The Law and Economics of Corporate Governance: Changing Perspectives

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Publication date
2010
Document Version
Final published version

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Changing Perspectives

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IN ASSOCIATION WITH THE BELGIAN-DUTCH ASSOCIATION FOR INSTITUTIONAL AND POLITICAL ECONOMY

Edward Elgar

Cheltenham, UK • Northampton, MA, USA

Published by
Edward Elgar Publishing Limited
The Lypiatts
15 Lansdown Road
Cheltenham
Glos GL50 2JA
UK

Edward Elgar Publishing, Inc.
William Pratt House
9 Dewey Court
Northampton
Massachusetts 01060
USA

A catalogue record for this book
is available from the British Library

Library of Congress Control Number: 2009942847

ISBN 978 1 84844 897 1

Printed and bound by MPG Books Group, UK

Contents

An introduction: changing perspectives on corporate law and economics

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1. SYNOPSIS

This book includes the proceedings of the conference on 'Changing Perspectives on Corporate Law and Economics', held in Rotterdam on 6 November 2008 in honour of one of the founders of the economic analysis of law, Guido Calabresi. The collection is made up of six main contributions and six shorter comments by the speakers who acted as discussants. The subject matter of the book – corporate governance – is one of the most heated topics in the economic analysis of law. In the aftermath of the largest global financial crisis after the 1930s, the negative consequences of which we are still experiencing, the connection between law and corporate finance has been evident from the news. More generally, this connection is extremely important for the governance of enterprises, which affects not only the financial markets, but also the efficiency of production, economic growth, and the overall well-being of our societies.

In addressing the above issues, this book takes an interdisciplinary perspective. Economic analysis of law is a fruitful intellectual challenge for economists and lawyers alike. It offers new views on legal and economic theory, questioning or reinforcing the traditional ones. It enhances the quality of counselling available to individuals and businesses. It allows policymakers to design better rules for society. Above all, in corporate governance, research, practice, and lawmaking are all based on the interaction of economics with the law. The present collection of chapters is an exemplary illustration of the virtues of this approach.

Within law and economics, corporate governance can be approached from different angles. The contributions to this book perform in-depth theoretical and empirical analyses from which different regulatory implications are derived. Some provide fresh empirical evidence on controversial theories of corporate law. Others attempt to develop new theoretical insights for addressing unresolved problems of corporate governance. They all analyse the economics of corporate governance with a view to

how it should, or should not, be regulated. The coverage of the book is very broad in this respect. It ranges from regulatory competition to harmonization of company law; from the law and economics of mergers and acquisitions to the risks of overregulating the market for corporate control; from enforcement of investor protection to the balance between authority and accountability in the corporation. These are all hot issues in the international debate, and they are more intimately related with each other than might appear at first glance. This book shows, like the conference before it, that economic analysis of law provides economists and lawyers with a single framework for discussing diverse issues in corporate governance.

Perspectives on corporate law and economics are changing though. This is the leitmotiv of this book, as it was of the conference. Perspectives differ between the economic and the legal standpoint. They vary from continent to continent, from country to country. They evolve over time. This book includes the views of three scholarly generations of corporate law and economics, from its very founder – Henry Manne – to the younger researchers in the field. Economists and legal scholars contribute to this collection of chapters in a balanced proportion. Their views are based on different geographical experiences and cultural backgrounds. The authors are all top scholars in corporate law and economics, affiliated to highly prestigious universities around the world. While all the chapters take an international approach to the corporate governance debate, different countries are represented among the authors. These are Britain, Italy, Germany, the Netherlands, and the United States. This additional layer of diversity offers a unique opportunity to compare the views of corporate governance from the two sides of the Atlantic and of the Channel.

As the following overview is going to illustrate, this combination of changing perspectives yields a number of new insights into the functioning of corporate governance and its legal underpinnings. Unsurprisingly, they also identify many interesting avenues for future research.

2. REGULATORY COMPETITION: EFFICIENCY OR PATH-DEPENDENCY?

The first contribution to this book (Carney et al.) tackles one prominent issue in the Law and Economics of Corporate Governance: the competition for corporate charters. Following Tiebout's (1956) celebrated insights, economic analysis of corporate law has focused on the competitive dimension of the production of legal rules in those countries where companies can choose to incorporate under different sets of rules. In

particular, this debate was initiated in the US where the 'Internal Affairs Doctrine' allows companies to choose between the corporate laws of 50 federal states, regardless of where they actually do business. While this process has apparently led the vast majority of publicly held companies in the US to incorporate under Delaware law (Bebchuk and Cohen 2003), the determinants of this outcome are far from settled.

In principle, under freedom of incorporation, jurisdictions can compete on offering companies the set of rules best suited to their needs. They have prominent incentives to offer attractive terms to companies, since incorporations bring revenues in the form of both taxes and increased demand for local services. The long-standing question is whether this competitive process unravels efficiently. The two opposite views on this, originally articulated by Cary (1974) and Winter (1977), are that regulatory competition leads to a 'race to the bottom' or to a 'race to the top'. On the one hand, states of incorporation may compete by offering rules that are attractive for those who control the (re-)incorporation decision – most prominently, corporate management – at the expenses of shareholders and other stakeholders. On the other hand, the quality of corporate charters and of the rules governing them is priced by efficient stock markets, and this guarantees that corporate jurisdictions compete on offering efficient terms for protection of shareholders and, when it is relevant, of stakeholders. In an influential paper, Romano (1985) found evidence of a race to the top. Her results have subsequently been questioned on different grounds, most prominently that US states do not actually compete with each other (Kahan and Kamar 2002) and that firms incorporated in Delaware do not (or at least, no longer) exhibit statistically significant excess values on the stock market (Subramanian 2004).

Carney at al. bring fresh insights to the debate. Their contribution is essentially twofold. On the one hand, they show that Delaware law scores worse than other jurisdictions on exactly those substantive aspects that would support winning a race to the top, namely flexibility and predictability of corporate governance regulation. On the other hand, they identify the reason for Delaware's success in attracting incorporations. This is US corporate lawyers' limited knowledge of better alternatives. As a result, Delaware's primacy as supplier of corporate law in the US does not reflect any virtuous or vicious competitive process, but only the 'bounded rationality' of American lawyers due to the biases in their education.

These results are derived from a combination of different methodologies. In contrast to the majority of previous studies, Carney et al. open the 'black box' of corporate law. They do not infer superiority of one jurisdiction over another, based on market outcomes. Instead, they look at the details of Delaware law in a number of critical situations (for

example, mergers and sale of assets) that may occur during the operation of a company. In these situations, Delaware law is extremely intricate and this results in the outcome of corporate litigation often being unpredictable. One prominent source of indeterminacy in Delaware law is the celebrated Business Judgment Rule, a norm of judicial abstention from second-guessing directors' choices as to how to conduct the corporate business. Delaware's courts are courts of equity, which encourages judges to undertake an *ex post* and fact-intensive review of directors' actions that undercuts the deference of the Business Judgment Rule. Under Delaware law, this doctrine features so many nuances and exceptions that shareholder litigation occurs nearly every time it is invoked. This stands in sharp contrast to the race to the top explanation of Delaware's superiority in attracting incorporations. Short of reducing transaction costs in the relationship between the company and its investors, incorporating in Delaware means facing a number of legal rigidities (selective application of the Business Judgment Rule) and uncertainties (on the meaning and the scope of the Business Judgment Rule) in corporate governance. Why then does Delaware still outperform its competitors?

Carney et al. answer this question in a most original fashion. In US law schools, they report, prospective lawyers do not study any corporate law other than those of Delaware and (normally, but not always) their home state. It may well be that Delaware managed to secure its competitive advantage by offering companies more efficient rules in the past, but this need not necessarily be the case – to be sure, it is *not* the case when we look at how Delaware law has evolved. Due to their education bias, lawyers tend to recommend incorporation under the law they are familiar with. Only in a specific subset of circumstances is this their home state. Most often, given the existing network effects favouring Delaware law at the initial public offering (IPO) stage and the narrow specialization of lawyers handling IPOs, they recommend Delaware law because they *mistakenly* believe that it is the best to secure deals and to handle litigation. In fact, they know little, if anything, about potential alternatives that may effectively reduce transaction costs. This understanding of the US incorporation puzzle by Carney et al. is supported by two complementary empirical investigations, a survey of lawyers' motivations in advising (re-)incorporation and a regression analysis of Delaware incorporations depending on the state of origin of the company and of its legal counsels.

In his comment on Carney et al., Kroeze takes stock of these arguments for analysing regulatory competition in European company law. The situation on this side of the Atlantic is notably different from the US. There is no 'Internal Affairs Doctrine', but rather, the opposite 'Real Seat Doctrine' (mandating incorporation where the firm effectively carries

out its main business) holds in most European member states. There is no Federal Constitution, but rather, a Treaty whose implementation by European courts and legislature has to struggle with individual resistance from the member states. Finally, there is no homogeneous set of property and contract law, but rather, the company law of most member states is embedded in their particular private law. Therefore, it could seem that regulatory competition in European company law is less developed than in the US. However, when we look at it more carefully, this competitive process exhibits a number of similarities (as well as differences) between Europe and the US.

After initial attempts to harmonize company laws in order to promote freedom of establishment of European companies without running the risk of a race to the bottom, European law seems to have taken a more decisive stance in favour of regulatory competition. To be sure, whether regulatory competition is effectively in place in European company law is still uncertain (Kraakman et al. 2009). However, developments in case law by the European Court of Justice (ECJ) have broadened the conditions for freedom of incorporation (for example, C-212/97 *Centros* of 1999; C-208/00 *Überseering* of 2002), albeit still incompletely (see C-210/06 *Cartesio* of 2008). Moreover, the EU legislation has recently taken positive steps in the direction of creating a level playing field (through the various initiatives adopted within the framework of the Company Law Action Plan of 2003 – COM/2003/0284) and of facilitating re-incorporation (most prominently, through the Directive 2005/56/EC on cross-border mergers). This suggests that, soon enough, Europe may experience competition in the production of corporate law very similar to what – for good or evil – we have been observing in the US. Then the warning by Carney et al. stands: competition may not occur on the merits, but rather, be driven by path-dependency. In this case – Kroeze observes – some member states stand to lose in the establishment of the network effects that, at least according to the American experience, has proved persistent. The difference is that, in Europe, the set of rules that minimizes transaction costs in dealing with shareholders and stakeholders has yet to be identified. When market forces are allowed to make this selection, companies are not expected to choose rigidity and indeterminacy. As a result, the Netherlands, which shares with Delaware not only a tradition of flexibility, but also a process whereby this flexibility has degenerated into more interventionist courts and unpredictability of litigation outcomes, is 'doomed to fail in a competitive environment'.

Beyond this, Kroeze is sceptical that situations of bounded rationality on the part of legal counsel can last for long. Rather, he seems to suggest that market mechanisms will, in the end, restore the lawyer's incentive to select

the best (that is, the most efficient) corporate law for incorporation. States, in turn, will compete to offer the most efficient set of rules. This argument parallels the debate on the effectiveness of arbitrage in securities markets, which is particularly topical in these times of financial crisis (Posner 2009). As arbitrageurs, lawyers may not respond immediately to changes in the relative quality of legal products, partly because – as Kroeze nicely puts it – 'they prefer a greater risk of being wrong collectively than a smaller risk of being wrong alone'. But, as Shleifer and Vishny (1997) show for arbitrage, this outcome only holds so long as the number of 'smart traders' is insufficient to make trading on fundamentals profitable. Therefore, it can be expected that choice of law will continue to be driven by efficiency concerns as soon as a sufficient number of players (lawyers or the companies they advise) realize that there are more profitable alternatives than relying on a flawed Delaware law. There is one important element of regulatory competition, surprisingly neglected in this debate, which points exactly in this direction. Regulatory competition is not just a horizontal process between states, but also a vertical process between the prevailing state jurisdiction and the federal legislature that may pre-empt it when it turns out to be unsatisfactory. This has recently turned out to be a key element of regulatory competition in the US (Roe 2008), and – as the following contributions show – it seems to be even more relevant in Europe.

3. EUROPEAN LAW AS A VEHICLE FOR REGULATORY COMPETITION

In Chapter 2, Eidenmüller et al. investigate the size and the determinants of a unique phenomenon on both sides of the Atlantic. This is the *Societas Europaea* (SE), which is a pan-European model of incorporation available for companies established in any of the EU member states. Established by Regulation 2157/2001/EC and effective since 2004, the SE has long been considered a failure of European lawmaking. And yet, after a somewhat disappointing start, the SE has turned out to be surprisingly popular among European companies, at least in certain European countries (most prominently, Germany and the Czech Republic). Eidenmüller et al. do not only document the success of the SE with empirical data. Perhaps most importantly, they analyse the variety of choice of this corporate form across European jurisdictions to infer the determinants of this success. As it turns out, the SE is illustrative of the ongoing process of framework harmonization of European company law and of its ability to lead to regulatory competition in a very special fashion.

The SE does not offer a fully-fledged alternative to the national models

of incorporation. Rather, it provides a number of options, some of which may not be available under the law of the company's state of origin. Likewise, the SE does not allow opting out of the 'Real Seat Doctrine'. Although the SE allows transference of the company's registered office, the latter must still be located where the company has its main place of business. Finally, in a number of respects, the SE is governed by the corporate law of the state where the company has its registered office. Little wonder that, in view of the costs of setting up the SE as opposed to its limited benefits, commentators have been sceptical about the practical utility of this form of incorporation (Bratton et al. 2009). The study by Eidenmüller at al. proves that they have been wrong. The options for corporate governance made available by the SE may be limited, but they matter a lot. The attempt by the European legislature to mediate between different national traditions, especially regarding board models and the involvement of employees in corporate governance, has transformed this example of framework harmonization into a 'vehicle for legal arbitrage'. Despite the evolution of ECJ case law, restrictions on re-incorporations still make it difficult for European companies to shop around among jurisdictions for suitable legal solutions. Transforming (or merging) into a SE provides an alternative. Formally, it is a model of incorporation partly governed by European law. In practice, however, it is a synthesis of different European models, which allows companies to opt out of some of the rigidity of their national corporate laws, while exploiting the advantages of relocating to a more favourable tax jurisdiction (Enriques 2004).

Eidenmüller et al. are the first to test this proposition empirically, through a combination of regression analysis and a survey of the motives for establishing SEs in Germany, which aims to compensate for the small sample size in statistical inference. In spite of this difficulty, their results are statistically robust and highly plausible. The choice of SE seems to be effectively motivated by legal arbitrage, albeit with some qualifications. The SE is most prominently a vehicle to reduce the impact of mandatory co-determination at the board level and to opt out of a mandatory two-tier board structure. This is consistent with the popularity of the SE, especially in those jurisdictions that feature these restrictions. However, neither the data nor the survey support the hypothesis that the SE is used to shop for more attractive company laws in general. This may have to do with the limitations on choice of law resulting from the Real Seat Doctrine. Noticeably, this factor does not undermine the tax incentives for relocation through the SE. Taxes remain a major driver of corporate mobility in the EU, which explains why the small European jurisdictions have the highest rates of SE incorporations to population.

Within these limits, the SE does promote regulatory competition in

European company law. Surprisingly enough, the European legislature has achieved this result by stepping into the competition directly. In contrast to the US picture, where federal legislation enters only as a potential competitor, the European approach to regulatory competition is based on a formal mandate to harmonize national laws. As previous attempts to establish a common European company law failed, framework harmonization has now become an instrument for allowing the selection of the best rules by market forces. Vesting different national traditions as eligible options under European law has proved more successful than forcing their mutual recognition or identifying their common core by binding legislation.

The comments by Leyens intervene exactly at this point. With special regard to Germany, the study by Eidenmüller et al. shows that publicly held companies suffer from a number of national legal restrictions that may undermine their competitiveness. The SE as a 'vehicle for legal arbitrage' has finally shown that companies may wish to opt out of these restrictions in the interest of their investors, but without jeopardizing the position of other stakeholders (more precisely, the employees). The choice as to board structure is not available to public companies governed by German law as opposed to companies registered in other European jurisdictions. Albeit repeatedly denounced by German legal scholars, this rigidity was ignored before the introduction of the SE showed that German companies too are willing to choose a one-tier structure. A similar argument applies to co-determination, which leads to impressively high numbers of directors sitting on the supervisory board. The empirical evidence on the use of SE shows that German companies are actually willing to negotiate with employees different, and less burdensome, forms of participation in corporate governance. Only within the limit of these negotiations, do the SE regulations allow for co-determination to be opted out of. But while the data provide unequivocal evidence of the efforts by German companies to devise more flexible solutions through the SE, most of the national rigidities remain. In only one case – Eidenmüller et al. report – the SE has allowed opting out of co-determination entirely. And none of the companies subject to co-determination has managed so far to opt for a one-tier board structure. Legally, this circumstance may frustrate the requirement that the SE allow an effective choice of board structure.

According to Leyens, it will eventually be the ECJ that restores the full potential for regulatory competition established by the SE against the rigidities maintained by the member states. Yet the outlook may be even more promising than that. One of the goals of the SE was to facilitate cross-border mergers. Eidenmüller et al. show that the experiment has been successful (also) in this respect. The matter has been subsequently addressed

by a potentially more powerful piece of EU legislation, which does not require the establishment of a corporate vehicle governed by European law. This is Directive 2005/56/EC on cross-border mergers, which has removed the national constraints on this technique for re-incorporation (see Kraakman et al. 2009). Whether and how one can expect cross-border mergers to lead to selection of the most efficient rule in European company law is an empirical question, addressed by the following contributions.

4. HOW DOES LAW MATTER? EVIDENCE FROM CROSS-BORDER MERGERS AND ACQUISITIONS

Economists are usually less insistent on the details of the law. Rather, they focus on the overall effects of legal institutions on economic performance. In this perspective, Martynova and Renneboog (Chapter 3) investigate the question of whether the wealth effects of cross-border mergers and acquisitions (M&A) in Europe are dependent on the quality of law. Their answer is positive, but more importantly, they show that – regardless of the direction of the acquisition – it is always the best law that prevails. This approach complements the legal debate reviewed so far. In particular, it supports the high expectations of academics and policymakers on the implementation of the European Directive on cross-border mergers. This offers the prospect of fruitful regulatory competition in European company law.

In their detailed empirical study, Martynova and Renneboog disentangle the effects of company law standards on both the bidder and on target returns after the announcement of a takeover. To this end, they have constructed a set of indices of quality of corporate law independent from those prevailing in the law and finance literature (La Porta et al. 1998; Djankov et al. 2008). As with previous studies, they find that 'law matters' – that is, it does affect economic results. However, both the 'measurement' of company laws and the setting in which their impact is tested are novel. With regard to the quality of law, the authors study the effects of three different indices of investor protection: the first is an index of *shareholder powers*; the second is an index of *minority shareholder protection* from expropriation; the third is an index of *creditor rights*. All indices are interacted with an enforcement variable to account for the relative efficiency of the judicial systems. More importantly, the indices account for the legal changes that have occurred every fifth year over the past 15 years, which allows a more precise estimate of the differences in investor protection between the bidder and the target company at the time of a takeover.

These differences in corporate governance standards may, in principle, have opposite effects when a change in control occurs. Martynova and

Renneboog distinguish between *spillover* (positive and negative) and *bootstrap* effects. Positive spillover depends on the target benefiting from the higher standards of investor protection of the bidder, either because the target is merged with the bidder (and therefore, changes nationality) or because the change in control is sufficient for the target to adopt the higher standards on a voluntary basis. Spillover can be also negative, when the corporate governance standards of the bidder are lower than the target's and the latter is merged with the former. However, in this case, the bidder may alternatively decide to bootstrap to the higher standards of the target on a voluntary basis. This bootstrap effect is also possible as an alternative to each company's sticking to its own standard when acquisitions are partial. Which of these effects prevails in cross-border M&A is ultimately an empirical question.

Carefully controlling for endogeneity and omitted variables in multiple specifications of their regressions, Martynova and Renneboog show that upgrading to the higher investor protection standards dominates this setting. Positive spillovers are unambiguously borne out by the empirical evidence. Negative spillovers are not. On the contrary, when the bidder's standards are lower than the target's, neither of them experiences lower returns upon announcement of the takeover – which supports the bootstrap effect in both full and partial acquisitions. This suggests that, all else being equal, cross-border M&A are an instrument for shareholders to reap the benefits of higher investor protection, regardless of whether the enhancement derives from the bidder's or the target's jurisdiction. This virtue of the market mechanisms is confirmed by the likelihood that companies are engaged in a cross-border, rather than a national, acquisition. This likelihood is higher the lower the shareholder powers under either the bidder's or the target's jurisdiction, although minority shareholder protection has exactly the opposite effect on bidders (high protection of minority shareholders makes national acquisitions more expensive).

In his comment, de Jong makes two important additions to these findings. First, he notes that spillover and bootstrap effects are only presented in terms of statistical significance. However, the framework set up by Martynova and Renneboog also allows the economic magnitude of these effects to be estimated. Despite his limited access to the data, de Jong manages to perform an interesting exercise, showing that the direction of the acquisition matters after all. Specifically, it is not a matter of indifference whether the bidder comes from a high-standards jurisdiction or the other way round, for the magnitude of the wealth effects is expected to be substantially larger under the first hypothesis. Secondly, de Jong notices that the increased sophistication with which the quality of law is measured relative to the first attempt by La Porta et al. (1998) still does not account

for firm-specific choices regarding compliance with standards higher than those mandated by law. This may be particularly relevant in the case of cross-listing.

More generally, the measurement of quality of law based on numerical indices makes two conceptual issues problematic. One is the inclusion of all the relevant legal information, which is an extension of de Jong's argument that goes much beyond the relevance of listing rules and corporate governance codes. The other, which is surprisingly taken for granted by both, is the judgement as to what 'good' corporate governance regulation is. Renneboog and Martynova draw an important distinction between protection of minority shareholders and empowerment of shareholders as a class. Similar distinctions, traditionally supported by the comparative legal literature (for example, Kraakman et al. 2009), are becoming increasingly important in empirical corporate law and economics (for example, Djankov et al. 2008). So far, however, the alternative specifications of investor protection have been too greatly correlated with each other to allow for separate empirical analyses. Whether, and to what extent, protection of shareholders in corporate governance requires their legal empowerment remains a theoretical question, to which we now turn.

5. BACK TO CORPORATE GOVERNANCE BASICS: MARKETS OR LAW?

Commentators tend to disagree on what constitutes 'good law' in corporate governance and on the virtues of the market mechanisms in selecting the most efficient rules. The question – do we need corporate law at all? – is hardly ever asked any more. Conceptually, however, this is a fundamental issue, and the very pioneer of corporate law and economics reminds us of its importance. In his contribution, Manne shows that, in corporate governance, legal rules may create more inefficiencies than they help to solve.

Taking stock of the 'corporate-governance-as-promise' approach recently proposed by Macey (2008), Manne warns in his usually provocative style that corporate governance needs little else than enforceable contracts, an active market for corporate control, and some insider trading in order to work efficiently. Any legal restriction on these market institutions undermines efficient separation of ownership and control, instead of promoting it. His argument is essentially threefold. First, there is actually no point in debating about the optimal structure, powers, and independence of board of directors vis à vis the rights of (minority) shareholders. Regulation can fare no better than the contractual arrangements devised by the company's founders, for the simple reason that they bear

the wealth effects of these arrangements when the company's shares are sold to the investing public – regulators have far lower-powered incentives. Secondly, and similarly, any regulation of the takeover process can only lessen the power of this fundamental mechanism of corporate governance. Unbridled competition in the market for corporate control most prominently protects investors by disciplining the management and making sure that incumbents who fail to maximize shareholder returns are promptly replaced. While there might be good reasons for limiting contestability by contract, especially considering the price that founders have to pay for this deal, any regulation reducing the bite of the market for corporate control in the name of protecting minority shareholders turns to their very disadvantage – the more regulatory restrictions on takeovers, the lower the returns to shareholders of prospective targets. Finally, prohibition of insider trading only undermines the incentives to produce valuable information, which could be timely impounded in stock prices otherwise. Once again, under the false claim that this is aimed at protecting investors' 'fair play', regulatory restrictions on insider trading limit both insiders' and outsiders' ability to correct misperceptions of corporate performance to the ultimate advantage of shareholders as a whole.

Manne does not argue that corporate law is unimportant, but he stresses that its role should be limited to minimizing transaction costs. Enabling and default rules should suffice for this purpose, perhaps with the sole exception of 'real acts of misbehavior by directors' – a concept upon which he does not elaborate. Manne's trust in the contracting process goes as far as to admit – in contrast to Macey (2008) and the majority of commentators – that the corporate charter may exclude contestability of control at the outset. This is not particularly surprising, for Manne himself (1965) never argued for more contestability than companies are willing to choose. On this point, he is sympathetic to the work by Bainbridge (2008), to which he compares my own (Pacces 2007). Manne agrees that the decision as to whether to resist a hostile takeover could be left with the directors, if the contact so stipulates, for reasons of protecting managerial firm-specific investments that ultimately benefit shareholders as well. But he sees neither what role corporate law should play in this nor why other mechanisms (for example, insider trading) could not solve the problem of rewarding managerial firm-specific investments without interfering with the market for corporate control.

In my reply, I try to address these points. Manne's reasoning has an implicit Coasian flavour, which is one approach that other contributors to this book discuss at length (see Chapter 6 and Comment on Chapter 6). However, Manne overlooks two important issues. First, the virtues of the bargaining process between shareholders and the corporate management

face the limitations of the contractual technology. These are most prominently due to the problem of contractual incompleteness, which explains why legal entitlements matter. This part of Coase's reasoning (1960) is often hidden behind the formulation of a theorem that he never stated. In corporate governance, this means that the failure to *enable* managerial empowerment through the legal system creates potential inefficiencies that cannot be remedied by contract. An illustration of this is that, in most parts of continental Europe, large shareholdings are the only way to secure control from outsiders' interference. Secondly, for exactly the same reason, the corporate contact cannot entirely protect non-controlling shareholders from expropriation. This holds for both the incumbent management and successful bidders in a takeover contest, provided that they have sufficient powers to alter the original terms of the contract with investors. Again, legal rules matter, but given the asymmetric distribution of powers between (actual and prospective) corporate controllers and non-controlling shareholders, investor protection needs to be mandatory. While this provides a good argument against insider trading, to the extent that it corresponds to an expropriation of outsiders' returns, it does not imply that regulation should weaken the market of corporate control by favouring minority shareholders in the distribution of takeover gains. Manne is quite right in contending that an active market for corporate control protects shareholders better than their legal empowerment, although I am sceptical that this can work efficiently in the absence of legal rules that both define control entitlements and limit their abuse.

6. POWERS VS TRIALS: ENFORCEMENT OF CORPORATE GOVERNANCE IN THE UK

The divide between shareholder protection and shareholder empowerment is one major issue in the analysis of UK corporate governance by Armour (Chapter 5). Moving away from the question, what is 'good law', Armour scrutinizes the patterns of enforcement of corporate governance regulation across its varied content (corporate law, securities regulation, takeover regulation). One emerging view in the international literature (La Porta et al. 2006; Djankov et al. 2008) is that investor protection under both corporate and securities law is most effective when it is enforced by private litigation. Apparently, effective private enforcement is also efficient for it allows higher separation of ownership and control, which in turn nurtures vibrant stock markets. Armour does not question the importance of enforcement of investor protection in corporate governance. However, he notices that while the patterns of separation of ownership and control

in the UK are comparable to those in the US, in the former 'shareholder lawsuits are conspicuous by their absence'. In British corporate governance, investors are just protected differently from shareholder litigation. Partly (but minimally), this protection is based on public enforcement. Most importantly, the enforcement of corporate governance in the UK is 'informal' as it is carried out outside the courts by players who can credibly threaten the management refusing to comply with the rules protecting outside shareholders.

Armour himself notices that this enforcement pattern is based on corporate governance powers, rather than on procedural rules making shareholder rights actionable. Yet these rules exist, although, in contrast to the US, they are ill suited to mass litigation. In Armour's view, informal enforcement is still a form of enforcement, for it operates 'in the shadow of the law'. It is ultimately the latter that confers upon the main players of this mechanism – the institutional investors – the power to threaten managers credibly. In Britain, shareholders can oust incumbent directors any time, by outvoting them (which is an option for sufficiently large coalitions of institutional investors) or by setting up a hostile takeover (which directors have very limited possibilities to resist). Indeed, these legal entitlements of shareholders are protected by courts or by self-governing bodies (like the Takeover Panel) having no less power to sanction the ouster of recalcitrant management from the financial community. But the fact that these are entitlements to exercise governance powers, rather than to claim compensation for directors' misbehaviour, is not a matter of indifference. Armour shows that shareholders in Britain enjoy very little protection of their investment by courts and public authorities (that is, almost no private enforcement and quite negligible public enforcement), but they are otherwise very powerful in disciplining managers who fail to maximize their returns. Whether this solution is preferable to the US approach – allowing non-controlling shareholders little interference with management, but powerful instruments for litigation – is a question that Armour does not address.

Armour provides a distinctive roadmap of all the possible enforcement patterns available in UK corporate governance, both formal and informal. Description of the former combines essential legal information with a patient collection of data. The results, reported as an impressively low frequency of enforcement actions, show that shareholder litigation is effectively a dead letter in the UK. Public enforcement scores somewhat better, although the frequency of actions per year barely reaches two digits in most of the 'formal' settings. Informal public enforcement is a different story, dominated – as expected – by the activism of the Takeover Panel. But, with this exception, data on informal enforcement are naturally dif-

ficult to collect. At this point, the empirical evidence reported by Armour becomes mostly suggestive. The combination of legal and economic arguments is sufficiently convincing though. With respect to informal private enforcement, institutional investors and takeovers are the major players. While the latter leave some traces behind (perhaps raising the question why, just like in the rest of the world, the vast majority of takeovers in the UK are friendly), the former operate 'behind closed doors' (Stapledon 1996). And yet, the comprehensive voting guidelines and the otherwise inexplicable CEO turnovers are indirect evidence of institutional investors' activism in the UK.

In his comment, Pardolesi is somewhat sceptical that informal enforcement can effectively substitute for formal enforcement. Like many other legal phenomena, its relevance is hard to prove empirically – which casts doubts on the popularity of 'numerical comparative law' (Siems 2005), especially in corporate governance, over the past decade. More importantly, informal enforcement is conceptually difficult to disentangle from the more general categories of public and private enforcement. The last two are more intertwined than the current debate – mostly centred on antitrust law – tends to suggest. Aside from the specific experiences of private and public enforcement on either side of the Atlantic, it seems that efficient enforcement of law needs an optimal combination of the two. The proportions defining the efficient combination may vary according to the institutional context. In this perspective, informal enforcement is undoubtedly part of the equation. One can agree that, at one extreme, informal enforcement suffices to compensate for lack of formal enforcement. But the very notion of informal enforcement is ill defined, for it tends to encompass forms of private and public action that do induce compliance with the law, albeit without resulting in formal legal proceedings. On this basis, any statement of preponderance of one form of enforcement over another is arbitrary. Conversely, if we narrow down the definition of informal enforcement based on the pursuit of specific goals (for example, investor protection) without the involvement of the courts or regulatory agencies, its equivalence to formal enforcement is yet to be proved. Both entail costs and benefits, and a detailed analysis of them is necessary for a sound judgment of relative efficiency.

7. CORPORATE LAW AND ECONOMICS IN A THEORY OF THE FIRM

The last two contributions to this book look at the very foundations of corporate governance. Somewhat in the spirit of Manne (Chapter 4), legal

rules initially disappear from the picture. But their absence does not last for long. Corporate governance is not analysed merely as the outcome of a market process, but rather, as an alternative to this process that *must* rely on a particular combination of public and private ordering. The corporation emerges for the same reason that market exchange is 'superseded' by authority in establishing a firm (Coase 1937): minimization of transaction costs. But the question still not completely answered by the law and economics literature is why the corporate form is chosen. In Chapter 6, Pagano endeavours to answer this question. Following Coase, he characterizes the firm as a centralization of market transactions. Where does the necessary authority come from (Alchian and Demsetz 1972)? Based on legal thought (Fuller 1969), the answer suggested by Pagano is decentralization of public ordering, which depends on the same problem of transaction costs as applied to lawmaking. The corporation emerges as a response to these two efficiency pressures. On the one hand, there is pressure to centralize transactions when they would be too costly to coordinate on the market. On the other hand, there is pressure to decentralize public ordering when it would be too costly to tailor legal rules to the specific requirements of firm production. Corporate governance is therefore a system of private ordering established by corporate law in order to satisfy these needs.

Guiding the reader through a fascinating theoretical journey, Pagano describes this result as a 'marriage' between the two fundamental contributions by Coase (1937) and Fuller (1969). The core of his argument is the – so far, neglected – link between them. To this end, he borrows from two additional contributors to Transaction Cost Economics. One is Williamson (1985), the very founder of this discipline and now Nobel Prize laureate for that reason. Surprisingly, the other (Calabresi 1970, 1991) is somebody who has hardly ever entered the debate on the theory of the firm, in spite of his laying down some of the very foundations of economic analysis of law. The marriage between Coase and Fuller is assisted by these two metaphorical best men, but it takes place in the framework developed by the latter. Telling enough, Coase and Fuller marry 'in the Cathedral', namely the ideal place where Calabresi and Melamed (1972) famously articulated their distinction between property rules and liability rules. Here is the missing link with the economic theory of the corporation identified by Pagano. Corporations are decentralized systems of private orderings for all transactions between insiders, which are governed by an internal set of property rules (that is, entitlements) in order to preserve relationship-specific investments. But corporations are also made accountable to society for these transactions via (joint) liability rules which enable outsiders to claim compensation for their own entitlements without undermining authority within the corporate enterprise.

Building on Coase (1937), the theory of the firm has been analyzing the consequences of the 'fundamental transformation' (Williamson 1985) that occurs after relationship-specific investments are made by two previously independent parties. After this transformation, the parties face a situation of bilateral monopoly where they are subject to mutual hold-up (Klein et al. 1978). The hierarchical structure of the firm solves this problem by centralizing distribution of the surplus ex post. But who decides? One intuitive answer, developed by the Property Rights Theory of the Firm (Grossman and Hart 1986; Hart and Moore 1990), is the owners of the firm. Yet – as Pagano notices – the answer is unsatisfactory, for it is mechanical (all decisions are effectively taken ex ante) and unidirectional (only the owners can be in control). In other words, the Property Rights Theory does not explain corporations as *governance* structures characterized by *separation* of ownership and control (Zingales 1998). Contrariwise, the transaction costs framework allows governance structures to be created on a purely contractual basis (Williamson 1991), without the limits (but also without the support) of property rights. Pagano attempts to fill this gap, hypothesizing a transfer of authority by decentralization of public ordering which goes beyond the existing set of property rights. With the help of Calabresi's (and Melamed's 1972) distinction between two ways to protect (alienable) entitlements, Pagano suggests that the state decentralizes to the corporation the definition of entitlements (property rules) within the firm. However, the corporation is exclusively responsible towards the rest of society for how these entitlements are exercised (liability rules). While legal personality is efficaciously presented as the unifying concept of power inside the corporation and responsibility outside it, Pagano's framework still raises a number of important questions for institutional analysis.

In his reply, van Oosterhout identifies a major weakness of Pagano's analysis. Pagano derives decentralization of public ordering as a necessary condition for the establishment of authority within the (corporate) firm. However, he fails to model the role of the government in this respect. Van Oosterhout observes that this cannot be taken for granted, for any form of private ordering arises as a delegation of powers from the state. This delegation may be implicit, but then its existence needs to be validated by unequivocal evidence. Except for his reference to the corporate legal personality, Pagano overlooks this fundamental issue. Yet legal personality tell us neither why courts should abstain from adjudicating controversial issues within the firm nor why third parties should be content with corporate liability for any misconduct by the firm's constituencies. To be sure, corporate law supports elements of each proposition, namely the Business Judgment Rule regarding courts' abstention and limited liability concerning the claims of third parties against shareholders. These elements

are neither included in the notion of legal personality nor specifically discussed by Pagano. More importantly, as with legal personality, the above-mentioned circumstances are explicitly supported by legal rules and they only hold within the boundaries defined by public ordering (courts do adjudicate intra-firm controversies when the conditions of the Business Judgment Rule do not hold; and limited liability only protects shareholders). In conclusion, a theory of firm based on decentralization of public ordering cannot just assume delegation of authority, but must model it explicitly.

Despite these criticisms, Pagano's theory addresses and tries to solve one problematic issue touched upon by various contributions to this book. That is, how are entitlements created by corporate law and how are they allocated among the firm's constituencies in order to ensure that they receive sufficient protection in corporate governance? If anything, the foregoing discussion shows that we do not yet have an answer to this fundamental question. Corporate governance seems to be about protecting investors, and yet the relevant investments in the corporate enterprise are not necessarily made only by shareholders – the ultimate owners of the firm's assets. Opinions differ on how to balance the interests of different constituencies in corporate governance, and so do the corporate laws that address this question in different jurisdictions. This variety suggests that there is no optimal solution readily available – at least, not that we know of. But, exactly for this reason, corporate law may be even more important than is commonly understood. The persistence of alternative solutions in spite of the global pressures towards convergence of legal standards may just be explained by the theoretical gap identified by Pagano. We still do not know how corporate law does (and should) complement the property rights system (Pacces 2007).

8. CONCLUDING REMARKS

The main results of this study can be summarized as follows. First, regulatory competition is neither good nor bad for corporate law. It may simply be misdirected, but the question is for how long. Secondly, harmonization of company law is not just a substitute for regulatory competition. As the European experience shows, it can actually be a complement. Thirdly, we may not need to worry about the quality of corporate law rules, for takeovers naturally tend to select the best. The question is whether we understand which rules actually enhance firm value and how much. Fourthly, we may have forgotten that the best of all worlds is one featuring few, if any, mandatory rules in corporate governance. The only problem is how

to make investors comfortable with unregulated control powers, takeovers, and insider trading, given the problem of contractual incompleteness. Fifthly, strong governance powers, as well as courts and regulatory agencies, may protect investors from expropriation, and perhaps even better. However, this pattern of 'informal enforcement' does not have clear defining boundaries, and thus it is hard to generalize outside the British context. Sixthly, corporate law may be understood as a decentralization of public ordering complementing the centralization of market transactions within the corporate enterprise. Unfortunately, we still know too little about whether, and under what conditions, corporate law can effectively establish a system of private ordering.

At the end of a long journey along these changing perspectives on corporate law and economics, it is not easy in summing up to do justice to the importance of each contribution. Perhaps a way out of this impasse is to stress the role of the interdisciplinary, international, and intergenerational approach of this book in its numerous achievements. The above results have one fundamental aspect in common. They are all derived by combining legal and economic analysis of the institutions of corporate governance. The authors' backgrounds differ as far as education, experience, and geography are concerned. This explains the selection of topics among the various issues debated in corporate governance, but not the choice of methodology for addressing them. Regardless of whether the contributions are authored by lawyers or economists, all evidence is reported and discussed with a rigorous empirical methodology. Equally impressively, lawyers and economists discuss legal and economic theory interchangeably. Economic analysis of law has thus established a common ground where changing perspectives on corporate governance are mutually reinforcing in the build-up of new knowledge.

Diversity between the contributors matters in two additional respects. Mapping the authors geographically, this book represents three major models of corporate governance in the developed world, namely the US, the UK, and continental Europe. Although all contributions take an international perspective, they naturally reflect the different relevance of corporate governance issues in the country of origin of the authors. Finally, the latter differ in terms of the generation of corporate law and economics they represent. The first generation reminds us of the importance of the origins of this debate (the market for corporate control), notwithstanding our improved understanding of the complexity of corporate governance. The second takes up the challenge of integrating new quantitative methodologies into the analysis of corporate law and of its economic effects. The third generation explores the recent developments in our knowledge of contracts, property rights, and their enforcement as applied to corporate

governance. Once again, these changing perspectives add substantially to the coverage, depth, and quality of the debate.

One of the contributors (Pardolesi, in his comment on Chapter 5) concludes, 'A good paper raises more questions than it can solve'. The same conclusion applies to this book as a whole. A similar point was made by Guido Calabresi in the final address to the conference organized in his honour, where all the contributions to this volume were first presented. In view of the financial crisis, these questions were particularly relevant when that conference took place, and so are they at the present times of reflection on how to prevent this from happening again in the future. All the open questions raised in this book, identifying as many avenues for future research, revolve around the fundamental trade-off between authority and responsibility at both the firm and the government levels. It is thus no surprise that we have not yet found all the answers. Over the past decades, the 'giants' of law and economics have advanced our knowledge of this matter and they have stimulated us to carry their insights further. A few of them have joined this venture across the changing perspectives on corporate law and economics either in person (Calabresi), in letter (Manne), or just in spirit (Coase, Williamson). However little this book may contribute to the fundamental debate on how law can improve the welfare of society, we hope to be standing on their shoulders.

Rotterdam, November 2009
The Editor

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Comment – Corporate governance and Coase's legacy: a reply to Henry Manne

Alessio M. Pacces

Professor Manne makes a fundamental statement, which he articulates in the domain of three major items of corporate governance. The statement is that 'there is no aspect of corporate governance that is not better left to private contracting and the play of market forces' (p. 190 of this volume).[1] This is applied to boards of directors, the market for corporate control, and insider trading. I do not think that Professor Manne would maintain his fundamental statement even in those circumstances that most evidently call for regulatory intervention. That he admits, implicitly, when he supports the 'need for courts to deal with real acts of misbehavior by directors' (p. 197 of this volume). By speculating on the limits of contracting and the meaning of misbehavior, I will try to illustrate why – maybe unfortunately – there is more need for regulation in corporate governance than Professor Manne suggests. Incidentally, my considerations are based on a framework not very different from his. While I am honored to be cited by the very pioneer of corporate law and economics, I am afraid I do not fully share his trust in the unfettered functioning of markets and private contracting for efficient corporate governance.

1. It is in the tradition of law and economics that regulation must be justified by market or contracting failures. This goes back to Ronald Coase (1960), whose views – as he also made clear in his Nobel Prize Lecture (Coase 1992) – tend to be misinterpreted in various formulations of a theorem that he has never enunciated. Coase did point to the virtues of the contracting process in resolving the misallocation of resources, but he

[1] In stating this, Manne refers to Macey (2008) who, however, articulates his reasoning through a more comprehensive set of institutions of corporate governance. For reasons of space, I am not in a position to comment upon Professor Macey's work, and on how it compares with the arguments developed by Manne. I briefly discuss Macey's contention that corporate law is made exclusively of default rules at the end of this comment.

also showed a number of limits to this process. Short of being unimportant, law can (but does not necessarily do so) support and correct private contracting in two ways: (1) by providing the entitlements to be contracted upon; (2) by regulating those entitlements whenever private contracting fails to do that efficiently because of high transaction costs.

When applied to corporate governance, this framework generates two basic grounds for regulatory intervention (Becht et al. 2007). The first is that some of the people affected by the deal might be missing from the bargaining table. The second is that the terms of the original agreement might be altered via renegotiation at a later stage. Both arguments reflect a problem known as contractual incompleteness. Contracts are imperfectly state-contingent, and as a result, unforeseen circumstances confer upon some of the parties to a so-called 'nexus of contracts' unanticipated power over the division of the firm's surplus. Those who may be adversely affected by these dynamics are naturally reluctant to invest in a long-term relationship. This is most unfortunate in corporate governance, whose major goal is maximizing the flow of investments committed to welfare-increasing production.

2. The first reason for regulatory intervention (third-party effects) is more often characterized as externalities of the corporate contract on other stakeholders' contracts. I doubt whether Ronald Coase would share this view. Put as externality, the argument is not powerful enough to support any further protection of shareholders or stakeholders than private ordering would grant. Both categories of players have a wonderful opportunity to contract for their rights in corporate governance when the firm goes public. High transaction costs would not give them a second chance when – as Professor Manne nicely puts it – public corporations evolve as entities in the market context. But then, more than about externalities, the real question is whether the property rights system confers upon these players a sufficiently broad range of entitlements to contract upon in the corporate governance set-up.

I believe that corporate law does this by complementing the property rights system with entitlements to control power that are not necessarily confined to ownership (Pacces 2007). This is the case when voting rights can be separated from ownership (for example, different classes of shares), or control rights are generated independently of voting rights (for example, management's privileged access to the proxy machinery). Although the issue of enabling rules is dismissed as one of secondary importance by Professor Manne, I consider this the most powerful argument for relying upon the market mechanism. When shareholders and stakeholder can effectively choose the entitlements necessary for protecting their investments, we may infer their preferences from this choice and its impact on

stock prices. Under the same condition, we can conclude that those who contract for control powers need to protect their firm-specific investment from unforeseen contingencies, whereas those who don't simply refrain from putting that at stake.

I share Professor Manne's concern that corporate laws may, and most often do, fail to support that freedom of contract, although I see at least one way in which law may do too little, instead of too much, in addressing corporate governance from this angle. Following Berle and Means (1933), American scholars tend to take transition to managerial capitalism for granted. The reason why this may not happen – as is still the case in most countries of continental Europe – is not just that regulation interferes too much with the market mechanism, but also that it fails to provide the players with a sufficient range of entitlements to bargain over. When we take a quick look at comparative corporate governance, we see that managers are in charge when corporate law effectively allows management-controlled directors to be empowered against shareholders. When it does not allow that, control powers need to be *legally* supported by ownership, and this is how corporate governance gets stuck in controlling shareholding structures, regardless of whether this is efficient (Cools 2005).

Professor Manne correctly connects this part of my work with Bainbridge's (2002) advocacy of 'director primacy' (including the argument that stakeholders would contract for board representation when this is needed for them to invest). But he overlooks an important difference. I do not consider directors as monitors, unless the contract or regulation specifically entrusts *some* of them with this task, exactly because I share Professor Manne's view that (most) directors are part of the management team. Boards of directors are mainly (albeit not exclusively, as I am going to illustrate in a moment) an instrument for the exercise of control powers. When corporate law makes them powerful enough relative to shareholders, we observe management-controlled companies. When corporate law does not allow directors' empowerment, boards will still be the center of managerial discretion, but they will have to defer to a controlling shareholder. What these two outcomes have in common is that corporate governance, like any form of firm governance, needs to feature a unique line of command in order to protect firm-specific investments. Again, based on the work by Ronald Coase (1937), authority is no less important than market exchange in a capitalist economy. A prominent consequence of separation of ownership and control is that authority cannot just be supported by property rights (Zingales 2000).[2]

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[2] For a theoretical discussion of this problem, see Chapter 6 by Pagano and van Oosterhout's Comment on it in this volume.

3. The second ground for legal intervention in corporate governance (opportunistic renegotiation) is related to the previous illustration of corporate law's support for private contracting. The corporate contract may well reflect efficient choices when the firm goes public. However, on the one hand, what is efficient today may no longer be efficient tomorrow. Indeed, this is the reason why law needs to support discretionary control powers (be they vested in the management or in controlling shareholders). On the other hand, unfettered discretion includes the power to alter the terms of the original agreement in the face of changed circumstances, and this may too easily result in expropriation of other constituencies. Leaving stakeholders aside, I agree with Professor Manne's argument that non-controlling shareholders would not invest if they were not confident that this arrangement still protects them well enough. But I disagree that the market mechanism is sufficient for this purpose. However control powers are allocated, the market can no longer support long-term commitments when it is 'superseded' by authority (Coase 1937).

For investor protection, Professor Manne especially relies on a market for corporate control operated by hostile takeovers. We would not need much else to prevent controllers from misbehaving – he argues – if a raider were always in a position to take control away from a disloyal or under-performing management. As highlighted by Lucian Bebchuk (1987, 1999), there are two reasons why this is not necessarily true. To start with, in a regulation-free environment, there is no guarantee that a new controller will enhance shareholder value instead of profiting from expropriation of non-controlling shareholders. Indeed, unconstrained opportunities for expropriation are a sufficient condition for shareholders to be under pressure to tender at any price. Secondly, hostile takeovers are ruled out whenever those in control are in a position to extract private benefits by diverting resources from minority shareholders into their own pockets. Since the only way for incumbents to be compensated for these benefits is selling control at a premium, they are committed to keeping control uncontestable.

Corporate controllers are therefore not in a position to commit to a no-expropriation policy by exposing themselves to the (threat of) hostile takeover. Quite to the contrary, that commitment must already be in place for hostile takeovers to be viable. Would the corporate contract be enough to support it? I believe not, and the reason is that controllers cannot credibly restrain their discretion through a contract whereby all control powers (including that of adapting the contract to unforeseen circumstances) are allocated to them in order to promote firm-specific investments. This is how regulation enters the picture. In order to support credible commitments that non-controlling shareholder will still be dealt with fairly,

restraints on the corporate controller's discretion must be mandatory – that is, they cannot be opted out of by the corporate contract or any of its amendments.

Professor Manne seems to concede that this may be a good reason for courts to perform a residual check on the corporate controller's misbehavior. I think that we might agree that the domain of this check should be diversion of corporate resources – that is, theft in broad terms – and little else. However, the implications of this contention for the regulation of corporate governance are more far-reaching than they may appear.

4. When managers or controlling shareholders are vested with unfettered discretion, the opportunities for turning this into stealing are ubiquitous. They range from daily operations to corporate control transactions. The problem is that value diversion is not easily distinguished from the legitimate exercise of business judgment. In order to make sense of the Business Judgment Rule – a norm that preserves outside shareholders' commitment to delegating discretionary management regardless of how badly it turns out in hindsight – courts rely on the procedural fairness of corporate decision-making. Even in the presence of conflicts of interest, courts rely more on validation by directors who are independent of those in control than on their own ability to second-guess business judgment. However, independent directors – whatever that means – are not there to interfere with the management, but only to make sure that investor protection does not come at the price of over-regulating managerial discretion. I believe this is a major challenge for regulation today, rather than just an option (which could be reneged upon at anytime) for the corporate contract.

A similar reasoning applies to takeovers. Hostile takeovers are at odds with the (economically justified) concern of managers and controlling shareholders over the stability of their control powers. This may be why we have only experienced this phenomenon in specific spatial and temporal circumstances. Takeovers can also induce corporate controllers to do their best when they are friendly (incidentally, it is worth noting that this used to be Professor Manne's contention in 1965). However, once again this requires regulation to cope with problems of credible commitment (or, in Coasian terms, transaction costs). Non-controlling shareholders can become suddenly powerful in the face of a tender offer, when they are allowed a free ride on the insurgent's profits. Little do they know that, by short-circuiting the takeover mechanism, their opportunism just results in more shirking by the incumbents. As Professor Manne contends, there are a number of free-market ways out of this. However, they all result in a situation in which shareholders are induced to tender at any rate (thereby reopening the door to shareholder expropriation). Regulation must find

the right balance between the bidder's commitment to enhance the company's value, shareholders' commitment to let him/her appropriate takeover gains, and the incumbent's commitment to part with control when he/she is compensated for its current value. I believe that it can (thereby restoring the virtues of Coasian bargain), although I concede to Professor Manne that it can better do so by weakening, instead of strengthening, minority shareholders.

Let me discuss very briefly the third topic analyzed by Manne, insider trading. I note that Professor Manne's argument in favor of insider trading is twofold. On the one hand, it improves the speed with which information is impounded in stock prices. On the other hand, it rewards the originators of information. I believe that the two arguments are related, so I will just explain why I am not entirely convinced about the latter. The rewards at issue are connected with profits on the stock market. While it is true that high-powered incentives to information acquisition, processing, and verification enhance stock market efficiency (Gilson and Kraakman 1984), I see two reasons why insiders should be prevented from profiting from their advantage in this.

First, insider trading reduces the incentives of outsiders to engage in the same activity, and accordingly, their returns from investing and willingness to invest in the stock market. Insiders may earn more from selling non-controlling stock when they are (legally) committed to letting only outsiders trade on information advantages. Secondly, prohibition of insider trading does not mean that insiders are prevented from otherwise reaping the gains of their information collection (another way of looking at their firm-specific investments). They can, indeed, to the extent that they manage to keep information about the firm's potential secret and to share it only with bidders who know better how to turn this potential into stock returns. This will allow two separate bargains on control and ownership: the first, rewarding the incumbent via a control premium; the second, making sure that insurgents take over if and only if they can enhance stock returns more than the market already anticipates.

5. My disagreement with Professor Manne on the unlimited virtues of private contracting generated a lively discussion at the conference[3] where our opposing views were aired. Based on that discussion, I need to clarify an important issue. My contention that mandatory rules are needed for investor protection could apparently be falsified by the observation that, even in those jurisdictions where this protection is considered high, the

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[3] See my introduction to this volume (at p. 11).

so-called 'mandatory rules' are not effectively binding. This seems to hold especially in the US, where traditionally corporate law has been considered to be mainly a collection of default rules (Easterbrook and Fischel 1991). The argument becomes particularly powerful when it is related to the choice of legal form and, even more so, of the corporate jurisdiction. Regardless of whether the law governing business corporations features mandatory rules in any given jurisdiction, these cannot be regarded as effectively mandatory when they can be opted out of either by choosing another legal form or by incorporating in another jurisdiction. This situation characterizes all American corporate jurisdictions, and particularly, the one governing the vast majority of US publicly held companies – Delaware. Within the limits of freedom of incorporation under European company law, the same argument would apply to Europe (Kraakman et al. 2009). It is therefore highly questionable whether investor protection in corporate governance is owing to the mandatory character of fiduciary duties – especially in the celebrated version administered by Delaware courts (Coffee 1989). Even in Delaware, 'fiduciary duties exist unless the parties have explicitly contracted them away' (Macey 2008: 23).

The argument that fiduciary duties are no exception to the enabling character of corporate law has a long-standing tradition in the US. Advocates of this position (for example, Romano 1989) contend that rational shareholders of a publicly held company would neither invest in a company offering insufficient protections against expropriation nor rubber-stamp a charter amendment aimed at removing those protections. The corporate contract thus protects investors well enough, and the question whether fiduciary duties need to be mandatory is the wrong question. Investors would only opt out of them in exchange for equivalent or stronger protections, for they would be fools to confer upon the management an explicit license to steal. The argument has been rejuvenated in a most interesting fashion by Hansmann (2006), who likewise contends that corporate contracts are very hard to amend due to the hold-out powers of minority shareholders. For this reason, companies choose not to depart from the statutory defaults and rely on the legislator to adapt the contract to changed circumstances. De facto, this makes default rules nearly as binding as mandatory rules. Both the companies and their investors, however, could take a different course of action. They could depart from the statutory defaults and opt out of any mandatory rules by incorporating in legal forms or jurisdictions that do not impose them. The fact that the vast majority of publicly held companies in the US do not do so does not change the circumstance that corporate law is exclusively made up of default rules.

In both the traditional and the most recent configuration, the argument is extremely formalistic. It revolves around the hypothetical propositions that: (a) shareholders *could* opt out of the protection supplied by fiduciary duties; (b) shareholders *would not* opt out of their contractual protections altogether unless they were irrational. Both propositions are true in a static setting, but they cease to hold in a dynamic context. The reason is that, unlike what both Romano and Hansmann assume, US investors are no longer in control of the corporate contract after the corporation has been established and, more importantly, floated on the stock market. A number of legal institutions, originally subscribed to by the investing public (for example, the proxy machinery and the limitations on outside shareholders' initiative), allow the corporate contract to be adapted to changed circumstances without the investors' effective consent. Non-controlling shareholders are normally asked to vote on these fundamental changes, but their vote doesn't mean much. On the one hand, it can only be solicited by those in control of the corporation. On the other hand, it is cast in situations of asymmetric information and collective action problems that could not lead to efficient bargaining. As a result, fundamental changes occur without non-controlling shareholders being involved in the bargaining. In the absence of alternatives, the latter simply rubber-stamp the decisions made by those whom they entrusted with the powers to deal with unforeseen circumstances in the first place.

These powers are very broad, as is shown by the significant incompleteness of the corporate contract (Rock and Wachter 2001). There is a void at the heart of the corporate contract, and intentionally so. Borrowing from the law and economics of contract law, Macey (2008) contends that one prominent way for shareholders to opt out of fiduciary duties is to stipulate in the corporate charter how certain contingencies should be dealt with. But this is done no more often than a choice of legal form other than the business corporation, or incorporation in jurisdictions more liberal than Delaware. Normally, publicly held companies *choose* to be subject to a set of mandatory rules for this is the only way to guarantee outside shareholders against expropriation without having to give up the flexibility of the corporate contract in the face of unforeseen circumstances. The business corporation provides a better balance of flexibility and commitment than the more contract-intensive legal forms available in Delaware or anywhere else in the US. In setting up the governance structure of a soon-to-be publicly held company, the founders *could not* afford to opt out of fiduciary duties because otherwise, the management *would* too easily renege on any other contractual promise that investors be dealt with fairly after the company has gone

public.[4] That outside shareholders *could* opt out of fiduciary duties, but they *would not* do so in the absence of equivalent contractual protections, thus becomes irrelevant. The natural incompleteness of the corporate contract leaves them with no real choice.

It is telling that the importance of mandatory rules to support credible commitments is recognized by the same legal scholars who otherwise question whether corporate law has any real mandatory character (Kraakman et al. 2009: 22–3). In fact, much in the vein of the economists in the law and finance strand of literature (Djankov et al. 2008), they argue that 'there may be often little practical difference between mandatory and default rules' (Kraakman et al. 2009: 25). I find this unconvincing. A brief comparison between the US and the UK on a key issue – removal of directors – shows that the distinction between default and mandatory rules does matter in corporate law.

Both the Delaware General Corporation Law (§ 141) and the British Companies Act (§ 168 and § 303) stipulate that directors may be removed by a shareholder vote without cause. However, while the former is a default rule, the latter is mandatory. The outcome for publicly held companies is exactly the opposite in the two situations. The majority of Delaware companies going public in the US opt out of the default rule, mainly through the establishment of staggered boards (Bebchuk et al. 2002).

Conversely, the non-waivable right to remove directors without cause lays down the very foundation of institutional investors' power in UK corporate governance (Armour, Chapter 5 in this volume). To be sure, this example differs substantially from fiduciary duties, since removal of directors protects investors by taking powers away from the management instead of by regulating their exercise. I have explained earlier in this comment why a more enabling approach to distribution of powers would be preferable. The point I am making here is that, no matter how investor protection is devised, it needs to be supported by mandatory rules. Commitments that non-controlling shareholders be dealt with fairly could not be taken credibly when they can be opted out of by the corporate contract and its successive amendments.

6. To conclude, it is worth stressing that there is a strong argument in favor of mandatory rules the protection of investors against expropriation

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[4] It could be argued that one alternative is to make the corporate contract more difficult to amend, for example by setting super-majority requirements. The disadvantages of this solution, which explain why it is hardly ever chosen by publicly held companies, are the same as for making the corporate contract more detailed to deal with future contingencies.

of the share of firm surplus they have originally contracted for. It becomes far shakier, if not untenable, when it is applied to ex-post bargaining over a surplus (or loss) generated by circumstances not fully anticipated by contract (for example, a takeover or a radical change in market conditions). Here I fully agree with Professor Manne that private contracting should be entirely relied upon. However, in the economics of incomplete contracts, this means that parties should have unlimited freedom to allocate entitlements to control powers ex ante. On the one hand, as I have said, this requires a bit more than freedom of contract in corporate governance. The available entitlements should be defined in the first place, and this is a major task for (enabling) corporate law. On the other hand, how can the control powers of managers and/or controlling shareholders be reconciled with the previous statement that outside shareholders should keep the share of surplus they have originally contracted for?

To this purpose, mandatory rules need to operate beyond corporate law and intervene also in the functioning of securities markets. What we can leave for the corporate contract to define are, for instance, the conditions for takeovers to be effected and for insiders to extract rewards from trading their shares. But in order for these conditions to hold throughout the company's lifecycle, a binding takeover and securities regulation must protect non-controlling shareholders from dilution through freeze-outs and withholding of key information on trading the company's stock. The metaphor of 'Securities Regulation as Lobster Trap' (Rock 2002) illustrates efficaciously how these protections complement corporate law's fiduciary duties in supporting credible commitments towards investors.

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