2001

Do Norms Matter?: A Cross-Country Examination of the Private Benefits of Control

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Working Paper No. 183

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January, 2001

Abstract

Recent empirical work has found that the private benefits of control differ significantly depending upon the underlying legal system in which the firm is incorporated. In particular, common law systems appear to outperform French civil law systems, but are trumped in turn by Scandinavian civil law systems. This evidence could be read to support the "law matters" thesis first advanced by Professors LaPorta, Lopez-de-Silanes, Shleifer and Vishny, which finds that "common law" legal systems incorporate superior legal protections for minority shareholders and therefore have deeper capital markets and more dispersed ownership. But the apparent superiority of Scandinavian legal systems complicates, and possibly subverts, this analysis, both because Scandinavian legal systems are more "like" other civil legal systems than they are "like" common law legal systems and because Scandinavian law does not encourage private enforcement of law through class actions and similar devices. Hence, an alternative hypothesis suggests itself: social norms in Scandinavia may discourage predatory behavior by those in control of the firm. This paper explores the competing merits of these two rival hypothesis - - law versus norms as instruments of social control - - by comparing the private benefits of control in various countries to other benchmarks, such as rates of criminal victimization. Although it finds no universal pattern, some strong congruences are discernible within particular legal systems (i.e., Scandinavian crime rates are very low, as are the private benefits of control that controlling shareholders expropriate from Scandinavian firms). A revised hypothesis is thus suggested: crime rates and the private benefits of control are the lowest in countries having the highest level of social cohesion and the lowest level of recent social and political disruption. This explanation works well for countries with crime and high private benefits of control (e.g., Russia, Mexico, and Brazil), but less well for many common law countries (such as the U.S.) in which the private benefits are low, but crime is high.

One implication of this comparison is that the impact of norms may be greatest when law is the weakest. This possibility may explain best why behavior within Scandinavian firms is different from that in French civil law firms, when both share relatively weak legal rights.

Do Norms Matter?: A Cross-Country Examination of
the Private Benefits of Control

by John C. Coffee, Jr.[1]

Introduction

That corporate behavior may be more shaped and determined by social norms than by legal rules seems to be an idea whose time has come.[1] Respected academics have placed the relative efficacy of social norms versus legal rules at the center of the debate over the judicial role in corporate law, and some have suggested that there are areas of internal corporate behavior and decision-making that courts should monitor less rigorously because of the adequacy of social norms.[2]

Although the relevance of norms cannot be denied, the problem with this debate is that it has an ineffable and subjective character. Of course, individuals internalize norms, seek to maximize their reputational capital, and function within teams that operate based on informal systems of consensus and cooperation. They do that within both corporations and all other forms of social organization. But once this is said, can any testable propositions be framed? In

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1 See Melvin Eisenberg, Corporate Law and Social Norms, 99 Colum. L. Rev. 1253 (1999); Robert Cooter and Melvin Eisenberg, Norms and Organizations, __ U. Pa. L. Rev. __ (2001); Edward Rock and Michael Wachter, Islands of Conscious Power: Norms and the Self-governing Corporation, __ U. Pa. L. Rev. __ (2001); Donald Langevoort, The Human Nature of Corporate Boards: Law, Norms and the Unintended Consequences of Independence and Accountability, __ U. Pa. L. Rev.__ (2001).

2 See, e.g., Rock and Wachter, supra note 1. But see Paul Mahoney and Chris Sanchirico, Competing Norms and Social Evolution: Is the Fittest Norm Efficient?, __ U. Pa. L. Rev. __ (2001) (arguing that the corporate norm that evolves within the organization may not necessarily be efficient).

particular, can a corporation's perceived compliance with norms that are not legally enforced be shown to affect the market value of its securities?

This brief article will answer both that compliance with non-legally enforceable social norms can significantly affect market value and that innovative legal engineering to develop credible signals of such compliance may be one of the most important services that the corporate attorney can perform for its client. In particular, existing research has shown that (i) it is feasible to measure the private benefits of control that those holding voting control over the corporation are likely to extract from minority shareholders, and (ii) credible signals that controlling shareholders will cease or reduce the expropriation of such private benefits appear to produce significant increases in the corporation's stock price. The unresolved question is what constitutes a credible signal.

This article's starting point is with the recognition that the average private benefits of control vary significantly across countries. But why? The simplest explanation is to ascribe this variation to differences in law between jurisdictions: for example, the law of jurisdiction X could privilege controlling shareholders to extract benefits from their corporation in the form of above-market salaries or non-pro-rata payments in connection with self-dealing transactions. But, this explanation cannot fit all cases. For example, if the substantive law is essentially similar between two jurisdictions while the private benefits of control appear to be significantly different, then some other explanation must be found. One possible alternative explanation could involve differences in enforcement mechanisms: one jurisdiction might have established powerful and well-incentivized mechanisms of private enforcement, while another jurisdiction having the same substantive law may not have. Or, one jurisdiction might invest more heavily than the other in public enforcement. Still, if these explanations also fail (or, at least, seem implausible), then the next most logical explanation involves social norms. That is, if two jurisdictions having similar legal rules and enforcement systems appear to permit controlling shareholders to extract on average very different levels of private benefits, then we may be witnessing a difference in prevailing norms. This article will argue that this pattern is not only possible, but pervasive.

Part I of this article will offer evidence that suggests that the social norms regarding the behavior of controlling shareholders do differ -- and significantly -- across jurisdictions. Even within jurisdictions having relatively similar legal rules, the level of compliance with these norms appears, on average, to differ materially. Although some of this variation can no doubt be explained in terms of differences in enforcement risks, it will be argued that the magnitude of these differences cannot be plausibly explained on any such deterrence-related basis.

Part II will turn to possible explanations for the magnitude of these differences in the private benefits of control across jurisdictions. It will take the uncharacteristic step (for a corporate law article) of seeking to relate these differences to other social characteristics that distinguish the jurisdictions being compared -- in particular, to the level of crime and law compliance within the jurisdiction. Although no satisfactory metric exists for measuring law compliance across jurisdictions, some reasonable proxies do suggest a rough correspondence: namely, societies with high crime and/or low social cohesion are also characterized by high private benefits of control.

Part III will then turn to the potential for value creation through credible signaling that a corporation will comply with social norms that are not legally enforced. On the one hand, it will suggest that there are incentives for a race to the top: that is, corporations that do bond themselves to protect the interest of minority shareholders beyond the level that is legally mandated or enforced in their home jurisdiction and that credibly signal this intent can significantly enhance their share prices. Such creative legal engineering more than pays for itself, because some evidence already suggests that corporations in countries with "weak legal systems can more than double their stock price through such self-help measures.[3]

On the other hand, there is also a reverse side to this coin: if controlling shareholders in "amoral" jurisdictions that are characterized by high private benefits of control were to acquire control of corporations incorporated in "moral" jurisdictions characterized by low private benefits of control (but in which the expropriation of private benefits was not legally constrained), a movement in the reverse direction toward greater inefficiency could begin. If controlling shareholders in "amoral" jurisdictions are not deterred by internalized norms or the threat of reputational loss in their home countries, they would have every logical incentive to acquire control in order to extract greater private benefits than the preceding controlling shareholder in the "moral" jurisdiction had done. Once, such perversely-motivated takeovers would have been infeasible because of the high national barriers to transnational takeovers. Today, however, in capital markets that are increasingly globalized and in which corporate control is increasingly contestable, movements in both such directions seem both possible and plausible.

Part I: Social Norms and the Private Benefits of Control: A Cross-Country Comparison

An important new body of research has argued that legal rules protecting the rights of investors -- and minority shareholders in particular -- are essential to the development of deep and

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3 See text and notes infra at notes 36 to 39.

liquid securities markets.[4] In a provocative series of articles, Professors Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny (hereinafter "LLS&V") have clearly documented the existence of significant differences among countries in terms of the breadth and liquidity of their capital markets, the ownership concentration of publicly traded firms, the dividend policies of firms, and the access of firms in these markets to external capital, which differences correlate closely with the nature of the country's legal system. More to the point, they have found that common law countries seem to outperform civil law countries by a significant margin in terms of both the depth and liquidity of their capital markets and the degree of dispersion in share ownership. Why? LLS&V conclude that the superior quality of the legal protections afforded minority shareholders in common law jurisdictions principally explains these differences.[5]

Yet, although LLS&V have unquestionably shown a statistically significant correlation between strong capital markets and certain specific legal protections that tend to characterize common law legal systems, correlation does not prove causation. The perplexing problem of multicollinearity thus makes its customary appearance here, as it often does when attempts are

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[4] See, e.g., Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, Law and Finance, 106 J. Pol. Econ. 1113 (1998); La Porta, Lopez-de-Silanes, Shleifer & Vishny, Legal Determinants of External Finance, 52 J. Fin. 1131 (1997); La Porta, Lopez-de-Silanos & Shleifer, Corporate Ownership Around the World, 54 J. Fin. 471 (1999); La Porta, Lopez-de-Silanes, Shleifer & Vishny, Investor Protection and Corporate Valuation, NBER Working Paper No. 7403 (1999); Lopez-de-Silanes, Shleifer & Vishny, Agency Problems and Dividend Policies Around the World, 55 J. Fin. 1 (2000).

[5] For the most recent statement of their position, see La Porta, Lopez-de-Silanos, Shleifer & Vishny, Investor Protection and Corporate Governance (2000) (available on SSRN Electronic Network at - ID=183908).

made to determine the true independent variable that influences the dependent variable.[6] Of the various nagging doubts surrounding their research, perhaps the most perplexing is the possibility that the specific legal protections identified by LLS&V are really proxies for some deeper, but hidden, characteristic of common law legal systems.

The point here in not to challenge the "law matters" thesis, which thesis would be highly plausible even in the absence of strong statistical correlations between minority legal protections and ownership dispersion. Rather, it is to suggest that the line between law and norms may be harder to define than this body of research has yet recognized. Specifically, investors may invest in public corporations in common law legal regimes (and may not invest in similar corporations in civil law legal regimes) less because they believe they have enforceable legal rights that adequately constrain managers and controlling shareholders in common law jurisdictions than because they believe managers and controlling shareholders in these common law legal regimes will abide by a series of legally non-enforceable norms. These norms (and the related corporate governance practices that implement them) may as a practical matter restrict unfair self-dealing and otherwise limit the potential for expropriation of the minority shareholder's investment. In short, investors invest because they expect to be treated "fairly" in a common law legal system (and have been so treated in the past), and they refrain from making similar investments in a civil law regime (or

[6] Multicollinearity refers to the possibility that covariation among independent variables can give the misleading impression that a measured independent variable has caused a change in a dependent variable, when in fact the causation is attributable to a hidden linkage between the dependent variable and a "true" independent variable that is covariant with the "false" independent variable. See Michael O. Finkelstein & Bruce Levin, STATISTICS FOR LAWYERS (1990) at 350-352. Suffice it to say here that this is a common problem in many regression studies, and can seldom be wholly corrected for.

make them only at severely discounted prices) because they have the opposite expectations (and possibly the opposite experience in the past).

Although the specific norms and governance practices that facilitate investment could have a close association with statutory legal protections that are more prevalent in common law legal systems, norms and legal rules can be entirely independent of each other, even though they appear closely associated. For example, no statute or legal rule in the U.S. or the U.K. requires a majority of the board of directors to be independent of management, but this is in fact the widely prevailing practice in the case of public corporations in both countries. Such a practice might also be statistically associated (or "co-variant") with a legal rule (such as the legal rules governing proxies in the U.S., which do facilitate shareholder ability to elect or oust the board of directors), but this correlation still does not imply causation. Hence, even if a norm or governance practice is associated with other certain legal rules, this correlation can be misleading if it is assumed that the legal rules "cause" the board to be independent. Indeed, this would be a clear example of multicollinearity at work, creating the misimpression that a legal rule (here, the proxy rules) had a casual relationship with the depth and liquidity of the U.S. capital markets.

Reality is, however, still more complex than this example would indicate, because legal rules may sometimes be embedded in a matrix of norms and conventional practices, which all interact with, and reinforce, each other. Arguably, corporation statutes can specify a "standard of conduct" for corporate fiduciaries that is higher than the standard that courts will actually use in imposing liability.[7] A relevant example is supplied by the "safe harbor" or "sanitizing" statutes

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[7] See Melvin Eisenberg, The Divergence of Standards of Conduct and Standards of Review in Corporate Law, 62 Fordham L. Rev. 437 (1993).

that most U.S. states have enacted to deal with the problem of conflict of interest transactions between the corporation and a director.[8] As interpreted by most courts, these statutes give considerable deference to the decision of independent directors to approve a self-dealing transaction between the corporation and a director, and they relax the standard of judicial review that would otherwise prevail.[9] Although these statutes may suggest a higher normative standard than they actually use for the imposition of liability, they do not require an independent board, and they even permit directors who have not made full disclosure to the board to validate the conflict of interest transaction by proving its intrinsic fairness.[10] At a minimum, these statutes thus create an incentive for corporations to adopt an independent board in order that its managers will receive relative immunity from judicial review. To this extent, even if they mandate nothing, they reinforce the convention (and probably the market's expectation) that public corporations should have independent boards.

Legal rules and social norms thus have a way of melting into each other, without a sharp clear line defining where the law ends and the norm begins. Investors realize that they are

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[8] Examples of such a "safe harbor" or "sanitizing" statute are supplied by New York Business Corporation Law Section 713 or Delaware General Corporation Law Section 144.

[9] Cases differ on how much protection such disinterested approval by independent directors affords. Compare Marciano v. Nakash, 535 A.2d 400 (Del. 1987) (disinterested approval triggers business judgment rule) with Fleigler v. Lawrence, 361 A. 2d 218 (Del. 1976) (approval merely removes "cloud" caused by director's self-interest).

[10] See, e.g., New York Business Corporation Law § 713(b) (duty on director in such case to prove transaction was "fair and reasonable to the corporation at the time."); Del. Gen. Corp. Law § 144(a)(3) (contract or transaction valid without disclosure to board if "fair to the corporation as of the time" authorized or approved).

protected by both, and hence an unexplained departure from a prevailing governance practice might elicit a market penalty. Yet, at least within the U.S. context, attempts to identify corporate governance practices that actually enhance shareholder value and elicit a positive market reaction have generally been unsuccessful.[11] Possibly, shareholders understand that there can be justifications for departures from generally accepted governance practices, or possibly they recognize that a variety of overlapping functional substitutes for any individual corporate governance practice exist so that an isolated departure may have little meaning.

If research within the U.S. on the relationship between corporate governance practices and market valuation has not been fruitful, one should not draw the hasty conclusion that the relationship is necessarily weak. The first thing one learns when one looks outside the U.S. is that there are huge variations, depending on the corporation's jurisdiction of incorporation, in the market's expectation that minority shareholders will face expropriation. Such expropriation most typically occurs because of the ability of a controlling shareholder to extract what economists term the "private benefits of control" from the corporation.[12] The term "private benefits of control" is a shorthand expression for all of the ways in which those in control of a corporation can siphon off benefits to themselves that are not shared with the other shareholders, including through (i) above-market salaries, (ii) unfair self-dealing transactions with the corporation, (iii) insider trading, or (iv) the issuance of shares to themselves at dilutive prices. In all jurisdictions,

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[11] Professor Black assesses these studies in his article in this volume. See Black, Does Corporate Governance Matter: A Crude Test Using Russian Data, __ U. Pa. L. Rev. __, at __ (2001).

[12] For a discussion of this standard term, see, e.g., Lucian Bebchuk & Marcel Kahan, A Framework for Analyzing Legal Policy Towards Proxy Contests, 78 Calif. L. Rev. 1073, 1090 (1990).

corporate law attempts to address and limit the private benefits of control -- but with varying degrees of success.

The new focus on comparative corporate governance has led researchers to seek to measure variations in the private benefits of control across countries. Tatiana Nenova, a Harvard economist, directly approached this task by identifying a sample of all dual-class firms whose securities were listed in the thirty largest national capital markets in the world, which sample came to some 661 such firms.[13] Dual class firms are corporations with two classes of shares having different voting rights, and thus they permit direct observation of the value of voting control. Essentially, once adjustments are made for any differences in cash flow or dividend rights, the aggregate premium at which the higher-voting class trades over the lesser-voting class is assumed to represent the value of control.[14] The bottom line conclusion from this study was that the value of corporate control differed enormously across countries, and in certain countries -- most notably, Brazil, Chile, France, Italy, Mexico and South Korea -- amounted to"alarmingly high" levels that were between a quarter and a half of the firm's market capitalization.[15] The extreme case was Mexico, where controlling shareholders were found to "expropriate one half of the value of the company, sharing the remaining half with minority shareholders in proportion to share

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[13] See Tatiana Nenova, The Value of Corporate Votes and Control Benefits: A Cross-country Analysis, Harvard University Economics Working Paper, available on SSRN at - ID=237809). (September 21, 2000).

[14] The basic methodology used in this study is not new and parallels that earlier used by Luigi Zingales in a series of seminal articles. See Zingales, What Determines the Value of Corporate Votes, 110 Q. J. Econ. 1047 (1999); Zingales, The Value of the Voting Right: A Study of the Milan Stock Exchange, 7 The Rev. of Fin. Stud. 125 (1994).

[15] See Nenova, supra note 13, at 4.

holdings."[16] Yet, in other countries, including the U.S. and Canada, the value of control was much less (generally below 4%),[17] thus apparently indicating that the private benefits of control diverted to controlling shareholders in these countries were considerably less.

Perhaps more importantly, not only did the private benefits of control differ dramatically across countries, but the average private benefits of control differed systematically in terms of the "legal families" to which individual countries belonged. Table One sets forth these differences:[18]

Table One

Legal Family	Average Private Benefits of Control as a Percentage of Firm's Market Capitalization
Scandinavian Civil Law	0.5%
Common Law Countries	4.5%
German Civil Law Countries	16.2%
French Civil Law Countries	25.4%

At first glance, this data certainly seems to support the "law matters" hypothesis. One can read it as demonstrating that the tougher the legal environment, the less the private benefits that the control holder can extract. Indeed, Professor Nenova concluded that:

16 Id. The use of the word "expropriate" here is conclusory and possibly unjustified, because one does not know what the minority shareholders paid for their shares. If they assumed that one half of the firm's cash flow would be diverted to controlling shareholders, they presumably paid correspondingly less for their shares.

17 Id.

18 Id. at 4. The sample contained a substantial number of observations of firms for each legal family: Scandinavian Civil Law Countries (109), Common Law countries (161), French Civil Law countries (224), and German Civil Law countries (167). Id. at 30-31.

> "More than 70% of the systematic differences in vote value are explained by the quality of investor protection that non-controlling shareholders enjoy as per the country laws, their rights in case of control transfer, and the extent of law enforcement."[19]

But is it this simple? Clearly, forces of social control seems more at work in some jurisdiction than others, and controlling shareholders in French Civil Law countries appear to feel substantially less inhibited than controlling shareholders elsewhere about extracting private benefits of control. But are they less constrained because they are less deterred or because they can rationalize their behavior under social norms that view the controlling shareholder as more entitled to extract such benefits? In short, this data raises, but does not resolve, the critical issue of the relative role of law versus other forces of social control.

One way to approach this question is to ask whether significant differences in the average level of private benefits of control extracted by controlling shareholders can be plausibly explained by differences in the prevailing substantive law. That is, if the substantive law were highly similar but the average private benefits differed dramatically, it would become more difficult to explain these differences in terms of the relative efficacy of the substantive law. To the extent that prior research has generally focused on common law versus civil law countries, these studies have plausibly sought to attribute differences in outcome to the seemingly major differences between the common law and the civil law. But the foregoing data set is not so easily explained, and actually tends to subvert this explanation. As Table One above showed, Scandinavian legal systems seems to outperform both common law and French and German civil law legal systems in terms of reducing the private benefits of control. If common law legal systems are straddled on

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[19] Id. at 4.

both sides by different forms of civil law systems, it becomes more difficult to rely on any explanation that assumes the natural superiority of the common law's technology for shareholder protection over that of the civil law.

In addition, significant variations are evident even within the same legal family. Table Two below breaks out some of the differences within family groups:[20]

Table Two

Country	Total Vote Value As a Percentage of Firm Value
Scandinavian Countries	
Denmark	.008
Finland	-.05
Norway	.058
Sweden	.01
Common Law Countries	
Australia	.23
Canada	.02
U.K.	.095
U.S.	.02
Hong Kong	-.028
South Africa	.06
German Civil Law Countries	
Germany	.095

[20] See Id. at Table 5 ("Comparison of Mean Total Vote Value as a Share of Firm Value, Raw Averages").

South Korea	.28
Switzerland	.05
French Civil Law Countries	
Brazil	.23
Chile	.23
France	.28
Italy	.29
Mexico	.36

Within Common Law countries, Australia stands out as an outlier. Although the U.S., the U.K. and Canada, each sharing much legal tradition and cultural heritage with Australia, all have low and closely similar percentages for total vote value as a percentage of firm value, Australia's percentage is over ten times higher than the next highest Common Law country on this table.[21] Germany also requires special attention for the opposite reason. Although researchers have regularly criticized German civil law for its lack of minority protections, the German and British figures for total vote value as a percentage of firm value are identical: 0.095.[22] Yet, in the case of South Korea, which derived its law from Germany but obviously not its cultural heritage or social norms, the corresponding percentage is 0.289 -- or over three times as high.[23] The obvious implication is that transplanted law may not "take," possibly because its conflicts with the host

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21 It is possible that this could be a consequence of the limited number of observations (3) in this study of Australian firms.

22 Here, there were numerous observations: 65 in the case of Germany and 27 in the case of the U.K.

23 There were 65 observations of South Korea firms and of German firms, so this comparison cannot be the result of one or two idiosyncratic firms.

country's own norms and customs.

A closer examination of the foregoing table also suggests that the assumed superiority of common law to civil law represents a gross oversimplification. If one looks at the German and Swiss figures (and drops South Korea from the class of German countries as a cultural misfit), then the value of control appears relatively similar in the case of both German and Common Law countries -- despite significant differences in their legal regimes. Scandinavian countries do significantly better on average than Common Law countries in restricting the private benefits of control -- again despite the presumed inferiority of the civil law tradition.

The real surprise that emerges from this table is the inferior performance of the French civil law countries. Uniformly, they exhibit very high values associated with voting control. Only South Korea and Australia rival their levels. Given the cultural heterogeneity of the French civil law family (the South American countries historically derived their law from France only because of the happenstance that Napoleon briefly controlled Spain at the time the legal systems of most South American countries were first codified), this evidence might conceivably support a strong interpretation of the "law matters" hypothesis. But it is also possible that the social norms in these quite dissimilar countries simply imposed few constraints on the behavior of controlling shareholders -- that is, a de facto "take-the-money-and-run" ethic prevails. Put differently, although the applicable norms in South Korea, Mexico, Italy and Brazil could differ significantly in their normative content, they could easily share the common characteristic of imposing little constraint on controlling persons. If so, however varied and nuanced these normative systems may be, they can be described as "weak" in an operational sense.

To sum up, a survey of all listed firms in some thirty countries shows that, in terms of limiting the private benefits of control, Scandinavian firms outperform Common Law country firms, which in turn outperform firms in German civil law countries -- but all these basically marginal differences pale in comparison to the virtual right to plunder that controlling shareholders seem to have in firms in French civil law countries. What interpretation best explains these results? The now standard explanation that the common law better protects minority shareholders cannot easily explain the Scandinavian superiority or the near equivalence between Common Law firms and German Civil Law firms. But the contrary hypothesis that "law does not matter" similarly fails to explain either the fact that deep and liquid securities markets are found only in common law countries[24] or the dramatic failure of French civil law in constraining the private benefits of control.

To be able to account for these results, any theory that assigns primary causal responsibility to law would have to explain why the civil law could outperform the common law in some countries but then underperform it in others. Such an explanation would logically have to respond either that (i) the civil law in Scandinavian countries was substantively very different from that in French or German countries (with French Civil Law being conspicuously more deficient) or (ii) there were significant differences in the enforcement of legal rules that distinguished these three legal families. Neither explanation seems remotely plausible. First, Scandinavian civil law does not treat the corporation notably differently than do the civil laws of France or Germany. According to LLS&V, who have constructed an "antidirector rights index" to measure the strength of the legal protections accorded shareholders, Scandinavian civil law ranks behind the

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[24] For the fullest statement of this finding, see La Porta, et al., Law and Finance, supra note 4.

Common Law and just equal to the world average.[25] Scandinavian law also affords no special legal protections to "oppressed minority" shareholders.[26] The one respect in Scandinavia does seem to outscore its rivals is in ratings for the "Efficiency of the Judicial System" and freedom from "Corruption."[27] Yet, ratings for lack of corruption arguably relate more to the strength of norms within the country than to the substantive superiority of its doctrinal law.

Second, in terms of enforcement capacity, the legal systems of Europe (both common law and civil law) differ markedly from that of the United States. Only the United States also has the class action and the contingent fee,[28] and these have been combined in the U.S. to assure generous compensation to the successful plaintiff's attorney in a class action. Finally, unlike the U.K., the U.S. normally makes each side bear its own legal expenses, with the result that plaintiffs are spared the prospect of fee shifting against them of the typically greater legal expenses incurred by corporate defendants. Together, these three elements -- the class action, the contingent fee, and the American rule on fee shifting -- have created in the U.S. (but basically no where else to any

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[25] See La Porta, Lopez-de-Silanos, Shleifer & Vishny, Investor Protection and Corporate Governance, supra note 5, at Table 1. Scandinavia's "antidirector rights index" rating of 3 is behind the 4 rating given to Common Law countries and equal to the 3 rating specified as the "World Average," but ahead of the 2.33 rating given to both French Civil Law and German Civil Law countries.

[26] Id. In contrast, 50% of German Civil Law countries and 94% of Common Law countries have such a remedy.

[27] Even on this score, German Civil Law countries were not far behind, although French civil law countries lagged badly.

[28] Canada and a few other countries have begun to experiment with the class action, but do not reward class counsel with a contingent fee in the form of a presumptive percentage of the recovery. Hence, few class actions have yet been brought in these jurisdictions.

equivalent degree) an entrepreneurial system of private law enforcement.[29] As a result, for a European legal system to compare favorably with the U.S. in terms of enforcement, it would have to feature very strong public enforcement of corporate legal rules. Again, this seems unlikely, because the SEC is generally recognized as the world's premier public enforcer in the area of corporate and securities law, and it has served as the template which several European countries have explicitly sought to emulate. Not only do the Scandinavian countries lack any comparable public enforcer, but their largest companies typically list on foreign stock exchanges (whether in New York, London, Paris or Frankfurt), and hence are subject to the self-regulatory rules of these bodies.

Where does this leave us? It suggests that if corporate law is reasonably similar across Europe and if aggregate enforcement efforts -- both public and private -- fall well below those in the United States, one must look beyond law to social norms to explain the very different performance of firms in Scandinavian, German, French and Common Law countries.

Part II <u>Beyond Law: What Else Explains Differences in Corporate Behavior?</u>

To this point, we have examined only differences in substantive law and in legal enforcement in order to explain the significant differences in the private benefits of control that controlling shareholders extract across different jurisdictions. In a world where all actors are assumed to be amoral and to be deterred only by the prospect of sanctions, this might exhaust the possible explanations. But an alternative set of explanations emerges if we postulate that the principal actors in corporate governance may internalize norms and act in accordance with them.

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29 See Coffee, <u>The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action</u>, 54 U. Ch. L. Rev. 877 (1987).

But is this proposition testable? Easy as it is to postulate norm internalization, it is more problematic to measure it or to relate it to cross-country differences in observed outcomes. Some approximate measures do, however, suggest themselves. For example, one can postulate that a strong norm of law compliance exists in some countries, but is less strong or absent in others. A rough proxy for this norm might be the national crime rate. In this light, it is noteworthy that Scandinavian countries have long had crime rates well below that of most industrialized nations.[30] A correspondence might then be hypothesized between a low crime rate and low expropriation of private benefits of control. If we look only to the Scandinavian countries, this generalization seems to work. Although there are few comparative studies of crime rates, a 1990 study under the auspices of the World Health Organization ranked twenty leading industrial countries based on victim survey data.[31] Three Scandinavian countries were included: Finland, Norway and Sweden. Norway ranked next to last (or 19th) with the second lowest rate of victimization, and Finland and Sweden were ranked below average at 11th and 13th, respectively, in terms of victimization rates.

But if this premise that Scandinavians are more law abiding than citizens of most other countries looks persuasive, it fails to provide an explanation for corporate opportunism, because many countries with poor records on corporate governance did equally well in terms of crime rates. For example, the two German law countries in this same sample -- Germany and

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30 This has consistently been true for decades. See, e.g., Henry Milner, <u>SWEDEN: Social Democracy in Action</u> (1989) at 206.

31 See Franklin Zimring and Gordon Hawkins, CRIME IS NOT THE PROBLEM: Lethal Violence in America (1997) at 7-8 (citing Jan Van Dijk and Pat Mayhew, CRIMINAL VICTIMIZATION IN THE INDUSTRIAL WORLD (1992)).

Switzerland -- ranked 15th and 17th, respectively. Even France, the symbol of shameless opportunism in corporate law matters, ranked 14th, better than either Sweden or Finland. What countries had the highest levels of crime victimization? The U.S. came first, New Zealand second, Australia third, and Canada fourth.[32] Obviously, the Common Law countries do not do well on this scorecard, even though they perform excellently in terms of policing the private benefits of control. Yet, the relationship between crime rates and corporate opportunism is not generally inverse, as the Scandinavian success testifies.

Of course, one explanation for this seeming paradox may be that serious crime (at least, the types measure by crime victimization studies) and corporate opportunism are different phenomena, engaged in by different classes of persons, located typically at different positions within society. Violent crime is, let us assume, engaged in most commonly by the social underclass, while controlling shareholders who expropriate wealth from minority shareholders belong by definition to a more socially privileged class. Still, in Scandinavia, both groups seem to obey the law more than elsewhere.[33]

Scandinavia's unique position actually suggests a revised hypothesis. Perhaps, what is most distinctive about Scandinavia is its level of social cohesion and homogeneity. In contrast, the U.S. is characterized by much greater diversity, both ethnic and religious, and possibly by a greater degree of polarization between social groups. Arguably, social cohesion produces greater

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[32] Id. at 8. England and Wales ranked 10th out of 20.

[33] One is thus led to consider more speculative theories: Perhaps, Scandinavians have seen too many Ingmar Bergman movies and are too guilt-ridden as a result to engage in any form of misconduct. Alternatively, there is the "blondes have more fun" theory under which Scandinavians ignore money to pursue goals that Freud understood.

conformity with social norms. Not only can this revised hypothesis explain low exploitation of minority shareholders in Scandinavia, but it may also explain the high expropriation rates in many French civil law countries. Table Two above showed that Mexico was characterized by the highest expected level of expropriation, because it had the highest value accorded to voting control (36%); Brazil and Chile were not far behind at 23% each. Although nominally French Civil Law countries, each are in reality Hispanic nations with sharp class and racial division, significant political tensions, and (in the case of Brazil and Chile) a recent history of military governments. None of this enhances social cohesion. Indeed, Brazil and Mexico are two of the very few countries that have a higher homicide rate than the United States.[34] Russia similarly is characterized by both a very high homicide rate and a unique level of expropriation of minority shareholders,[35]

To be sure, this social cohesion thesis does not answer all questions. Both France and

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34 Although the United States is often loosely asserted to have the highest homicide rate in the world, the evidence is otherwise. According tho the Statistical Abstract of the United States, the U.S. homicide rate in 1996 was 7.0 per 100,000 citizens (a level well above all European countries other than Russia), which rate was a decline from the 7.9 level in 1996. See U.S. Dept. of Commerce, Bureau of Census, STATISTICAL ABSTRACT OF THE UNITED STATES, (119th ed. 1999) at Table No. 348, p. 217. Brazil in contrast has a rising homicide rate that reached 25 per 100,000 in 1996 (or more than three times the U.S. rate in that year). See Paulo Pinheiro, "Democratic Governance, Violence and the Unrule of Law," Daedalus, March 22, 2000. The Mexican homicide rate has been recently estimated at 16.8 per 100,000. See Richard Cottrol, <u>Criminal Justice and Other Programs: Submission Is Not the Answer: Lethal Violence, Microcultures of Criminal Violence, and the Right to Self-Defense</u>, 69 U. Colo. L. Rev. 1029, 1036 n. 16 (1998).

35 The Russian homicide rate (for 1993) has been estimated at 19.3 per 100,000 (midway between Brazil and Mexico and two and one-half times the current U.S. rate). See Cottrol, supra note 34, at 1036 n. 16.

Italy have moderate overall crime rates, but high rates of expropriation of the private benefits of control that rival those of Brazil and Chile. While perhaps not as cohesive or homogeneous as Scandinavia, neither France nor Italy approaches Brazil or Mexico in terms of internal tensions, class divisions, or ethnic conflict. Still, their controlling shareholders appear to behave much like those in these more conflicted societies.

A final possibility may be that some characteristic of the average corporation in a civil law country justifies (or, at least, can be used to rationalize) the belief of its controlling shareholders that they are entitled to extract greater private benefits. To illustrate, let us contrast the prototypical experience of two start-up companies, one in the U.S. and the other in a civil law jurisdiction. In the U.S., the young entrepreneurs of a high-tech start-up secure venture capital backing and within four to five years effect a successful initial public offering ("IPO") in which the company goes public at a price-earning ration of 50:1. Public stockholders buy over 70% of the equity in this company, leaving management holding only weakly in control with a 30% block (typically, the venture capitalists who initially financed the company cash in their chips and move on within a year of the offering). The founders' shares here do not carry a control premium, because control has in effect been sold to the public market (where a determined corporate bidder might well be able to acquire it in a hostile tender offer).

Next, let us focus on the more standard European history. A company is founded, but without the assistance of venture capital financing (which is less available in Europe, in part because venture capitalists cannot anticipate an early IPO in the wake of which they will be able to liquidate their investment). In fact, the company never effects an IPO in the U.S./U.K. sense of that term, but over time (say, ten to twenty years), its stock becomes dispersed into hands of customers, suppliers, and descendants of the founders, and trading begins in an illiquid market. Because its founders still hold an easily controlling block of stock in their company (say, 75%), the publicly traded shares trade at a large discount that reflects that control premium held by the founders (and their ability to extract private benefits). Hence, some public shareholders who are unaffiliated with the founders may acquire blocks in the secondary market equal to 1% to 3% of the outstanding stock at highly discounted prices that are well below the company's liquidation value per share.

Will the managements of these two companies regard their public shareholders in the same light? Arguably, they will not. The American management sees a shareholder class that paid a high premium in the expectation that management owes them a fiduciary duty, and that, therefore, demands a duty of exacting loyalty. In contrast, the European founders/managers may regard their public shareholders as opportunists who bought at discounted prices that reflected the founders' right to control and to extract private benefits. Indeed, the European founders may view their failure to extract their traditional level of private benefits from their company as in effect bestowing a windfall on the public shareholders who bought at discounted prices that assumed those private benefits would continue to be extracted.

To present this justification is not to accept it. There are social costs and allocative inefficiencies to a capital market system that systematically underprices the stock of such firms in concentrated ownership systems. Rather, the point of this illustration is, first, that norms are central, and, second, that they may be context specific. Arguably, the American entrepreneurs might have the same sense of entitlement to extract private benefits if they saw their minority shareholders buying their stock at heavily discounted prices. Hence, the operative norms may vary, less because of national normative differences, than because of differences in the characteristic development of firms, with "weak" European securities markets in effect producing correspondingly "weaker" social norms about the obligations of controlling shareholders. In turn, based on these "weaker" norms, "weaker" duties might be codified in civil law systems than in Common Law systems. There is a potential irony here. While LLS&V argue that strong markets presuppose strong laws protecting minority shareholders, one can at least imagine the reverse dynamic: strong markets come first and create a demand for stronger laws to protect the constituency of investors who have entered those markets.

Part III Norms and the Market

Norms are often defined as informal rules of conduct that constrain self-interested behavior but that are not enforced by any authoritative body that can impose a sanction.[36] The absence of an enforcer does not mean, however, that there is no sanction. Reputational loss to a firm when it violates a norm (and is detected in so doing) can be severe.[37] But what happens when norm violation is endemic, in effect when "everyone is doing it"? In such a world, where the norm is in effect more honored in the breach than in the observance, the market cannot logically expect that any firm will comply with the norm, and it should discount all firms by the value that the expected noncompliance subtracts from what otherwise would be the firm's market capitalization. But, even in such a world where the norm is arguably more nominal than real,

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[36] This definition roughly parallels that used by Maloney and Sanchirico, supra note 2, at [4] ("Norms .. are rules of conduct that constrain self-interested behavior and that are adopted and enforced in an informal, decentralized setting.")

[37] See John Karpoff and John Lott, The Reputational Penalties Firms Bear From Committing Criminal Fraud, 36 J.L. & Econ. 757 (1993).

those firms that can credibly signal their intent to comply with the norm may be able to enhance their market value.

Professor Bernard Black's article in this symposium provides striking evidence that the market does respond to credible signals that a firm will comply with norms that protect minority shareholders -- at least when such a signal differentiates the firm from the majority of firms that are not so complying.[38] Essentially, he finds a strong and statistically significant correlation between the corporate governance ranking that a group of Russian firms received from one Russian investment bank and the ratio of their actual market capitalization to their potential market capitalization in a Western market, as independently estimated by another Russian investment banking firm. That is, some firms in his Russian sample traded at prices well under 1% of their potential Western market capitalization, while others traded at levels as high as nearly 50% of their estimated potential Western market capitalization.[39] The defining difference between these firms appeared to lie in the quality of their corporate governance practices: firms with good governance rankings traded as high as 48% of their estimated Western market capitalization, while firms with low rankings traded at under 1%.

As Professor Black notes, similar research on corporate governance practices in the U.S. or other Western nations has not yielded similarly dramatic results. Thus, the key factor underlying the strong correlation between governance practices and market value in his study may

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38 Bernard Black, supra note 11, at ___.

39 Only one firm -- Vimpelcom -- traded at this approximate level (actually 48%), and it had listed on the New York Stock Exchange. The next highest firms traded at 18% and 16% of their estimated potential Western capitalization, while the lowest ranking traded at .01% and .02%.

be the weakness of the underlying Russian law and the entire Russian legal system. If legal rules are too weak or underenforced to provide protection, alternative sources of protection become correspondingly more important.

But, for precisely this reason, it is necessary to examine more closely the factors that comprised the corporate governance rankings in his study. Basically, they fall into two general categories: (1) reputational factors, and (2) bonding efforts that give rise to enforceable rights. For example, a Russian company's past reputation and the attitude of its management toward shareholders may signal a sincere intent to comply with social norms that generally prevail in the West, but they confer no enforceable rights. Conversely, a preemptive rights charter provision, a low ceiling on authorized shares, or the deliberate creation of a blocking position that permits minority shareholders to veto proposed charter amendments are efforts at bonding; they in effect tie management's hands -- at least if Russian courts will enforce the corporate contract as it was written. Such contractual rights (even if they only establish procedures) are quite different from non-legally enforceable norms (or "NLERS"). Thus, while Professor Black's data tends to confirm that "corporate governance matters," it is far more equivocal evidence as to whether "norms matter." That is, to the extent we define norms as conventions and practices that may be expected but are not legally enforceable, many of the factors in the corporate governance rankings that he uses do give rise to enforceable protections (while others are only reputational in character). Hence, it is indeterminate whether his data shows the market responding to unenforceable signals of an intent to comply with Western norms of corporate governance or to more objective and enforceable measures that effectively create contractual rights.

This same ambiguity also underlies earlier studies. This author has previously suggested that the cross-listing by non-U.S. firms on the New York Stock Exchange may also represent a form of bonding, as it assures investors of enhanced disclosure and potentially subjects them to litigation in U.S. courts.[40] While it has long been known that such a cross-listing on the NYSE by a foreign firm elicits an increase in stock price, recent research has found that firms incorporated in jurisdictions having "weak" corporate laws are more likely to cross-list than firms incorporated in jurisdictions with "strong" corporate law.[41] Subsequent to cross-listing in the U.S., foreign firms are also more likely to conduct an equity offering in their own country, thus suggesting that a U.S. cross-listing gives meaningful assurances to investors in the firm's home country.

But what exactly is the market responding to when the stock price increases of a firm that cross-lists? Is it the promise of better and fuller disclosure (based on the need to satisfy U.S. generally accepted accounting principles)? Or, is it the potential threat of Rule 10b-5 liability if the issuer makes false statements? Or, is it simply the signal that the firm is seeking to improve its corporate governance? Alternatively, the price increase might not be the result of bonding at all, but only of the change in supply and demand once the firm taps into the much larger U.S. capital market.

These ambiguities prevent bottom-line conclusions at this point. Clearly, self-help efforts to signal intended compliance with norms matter when the corporation takes action that binds the

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[40] See John C. Coffee, Jr., The Future As History: The Prospects for Global Convergence in Corporate Governance and Its Implications, 93 Nw. U. L. Rev. 641 (1991).

[41] See William Reese and Michael Weisbach, Protection of Minority Shareholder Interests, Cross-listings in the United States and Subsequent Equity Offerings, (Working Paper 2000 available on the SSRN Electronic Network at _ ID= 194670).

hands or limits the discretion of those who might violate those norms. For example, inclusion in the corporate charter of a provision establishing preemptive rights should logically have as much real world impact as the existence of legal rule that mandates preemptive rights. Whether more precatory statements by the corporation not accompanied by measures giving rise to enforceable rights also impact on a firm's valuation is more open to question, because the existing research has not yet isolated the specific elements in corporate governance policies that affect market value.

Even if precatory corporate signals to the market (i.e., those not accompanied by actions that limit the discretion of the self-interested) do effect market value (as is certainly possible), it should not be assumed that the market has necessarily found its equilibrium position. Such precatory signals are relatively costless, and if they do effect market value, it can be assumed that many firms will eventually send them. At this point, a Gresham's Law of promises may take hold, as "bad" signals will proliferate and drive out the "good." Eventually, as in the classic "lemons market," all such signals will be discounted equivalently, because investors cannot discriminate between the "honest" signals and the "false" signals (at least in the absence of actions that truly commit the corporation to a promised course of action).[42]

For these reasons, this author is less optimistic than Professor Black that higher corporate governance rankings will correlate with higher corporate valuations. But the issue is open, at

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[42] See George Ackerlof, The Market for Lemons: Qualitative Uncertainty and the Market Mechanism, 84 Q. J. Econ. 488 (1970). Ackerlof's point was that when buyers in a market (including investors in the securities market) cannot distinguish "good" from "bad" merchants, they will discount all more or less equally. To escape this dilemma, signals must be credible -- particularly once they become common.

least to the extent that creative legal engineering may make such signals credible. Those who succeed will be amply rewarded.

Conclusions

Norms do matter, but exactly when and how much remain more problematic issues. The magnitude of the variations in the private benefits of control across countries cannot be satisfactorily explained simply in terms of differences in substantive corporate law or associated enforcement systems. Law compliance also varies across countries, although not in a manner that systematically parallels the variations in the private benefits of control. Still, to varying degrees, social forces that are independent of any legal sanction constrain managers and controlling shareholders. What explains the striking variations among countries remains, however, largely unexplained.

One tentative generalization may, however, be advanced: Norms may matter most when law is the weakest. When formal law does not adequately protect shareholders, the strength of social norms becomes more important, because they could provide a functional substitute for law. Conversely, when legal rights and remedies adequately protect investors, there is less need for corporations to signal their intentions to observe standards that are already legally mandated or to develop creative means by which to bond those promises through self-help corporate governance measures. This may explain why corporate governance measures have seldom been found to affect the corporation's stock price in the U.S., but apparently do have such an impact in Russia.[43]

When law is weak and social norms about shareholders' rights are also underdeveloped (as appears to be the case today in Russia and possibly French Civil Law countries), then credible

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[43] See Black, supra note 11, at __.

signals about the corporation's intentions (and those of its controlling shareholders) become critical. The open question is when such a signal will be credible. Obviously, the more it is made enforceable, the more it becomes a functional substitute for legal rules. But even naked promises unaccompanied by corporate actions may sometimes work if the corporation has previously developed a reputational capital surplus that it can in effect pledge.[44] In these respects, both corporate practice and the task of corporate valuation may be more complex and challenging in transitional countries than in the Common Law world, where law and norms today come closer to coinciding.

[44] This concept of pledging a firm's reputational capital has long been used to explain why reputations are particularly important among financial intermediaries, and especially underwriters. See Ronald Gilson and Reinier Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549 (1984).