special committees of independent directors or a majority of minority vote as developed under U.S. law.

There is a strong case for regulatory involvement in "going private" transactions. That may include court evaluations of the price at which minority shareholders are being cashed out, even though procedural rules—including disclosure and shareholder voting—deserve preference over any authoritative guessing about the *iustum pretium*.²⁹⁷ To the extent courts do set price valuations, they should have to take into account control premiums as potentially efficient devices to compensate the controlling shareholder for his cost of control.²⁹⁸ Otherwise, going private transactions might be discouraged inefficiently in comparison with other control transactions, in particular the sale of controlled companies.²⁹⁹

²⁹⁶ To the extent that the acquirer will later be able to force the remaining shareholders out with a "short form merger" or "squeeze out," the situation is further aggravated and concludes with a similar degree of potential coercion as in the case of freeze outs by mergers.

²⁹⁷ *Iustum pretium* is a medieval common law term meaning "just price."

²⁹⁸ The determination of the proper size of the control premium would conceptually have to simulate a sale to an independent third party in the same position as the current controlling shareholder. Control premiums in sale transactions of similar companies could serve as a reference. This also means that future costs of control and value creations by the controller as a consequence thereof would not have to be shared with minority shareholders or at least not proportionately. EASTERBROOK & FISCHER, *supra* note 196, at 134-39.

²⁹⁹ Cf. Gilson, *supra* note 41, at 128 (arguing for the consistent treatment of different forms of control transactions involving controlled companies).

VII. Mitigating Entrenchment Risks

A. *Management v. Shareholder Entrenchment*

Entrenchment risks are at the center of corporate governance discussions in dispersed companies. Management may be protected by poison pills, staggered boards,³⁰⁰ voting restrictions,³⁰¹ or other takeover defenses, and can thus shirk or otherwise ignore shareholder interests. Empirical research, in fact, indicates more robust correlations between management entrenchment and firm performance than for other corporate governance phenomena.³⁰²

In principle, management entrenchment is not an issue in controlled companies, since close monitoring by controlling shareholders tends to obstruct it at early stages.³⁰³ This may be the major explanatory factor for the superior performance of controlled companies in accordance with at least some empirical studies.³⁰⁴ However, the concentration of ownership creates a different entrenchment potential at the shareholder level. This is arguably a less serious risk, since agency issues at the shareholder level are less pronounced than at the management level. Nonetheless, entrenchment of controlling shareholders can become a real threat in situations of corporate crises with regard to succession decisions or in the face of opportunities for growth or the sale of the company. In such situations, there is the potential of "political" or "irrational" behavior by the controller.³⁰⁵ The question then becomes how legal rules can mitigate the risks of

³⁰⁰ Staggered boards are a U.S.-specific phenomenon, since U.S. law allows shareholder rights to be preempted such that the right to table certain amendments to the statute of incorporation can be left exclusively with the board. That would be against the notion of shareholder supremacy in other countries.

³⁰¹ This is a typical Continental European phenomenon, but not uniformly. It is legally possible in Switzerland, but no longer so in Germany.

³⁰² Clark, *supra* note 158, at 42-43.

³⁰³ There is, perhaps, an indication of that in a recent survey summarized in a 2005 NY Times article showing that CEOs seem to have more job security in the United States than elsewhere, including Europe, where controlling shareholder structures are more widespread. Eric Dash & Heather Timmons, *U.S. Chief Executives Fare Well in Job Security, Survey Finds*, N.Y. TIMES, May 18, 2005, at C3.

³⁰⁴ Cf. *supra* § III. A.

³⁰⁵ Of course, self-defeating behavior is as much a possibility in dispersed companies, where shareholders might be acting irrationally, too, for example institutional shareholders driven by strategic political goals or mired in internal agency conflicts.

entrenchment on the part of controlling shareholders.³⁰⁶

When the entrenched controlling shareholder is also the CEO, the board may "help" him out. Shareholder discontent at shareholders meetings and in private encounters with the controlling shareholder might play a complementary role.³⁰⁷ To be sure, the very self-interest of the controlling shareholder in preserving the value of his company should cause him to act earlier. Even so, there remains a residual risk. Bias and stubbornness can distort the judgment of the best entrepreneur and damage him and the minority shareholders.³⁰⁸ For minority shareholders, the last resort is to exit by selling their shares.

B. Exit Measures

The exit of minority shareholders through stock market sales after the entrenchment occurs is not the best solution, since prices will already have fallen. Legal rules may therefore grant exit relief at an earlier stage, mitigating potential entrenchment risks. Examples of such preventive exit options include the appraisal rights of minority shareholders under U.S. law or its counterpart in German law.³⁰⁹ Mandatory bid rules have the same function, or at least the same effect: they allow a shareholder to exit a company once a new shareholder has assumed control.³¹⁰

Another exit measure for minority shareholders is a company-dissolution action, sometimes provided for in corporate laws.³¹¹

³⁰⁶ Cf. THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH, *supra* note 8, at 118. In a wider sense, "entrenchment" can be seen as including all decisions by the controlling shareholder that are political-strategic and destructive to minority shareholder interests, including, for example, a policy not to pay out any dividends in order to "starve" minority shareholders.

³⁰⁷ *Id.* at 121-23. This is a reason for requiring shareholder votes even for transactions where the controlling shareholder has de facto sealed the vote before the meeting.

³⁰⁸ *Id.* at 139. Similar rationales apply for other entrenchment scenarios, for example, a succession crisis or the refusal of a controlling shareholder to grow or sell his company.

³⁰⁹ *Id.* at 124-28.

³¹⁰ Cf. *supra* § VI.C. There is also a cost side to such rules in that they impose additional transaction costs on controlling shareholders. In addition, to the extent that they restrict control premiums, they threaten to hamper the efficient exercise of entrepreneurial control by controlling shareholders. They should therefore be kept flexible or allow for proper opting out solutions by controlled companies. *Id.*

³¹¹ For example, under Swiss law minority shareholders with at least ten percent of

This is an extreme device for protection against the entrenchment of controlling shareholders. However, such a remedy has only theoretical relevance in the context of listed companies where the sale of minority shares in the stock market always remains a preferable, less value-destroying alternative.

"Sunset" rules can also break the entrenchment of a controlling shareholder. One such example is the so-called "breakthrough rule" in Section 11 of the recently enacted 13th Corporate Law Directive on Takeovers in the European Union,³¹² which suspends share transfer and voting restrictions in certain situations.³¹³ No transfer restrictions, including those in shareholders agreements,³¹⁴ apply vis-à-vis the offeror upon the publication of a tender offer.³¹⁵ No voting restrictions apply for shareholder resolutions on defensive measures during the offering period.³¹⁶ In the first shareholders' meeting called by the offeror after the bid to amend the articles of association or to appoint and remove members of the board,³¹⁷ multiple voting shares are limited to one vote each. Following a bid, if an offeror holds seventy-five percent or more of the capital carrying voting rights, no restrictions shall apply any further on either the transfer of shares or the voting rights in connection with resolutions of the shareholders meeting on defensive measures.³¹⁸

Section 11 of the 13th Directive represents a novel and differentiated attempt to cope with the issues surrounding the perennial topic of "one share one vote."³¹⁹ It may be an optimal approach to entrenchment in companies with dispersed shareholder structures. However, as shown earlier, "one share one

the votes may file a dissolution action. Swiss Code of Obligations, *supra* note 154, § 736(4).

³¹² 13th Directive, *supra* note 236.

³¹³ The restrictions are subject to "equitable compensation" to be specified by the laws of the member states.

³¹⁴ There is a grandfathering clause for shareholders agreements entered into prior to the enactment of the 13th Directive.

³¹⁵ *Id.*

³¹⁶ Equally, multiple voting shares are limited to one vote each. However, voting restrictions for shares with special pecuniary advantages (e.g., preference shares) remain in force. *Id.*

³¹⁷ The offeror also gets the right to call a meeting.

³¹⁸ 13th Directive, *supra* note 236.

³¹⁹ *Id.*

vote" may be less than efficient in controlled companies.³²⁰ A mandatory breakthrough rule would therefore potentially stifle efficient capital structures in controlled companies and threaten the benefits of control for controlling shareholders and minority shareholders alike. From an efficiency perspective, it seems that EU member countries should, therefore, be advised to opt out of Article 11³²¹ allowing companies to opt back in individually³²² where the benefits of the rule outweigh its costs.³²³

VIII. Conclusions

Legal analysis can be empirical,³²⁴ normative, or doctrinal. Many of the recent contributions to the U.S.-led debate about controlled company structures have been empirical.³²⁵ Normative conclusions were drawn only selectively.³²⁶ European legal articles, on the other hand, tend to be merely doctrinal.³²⁷ Their focus is on the interpretation of given legal norms, such as minority shareholder rights provided for in statutes. However, on both sides of the Atlantic, broad normative discussions about the merits and demerits of controlled company structures and their optimal regulation have not had center stage. Consequently, this paper has tried to take a broad view of controlled companies along normative lines, drawing general as well as specific conclusions about their governance and regulation.

The comparison of controlled with dispersed ownership structures shows different potentials and risks. Neither conceptual analysis nor empirical data favor one structure over the other. Both ownership structures have their own comparative advantages

³²⁰ Cf. *supra* §VI.E.

³²¹ 13th Directive, *supra* note 236, at art. 12.

³²² Art. 12 grants that power to the shareholders meeting. *Id.*

³²³ John Coates, *Ownership, Takeovers and EU Law: How Contestable Should EU Corporations Be?* (ECGI-Law Working Paper No. 11/2003, 2004), http://www.law.harvard.edu/programs/olin-center/corporate_governance/papers/03.Coates.Ownership.pdf (expressing skepticism about the merits of a rigid break through rule in general).

³²⁴ This includes economic, sociological, or historic studies, looking at legal structures as they are or were.

³²⁵ See La Porta et al., *supra* note 4; Gompers et al., *supra* note 72; Dyck & Zingales, *supra* note 194; Franks & Mayer, *Ownership: Evolution and Regulation*, *supra* note 46; Cheffins *supra* note 8.

³²⁶ See Ferrell, *supra* note 8; Cheffins, *supra* note 46; Cheffins, *supra* note 8.

³²⁷ "Stamp collections" in the (exaggerated) words of Ronald Coase.

and specific agency risks. Hence, selection should be left to the markets as arbitrators. Everything else would be a "pretense of knowledge."³²⁸ Therefore, the normative challenge is to devise regulatory frameworks within which the open competition between different forms of ownership structures can take place without distortions. Such an approach presumes legal regimes in which both structures are treated equally. Yet equal treatment requires that unequal structures be treated unequally. Thus, given the different risks and opportunities of dispersed and controlled ownership structures, legal systems should provide for properly differentiated rules.

The particular potential of controlled companies lies in the shared benefits of control they can generate for all shareholders. The main risk is that controlling shareholders may reap private benefits of control. However, an undifferentiated concept of "private benefits of control" might lead to overregulation. Distinctions should be made before rushing to any normative conclusions. One primary distinction is the difference between internal and external private benefits of control. Only internal benefits leave no doubt about the efficiency of legal intervention in the form of disclosure, minority shareholder rights, fiduciary duties, and restrictions on self-dealing. On the other hand, external benefits of control must be assessed in light of their counterpart: the external private costs of control. Where the shared benefits of control promise to be large, the controlling shareholders might be willing to undertake them anyway. At the margin, however, these costs will not be incurred unless controlling shareholders have a sufficient prospect of recouping them. Control premiums allow this to happen.

Therefore, efficient legal rules must differentiate between different forms of private benefits of control. These rules should also take into account that there are various forms of controlled ownership, such as family companies or corporate group structures. Thus, corporate governance rules should not be geared towards dispersed ownership structures and then imposed blindly on controlled companies across the board. Default rules allowing for opt-out solutions can offer the necessary flexibility. Corporate governance codes of the "comply or explain" type represent

³²⁸ Cf. FRIEDRICH VON HAYEK, *THE ROAD TO SERFDOM* 83-84 (Univ. of Chicago Press 1994).

another regulatory technique that allows for proper adjustments in the context of controlled companies. These approaches recognize a truism that is as relevant in corporate governance as elsewhere: one size does not fit all.