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Why Investor Protection Is Not All That Matters in Corporate Law and Economics

*Alessio M Pacces**

The standard approach to the legal foundations of corporate governance is based on the 'law matters' thesis, according to which corporate law promotes separation of ownership and control by protecting minority shareholders from expropriation. This paper takes a broader perspective on the economic and legal determinants of corporate governance. It shows that investor protection is a necessary, but not sufficient, legal condition for efficient separation of ownership and control. Supporting control powers vested in managers or controlling shareholders is at least as important as protecting investors from abuse. Corporate law does not only matter in the latter respect; it matters in both. This result is derived by interpreting corporate governance based on three categories of private benefits of control. Corporate law affects corporate governance, depending on its impact on each category of private benefits, and not just on those accounting for shareholder expropriation. Three major areas of corporate law are considered with this view—the legal distribution of corporate powers, the discipline of related-party transactions, and the regulation of control transactions. These areas are investigated comparatively in the US, the UK, Italy, Sweden, and the Netherlands. Investigation shows that, when corporate law is analyzed in this fashion, it explains the different patterns and performance of corporate governance. This account of corporate law is not only useful for understanding the separation of ownership and control, but also for indicating how to improve its efficiency through legal intervention.

Introduction

Corporate governance is a hot issue on the agenda of policymakers and scientific debates. The importance of economic and legal analysis, for its understanding, is hardly questionable. The integration of both is nowadays perceived as indispensable for interpreting different patterns of corporate governance around the world. In spite of the long-standing tradition of economic analysis of law, legitimacy of this approach is still questioned in some fields of legal analysis, not including corporate law. Economists have acknowledged that law

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matters for both the form and the efficiency of corporate governance (La Porta *et al.*, 1998). Lawyers, who have never doubted it, are inclined more and more on assessing the merits of legal policies, based on their economic effects (Kraakman *et al.*, 2004). Unfortunately, mainstream corporate law and economics still do not explain a number of factual circumstances, let alone their efficiency or inefficiency. Based on the view that managers and shareholders are involved in a principal-agent relationship, the prevailing approach identifies investor protection as the key legal underpinning of the separation of ownership and control, and as the ultimate goal of corporate law (Becht *et al.*, 2007). However, separation of ownership and control varies considerably, in kind and degree, both within and between jurisdictions that provide outside shareholders with good protection of their investment. This applies, for instance, not only to Sweden and the Netherlands, but also to the US and the UK.

By combining the existing empirical evidence with economic theory and comparative corporate law, a broader perspective of the economic and legal determinants of separation of ownership and control has been taken. This perspective is illustrated at length in the book, *Featuring Control Powers: Corporate Law and Economics Revisited* (Pacces, 2007). This paper attempts at presenting the major findings of that book.

The paper argues that investor protection is a necessary, but not a sifficient condition, for the separation of ownership and control. Corporate governance requires further legal support, namely the empowerment of corporate controllers with limited ownership, and their inducement to part with control, when confronted with a bid by a more efficient management. Featuring control powers in corporate governance is at least as important as protecting investors from abuse. Corporate law does not only matter in the latter respect; it matters in both.

Three Categories of Private Benefits of Control

The argument that investor protection is not all that matters in corporate governance, is based on three categories of private benefits of control. This parallels the current focus of the economic and legal analyses on the extraction of private benefits by managers and controlling shareholders, at the expense of the non-controlling shareholders (Dyck and Zingales, 2004). However, I argue that the prevailing account of private benefits of control is underspecified. It only includes the private benefits that corporate controllers can extract, in their capacity as shareholder agents. Consequently, private benefits of control are either distortionary or diversionary in nature, depending on whether they account for the management's failure to maximize shareholder value or for outright shareholder expropriation (Mayer, 2001). Merging the key insights of the theory of entrepreneurship with the incomplete contracts theories of the firm, I posit that a third category of private benefits exists, which is idiosyncratic to the corporate controller, i.e., it depends on his/her identity, in combination with the firm under control (Williamson, 1979).

Ex-ante, idiosyncratic private benefits of control are harmless to non-controlling shareholders, inasmuch as they account for further value to be uncovered by the application of entrepreneurship to the corporate enterprise. In sole proprietorships, entrepreneurs appropriate this value as a reward for investment of firm-specific human capital under conditions of uncertainty, when the firm they own turns out to be successful. Separation of ownership and control makes *ex-post* appropriation of private benefits of control a more complicated issue for both wealth-constrained entrepreneurs and suppliers of equity finance. While on the one hand, controllers fear that outside shareholders will expropriate them of idiosyncratic private benefits by interfering with the management, and by eventually forcing a change in control via a hostile takeover, on the other hand, non-controlling shareholders fear that controllers will fail to maximize profits, or even divert a part of them to their pockets, when they are in control of corporate assets that they own only partially. Both categories of players are reluctant to separate ownership from control because of that (Rock and Wachter, 2001).

The introduction of a richer taxonomy of private benefits provides a comprehensive explanation of how these problems affect the efficiency of corporate governance. Private benefits have different implications for firm value. Diversionary private benefits are only extracted with a deadweight loss, which implies, in turn, a higher cost of capital; they are, therefore, unambiguously 'bad'. Distortionary private benefits are the traditional dimensions of agency costs involved by the separation of ownership and control, which alignment of managerial incentives can only partially cope with. They may be 'ugly', for they cannot be eliminated, but separation of ownership and control still brings mutual benefits to entrepreneurs and outside investors, in spite of them (Bratton and McCahery, 2001). Idiosyncratic private benefits are the prospective rewards for entrepreneurship in corporate governance. Entrepreneurs are reluctant to go public to the extent that they cannot secure these benefits in the wake of a takeover, i.e., when corporate control is not tenured (Coates, 2004). However, control tenure apparently prevents takeover by a more efficient management, thereby increasing the potential for extraction of diversionary and distortionary private benefits. This conclusion is unwarranted when the only constraint to efficient takeovers is the compensation of idiosyncratic private benefits of control (Schnitzer, 1995). Therefore, these benefits are 'good', inasmuch as they promote the investment of entrepreneurial talent *ex-ante*, and create no further impediment to efficient takeovers than their being compensated *ex-post*.

This interpretation of corporate governance has far-reaching implications on how corporate law matters. This depends on how corporate law affects each category of private benefits of control, and not just those accounting for shareholder expropriation (Pacces, 2008a). I consider three major areas of regulation of corporate governance with this view—the 'legal discipline of conflicted interest transactions', setting constraints on the extraction of 'bad' private benefits of control; the 'legal distribution of corporate powers', determining how 'good' private benefits can be appropriated by corporate controllers; and the 'regulation of corporate control transactions', affecting the way in which 'ugly' benefits are minimized by the market for corporate control. In order to check the consistency of this approach with the empirical evidence, I formulate three predictions on how different laws can make separation of ownership and control differ from country to country, and on whether the outcomes are efficient or not.

Three Predictions on How Law Affects Corporate Governance

Prediction 1: Law and Investor Protection

Law matters as a safeguard of non-controlling shareholders against 'diversionary private benefits' that may be extracted by the corporate controller. Effective protection makes vast separation of ownership and control a workable way to finance business, whereas ineffective protection hampers it. This prediction confirms the mainstream 'law matters' argument (La Porta *et al.*, 1997), and therefore, it does not require further elaboration.

Prediction 2: Law and Support of Corporate Control

Law also matters for the separation of ownership and control, in that it protects the corporate controller's 'idiosyncratic private benefits'. Once shareholders are protected from expropriation of their investment, the provision of legal entitlements to firm control, via distribution of powers between the management and the non-controlling owners, determines how much separation of ownership and control can be afforded in corporate governance. Given the management's concern with non-contractible rewards to entrepreneurship, the distribution of corporate powers may make the ownership structure either more or less concentrated than what is necessary for the firm to be efficient.

This prediction is partly novel. The distribution of legal powers in the corporation, whose importance was recently highlighted in the literature (Cools, 2005), has not yet been connected with the incentive effects of private benefits of control on wealth-constrained entrepreneur's dealing with uncertainty (Hart, 2001).

Prediction 3: Law and the Market for Corporate Control

Besides supporting control powers and constraining abuse of these, law is important since it promotes a market for corporate control based on non-hostile takeovers. Insufficient protection of non-controlling shareholders makes control immovable from overly concentrated ownership structures. However, when takeover regulation features excessive shareholder protection, insurgents may be prevented from inducing less efficient incumbents to part with control via side payments. Eventually, this leads to the excessive consumption of 'distortionary private benefits' under too-dispersed or too-concentrated ownership structures.

This prediction is novel. Both the consequences of private benefits of control on the takeover mechanism (Bebchuk, 1994), and the effects of shareholder protection on the acquirer's incentives (Burkart and Panunzi, 2004), are dealt with by the existing literature, but they have always been considered separately.

The above predictions are both positive and normative in character. I have tested the positive account through the analysis of corporate governance and its regulation in a five-country case study. Despite the popularity of quantitative methods for assessing the impact of corporate laws on the separation of ownership and control (Djankov *et al.*, 2008), the test is performed qualitatively and not quantitatively. The reason is that the state of our knowledge does not allow broad legal comparisons to be performed quantitatively. Comparative law is meaningful only to the extent that it is functional to the problem being addressed (Siems, 2007). The regulatory factors that have a potential bearing on each of the three predictions are simply too many to be evaluated for more than a restricted sample of countries. Conversely, the number of jurisdictions included in quantitative analysis should be sufficiently large for statistical inference to be reliable.

Selection of the countries of the case study is based on a falsification criterion. According to the mainstream view, investor protection is the only dimension in which corporate law matters, for the separation of ownership and control. Therefore, I pick five countries that, for different reasons, cast some doubts on the validity of this explanation. These countries are: (i) Italy, whose typical ownership structure remains highly concentrated in spite of the recent improvements in investor protection (Bianco *et al.*, 2005); (ii) the US; (iii) the UK, whose entirely different approaches to investor protection, likewise, support highly dispersed ownership (Franks and Mayer, 2002); (iv) Sweden, where virtually any listed company has a controlling shareholder in spite of excellent investor protection (Agnblad *et al.*, 2001); and (v) the Netherlands, which supports significant separation of ownership and control, despite allegedly 'bad' investor protection (de Jong *et al.*, 2001). A comparative legal inquiry based on the above predictions turns out to match the different corporate governance patterns of these five countries. Thus, the underlying theory of private benefits of control has higher explanatory power than the standard 'law matters' approach to corporate law and economics. I contend that these predictions are sufficiently robust to draw normative conclusion on how corporate law should be, in order for corporate governance to be efficient.

Legal and Economic Analysis of Corporate Governance

I have divided the following discussion in three subsections.[1] The first section reviews the existing knowledge about corporate governance and its regulation, and highlights what both theoretical and empirical analyses have been unable to explain so far. The second part introduces an alternative framework of analysis, based on three categories of private benefits of control and on how corporate law can provide opportunities for and constraints to their extraction. The third part is where the three predictions on how corporate law affects separation of ownership and control are confronted with the five-country case study. A discussion of the effects of regulation on the prevailing patterns of separation of ownership and control shows the explanatory power of this framework and supports a number of implications for both the theory of corporate governance and its legal policy.

Theory and Evidence on Corporate Law and Economics

The core problem of corporate governance is the separation of ownership and control. This can be analyzed from different angles. I take the perspective of entrepreneur's access

[1] This corresponds with Parts I, II, and III in Pacces (2007).

to finance, and accordingly, divide the players of corporate governance into two major categories—controllers and non-controlling shareholders. The corporate structure addresses this setting through a number of features customarily identified by economic analysis of corporate law (Kraakman *et al.*, 2004). These are legal personality, limited liability, free transferability of shares, centralized management, and shareholder ownership. Unfortunately, these features fail to account for at least one player and one problem in real-world corporate governance. The player is the entrepreneur in his/her capacity as the corporate controller (Zingales, 2000); the problem is the disenfranchisement of non-controlling shareholders (Hellwig, 2000). Consideration for both could be integrated in corporate law and economics, if entrenchment of corporate control was considered as one additional feature of corporate governance, and not just as a distortion. The theory of entrepreneurship provides the scientific background for this hypothesis (Ricketts, 2002).

The importance of this hypostasis is confirmed by comparative corporate governance, although the empirical research available in this field is contradictory (Barca and Becht, 2001; and Faccio and Lang, 2002). While on the one hand, this depends on our inability to ascertain how corporate control is exercised, and with how much ownership, with a single methodology suitable for every country, on the other hand, this has also to do with limited availability of data and narrow assumptions for making them comparable between different countries. When international comparisons are reconciled with more precise studies at the national level, some countries turn out to have higher concentration of ownership (e.g., the US) or just more controlling shareholders (e.g., Sweden), than what they are normally credited for. In other countries, controlling shareholders account for much less than that reported in the international comparisons. Most notably, among Dutch listed companies, managerial control seems to be as frequent as controlling shareholders. Regardless of diversity in the prevailing ownership structures, entrenchment of corporate control is what all systems of corporate governance seem to have in common.[2]

Do existing theories of corporate governance match the evidence? Apparently, the answer is in the negative. The traditional principal-agent framework cannot explain why different patterns of corporate governance exist in different countries, and what corporate law has to do with this. Consideration for contractual incompleteness may possibly explain both things (Zingales, 1998). Unfortunately, incomplete contracts theories of the firm have problems in featuring control as separated from ownership (Hart, 1989). While on the one hand, existing models seem to allow just for control rights to be delegated from shareholders to the management, under the threat of delegation being withdrawn in case of underperformance (Burkart *et al.*, 1997), on the other hand, contractual incompleteness opens the door not just to division of control rights between owners and managers, but also to legal protection of non-shareholder constituencies (Rajan and Zingales, 2000). While existing arguments against stakeholder involvement in corporate governance are quite convincing, regardless of how control is allocated between managers and shareholders (Williamson, 1985), upgradation of the agency framework, based on delegation of control

[2] See Chapter 2 in Pacces (2007).

rights, still does not explain why we observe much less convergence in corporate governance, corporate laws, and contestability of corporate control, than what the theory would predict.

A relatively autonomous line of inquiry is based on institutional analysis. As far as corporate governance is concerned, institutions may explain, not only why patterns of separation of ownership and control differ between countries, but also why contestability of corporate control fails to occur. This approach currently provides the theoretical basis of the 'law matters' approach to comparative corporate governance. This is the domain where two different schools of thought meet. On the one hand, economists stand with the strength of econometric analysis and the weakness of legal knowledge (Djankov *et al.*, 2008). On the other, law and economics scholars respond with a subtler account of mandatory and enabling rules in corporate law (Kraakman *et al.*, 2004), but have often a weak case against a much-too-coarse statistical inference that ultimately works (Siems, 2005). Both strands of literature have significant limitations in arguing why, how, and in which respects, law matters for corporate governance. With very few exceptions (Rock and Wachter, 2001), neither account considers the possibility that law may matter not only in restricting extraction of private benefits of control from shareholder wealth, but also in allowing protection of control rents that outside shareholders are unable to price at the outset, and yet may wish to appropriate at a later stage. In this narrow configuration, corporate law does not explain international diversity in prevailing ownership structures, as opposed to the regularity of entrenchment of corporate control.

Rethinking 'Law Matters' in a Theory of Private Benefits of Control

The above difficulties may be overcome by interpreting corporate governance based on a more comprehensive taxonomy of private benefits of control (Pacces, 2008b). Most recent advances in corporate law and economics have already suggested that the presence of private benefits of control, not arising from shareholder expropriation, may explain different outcomes in corporate governance, in spite of functional equivalence of corporate laws, and of other institutional factors as to the protection of non-controlling shareholders (Gilson, 2006). The problem with this approach is that principal-agent models upon which it is based, do not really allow private benefits to enter corporate governance efficiently, for they can only be diversionary or distortionary in that framework. The conclusion is different when the agency paradigm is departed from, and consideration for a third category of private benefits—the idiosyncratic ones—is added. How corporate governance is implemented at both the firm and the country level depends on the interaction between all these three kinds of private benefits, and not just between the two of them. Adding consideration of control rents as a prospective reward to idiosyncratic investments allows for a more even welfare assessment of private benefits of control. I argue on this basis that, while diversionary private benefits undermine efficiency of corporate governance in the absence of adequate institutional constraints, idiosyncratic private benefits can provide an efficiency-based explanation of entrenchment of corporate control (Almazan and Suarez, 2003). In this framework, distortionary private benefits are ultimately policed by a market for corporate control, where takeovers are friendly and not hostile. This explanation is consistent with the empirical evidence.

Entrenchment is then not a distortion of the separation of ownership and control, as it is commonly understood, but is, rather, one of its distinctive features. The next step is to investigate how this feature is implemented in the corporate structure and the conditions under which such an arrangement is an efficient way to conduct and finance the corporate business. Implementation requires a legal distribution of powers, whereby control rights are definitively allocated to the corporate controller, and not just delegated from shareholders. Unfortunately, this solution raises severe concerns of incentive compatibility in the management of the corporate enterprise. Consistently with the traditional 'law matter' thesis, corporate law should also ensure that control powers are not abused through the extraction of diversionary private benefits. This is necessary, but not sufficient. Corporate controllers should also be induced to part with control when profits are not being maximized, i.e., when distortionary private benefits are extracted in excessive amounts. This problem can be handled through side payments, compensating for the incumbent's idiosyncratic rents, while allowing insurgents to reap the remainder of the gains from an efficient takeover (Schnitzer, 1995). The market for corporate control is, thus, interpreted as an application of the Coase Theorem. Corporate law should, accordingly, cope with its frictions, depending on transaction costs.

This framework provides the theoretical underpinnings of the three predictions concerning corporate law's impact on the separation of ownership and control. In the next subsection, I summarize the results of testing these predictions in the five jurisdictions of the case study.

Corporate Law and Economics Revisited

This section starts by discussing the second prediction, namely how corporate law protects idiosyncratic private benefits (and the underlying firm-specific investments) by supporting corporate control.[3] The sequence of predictions 1 and 2 is inverted for logical reasons. When investor protection is not all that matters in corporate governance, regulatory constraints on abuse of control powers are better understood after the discussion of how these powers are supported by corporate law in the first place. I address the matter directly at its functional core—the distribution of decision rights between the board of directors and the general meeting of shareholders. The focus is on whether directors may avail themselves of sufficient powers to exercise ongoing control and to resist ouster. The hypothesis is that managerial control would not emerge otherwise (Cools, 2005). The discipline of director's appointment and removal, the regulation of the agenda of the shareholder meeting, proxy voting and its regulatory substitutes, and the legal devices for takeover resistance, are highly explanatory in this perspective. These factors tell us why managerial control is viable in some countries (e.g., the US and the Netherlands), but not in others (e.g., Italy and Sweden). This analysis can be extended to departures to the one share-one vote principle. Disproportional voting structures (e.g., dual class shares) moderately support dispersed

[3] See Chapter 7 in Pacces (2007).

ownership, where controlling shareholders is the only option for corporate governance (most prominently, in Sweden).

The standard arguments in favor of empowerment of the non-controlling shareholders are reversed in this framework. So are the traditional beliefs that Dutch law empowers shareholders too little (Roosenboom and van der Goot, 2003), that American law empowers directors too much (Bebchuk, 2005), and that the liberal attitude of Swedish law towards disproportional voting power is problematic (Holmén and Högfeldt, 2005). Opposite results hold for the celebrated, but often little understood, shareholder friendliness of British company law. Regulation in the UK indeed supports dispersed ownership, by empowering the non-controlling shareholders, but does so by discouraging concentrated ownership structures. American and Dutch corporate laws are more neutral, and for this reason, they support both the controlling shareholdings and managerial control. Issues of board structure and stakeholder involvement in the appointment of board members turn out to be of secondary importance, in spite of their popularity in literature (Becht *et al.*, 2007).

Turning to the first prediction—how corporate law protects non-controlling shareholders from extraction of diversionary private benefits—I discuss this issue in two parts. First, I illustrate the discipline of related-party transactions in functional terms.[4] As shown in the literature on law and economics, this regulation deals with just one kind of potential misbehavior by the corporate controller—that depending on 'stealing' (diversionary private benefits), and not on 'shirking' (distortionary private benefits) (Roe, 2002). Legal interference with the second kind of behavior would involve second-guessing of management decisions, which courts are normally unwilling to undertake. Judicial abstention from reviewing business judgment is considered efficient by economic analysis (Easterbrook and Fischel, 1991). However, interference with business judgment is almost unavoidable in the scrutiny of related-party transactions. Their discipline is best analyzed as a tradeoff between discretion and accountability (Bainbridge, 2002), or between false positives (innocent being convicted) and false negatives (guilty being acquitted), in policing diversion of shareholder value (Enriques, 2000). Efficiency of the three functional features of this regulation—disclosure, standards, and enforcement (Gilson, 2006)—must be assessed, keeping this criterion in mind.

Secondly, I apply the functional framework for evaluating the discipline of self-dealing on the five jurisdictions under consideration.[5] While on the one hand, the discipline of related-party transactions turns out to be more accurately assessed in a functional, qualitative framework, than by the popular quantitative methodology of international comparisons, on the other hand, this more accurate investigation demonstrates that, contrary to the standard 'law matters' thesis, shareholder protection from self-dealing only partly explains the dispersion of ownership. Sweden features a limited degree of separation of ownership and control in spite of excellent investor protection, due to a highly peculiar combination of legal and extra-legal factors. The Dutch corporate law, which otherwise

[4] See Chapter 8 in Pacces (2007).

[5] See Chapter 9 in Pacces (2007).

supports dispersed ownership by disempowering the non-controlling shareholders, does not fail to protect the latter from expropriation, as the numerical comparisons suggest. In the Netherlands, good quality of shareholder protection obtains from case-law elaboration on the general clauses of the civil code, from a specialized judiciary, and from a powerful procedure for private enforcement (Timmerman and Doorman, 2002). American and British law also feature an overall strong shareholder protection, but their disciplines of related-party transactions have much less in common than what is gathered from received wisdom. Specifically, in the UK, this discipline is hardly ever enforced by courts, whereas shareholder expropriation is policed by powerful institutional investors 'behind closed doors' (Armour, 2008). Italian corporate law actually features weak protection of minority shareholders, but, in the light of recent regulatory improvements, this cannot be solely responsible for persisting ownership concentration. In addition, Italy is not the only country where the balance between false positives and false negatives in policing diversionary private benefits can be improved. In this regard, I suggest that reforms of independent directorships would fare better than enhancing private enforcement (Pacces, 2009).

Discussion of the third prediction—how corporate law affects the market for corporate control—is also divided into two parts. I first set the theoretical framework for analyzing friendly takeovers, on the assumption that hostility is ruled out of takeovers by the presence of idiosyncratic private benefits of control.[6] In order to identify the role of corporate law, I analyze how transaction costs undermine efficiency of the takeover process. This results in a relatively narrow set of conditions for value-decreasing takeovers, depending on the extraction of diversionary private benefits, which need to be disallowed by regulation. However, in order for distortionary private benefits to be minimized by the market for corporate control, regulation should encourage value-increasing takeovers too. Contrary to the mainstream approach to takeover regulation (Burkart and Panunzi, 2004), this problem is not necessarily solved as a tradeoff between shareholder protection and efficient allocation of corporate control, which typically provides the rationale for a mandatory bid, with equal treatment of outstanding shareholders (Bebchuk, 1994). Takeover regulation is more efficient when it provides for an optimal discipline of squeeze-out, coupled with a ban on takeovers having looting purposes. This makes the case for mandatory bid very weak, regardless of whether ownership is dispersed or concentrated.

Shareholder protection in takeovers may then compromise the operation of the market for corporate control, not because there is too much or too little of it, but, more importantly, because it is wrongly implemented. This is a major result of comparison of the two leading models of takeover regulation—the American and the British.[7] They have just two opposite attitudes towards the key aspects of discipline (Armour and Skeel, 2007). Shareholder protection is implemented either by fiduciary duties or by a mandatory bid. Regulation of control premia and managerial severance payments is either very permissive or very

[6] See Chapter 10 in Pacces (2007).

[7] See Chapter 11 in Pacces (2007).

restrictive. Takeover resistance is either allowed or prohibited. Contrary to what is often argued, hostile takeovers are extremely rare events, not only in the US (Schwert, 2000), but also in the UK (Weir and Laing, 2003). Nevertheless, insistence of the British law on equal treatment of shareholders results in somewhat lower frequency and worse performance of friendly takeovers (Franks *et al.*, 2001). The drawbacks of the mandatory bid are much more severe in continental Europe, where ownership is significantly more concentrated than in Britain (Kraakman *et al.*, 2004). The emulation of the British model by the EC Takeover Directive[8] has, therefore, been most unfortunate. Not only has harmonization failed in a number of key respects, but the ability of European jurisdictions to support an efficient market for corporate control seems to depend on the circumvention of a few items that have been ultimately harmonized—most notably, the mandatory bid. This is confirmed by the implementation policies adopted in Sweden, Italy and in the Netherlands.

Towards a New Approach to Corporate Law and Economics

The previous analysis can be synthesized in a number of general results on the theory of corporate governance and on how corporate law affects both the separation of ownership and control and its efficiency. These findings complement the mainstream economics of corporate governance with fresh insights, and provide a number of policy implications for the optimal regulation of corporate governance. Both are summarized below.

What is Missing from the Theory of Corporate Governance

Principal-agent models of corporate governance assume that shareholders delegate control rights to managers, so that they can withdraw from that delegation any time the management is under-performing. However, comparative corporate governance shows that control rights are not delegated by the owners, but are rather retained as permanent entitlements by corporate controllers. This suggests that the agency paradigm may be the wrong approach to corporate law and economics. The principal-agent framework still captures two prominent features of corporate governance (Jensen and Meckling, 1976). One is that corporate controllers' incentives need to be aligned with the interest of the shareholders, for they would not invest otherwise. The other is that incentive alignment can only be achieved as a second best option. The crucial difference highlighted by the present study is that institutions of corporate governance do not support incentive-compatibility by allocating powers to shareholders, but by constraining abuse of the same by corporate controllers. In this perspective, managers and controlling shareholders can no longer be considered as agents, as if they were a sort of employee of investors. Surely, they do not consider themselves as being in such a position. Despite the extent of ownership placed with the investing public, corporate controllers still play an entrepreneurial role in the management of the corporate enterprise.

[8] Directive 2004/25/EC of the European Parliament and of the Council of April 21, 2004, on takeover bids (OJ L 142, 30/04/2004, 12-23).

Uncertainty is the ultimate reason for the existence of entrepreneurs (Knight, 1921). They may be especially skilled individuals or just visionaries (Shackle, 1970; and Casson, 1982), but the fact is that they look beyond what markets already give price to (Kirzner, 1979). Every day, many entrepreneurs fail, and only a few of them succeeed. We owe economic progress to the latter, but they may never get their chance in the absence of the former (Schumpeter, 1943). Uncertainty is also the reason why contracts are incomplete and firms need to exist as hierarchical organizations alternative to markets (Coase, 1937). Perhaps, the most curious thing about the study of uncertainty is that it has generated two theories of the same phenomenon that hardly go with each other—the theory of the firm and the theory of entrepreneurship. A thorough understanding of corporate governance requires integration of both. When ownership is separated from control, rewards to entrepreneurial talent are only appropriable in the non-contractible form of private benefits of control (Hart, 1995). The corporate structure supports this result by providing entitlements to firm control, separated from the ownership of the enterprise.

The idea that private benefits of control may play a beneficial role, conflicts with both the lawyers' view of shareholder democracy and the economists' reliance on principal-agent models. Albeit for different reasons, both views contend that shareholders, as a group, should be ultimately in charge of corporate governance, and that resisting the extraction of private benefits of control should be a major goal of corporate law. Empirical evidence contradicts both fairness and efficiency of this ideal picture. Non-controlling shareholders are happy with their being powerless, so long as they earn conspicuous returns on their investments. The vast majority of companies featuring generations of controlling shareholders or self-perpetuating management are both profitable for investors and reward controllers with private benefits. The only way to reconcile this evidence with efficiency (and maybe with fairness, if we could agree on a unique definition of that) is to allow private benefits of control to also confer some beneficial role in corporate governance. The present work demonstrate that, not only they can, but must also perform such a role. Idiosyncratic private benefits of control explain how entrenchment of corporate control can be efficient in corporate governance. Entrenchment is what allows idiosyncratic private benefits to play a motivational role for entrepreneurship in corporate governance.

Entrenchment of corporate control implies that hostile takeovers be disallowed. This is consistent with efficient protection of idiosyncratic private benefits, which is confirmed by the fact that most takeovers in the real world are friendly, not hostile. Friendly takeovers also promote the efficiency of corporate governance (Manne, 1965). The market for corporate control can still ensure that shareholder value is maximized, under the constraint that previous entrepreneurship is rewarded, when changes in control are operated on the condition that the incumbent's private benefits are assured. This compensation is a side payment, which usually takes the form of golden parachutes or control premia, depending on whether the management or a controlling shareholder is in charge. Efficiency of the market for corporate control rests ultimately on Coasian bargaining (Coase, 1960). If this is frictionless, corporate law should do nothing else but define entitlements to corporate control. The presence of transaction costs explains why allocation and regulation of these entitlements matter. A market for corporate control, based on a smooth sequence of friendly acquisitions, can guarantee dynamic efficiency of control allocation, so long as the incumbent's control rents are compensated at every stage, and value diversion from minority shareholders is disallowed. In fact, diversionary private benefits also interfere with the takeover mechanism, and they may compromise its constrained efficiency by allocating control to the best 'thief', instead of to the best manager (Bebchuk, 1999).

Policy Implications

Entrepreneurs concerned with idiosyncratic private benefits may only go public with an ownership structure that supports the ongoing exercise of corporate control and its protection from hostile takeover (Coates, 2004). Corporate law determines how much ownership entrepreneurs can sell to the investing public, without the risk of losing control, by supplying control rights only partly related to ownership or even not at all. In this perspective, corporate law complements the system of ownership entitlements established under property law. How these entitlements are allocated between participants in the corporate enterprise depends on the legal distribution of corporate powers. Some distributions of powers are suitable for dispersed ownership structures, whereas others just suit the controlling shareholdings (Cools, 2005). Ideally, both kinds of distribution should be available in corporate law in order to support the efficient choice of ownership structure at the firm level. Managerial control of publicly held companies is only possible in those jurisdictions that empower the board of directors in relation to the general meeting of shareholders. This needs not distort the choice of ownership structure in favor of dispersed ownership, so long as a controlling shareholder can still be in control of the board. A regulatory bias against the controlling shareholders only supports managerial control at the price of such a distortion. Conversely, empowerment of shareholders as a class, makes managerial control unfeasible, and biases corporate governance towards ownership concentration.

The dichotomy between managerial and shareholder control is an oversimplification of the choice between ownership structures. Dispersed ownership is also compatible with controlling shareholders. Then, voting rights have to be separated from ownership stakes or, at least, the two must not stand in a relation of strict proportionality. The principle of proportionality in security-voting structures—also known as 'one share-one vote'—sets a constraint on the ability of controlling shareholders to deconcentrate ownership. If they wish to remain controlling shareholders safely, they may not sell more than a half of the share capital to the investing public. Any further dilution of controlling ownership would result in exposure to a hostile takeover. The bottom line is that distribution of powers in corporate law not only affects the legal feasibility of managerial control, but also determines how far separation of ownership and control can go under shareholder control, until transition to managerial control is economically viable. It does so by allowing deviations from the one share-one vote arrangement. Therefore, the one share-one vote regulation in corporate law restricts the range of choices as to the separation of ownership and control, and may force the adoption of suboptimal ownership structures (Burkart and Lee, 2008).

By focusing on investor protection, legal and economic analyses of corporate governance tend to overlook that corporate law must also facilitate protection of managerial firm-specific investments, independent of corporate ownership. As I showed, corporate law can efficiently do that by providing a sufficiently broad range of entitlements to control power. This makes legal protection of the non-controlling shareholders likewise necessary for the separation of ownership and control, for outside shareholders would never invest when they are both powerless and exposed to expropriation (Shleifer and Vishny, 1997). Differently from other commercial contracts, decision rights in the controller-shareholders relationship are barely constrained by private ordering. Corporate contracts are almost empty at their core. Virtually, none of their provisions is governed by unanimity, and control powers include the ability to have them amended when new circumstances emerge. This spectacular flexibility depends on the hierarchical nature of the firm, but has an important drawback—the corporate contract cannot be a source of credible commitment for controllers. The rules countering expropriation of the non-controlling shareholders, thus, need to be mandatory, in order to be out of the controller's reach. However, mandatory constraints on the controller's decision making powers should not exceed the domain of conflicts of interest, which is most likely to result in the diversion of shareholder value.

The exemplary domain of corporate controllers' conflicts of interest is related-party transactions (Djankov *et al.*, 2008). A problem with these transactions is that they may easily result in expropriation of outside shareholders, but may also have plenty of business purposes. At the end of the day, nobody can scrutinize the diversionary potential of business decisions without interfering with its merits. Any regulation of related-party transactions, then, involves a conflict between discretion and accountability of corporate control. This is more precisely understood as a tradeoff between false positives and false negatives in the enforcement of shareholder protection against stealing. Whatever be the configuration, this tradeoff cannot be eliminated; however, an efficient regulation of related-party transactions should provide for its optimization. Comparative corporate law shows that, as far as accountability is concerned, systems based on independent scrutiny of conflicted interest transactions may fare as well as those based on empowerment of non-controlling shareholders in decision making. However, the former normally outperform the latter as far as discretion in the exercise of business judgment is concerned. This is a sufficient reason to avoid confusion between shareholder protection from expropriation, and shareholder empowerment in corporate governance (Pacces, 2009). As it turns out, empowering non-controlling shareholders may add little to their protection from expropriation, and just result in too conservative management strategies that undermine the profitability of their investment.

Efficiency of corporate governance ultimately depends on the market for corporate control. A real serious problem with the operation of the market for corporate control is the distribution of takeover gains between the acquirer and the existing shareholders (Burkart and Panunzi, 2008). From a regulatory perspective, this problem is typically understood as a tradeoff between the efficient allocation of corporate control and, again, the protection of non-controlling shareholders. By making the incumbent participate in the distribution of takeover gains, I have shown that the tradeoff is actually different—it is between *ex-ante* efficiency of rent protection and *ex-post* maximization of shareholder value. This tradeoff is solved dynamically through a process of value-increasing acquisitions, conditional on compensation of existing control rents. For this process to be smooth, most of the remaining gains should be allocated to prospective acquirers. Protection of non-controlling shareholders is unnecessary as long as looting is disallowed, and there is potential competition among bidders. Under these conditions, the minority shareholders are efficiently excluded from the takeover gains. A prominent implication of this reasoning is that the market for corporate control is optimally operated by the squeeze-out of minority shareholders, as long as regulation prevents them from being exploited by this mechanism. This result, which has been recently demonstrated for takeovers in dispersed ownership structures (Amihud *et al.*, 2004), equally holds in concentrated ownership structures with minor regulatory adjustments.

Compulsory exclusion of minority shareholders from takeover gains requires that unequal treatment of shareholders be upheld by corporate law, at least in the takeover context. This is especially problematic, since corporate law tends to support the opposite principle of equal treatment of shareholders (Kraakman *et al.*, 2004). The principle itself is hardly questionable, but must be put in perspective. It certainly implies that shareholders participate in the division of corporate profits proportionately (Rock and Wachter, 2001), but not also that they should be granted equal opportunities to share in the control premium (Bebchuk, 1994). The implications of entrepreneurship for the market for corporate control are that incumbents must cash in their idiosyncratic private benefits and that insurgents must be able to appropriate the remainder of differences between the current and prospective shareholder value. Otherwise, neither would incumbents part with control, nor would insurgents bother about uncovering new profit opportunities in potential takeover targets. In their capacity as active entrepreneurs, not as passive shareholders, these players need to gain more than what non-controlling shareholders do. Therefore, granting exit to both the controlling and the non-controlling shareholders on equal terms, via the mandatory bid, is economically unfounded. It has the advantage of preventing value-decreasing acquisitions from being imposed on non-controlling shareholders. To this purpose, however, it reduces the frequency of value-increasing takeovers, by making compensation of the control premium overly expensive (Burkart and Panunzi, 2004). Value-decreasing acquisitions are no longer a problem, when takeovers are friendly and extraction of diversionary private benefits of control is efficiently constrained by the controller's fiduciary duties. In this situation, market bargaining for control premium provides sufficient guarantee that takeovers are efficient. The requirement that the control premium be shared on equal terms between the controlling and the non-controlling shareholders unnecessarily interferes with this mechanism.

Conclusion

Summing up the results of a large research project, this paper shows that investor protection is not the only institutional underpinning of efficient corporate governance. The 'law matters' approach to corporate governance contends that protection of the non-controlling shareholders is both a necessary and a sufficient legal condition for the separation of ownership and control. Contrariwise, it has been argued that this is necessary, but not sufficient. The reason is that rewarding entrepreneurship is also important in corporate governance, and to this purpose, corporate law needs to provide controllers with entitlements to control powers.

Corporate governance is not just a relationship between principals and agents. The setting does not allow those who exercise corporate control to secure a reward for their firm-specific investments. When contractual incompleteness is combined with the separation of ownership and control, this reward can only be secured in the form of private benefits of control. This explains how extraction of private benefits of control can also be efficient in corporate governance. However, this extraction is only possible when corporate control is tenured. As a result, the market for corporate control is normally operated by friendly, instead of hostile, takeovers. This operation still guarantees the maximization of shareholder value over time, to the extent that compensation of the incumbent's private benefits is allowed in the form of side payments.

This framework has important implications for the regulation of corporate governance. First, corporate law should support corporate control under alternative ownership structures. Managerial control is only viable when directors can be autonomously in charge, without the support of a controlling shareholder. Controlling shareholders can, in turn, afford higher dispersion of ownership, when the law is not so strict about proportionality between ownership and voting rights. This does not imply that investor protection is not important. Separation of ownership and control requires both willing sellers and willing buyers of outside stock. Non-controlling shareholders would not invest in the absence of protection of their investment from expropriation. This protection may be supported by different combinations of legal and extralegal institutions. However, shareholder protection from expropriation should not be confused with shareholder empowerment in corporate governance.

Investors not only expect protection of their investment, but also maximization of their returns. The market for corporate control is the place where this expectation is reconciled with the corporate controller's reward, in the form of private benefits. For this purpose, friendly takeovers need to allow for side payments compensating for the current value of corporate control. Insurgents need to be in the position to appropriate the remainder of takeover gains, for they would not seek potential takeover targets otherwise. This outcome is supported by an optimal discipline of compulsory exclusion of minority shareholders (squeeze-out), which prevents them from free riding, while protecting them from expropriation. Regulatory concerns for equal treatment of shareholders, which underlie the current popularity of mandatory bid regulations, undermine the efficiency of this mechanism.

A far more general, but likewise important, conclusion of this work is that economists and legal scholars have much to learn from each other. Most of the results of this inquiry rely on a combination of legal and economic expertise. In the same vein, a number of issues seem worthy of future interdisciplinary research. One of them is the institutional or contractual nature of the public company. This parallels the fundamental question about how institutions are created, and how they evolve over time in the economy and society. Solving this puzzle is a major challenge for both legal and economic institutionalism. A related question is the ownership structure of the corporate enterprise and the determinants of its evolution, at different stages of economic development. Our knowledge of the matter is still very limited, from both theoretical and empirical points of view. One final question concerns the mechanisms of production of corporate laws. This work only takes a public interest approach, but framing of legal rules is actually influenced by private constituencies, public bodies, and inter-jurisdictional competition. Applying this perspective to the alternative interpretation of corporate governance proposed here would be a very interesting line of inquiry for corporate law and economics.◇

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