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CONTROLLING THE CORPORATE CONTROLLER'S MISBEHAVIOUR

ALESSIO M PACCES*

The corporate governance debate mainly deals with the effectiveness of techniques to protect shareholders from the controllers' misbehaviour. This article takes a different approach. Focusing on self-dealing, it shows that effective strategies to protect investors from expropriation differ from country to country. However, some may be more efficient than others. The inefficiency of an effective discipline of self-dealing stems from the constraints it imposes on the discretion of controlling managers and shareholders. This article shows that both the US litigation-based model and the UK governance-based model are effective against expropriation, but their efficiency can be improved. In light of this, this article recommends restricting the influence of non-controlling shareholders to the selection of a minority of independent directors, whose task should be limited to monitoring and validating self-dealing. These findings can be extended from self-dealing to similar conflicts of interest that may lead to expropriation of shareholders, and to their regulation in other jurisdictions.

A. Introduction

Investor protection is one of the major subjects in the legal and economic literature on corporate governance. Because separation of ownership and control entails agency costs,[1] shareholders are only willing to delegate to management if they are sure they can earn a return on their investment.[2] This has two main implications. First, management should be accountable to shareholders. Secondly, law should support this accountability in order to minimise agency costs.

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1 MC Jensen and WH Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure" (1976) 3 *Journal of Financial Economics* 305.

2 A Shleifer and R Vishny, "A Survey of Corporate Governance" (1997) 52 *Journal of Finance* 737.

Accountability is most needed when shareholders run the risk of being expropriated of their investment. On this basis, the law and finance scholarship has powerfully argued that failure of regulation to protect shareholders against the misbehaviour of those in control undermines the separation of ownership and control and the development of stock markets.[3] This strand of literature has recently concluded that, in order for this protection to be effective, law should not only make it easier for shareholders to litigate self-dealing but it also should empower them to review it.[4]

In this article, I argue that neither litigation nor the general empowerment of shareholders is an efficient solution to self-dealing. This is based on an approach complementary to law and finance. That is to say, although effective protection against expropriation is necessary for the separation of ownership and control, this protection comes at a cost to shareholders. On the one hand, a strict regulation of self-dealing may induce the management to refrain from transactions that are profitable for the company, for fear of being sued. On the other hand, strong shareholder powers may be used opportunistically by some investors, thereby undermining the commitment of managerial discretion to valuable firm-specific investments and long-term strategies. Therefore, an effective shareholder protection is not necessarily efficient. For the purposes of this article, efficiency is defined as maximisation of long-term shareholder value without considering the wealth effects of corporate governance and law enforcement on taxpayers and other stakeholders.

The legal strategies to protect shareholders from expropriation differ both in effectiveness and efficiency. There is a major distinction between regulatory strategies enforced through litigation and governance strategies relying on shareholders' influence on management.[5] Recent research shows that, at least in the US and the UK jurisdictions, which undoubtedly protect shareholders well, these strategies can be equally effective.[6] However, the law and economics scholarship is not unanimous as to which is more efficient. Some argue in favour of shareholder empowerment,[7] others argue against it.[8] Some advocate

[3] This scholarship has been named after the first of a series of influential articles: R La Porta, F Lopez-de-Silanes, A Shleifer and R Vishny, "Law and Finance" (1998) 106 *Journal of Political Economy* 1113.

[4] S Djankov, R La Porta, F Lopez-de-Silanes and A Shleifer, "The Law and Economics of Self-Dealing" (2008) 88 *Journal of Financial Economics* 430.

[5] L Enriques, H Hansmann and RH Kraakman, "The Basic Governance Structure: The Interests of Shareholders as a Class" in RH Kraakman, J Armour, PL Davies, L Enriques, H Hansmann, G Hertig, KJ Hopt, H Kanda and EB Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford University Press, 2nd edn, 2009), 38.

[6] J Armour, BS Black, BR Cheffins and R Nolan, "Private Enforcement of Corporate Law: An Empirical Comparison of the UK and US" (2009) 6 *Journal of Empirical Legal Studies* 687.

[7] See, eg LA Bebchuk, "The Case for Increasing Shareholder Power" (2005) 118 *Harvard Law Review* 833.

[8] See, eg SM Bainbridge, "Director Primacy and Shareholder Disempowerment" (2006) 119 *Harvard Law Review* 1735; WW Bratton and ML Wachter, "The Case against Shareholder Empowerment" (2010) 158 *University of Pennsylvania Law Review* 653.

strengthening litigation,[9] while others advocate restricting it.[10] I share the view of those commentators who claim that investor protection is not everything that matters in corporate governance, as managerial discretion is also important for efficiency. Moreover, as it has been argued, there is a trade-off between discretion and accountability.[11] I believe that this trade-off is even more difficult to resolve in the case of self-dealing because market forces alone are not able to cope with expropriation. Thus, the law has to strike a difficult balance between the risk of embezzlement by those in control and the risk of opportunism by non-controlling shareholders.

I will analyse the efficiency of alternative disciplines of self-dealing from this perspective. Focusing on solutions that are effective against expropriation, I will contend that efficient regulation should minimise the impact of accountability on managerial discretion. As the US and the UK experiences suggest, neither litigation-based nor governance-based protection alone is able to achieve that goal. Litigation tends to over-deter related-party transactions in the US. In the UK, the general influence of non-controlling shareholders on boards of directors can be abused to steer the management towards catering to stock market myopia, which rewards short-termism of certain institutional investors and of their managers. The same influence may even discourage controlling shareholders in British listed companies.

Both the US and the UK models fail to commit to a more focused scrutiny of self-dealing by independent directors, either because non-controlling shareholders are not powerful enough to secure effective directors' independence or because they are too powerful to restrict their influence to the control of expropriation. I would argue that a discipline of self-dealing relying exclusively on independent directors would be more efficient. Independent directors should be selected by non-controlling shareholders. Moreover, their mandate should be limited to monitoring self-dealing and similar conflicts of interest which may result in expropriation.

In the rest of this article, I will focus on the following aspects. In section B, I will discuss misconduct of managers and controlling shareholders, how legal investor protection may lead to opportunism of non-controlling shareholders and why these problems are particularly severe in the case of self-dealing. In the next section, I will describe effectiveness and efficiency of self-dealing

9 See, eg JC Coffee, "Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation" (2006) 106 *Columbia Law Review* 1534.

10 See, eg JR Macey, *Corporate Governance: Promises Kept, Promises Broken* (Princeton University Press, 2008), 130–54.

11 See most recently SM Bainbridge, *The New Corporate Governance in Theory and in Practice* (Oxford University Press, 2008), 11–19; PL Davies, *Gower and Davies, Principles of Modern Company Law* (London, Sweet & Maxwell, 8th edn, 2008), 359–63. I have elaborated on this view in AM Pacces, *Featuring Control Power—Corporate Law and Economics Revisited* (Rotterdam, Erasmus Universiteit, 2007).

regulation in terms of false negatives and false positives in the detection of expropriation. In section D, I will illustrate the functional characteristics of a discipline of self-dealing, with a view to disentangling the determinants of its effectiveness from the adverse consequences on efficiency. In section E, I will apply this functional framework to the analysis of the US and the UK models of disciplining self-dealing, showing the disadvantages of each. In section F, I will present the features and advantages of a discipline of self-dealing based on independent directors. In the last section, I will conclude by hinting at possible extensions of this solution to other jurisdictions and/or conflicts of interest.

B. Investor Protection in Perspective

1. Misbehaviour of Corporate Controllers

There are two major players in corporate governance: those who "run" the company and those who provide the company's equity. Normally, these players are referred to as management and shareholders respectively. This characterisation does not always capture the essence of the separation of ownership and control.[12] On the one hand, in the majority of listed companies around the world, the management is not the agent of shareholders as a class, but only of some of them, namely the dominant or the so-called "controlling" shareholders.[13] On the other hand, in those companies with no controlling shareholders, the management appears to be more powerful than a mere shareholder agent. The above categorisation usually distinguishes corporate governance in Continental Europe from the Anglo-Saxon model. However, although controlling shareholders are not so common in the US and even less common in the UK, they exist on both countries' stock exchanges.[14] This circumstance justifies the

[12] See, eg LA Bebchuk and A Hamdani, "The Elusive Quest for Corporate Governance Standards" (2009) 157 *University of Pennsylvania Law Review* 1263, 1280–1305.

[13] A controlling shareholder is one that controls sufficient votes to effectively determine voting outcomes and corporate decision-making. *Ibid*, 1267. A controlling shareholder does not necessarily own or control the majority of voting rights. In fact, listed companies can be effectively controlled with 25% of voting rights, or even less, held by one dominant shareholder or a coalition of them. See, eg M Becht and C Mayer, "Introduction" in F Barca and M Becht (eds), *The Control of Corporate Europe* (Oxford University Press, 2001), 1–45; M Faccio and LHP Lang, "The Ultimate Ownership of Western European Corporations" (2002) 65 *Journal of Financial Economics* 365. In this article, I do not distinguish between majority, dominant, and broadly speaking controlling shareholders.

[14] See C Holderness, "The Myth of Diffuse Ownership in the United States" (2009) 22 *Review of Financial Studies* 1377, 1378 (reporting 12% of majority shareholders in US listed companies); Y Gadhoum, LHP Lang and L Young, "Who Controls US?" (2005) 11 *European Financial Management* 339, 334 (according to whom 28% of US listed companies have a block holder controlling 20% of the voting rights); C Van der Elst, "Shareholder Mobility in Five European Countries", ECGI-Law Working Paper 104/2008 (April 2008; http://ssrn.com/abstract=1123108), 28–29 (reporting over 1/10 of blockholders with more than 30% of voting rights, but less than 1/20

discussion of misbehaviour by controlling shareholders also in the US and the UK, who are the major focus of this article. In this way, I will attempt to identify the potential inefficiencies of investor protection when either shareholders or managers exercise corporate control.

In order to capture both control patterns, I describe those who are ultimately in charge as "corporate controllers" and those who only provide the equity as "non-controlling" shareholders. The latter include institutional investors to the extent that they can be characterised as large non-controlling shareholders. Although in some countries, most notably the UK, institutions can form powerful coalitions, normally they do not exert control as direct involvement in the company's affairs.[15] This is reserved to corporate controllers. Both managers and controlling shareholders of controllers need to have a strong influence on the board of directors to effectively control decision-making.[16] To keep the discussion simple, I assume that they sit on the board and/or have a sufficient number of their nominees appointed to it.

When non-controlling shareholders decide whether to buy the company's stock, they worry about two things: namely, the corporate controller may abscond with their money, and conversely, the controller may fail to maximise the returns on their investments by consuming some of the firm resources as control perquisites. Both kinds of misbehaviour imply extraction of private benefits of control and are a source of agency costs. Professor Roe has distinguished them as *stealing* (diversion of shareholder value) and *shirking* (underproduction of that value).[17]

Shirking can be even more harmful to shareholders than stealing, but it is comparatively less worrisome. There are a number of market mechanisms that deal with the controller's underperformance. Two of them are particularly important. First, the controller's interest in the company's profits, whereby competitive pressure in the product market aligns the controller's incentives with the interest of shareholders. Secondly, the market for corporate control, wherein actual and prospective management alternatives provide inferior controllers with discipline (hostile takeovers) or opportunities for exit (friendly takeovers). Although the disciplinary function of takeovers is not always borne out by the empirical evidence,[18] the market for corporate control still generates sizeable

of majority shareholders in UK listed companies). See also *supra* n 13, for additional references, and *infra* text to nn 149–50.

15 See, eg BR Cheffins, *Corporate Ownership and Control—British Business Transformed* (Oxford University Press, 2008), 373–81. On hedge funds, see *infra* text to n 34.

16 AA Berle and GC Means, *The Modern Corporation and Private Property* (New York, MacMillan, 1933), 86–90.

17 MJ Roe, "Corporate Law's Limits" (2002) 31 *Journal of Legal Studies* 233, 233–36.

18 See, for the UK, J Franks and C Mayer, "Hostile Takeover and the Correction of Managerial Failure" (1996) 40 *Journal of Financial Economics* 162; for the US, GW Schwert, "Hostility in Takeovers: In the Eyes of the Beholder?" (2000) 55 *Journal of Finance* 2599.

gains allowing future opportunities to be captured rather than focusing on past failures.[19] In other words, takeovers correct sub-optimal allocations of corporate control based on forward-looking instead of backward-looking information.[20]

Apparently, the law can fare no better in constraining shirking, as that would imply second-guessing business judgment in the absence of objective standards on how a company should be managed.[21] Conversely, corporate law is most useful for countering stealing.[22] On the one hand, market solutions do not work well in this domain because correcting embezzlement *ex post* generates insufficient private gains (expropriation benefits the controller as much as it harms non-controlling shareholders). On the other hand, law can more easily identify and cope with the pecuniary conflicts of interest that, by allowing shareholder expropriation *ex post*, undermine financial exchange *ex ante*.

Countering expropriation is thus essential to legal investor protection. However, the impact of corporate law on the controller's behaviour is not confined to expropriation for two reasons. First, controlling the corporate controller's misbehaviour requires constraining their decision-making for good as for bad purposes. Transactions entered into under pecuniary conflicts of interest, such as self-dealing, potentially involve embezzlement, but they may also be beneficial for the company. In policing these transactions, corporate law faces a trade-off between the controller's discretion in operating the company's assets and accountability of this operation to non-controlling shareholders. Secondly, corporate law can directly constrain the controller's behaviour or empower non-controlling shareholders to that effect. These legal strategies for reducing agency costs are known as regulatory and governance strategies respectively.[23] Both can be effective against embezzlement. However, while the operation of regulatory strategies can be confined to dangerous situations like self-dealing, this is not possible for governance strategies. Courts can, and often do, defer to the controller's discretion in the absence of conflicts of interest, but second-guessing business judgment becomes ubiquitous when investors are given influence on the controller's decision-making.[24] As a result, in controlling

[19] See M Becht, P Bolton and A Röell, "Corporate Law and Governance" in AM Polinsky and S Shavell (eds), *Handbook of Law and Economics* (London, North-Holland, 2007) 833, 881 (reviewing the empirical evidence in this regard).

[20] J Franks and C Mayer, "Corporate Ownership and Control in the UK, Germany and France" (1997) 9 *Journal of Applied Corporate Finance* 30, 41 and 43–44.

[21] This is the economic rationale of the Business Judgment Rule, a norm of judicial abstention from reviewing the board's decision-making in the absence of conflicts of interest. See, eg FH Easterbrook and DR Fischel, *The Economic Structure of Corporate Law* (Harvard University Press, 1991), 93–102.

[22] BS Black, "The Legal and Institutional Preconditions for Strong Securities Markets" (2001) 48 *UCLA Law Review* 781.

[23] See *supra* n 5.

[24] Bratton and Wachter, *supra* n 8, 709–16.

the corporate controller's misbehaviour, the discretion/accountability trade-off may extend well beyond the situations of potential expropriation.

Whether shareholders run the risk of being expropriated or of earning poor returns on their investment, improving the accountability of corporate control implies reducing managerial discretion. The interesting question is the optimal solution of this trade-off. Legal rules can make controllers accountable to investors in a number of ways, which differ in both effectiveness against the controller's misbehaviour and efficiency in restricting managerial discretion. The reason for choosing less restrictive rules must be that the benefits of discretion exceed the costs of reduced accountability. As the following discussion will show, this balance is most likely to be positive in the case of managerial underperformance, which confirms that law should be more concerned with the stealing problem. Even in this domain, however, regulation may err on the side of accountability.

2. Discretion and Accountability in Corporate Governance

Non-controlling shareholders obviously want the company to be managed in their interest. In setting the rules of the game, however, they have also good reasons for vesting the corporate controllers with discretionary powers. They can be summarised as follows.

First, it is not efficient for non-controlling shareholders to be involved in operational decision-making.[25] This depends on the well-known problems of rational apathy and collective action. Non-controlling shareholders are typically diversified investors, not business experts. Being involved in the management of individual companies would cost them more than they could benefit, because the gains affect a small part of their wealth while all other investors can free ride. Secondly, discretion enables both managers and controlling shareholders to implement longer-term strategies, which may look beyond the signals received from the stock market on a daily basis. It is hardly contestable that controllers know more than stock market prices, which do not always reflect the long-term value of the company's investments.[26] Especially in those businesses that have uncertain prospects in the short run, a commitment to managerial discretion is a necessary condition for maximising long-term values. Lastly, discretion allows corporate controllers to make firm-specific investments, which may benefit shareholders as a whole.[27] In innovative firms, non-controlling shareholders welcome controllers who are deeply invested in the company with their human capital. However, as the performance of these investments is not

[25] EF Fama and MC Jensen, "Separation of Ownership and Control" (1983) 26 *Journal of Law and Economics* 301.

[26] See Bratton and Wachter, *supra* n 8, 688–703.

[27] EB Rock and ML Wachter, "Islands of Conscious Power: Law, Norms and the Self-Governing Corporation" (2001) 49 *University of Pennsylvania Law Review* 1619, 1630–40.

immediately observable through the stock price, controllers cannot generate a return on firm-specific investments (and appropriate their share of it) without discretion.[28] But purely discretionary management is not sufficient; controllers need to be accountable.

A purely discretionary management can extract private benefits of control via expropriation or otherwise, which in the end could damage investors more than managerial discretion benefits them. The controller's accountability is needed for this reason. Ideally, accountability should just prevent discretion from being abused. But if accountability can be abused, too—for instance, because outside shareholders behave opportunistically—controllers may end up having less discretion in business judgment than would be optimal.

The opportunism of non-controlling shareholders could be considered as only a theoretical problem. The standard assumption in the corporate governance literature is that rational apathy and lack of coordination among atomistic shareholders provides controllers with more discretion than could possibly be efficient.[29] This assumption has been contentious.[30] In pursuing controllers' accountability for misbehaviour, corporate law may empower non-controlling shareholders so much as to restrict managerial discretion inefficiently. While investors have an interest in conferring discretion upon controllers *ex ante*, their incentives to challenge this discretion *ex post* are not easily confined to situations of misdeed. Non-controlling shareholders can behave opportunistically both in litigating the controller's behaviour and in exercising their governance rights.[31]

Litigation is normally not an attractive option for individual or institutional shareholders, who have to bear its high costs while being entitled only to a share of the benefits. However, law may support litigation as an accountability device allowing the aggregation of shareholders' interests, for instance, through an agent (typically a lawyer) whose reward is contingent upon the damage awarded to the entire group. At this point, whether directors have misbehaved or not, a suit may be brought against them in order to recover from a substantial decline in stock prices.[32] Even the most sensible business decision can look misguided in hindsight, when it turns out badly. In a litigation-friendly environment, like the US, shareholders and their agents may find it profitable to renege on the original arrangement that controllers should have discretion in operational decision-making. Considering this, courts are reluctant to impose

28 See, eg M Schnitzer, "'Breach of Trust' in Takeovers and the Optimal Corporate Charter" (1995) 43 *Journal of Industrial Economics* 229.
29 Shleifer and Vishny, *supra* n 2, 740–44.
30 See, eg M Burkart, D Gromb and F Panunzi, "Large Shareholders, Monitoring, and the Value of the Firm" (1997) 112 *Quarterly Journal of Economics* 693.
31 See, eg Easterbrook and Fischel, *supra* n 21, 238.
32 See, eg R Romano, "The Shareholder Suit: Litigation without Foundation?" (1991) 7 *Journal of Law, Economics, and Organization* 55.

liability for breach of duty of care.[33] But there are other situations that do not qualify for courts' deference to business judgment, for instance when there is allegation of fraud. In such situations, the credible threat of litigation chills the exercise of control discretion with respect to all courses of action, either efficient or inefficient, that may result in liability or other sanctions.

Abuse of governance rights can only be an issue for institutional investors who are sufficiently large to overcome the free rider problem. To illustrate the potential for opportunism, I will not take into account two polar kinds of institutional shareholders: tracker (or indexed) funds and hedge funds. The former have hardly any incentive to monitor management due to the rigidities of their portfolios. The latter do not just monitor because they have better options that are unavailable to other institutions: either short-selling overvalued stock or targeting undervalued equity with a view to taking control of management.[34] I am thus focusing on traditional institutional investors (pension funds, insurance companies, mutual funds) who can monitor management by choosing between three strategies: exit, voice and loyalty.[35]

Normally, the best strategy for institutional shareholders to protect their investment in a portfolio company is to exit it in a timely manner. This strategy, however, is profitable on the condition that institutions invest in gathering forward-looking information. Selling on backward-looking information, which is already public, can only result in losses. In this perspective, moderately large shareholders who trade on superior information discipline management via the price effect on the controller's shares.[36] The same institutional shareholders protect the management from short-term market pressure by choosing loyalty, instead of exit, whenever they have a more informed view than the market does about the company's fundamentals. The incentive to collect forward-looking information is weakened by strong governance rights, which increase the attractiveness of voice relative to exit and loyalty. Investors who can directly influence management can simply (re)act upon backward-looking information. Not only is this information cheaper to collect, but also the exercise of voice is less expensive than it looks when it constitutes a credible threat. So long as institutions have the legal right to oust the controlling management and they are (collectively) large enough to do so, the threat is sufficiently credible and only needs to be implemented in exceptional circumstances. Compared to the threat of exit, a credible exercise of voice can be more effective in deter-

33 See Enriques *et al*, *supra* n 5, 79–81.

34 M Kahan and EB Rock, "Hedge Funds in Corporate Governance and Corporate Control" (2007) 155 *University of Pennsylvania Law Review* 1021, 1028–47.

35 AO Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms* (Harvard University Press, 1970).

36 See most recently in this literature, A Edmans and G Manso, "Governance through Trading and Intervention: A Theory of Multiple Blockholders" [2011] *Review of Financial Studies* forthcoming (http://ssrn.com/abstract=1102730).

ring expropriation because ouster imposes losses on controllers that exceed the price effect of embezzlement on their shares. The problem is that an effective threat of ouster by non-controlling shareholders also deters managerial actions, which might be efficient but are not in the immediate interest of institutional investors. Managers who fear ouster by disgruntled investors may refrain from policies or firm-specific investments that fail to generate the quarterly results that institutional shareholders expect, although the same policies and investments could increase shareholder value in the long run.[37] The reason is that, in a world where market prices do not always reflect fundamental values, institutional investors have incentives to be short-termist.[38] In the first place, the vast majority of funds are open-ended, which exposes them to the risk of withdrawal when they perform poorly in the short run. In addition, market benchmarks are widely used to measure the performance of portfolios and their managers,[39] implying that the majority of asset managers compete (and are rewarded) on short-term results also when institutions have longer investment horizons. By inducing the management of portfolio companies to cater to myopic market sentiment, institutional investors and their managers gain at the expenses of the future shareholders and of the maximisation of (long-term) shareholder value.[40]

Remarkably, the opportunistic pursuit of short-term goals by institutional investors depends more on voice than on exit. The unavailability of strong governance rights is a commitment device for investors to exercise exit or loyalty on a more informed basis than the market sentiment. This may explain the empirical evidence that institutional ownership promotes long-term investments in the US, where non-controlling shareholders have relatively weak governance rights.[41] Recent theoretical models demonstrate that institutions counter, not foster, managerial myopia when they are committed to building and trading their holdings on superior information.[42] However, these models predict the opposite result when shareholders can directly influence management choices through strong governance rights, because asset managers can make easier

[37] See Bratton and Wachter, *supra* n 8, 698–703, 709–13. See also I Anabtawi, "Some Skepticism about Increasing Shareholder Power" (2006) 53 *UCLA Law Review* 561, 579–83; M Lipton and W Savitt, "The Many Myths of Lucian Bebchuk" (2007) 93 *Virginia Law Review* 733, 745–47.

[38] A Rappaport, "The Economics of Short-Term Price Obsession" (2005) 61 *Financial Analysts Journal* 65, 75–76.

[39] See, eg JC Coffee, "Liquidity versus Control: The Institutional Investor as Corporate Monitor" (1991) 91 *Columbia Law Review* 1277, 1325–26. Of course, this argument does not apply to tracker funds and hedge funds, which are excluded from the present analysis.

[40] P Bolton, J Scheinkman and W Xiong, "Executive Compensation and Short-Termist Behaviour in Speculative Markets" (2006) 73 *Review of Economic Studies* 577, 597.

[41] P Aghion, JM Van Reenen and L Zingales, "Innovation and Institutional Ownership", FEEM Working Paper No. 99 (http://ssrn.com/abstract=1669323, August 2010). On the limitations of governance rights in the US, see *infra* text to nn 120–23.

[42] A Edmans, "Blockholder Trading, Market Efficiency, and Managerial Myopia" (2009) 64 *Journal of Finance* 2481.

money by inducing generation of short-term profits.[43] Although this prediction has not yet been tested empirically, the British experience seems to support it. In the UK, where non-controlling shareholders enjoy strong governance rights, institutional investors seem to engage exclusively in uninformed trading focusing on companies on which they have good influence.[44] Moreover, institutions are quite effective in determining management turnover through behind-the-scene pressure on the board of directors, especially when a company needs new equity.[45] Finally, turnover of executive directors is highly dependent on poor performance and on the potential for voting coalitions of outside shareholders.[46]

Accountability through governance rights has an obvious limitation, which impinges on both its effectiveness in constraining misbehaviour and the risk that it is abused to influence business judgment opportunistically. This limitation is the presence of a controlling shareholder. When outvoting a controlling shareholder is too costly, or impossible, the threat of ouster by non-controlling shareholders is not credible. However, this is not a guaranteed outcome. Investor empowerment may go so far as to raise the costs for controlling shareholders to grow to the point where they could avoid accountability to non-controlling shareholders.[47] One example of this is the mandatory bid, making it particularly onerous for controlling shareholders to increase their stake above a certain threshold. As we will see, veto rights in ongoing private transactions similarly increase the costs of short-circuiting investors' influence on business strategies. When corporate law makes consolidating controlling ownership expensive, a coalition of sufficiently large institutional investors can credibly threaten to outvote the controlling shareholder.[48] Under these conditions, the controlling shareholder may not be able to control the board or even resist ouster from it. This limits not only the controller's ability to expropriate minority shareholders, but also managerial discretion, at least to the extent that institutional investors are dissatisfied with its performance in the short run. As the pursuit of long-term strategies and rewards to firm-specific investments

[43] In a sense, institutional investors are "spoiled" by strong governance rights. *Ibid*, 2497.

[44] P Lysandrou and D Stoyanova, "The Anachronism of the Voice-Exit Paradigm: Institutional Investors and Corporate Governance in the UK" (2007) 15 *Corporate Governance: An International Review* 1070.

[45] See, eg J Franks, C Mayer and L Renneboog, "Who Disciplines Management in Poorly Performing Companies?" (2001) 10 *Journal of Financial Intermediation* 209, 225–28.

[46] See R Crespi and L Renneboog, "Is (Institutional) Shareholder Activism New? Evidence from UK Shareholder Coalitions in the Pre-Cadbury Era" (2010) 28 *Corporate Governance: An International Review* 274, 287–92. On the contrary, CEO turnover in the US seems to follow the informed exit by some institutional investors. See R Parrino, R Sias and L Starks, "Voting with Their Feet: Institutional Ownership Changes around Forced CEO Turnover" (2003) 68 *Journal of Financial Economics* 3.

[47] See J Armour and JN Gordon, "The Berle-Means Corporation in the 21st Century", unpublished manuscript (October 2008, on file with author), 18.

[48] Specifically for the UK, see Van der Elst, *supra* n 14, 26 and *infra* text to nn 143–47.

is what normally motivates a controlling shareholder to bear the costs of an undiversified investment,[49] one may even speculate that such an emphasis on accountability discourages controlling shareholdings altogether.

Accountability is not necessarily achieved by undermining managerial discretion, or worse, by discouraging certain ownership structures relative to others. This is illustrated by how takeovers deal with sub-optimal allocations of corporate control without allowing non-controlling shareholders to engage in opportunistic litigation or power struggle.[50] Whether takeovers are friendly or hostile, a new discretionary management replaces an equally discretionary one on the condition that the former is credibly committed to enhancing prospective shareholder value through the acquisition of a controlling stake. As opposed to the replacement of management (or threat thereof) by large non-controlling shareholders, takeover (or threat thereof) is only credible when the opportunity costs of controlling ownership are factored in.[51] Hence, the takeover mechanism does not allow for opportunistic challenge of control discretion because it forces insurgents who claim they can make better use of control discretion than incumbents do to "put their money where their mouth is".[52] This money may even include compensation of the incumbent's non-pecuniary private benefits of control, whenever companies wish to rule out takeover hostility in order to commit to long-term policies and/or firm-specific investments.[53]

As hinted before, market solutions do not work as well against outright embezzlement. For example, in the presence of large pecuniary private benefits of control, takeovers would allocate control to the best "thief" rather than to the best management.[54] The problem with the discretion/accountability trade-off is therefore more acute in this setting. Lack of market self-help implies that accountability can be achieved only by restricting the controller's discretion or empowering non-controlling shareholders to review it. The risk that regulation strikes the wrong balance is evidently high. An important lesson

[49] See, eg P Bolton and EL von Thadden, "Blocks, Liquidity, and Corporate Control" (1998) 53 *Journal of Finance* 1. See also RJ Gilson, "Controlling Shareholders and Corporate Governance: Complicating the Taxonomy" 119 *Harvard Law Review* 1641, 1661–65 (emphasising the importance of non-pecuniary private benefits of control to subsidise efficient controlling shareholder structures).

[50] See HG Manne, "Mergers and the Market for Corporate Control" (1965) 76 *Journal of Political Economy* 110. Hedge funds operate in a similar manner. See Macey, *supra* n 10, 244–51.

[51] *Ibid*, 118–22 and 209–12.

[52] See, eg B Holmstrom and SN Kaplan, "Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s" (2001) 15 *Journal of Economic Perspectives* 121, 138.

[53] See L Enriques, RJ Gilson and AM Pacces, "The Case for a Neutral Takeover Law", unpublished manuscript (August 2010, on file with author). See also *supra* text to nn 28 and 49.

[54] LA Bebchuk, RH Kraakman and G Triantis, "Stock Pyramids, Cross-Ownership, and Dual Class Equity: the Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights" in R Morck (ed), *Concentrated Corporate Ownership* (University of Chicago Press, 2000), 295.

from the previous discussion is that accountability of corporate control to non-controlling shareholders is not always a good thing. This accountability should ideally be confined to situations of potential expropriation, which cannot be resolved efficiently by market forces. But even in this domain, accountability might become excessive and lead to inefficient management when it allows for opportunism by non-controlling shareholders. Equipped with these insights, we can turn to the analysis of legal policies on self-dealing.

C. Economics of Self-Dealing Regulation

1. Self-Dealing and Expropriation of Shareholders

In corporate governance, expropriation of shareholder value is typically effected by violating the principle that distributions of the company's assets and residual cash flows must be made pro rata to all shareholders.[55] Non-pro-rata distributions can be implemented, for instance, by selling goods to or purchasing them from another company in which the controller has a higher ownership interest than in the first company.[56] Because of the obvious conflict of interest in determining the exchange price, transactions of this kind are extremely dangerous for non-controlling shareholders. As they involve a party whose interests are connected to those of the corporate controller, they are known as "related-party transactions" or, broadly speaking, as "self-dealing". Although self-dealing is not the only way to implement non-pro-rata distributions,[57] it is highly representative of the problems of a legal discipline aimed at countering expropriation of non-controlling shareholders.

Shareholder expropriation is difficult to define in legal terms. It is not difficult to imagine a broad prohibition of non-pro-rata distributions, which is included by virtually every corporate jurisdiction. However, "there are a million and one ways to evade such a rule".[58] A specific prohibition of self-dealing would raise another difficulty. Self-dealing is not evil by definition; it is just one of the many ways to conduct the corporate business. If related-party transactions could only be entered into for diversionary purposes, they would be ruled out by the law or the corporate contract. But they are not. Comparative

[55] Rock and Wachter, *supra* n 27, 1659–60.

[56] S Johnson, R La Porta, F Lopez-de-Silanes and A Shleifer, "Tunneling" (2000) 90 *American Economic Review* 22.

[57] For a broader taxonomy, See, eg V Atanasov, BS Black and CS Ciccotello "Unbundling and Measuring Tunneling", University of Texas Law and Economics Research Paper No. 117 (January 2008; http://ssrn.com/abstract=1030529).

[58] Rock and Wachter, *supra* n 27, 1661.

corporate law shows very few examples of self-dealing transactions that are prohibited because they may result in diversion of shareholder value.[59]

Self-dealing can easily lead to embezzlement, but this is not necessarily the case. These transactions can also be beneficial for shareholders as a whole.[60] The corporate controller's related party may offer terms more suitable to the company's strategy, that is, it might be in the exclusive position to supply the right goods at the right moment, or provide the right synergies for outperforming competitors. From the perspective of outside shareholders, the controller's conflict of interest is not a sufficient reason to forego these potential advantages *ex ante*. Self-dealing is thus a part of the discretionary mandate to manage the company entrusted to corporate controllers.

2. Effective vs. Efficient Discipline of Self-Dealing

Non-controlling shareholders may count on two fundamental mechanisms to avoid the diversionary implications of self-dealing. The first is regulation of related-party transactions, whose breach can be challenged in court. The second is the exercise of shareholders' governance rights in opposition to the controlling management or shareholder. Both mechanisms are effective against non-pro-rata distributions when they can stop these at the outset or support a credible threat of punishment if they are implemented. However, effective prevention or deterrence of expropriation has important shortcomings. As self-dealing does not necessarily imply non-pro-rata distributions, a very strict regulation may lead to a sub-optimal frequency of related-party transactions. Similarly, to the extent that the governance rights of non-controlling shareholders are not confined to self-dealing, their exercise (or threat thereof) may constrain managerial discretion also in the absence of a real risk of expropriation. In other words, placing effective constraints on the controller's ability to engage in self-dealing is not necessarily efficient.

To demonstrate why this is the case, I am not considering the effects of legal policies on players other than shareholders (that is, taxpayers and other stakeholders).[61] The efficiency criterion is based on shareholders wealth, not on overall social welfare, and it is therefore only applied to the discretion/accountability trade-off defined in the previous section. Following authoritative examples in corporate law and economics scholarship,[62] I evaluate the impact of the regulation of self-dealing on this trade-off based on a standard paradigm for

[59] L Enriques, G Hertig and H Kanda, "Related-Party Transactions" in Kraakman *et al*, *supra* n 5, 169–70.

[60] *Ibid*, 154–55. See also Davies, *supra* n 11, 531.

[61] For a stakeholder perspective on similar issues, see M Gelter, "The Dark Side of Shareholder Influence: Managerial Autonomy and Stakeholder Orientation in Comparative Corporate Governance (2009) 50 *Harvard International Law Journal* 129.

[62] L Enriques, "The Law on Company Directors' Self-Dealing: A Comparative Analysis" (2000) 2 *International and Comparative Corporate Law Journal* 297.

assessing the efficiency of constraints on human behaviour, which may result in an undesirable outcome, but whose connection with the same outcome is ambiguous. This is the "Type I/Type II error" paradigm borrowed from statistical inference. In economic analysis of law,[63] the typical Type I error—or false positive—is conviction of an innocent person. The typical Type II error—or false negative—is acquittal of a guilty person.

When regulation of self-dealing is very effective, non-pro-rata distributions (the undesirable outcome) are easily inferred from related-party transactions (the ambiguous behaviour), be that in court or because self-dealing is directly challenged by non-controlling shareholders equipped with strong governance rights. As few non-pro-rata distributions can escape discipline, there is a limited risk that expropriation goes through (false negative). However, corporate controllers might have to forego valuable projects implying related-party transactions for fear of being held accountable also when those transactions have no diversionary purpose. This is one example of false positives. When accountability is supported by strong governance rights, managerial discretion might be over-deterred also with respect to choices other than self-dealing. The threat of intervention by non-controlling shareholders may deter controllers from expropriation as well as from long-term strategies that risk yielding poor returns in the short run. Short-term underperformance is not necessarily related to non-pro-rata distributions, and it is potentially efficient in the long run. This is another source of false positives.

When corporate controllers bear little accountability for related-party transactions or to non-controlling shareholders in general, the discipline of self-dealing is ineffective in countering expropriation. This is also inefficient, but for the opposite reason. On the one hand, there is little risk of false positives, as the ability to use managerial discretion for good purposes does not suffer many restrictions even in the face of conflicts of interest. On the other hand, the risk of false negatives is high because the lack of accountability induces controllers to use their discretion to expropriate investors instead of to maximise shareholder value. Because of this problem, investors are willing to pay less for outside stock and thus valuable projects may fail to be financed.[64]

In policing self-dealing, false negatives can only be reduced by accepting a higher risk of false positives, and vice versa. As in the more general case of discretion and accountability, there is a trade-off between the two. Framing this trade-off as false positives and false negatives in countering non-pro-rata distributions brings one advantage: it allows us to focus on those situations where discretion is most likely to be abused for the purpose of expropriation. This has two important implications on how to optimise the discretion/

63 See, eg RD Cooter and TS Ulen, *Law and Economics* (Boston, MA, Addison-Wesley, 5th edn, 2008), 489–90.

64 See *supra* text to nn 3–4.

accountability trade-off in controlling the controller's misbehaviour. First, the general accountability of the controlling management or shareholder to non-controlling shareholders may be unnecessary in countering expropriation, but it exacerbates the false-positives problem. Restricting this accountability to related-party transactions is more efficient as long as the benefits of reducing false positives are higher than the costs of additional false negatives. Secondly, the corporate controller's ability to enter into related-party transactions should be constrained so long as the potential gains of these transactions to shareholders as a group do not exceed the expected value of diversion. Beyond that point, self-dealing is efficient and it should be allowed.

These simple guidelines obviously cannot eliminate the errors of a discipline of self-dealing. However, they are very useful for designing such a discipline with an optimal balance between the risk of false negatives and of false positives. To this purpose, I am going to analyse alternative rules, procedures and enforcement patterns governing related-party transactions. I will attempt to distinguish the determinants of their effectiveness against expropriation from their adverse consequences on the efficient use of managerial discretion.

D. Regulation of Self-Dealing: Functional Analysis

As the legal responses to self-dealing are nominally different across jurisdictions, comparisons must be performed functionally. This approach has enabled detailed comparisons of self-dealing regulations for a number of countries.[65] For the more modest purpose of this inquiry, I will follow a simplified functional framework along the lines identified by Professor Gilson.[66] The effectiveness of a discipline of self-dealing depends on three major factors. The first is *disclosure*, enabling detection of non-pro-rata distributions. The second is a *standard* to determine whether related-party transactions actually involve non-pro-rata distributions. The third is *enforcement*, whereby both disclosure and standard are applied to prevent or deter expropriation. The combinations of these elements have different implications for efficiency.

1. Disclosure

An effective disclosure of related-party transactions must concern the underlying conflicts of interest and include all information necessary to disentangle the transaction's business purpose from its implications for the controller's personal wealth. This is a precondition for identifying non-pro-rata distributions. Disclosure may be required *ex ante*, as a *qua non* for entering into related

[65] See, eg Djankov *et al*, *supra* n 4; Enriques *et al*, *supra* n 59.
[66] Gilson, *supra* n 49, 1653.

party-transactions, but also *ex post*, in order to allow investors to adjust their choices to the amount and implications of self-dealing reported by individual companies.[67] As disclosure involves no substantive constraint on related-party transactions, it is a relatively inexpensive strategy to counter expropriation. But there are two important qualifications. First, disclosure has a cost for shareholders because it consumes corporate resources. Secondly, disclosure may be over-enforced, and therefore could result in profitable related-party transactions being foregone.

It is often believed that disclosure is most effective when it takes place *ex ante*.[68] Whatever diversionary potential the transaction has, the money will already have gone when disclosure follows its implementation. However, this argument is not very convincing. *Ex post* disclosure can be a powerful deterrent of non-pro-rata distributions when it is enforced aggressively as an obligation to tell the truth.[69] Few people would steal if they were compelled to disclose stealing *ex post* under a credible threat of disruptive sanctions. The validity of this contention depends on a number of things. They are: how easily courts infer concealment of information from external circumstances; how much the corporate controllers fear the sanctions for breach of the duty to disclose; and the likelihood that these sanctions are triggered by selective disclosure. By the same token, the simple observation that production, dissemination, and authentication of information are costly (that is, efficient disclosure must be selective)[70] suggests that aggressive enforcement of the duty to disclose may result in over-deterrence of self-dealing. The most honest statement by the corporate controller on related-party transactions may be regarded as evidence of misdisclosure when it has adverse effects on stock prices.[71] This is a clear source of false positives.

Ex ante disclosure does have advantages over *ex post* disclosure, but these have to do with efficiency instead of with effectiveness. *Ex ante* disclosure aims not to deter expropriation, but to provide investors and their agents with the information necessary to prevent non-pro-rata distributions.[72] The efficiency advantage of enforcing disclosure at an earlier stage is twofold. First, the assessment of self-dealing does not suffer from hindsight bias, because disclosure can account for potential benefits of the transaction to shareholders that may not show immediately in the company's earnings. Secondly, disclosure can be targeted

[67] Enriques *et al*, *supra* n 59, 155–61.
[68] Djankov *et al*, *supra* n 4, 436.
[69] See L Loss, *Fundamentals of Securities Regulation* (Boston, MA, Little, Brown & Co, 1983), 33: "People who are forced to undress in public will presumably pay more attention to their figures."
[70] RJ Gilson and RH Kraakman, "The Mechanisms of Market Efficiency" (1984) 70 *Virginia Law Review* 549.
[71] See *infra* n 109 and accompanying text.
[72] On the divide between prevention and deterrence of harmful acts, see S Shavell, "The Optimal Structure of Law Enforcement" (1993) 36 *Journal of Law and Economics* 255.

to professional reviewers of related-party transactions who do not share other agents' incentives to challenge self-dealing opportunistically. While these factors reduce the risk of false positives relative to *ex post* disclosure, they may also result in under-enforcement (false negatives), for instance because the information provided is one-sided or the reviewers are "captured" by the corporate controller.[73] This problem is addressed by the standard for reviewing related-party transactions.

2. Standard

It might be tempting to subject the scrutiny of related-party transactions to a substantive standard. After all, what enables non-pro-rata distributions is the departure of self-dealing from market conditions. Therefore, it is often held by lawyers that related-party transactions are fair as long as they are carried out at arm's length. The problem with this approach is that related-party transactions cannot meaningfully be compared with transactions concluded at arm's length in precisely those circumstances in which they have a legitimate business purpose. Efficiency of self-dealing depends on the (related) counterparty's being in the exclusive position to supply certain items, relationships, or contractual terms, which would not be available in a standardised market exchange.[74]

Substantive standards of "fairness" to shareholders, defining the duty of loyalty owed by directors in self-dealing, perform a more modest role. They identify a standard of conduct whereby shareholders are not worse off because of the related-party transactions.[75] As the causal connection is difficult to establish, especially *ex post*, courts only in exceptional circumstances review self-dealing based on a substantive standard. One peculiar feature of corporate law is that standards of conduct—defining how an agent should behave—are allowed to diverge from standards of review—on the basis of which courts evaluate actual behaviours.[76] The rationale of this divergence is exactly the same underlying courts' reluctance to second-guess business judgment: protecting the exercise of managerial discretion from hindsight bias. While the presence of a conflict of interest prompts courts to review the conduct of corporate controllers, this review may not need to go as far as to question the merits of related-party transactions. Courts can be content to uphold self-dealing as if it were at arm's length when the decision to enter into it was emancipated from the conflict of interest through an informed and independent assessment of its business

[73] Enriques *et al*, *supra* n 59, 181–182.

[74] Transactions of this kind differ from standardised market exchange because "the specific identity of the parties has important cost-bearing consequences". OE Williamson, "Transaction–Cost Economics: The Governance of Contractual Relations" (1979) 22 *Journal of Law and Economics* 233, 240.

[75] Enriques *et al*, *supra* n 59, 173.

[76] MA Eisenberg, "The Divergence of Standards of Conduct and Standards of Review in Corporate Law" (1989) 62 *Fordham Law Review* 437.

purpose relative to the diversionary implications.[77] When this is the case, the standard of review is not substantive, but procedural.

A procedural standard shifts the locus of the assessment from courts to other reviewers, and its timing from *ex post* to *ex ante*. The review is typically carried out by the directors not interested in the transaction, with independent directors playing a most prominent role.[78] In some situations, particularly in the presence of significant transactions and/or of controlling shareholders, the law may also require a vote by non-controlling shareholders.[79] In both cases, the quality of *ex ante* disclosure of related-party transactions is a precondition for a valid independent review. This approach is supposed to validate self-dealing when the expected benefits to shareholders exceed the risk of expropriation—that is, when self-dealing is efficient. Here a few qualifications are needed.

The reduction of false positives relative to a judicial review stems from the different timing of the assessment. However, previous approval by non-controlling shareholders is also a potential source of false positives, because its high costs may offset the benefits of self-dealing and some shareholders may behave strategically in order to extract rents from their veto right.[80] An exclusive reliance on independent directors, whose involvement is cheaper and more professional, could overcome these problems. However, as the accountability of independent directors to non-controlling shareholders is limited, so is their effective independence from the corporate controllers.[81] Therefore, independent directors alone may fail to prevent shareholder expropriation through related-party transactions.

Corporate laws do not entirely rely on independent directors for the review of related-party transactions.[82] First, the application of the procedural standard can be questioned in court, on grounds that the review was not independent and/or not adequately informed. Secondly, courts may be willing to hear allegations of substantive unfairness when they consider the independent review insufficient to mimic an arm's length bargaining. Thirdly, non-controlling shareholders may have the legal power not only to veto certain related-party transactions *ex ante*, but also to challenge the controller's discretion *ex post* whether or not this was applied to self-dealing. All these redress options, which aim to compensate for the lack of information and independence in the review of self-dealing, could of course bring the false-positives problem to the forefront

77 Easterbrook and Fischel, *supra* n 21, 104–05.
78 Enriques *et al*, *supra* n 59, 162–66.
79 *Ibid,* 166–69.
80 *Ibid,* 167.
81 L Enriques, H Hansmann and RH Kraakman, "The Basic Governance Structure: Minority Shareholders and Non-Shareholder Constituencies" in Kraakman *et al*, *supra* n 5, 94–96; Enriques *et al*, *supra* n 5, 64–66.
82 Enriques *et al*, *supra* n 59, 181–82.

again because both litigation and governance rights may be enforced opportunistically by non-controlling shareholders or their agents.

3. Enforcement

Leaving aside the debate on the relative merits of public versus private enforcement of corporate law,[83] I am focusing here on private enforcement of the constraints on self-dealing. Recent research shows that the public and private enforcement are highly complementary in this field.[84] Moreover, the variety of private enforcement strategies towards self-dealing is most interesting for assessing effectiveness and efficiency of regulation.

Non-controlling shareholders can tackle related-party transactions in one of the following ways. *Ex post*, they can sue the company and its directors for having failed to disclose material information; they can sue directors for breach of duty of loyalty; and they induce directors suspected of misbehaving to resign. To be effective, these strategies need to trigger sanctions that deter wrongdoing and they must rely on credible mechanisms to overcome collective action problems. When these conditions are met, the question is whether the threat can be confined to non-pro-rata distributions or whether it also generates potential inefficiencies as false positives.

Alternatively, non-controlling shareholders can intervene *ex ante* and stop potentially harmful self-dealing. To do that, collective action problems must also be overcome. But, in addition, investors or their agents need to have sufficient information and independence from the corporate controller to assess the prospective impact of related-party transactions on shareholder value. Similarly to *ex post* enforcement, false negatives occur if these requirements are not met. However, as I am going to show, an appropriate discipline of independent directors as delegated monitors can cope with this problem without increasing the risk of false positives. In other words, independent directors can be both effective and efficient enforcers of a discipline of self-dealing.

(a) Sanctions and Deterrence

Deterrence obviously stems from the fear of liability.[85] However, corporate controllers face little risk of out-of-pocket liability for various reasons. Primarily, shareholder lawsuits can be credibly implemented only in few jurisdictions and can hardly be targeted directly to controlling shareholders outside the US,

[83] See, eg HE Jackson and MJ Roe, "Public and Private Enforcement of Securities Laws: Resource-Based Evidence" (2009) 93 *Journal of Financial Economics* 207.

[84] JD Cox and RS Thomas "Mapping the American Shareholder Litigation Experience: A Survey of Empirical Studies of the Enforcement of the US Securities Law" (2009) 6 *European Company and Financial Law Review* 164.

[85] S Shavell, *Foundations of Economic Analysis of Law* (Cambridge, MA, Harvard University Press, 2004), 177–256.

where such shareholders are less frequent.[86] Moreover, directors can be indemnified or insured by the company against all cases of liability other than against proven fraud.[87] Lastly, most cases of director liability (including self-dealing) are settled out of court and directors seem to contribute little, if anything, to the settlement.[88] In spite of this, controllers' misbehaviour is also deterred by two other sanctions, complementary to or independent of a liability suit, namely, ouster and shaming.[89]

Ouster deters by imposing the loss of the benefits that managers or controlling shareholders reap from their position. Managers who are suspected of improper self-dealing can be fired or pressurised to resign from the board, thereby losing non-pecuniary private benefits of control and the chance of negotiating their compensation in a future takeover.[90] Controlling shareholders likewise suffer from withdrawal of investor support via the price effect on their shares, which may result in a different form of ouster. Controlling shareholders who are suspected of improper self-dealing may be induced to step down from the board, not so much to prevent outvoting by a coalition of non-controlling shareholders, but more in order to protect the value of their undiversified investment. This situation also results in the loss of non-pecuniary private benefits of control because the controller's stake can no longer be sold at a premium.

Shaming, on the other hand, reinforces the deterrent effect of ouster, particularly in those situations where non-controlling shareholders do not have the power to dismiss directors at will.[91] Being labelled as "thief" prevents a controller from playing any further game in the financial community. Controlling shareholders would not be able to raise additional finance; and directors would have to resign even where they enjoy positional advantages in corporate elections. Similarly, shaming can make ouster permanent. Controllers having a reputation of embezzlement are not likely to sit on a board of directors ever again. These effects depend on the importance of social norms, and thus they do not have the same strength everywhere.[92] However, shaming and ouster often follow the settlement of a liability suit especially when it is combined with investigations by a securities agency or criminal proceedings.

86 Enriques *et al*, *supra* n 59, 174–76.
87 BS Black, BR Cheffins and M Klausner, "Outside Director Liability: A Policy Analysis" (2006) 162 *Journal of Institutional and Theoretical Economics* 5, 11–13.
88 Romano, *supra* n 26, 57–70; Coffee, *supra* n 9, 1550–54.
89 See, eg TA Paredes, "A Systems Approach to Corporate Governance Reform: Why Importing US Corporate Law Isn't the Answer" (2004) 45 *William and Mary Law Review* 1055, 1085–1103.
90 On efficient extraction of private benefits of control, see AM Pacces, "Control Matters: Law and Economics of Private Benefits of Control", ECGI-Law Working Paper 131/2009 (August 2009; http://ssrn.com/abstract=1448164).
91 See Macey, *supra* n 10, 31–44.
92 See, eg DA Skeel, "Shaming in Corporate Law" (2001) 149 *University of Pennsylvania Law Review* 1811.

This operation of deterrence is problematic. In litigation-friendly environments, the mere suspicion of non-pro-rata distributions may trigger the sanctions whenever the company is doing badly. As courts are inclined to infer misconduct with hindsight bias, the credibility of the threat mainly depends on the ease with which related-party transactions (and their disclosure) can be litigated *ex post*.[93] This situation over-deters self-dealing because lawsuits can be brought and successfully settled also in the absence of actual expropriation. Similarly, in those jurisdictions where the threat of shareholder suit is not credible, effective enforcement requires that non-controlling shareholders be given stronger powers to oust controllers (and possibly to shame them within a close-knit community) independently of litigation.[94] This solution is exposed to false positives too, as the sanctions may be imposed even in the absence of self-dealing. In both situations, the false positive problem is exacerbated by delegation of the enforcement action.

(b) Delegated Enforcement

Because individual shareholders face collective action problems, an effective delegation mechanism is needed for enforcement to be credible. By providing an agent with incentives to collect information and to act upon it that investors lack individually, the controllers' misbehaviour is more likely to be detected and challenged, and therefore deterred. The problem with this strategy is that, in trying to cope with the agency problem between investors and corporate controllers, it creates a new one between non-controlling shareholders and their enforcement agents. Here I shall consider only two of these agents for the *ex post* enforcement through litigation or governance rights respectively. These are the class action lawyers and the institutional investors.

Lawyers can be a very effective enforcement agent when their reward is contingent upon successful litigation and when it is commensurate with the damages collectively awarded to shareholders.[95] Other factors also contribute to this result, most notably courts' inclination to infer breach of disclosure rules from adverse movements in stock prices and their willingness to review the substantive fairness of related-party transactions.[96] Under these circumstances, lawyers have powerful incentives to detect potential misconduct and to sue on the investors' behalf. However, these incentives are poorly aligned with maximisation of shareholder value.[97] The probability of making a successful case

93 See Macey, *supra* n 10, 140–53.

94 See J Armour "Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment" in AM Pacces (ed), *The Law and Economics of Corporate Governance: Changing Perspectives* (London, Edward Elgar, 2010), 213–58.

95 JC Coffee, "The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action" (1987) 54 *University of Chicago Law Review* 877.

96 See *infra* text to nn 109–19.

97 Macey, *supra* n 10, 136–37.

in court or a lucrative settlement depends on conditions only loosely connected with actual expropriation. Lawyers maximise their fees by attacking self-dealing and situations that may conceal it. Not only does this circumstance deter non-pro-rata distributions, it also over-deters related-party transactions.

Institutional investors' incentives to act as enforcement agents depend on them having (as a coalition) sufficient powers to oust controllers and on their exit option being not immediately attractive, for instance, because their investment amounts to a relatively large share of the company's capital.[98] Under these conditions, institutional investors can be expected to police self-dealing out of concern for the value of their investment. However, as the latter is diversified, institutions are unlikely to engage in a detailed scrutiny of related-party transactions. They would rather seek to enhance the overall accountability of controllers through more cost-effective policies, whose design and enforcement can be generalised across the portfolio companies.[99] These policies include constraints on the controller's discretion (for instance, the requirement that the majority of the board and its Chairman be independent) that exceed the purpose to detect non-pro-rata distributions.[100] The reason for this is that institutional investors and their fund managers care not only about expropriation, but also about the performance of their portfolios in order to ensure that they do not underperform relative to the market benchmarks upon which they are evaluated by their customers or employers. This influence of institutional investors on managerial choices is a source of false positives because it over-deters not just self-dealing, which will not be challenged so long as the procedural safeguards are respected, but also long-term strategies. When these generate poor results in the short run, institutions with strong governance powers would not adjust their trading to long-term fundamentals; they would rather use their influence on the boards to steer a recalcitrant management towards short-term profits.[101]

(c) Delegated Monitoring

Ex post enforcement and its delegation are a pernicious combination. The price to pay for effective deterrence of misbehaviour is the application of sanctions also to behaviours that could have been efficient *ex ante*, but hardly look such *ex post*. Moreover, in order for enforcement to be credible, the enforcing agents are rewarded for acting in situations of potential misconduct, which

[98] See, eg Cheffins, *supra* n 15, 370–72. Note that in the presence of strong governance rights institutions may deliberately choose to be large enough to be committed to voice instead of exit. See Edmans and Manso, *supra* n 36, 23–24, and text to nn 38–46.

[99] BS Black and JC Coffee, "Hail Britannia: Institutional Investor Behavior under Limited Regulation" (1994) 92 *Michigan Law Review* 1997, 2034–55.

[100] See, eg Armour, *supra* n 94, 249–51.

[101] See *supra* text to nn 42–43.

induces opportunistic over-enforcement as long as the agents do not bear the adverse consequences of false positives on long-term shareholder value. Here the attempts to reduce over-deterrence may easily result in high risk of false negatives, because, for instance, lawyers and institutional investors would take much less trouble in uncovering stealing if their rewards and/or powers were confined to situations of manifest expropriation. These problems are less severe when enforcement is crafted as monitoring *ex ante*.

I will first consider the case of previous shareholder approval. The advantage of this solution is twofold: first, the powers of non-controlling shareholders can be limited to self-dealing; secondly, the review of self-dealing can balance *ex ante* the controller's conflicts of interest against potential efficiencies. However, as we know, this approach still supports some false positives for it is costly and may foster strategic behaviours. More importantly, *ex ante* shareholder approval is unlikely to be effective on its own. The implementation of this strategy is implicitly delegated to large institutional investors, who depend on controllers for information but who do not have incentives to actively investigate non-pro-rata distributions or failure to disclose them. To avoid the risk of false-negatives, non-controlling shareholders must also rely on other forms of board's accountability *ex post*, such as the right to remove directors at will,[102] which, as we have seen, may deter both misconduct and potentially efficient behaviours.

Because non-controlling shareholders face collective action problems, delegation of monitoring is unavoidable. However, the agency costs of delegation can be minimised when the scrutiny of self-dealing is exclusively entrusted to independent directors. In addition to the general advantages of monitoring self-dealing *ex ante*, independent directors provide the following benefits.[103] First, the scrutiny is obviously cheaper. Secondly, independent directors are unlikely to behave strategically in reviewing self-dealing, because their incentives are at least partly based on a reputation of professional monitors. Thirdly, for the same reason, independent directors can be expected to stop most egregious non-pro-rata distributions. Clearly, this is not enough to cope with the false-negatives problem. Directors cannot be entirely independent when they are nominated by boards alternatively deferring to the managers or to the controlling shareholders. This circumstance compromises their incentives to dig deeper into self-dealing or into comparable situations. Independent directors' staying in business depends not only on their reputation with investors, but also on some congeniality with the controllers who are supposed to hire them.[104]

A simple solution to the imperfect reliability of independent directors is to supplement their previous scrutiny with deterrence of the expropriation that may still go through. That implies continuing to rely on *ex post* enforcement by

[102] Armour, *supra* n 94, 251–56.
[103] Enriques *et al*, *supra* n 59, 162.
[104] Macey, *supra* n 10, 93–95.

non-controlling shareholders via litigation or broad governance rights. Short of the false positives that it involves, this approach avoids dealing with the crux of the matter, that is, directors' independence. The latter can be enhanced by rules on the appointment of outside directors that exclude the controllers' influence on the process. However, to avoid falling back to the false-positives problem, independent directors' number and mandate should be limited to monitoring self-dealing and similar pecuniary conflicts of interest on the controller's side. Before elaborating on the advantages of this solution, I shall look in more detail at the shortcomings of alternative approaches.

E. Law and Economics of Related-Party Transactions: A US–UK Comparison

This section illustrates the inefficiencies of effective disciplines of self-dealing in the real world. I have selected two major models of regulation: the US and the UK. Their effectiveness in investor protection is confirmed by the exceptionally high figures on stock market development in those two countries.[105] It is also well known that this result is achieved very differently in the two jurisdictions, for instance, in the US by supporting investor protection through litigation and in the UK by empowering non-controlling shareholders in corporate governance.[106] Based on the functional framework developed above, it can be shown that both models generate substantial false positives.

1. Litigation-Based Protection in the US

Disclosure is one major cornerstone of investor protection in the US. This also applies to self-dealing, which must be disclosed both *ex ante* (to the board) and *ex post* (to investors).[107] *Ex post* disclosure is particularly important for deterrence, because non-pro-rata distributions must involve some misdisclosure and the latter can be easily litigated under federal securities law. In fact, securities litigation account for the largest part of private enforcement of investor protection in the US and it is considered the most powerful deterrent against expropriation.[108] This outcome especially depends on two factors. On the one hand,

[105] In the US and the UK, the stock market capitalization to GDP is about 50% higher than the world mean and outperforms by over one third the average high-income OECD country. See T Beck, A Demirgüç-Kunt and R Levine, "A New Database on Financial Development and Structure" (2000) 14 *World Bank Economic Review* 597 and its subsequent updates, available at http://go.worldbank.org/X23UD9QUX0.

[106] See, eg Armour *et al*, *supra* n 6.

[107] *Ex post* obligations stem from multiple sources: Securities Exchange Act 1934, s 16(a) (amended by Sarbanes-Oxley Act 2002, s 403); SEC Regulation S-K, Item 404; and the US Generally Accepted Accounting Principles (SFAS 57). On disclosure *ex ante*, see *infra* text to nn 115–16.

[108] Armour *et al*, *supra* n 6, 710–11; Paredes, *supra* n 89, 1097–99.

securities law allows a court to infer misconduct from adverse movements in the stock prices whenever bad news suggests failure to disclose material information.[109] On the other hand, the rules governing mass litigation, civil procedure and the attorney's fees provide shareholders' lawyers with powerful incentives to sue in these circumstances, which may well conceal self-dealing, but do not necessarily imply expropriation.

There is a unique system of "entrepreneurial litigation" of mass claims in the US, which is mainly due to the special combination of class actions with the attorney's contingent fee arrangement.[110] Class actions effectively overcome shareholders' collective action problems. When the class is certified, the class attorney—not the class representatives—has incentive to act as shareholder agent because they can earn a fee commensurate with the damages awarded to the entire class. This pattern of private enforcement is highly controversial. In theory, lawyers earn no fee when they do not win the case; this should induce them to select and enforce only meritorious claims. However, most class actions are settled out of court, because courts are biased in assessing misdisclosure when the company is doing badly, the rules on discovery are particularly burdensome for the company, and directors enjoy liability insurance whenever they are not found guilty of fraud.[111] Settlement is always a success for lawyers, because they get their generous share of damage compensation. This is paid by the company, either directly or via insurance premiums, and not by the corporate controllers named as secondary defendants. For this reason, Professor Coffee authoritatively contends that class actions are not only expensive for shareholders, but they also fail to deter the controllers' misbehaviour.[112]

However, as we have seen, deterrence stems not only from liability. Securities class actions can be highly detrimental for the corporate controller's reputation, leading to ouster or shaming, or both. Recent empirical and anecdotal evidence supports this proposition. Both directors and controlling shareholders are induced to step down from the board in the wake of scandals accompanied by litigation; and they are unable to secure comparable appointments

[109] This depends on "fraud-on-the-market' doctrine governing private actions under SEC Rule 10b-5, whose cause of action includes much more than (failure to disclose) self-dealing. See *Basic Inc v Levinson* 485 US 224 (1988). As this doctrine trivialises the proof of causation between misdisclosure and investors' damages, it promotes shareholder suits whenever adverse movements in stock prices can be justified by the failure to disclose some material information. See, critically, JR Macey and GP Miller, "Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory" (1990) 42 *Stanford Law Review* 1059; LE Ribstein, "Fraud on a Noisy Market" (2006) 10 *Lewis and Clark Law Review* 137.

[110] Coffee, *supra* n 95. Another important factor is the absence of rules on fee shifting in the US. See *infra* text to n 126.

[111] Romano, *supra* n 32. On courts' hindsight bias see particularly GM Gulati, J Rachlinski and DC Langevoort, "Fraud by Hindsight" 98 *Northwestern University Law Review* 773.

[112] Coffee, *supra* n 9, 1547–56.

later on.[113] Controllers cannot be insensitive to suspicions of theft because, in the US, securities litigation triggers a general discomfort in the financial community, serious investigations by the SEC and often the stigma of a criminal proceeding.[114] Therefore, securities litigation can deter expropriation quite effectively. The problem is that this mechanism does not require the presence of non-pro-rata distributions at all. In adverse circumstances, the mere existence of a conflict of interest supports credible allegations of misdisclosure and the lawyers' profiting from them. Thus, securities litigation is most likely to over-deter self-dealing.

Related-party transactions are strictly regulated by state corporate laws too. Courts review both procedural and substantive fairness of the transaction.[115] However, the application of the substantive standard can be avoided when the conflicts of interest are properly disclosed *ex ante* and the transaction is approved by a majority of independent directors or, when the board defers to a controlling shareholder, a majority of minority shareholders.[116] Similar rules apply to the shareholders' standing to sue controllers derivatively, that is, on the company's behalf. Although derivative suits have more bite in the US than elsewhere, they can be short-circuited by the board when a committee of independent directors is set up to handle, and possibly dismiss, the litigation.[117] It is worth noting that the incentives underlying corporate litigation are similar to those of securities litigation. Because only the company is entitled to damage compensation, the shareholder suit has a class dimension allowing lawyers to earn substantial contingent fees. In view of the above restrictions, lawyers would only take the lead in derivative litigation when they are quite certain that they can make a successful case out of failure to free self-dealing from the controller's conflicts of interest. This outcome seemingly supports an efficient balance between false positives and false negatives, as it mainly relies on delegated monitoring by independent directors. But there is an important qualification to be made.

At least in Delaware, the most important jurisdiction for US listed companies, courts are more aggressive in reviewing self-dealing and lawyers in challenging it. The fact that formally independent directors have validated related-party transactions, or dismissed derivative litigation, is not a sufficient

[113] On inside and outside directors turnover, see sources cited by Macey, *supra* n 10, 206 and Coffee, *supra* n 9, 1554 (see also Romano, *supra* n 32, 71–76). On controlling shareholders, see the Hollinger case discussed in Enriques *et al*, *supra* n 81, 96, and Enriques *et al*, *supra* n 59, 160.

[114] Paredes, *supra* n 89, 1086–96.

[115] Enriques *et al*, *supra* n 59, 173–76.

[116] Compare Revised Model Business Corporation Act (RMBCA), ss 8.60–8.63, with Delaware General Corporation Law (DGCL), s 144. See also *Sinclair Oil Co v Levien* 280 A2d 717 (Del Sup1971).

[117] See *Auerbach v Bennett*, 419 NYS 2d 920 (NY 1979). See also SM Bainbridge, *Corporation Law and Economics* (New York, Foundation Press, 2002), 393–404.

reason for courts to defer to the board's business judgment; it only shifts to the plaintiff the burden of proving misconduct.[118] In practice, whenever a plaintiff's attorney can convince the court that the review of conflicts of interest was not effectively independent of the corporate controller, litigation of self-dealing is most likely to be successful and to be settled on the basis of this expectation. The risk that the merits of self-dealing will be second-guessed in hindsight is an obvious source of false positives. The ambiguity of Delaware case law on this point exacerbates this result by fostering lawyers' opportunism.[119] On the other hand, unfettered reliance on the procedural standard could not avoid the opposite problem of false negatives, because the appointment of independent directors in the US is done in any case under the influence of corporate controllers.

This fact is unchanged even after regulation has emphasised board independence following the financial scandals at the beginning of the century.[120] Securities law and listing rules regulate eligibility, tasks and the proportion of independent directors, but not their appointment and removal. In this regard, the general rules apply. These rules do not restrict the controlling shareholder's ability to appoint whom they want. They also favour the incumbent board, and thus the management, in making director nominations, soliciting proxy voting, winning uncontested elections and fighting contested ones.[121] In addition, as the US boards have the upper hand in supporting charter provisions that entrench directors, even a costly proxy contest may not be an option for non-controlling shareholders to remove directors they are unhappy with.[122] This applies, of course, unless a director's reputation is compromised up to the point of making resignation unavoidable.

It is therefore not surprising that formally independent directors ultimately defer to those managers or controlling shareholders who control the board. Independent directors cannot be fully trusted to control the controller's misbehaviour, which thus needs to be disciplined by aggressive litigation. To avoid the false positives that this involves, it might be tempting to strengthen non-controlling shareholders' power to hold directors to account instead. As a result of the authoritative advocacy by Professor Bebchuk, of new forms of shareholder activism and of the general discomfort with bankers' power after the financial

[118] See *Zapata Corp v Macdonaldo* 430 A 2d 779 (Del Sup1981) (derivative litigation); *Kahn v Lynch Communication Systems* 638 A 2d 1110 (Del Sup1994) (self-dealing).

[119] See WJ Carney, GB Shepherd and JM Shepherd, "Delaware Corporate Law: Failing Law, Failing Markets" (2010) in Pacces, *supra* n 94, 23–81.

[120] See Enriques *et al*, *supra* n 5, 65.

[121] See efficaciously, S Cools, "The Real Difference in Corporate Law between the United States and Continental Europe: Distribution of Powers" (2005) 30 *Delaware Journal of Corporate Law* 697, 738–50.

[122] See DGCL, s 141(k); RMBCA, s 8.08. See also LA Bebchuk and A Cohen, "The Costs of Entrenched Boards" (2005) 78 *Journal of Financial Economics* 409.

crisis, corporate governance in the US seems to be moving in this direction.[123] However, as I am going to illustrate in the case of the UK, the general empowerment of investors has drawbacks too.

2. Governance-Based Protection in the UK

Regulation of self-dealing in the UK is no less strict than in the US. However, this regulation is enforced only marginally by litigation. Private enforcement of corporate and securities law in Britain is virtually not existent compared to the US.[124] The reasons include procedural restrictions on the ability of non-controlling shareholders to sue derivatively.[125] But more important is the absence of lawyers' high-powered incentives to wage shareholder suits because of the ban on contingent fees and the loser-pays rule on the allocation of litigation expenses.[126] Yet, corporate controllers comply with the discipline of related-party transactions under the credible threat of punishment by institutional investors who have the economic and the legal power to oust those who misbehave from the board and ostracise them from a close-knit financial community.

Self-dealing must be disclosed both *ex ante* and *ex post*.[127] Disclosure *ex ante* is particularly important. Courts do not review substantive fairness: directors who fail to disclose to the board their interest in the prospective transaction are in breach of duty of loyalty.[128] The role of independent directors is implicit in this mechanism, as disclosure allows them to detect (and to stop) non-pro-rata distributions. Disclosure to the board is not sufficient to validate all kinds of related-party transactions. Company law requires that specific transactions be sanctioned by the shareholders' meeting too.[129] And the Listing Rules mandate informed shareholder approval of all non-routine transactions exceeding a certain value.[130] Company law is comparatively less strict with controlling shareholders, especially when they do not sit on the board. As the remedies against

[123] See lately LA Bebchuk, "The Myth of the Shareholder Franchise" (2007) 93 *Virginia Law Review* 675; M Kahan and EB Rock, "Embattled CEOs", ECGI-Law Working Paper 116/2008 (October 2008; http://ssrn.com/abstract=1281516). Most recently, s 971(b) of the Dodd-Frank Act have authorised the SEC to regulate outside nominations to the board. See Rule 14a-11, SEC Release No 33-9136 of 25 August 2010. However, the implementation of outside proxy access has been delayed in response to a judicial petition by the US Chamber of Commerce and the Business Roundtable challenging the legality of SEC rulemaking.

[124] Armour *et al*, *supra* n 6, 696–701, 711–14 (showing, at 715–17, that also public enforcement is negligible).

[125] Compare *Foss v Harbottle* (1843) 2 Hare 461 with Companies Act 2006 (CA), ss 260–264. See also Davies, *supra* n 11, 605–23; Armour, *supra* 94, 223.

[126] *Ibid*, 224–25.

[127] Enriques *et al*, *supra* n 59, 156–57.

[128] See CA, ss 175–77 and Davies, *supra* n 11, 530–31.

[129] CA, ss 188–226.

[130] LR 11.1.5–7 (related-party transactions). Significant transactions, which exceed certain percentages of the company's assets, capital and profits, are subject to shareholder approval even in the absence of conflicts of interest. See LR 10.5.1.

abuse of voting rights are poorly enforced in listed companies,[131] controlling shareholders could approve, in theory, all self-dealing they want. However, the Listing Rules explicitly consider related party any shareholder accounting for more than 10% of voting rights and prohibits them and their associates from voting on transactions in which they have an interest.[132]

These rules are enforced in a very peculiar fashion. One important feature of UK company law is that directors can be removed without cause by the majority of the votes casted at the shareholders' meeting.[133] Unlike in the US, where companies can and most often do opt out of similar provisions, this rule is mandatory in the UK. In addition, sufficiently large non-controlling shareholders (or coalitions thereof) can call a meeting to remove directors or request the company to circulate a proposal to that purpose.[134] Therefore, institutional investors do not need to go through the hurdles of litigation in order to secure directors' compliance with the law. In the typical UK listed company, a coalition of the largest institutional investors is sufficient to make a majority.[135] They thus have both the right and the voting power (which they protect by effectively vetoing control-enhancing mechanisms, such as dual class shares)[136] to oust the directors they are dissatisfied with. Because the threat is credible, these powers hardly need to be used. Institutions very seldom cast their vote against directors, but directors often resign under pressure exercised behind closed doors.[137]

This mechanism deters expropriation well enough. Failure to disclose self-dealing or otherwise comply with its procedural requirements would result in directors being fired. This includes independent directors, who are therefore prompted to monitor the controller's conflicts of interest carefully. Noticeably, in the UK as elsewhere, institutional investors do not actively select or monitor independent directors.[138] However, British institutions are more active on policies that can be generalised across portfolio companies, which include, among others, the Combined Code's provisions recommending board inde-

[131] On the limited impact of legal remedies for majority/minority conflicts in listed companies, see Davies, *supra* n 11, 649–63, 681–708.

[132] LR 11.1.4 and Appendix 1.

[133] CA, s 168.

[134] CA, s 303 (10% of voting rights enable to call a meeting) and s 338 (5% of voting rights enable to place an item on the agenda). Similar options are restricted or unavailable in the US. See, eg DGCL, s 211(d), and SEC Rule 14a-8.

[135] M Goergen and L Renneboog, "Strong Managers and Passive Institutional Investors in the UK" (2001) in Barca and Becht, *supra* n 13, 270–72.

[136] Cheffins, *supra* n 15, 316–17.

[137] See Black and Coffee, *supra* n 99, 2053–55; GP Stapledon, *Institutional Shareholders and Corporate Governance* (Oxford University Press, 1996), 122–29: more recently, M Becht, J Franks, C Mayer and S Rossi, "Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund" (2009) 22 *Review of Financial Studies* 3093, 3119–21.

[138] Stapledon, *supra* n 137, 142–54.

pendence on a "comply-or-explain" basis.[139] In addition, institutional investors can oust anyone from the board and add significant reputational sanctions to that. By the same token, they can veto future reappointments of directors suspected of handling conflicts of interest improperly. Large investors are keen to have a general influence on boards of directors because in this way they can save the costs of engaging with individual companies on specific issues. Short of exceptional circumstances in which institutional investors must intervene, also to signal the credibility of the threat, this influence is sufficient to guarantee that self-dealing is disclosed and approved according to the rules.

The disadvantages of this strategy for efficiency depend on the same factors that determine its effectiveness against expropriation. First, non-routine self-dealing must be approved by non-controlling shareholders. While this guarantees independent approval, it creates some false positives, if not because of strategic behaviour (institutional investors are committed to approving value-increasing transactions), then certainly on the account of its costs.[140] Secondly, non-controlling-shareholders' influence on the board is more far-reaching than self-dealing, and thus it can be used opportunistically. This influence enables institutional investors and their managers to maximise the returns on their portfolios relative to market benchmarks instead of investigating more carefully the company's fundamentals. The reason for this is that they can steer the corporate management towards production of short-term results simply by threatening board turnover.[141] Thirdly, the danger of investors' second-guessing business judgment may extend to controlling shareholders. In such a case it becomes even more worrisome because the ability to implement long-term policies and firm-specific investments is one major rationale of concentrated ownership structures.[142] This danger may be real in the UK because in the typical listed company, the largest shareholder can be outvoted by the other blockholders.[143] Moreover, regulation makes it very costly for controlling shareholders to become large enough to offset that threat.

One major legal factor that affects the powers of controlling shareholders and their accountability to institutional investors for good as well as bad purposes is the mandatory bid. When the controlling shareholder's stake increases above 30%, it is compelled to make a bid for the remainder of the stock offering no less than the highest price paid in the previous 12 months.[144] Because increasing voting power and purchasing undervalued stock is expensive for controlling shareholders close to the 30% threshold, disgruntled institutional investors can

[139] Financial Reporting Council, "The Combined Code on Corporate Governance", June 2008. "Comply-or-explain" is mandated by LR 9.8.6(5–6). See also Armour, *supra* 94, 248–57.
[140] See *supra* text to nn 80 and 102.
[141] See *supra* text to nn 37–43.
[142] See *supra* text to nn 47–49.
[143] Van der Elst, *supra* n 14, 26.
[144] City Code on Takeover and Mergers, Rule 9.1.

punish them in two ways. To begin with, they may force resignation from the board and/or veto the controller's nominees to it. They can also gradually reduce their stake in the company, thereby imposing larger losses on controlling shareholders who cannot sell their block piecemeal. In an attempt to secure a control premium from investors' interference, controlling shareholders may try to take the company private—but UK regulation makes this strategy expensive too. It depends on the strict rules on equal treatment of shareholders in voluntary bids,[145] the non-tendering shareholders' veto power (increasing in the stake held by the bidder) over squeeze-out[146] and the exclusion of the controller's votes from the super-majority necessary to effect a cash-out merger by scheme of arrangement.[147]

These rules, whose strictness is unparalleled in the US,[148] can raise the costs for controlling shareholders to consolidate ownership up to a point where they cannot avoid the influence of institutional investors on how they choose to conduct business. In a sense, this emphasis on investor empowerment is necessary to counter expropriation, as controlling shareholders could easily circumvent the rules on self-dealing if they could escape accountability to institutional investors. The problem is that accountability may go much further than that. One recent case study illustrates this point.

The controlling shareholder of EasyJet plc was engaged in a long battle for the control of the board, which he eventually lost.[149] He wanted to push a business strategy more conservative than the one supported by the board. Therefore, he sought to enforce the article's provisions conferring upon shareholders larger than 25% (he had a 26.9% stake) the right to appoint the Chairman and two additional board members. This, however, would have been contrary to the Combined Code's recommendations. After institutional investors signalled their discomfort with this attempt, withholding some of their votes in the annual election, the controlling shareholder had to back off and

[145] City Code, Rule 6 disallows outside-bid purchases on more favourable terms. See Davies, *supra* n 11, 1015–16.

[146] *Ibid*, 1046–54 and CA, s 979. In order to be able to squeeze-out the minority, the bidder must reach a 90% rate of acceptance. This penalises bidders having already a large stake, by increasing non-controlling shareholders' veto power.

[147] CA, s 899 and LR 11.1.4. The majority (in number) must account for 75% in value of the shares voted at the meeting, excluding the controlling shareholder's votes. The higher is the controller's stake and the lower the turnout, the easier for non-controlling shareholders to veto the transaction. On schemes of arrangement, see more generally Davies, *supra* n 11, 1061–69.

[148] There is no mandatory bid in the US. In addition, the Williams Act does not require equal treatment of shareholders outside tender offers. See P Davies and K Hopt, "Control Transactions" in Kraakman *et al*, *supra* n 5, 251–56. Finally, the law on freeze-outs is less strict. See EB Rock, P Davies, H Kanda and RH Kraakman, "Fundamental Changes" in Kraakman *et al*, *supra* n 5, 202–05.

[149] See "Sir Stelios Looks to Take Controls at EasyJet", *Financial Times*, 15 November 2008, 17; "EasyJet Finance Chief to Depart", *Financial Times*, 2 May 2009, 12; "EasyJet Founder Backs Down", *Financial Times*, 15 June 2009, 17.

to reach a compromise on his requests. Noticeably, the controlling shareholder could have minimised the risk of being outvoted relying also on the 11.3% of shares held by his brother. However, engaging the institutional investors with that additional muscle would have exposed both to the mandatory bid as action in concert.[150] Similarly, the high family stake adversely affected the controller's ability to effect a going-private transaction.

In the absence of comprehensive studies on the role of controlling shareholders in British corporate governance, this case can only be generalised in principle. The Combined Code is particularly strict in defining independence of the majority of the board and of its Chairman, as it explicitly excludes representation of significant shareholders.[151] Although the Code is not formally binding, institutional investors seem to be particularly keen on the letter of this and other provisions.[152] The few companies that meaningfully explain non-compliance apparently outperform the compliant ones, but this effect is not timely incorporated into market prices and, arguably, the choices by institutional investors.[153] This suggests that institutional investors value compliance *per se* in the framework of standardised guidelines aimed to preserve their influence on the board, which they enforce by threatening to use their statutory powers against corporate controllers. In management-controlled companies, which are the vast majority in the UK, this mechanism induces managers to refrain from embezzlement, but also to cater to the short-termism of institutional investors. At least in theory, the same mechanism discourages controlling shareholdings altogether because, by constraining the largest shareholders' ability to control the board, it also limits the non-pecuniary private benefits of control that reward large undiversified investments.[154] While effectively countering expropriation, the UK model of investor protection might fail to support commitments to long-term policies and firm-specific investments.[155]

F. A Limited Role for Independent Directors

The problem with the US and UK models of investor protection is that their effectiveness against expropriation depends on the deterrence of a wider range of corporate controllers' behaviours, which may well be efficient. The ease of

[150] See Davies, *supra* n 11, 1021–24.
[151] Combined Code A.3.1.
[152] SR Arcot and VG Bruno, "In Letter but not in Spirit: An Analysis of Corporate Governance in the UK", Working Paper (May 2006; http://ssrn.com/abstract=819784).
[153] SR Arcot and VG Bruno, "One Size Does Not Fit All, After All: Evidence from Corporate Governance", Working Paper (January 2007; http://ssrn.com/abstract=887947), 23–25.
[154] Gilson, *supra* n 49, 1661–65.
[155] For a similar view, see C Mayer, "Firm Control" in J Schwalbach (ed), *Corporate Governance: Essays in Honor of Horst Albach* (Berlin, Springer-Verlag, 2001).

litigation in the US over-deters self-dealing. Strong governance rights of non-controlling shareholders in the UK over-deter managers from policies that risk yielding poor short-term results and, possibly, controlling shareholdings altogether. Both situations generate false positives because of the difficulties of focusing *ex post* enforcement on non-pro-rata distributions. The two jurisdictions variously rely on *ex ante* monitoring by independent directors, but reliance is incomplete because that monitoring alone, albeit arguably more focused, cannot be trusted to be entirely independent. As a result, in order to counter expropriation effectively, monitoring by independent directors is either supplemented by litigation or backed by the institutional investors' threat of removing inside and outside directors at will. The drawbacks of this approach are unwarranted when the problem of director's effective independence is addressed directly at its core.

Director's independence is normally defined in terms of the absence of financial and family ties with the controlling management or shareholder.[156] Although these requirements are necessary for independence, they are not sufficient. The main problem is that independent directors are nominated, and thus selected, by the board. In the US, the establishment of formally independent nomination committees has not changed the fact that board insiders are in control of the elections, short of the limited risk of a proxy contest and of the modest impact of shareholders' withholding their votes.[157] Moreover, US controlling shareholders can appoint any independent directors they want, except themselves and their family members.[158] A similar situation occurs in the UK *de facto*, because institutional investors do not normally use their right to challenge the board's nominations and prefer to rely on the more cost-effective threat of removing (or vetoing) directors they do not like.[159] However, in order to comply with the Combined Code (and to avoid upsetting institutional investors), controlling shareholders' "representatives" cannot be appointed as independent directors. British institutional investors thus oversee board independence not directly, but in the framework of their general influence on the boardIn this situation, board independence is either illusory or unimportant for the purpose of disciplining self-dealing. It is illusory when independent directors depend on the controller for (re)appointment, as in the US, because they will be lenient with self-dealing unless they fear the repercussions of litigation on their employability. It is unimportant when institutional investors can remove directors, independent and not, as in the UK, because deterrence of expropriation effectively stems from their overall influence on the board. These

[156] Enriques *et al*, *supra* n 5, 65; Enriques *et al*, *supra* n 81, 95.
[157] Macey, *supra* n 10, 95, 208–10. As mentioned *supra* n 123, this situation may change after the implementation of proxy access by outside shareholders (Dodd-Frank Act, s 971(b)).
[158] See, eg NYSE Rule 303A.02.
[159] Stapledon, *supra* n 137, 142–49.

reflections cast some doubts on the overall approach of regulation and codes of best practice to independent directors, insisting more on the quantity than on the quality of directors' oversight. First, "the more the merrier" is the conventional wisdom. In both the US and the UK, at least the majority of board members are supposed to be independent.[160] Secondly, policymakers expect independent directors to be both good monitors and good advisers of the management.[161] Although the idea is that a preponderance of independent directors could cope with virtually all agency problems in corporate governance, this approach risks making them ineffective in dealing with any of them.[162]

Both empirical and theoretical analyses suggest that independent directors may be simply asked too much. The empirical evidence is inconclusive as to whether higher proportions of independent directors improve corporate performance.[163] One theoretical explanation for this result is that there is a trade-off between "real" independence and information of independent directors.[164] The more directors are independent, the less information they receive from controllers. This undermines their ability to contribute to the quality of management. Conversely, informed independent directors are better advisers, but they are eventually captured by controllers whom then they will monitor less strictly. The ambiguous effect on performance may depend on the relative importance of monitoring and advice for individual companies.[165]

As in the more general case of the discretion/accountability trade-off, there is probably no one-size-fits-all solution. But the trade-off can be narrowed down to situations where regulatory intervention is necessary and monitoring is most important, as in the case of pecuniary conflicts of interest exemplified by self-dealing. In these situations, the adverse effects of accountability on control discretion can be minimised if independent directors are entrusted exclusively with monitoring tasks, while controllers choose separately the degree of external advice they deem fit to remain competitive in both the product market and in the market for corporate control.

The solution I am advocating is based on confining the role of independent directors to the scrutiny of related-party transactions and of similar situations that may result in investor expropriation. In this fashion, the disadvantages of making the monitors entirely independent of the corporate controller, and only

160 See, for the UK, Combined Code A.2.2 and A.3.2. For the US, NYSE Rule 303A.01 and NASDAQ Rule 4350(c)(1).

161 See, eg L Enriques, "Bad Apples, Bad Oranges: A Comment from Old Europe on Post-Enron Corporate Governance Reforms" (2003) 38 *Wake Forest Law Review* 911, 926–27.

162 Enriques *et al*, *supra* n 5, 66.

163 See, eg S Bhagat and BS Black, "The Non-Correlation between Board Independence and Long-Term Firm Performance" (2002) 27 *Journal of Corporation Law* 231.

164 See A Boot and JR Macey, "Monitoring Corporate Performance: The Role of Objectivity, Proximity and Adaptability in Corporate Governance" (2004) 89 *Cornell Law Review* 356; RB Adams and D Ferreira, "A Theory of Friendly Boards" (2007) 62 *Journal of Finance* 217.

165 Macey, *supra* n 10, 102–03.

accountable to non-controlling shareholders, are contained. By the same token, effective independence of the monitoring substantially reduces the need for *ex post* enforcement and the false positives that it involves. Such independent directors are supposed neither to provide managerial advice nor to interfere with business judgment in the absence of conflicts of interest. Conversely, no self-dealing could be entered into by the controlling management or shareholders without the informed approval by independent directors. This veto right corresponds to the procedural standard of review of related-party transactions, although there are differences compared to both the US and the UK models. First, informed approval by independent directors would be sufficient to validate self-dealing. Courts would not review substantive fairness or the quality of *ex post* disclosure, but would presume that these are lacking if and only if previous approval was procedurally flawed or missing altogether. Secondly, non-controlling shareholders would not have to approve related party-transactions, unless the articles of association provide otherwise. Thirdly, at least by default, non-controlling shareholders' influence on the board would be limited to independent directors.

These three conditions obviously aim to minimise the risk of false positives. However, they are crafted in such a way as to avoid resulting in the opposite problem of false negatives. What makes monitoring of conflicts of interest effective are the independence and the information of the reviewers. For the purpose of independence, a minority of directors should be reserved for nomination by non-controlling shareholders in order for the board to be properly constituted. Non-controlling shareholders should also have exclusive removal rights on that minority. This solution eliminates the main source of director's dependence on the corporate controller. For institutional investors, however, this solution is of course more costly than having a broader influence on the board. Hence, it is important to commit institutional investors to selecting independent directors by restricting their influence on the remainder of the board, unless the individual articles of association opt for stronger accountability.[166] On the cost side, institutions' activism should be subsidised, allowing "piggy-backing" of the company's proxy materials for independent nominees along the lines identified by Professor Bebchuk for the whole of the board's slates.[167] The

[166] This qualifies a similar proposal made authoritatively in the past (RJ Gilson and RH Kraakman, "Reinventing the Outside Director: An Agenda for Institutional Investors" (1991) 43 *Stanford Law Review* 863). Sceptics have argued that institutional investors would be unwilling to nominate a minority of directors (eg Coffee, *supra* n 39, 1360–62). Indeed, institutional investors are reluctant to nominate directors even in the UK, where they have the power to do so. Limiting by default the power of non-controlling shareholders to remove and veto directors altogether should commit large investors to actively select the directors reserved to their nomination, if only for lack of alternatives to monitor the controller's conflicts of interest effectively.

[167] LA Bebchuk, "The Case for Shareholder Access to the Ballot" (2003) 59 *The Business Lawyer* 43.

crucial difference, which addresses a major criticism of Bebchuk's proposal,[168] is that the number and mandate of independently appointed directors would be limited to monitoring self-dealing, thereby excluding undue interference in the controller's discretion outside that context.

Under the proposed solution, independent monitoring would also be informed. The reason for this is twofold. First, the only way for controllers to enter into self-dealing legally is to convince independent directors that self-dealing is efficient for shareholders as a whole. Secondly, independent directors who depend on non-controlling shareholders for staying in office (and in business) are unlikely to validate self-dealing upon poor information.[169] There is then a double layer of protection against false negatives, one litigation based (controllers who breach the procedural standard can be sued) and the other governance based (independent directors who fail to monitor accurately can be fired). Although the relative importance of these strategies varies across jurisdictions, the advantage of this solution is that it takes the best from both.[170] The only function of *ex post* enforcement is to induce *ex ante* disclosure of self-dealing to independent directors. The restrictions imposed on the threat of litigation and director's removal are intended to avoid the false positives stemming from an *ex post* review of self-dealing or from second-guessing the controller's discretion in general.

One might say that this solution does not fully address the question of independent directors' incentives. Independent directors might still fail to dig deeper into situations of potential expropriation, be too strict with disclosed self-dealing, or both. However, the proposed solution already improves the situation from the status quo. When independent directors have a limited mandate and are accountable exclusively to non-controlling shareholders, failure to detect non-pro-rata distributions should be as good a reason for them to lose their job as turning down self-dealing which is profitable for the company. That being said, the question how to further align the incentives of independently appointed directors is better left for another study.[171]

[168] The criticism is that non-controlling shareholders, as opposed to the winner of a control contest, lack credibility to select executive directors. See Macey, *supra* n 10, 209–12 and *supra* text to nn 50–52. The new SEC rule on proxy access (*supra* n 123) partly copes with this criticism allowing outside shareholders to nominate up to a quarter of the board (which is most likely to include only the non-executive directors). However, differently from the solution I am advocating, the mandate of outside shareholders' nominees is not limited to monitoring self-dealing and similar conflict of interest.

[169] *Ibid*, 90–93 (discussing the incentives of "dissident directors").

[170] Compare with Djankov *et al*, *supra* n 4, 463 (advocating unrestricted governance-based and litigation-based protection). The proposed solution mainly differs in the concern for over-deterrence, which is addressed through the filter of independent directors.

[171] Research has already emphasised the advantage of rewarding outside directors for good monitoring. See A Hamdani and RH Kraakman, "Rewarding Outside Directors" (2007) 105 *Michigan Law Review* 1677. This approach would be complementary to the proposed solution,

G. Conclusion

The central point of this article is that effective protection of non-controlling shareholders is not always efficient. The adverse implications of investor protection on the proper use of control discretion should be factored in in the assessment of legal policies towards corporate governance. I have discussed this contention regarding the discipline of self-dealing, which is a critical issue for countering shareholder expropriation by corporate controllers, but also a difficult one as self-dealing and other behaviours that sometimes conceal it can well be efficient.

With the aid of a simple functional framework, I have shown how the same legal factors that make the discipline of self-dealing effective against expropriation may have adverse consequences on the efficiency of decision-making by corporate controllers. As applied to the US and the UK models of regulation, which unambiguously protect investors well, this framework illustrates the disadvantages of both mass litigation and strong governance rights of non-controlling shareholders in policing expropriation. This analysis suggests a more efficient alternative for regulating self-dealing effectively, that is, exclusive reliance on a minority of independently appointed directors.

The implications of this approach are potentially more far-reaching. First, related-party transactions are not the only way to expropriate investors. The same framework could be extended to similar conflicts of interest supporting the risk of expropriation, such as corporate restructurings and executive compensation. Secondly, as many other countries exhibit above-average stock market development, the US and the UK may not be the only jurisdictions that counter shareholder expropriation effectively. The approach developed in this article could thus be useful for assessing and improving other models of disciplining self-dealing and similar conflicts of interest. Thirdly, the finding that the controller's accountability to investors undermines efficiency when it is too broad could contribute to the current debate on shareholder empowerment in corporate governance. Limiting accountability to situations of pecuniary conflicts of interest might help tackle the problem of managerial short-termism, which stands out as one of the causes of the last financial crisis.[172]

These are all interesting avenues for future research.

which implicitly rewards independent directors through the effects of a balanced monitoring on the reputation with large investors (and thus on employability with them).

[172] See, eg AM Pacces, "Consequences of Uncertainty for Regulation: Law and Economics of the Financial Crisis" (2010) 7 *European Company and Financial Law Review* 479.