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Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy

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Abstract

The focus of comparative corporate governance scholarship is shifting from takeovers to controlling shareholders in recognition of the fact that public corporations everywhere but in the U.S. and U.K. are characterized by a shareholder with effective voting control.Debate is now turning to the merits of controlling shareholder systems, both on their own terms and in comparison to the U.S. and U.K. widely-held shareholding pattern. To date, the debate has treated the controlling versus widely-held distinction as central, disagreeing over whether a particular country owed its characteristic shareholder distribution to the quality of minority shareholder legal protection or to politics. This simple dichotomy is far too coarse to provide an understanding of the diversity of ownership structures and their policy implications. This article complicates the analysis of controlling shareholders and corporate governance by providing a more nuanced taxonomy of controlling shareholder systems. In particular, it distinguishes between efficient and inefficient controlling shareholders, and between pecuniary and nonpecuniary private benefits of control. The analysis establishes that the appropriate dichotomy is between countries with functionally good law, which support companies with both widely-held and controlling shareholder distributions, and countries with functionally bad law, which support only controlling shareholder distributions. In this account, the United States and Sweden are the same side, rather than on opposite sides of the dividing line. The articles examines the different understanding of the role of controlling shareholders in corporate governance and the policy implications that flow from a taxonomy that focuses on support of diverse shareholder distributions.

Keywords: corporate governance, shareholders systems, control.

JEL Classifications: G32, G38, K22

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Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy

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The big issue in corporate governance scholarship is in the process of changing. Over the last fifteen years, the focus of academic and policy debate has been on hostile takeovers. The terms and tenor of the debate in the United States are by now numbingly familiar. The same pattern is now observable in Europe[1], where the tone of the debate, if not necessarily its politics, seems to have moderated a great deal.[2]

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[1] Fifteen years ago, European and American views differed quite dramatically. Two quotes capture the tension of the period. In the face of the mainstreaming of hostile takeovers in the United States and United Kingdom's business culture and jurisprudence, Continental Europe had a radically different conception. The Chairman of the Deutschebank described hostile takeovers as one of the "blunders of American Capitalism." Ernst-Ludwig Von Thadden, On the Efficiency of the Market for Corporate Control, 43 Kyklos 635, 635 (1990) (citing Frankfurter Allegmeine Zeitung, Dec. 23, 1983) In turn, Francois Mitterand, the President of the French Republic, characterized hostile takeovers as "gangsterism and the law of the strongest." Id. (citing Le Monde, Gef. 14, 1989).

[2] Marco Becht, an active participant in the European academic debate and a sophisticated observer of the politics of European corporate governance, recently described the now civilized role for hostile takeovers in Europe: "An European market for corporate control is seen as an integral part of a single market and a major driver of European competitiveness, innovation and growth." Marco Becht, Reciprocity in Takeovers, ECGI Working Paper No. 14/2003 (Oct. 2003), available at http://ssrn.com/abstract=463003. To be sure, the European Parliament finally approved the aptly numbered Thirteenth Directive only in a form substantially diluted from a Commission proposal that would have gone a great deal further in establishing a European market for corporate control, but at

As the issues surrounding hostile takeovers have clarified, attention has begun to shift from debating a phenomenon observed largely in the United States and the United Kingdom, because only in those two jurisdictions is control of most public companies in the public float, to understanding the kind of control structure that dominates public corporations everywhere other than the U.S. and the U.K. Put simply, public companies in the rest of the world have a shareholder or group of shareholders with effective voting control, often but not invariably without corresponding equity holdings. Debate is now turning to the merits of controlling shareholder systems, both on their own terms and in comparison to the U.S. and U.K.'s widely-held shareholder systems.

In this article, I venture some early thoughts concerning how this inquiry might usefully be framed. As I will develop in more detail, the simple dichotomy between "controlling shareholder" systems and "widely-held shareholder" systems that has largely dominated academic debate thus far seems to me much too coarse to allow a deeper understanding of the diversity of ownership structures in different national capital markets and their policy implications. My goal here is to complicate our analysis of controlling shareholders and corporate governance by taking a first step in developing a more nuanced taxonomy of controlling shareholder structures, and then by examining the implications of this view on our understanding of widely-held and controlling shareholder systems. Most important, I will argue that this familiar dichotomy in fact is simply wrong, leading to the conclusion, surprising in terms of the current debate but straightforward in light of a more complicated taxonomy, that the appropriate distinction is between systems that support a diversity of shareholder distributions and systems that essentially support only a controlling

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least the debate came to be framed in terms of subsidiarity and reciprocity rather than by epithets like shareholder distribution. From this perspective, the United States and Sweden, typically thought of as, respectively, the quintessential widely-held and controlling shareholder systems, have much more in common with each other than Sweden has with most other controlling shareholder systems.

Important early work on controlling shareholder regimes has taken two general directions. The first, reflected in a series of articles by combinations of Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny,[3] linked the breadth of shareholder distribution and the quality of a jurisdiction's law. In this account, controlling shareholder regimes exist because a jurisdiction's legal system does not protect minority shareholders from diversion of private benefits of control by dominant shareholders. As a result, a controlling shareholder who takes a company public will not part with control; if she does, someone else will purchase control in the market and exploit her. The second direction finds the explanation for concentrated ownership patterns in politics. In an important book, Mark Roe identified social democratic politics as the driving force toward ownership concentration.[4] Where labor, through politics, speaks with a unified voice, capital must concentrate to respond effectively.

While important contributions, neither scholarly direction seems to me sufficient to explain the patterns of shareholder distribution we observe. As Roe notes, we observe controlling shareholder regimes in jurisdictions with good law, so law cannot explain the complete distribution. At the same time, we observe controlling shareholder regimes in countries without a serious social democratic movement, so politics is likely not all of the answer either. Additionally, because both approaches are essentially path dependency accounts – the initial condition,

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gangsterism.

whether quality of law or character of politics, dictates the pattern of shareholder distribution – they lack an efficiency account of the success of some controlling shareholder regimes. As I have argued elsewhere, "[t]he path dependent characteristics of a given national governance system confront the disciplining effects of the operative selective mechanisms. In the end, institutions are shaped by a form of corporate governance plate tectonics, in which the demands of current circumstances grind against the influence of initial conditions."[5] Thus, a more complete explanation for the distribution of shareholdings must incorporate politics, law and efficiency, together with the serendipity of each country's initial condition.

My effort to complicate the analysis of controlling shareholders and corporate governance proceeds as follows. Part I sets out some necessary background concerning both the phenomenon to be explained and prior efforts at explanation. Part II provides a framework to structure the analysis, the controlling shareholder tradeoff. Part III then begins to complicate the controlling shareholder taxonomy by defining good law functionally rather than formally, and then distinguishing between two very different kinds of controlling shareholders: efficient and inefficient controlling shareholders. The result is to transform the sharp dichotomy between controlling shareholder and widely-held shareholder distributions. Instead we see one category encompassing controlling shareholders regimes with functionally bad law, and a second, broader category encompassing regimes with functionally good law, that supports a diversity of shareholder distributions and includes both Sweden, which is characterized by companies with controlling shareholders, and the United States, which is characterized by companies with widely-held shareholdings. Part IV then

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[3] See note 17 infra.
[4] Mark J. Roe, Political Determinants of Corporate Governance (2003).
[5] Ronald J. Gilson, Corporate Governance and Economic Efficiency: When Do Institutions Matter?, 74 Wash. U.L.Q 327 (1996).

continues the effort at complication by distinguishing between two different kinds of private benefits of control: pecuniary and non-pecuniary private benefits. Part V concludes with a brief consideration of some policy implications that arise from a more complicated taxonomy of controlling shareholders.

I. Background: Facts and Generations of Scholarship

At the risk of belaboring a point that has become familiar, it is helpful to start by recounting the actual ownership structure of publicly traded corporations. Over the last 10 years, important empirical work has revealed that, excluding the United States and the United Kingdom, the world wide corporate governance landscape has a single monolithic feature: control of publicly traded corporations is typically lodged in a single individual, family or group.[6] Marco Becht, for example, reports that 82.5 percent of German listed companies, 65.8 percent of Italian listed companies, and 64.2 percent of Swedish listed companies, have a blocking shareholder minority of at least 25 percent.[7]

Table 1
Control Blocs in Selected Countries

	Germany	Italy	Sweden	Far East
Control > 25%	82.5%	65.8%	64.2%	---
Control > 50%	64.2%	56.1%	26.3%	67%

Source: Becht (2003); Claussens, Djankov & Lang (2000)

[6] See, e.g., Marco Becht & Colin Mayer, Introduction, in The Control of Corporate Europe (F. Barca & M. Becht, eds., 2001), Mario Faccio & Larry H.P. Lang, The Ultimate Ownership of Western European Corporations, 65 J.Fin. Econ. 365 (2002); Jeremy Grant & Thomas Kirchmaier, Who Governs? Corporate Ownership and Control Structures in Europe, working paper (2004), available at http://ssrn.com/abstract=555877; Stijin Classens, Simeon Djankov & Larry H.P. Lang, The Separation of Ownership and Control in East Asian Corporations, 58 J.Fin. Econ. 81 (2000); Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, Corporate Ownership Around the World, 54 J.Fin. 471 (1999).

[7] Becht, supra note 2.

Moving the control level up to a majority lowers the percentage of listed companies with a control block to 64.2 percent in Germany, 56.1 percent in Italy, and 26.3 percent in Sweden,[8] but the importance of controlling shareholders remains dramatic. For East Asian countries, Classens, Djankov and Lang found that a single shareholder controls more than two-thirds of listed firms.[9]

It is also commonplace in Europe for control by a dominant shareholder to result from structural devices that leverage voting rights above the level of equity investment. For example, Table 2 shows that 66 percent of listed Swedish companies, 51.7 percent of listed Swiss companies, 41.3 percent of listed Italian companies, and 17.6 percent of listed German companies issue dual classes of common stock, with one class having dramatically higher voting rights.[10] Control is also frequently enhanced through the use of pyramids and multiple control chains.[11] The pattern is repeated in East Asia.[12]

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[8] Id. at 19.
[9] Classens, Djankov & Lang, supra note 6.
[10] Becht, surpa note 2,. at Table 6. Dual class shares are rarely used in Portugal, Spain, Belgium and France. Id. In Sweden, for example, Rolph Skog reports that controlling shareholders in companies with dual class shares have 41 percent of the votes but only 21 percent of the equity. Rolph Skog, The European Union's Proposed Takeover Directive, the "Breakthrough" Rule and the Swedish System of Dual Class Common Stock 14 (working paper, 2003).
[11] Becht, supra note 2, at Table 7. For example, of the firms in Germany with a control bock of 20 percent, 22.89 percent use a pyramid structure and 7.22 percent use a multiple control chain to leverage their equity. See Randall Morck, Daniel Wolfenson & Bernard Yeung, Corporate Governance, Economic Entrenchment and Growth, NBER Working Paper #10692 (Aug. 2004)(discussing use of pyramid structure); Grant & Kirchmaier, supra note 6 (same).
[12] "East Asian firms also show a sharp divergence between cash-flow rights and control rights – that is, the largest shareholder is often able to control a firm's operations with a relatively small direct stake in its cash flow rights." Stijn Classens, Simeon Djankov, Joseph P.H. Fan & Larry H.P. Lang, Disentangling the Incentive and Entrenchment Effects of Large Shareholdings, 57 J.Fin. 2741, 2742 (2002).

Table 2
Use of Structural Devices to Leverage Voting Rights

	Sweden	Switzerland	Italy	Germany
% of listed companies with dual class stock	66%	51.7%	47.3%	17.6%

Source: Becht (2003)

The initial reaction to the empirical reality that systems in which control of most listed companies is in the public float are the exception rather than the rule reflected a teleological view of the evolution of capital markets. A U.S./U.K. style widely-held distribution of stock ownership and control was seen as the end point of corporate governance evolution; progress consisted of accelerating what selection would make inevitable. While there were some early skeptics – Masahiko Aoki with respect to "J-Form" governance in Japan[13] and Julian Franks and Colin Mayer with respect to "inside systems" in Europe[14] were among the most tenacious – global policy seemed to be influenced by this belief. A preference for dispersed shareholdings was plainly evident in the IMF and the World Bank's response to the 1997-1998 East Asian financial crisis; financial assistance was conditioned not just on macroeconomic criteria, but also on corporate governance reform.[15] The same

[13] See, e.g., Masahiko Aoki, Toward an Economic Model of the Japanese Firm, 28 J.Econ. Lit. 1 (1990).
[14] See, e.g., Julian Frank & Colin Mayer, Capital Markets and Corporate Control: A Study of France, Germany and the UK, 10 Econ. Pol'y 189 (1990)
[15] See, e.g., Timothy Lane, et. al., IMF-Supported Programs in Indonesia, Korea, and Thailand 72-73 (Int'l Monetary Fund Occasional Paper No. 178, 1999); Asia Pacific Talks Vow Tough Action on Economic Crisis, N,Y.Times, Nov. 26, 1997, p. A1. Ronald Dore captured something of the tone of this perspective in relation to Japan:

preference also seems to explain the centrality of breakthrough rules in the debate over the Commission's 2002 proposal for a Thirteenth Directive on takeovers.[16]

In turn, this quite skeptical view of controlling shareholder regimes was provided academic support by a growing "law and finance" literature that sought to reveal the empirical links between measures of the quality of legal regimes and the nature of national capital markets and corporate governance systems.[17] For present purposes, a particular claim is central – that a controlling shareholder structure is associated with "bad law." Where minority shareholders are not protected from controlling shareholders extracting large private benefits of control, the argument runs, entrepreneurs will not part with control through public offerings because they then would run the risk of their own subsequent exploitation by someone who assembles control through the market and whose extraction of private benefits would be unchecked by the legal system. Under this analysis, controlling shareholder systems will be characterized by weak equity markets – too much liquidity tied up in control blocks – and by large differences in the value of controlling and minority blocks as a result of private benefit extraction by the controlling shareholder.

> What … all these slogans [concerning Japanese capital market reform] add up to is a general belief that (1) the principles according to which the typical neoclassical economics textbooks say the economy works are a priori correct principles, (2) those principles are best exemplified in the American economy; (3) the rightness of those principles is further confirmed by American success, and (4) Japan's present plight is not just a cyclical phenomenon and a debt-deflation hangover from the bubble; it is the natural and wholly just retribution on Japan for not following these principles.

Ronald Dore, Japan's Reform Debate: Patriotic Concern or Class Interest? Or Both?. 25 J. Japanese Stud. 65, 66 (1999).

[16] As sent to the European Parliament for approval in 2001, the proposed Thirteenth Directive limited the operation of structural features like dual class common stock with different voting rights when a bidder secured more than 75 percent of the target's equity. The result would have been to move the European corporate governance environment in the direction of the U.S./U.K. pattern.

[17] See, e.g., Rafael LaPorta, Florencio Lopez-de-Silanes & Andrei Shleifer, Corporate Ownership Around the World, 54 J.Fin. 471 (1999); Rafael LaPorta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, Legal Determinants of Outside Finance, 52 J. Fin. 1131 (1997); Rafael LaPorta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, Law and Finance, 106 J.Pol. Econ. 113 (1998); Rafael LaPorta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, Investor Protection and Corporate Ownership, 58 J. Fin. Econ 3 (2000). Charles P. Himmelberg, R. Glenn

This brings us to a more recent, emergent generation of scholarship that, at present, stresses two themes. The first, largely positive, argues that the parsimony of the law and finance taxonomy – whether or not a national system is characterized by controlling shareholders – camouflages a much more complicated reality. In fact, countries with both good and bad law are characterized by controlling shareholder systems.[18] For example, both Mexico with bad law, and Sweden with good law, have controlling shareholder systems. Moreover, countries with a controlling shareholder system experience dramatically different levels of private benefit extractions, at least as they have been measured so far.[19] To stay with the same example, Mexican controlling shareholders are said to expropriate approximately half the value of the company;[20] in contrast, expropriation by Swedish controlling shareholders is limited to approximately 1 percent of company value.[21]

To further complicate the controlling shareholder landscape, controlling shareholders come in different forms – for example, families as opposed to widely-held corporations – and hold control through different devices; as we have seen some controlling shareholders' control is matched by their equity investment, while others' control is leveraged through structural devices like dual class stock and pyramids. At least in some countries, early empirical studies suggest that the level of private benefit extractions differs among different types of controlling shareholders. Benefit

Hubbard & Insessa Love, Investor Protection, Ownership, and Investment: Some Cross-Country Evidence (working paper, Sept. 2000), reaches a similar result using different econometric techniques.

18 See M. Roe, supra note 4.

19 See text at notes 36 - 42 infra.

20 See Tattiana Nenova, The Value of Corporate Voting Rights and Control: A Cross-Country Analysis, 68 J.Fin. Econ. 325 (2003).

21 Mark Roe's emphasis on politics as a determinant of shareholder distribution focuses on good law jurisdictions, but it is equally applicable to a bad law jurisdiction. The demand for law is, tautologically, politically driven. Thus, as we will see later, there will be a political story in every jurisdiction. For example, political motivations are an important influence on business in countries without a social democratic tradition. See, e.g., Pramuan Bunkanwanicha & Yupana Wiwattanakantang, Tycoons Turned Leaders, working paper, Jan. 2005 (Companies whose executives become high political officials outperform similar companies after the executives achieve office).

extraction is lower when the controlling shareholder's stock is widely-held, as opposed to family owned, and when the divergence between control and equity is smaller.[22]

Recognition of the variety of types of controlling shareholders and their potential for having different impacts on minority shareholders gives rise to a second, and as yet more tentative, theme in the new generation of controlling shareholder scholarship. What, after all, is wrong with controlling shareholder systems? Here the concern is normative. If controlling shareholder regimes do not *necessarily* lead to large private benefits of control at the expense of minority shareholders, is there really a problem? In turn, this point reads back on the Law and Finance lock-in theme. If controlling shareholders need not fear subsequent dilutive private benefit extraction if they part with control because private benefits of control are low, why do we still observe a pattern of concentrated shareholdings? This defense of controlling shareholder regimes surfaces clearly in Sweden's energetic defense of its dual class voting structure within the European debate over the Thirteenth Directive.[23]

So where does this recitation of familiar facts and emerging scholarly themes leave us? When the world seems more complicated than what our theory can explain, we probably do not yet understand the world. Put differently, perhaps the mistake is in thinking that the critical factor in understanding corporate governance systems as different as those of the Far East, Latin America, Europe and Scandinavia, is their shared controlling shareholder systems broadly defined.[24] And if this is right, then we

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[22] Classens, et. al., supra note 6 (East Asia); Karl V. Lins, Equity Ownership and Firm Value in Emerging Markets, 38 J.Fin. & Quant. Analy. 159 (2003).
[23] See Skog, supra note 10.
[24] Tolstoy's complication of the dichotomy between good and bad families captures the point nicely: "Happy families are all alike; every unhappy family is unhappy in its own way." Leo Tolstoy, Anna Karenina 3 (1963) (translated by Constance Garnett). While jurisdictions with widely distributed shareholdings likely share a common set of characteristics, the intuition is that controlling shareholders regimes differ in important ways among themselves.

need a richer taxonomy of controlling shareholder systems than we are currently using. In this essay, I propose to take a first step in responding to that deficiency by looking more closely at two central features of a more complex taxonomy: what is a controlling shareholder, and the concept of private benefits of control. Both complications turn out to provide useful insights into the role of controlling shareholders in corporate governance.

II. A Framework for Analysis

The first step in complicating the taxonomy of controlling shareholders is to understand what Jeffrey Gordon and I have called the controlling shareholder tradeoff.[25] The role of controlling shareholders lies at the intersection of the two elements of the agency problem that is at the core of public corporation governance. The first element is the familiar agency problem that arises from the separation of ownership and control. This is the domain of governance devices like hostile takeovers and independent directors that have been the focus of so much attention over the last 20 years. While important techniques, these efforts to bridge the separation have significant limitations. Getting the incentives of independent directors right is difficult: paying them enough to secure their full attention may be inconsistent with their independence. Takeovers, in turn, are rather blunt instruments: they are responsive to only some kinds of governance problems,[26] and the large premium necessary for success both emphasizes their large transaction costs and makes them appropriate only for very large problems.

[25] The following discussion draws on Ronald J. Gilson & Jeffrey Gordon, Controlling Controlling Shareholders, 152 U.Penn. L.Rev. 785 (2003)

[26] For example, hostile takeovers may be an effective device at breaking up inefficient conglomerates, which requires little internal information to sell off unrelated businesses, while fixing the problems of a single business may require deep local knowledge of the business that may not be available to an outside owner.

From this perspective, a controlling shareholder may better police the management of public corporations than the standard panoply of market-oriented techniques employed when shareholdings are widely-held. This is the point that motivates the efficiency defense of controlling shareholder systems. Because of a large equity stake, a controlling shareholder is more likely to have the incentive either to effectively monitor managers or to manage the company itself and, because of proximity and lower information costs, may be able to catch problems early. Rather than being the result of functionally bad law, a controlling shareholder system is in this view an alternative to the frictions associated with ameliorating the separation of management and control that inevitably arises from widely-held shareholdings.[27]

The second element of the public corporation agency problem is the conflict between a controlling shareholder and non-controlling shareholders over the potential for the controlling shareholder to extract private benefits of control – benefits to the controlling shareholder not provided to the minority shareholders (and that drive the bad law/controlling shareholder regime nexus). Thus, controlling shareholder monitoring as a means to ameliorate managerial agency problems also comes with frictions. Conditional on maintaining control, the less equity the controlling shareholder has, the greater the incentive to use control to extract private benefits; increased productivity accrues to shareholders proportionally to their equity, while private benefits of control are allocated based on governance power. A controlling shareholder may increase productivity by effectively managing the company or by

[27] This is consistent with empirical findings that firm value increase in the level of inside ownership, at least over the lower ranges. See, e.g., Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, Investor Protection and Corporate Valuation, 57 J.Fin. 1147 (2002); John McConnell & Henri Servaes, Additional Evidence on Equity Ownership and Corporate Value, 27 J.Fin. Econ. 595 (1990); Randall Morck, Andrei Shleifer & Robert Vishny, Management Ownership and Market Valuation, 20 J.Fin. Econ. 293 (1988).

effectively monitoring managers, but may take more than its share of the gain.[28] As we will see later, leveraged control may create an incentive to adopt strategies that reduce productivity if private benefits of control are increased sufficiently.

There is, however, a point of tangency between these two elements. Because controlling shareholders must bear liquidity and non-diversification costs from holding a concentrated position as well as the direct costs of monitoring, some private benefits of control likely are necessary to induce a party to play that role. Thus, from the public shareholders viewpoint, the two elements of the corporate agency problem present a tradeoff. Public shareholders will prefer a controlling shareholder as long as the benefits from reduction in managerial agency costs exceed the private benefits that the controlling shareholder will extract.

Framing the controlling shareholder structure as an alternative to techniques such as independent directors and takeovers as a monitoring device, whose attraction depends on a trade off between increased monitoring and increased private benefit extraction, provides a framework to better understand the complexity of controlling shareholder systems and the role of law. Different law may result in particular controlling shareholder systems having very different costs and benefits.

III. Complicating the Controlling Shareholder Taxonomy: Different Kinds of Controlling Shareholders

The central implication of the controlling shareholder tradeoff framework is that the fact that a country has a controlling shareholder governance system is too

[28] This is consistent with empirical findings that firm value decreases in the difference between equity ownership and voting control. See Classens et. al., supra note 6; Lins, supra note 22; Paul Gompers, Joy Ishii & Andrew Metrick, Incentives vs. Control: An Analysis of U.S. Dual Class Companies, NBER Working Paper 24 (Jan. 2004).

general an observation to tell us very much.[29] A first cut at a more complicated taxonomy recognizes that a national pattern of concentrated control of publicly traded corporations can be consistent with two very different equilibria. First, the ownership pattern may reflect a structure of *inefficient* controlling shareholders, where because of bad law the cost of private benefit extraction exceeds the benefits of more focused monitoring of management – minority shareholders are net worse off from the controlling shareholder's monitoring effort. Alternatively, the ownership pattern may reflect a structure of *efficient* controlling shareholders, where because of good law the benefits of more focused monitoring exceeds the cost of private benefit extraction and the value of minority shares increases as a result. From this perspective, an inefficient controlling shareholder regime is a drag on the financial system, while an efficient controlling shareholder regime can be a preferred alternative to market-based monitoring.

This first step toward a more complex typology seems to have a good deal of explanatory value. Without the ambition of being exhaustive, I survey in the remainder of this Part the implications that follow from distinguishing between inefficient and efficient controlling shareholder systems.

A. Inefficient and Efficient Controlling Shareholder Systems and the Quality of Law

First, a more complex taxonomy provides a context to understand the more nuanced empirical studies of controlling shareholder systems and, in particular, the role of legal and quasi-legal institutions in supporting a particular ownership pattern. For purposes of this inquiry, I have in mind the legal realist's broader concept of law than typically reflected in the law and finance literature. Good law limits private

[29] To be frank, it is hardly a startling implication that a taxonomy that divides the world into two categories – the U.S. and the U.K on the one hand and everyone else on the other – does not tell us very much about the rest ot the world. The payoff has to come from the complications that follow.

benefits of control to amounts that are smaller than the increased productivity from more focused monitoring. To accomplish this, good law must specify substantive standards; require sufficient disclosure that those with the power to enforce the standards know of violations; and provide an effective enforcement process.[30] This can be accomplished through detailed legislation, as with European laws governing corporate groups, or by judicially developed principles of fiduciary duty, as in the United States.[31]

In turn, standard setting can be accomplished by formal legal rules or, as is particularly important in the United Kingdom, through private regulatory organizations. Further, the effectiveness of legal rules is influenced by the interaction of other social institutions. For example, the specification of substantive standards is facilitated by social norms as is the effectiveness of enforcement (the operation of one's conscience has low transaction costs).[32] Similarly, an energetic and uncensored press is complimentary to the formal disclosure process.[33] Thus, while it is relatively easy to describe the requirements of good law in this broader functional sense, it is much more difficult to capture empirically other than through simple backward induction – countries with low private benefits of control must have functionally good law.[34]

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[30] See Bernard Black, The Core Institutions that Support Strong Security Markets, 55 Bus. Law. 1565 (2000).

[31] Vice Chancellor Strine's review of the behaviour of Lord Black, the controlling shareholder of Hollinger, Inc., is a good example of judicial standard setting. Hollinger Intn'l Inc. v. Black, 844 A.2d 1022 (Del. Ch. 2004).

[32] See John C. Coffee. Jr., Do Norms Matter? A Cross-Country Examination of Private Benefits of Control, 149 U.Pa. L.Rev. 2151 (2001). Economists have examined this intuition empirically by studing the impact of differences in a country's dominant religion – presumably a powerful source of norms – on economic growth. See Rafael La Porta, Florencio Lopez-de-Silanas, Andrei Shleifer & Robert Vishny, Trust in Large Organizations, 87 Am. Econ. Rev. 333 (1997).

[33] Alexander Dyck & Luigi Zingales, Private Benefits of Control: An International Comparison, 59 J.Fin. Econ. 537 (Dec. 2004).

[34] For example, Dyck and Zinglaes, supra note 33, argue that a strong press is an alternative to good law; it may substitute for gaps in the formal disclosure regime and, by publicizing norm violating conduct, substitute through public shaming for gaps in the formal enforcement regime. Here I note simply that the public press is itself much more effective when there is effective legal disclosure

Now recall that the initial claim made by the law and finance literature was that controlling shareholder systems were associated with functionally bad law: entrepreneurs retained control to protect themselves against private benefit extraction by someone who might subsequently assemble control if the existing controller gave it up. Having retained control, the entrepreneur then exploits it by extracting private benefits of control. This framework has clear empirical implications. In inefficient controlling shareholder systems (1) the value of controlling shares should be dramatically larger than minority shares; and (2) the extent of private benefits will decrease in the amount of the controlling shareholders' equity holdings and increase in the difference between percentage of control and percentage of equity. In contrast, efficient controlling shareholder systems will be characterized by functionally good law; that is, law and related social institutions that effectively limit private benefit extraction to an amount necessary to compensate a controlling shareholder for the costs of focused monitoring and which is less than the benefit from focused monitoring. Thus, in efficient controlling shareholder systems (3) the value of controlling shares will exceed that of minority shares by a much smaller amount than in inefficient controlling shareholder systems.

The new generation of scholarship supports all three implications of the controlling shareholder tradeoff framework. The level of private benefit extraction should be reflected in the difference in value between controlling and minority shares; only the value of controlling shares includes the net present value of expected private benefits of control. As shown in Table 3, the level of private benefit extraction in functionally bad law regimes is large whether measured by the difference between the

regime. Thus, one may reason backwards from the presence of an effective press to the existence of an effective disclosure regime.

market price of high voting and low voting shares,[35] or by the size of the premium paid for a controlling block.[36] Measured by differential market price, control represents approximately 36 percent of firm value in Mexico, 29 percent in Italy, and only 1 percent in Sweden.[37] Mexico and Italy are typically characterized as bad law states and Sweden as a good law state. Measured by the size of block premium to the value of firm equity, control represents 34 percent of firm value in Mexico, 37 percent in Italy, and 7 percent in Sweden.[38] Both studies conclude that differences in the quality of law account for a large portion of the difference between countries.

Table 3
Differential between controlling and minority shares in CS systems depends on the quality of law

	Mexico	Italy	Sweden
•PBC measured by difference in market price	36%	29%	1%
•PBC measured by control block premium	34%	37%	7%

Source: Nenova (2003); Dyck & Zingales (2004)

A recent study of Southeast Asian countries, also characterized by functionally bad law, provides empirical support both for the relationship between the size of controlling shareholders' equity holdings and the extent of private benefit extraction, and for that between the size of the difference between equity ownership and control on the one hand and private benefit extraction on the other. In systems that are dominated by controlling shareholders, firm value increases in the equity share of the

[35] See Nenova, supra note 20.
[36] Dyck & Zingales, supra note 33.
[37] Nenova, supra note 20, at Table 3, p. 334.
[38] Dyck & Zingales, supra note 33 at Table II.

largest shareholder, and decreases with the size of the difference between control rights and equity holdings.[39]

Finally, the link between the level of private benefits extraction and the quality of law appears from the results of another empirical strategy. A recent study of large publicly traded companies in South Korean, a jurisdiction characterized by a controlling shareholder system, tracked the impact of a legal reform that mandated a majority of independent directors; i.e., the reform added a component of good law. Controlling for measures of productivity and all other governance characteristics, Black, Jang and Kim find that large firms with 50 percent outside directors, required by a recent change in South Korean law, experienced a 40 percent increase in stock price.[40] Of particular significance, the increase in stock price did not result from increased firm productivity; companies did not become more productive because of a majority of independent directors. Rather, the presence of a majority of outside directors appeared to have caused the market to value more highly the company's existing cash flow. The authors interpret their results as showing the importance of outside directors – i.e. functionally good law -- in controlling private benefit extraction by controlling shareholders: "The most likely reason why outside directors add value is that they may control self-dealing by controlling shareholders."[41]

[39] Claessens, Djankov, Fan & Lang, supra note 12.

[40] See Bernard S. Black, Hasung Jang & Woochan Kim, Does Corporate Governance Predict Firms' Market Value? Evidence from Korea (July 2003), Stanford Law & Economics Working Paper No. 237, http://ssrn.com/abstracts=311275. The authors do not address why the legal improvement actually worked. In a country like Korea where a controlling shareholder structure is commonplace and private benefits of control are large, one would expect that the new outside directors would not bring to their new job a commitment to constraining a pattern that was commonplace in the business community. Thus, while the empirical support for an important role for outside directors is strong, the explanation for that role remains interestingly ambiguous.

[41] Id. at 48. Making the same point a little differently, the authors state: "We do not find strong evidence that better governed firms are more profitable or pay higher dividends. We do find that investors value the same earnings or the same dividends more highly for better governed firms." Id. at 6. A similar result emerges in a recent study of market valuation of research and development investments in Europe. Hall and Oriani report that research and development investments by publicly traded Italian firms are not as highly valued by the market as similar investments by German and French firms. The authors attribute the difference to the potential for Italian controlling shareholders to

In short, then, the controlling shareholder tradeoff framework implies a different relationship between the quality of law and controlling shareholder regimes. As a first step, the quality of law distinguishes between types of controlling shareholder regimes: functionally good law supports efficient controlling shareholder systems; functionally bad law supports inefficient controlling shareholder systems. As a second step, in Section III.C., I will argue that this understanding of the relationship between quality of law and the character of a country's shareholder distribution undercuts the usual distinction between widely-held and controlling shareholder regimes.

B. Functional Convergence and Diversity of Shareholding Concentration.

In an efficient controlling shareholder system, concentration of control operates as a cost effective response to the managerial agency cost problem. It is observed when the benefits of more focused monitoring exceed the limited extraction of private benefits of control allowed in a country with functionally good law. This represents a form of functional convergence – within limits, different corporate governance systems may solve the same monitoring problem through different institutions.[42]

As well, we can expect diversity – different firm level ownership patterns – within the same efficient controlling shareholder system. The efficiency advantages

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appropriate the returns on the research and development investments. The authors report that they "found a positive relationship between R&D and market value only after controlling for the eventual control by the major shareholder." Bronwyn H. Hall & Raffaele Oriani, Does the Market Value R&D Investment by European Firms: Evidence from a Panel of Manufacturing Firms in France, Germany, and Italy 24 (working paper, 2004), available at http://ssrn.com/abstracts=528989.

[42] See Ronald J. Gilson, Globalizing Corporate Governance: Convergence of Form or Function, 49 Am. J.Comp. L. 329, 332-33 (2001); Ronald J. Gilson, Corporate Governance and Economic Efficiency, 74 Wash. U.L.Q. 327, 332-33 (1996). For example, a controlling shareholder's extraction of private benefits of control by a controlling shareholder can be constrained by rules against self-dealing, or by a mandatory bid rule that forces the controlling shareholder to increase its equity ownership and thereby decrease the attraction of benefits distributed based on control rather than equity. Gilson, Globalizing Corporate Governance, at 336-37. Note also how this account intersects with Mark Roe's political account of concentrated ownership. See Roe, supra note 4. Roe explains why the politics of a particular country may lead to concentrated ownership. The efficiency account here helps explain why concentrated ownership regimes in some countries succeed economically and those in others do not – politics alone does not explain this difference.

of a controlling shareholder in a system with good law that minimizes the potential for private benefit extraction depends on the value gain that results from more focused monitoring of management performance than possible with market-based techniques like independent directors and the market for corporate control.[43] So, following Demsetz and Lane,[44] the size of this value gain, in turn, should be sensitive to differences in industry, companies, and controlling shareholders. For example, focused monitoring by a controlling shareholder may have no comparative advantage over market-based monitoring when competition in the product market is sufficiently intense. So, in high technology industries characterized by intense product market competition and rapid technological change, we may observe companies with widely distributed shareholdings even in an efficient controlling shareholder system. These alternative monitoring techniques make even limited private benefit extraction to pay for more focused monitoring unnecessary.[45] Similarly, a firm's industrial organization may influence the effectiveness of different monitoring systems. Large private benefits of control require a mechanism to move large amounts of funds. The easiest way, short of simple theft, is to use transfer pricing favorable to the company in which the controlling shareholder has the larger equity interest. A controlled group of firms whose businesses do not lend themselves to intra-group supply transactions may credibly signal that private benefits of control are low.[46] This technique would

[43] The focus on the benefits of monitoring performance rather than merely the costs of private benefit extraction distinguishes this discussion from that of Mike Burkhart, Fausto Panunzi & Andrei Shleifer, Family Firms, NBER Working Paper 8776 (Feb. 2002), which treats monitoring as extending principally to the consumption of private benefits by a non-owner manager.

[44] See Harold Demsetz, The Structure of Ownership and Control and the Theory of the Firm, 26 J. L. & Econ. 375 (1983); Harold Demsetz & Kenneth Lane, The Structure of Corporate Ownership: Causes and Consequences, 93 J. Pol. Econ, 1155 (1985)(Breadth of shareholder distribution is endogenous to the corporation's productive activity).

[45] For discussion of product market competition as a monitoring mechanism, see Mark Roe, Rents and Their Corporate Law Consequences, 53 Stan. L.Rev. 1463 (2001); Dyck & Zingales, supra note 33.

[46] It is important to stress that the signal's credibility depends on the structure of the controlled group rather than on the quality of a country's law. As a result, the technique is available to companies in inefficient controlling shareholder regimes. While the absence of intra-group transfers reduces the

be especially important to a company in a bad law country that did not wish to extract private benefits of control. A signal of this type depends on industrial organization, not on the legal system.

Diversity also may result from differences between particular controlling shareholders with respect to their taste for or skill at focused monitoring. Such differences may tip the balance between a controlling shareholder distribution and a widely-held shareholder distribution for a particular company, so that some diversity of shareholder distribution may exist in an efficient controlling shareholder system even within the same industry. Thus, the controlling shareholder tradeoff framework predicts diversity of ownership structures within an efficient controlling shareholder system. We should see companies with both controlling shareholders and widely-held shares.[47]

In contrast, the controlling shareholder tradeoff framework predicts much less diversity of ownership structures within an inefficient controlling shareholder system. In the absence of constraints on pecuniary private benefit extraction by a subsequent acquirer of control, an existing controlling shareholder cannot part with control without running the risk of subsequent exploitation. The only viable strategy for a controlling shareholder who lacks the taste for control then would be to sell control to someone who would more effectively use that control, rather than dissipate control through a public offering. To be sure, this analysis does not rule out the presence of any widely-held companies in an inefficient controlling shareholder regime. For

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potential for private benefits of control, such transfers can also take place through "bail-out" mergers among companies in which the controlling shareholder owns more of a poorly performing target company than she does of the better performing acquiring company. See Kee-Hong Bae, Jun-Koo Kang & Jin-Mo Kim, Tunneling or Value Added? Evidence from Mergers by Korean Business Groups, 57 J. Fin. 2695 (2002)(evidence of value transfers to controlling shareholder in intra-chaebol mergfers).

[47] Part IV takes up in greater detail the importance of differences in tastes among controlling shareholders in an efficient controlling shareholder system.

example, companies that begin as widely-held, perhaps through privatization, may survive, especially if the nature of the business restricts the opportunities for transferring value to a controlling shareholder. Nonetheless, we would expect there to be less diversity of shareholder distribution among companies in an inefficient controlling shareholder system than in an efficient controlling shareholder system.

The available data support this prediction. Table 4 shows the percentage of widely-held and family controlled public corporations in Sweden, an efficient controlling shareholder system (one that constrains private benefits of control), and in Italy, an inefficient controlling shareholder system (one that does not constrain private benefits of control. While Sweden exhibits rough parity between publicly traded

Table 4
Distribution of Controlling Shareholder and Widely-held Companies in Sweden and Italy

	Controlling Shareholder (family)	Widely-held
Sweden	46.94 %	39.18 %
Italy	59.61 %	12.98 %

Source: Mara Faccio & Larry H.P. Lang, The Ultimate Ownership of Western European Corporations Table 3 (working paper,2003)

companies with a controlling shareholder and those with widely-held shareholder structures, Italy has close to 5 times more companies with controlling shareholders than companies whose shares are widely-held.[48]

[48] Comments from participants in workshops in Italy at which an earlier draft of this article was presented expressed skepticism that as many as 12.98 percent of Italian public companies were widely held. A common theme was that the companies included within this number were either newly privatized entities whose special structure prevented the aggregation of control form the outside, or companies where there was a de facto controlling shareholder whose identity and control arrangements

C. Diversity and Recasting the Dichotomy between Controlling Shareholder and Widely-Held Shareholder Systems.

As described at the outset of this article, the main theme of the new comparative corporate governance debate has been the difference between systems characterized by companies with controlling shareholder and systems characterized by companies whose shares are widely-held. Recognizing that different distributions of shareholdings coexist in functionally good law jurisdictions calls into question the usefulness (and accuracy) of this central feature of the comparative taxonomy. The United States is treated as the quintessential widely distributed system. However, the U.S. also has a large number of corporations with controlling shareholders. Most prominently of late, both Google and Dreamworks went public with a "Swedish" capital structure – the founders retained stock with ten times the voting power of the class of common stock sold to the public. Recent research reports 255 U.S. publicly traded companies with dual class stock,[49] and 34 percent of the S&P 500 companies with founder family equity ownership, whose holdings average 18 percent.[50] From this perspective, the U.S. and Sweden no longer fall on opposite sides of a widely-held/controlling shareholder dichotomy, but are points on a single functionally good law continuum, with the placement of a jurisdiction at a particular point in time reflecting the particular history of the jurisdiction and the company, and the current dynamics of industrial organization and capital markets.

The idea that the appropriate taxonomic line is between countries whose systems support companies with diverse patterns of share distributions (widely-held

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would not appear from the public records. These observers estimated that there were very few widely held Italian public companies.

[49] Gompers, Ishii & Metrick, supra note 28.

[50] Ronald C. Anderson, Sattar A. Mansi & David. M. Reeb, Founding Family Ownership and the Agency Cost of Debt, 68 J. Fin. Econ, 263 (2003). Randall Morck & Bernard Yeung, Family Control

shareholder systems and efficient controlling shareholder systems) on the one hand, and inefficient controlling shareholder systems on the other, finds further support in data that shows that companies with controlling shareholders, and especially family controlling shareholders, perform worse than comparable companies in inefficient controlling shareholder systems,[51] and better than comparable companies in efficient controlling shareholder systems, at least when the family member involved in the company's operations is the founder rather than an heir.[52] This outcome is consistent with the controlling shareholder tradeoff developed in Part II. Where functionally good law constrains the level of private benefits of control, minority shareholders benefit from a controlling shareholder's more focused monitoring, leading to better performance. Absent constraints on private benefits, minority shareholders are net worse off from a controlling shareholder. In countries where good law supports diverse patterns of shareholders, the cost of a controlling shareholder increases when power shifts from the founder to an heir, but here the problem is not a problem of the legal system, but a regression to the mean in the talents of the founder's families.

While this analysis puts the United States and Sweden on the same side of a functionally good/functionally bad law divide, rather than on opposite sides of a divide based on the prevalence of controlling shareholders, there remains, of course, the question of explaining the differences between the two systems. While we observe controlling shareholders in both systems, publicly held Swedish public companies are characterized by controlling shareholders and U.S. public companies are characterized by widely-held shareholdings. I will return to this question in the

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and the Rent-Seeking Society, Davidson Institute Working Paper #585 (June 2003), report that 20 percent of large U.S. publicly traded firms have families with shareholdings of 20 percent or greater.

[51] Morck, Wolfenzon & Yeung, supra note 11; Maria Faccio, Larry P.H. Lang, & Lesllie Young, Dividends and Appropriation, 91 Am. Econ. Rev. 54 (2001).

next Part, after introducing another complication: the distinction between pecuniary and non-pecuniary private benefits of control.

D. Path Dependency in Patterns of Shareholder Distribution

In the preceding section, the controlling shareholder tradeoff framework suggested that in countries with functionally good law (both widely-held and efficient controlling shareholder systems) an individual company has available to it both a controlling shareholder distribution and a widely-held distribution. Conditional on the presence of good law, in some industries and in some circumstances a controlling shareholder structure may be superior. In others, a widely-held shareholder structure may be superior. Finally, the two patterns of shareholdings may in some circumstance be functional substitutes; that is, they have equivalent monitoring capacity. In the absence of extremely competitive markets and rapid technological or market change, the domain over which the two patterns are substitutes may be substantial.

In the domain where the two patterns are substitutes, the ultimate outcome may be path dependent; that is, the pattern that develops will turn on a set of initial conditions driven by factors other than efficiency, and with the passage of time will prove costly to change even if a different pattern becomes more efficient at a later date.[53] So, for example, recent studies of the origins of the shareholding patterns in the U.K and Sweden, in the end both functionally good law countries, stress local, non-efficiency factors as explanations for each country's start down a path toward

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[52] Anderson, Mansai & Reeb, supra note 50, at 265; Ronald C. Anderson & David M. Reeb, Founding-Family Ownership and Firms Performance: Evidence from the S&P 500, 58 J. Fin. 1301 (2003); Morck, Wolfenson & Yeung, supra note 11.

[53] The application of a path dependency analysis to explain differences in industrial organization dates to Michael J. Piore & Charles F.Sabel, The Second Industrial Divide (1984), in which the point was to explain on non-efficiency grounds the U.S. pattern of mass production and the European pattern of smaller team oriented organization. For applications in the corporate governance context, see Lucian Ayre Bebchuk & Mark J. Roe, The Theory of Path Dependence in Corporate Ownership and Governance, 52 Stan. L.Rev. 127 (1999).

widely-held or controlling shareholder systems.[54] Once on that path, and contingent on functionally good law, there is little to cause to change. Both systems support efficient production, and will persist unless significant environmental change or, as we will see, firm specific problems, substantially alters the balance. For a controlling shareholder system, the frictions that hold the pattern in place range from the lock-in effect of capital gains taxes on the sale of a controlling position,[55] to the fact that even if functionally good law keeps the size of pecuniary private benefits of control low, it may do little about non-pecuniary private benefits, a distinction that will be addressed in the next Part. As a result, persistence in shareholder distribution in efficient controlling shareholder systems will depend in part on the persistence of controlling shareholder tastes. Anticipating the outcome of the next Part's analysis, an efficient controlling shareholder system may be less stable than an inefficient controlling shareholder system, and less dynamic than a widely-held shareholder system.

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[54] See Peter Högfeldt, The History and Politics of Corporate Ownership in Sweden, ECGI Finance Working Paper No. 30/2003 (Sept. 2003), available at http://ssrn.com/abstract=449460 (pattern the result of coalition between labor and family owners to socialize capital without public ownership); Julian Franks, Colin Mayer & Stefano Rossi, The Origination and Evolution of Ownership and Control, ECGI Working Paper No. 9/2003 (Jan. 2003), available at http://ssrn.com/abstract =354381 ("[T]he U.K. is fundamentally different from most other countries." UK shareholding patterns were the result of implicit contracts enforced by informal relations of trust and confidence that encouraged participation of largely local outside investors). See Brian R. Cheffins, Mergers and the Evolution of Patterns of Ownership and Control: The British Experience, 46 Bus. Hist. 256 (2002); Brian R. Cheffins, Law as Bedrock: The Foundations of an Economy Dominated by Widely Held Public Companies, 23 Ox. J.Leg. Stud. 1 (2003); Brian R. Cheffins, Are Good Managers Required for a Separation of Ownership and Control, 13 Indus. & Corp. Change 591 (2004). In both cases, the path dependency story is quite different than the Law and Finance story. In the Law and Finance account, the existence of good law gives rise to widely-held and efficient controlling shareholder systems. In these path dependent accounts, the direction of causation is reversed, initial serendipity giving rise to a shareholding pattern that then demands good law. In the Swedish case, once politics allowed the leading families to lock in control, a demand arose to assure that the locked in controllers did not steal. John Coffee argues persuasively that this was the direction of causation in the United States as well. John C. Coffee, The Rise of Dispersed Ownership: The Role of Law and the Role of the State, 111 Yale L.J. 1 (2001). In Sweden, the account is consistent with Roe's political theory; in the U.K., it is not. The lesson may be that every country's initial conditions may be unique even if the outcomes converge to one of a few patterns; politics characterize the initial conditions in some countries, but not in others.

[55] Capital gains taxes may reinforce the path dependency of controlling shareholder systems by imposing a substantial change on a controlling shareholder selling its long held position even if, in a world without taxes, changes in the economy would cause controlling shareholders to sell. Eliminating this barrier to restructuring the ownership distribution of German corporations led Germany to

IV. Complicating the Controlling Shareholder Taxonomy: Pecuniary versus Non-Pecuniary Private Benefits of Control

In Part III, I extended the standard good law/bad law account of controlling shareholder systems by complicating the taxonomy of controlling shareholder systems to distinguish between efficient and inefficient controlling shareholder systems. I argued that an efficient controlling shareholder system has much more in common with a widely-held shareholder system than with an inefficient controlling shareholder system; both widely-held and efficient controlling shareholder systems support diversity in shareholder distributions among companies and an inefficient controlling shareholder system does not. The next step is to further complicate the taxonomy by looking more carefully at the concept of private benefits of control, a central but to this point largely unexplored element of the analysis, and one of great importance to understanding good law systems that support diverse shareholder distributions.

Consistent with the vast majority of the existing literature, I have not as yet defined what I mean by private benefits of control. That now needs to change. For present purposes I want to make a quite simple conceptual distinction, which may turn out somewhat less distinct in application, between two kinds of private benefits of control. The first is *pecuniary* private benefits of control; that is, the non-proportional flow of real resources from the company to the controlling shareholder. A familiar example is tunneling accomplished by inter-company dealings whose terms favor the company in which the controlling shareholder has the larger equity stake.[56] The second is *non-pecuniary* private benefits of control; that is, forms of psychic and other

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eliminate the capital gains tax on the sale of long held cross-holdings. See Gilson, Globalizing Corporate Governance, supra note 42, at 341-42.

[56] See Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, Tunneling, 90 Am. Econ. Rev. (Papers and Proceedings) 22 (2000). In U.S. corporate law, the concept is similar (although termed “self-dealing”: the highest standard of judicial review is reserved for a transaction in which a controlling shareholder receives something of value to the exclusion and detriment of minority shareholders. See Sinclair Oil Corp v. Levien, 280 A.2d 717 (Del. SCt. 1971).

benefits of control that, without more, involve no transfer of real company resources and are not disproportionately dilutive of the value of the company's stock to a diversified investor. For example, control of a large company in a small economy may provide a desirable social standing for the controlling family. A good analogy may be to the difference between common values and private values in the economics of auctions.[57]

The existing literature, both analytical and empirical, focuses almost exclusively on pecuniary benefits of control although typically without acknowledging the distinction.[58] This can be seen most clearly in the empirical literature. Whether measured by differences in value between high and low voting classes of common stock, or by the premium paid for a control block relative to the entire firm, these amounts reflect the capitalized value of real resources diverted to the controlling shareholder at the expense of minority shareholders.[59] As we have seen, a number of studies show clearly that the market values the same cash flows differently when produced by a company with an inefficient controlling shareholder as opposed to an efficient controlling shareholder.[60] The difference is pecuniary private benefits of control.

Focusing on pecuniary private benefits of control, however, raises a real quandary. The empirical evidence shows very low pecuniary private benefits of control in efficient controlling shareholder systems. But holding a controlling

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[57] In a common value auction, the asset has the same value to all bidders. In a private value auction, the asset's value depends on the bidder. See R. Preston McAfee & John McMillan, Auctions and Bidding, 25 J.Econ. Lit. 699 (1987).

[58] Dyck & Zingales, supra note 33 at 32, are notable in that they recognize the difference between the two categories. Their principle point, however, is only to show the importance of pecuniary private benefits of control -- "that not all private benefits are psychic" – rather than to examine the implications of psychic benefits.

[59] See TAN 35 supra.

[60] See TAN 37-41 supra. Black, Jang & Kim, supra note 40, provide the best example. The same cash flows increase in market value as a result of an improvement in law that reduces the potential for pecuniary private benefits for controlling shareholders.

position imposes real costs in liquidity and lack of diversification on the controlling shareholder, as well as actual the cost of monitoring. Why then do we ever observe controlling shareholders in countries with functionally good law (widely-held and efficient controlling shareholder regimes) if controlling shareholders can extract only limited amounts of pecuniary private benefits of control? Unlike in an inefficient controlling shareholder system, these controlling shareholders are free to sell their positions without fear of subsequent exploitation by someone who subsequently assembles a new control position. This is the realm of non-pecuniary private benefits of control. Almost tautologically, non-pecuniary benefits of control must play a prominent role in regimes where functionally good law keeps pecuniary private benefits low.

While a comprehensive exploration of non-pecuniary private benefits of control requires considerably more attention than I can devote here,[61] a hypothetical question can serve to motivate the analysis. Suppose a family that controls a firm has a net worth of $4 billion, all invested in the controlled firm. What does the family's utility function look like? What does the family maximize? For example, suppose a potential acquirer will pay a $300 million dollar premium for the family's controlling interest because the acquirer can increase the company's productivity or capture synergies. The family confronts a tradeoff: control of a major industrial company versus a 7.5 percent increase in family wealth. Is maintaining a role as leading industrialists in a country, with the social and political access associated with that

[61] For example, non-pecuniary private benefits of control may in some areas provide both psychic benefits to the controlling shareholder and real benefits to the company (and, hence, to the minority shareholders). Political influence may be the best illustration. The ability to influence political action can provide great personal benefits. At the same time, that influence can also lead to government policies beneficial to the company. Data for Thailand, for example, supports this dual function. After company executives become high political officials, corporate performance improves relative to that of "unconnected" companies. Bunkanwanicha & Wiwattanakantang, supra note 21.

role, worth more than additional wealth at a point where decreasing marginal returns to wealth must surely have set in?[62]

To generalize the intuition, the existence of private benefits of control means that for the controlling shareholder the separation theorem does not apply; that is, the controlling shareholder's utility is affected by company decisions in ways other than through the decision's impact on the company's stock price.[63] Thus, maximizing the controlling shareholder's utility may mean something other than maximizing the value of the corporation. As with complicating the concept of controlling shareholder in Part III, complicating the concept of private benefits of control has a number of interesting implications.

A. Explaining the Difference between the United States and Sweden

The distinction between pecuniary and non-pecuniary private benefits of control helps explain the continuing differences between the incidence of controlling shareholders in the United States and Sweden. The U.S. is characterized by widely-held shareholder distributions, while Sweden is characterized by controlling shareholder distributions, even though in both countries functionally good law supports, and we observe, both patterns of shareholdings. Controlling shareholders in countries with good law are compensated for the extra costs of their controlling position through non-pecuniary private benefits of control. Thus, the different patterns of shareholdings in the two countries should depend importantly on the potential for non-pecuniary private benefits of control.

A first observation turns on the relative size of the two economies. Because the Swedish economy is relatively small, a group of fifteen families were sufficient to

[62] The work of Bruno Frey has most prominently stressed the importance of non-pecuniary benefits in economic analysis. See Bruno Frey, Not Just the Money: An Economic Theory of Personal Motivation (1997).

dominate. Being one of fifteen leading families provides a social and political position that is unlike anything in the United States, whose economy is simply too large for a small number of families to play a national role comparable to that played by the Swedish industrial families. Neither Warren Buffett not Bill Gates, for example, looks like an American version of the Swedish Wallenbergs. Thus, non-pecuniary private benefits of control are likely to be generally smaller in the United States, local rather than national, which suggests that we should observe fewer companies with controlling shareholders. The smaller level of non-pecuniary benefits of control should also increase the rate at which control is dissipated by controlling shareholders and their heirs. Entrepreneurial companies making an initial public offering almost always have a controlling shareholder. As we will see in section B of this Part, the rate of reduction in control by the entrepreneurs' heirs increases as the level of non-pecuniary benefits go down.

A second observation builds on the first. We should observe controlling shareholders in the U.S. in those industries where non-pecuniary private benefits of control are likely to most pronounced. So, for example, one would expect to find controlling shareholders in major newspaper companies, as is the case, for example, with the companies that operate the New York Times, the Washington Post, the Wall Street Journal and, until recently, the Los Angeles Times. Running a major national newspaper puts one at the center of major public and cultural issues, with the potential to influence the outcome. Like Dreamworks' Swedish style capital structure,[64] studies report that a dual class capital structure, designed to facilitate maintenance of control without maintaining a controlling share of a company's equity, are disproportionately found in the printing, publishing and communications industries, as

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[63] See Ronald J. Gilson, Separation and the Function of Corporation Law, forthcoming, Berkeley

well as in media firms and sports teams.[65] Examples include most large U.S. cable television companies.[66]

Thus, the incidence of controlling shareholders in the United States and Sweden, countries where functionally good law supports both widely-held and controlling shareholder distributions, reflects not only the serendipity of where the two countries started,[67] but on a continuing basis the potential for non-pecuniary private benefits of control as well.

B. Macroeconomic Implications of Non-Pecuniary Private Benefits of Control

The empirical evidence supports the proposition that minority shareholders are not uniquely disadvantaged in an efficient controlling shareholder system. Good law keeps diversion of pecuniary private benefits of control low and, in a reasonably efficient stock market, the costs of these payments for focused monitoring, as well as the risk that the talent of future generations of family managers will regress to the mean, will be priced. Unlike in inefficient controlling shareholder systems, minority shareholders in an efficient controlling shareholder system are playing in a basically fair game.

The inquiry, however, does not end with the position of minority shareholders. The existence of a significant role for non-pecuniary private benefits of control has macroeconomic significance, which impacts the country as a whole. We take up three such circumstances.

Journal of Business Law (2005)(role of the separation theorem in corporate law).

[64] See TAN 49 supra.

[65] See John C. Coates, Explaining Variation in Takeover Defenses: Blame the Lawyers, 89 Cal. L. Rev. 1301, 1343 (2001); Laura Casares Field, Control Considerations of newly Public Firms: The Implementation of Antitakeover Provisions and Dual Class Shares Before the IPO, working paper, available at http://www.ssrn.com; Demsetz, supra note 43; Demsetz & Lane, supra note 43.

[66] Gompers, Ishii & Metrick, supra note 28.

[67] See TAN 54 supra.

Consider first the failure of separation just discussed. Some controlling shareholders' preferences may simply reflect misjudgment or over confidence. To the extent that the controlling shareholder or her heirs wish to go on directly managing the company, there may be a powerful inclination to over invest in the company's existing businesses – those with which the family manager is more comfortable – even though other opportunities that require different managerial skills may offer higher returns. Alternatively, the controlling shareholder may prefer to enter new businesses about which she knows little but which are alluring personally; the transformation of the businesses in which companies associated with the Bronfman family engage – from liquor and oil to entertainment – may be an example. To the extent these actions are motivated by non-pecuniary benefits of control, the fact that they are value reducing may matter a great deal to the country as a whole even if minority shareholders accurately predict both the controlling family's preferences and abilities.

A second implication of the failure of separation returns to the likelihood of declining skills in successive generations of family managers – the operation of the gravity of generations. Even if the risk of underperformance over time is priced, that underperformance still operates as a drag on the economy through the misallocation of resources. Recent empirical work shows that per capita GDP is highly and significantly negatively correlated with measures of the extent of family control over a country's private sector.[68] The underperformance appears to get worse as control passes from founding entrepreneur to heir. Morck, Strangelend and Yeung report that Canadian "heir controlled firms are less profitable than otherwise comparable firms in

[68] Morck & Yeung, supra note 50.

the U.S. and in Canada."[69] Data for Sweden, a functionally good law jurisdiction, appears consistent. Minority share discounts in Swedish family complexes appear related to factors other than pecuniary private benefits of control.[70]

The United States data concerning the impact of a shift from founder to heir is more mixed. While an early study suggested that family ownership resulted in worse performance than that of widely-held firms,[71] recent work is more tentative, suggesting that family controlled firms may outperform non-family controlled firms, but that the advantage disappears when the heir of a founder serves as CEO (although performance remains no worse than non-family firms). This description is consistent with an efficient controlling shareholder structure that loses its advantage, but does not deteriorate badly, when management passes to the next generation.[72] There is a plausible explanation for the difference in performance – both overall and with respect to the slower deterioration in performance after management shifts from founder to heir -- between family-controlled and widely-held companies in the U.S. as compared to controlling shareholder firms in other countries with functionally good law (countries that support both widely-held and controlling shareholder distributions). The U.S., unlike for example Canada and Sweden, is not characterized by pyramid ownership structures through which a family controls multiple levels of

[69] Randall Morck, David A. Stangeland & Bernard Yeung, Inherited Wealth, Corporate Control, and Economic Growth: The Canadian Disease, in Concentrated Corporate Ownership 319 (R. Morck ed., 2000). The result generalizes: countries in which the wealth of the heirs of the founders of large companies is large relative to GDP grow more slowly than those where the wealth of the founders are large relative to GDP.

[70] Martin Holmen & Peter Hogfeldt, Pyramidal Discounts: Tunnelling or Agency Costs, working paper (2005)(evidence based on intra-group mergers within family controlled pyramids); Martin Holmen & John D. Kopf, Minority Shareholder Protection and the Private Benefits of Control for Swedish Mergers, 39 J. Fin. & Quant. Analy. 167 (2004)(same).

[71] Randall Morck, Andrei Shleifer & Robert W. Vishny, Management Ownership and Market Valuation, 20 J. Fin. Econ. 293 (1988)(Performance of older firms lower when firm is run by member of founding family).

[72] Ronald C. Anderson & David M. Reeb, Founding-Family Ownership and Firm Perforamnce: Evidence from the S&P 500, 58 J. Fin. 1301, 1303 (2003). See Ronald C. Anderson & David M. Reeb, Founding-Family Ownership, Corporate Diversification, and Firm Leverage, J. Law & Econ. 653 (2003)(U.S. family-controlleded firms less diversified than widely-held firms).

firms. Controlling families in the United States typically do not leverage their equity to control more than one company.[73] Thus, outside the U.S., the effect of less skilled heirs taking over is both exacerbated by the greater difficulty of running a diversified company and multiplied over a larger asset base.

A final implication may be the most significant. As suggested in Part III, efficient controlling shareholders systems have greater diversity in patterns of shareholder distribution. Part of this diversity is positive – driven by the fit between particular companies and particular industries on the one hand and the monitoring techniques associated with controlling shareholder or widely-held shareholder distributions on the other. But part of this diversity may be negative – reflecting the absence of market pressures on controlling shareholders to respond to changes in the external economic environment and of market mechanisms to impose those changes from the outside when the controlling shareholder fails to respond.

The insulation of the controlling shareholder from market pressure is not necessarily always bad. As I have argued previously, "institutions matter when they fit with existing industrial technology."[74] The stability that a controlling shareholder can provide may be quite effective when, as with the happy match between Japanese corporate governance and Japanese industrial organization over a large part of the post-War period, it supports worker firm and team specific human capital investment and the industry experiences largely linear technological change.[75] The converse, however, is also true: "institutions matter when they do not fit with the industrial technology demanded in a state of the world different from that which gave rise to the

[73] Morck, Wolfenzon & Yeung, supra note 11.
[74] Gilson, Corporate Governance and Economic Efficiency, supra note 42, at 341.

[75] See Ronald J. Gilson & Mark J. Roe, Lifetime Employment: Labor Peace and the Evolution of Japanese Corporate Governance, 99 Col. L.Rev. 508 (1999.

governance institutions in the first place."[76] When companies and industries must adapt quickly to large and abrupt changes in the economic environment, the stability associated with an efficient controlling shareholder system becomes a barrier to necessary adaptation; in this circumstance, a widely-held shareholder system, with control open to the market, likely will be more efficient.[77] In particular, a widely-held shareholder system facilitates a dynamic cycle between public and private ownership that polices adaptivity. When a public company experiences managerial underperformance, the private equity market can mount an acquisition through buyout funds that will put into place a highly incentivized, intensively monitored governance structure that is suited to fixing the problem. Then, because the buyout funds typically must liquidate after ten years, the now "fixed" company is taken public again to allow the distribution of liquid assets to the buyout fund's investors.[78] If it is difficult to design a system that is both adaptive like a widely-held shareholder system and stability providing like an efficient controlling shareholder system, the choice between them will depend on one's predictions of the future: will the environment be one that favors adaptation or stability? The public/private dynamic found in widely-held controlling shareholder systems may serve to balance this tradeoff.

B. Ameliorating Influence I – The Potential Instability of Efficient Controlling Shareholder Systems

Some factors work to ameliorate an efficient controlling shareholder system's insulation from market pressures for change. Precisely because non-pecuniary private

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[76] Gilson, Corporate Governance and Economic Efficiency, supra note 42, at 341.
[77] See Ronald J. Gilson, The Political Ecology of Takeovers: Thoughts on Harmonizing the European Corporate Governance Environment, 61 Ford. L. Rev. 161 (1992); Gilson, Corporate Governance and Economics Efficiency, supra note 42. This concern with the barriers to adaptation in efficient controlling shareholder systems recently has received broader attention. See Hans Tson Söderström (ed.), Erik Berglöf, Bengt Holmström, & Eva M. Meyersson Milgrom, Corporate Governance and Structural Change, SNS Economic Policy Group Report 2003; Raghuram Rajan & Luigi Zingales, Banks and Markets: The Changing Character of European Finance, NBER Working Paper 9595 (March 2003).

benefits are idiosyncratic to the particular controlling shareholder, and because the identities of controlling shareholders change with generations, it is plausible to expect changes in the value of the non-pecuniary private benefits of control over time (whether from lifecycle changes, increased wealth within a single generation, or intergenerational changes in taste or abilities). At some point, the wealth gain from adaptation reflected in a large acquisition premium, or an increase in market value from giving up control and hiring professional managers, outweighs the non-pecuniary private benefits of control experienced by that controlling shareholder, a process which can be expected to accelerate as succeeding generations experience greater regression to the mean in managerial skills,[79] and as the number of family members actively involved in the company increases.

As a result, efficient controlling shareholder systems will tend to deteriorate simply from the gravity of generations. For example, the recent SNS Economic Policy Group report notes with respect to Sweden, an efficient controlling shareholder system, that "[o]nly a few of the 'fifteen families' who used to dominate Swedish industry remain major owners in a position of control… ."[80] To the extent that the

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[78] See Ronald J. Gilson and Bernard S. Black, The Law and Finance of Corporate Acquisitions c.11 (2d. ed. 1995)(description of structure and operation of private buyout funds).

[79] See Fancesco Caselli & Nicola Gennaioli, Dynastic Management, NBER Working Paper 9942 (Jan. 2003)(models inefficiency of family control as in part a function in part of the degree of inheritability of talent across generations).

[80] Söderström, et. al., supra note 42, at 13. Högfeldt, supra note 35 at 11, describes the extent to which the Wallenberg group in Sweden has recently withdrawn control from a significant number of companies. Speaking of the change in the role of the Wallenberg group, Sweden's deputy finance minister recently described a secular reduction in their and other Swedish family groups: "They [the Wallenbergs] have been enormously important, no doubt. They continue to be quite important, but less important than they were… They are increasingly being challenged by other power centres in the Swedish economy. The dynastic model is unlikely to survive in the in the years and decades ahead, particularily with the amount of European integration we are now seeing and the efforts to reach a level playing field in the European economy," Christopher Brown-Humes, Can the Next Wallenberg Generation Maintain its Status and Influence?, Fin. Times, July 12, 2004, p.9. The recent proposal to reduce the disparity in voting rights in Ericsson, a Wallenberg company, from 1000 to 1, to 10 to 1, reflects this process. As a result of the proposal, the voting rights of Wallenberg entities will be reduced to less than 40 percent. See Ericsson Press Release, The Works Group presents a proposal to reduce the differences in voting rights in Ericsson to 1:10, Feb. 19, 2004. Daniel Fristedt & Sven-Ivan Sundqvist, Owners and Power in Sweden's Listed Companies 10 (2004), shows that 7 of the 10 largest Swedish shareholders are non-family institutions like pension and mutual funds. This point was

deterioration is in part driven by a control premium that increases with the value that would result from change, the timing of the deterioration at least may be influenced in the direction of efficiency: the greater the efficiency gain from adaptation, the faster the deterioration of the controlling shareholder system.[81]

This assessment is consistent with another recent characteristic of the Swedish system. Despite the dominant role of controlling shareholders, Sweden has experienced a high level of takeovers, by definition friendly. Rolph Skog reports that of the 245 Swedish listed companies that were taken over between 1990 and 2002, 157 or 64 percent had dual class stock with different voting rights, roughly the same percentage as companies with dual class stock are among all listed companies.[82] This suggests that the circumstance when the size of the offered premium exceeds the controlling shareholder's non-pecuniary benefits of control may track the circumstances that give rise to takeovers more generally.

C. Ameliorating Influence II – Public Pressure on Efficient Controlling Shareholders

There is reason to think that external pressure may operate as some constraint on controlling shareholders. The role of public opinion has been raised primarily in connection with reducing pecuniary private benefits of control in bad law countries, essentially as a substitute for an effective legal system.[83] Public opinion driven policing of non-pecuniary private benefits of control, however, may prove more

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confirmed anecdotally by leading Swedish corporate governance lawyers who made the point lightly by remarking that Sweden is still controlled by 15 people, but these people were now heads of pension funds rather than heads of families. Interview with Gunnar Nord, Robert.Ohlsson, and Rolf Skog, (May, 2004).

[81] At the same time, the political forces that in Mark Roe's account leads to stable concentrated shareholdings may be reclining in importance as a result of globalization and the resulting decrease in labor influence. See the remarks of the Swedish Deputy Minister of Finance, supra note 80.

[82] Skog, supra note 10.

[83] See, e.g., Dyck & Zingales, supra note 33, who use the importance of newspapers (circulation per 100,000 inhabitants) as a measure of the force of public opinion in a jurisdiction. They find that one standard deviation increase in circulation reduces the value of control measured by pecuniary private benefits by 6.4 percent.

difficult. For public opinion to operate as a constraint, two conditions are necessary (although not necessarily sufficient). First, the controlling shareholder's conduct must be observable to the public, which is why the most promising empirical study of the role of public opinion as a constraint on private benefits of control uses newspaper circulation as a measure.[84] Second, and for present purposes more difficult, there must be a shared public conception that the behavior disclosed to the public is wrong. This is plausible with respect to pecuniary private benefits of control – the concept that "thou shalt not steal" is surely widely shared and diversion of company cash flows for the benefit of a controlling shareholder may well be widely understood as stealing. However, the range of behaviors that may provide non-pecuniary private benefits of control may lack the same public consensus. Thus, the extent to which public opinion acts as a constraint on non-pecuniary private benefits of control likely is quite sensitive to the particular manifestation of the private benefit and to local culture. For example, the extent to which nepotism is widely viewed as improper may differ widely among jurisdictions.

More important, the characteristics that give rise to private benefits of control are plainly culturally influenced. For example, the maintenance of family control – the private benefit of being a leading family – may be more highly valued in Asia than it is in the United States. Thus, Asian controlling shareholders may be willing to forego more potential value to keep control in the family, with the result that a controlling shareholder pattern may persist longer in Asia than in Western countries. To be sure, culture and economics are related in complicated ways. In inefficient controlling shareholder systems, a cultural attribute that assigns great value to the non-pecuniary private benefit of maintaining family control reinforces the economic

[84] Id.

motivation to maintain control to avoid being exploited later as a non-controlling shareholder. Conversely, the continued globalization of commerce, which serves to increase the opportunity cost of the non-pecuniary benefits of maintaining family control through forced competition with more efficiently organized companies, will have the effect of eroding the cultural assessment of the value of control. Here, however, we know as yet very little about the dynamics of the interaction between culture and economics in determining the sources and intensity of elements of non-pecuniary private benefits of control.

V. Implications and Conclusion

In this article, I have argued that a good deal can be learned by looking at the usual taxonomy of controlling shareholders through the framework of the controlling shareholder tradeoff – focused monitoring in return for some private benefits of control and at a cost in speed of adaptation. In particular, the framework highlights the value of distinguishing between efficient and inefficient controlling shareholder systems, and between pecuniary and non-pecuniary private benefits of control. I want now to conclude by briefly considering two policy implications – one broad, the second narrow – that are suggested by a more complicated controlling shareholder taxonomy.

A. Eliminating Inefficient Controlling Shareholder Systems: Better Law or More Market Exposure?

One straightforward implication of a more complicated taxonomy is the need to eliminate inefficient controlling shareholder systems. This can be attempted by three different, but not mutually inconsistent, strategies. First, an inefficient system can be attacked directly by improving the legal system to constrain pecuniary private benefits of control to levels that, net of these costs, leave minority shareholders better off as a result of focused monitoring. At that point, the country will have moved into an efficient controlling shareholder system that is supported by non-pecuniary private benefits of control that are subject to the ameliorating influences discussed in Part IV. Second, an inefficient system can be attacked indirectly by changing legal rules and supporting institutions to increase the exposure of control to the market. Third, the capital market may in some circumstances operate to dissipate a controlling shareholder's position in just those circumstances when the social costs of underperformance are the greatest.

1. Improving the Legal System.

Improving the legal system generally involves eliminating deficiencies in three areas – the statement of the standards that make significant pecuniary private benefits of control unlawful; the disclosure process that allows pecuniary private benefits of control to be observed by those who have the power to enforce the legal standard; and the public and private enforcement mechanisms available to prosecute violations. This process can be slow, and certainly requires a political moment when the public perception of the need for reform outweighs the influence of entrenched inefficient controlling shareholders, but there is some evidence that it can happen. Recent reform in Italy may be a case in point.

Recall that empirical studies show that in Italy private benefits of control amount to as much as 30 to 37 percent of total firm value.[85] In 1998, Italy adopted legislation that made it significantly easier for minority shareholders to pursue derivative litigation against management appointed by a controlling shareholder.[86] Dyck and Zingales report a dramatic drop in the level of pecuniary private benefits of

[85] See TAN 37-38 supra.
[86] Article 129, Legislative Decree no. 58, allows shareholders with more than 5 percent of the outstanding stock to sue the directors on behalf of the corporation. See Marco Ventoruzzo, Experiments in Comparative Corporate Law: The Recent Italian Reform and the Dubious Virtues of a Market for Rules in the Absebce of Effective Regulatory Competition, working paper (June 2004), available at http://ssrn.com/abstract=556601.

control after the reform, although the results can only be suggestive given the very small sample.[87] Effective January 1, 2004, additional new legislation in Italy extended reform to both the standard specification and disclosure elements of a "good law" system by substantially reforming the legislation governing groups of companies dominated by a controlling shareholder.[88] In addition to extending the circumstances in which voting control imposes liability on the controlling shareholder for the mismanagement of the controlled company management, the legislation imposes extended disclosure obligations concerning transactions with the controlling shareholder and, with respect to decisions actually influenced by the controlling shareholder, a requirement to disclose the reasons for taking the decision in question.[89] While these reforms do respond to the demands of substantive standards and disclosure necessary to a good law regime, it remains unclear whether the enforcement requirement will be met. In the end, the effectiveness of enforcement depends on matters of civil procedure and judicial efficiency, as to which commentators have expressed reservations.[90] Even the enforcement effect of non-judicial institutions, like the public press, depends on the extent of widely-held cultural beliefs that the pecuniary private benefits of control are improper.[91]

Despite the potentially important but still uncertain efforts in Italy, broad based legal reform may move quite slowly in some countries. For example, as may turn out to be the case in Italy, legislation may state standards of conduct more

[87] Dyck & Zingales, supra note 33. Unfortunately, the Dyck & Zingales sample containes only 6 observations of a controlling shareholder block sale before the 1998 reform and two after the reform. Additionally, Marco Ventoruzzo states that the new power to bring a derivative suit "was never used." Ventoruzzo, supra note 86.

[88] Legislative Decree n. 6 of January 17, 2003. See Umberto Tombari, The New Italian Company Law: An Emerging European Model?, working paper (May 2003).

[89] Venturuzzo, supra note 86.

[90] Id.

[91] Sarbannes-Oxley provides an example of how legal reform can increase constraints on pecuniary private benefits of control even in a country with functionally good law. The statute's focus on internal

aggressively and may require more effective disclosure, but reform may still founder on the enforcement process. If, for example, a country lacks a sophisticated and effective court system, it may be a time consuming process to create one, even if political barriers can be overcome. Without effective enforcement, improved standards and more effective disclosure are unlikely to be enough.

In these cases, the second strategy – legal reform that exposes controlling positions to the market – may be more effective. Here the most obvious example is the mandatory breakthrough rule proposed by the Winter Report and reflected in the 2002 Commission draft of the Thirteenth Directive. Under the proposal, if a bidder secures 75 percent of the target's equity, then the extra votes of a high voting class would be ignored for such things as election of directors. The effect of the rule would be to sharply limit the extent to which a controlling shareholder could use certain devices to lever its equity into control; a minimum of 25 percent of the equity value plus one share would be necessary to command a majority of the vote.[92] Importantly, however, the coverage of the proposed breakthrough rule is only partial. Much of European company controlling shareholder structures are based on devices that heavily leverage the controlling shareholder's equity through the use of pyramids instead of or in addition to dual class common stock or other voting rules that are the object of the breakthrough proposal. Pyramidal structures would not be affected by the proposed rule,[93] thereby reducing its impact even if it the Thirteenth Directive would have been adopted as proposed.

For present purposes, the proposed breakthrough rule had two important characteristics. First, it was to be imposed on a European level, thereby at least

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controls and on officer certification, coupled with increased penalties and rigorous enforcement, makes the kind of transfers associated with pecuniary private benefits of control much more difficult.

[92] Jaap W. Winter et al., Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids in the European Union (Jan. 10, 2002), available at http://ssrn.com/ abstract=315322

partially bypassing the political problem of controlling shareholder influence on a particular country's legislature.[94]

The second characteristic is rather more speculative. The Thirteenth Directive, as imagined by the Winter Report and the Commission, might have had the interesting effect of having a quite different impact on inefficient and efficient controlling shareholder systems. For inefficient systems, control is opened up to widely-held bidders, who will be in a position to purchase 75 percent of the equity at a premium that shares with minority shareholders the gains from eliminating pecuniary private benefits of control, much like shareholders participated in the gains resulting from a 1980s style takeover motivated by eliminating the misuse of free cash flow.[95] In the free cash flow motivated takeover, the bidder shared the gains from redeploying free cash flow through the premium paid for the target's stock; the remainder went to the acquirer through improved target performance. In an inefficient controlling shareholder takeover, the bidder would share the gains from better performance as a result of eliminating pecuniary private benefits of control through the premium paid for 75 percent of the company's equity,

In contrast, the breakthrough rule's threat to control in efficient controlling shareholder systems would be substantially more muted. Because of the low level of pecuniary private benefits of control in an efficient controlling shareholder system, there would be no easy source of premiums for would-be bidders. To be sure, controlling shareholders would in some cases have to increase their equity ownership to 25 percent to protect control, thereby increasing the costs of focused monitoring and in particular circumstances resulting in a shift in the outcome of the controlling

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[93] Id.

[94] To be sure, individual states can and do drag their feet on adopting legislation implementing a directive.

shareholders tradeoff, but European Union-wide, the balance would seem to be positive.

That leaves the third, market-based, approach to improving the operation of inefficient controlling shareholder systems. In an inefficient controlling shareholder system, poorly managed companies, and those from whom controlling shareholders have siphoned pecuniary private benefits of control, may require additional capital, especially to respond to the globalization of their markets and to new, more efficient, foreign competitors. For these companies, internally generated funds will be insufficient, requiring recourse to the capital market. In this context, suppliers of debt or equity can be expected to insist on a means to dissipate the controlling shareholder's influence if performance threatens the new investment. I suggested the use of performance based conversion as a means of constraining controlling shareholders four years ago,[96] and discovered recently that just such a technique was used with respect to a prominent controlling shareholder in Italy. In order to raise $3 billion for restructuring in 2002 from Italy's largest banks, Fiat was required to accept debt that was convertible into Fiat shares if certain financial targets were not met. If the debt was converted following poor performance, the controlling Agnelli family's ownership in Fiat would be diluted from 30 percent to 22 percent, giving the banks a 30 percent interest and making them the largest Fiat shareholder.[97] From this perspective, globalization, even without additional regulatory initiatives, will operate to undermine inefficient controlling shareholder systems.

B. Understanding the Dynamics of Efficient Controlling Shareholder Systems

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[95] See Ronald J. Gilson & Bernard Black, The Law and Finance of Corporate Acquisitions c. 11 (2nd ed. 1995).
[96] See Gilson, Globalizing Corporate Governance, supra note 42, at 347-49.
[97] Alan Cowell & Eric Sylvers, Fiat is Trying to Get back in the Fast Lane, Intn'l Herald Tribune, June 1, 2004, p. 1, 8.

The most serious policy concern with efficient controlling shareholder systems is that controlled firms adapt less quickly to changes in the economic environment. Because private benefits of control are largely non-pecuniary, controlled firms in efficient controlling shareholder systems may be less nimble in responding to changes in the economic environments than widely-held firms. The market for corporate control can force a widely-held firm to internalize change; nothing plays a similar role in a controlling shareholder regime save the market mechanism just considered, which in an efficient controlling shareholder system can be expected to operate rather slowly because of the absence of the financial drain of tunneling. At the same time, we also saw that the importance of non-pecuniary private benefits of control may make efficient controlling shareholder systems less stable. From the perspective of the controlling shareholder, the relative value of non-pecuniary private benefits of control – the balance between non-pecuniary private benefits and the pecuniary gains from a more adaptive control structure – can shift with the identity and generation of the controlling shareholder.

At this point, however, we can do little more than identify the tension, rather than either effectively model or test empirically the relationship. And this is an appropriate point with which to conclude. To better understand the macroeconomic impact of efficient controlling shareholder systems, we need to better understand the micro level dynamics of this ownership structure. As the focus of corporate governance scholarship shifts to controlling shareholder systems, we need to think small.

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