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CONTROLLING FAMILY SHAREHOLDERS IN DEVELOPING COUNTRIES:

ANCHORING RELATIONAL EXCHANGE

Ronald J. Gilson*

INTRODUCTION

In recent years, corporate governance scholarship has begun to focus on the most common distribution of public corporation ownership: outside of the United States and the United Kingdom, publicly owned corporations often have a controlling shareholder.[1] The presence of a controlling shareholder is especially prevalent in developing countries. In Asia, for example, some two-

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1. Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641 (2006), surveys this development. *See* Luca Enriques & Paolo Volpin, *Corporate Governance Reforms in Continental Europe*, 21 J. ECON. PERSP. 117 (2007) (describing recent reforms in European controlling shareholder systems).

thirds of public corporations have one, most of whom represent family ownership.[2] The law and finance literature, exemplified by a series of articles by Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, Robert Vishny and others, treats the prevalence of controlling shareholders as the result of bad law; more specifically, controlling shareholders are ubiquitous in countries that do not adequately protect minority shareholders from the extraction of private benefits of control by dominant shareholders.[3] The logic is straightforward. Controlling shareholders will not part with control because that will expose them to exploitation by a new controlling shareholder who acquires a controlling position in the market.

The law and finance account of the distribution of ownership, while compelling as far as it goes, is at best partial. I have argued elsewhere that the syllogism is too simple to explain all controlling shareholder systems because we find significant numbers of controlling shareholders in countries with good law.[4] If jurisdictions that adequately protect minority shareholders have a significant number of companies with a controlling shareholder, something other than bad law is at work. And while the link between shareholder protection and distribution of shareholdings remains persuasive with respect to countries with poor shareholder protection—minority shares change hands at a significant discount to controlling shares in such jurisdictions[5]—it still leaves important parts of even this landscape unexplained. It does not, for example, explain why in Asian countries controlling shareholders are likely to be families. And it does not explain, given poor shareholder protection, why we observe minority shareholders at all. Since the law and finance account does not posit the existence of observable limits on how much of a minority shareholder's investment the controlling shareholder can extract, why is not the

2. *See* Stijn Claessens, Simeon Djankov, Joseph P. H. Fan & Larry H.P. Lang, *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, 57 J. FIN. 2741, 2748, 2750 tbl.II (2002); Stijn Claessens, Simeon Djankov & Larry H.P. Lang, *The Separation of Ownership and Control in East Asian Corporations*, 58 J. FIN. ECON. 81, 92 & tbl.3, 93 (2000).

3. *See, e.g.*, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, *Law and Finance*, 106 J. POL. ECON. 1113 (1998); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3 (2000); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997).

4. *See* Gilson, *supra* note 1, at 1649.

5. *See* Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537 (2004) (measuring differences by relative prices in control transactions); Tatiana Nenova, *The Value of Corporate Voting Rights and Control: A Cross-Country Analysis*, 68 J. FIN. ECON. 325 (2003) (measuring relative differences in stock exchange trading prices). The price difference between controlling and non-controlling shares, however measured, is dramatically smaller in countries with good shareholder protection.

value of minority shares in such jurisdictions—and, it follows, the number of minority shareholders—zero?

In this Article, I want to continue the effort to complicate the controlling shareholder taxonomy by looking at the impact of bad law in a very different sense than that contemplated by the law and finance literature. In particular, I want to address the effect on the distribution of shareholdings when a jurisdiction provides not only poor minority shareholder protection, but poor commercial law generally.[6] Put differently, the goal is to play out the implications for the distribution of shareholders when the focus is not on conditions in the capital market, where poor shareholder protection has figured so prominently, but on conditions in the product market, where the driving legal influence is the quality of commercial law that supports the corporation's actual business activities. Can bad commercial law help explain shareholder distribution?

In an important sense, the law and finance literature's sharp focus on minority shareholder protection treats the shareholder distribution as independent of what the company actually does. In Miller-Modigliani terms, the distribution of shareholdings is "irrelevant" to the company's actual activities. Just as the division of capital between debt and equity on the right side of the balance sheet does not, under the irrelevancy propositions, affect the value of real assets on the left side of the balance sheet,[7] the line that separates the two sides of the balance sheet also isolates the distribution of equity among shareholders from the value of the corporation's assets. My hypothesis is that bad commercial law, as opposed to just poor minority shareholder protection as contemplated by the law and finance literature, breaks down the separation between equity distribution and firm value. I posit that the presence of a controlling shareholder, particularly a family controlling shareholder, allows the corporation to better conduct its business, but in a way quite different than the potential for a controlling shareholder to more effectively police the agency conflict between management and shareholders, the productive advantage typically ascribed to a controlling shareholder structure.[8]

Broadening the concept of "bad law" to take into account not only the quality of minority shareholder protection, but also the quality of commercial law more generally, frames the problem. In an environment of bad commercial law, a corporation's basic business depends on its capacity to engage in self-enforcing exchange—that is, commercial transactions where the parties perform their contractual obligations because it is in their self-interest to

6. I should be clear at the outset that my shorthand terms "poor" or "bad" commercial law encompass two different sources of failure: substantively bad law regardless of the quality of enforcement and substantively good law but with poor enforcement. Thus, a wonderful civil code that is not effectively enforced would fall within my terms.

7. *See, e.g.*, STEPHEN A. ROSS, RANDOLPH W. WESTERFIELD & JEFFREY JAFFE, CORPORATE FINANCE 407-09 (7th ed. 2005).

8. Gilson, *supra* note 1, at 1651-52.

perform, not because of the threat of legal sanction. With bad commercial law, exchange must be self-enforcing because there are neither authoritative rules nor an effective judicial system to enforce those obligations.[9] Transactions in this circumstance take place in a reputation market, which substitutes for law (or law's shadow) as a means to assure that parties perform their contractual obligations.

Framing the problem as one of commercial contracting in a bad law environment suggests a very different function for shareholder distribution than that contemplated by the law and finance literature. When commerce must take place in a reputation market, in which a corporation's business must be effected through self-enforcing transactions, the distribution of shareholdings, and particularly the presence of family ownership, facilitates the development and maintenance of the reputation necessary for a corporation's commercial success.[10] More speculatively, the role of reputation in the product market may help explain why we observe publicly held minority shares in the capital market even though poor shareholder protection does not impose a formal limit on the amount of private benefits that a controlling shareholder can extract. If bad behavior toward minority shareholders can affect the corporation's reputation in the product market as well as the capital market, then self-imposed limits on controlling shareholders' extraction of private benefits may derive from their concern over success in the product market. Indeed, the corporation may choose to have minority shareholders at all, despite the high price of equity capital in the face of poor minority protection, as a kind of hostage to support its reputation in the product market.

My ambition here is to offer a working hypothesis, an account neither formal in method nor deeply grounded in the history and structure of particular jurisdictions.[11] What happens when we turn the capital market-oriented bad

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9. John Shuhe Li states, "In catching-up economies, there is generally no rule-based [formal enforcement] governance; hence relation-based governance is the only available mechanism to enforce agreements." John Shuhe Li, *Relation-Based Versus Rule-Based Governance: An Explanation of the East Asian Miracle and Asian Crisis*, 11 REV. INT'L ECON. 651, 658 (2003). *See generally* Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981); L.G. Telser, *A Theory of Self-Enforcing Agreements*, 53 J. BUS. 27 (1980).

10. Interesting recent work has sought to link elements of corporate governance other than shareholder distribution to conditions in the product market. *See, e.g.*, K.J. Martijn Cremers, Vinay B. Nair & Urs Peyer, *Weak Shareholder Rights: A Product Market Rationale* (Yale Int'l Ctr. for Fin., Working Paper No. 06-29, 2006), *available at* http://ssrn.com/abstract=890570 (discussing the relation between strength of shareholder rights and character of product market competition); Maria Guadalupe & Francisco Pérez-González, *The Impact of Product Market Competition on Private Benefits of Control* (Feb. 2006) (unpublished manuscript), *available at* http://ssrn.com/abstract=890814 (discussing the impact of product market competition on private benefit extraction).

11. There is a very interesting literature addressing the institutions necessary to support trade that is both formally sophisticated and historically grounded. The work of Avner Greif on the organization of the Maghribi traders and of Avner Greif, Paul Milgrom, and Barry Weingast on medieval European trade are examples of this work. *See* Avner Greif, *Contract*

law account of concentrated ownership on its head, and focus instead on how product market-oriented bad law influences the distribution of equity? The value of so minimalist an approach lies in framing the issue clean of the complications inevitably associated with particular jurisdictions, with the hope that if the account proves intriguing, then it will be of assistance in the real task—that of understanding the development of particular national markets and one of the foundations of economic development more generally. Part I sets out the basic problem of commercial exchange in a jurisdiction without effective commercial law. Part II develops how conducting business through a corporation can facilitate reputation formation and maintenance. Part III examines how family ownership can improve a corporation's capacity to act as a reputation bearer in the product market. Part IV then speculates on why a controlling family shareholder might voluntarily limit the amount of private benefit extraction from minority shareholders—not because the treatment of minority shareholders affects the controlled corporation's ability to raise additional equity capital, but because bad behavior will degrade its reputation in the product market. Part V addresses a final speculation about the dynamic character of controlling shareholder systems in developing countries. The role of shareholder distribution described here is one that supports reputation-based product markets. Such markets are limited in scale so that further economic development requires a transition to institutions that support anonymous product markets—a rule-of-law-based commercial system with effective formal enforcement. The transition, however, will be impeded both by the particular characteristics of existing institutions—what Paul Milgrom and John Roberts call "supermodularity"[12]—and by the political influence of those who have large investments that are specific to a reputation-based product market. Part VI concludes by framing the question with which we are left: how does the necessary transition take place in the face of structural and political barriers?[13] More specifically, does the answer relate to the recent historical pattern of economically benevolent dictators observed during the transition period in many countries that have successfully developed?

I. THE STRUCTURE OF REPUTATION MARKETS

In its most simple form, a self-enforcing commercial arrangement can be based only on the expectation of a long horizon of future transactions. Where two parties expect to engage in repeated transactions, neither will have an

Enforceability and Economic Institutions in Early Trade: The Maghribi Traders' Coalition, 83 AM. ECON. REV. 525 (1993) [hereinafter Greif, *Maghribi Traders' Coalition*]; Avner Greif, Paul Milgrom & Barry R. Weingast, *Coordination, Commitment, and Enforcement: The Case of the Merchant Guild*, 102 J. POL. ECON. 745 (1994).

12. *See infra* text accompanying note 47.

13. Here I anticipate ongoing work with Curtis Milhaupt. *See infra* text accompanying note 54.

incentive to misbehave in a particular transaction because bad behavior by one party in a transaction will be punished by the counterparty, whether by retaliating in future transactions, changing the terms of future transactions or refusing to engage in future transactions at all.[14] This simple reciprocity model has significant limitations. First, it requires the expectation of a lengthy relationship to avoid the incentive to cheat. In the absence of future dealings, one party has no reason not to cheat on the current exchange. And even the expectation of future rounds may be insufficient to assure self enforcement if the present value of future rounds is small compared to the payoffs from cheating.[15] Second, and for my purpose more important, the requirement of long-lasting bilateral exchange to support self-enforcing transactions severely limits the size of the economy; individuals are limited in the number of long-term trading partners they can directly support.

Increasing the number of parties with whom one can trade requires adding the concept of reputation. If one party will trade with others in the future, but may not trade with any single party repeatedly—that is, if trade will be multilateral rather than bilateral—self enforcement still will work if the party's behavior in one exchange becomes known to future counterparties. In other words, to support multilateral exchange, the party must become known beyond its current trading partners—it must develop a reputation.

Self-enforcing commercial exchanges where individual parties do not necessarily expect to transact with each other in the future—reputation-based markets—require a number of supporting factors. First, parties must expect to engage in similar transactions in the future, even if not with the same trading partner; this creates the potential that bad behavior will be punished. Second, there must be a shared understanding among potential future trading partners of what constitutes performance or breach. Third, a party's actual performance—whether it performed as anticipated or behaved badly—must be observable by potential future trading partners.[16]

14. *See, e.g.*, AVINASH K. DIXIT, LAWLESSNESS AND ECONOMICS: ALTERNATIVE MODES OF GOVERNANCE 16-17 (2004).

15. This is the "folk theorem" of non-cooperative game theory. *See, e.g.*, *id.* at 61; Drew Fudenberg & Eric Maskin, *The Folk Theorem in Repeated Games with Discounting or with Incomplete Information*, 54 ECONOMETRICA 533 (1986).

16. I develop similar conditions to reputation-based contracting in the venture capital market in Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1086-87 (2003). Douglass North states the conditions in terms of the barriers they present: exchange "is difficult to sustain when the game is not repeated (or there is an end game), when information on the other players is lacking, and when there are large numbers of players." DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 12 (1990). The discussion in the text assumes the condition that MacLeod and Malcomson specify as necessary before the game is worth the candle: "The fundamental requirement for an implicit contract to be self-enforcing is that there exist sufficient economic surplus from continuing it over what the parties can jointly get if it is terminated." W. Bentley MacLeod & James M. Malcomson, *Implicit Contracts, Incentive Compatibility, and Involuntary Unemployment*, 57 ECONOMETRICA 447,

These factors have implications that limit the kind of market that can be supported by reputation-based exchange, all of which will restrict the level of commercial activity in that market. Avinash Dixit, in his model of relation-based exchange, uses the concept of "distance" to express the limiting impact of these factors.[17] He invokes the language of physical distance as a metaphor for the investment in information necessary to establish and maintain a reputation for contractual performance. Physical distance makes information costly to transmit in the absence of advanced technology.

Similarly, both a shared understanding of what constitutes performance and the observability of breach depend, in the end, on the cost of information transmission. The common values that underlie a shared understanding of performance under differing circumstances must be transmitted among future trading partners; as conditions change and values evolve, new information must be transmitted. Communicating this information is a function of distance: it is more costly and less successful to communicate both with traders who are physically distant from the core of market participants and with traders who are socially distant from the core, whether by culture, language, or class.[18]

Correspondingly, it is more costly to communicate the necessary information to sustain reputation-based transactions that are new or complicated; the concept of performance that must be shared requires more information and more new information, and lacks the shared understandings that define adequate performance in the traditional markets. The result is straightforward: "cheating becomes more attractive the more distant the partner."[19]

The scope and scale of a reputation-supported market is thus defined by a trade-off between the gains from trading with more distant partners, who may offer different skills and goods and at least additional volume, and the increased costs associated with transmitting information to them. These costs increase in the distance to the marginal trader, while the accuracy of a trader's reputation decreases in that distance. The implication is that the size of the market depends on information technology; the better the technology, the lower the cost of transmitting shared values and performance information. Therefore, the less distant potential trading partners are from each other and the larger the size of the market that can be supported by reputation. This relationship

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448 (1989).

17. DIXIT, *supra* note 14, at 67-71.

18. "Cultural beliefs and behavioral norms coordinate expectations and provide a shared understanding of the meaning of various actions." Avner Greif, *Commitment, Coercion, and Markets: The Nature and Dynamics of Institutions Supporting Exchange*, *in* HANDBOOK OF NEW INSTITUTIONAL ECONOMICS 727, 762 (Claude Menard & Mary M. Shirley eds., 2005); *see* Markus Mobius & Adam Szeidl, *Trust and Social Collateral* (Nat'l Bureau of Econ. Research, Working Paper No. 13126, 2007) (modeling a decrease in trust among trading partners in a reputation market as the heterogeneity of potential trading partners increases).

19. DIXIT, *supra* note 14, at 70.

between information costs and the size and diversity of a reputation-based market creates the role for corporations to reduce the costs of establishing and sustaining such a market.[20]

II. CORPORATIONS AS LONG-LIVED REPOSITORIES OF REPUTATION

David Kreps, in a well-known essay on the economics of corporate culture, argues that a corporation can play a special role in a reputation-based market because of its superior capacity to establish and maintain a reputation.[21] Recall that the stability of a reputation market depends on a party's assessment that there will be a sufficiently long series of transactions with an existing trading partner, or with future trading partners with access to the party's prior performance, to prevent anticipation of a rollback cascade from subverting contractual performance in the first place. As discussed in the previous Part, the length of anticipated dealings prevents an equilibrium of voluntary performance of obligations from unraveling into cheating in the current round once it can be expected that there will be a final round in which it will be in a party's interest to cheat.[22] In contrast to individuals who die or retire, corporations have a potentially infinite life; they will not necessarily have a final period that triggers a cascade into current non-performance. As a result, corporations will invest more in establishing a reputation and be more diligent about protecting one. As Kreps puts it, "The firm is a wholly intangible object in this theory—a reputation bearer."[23]

One additional step is necessary to enable the corporation to function as a long-lived reputation bearer. As a formal matter, a corporation is just a long-

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20. This account assumes that misbehavior is punished only by individuals—the injured trading partner and those who learn of the misbehavior—who decline to trade with the misbehaving trader. However, reputation markets can develop institutions that facilitate the market's operation by collectivizing information acquisition and sharing, and expanding the breadth of responsive sanctions. *See* Greif, *supra* note 18, at 733-34 (discussing "[o]rganic, multilateral reputation institutions"); Barak D. Richman, *Firms, Courts, and Reputation Mechanisms: Towards a Positive Theory of Private Ordering*, 104 COLUM. L. REV. 2328, 2338-50 (2004) (contrasting the circumstances that underlie the choice of enforcing a contract through firms, courts, or private organizations). Because of the path dependency of institutional characteristics in particular jurisdictions, an account of their development requires a rich historical context. *See, e.g.*, Greif, *Maghribi Traders' Coalition*, *supra* note 11 (reputation-based contract enforcement among early Maghribi traders). My argument does not depend on the simplified presentation in the text; however, its application to a particular country will require developing the context, including the institutional structure of the reputation market.

21. David M. Kreps, *Corporate Culture and Economic Theory*, *in* PERSPECTIVES ON POSITIVE POLITICAL ECONOMY 90 (James E. Alt & Kenneth A. Shepsle eds., 1990).

22. A rollback cascade occurs when a potential trading partner knows that the party will not perform in the final round, so it will anticipate that behavior and not perform in the next-to-last round, which will be anticipated by the first party, and so on back to non-performance in the current round.

23. Kreps, *supra* note 21, at 111.

lived piece of paper on which appears the corporation's charter. The corporation's decisions—in our context, to perform its contractual obligations or not—are made by individuals with finite professional lives. It may be in the corporation's interest—that is, in the interest of future owners of the corporation—for it to invest in establishing and sustaining a reputation by performing its obligations to trading partners, because those investments will pay off over the corporation's infinite life. But the investment will not be made unless it is also to the advantage of the short-lived individuals who actually make the corporation's decisions. For example, if all profits are currently paid out and the decision makers have no way to benefit from the value of the corporation's reputation when they retire, then the corporation, in effect, will have a final period determined not by the corporation's infinite life, but by its current owners' mortality.

Kreps's solution to the problem of inducing short-lived individuals to think like a long-lived corporation is to allow the current generation of decision makers to sell their position (equity) to the next generation of decision makers. By allowing the current generation to secure a payment based on the discounted value of future corporate earnings, they then have an incentive to value the corporation's future dealings beyond the length of their own careers, and therefore to make efficient current investments in the corporation's reputation.[24]

The value of a long-lived reputation bearer in a jurisdiction with bad commercial law now should be apparent. Developing long-lived bearers of reputations as trading partners reduces the costs of building reputations—one reputation lasts a long time—and, by reducing the number of participants over time, reduces the costs a trading partner must incur to learn the reputation of potential trading partners. The resulting reduction in information costs decreases the distance between traders and therefore increases the range of parties with whom any single trader can contract. In turn, this increases the size, scale, and diversity of the market that reputation-based trading can support and, in the end, increases productivity and economic growth.

III. THE FAMILY AS A MORE EFFICIENT REPUTATION BEARER

In fact, the strategy of reducing information costs through trading partners organizing production in long-lived corporations, and thereby increasing the size and scale of reputation-supported product markets, is more complicated than the discussion thus far has acknowledged. As we saw in Part II, Kreps gives current corporate decision makers the incentive to invest in long-term

24. *Id.* at 108-10. Other techniques also can be used to bond future reputation, such as making observable investments in assets that will be valuable only if the corporation is successful. *See* Klein & Leffler, *supra* note 9. However, all strategies require confronting the time preferences of the corporation's short-lived decision makers.

reputation by organizing the corporation so that the decision makers can sell their stake in the corporation before retiring. This eliminates the problem of the decision makers facing a final period even if the corporation does not. But this temporal arbitrage does not quite work.

In Kreps's account, the arrangement that creates the incentive for the decision makers to cause the corporation to invest in reputation that will pay off after their careers end, and which makes that reputation credible to potential trading partners, is part of the corporation's internal governance structure. This structure is not readily observable by potential outside trading partners; the information costs of learning about the corporation's internal characteristics, which are central to a trading partner relying on the corporation's reputation, are very high. At this point, poor shareholder protection law (in addition to poor commercial law) enters the analysis. An effective corporate disclosure regime will require the corporation to make public the structure of its owners' and managers' incentives, thereby reducing the costs of acquiring this information not only by the capital market, but by potential trading partners as well. Without the ready availability of such information, the corporation may not succeed as a long-lived reputation bearer because trading partners will have no credible reason to believe that the relevant reputation is that of the corporation rather than the short-lived decision maker.

Recent corporate governance debates demonstrate that the problem of high information costs concerning the incentives of corporate decision makers, and the difficulty of evaluating them even if disclosed, are hardly theoretical. Not long ago, criticism of the U.S. corporate governance system claimed that the incentive structures of U.S. corporations resulted in myopic planning, with too high a discount rate being applied in the capital budgeting process. German and Japanese corporations, in contrast, were said to be long-term-oriented because their decision makers faced a different, more patient, incentive structure. Not many years later, the direction of the debate had switched, with the U.S. system lauded as providing incentives to innovate that were not present in the more conservative German and Japanese governance systems.[25] Even more recently, the argument has shifted again. Executive compensation scandals, concerning both the absolute amounts paid and the integrity of the process by which stock options were granted, at least raise questions concerning the incentive structure that had been said to support innovation, as well as doubts concerning the observability of managerial incentives even in the United States, the jurisdiction with what is likely the best shareholder protection.[26]

25. *See* Ronald J. Gilson, *Corporate Governance and Economic Efficiency: When Do Institutions Matter?*, 74 WASH. U. L.Q. 327, 331-34 (1996) [hereinafter Gilson, *Corporate Governance and Economic Efficiency*] (describing the debate's evolution); Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329, 330-32 (2001) [hereinafter Gilson, *Globalizing Corporate Governance*] (same).

26. *See, e.g.*, Reena Aggarwal, Isil Erel, René Stulz & Rohan Williamson, *Do U.S. Firms Have the Best Corporate Governance? A Cross-Country Examination of the Relation*

My point is not to extend this continually shifting debate, but only to note that it is very hard to get the corporation's internal incentives right even when you are trying.[27] And the harder it is to get it right, the higher the information costs associated with an outside potential trading partner trying to assess whether the corporate decision makers have the right incentives to cause the corporation to make investments in its long-term reputation for performing its contractual obligations with trading partners. The harder it is to evaluate internal incentives, the more assessment of a particular company matters, and the more a particular trading partner has to know to assess a corporation's reputation. Of course, this company-specific information is costly, especially in a jurisdiction with weak shareholder protection, and the resulting impact on a reputation-based commercial market should be clear. The increased cost of assessing reputation increases the distance between potential traders, and reduces the size and scale of commercial activity that can be supported. Kreps's conception of the corporation as a bearer of reputation thus in part founders on the barriers to transmitting the information on which the corporation's reputation depends.

Here, finally, is where family ownership comes into the account. When the corporation is owned by a family, the internal incentives become much more transparent. The problem with Kreps's model is the need for an intergenerational transfer between the current and the next generation of corporate decision makers so that current decisions will take long-term reputation creation into account. In turn, the transfer mechanism has to be observable to potential future traders, a communication process that can be expected to be costly when the mechanism and its underlying incentive structure have to be set out in an explicit contract. In contrast, family ownership solves the intergenerational transfer process rather elegantly. Because of intrafamily inheritance and family ties, the current generation of decision makers, at least in functional family businesses, treats the next generation's utility as the equivalent of their own, so there is no temporal distortion of incentives to invest in reputation.

The critical point is that family ownership substitutes for internal incentive and transfer mechanisms as an assurance of the corporation's commitment to long-term reputation, but with one important difference. Family ownership is

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Between Corporate Governance and Shareholder Wealth (European Corporate Governance Inst., Finance Working Paper No. 145/2007, 2007), *available at* http://ssrn.com/abstract=954169 (finding that U.S. firms, on average, have better corporate governance than comparable foreign firms).

27. *Compare* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004) (criticizing the design of U.S. executive compensation), *with* Bengt Holmstrom, Pay Without Performance *and the Managerial Power Hypothesis: A Comment*, 30 J. CORP. L. 703 (2005) (assessing criticisms and defenses), *and* Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847 (2002) (rebutting criticism).

much more easily observed by potential trading partners; so long as cultural values concerning family support the belief that current decision makers are committed to intergenerational utility equivalence, information concerning the corporation's commitment to contractual performance is cheaper to transmit.[28]

By this point, it is apparent where the argument is going. The combination of Kreps's insight that, because of its infinite life, the corporation can be an effective bearer of a long-term reputation for contractual performance, with the fact that family ownership can be a low cost way of communicating to potential trading partners that the corporation values future trading, increases the size and scale of the reputation-based trading market. If the corporation is the bearer of reputation, family substitutes for internal contract as the corporation's DNA. In an environment of bad law—both commercial and shareholder protection—controlling family corporations will have an evolutionary advantage.[29]

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28. Cultural values concerning the importance of family and the trade-off between intrafamily loyalty and individual self interest will differ among countries. *See* Gilson, *supra* note 1, at 1673 (noting the cultural value of family control in Asia). Once the commitment to maximizing family wealth, as opposed to that of individual family members, breaks down—whether through cultural change as a result of modernization or because of what I have called the "gravity of generations," *id.* at 1668—then inside conflict over distributional issues will result in decreased commitment to reputation and reduced productivity generally. This, in turn, will undermine the support family ownership provides to reputation-based product market exchanges. Müller and Wärneryd argue that public ownership responds to such internal distributional competition by forcing inside managers to unite against the outside owners' demand for resources. While Müller and Wärneryd do not have family ownership in mind, the intuition seems applicable: dysfunctional family ownership leads to a public offering. Their model, however, assumes that the public's investors have the power through legal rules to assert themselves, a circumstance that is likely not present in developing countries. Holger M. Müller & Karl Wärneryd, *Inside Versus Outside Ownership: A Political Theory of the Firm*, 32 RAND J. ECON. 527 (2001). For a striking example of the disintegration of intrafamily loyalty within a very successful U.S. family-controlled business, see Suzanna Andrews, *Shattered Dynasty*, VANITY FAIR, May 2003, at 182 (detailing how internal conflicts within the Pritzker family led to the breakup of the family fortune).

29. Steven Tadelis develops a model of reputation formation that, in contrast to Kreps's focus on moral hazard (one party cheating in a future round), is based on adverse selection (future buyers are uncertain about whether future owners will be talented or trustworthy). Steven Tadelis, *What's in a Name? Reputation as a Tradeable Asset*, 89 AM. ECON. REV. 548 (1999). Tadelis's model assumes that shifts in ownership of a business are not observable by customers of the business—hence the adverse selection problem that drives the model. Family ownership, by making ownership shifts to nonfamily transparent to future clients, therefore reduces the barriers to the operation of a reputation market in an adverse selection-driven model, just as it does in Kreps's moral hazard approach. To be fair, Tadelis does briefly consider the possibility that family ownership might address the adverse selection problem, but dismisses the fact of family ownership as providing too little information to support a separation between good and bad service providers: "Clearly, businesses that have signs claiming that they have been owned by the same family for 75 years convey little information about the quality of the current owner, let alone of the key employees." *Id.* at 560. In settings where family ownership powerfully predicts individual family member preferences for business success, Tadelis dismisses the impact of family ownership too quickly. His point might be better understood as a prediction of regression to

While it is beyond my ambition to fully explore the implications of this conclusion here, I will address one such implication to provide an example of what is possible. It is commonplace in developing countries that family-controlled companies are conglomerates, operating in a range of different industries that do not share production economies of any type, whether scale, scope or vertical integration. The two most familiar explanations for conglomerate organization in this setting are financial. First, in the absence of an efficient external capital market, an internal capital market in which project funding is determined not by the market, but by the corporation's internal capital budgeting process, may well be more effective. Of course, this explanation is consistent with the capital market-oriented bad law argument; poor shareholder protection means poor disclosure, which in turn means an informationally inefficient capital market. Thus, a conglomerate can serve to internalize the capital allocation process.[30] Second, a controlling shareholder bears the cost of non-diversification, especially where a weak local capital market makes laying off risk costly. A conglomerate strategy allows diversification at the company level, where it benefits the controlling shareholder.[31]

A third explanation for conglomerate organization in developing countries, building on the role of family ownership developed in this Part, focuses on the product market rather than the capital market. The conjecture is that family control combines with Kreps's conception of the corporation as a reputation bearer to reduce the information costs associated with maintaining a reputation. Because in a country with bad commercial law all transactions are reputation-based, investment in reputation produces an asset subject to both economies of scale and scope. Once family ownership is established, the marginal cost of transmitting that fact, and thereby providing a foundation for reputation-based trading, decreases with scale. And the same forces that create reputational scale economies within a single industry also create reputational scope economies across industries, because reputation for contractual performance need not be industry specific where the performance uncertainty is integrity, not capacity. To be sure, the cost of information transmission may be initially higher when the corporation enters a new industry, so that potential traders in that industry are at a greater functional distance from the corporation; nevertheless, family ownership remains a less costly fact to convey.

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the mean in talent as control shifts from the business's founder to her heirs. There is some empirical evidence that supports this inference. *See* Gilson, *supra* note 1, at 1668-69 (reviewing studies).

30. *See, e.g.*, Tarun Khanna & Krishna Palepu, *Is Group Affiliation Profitable in Emerging Markets? An Analysis of Diversified Indian Business Groups*, 55 J. FIN. 867 (2000) (explaining the advantages of an internal capital market in emerging market jurisdictions).

31. *See, e.g.*, RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 332-57 (2d ed. 1995) (reviewing explanations for conglomerate acquisitions).

IV. WHY MINORITY SHAREHOLDERS?

We now move to a more speculative but also more narrowly defined question of how the product market influences the distribution of shareholders in the capital market. The role of family ownership in supporting self-enforcing corporate commercial exchange explains family control of corporations in developing countries, but it does not itself explain public ownership of a minority stake in the family-controlled corporation, also a familiar element of shareholder distribution in developing countries.[32] Thus far in the analysis, the product market explanation for family ownership shares this gap with the law and finance explanation of concentrated ownership. As discussed in the introduction, a bad shareholder protection explanation for the prevalence of controlling shareholders does not explain why we observe any minority shareholders. If investors know that there is an effective upper bound on the amount of private benefits that a controlling shareholder can divert, then they will pay a fair price for the earnings that remain and earn a fair return on their investment even if the trading price for minority shares is significantly below that for controlling shares to reflect the diversion. The problem is that the literature does not reveal the source of that upper bound.[33]

One could imagine that the need for controlling shareholders to return to the capital market to raise equity in the future could support an upper bound—an expected decrease in the price paid in the next offering would decrease the incentive to divert following the first. There is, however, reason to be skeptical of this explanation. As a factual matter, such companies do not frequently return to the capital market for equity, sharing that characteristic with public

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32. A number of explanations have been advanced for why a controlling shareholder would want to establish public minority shareholders, whether in an initial public offering or in a spin-out public sale of a minority interest in a previously wholly owned subsidiary. These include the evaluative information provided by the pricing of an efficient stock market and the availability of publicly traded shares as an incentive compensation vehicle. *See* Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 791 (2003) (summarizing benefits to a controlling shareholder from having a publicly traded minority); Katherine Schipper & Abbie Smith, *A Comparison of Equity Carve-Outs and Seasoned Equity Offerings: Share Price Effects and Corporate Restructuring*, 15 J. FIN. ECON. 153, 182 (1986) (explaining the information effect of a minority carve-out). Such information-based explanations, however, require an efficient stock market, a condition that is not consistent with poor shareholder protection law.

33. Heitor Almeida & Daniel Wolfenzon, *Should Business Groups Be Dismantled? The Equilibrium Costs of Efficient Internal Capital Markets*, 79 J. FIN. ECON. 99, 116 (2006), provide a good example. In Almeida and Wolfenzon's model, the extent to which the controlling shareholder can divert assets is expressed as a "pledgeability" parameter; the model then yields different results depending on the extent to which returns can be effectively committed to minority investors. However, the institutional structures that allow an effective commitment not to divert more than a particular value of the parameter are not discussed. Andrei Shleifer & Daniel Wolfenzon, *Investor Protection and Equity Markets*, 66 J. FIN. ECON. 3, 14 (2002), use a similar modeling technique to parametize the level of diversion.

corporations in developed countries. The explanation may be simply a bad shareholder protection variant of a pecking order theory of capital structure.[34] This theory posits that a company's choice of what securities to issue turns on the informational asymmetry between the company and prospective investors, and that the asymmetry is more significant the riskier the security. As a result, a company will use retained earnings to finance its activities when it can, with debt the second choice (less risky than equity because debt has priority), and equity (whose value is dependent on the most risky part of the company's future earnings) as the last resort. Because the difficulty of securing credible information about future corporate performance, which underlies valuation of an equity offering, is much greater in a bad shareholder protection jurisdiction, information asymmetry and equity's place at the bottom of the pecking order are reinforced. Thus, the cost difference between bank financing or internal financing on the one hand and equity financing on the other should be substantially greater than in a good shareholder protection jurisdiction.

The need to return to the equity market is therefore not a likely source of an upper bound for controlling shareholders' private benefit extraction in bad shareholder protection jurisdictions. Cost considerations make equity capital an even less attractive source of financing in these jurisdictions than in those with good shareholder protection. Indeed, it is a two-sided puzzle, with the possibility of a lemons' market on both sides: why do companies choose to pay the very high price for equity given the bad shareholder protection discount and the availability of cheaper alternatives, and why do minority shareholders purchase any shares at all in the absence of an observable ceiling on private benefit extraction? Without more, both issuers and investors should shun this segment of the capital market.[35]

An attractively more straightforward, but still troublesomely vague, source for a ceiling on private benefit extraction is the intuition that even in a bad shareholder protection jurisdiction, the courts or regulators (or someone in authority) will act if a controlling shareholder is too greedy or too blatant in his exploitation of the minority. Perhaps even other controlling shareholders will support action against behavior that, because of the extremity of its revealed avarice, calls attention to the more measured diversion of others, something of an honor among thieves argument (or, less judgmentally, a private ordering solution to enforcement).[36] But here the problem is how the market knows what the self- or collectively-imposed ceiling is. Even if the market is informationally efficient, in the sense that it is an unbiased estimate of the

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34. *See, e.g.*, RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE 490-93 (8th ed. 2006); STEPHEN A. ROSS ET AL., *supra* note 7, at 450-53.

35. Gilson, *supra* note 1, at 1674-78, addresses possible reforms to improve these adverse selection problems.

36. *See* Greif, *supra* note 18, at 732-35 (describing self enforcement among traders); Richman, *supra* note 20, at 2338-48 (describing private ordering systems).

ceiling's height, the estimate is likely to vary widely around the unobservable true value. Because all companies with a controlling shareholder will present the risk of uncertainty in the height of the ceiling, which cannot be diversified away in the national market, the minority share discount will be driven even higher.

If instead we approach the problem of locating a ceiling on private benefit extraction from a product market perspective rather than a capital market perspective, an alternative explanation is possible, although it shares a troublesome vagueness with the unofficial ceiling on diversion explanation just considered. In this product market-based explanation, minority shareholders may play an important reputation role in jurisdictions with both bad shareholder protection and bad commercial law. As we saw in Part I, the cost of transmitting performance information is critical to the scale of the reputation-based product market that can be supported. Suppose that the treatment of minority shareholders is visible to a company's potential trading partners at a low cost, perhaps because such exploitation is covered by the local newspapers.[37] Fair treatment of minority shareholders then serves as evidence of the corporation's integrity, including its commitment to performing its contractual obligations, a signal that is credible because it is costly—some extraction of private benefits of control must be given up. If the family-controlled corporation does not cheat in easy ways (given poor shareholder protection) by exploiting minority shareholders, the reasoning goes, the controlling family shareholder also will not cheat its customers.[38]

The decision to have minority shareholders then can be explained not by the need for capital at the time of the initial public offering or in the future, but as a way of developing reputation that will be valuable in the product market (and which may justify the higher cost of capital for a one time issuance of minority shares). From this perspective, minority shareholders play the role of reputational canaries, whose value is that they help credibly convey to potential traders that the corporation is an honest trading partner. The analysis is akin to Klein and Leffler's argument that reputation for product quality is supported by

37. *See* Dyck & Zingales, *supra* note 5, at 582-86 (treating newspapers as a corporate governance constraint). Luca Enriques has pointed out that the role of the financial press may be limited to a handful of developed countries where there is a widespread confidence in the newspapers' journalistic integrity. Absent that confidence, they cannot play the contemplated "shaming" role. E-mail from Luca Enriques, Professor of Law, University of Bologna, and Commissioner, Commissione Nazionale per le Società e la Borsa (CONSOB) (Nov. 24, 2006) (on file with author).

38. I recognize that I am at this point glossing over a serious problem—why is a controlling shareholder's treatment of minority shareholders more observable than the quality of the products or services it provides? Or, setting the bar at a realistically lower level, is the controlling shareholder's treatment of minority shareholders sufficiently observable that it adds something to the customer's assessment of the corporation's reputation based only on the products or services it provides? I will return to this concern after describing the product market explanation for minority shareholders in family-controlled corporations. *See infra* pp. 651-52.

sellers investing in long-lived assets unrelated to product quality (like expensive offices for public accounting firms) whose value drops sharply if the company fails as a result of providing poor quality goods or services.[39] More generally, think of corporate investment in image advertising: its principal value is demonstrating something about corporate character, which is believed to influence potential customers' assessment of the corporation's product or service. In our context, the investment (or image advertising) is forgoing poor treatment of minority shareholders, which requires having minority shareholders in the first place.

To be sure, this preliminary account of a product market-based role of minority shareholders is far from complete. The most significant gap that remains is how potential trading partners know what the acceptable level of diversion is, so they can know when the canary is gasping. In this respect, the account suffers from the same problem as does the explanation that there is an unofficial ceiling on diversion that is both observable by minority shareholders and observed by controlling shareholders. As developed in Part I, any reputation-based account of exchange—here the account is cross-market with reputation in the capital market supporting exchange in the product market—requires a shared understanding of what constitutes appropriate performance, now with respect to treatment of minority shareholders.

While it is beyond my ambition here to fully develop the product market-based account, the shape of a hypothesis does take form. The gap in an informal ceiling on diversion explanation for the presence of minority shareholders is that one still is left without an explanation for why a corporation wants minority shareholders in the first place given less costly alternatives of bank financing or internally generated funds. The product market-based account provides an answer to why the family corporation might want minority shareholders—because of the impact of their treatment on the corporation's reputation in the product market—but still requires a mechanism by which fair treatment is visible to the family corporation's customers. An important difference between the two accounts, however, is that the product market-based explanation of minority shareholders as a signal of commitment to contractual performance at least provides an enforcement mechanism. In the product market account, mistreatment of minority shareholders will be punished in the product market. In a setting in which the corporation need not return to the equity market, the informal enforcement explanation does not explain how mistreatment of minority shareholders in excess of the norm is punished at all; rather, like the economist's joke about being stranded on a desert island, it simply assumes unspecified informal enforcement through an unidentified actor.[40]

39. Klein & Leffler, *supra* note 9.

40. The joke concerns a physicist, a chemist, and an economist stranded on a desert island with a can of food and no obvious way to open it. After the physicist and chemist

Turning now to the observability problem with a product market-based explanation of minority shareholders, the product market account starts with two advantages. First, the controlling family shareholder has a clear incentive to make its treatment of minority shareholders observable to product market customers; without that disclosure, there is no reason to have the minority shareholders at all. Second, the observability of minority shareholder treatment need not be perfect. Rather, the signal of fair treatment of minority shareholders need only add information to the direct information the corporation's customers receive concerning the quality of its contractual performance. Here the point is not merely whether the product market-based explanation for the existence of minority shareholders is better than an informal enforcement explanation—even if better, both explanations could be wrong—but whether, net of its cost, it adds anything to the operation of the product market's direct transmission of information concerning product quality.

There is good reason to think that the capital market signal of product quality sent by the treatment of minority shareholders adds to a customer's information set concerning product quality. Here the idea is that assessing product quality is difficult in a jurisdiction with poor commercial law. The experience of an individual customer may be a noisy measure of overall producer quality, even to the particular customer—did the customer receive a bad lot or was the seller simply a poor producer? Given the barriers to actual observation in a jurisdiction with poor commercial law—for example, where techniques like warranties are not viable—room exists for a signal of quality that supplements a customer's direct observation. Additionally, the minority shareholder signal may have a cost advantage over further direct observation of product quality. The minority shareholder signal is given by the family-controlled corporation; additional direct information concerning product quality in a bad commercial law jurisdiction requires aggregation of information from many parties, the institutions for which may be expensive to create and which require significant collective action.

This analysis still leaves a gap: how does the controlling family shareholder make its signal of fair treatment of the minority credible? But this is an acceptable place to stop in describing what, in the end, is meant only to be a hypothesis. Signals have to be understood in a context, and their development is dynamic; a signaler changes its signal as it better understands the recipients' response. For now, it is enough that a hypothesis of a product market-based explanation of the existence of minority shareholders in family-controlled corporations is plausible. It is more completely specified than an informal enforcement explanation, and it need not be a better signal of quality than producers' direct provision of information—it need only add to the total

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suggest complex and unrealistic ways to open the can based on their specialties, the economist, expressing disdain for the inelegance of his companions' efforts, offers his solution: assume a can opener.

information the customer receives. My claim is that the product market-based account is worth our thinking about.

Of course, a reputation-based product market account and an informal enforcement ceiling are not mutually exclusive, nor are they the only approaches to explaining why family-controlled companies in developing markets have minority shareholders. Yet another account places the motive for the existence of minority shareholders in the realm of political economy. In many emerging market countries, having a stock market is like having a national airline—a badge of modernity that does not demand an economic justification. The government wants a stock market; the company goes along by issuing equity and paying the higher cost of capital—a tax of sorts—and the individual investors buy equity for the same reason that Americans buy state lottery tickets, or because few alternative investments are available. This account also lacks a ceiling on private benefit extraction, but one can imagine that if the government wants to have a stock market, it may have the capacity to enforce, however informally, a particular ceiling.[41] In any event, elements of a reputation-based product market account, an informal ceiling account, and a vanity stock market account for minority shareholders all may be operative; and the relative importance of each may differ depending on the context of a particular national market. The key is understanding the range of explanations that may be at work.

V. THE DYNAMICS OF REPUTATION-BASED EXCHANGE

This brings us to the final element of our assessment of family-controlled corporations in developing markets. To this point, the analysis has been largely static, with attention focused on the conditions necessary for reputation-based self-enforcing exchange, and the complementary shareholder distribution in jurisdictions with bad commercial law. I want to close with a preliminary consideration of the dynamics of such markets, to the end of framing a central question about national economic development: how does a nation make the leap from reputation-based relationships to anonymous, rule-of-law-based commercial relationships that is necessary to sustain economic growth?

A reputation-based commercial system can grow quickly.[42] However, such a system runs into an upper bound. For example, the distance-limited size of

41. The enforcement of a Japanese main bank's obligation to undertake a rescue of its clients has been said to operate in this informal way. While a main bank had no formal legal obligation to undertake a rescue, the Ministry of Finance had to approve applications to open new bank branches, a decision that was left entirely in the Ministry of Finance's discretion. The failure to discharge the informal rescue obligation would be punished by the denial of branch applications. *See* Masahiko Aoki, Hugh Patrick & Paul Sheard, *The Japanese Main Bank System: An Introductory Overview*, *in* THE JAPANESE MAIN BANK SYSTEM 3, 31-32 (Masahiko Aoki & Hugh Patrick eds., 1994).

42. *See* DIXIT, *supra* note 14, at 82; Li, *supra* note 9, at 651.

the market for a particular product discussed in Part IV forces a corporation to expand into unrelated businesses to achieve economies of scale and scope associated with its reputation. This strategy comes, however, with a cost: production of unrelated products with which the corporation has no experience will be less efficient. As with any expansion, decreasing returns on reputation will set in at the margin as sales extend to trading partners at a greater "distance." At the same time, marginal costs will increase with "distance" as a result of expanding into new geographical markets, and expanding into unrelated but geographically proximate businesses, both from lack of experience and from the difficulty of managing the growing number of different industries in which the now-conglomerate corporation participates. Because both the number of potential traders within a feasible reputation-distance from the corporation, and the number of industries in which the firm can successfully operate, have finite limits, sooner or later economic growth in reputation-based product markets slows down.

At this point, the jurisdiction has to transform its commercial law to a system that provides effective formal enforcement of contractual obligations in order to extend the reach of its producers to buyers too distant to rely entirely on reputation-based self enforcement.[43] However, this process is unlikely to be linear, and ultimately may not succeed. As Dixit reasons:

> [T]he fixed costs of rule-based governance are a public investment; therefore society must solve a collective-action problem to put such a system in place. This is not automatic; there are the usual problems of free riding, underestimation of the benefits to future generations in today's political process, and the veto power held by those who stand to lose from the change.[44]

The potential for those who have been most successful in the relation-based economy to resist transition to a rule-of-law-based system is a matter of particular concern. Precisely those families which the existing relation-based system most advantages, and which therefore have the greatest system-specific investment in reputation, have the most to lose from the reduction in entry barriers caused by a system transition to rule-of-law-based formal enforcement, and likely also have the most political influence.[45] As Mancur Olson has argued, these families will have both the incentive and the resources to make

43. Both DIXIT, *supra* note 14, at 80-82, and Li, *supra* note 9, at 659-60, stress this point. Douglass North has stated that "the inability of societies to develop effective, low-cost enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment in the Third World." NORTH, *supra* note 16, at 54.

44. DIXIT, *supra* note 14, at 80.

45. For example, in a system with good commercial law, contractual commitments like warranties can provide new entrants a substitute for difficult-to-acquire reputation. When KIA, a Korean automobile manufacturer, entered the U.S. market, it offered a substantially longer warranty than its established competitors. *See* Micheline Maynard, *Things Are Looking up for South Korea's Carmakers*, N.Y. TIMES, Dec. 7, 2001, at F1.

more difficult, or to block, the development of new formal institutions that devalue the families' investment in relation-supporting institutions.[46]

As a result, economic growth may falter or turn negative in this transition period, when existing relation-based institutions are becoming less efficient and their replacement by rule of law-based commercial institutions is not yet complete. The same institutions that made the economy grow so quickly during its early development period then operate as a barrier to effective transition, a phenomenon that Paul Milgrom and John Roberts call "supermodularity."[47] As they put it, "Even if a coordinated adjustment on all the relevant dimensions might yield an improvement in performance, it may be that until all the features of the new pattern have been implemented, the performance of the system may be much worse than in the original position."[48] Indeed, John Shuhe Li ascribes the shift between the "East Asian miracle" and the "Asian [financial] crisis" to just such a phenomenon: "The dismantling of too many existing relation-based mechanisms in so short a period can damage the future potential of economies at an early stage of development to continue to catch up; i.e., before reaching the turning point where relation-based governance is still more cost-effective than rule-based governance . . . ."[49]

CONCLUSION: HOW IS THE TRANSFORMATION TO RULE OF LAW ENFORCEMENT ACCOMPLISHED?

The function of shareholder distribution looks quite different when approached from the product market side rather than from the capital market side. While the absence of effective minority shareholder protection may in some circumstances explain the absence of corporations whose shares are widely held, it does not explain why we observe minority holdings at all, nor the special role of controlling family shareholders in many countries.[50] From

46. MANCUR OLSON, THE RISE AND DECLINE OF NATIONS, 167-70 (1982). Almeida and Wolfenzon, *supra* note 33, make the same point about conglomerates in developing countries. Once conglomerates become a large enough part of the economy, they may impose a negative externality by causing the overall capital market to operate inefficiently because of a kind of crowding phenomenon, even if the conglomerates' internal capital markets operate efficiently. In this setting, government intervention may be necessary to reduce the conglomerates' role.

47. Paul Milgrom & John Roberts, *Complementarities and Systems: Understanding Japanese Economic Organization*, 9 ESTUDIOS ECONÓMICOS 3, 12 (1994).

48. *Id.*

49. Li, *supra* note 9, at 669.

50. Recent scholarship suggests that in some countries causation may run in the opposite direction. Julian Franks, Colin Mayer and Stefano Rossi, *Spending Less Time with Family: The Decline of Family Ownership in the UK*, *in* THE HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD: FAMILY BUSINESS GROUPS TO PROFESSIONAL MANAGERS (Randall Morck ed., 2005), argue that U.K. shareholding patterns arose from informal relations of trust and confidence that encouraged equity investment by investors geographically proximate to the issuer. Here the influence is from product market to capital

the perspective of the product market, shareholder distribution, including family control, may play a role in facilitating the corporation's operation as a reputation bearer in markets where commercial exchange is supported by reputation rather than formal enforcement.

A focus on shareholder distribution from a product market perspective also highlights the importance of a dynamic account of the institutions necessary for economic growth. For developing economies, reputation-based markets can develop more easily and grow more quickly than markets that support anonymous trading, because the institutional structure of a system based on formal enforcement is both more expensive and more difficult to develop. Formal enforcement requires the rule of law and a well-functioning government.[51]

The problem is transition. The institutions that supported relation-based exchange, and in which the families that have been most successful have large investments, ultimately become barriers to further development; a public choice analysis suggests that those who have succeeded in a relation-based economy will resist the transition to formal enforcement. The politics of transition then are driven by the size of one's piece, rather than the size of the pie. If this analysis is plausible, we are left with a task and a conjecture. The task is to develop a dynamic account: what breaks the transition logjam—how does a country overcome the political barriers to shifting the character of its product markets by supplementing reputation with rule-of-law-based formal enforcement.[52] The problem is made especially interesting because dictators as a class do not result in faster growth;[53] only certain dictators have helped. The

market. This diversity in actual history among jurisdictions is consistent with Avner Greif's conclusion that the structure of reputation markets in individual countries will be path dependent: "Cultural beliefs and behavioral norms coordinate expectations and provide a shared understanding of the meaning of various actions. *Ceteris paribus,* initial social structures and cultural features therefore influence which, among the many possible organic [reputation market structures] will emerge . . . ." Greif, *supra* note 18, at 762. *See* Gilson, *Corporate Governance and Economic Efficiency, supra* note 25 at 329-34 (discussing path dependency of corporate governance institutions); Gilson, *Globalizing Corporate Governance, supra* note 25 (same).

51. *See* Kenneth W. Dam, *Legal Institutions, Legal Origins, and Governance* (Chicago Working Paper Series, John M. Olin Law & Econ. Working Paper No. 303, 2006), *available at* http://ssrn.com/abstract=932694 (surveying literature).

52. Avner Greif and David Laitin provide an analytic road map for developing a dynamic account of system change, noting that a game-theoretic account explains an equilibrium, not what causes a system to shift to a new equilibrium. Avner Greif & David D. Laitin, *A Theory of Endogenous Institutional Change*, 98 AM. POL. SCI. REV. 633 (2004). A shift resulting from changed external conditions is easy enough to explain—the rules of the game have changed. The harder question is to explain how systems change as a result of internal forces. Given the equilibrium analysis, "[e]ndongenous institutional change appears, then, to be a contradiction in terms." *Id.* at 633.

53. *See* Dani Rodrik, *Institutions for High-Quality Growth: What They Are and How to Acquire Them*, STUD. COMP. INT'L DEV., Sept. 2000, at 3, 16-20 (2000) (finding that, in sample of countries, authoritarian regimes are associated with more volatility in economic

conjecture, which I am pursuing in work with Curtis Milhaupt, is that, in countries that in recent years have successfully made the switch, the architects of the institutional and market transition were what we term "economically benevolent dictators," whose political power allowed the imposition of their individual utility function—continued economic growth even at the expense of (or by buying off) influential families.[54] If this conjecture turns out to explain some of the variance in development between different nations, the task is not to find more dictators—economically benevolent dictators, even if one could find them, have not been benevolent along other important dimensions—but instead to understand the function that they play and then to design less oppressive substitutes.

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growth).

54. Fareed Zakaria makes a related claim that explains the development of democratic government rather than economic development. He argues that the success of democracy is a function of per capita GDP. In his view, the first step toward representative government is economic development, which may require a dictator, but which also then creates the middle class that will bring the dictator down. FAREED ZAKARIA, THE FUTURE OF FREEDOM 69-73 (2003). Played through the model in Greif and Laitin, *supra* note 52, this would be an example of an equilibrium whose circumstances undermine its stability.