Rethinking Corporate Law and Economics in a Theory of Private Benefits of Control

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Introduction

In the last decade, Corporate Law and Economics have faced one major challenge: reconciling diversity in corporate governance with a single economic framework. To both economists and legal scholars, the law appeared as a good candidate for explaining transnational differences without having to reconsider the traditional agency paradigm for analyzing separation of ownership and control. This is how the general agreement on the importance of law in corporate governance has emerged (Shleifer & Vishny 1997). Undoubtedly, good quality of law when it comes to investor protection is a precondition for separation of ownership and control (Black 2001). The more the legal institutions protect outside shareholders, the more they will be willing to delegate control to a non-owner manager. However, the ‘law matters’ approach inaugurated by Law and Finance (La Porta et al. 1998) claims that this is not only a necessary condition for dispersed ownership, but it is also sufficient. According to this interpretation, the higher frequency of controlling shareholders outside the US and the UK is just due to suboptimal investor protection by the other corporate law jurisdictions.

This perspective is one-sided in many respects, but this paper will only deal with one. Based as it is on a principal-agent framework, this approach tends to overlook that the decision to separate ownership from control is taken by two categories of players. One is the manager; the other is outside investors. Before going public, the manager is not an agent seeking employment by financiers. She is actually an entrepreneur. The fact that eventually
she may need funds from outside financiers does not imply that she would accept parting with firm control and downgrading her position to that of an agent, but only that she would not succeed in attracting non-controlling shareholders without taking a commitment that they will be dealt with fairly. Having identified in the law the source of this commitment is the fundamental merit of the ‘law matters’ strand of literature, but also its limit. The governance of publicly held companies also requires that somebody be in charge (Zingales 1998). This may be a controlling shareholder or the top corporate management. In both cases, corporate control is hardly ever exposed to shareholder insurgency (Hellwig 2000). More importantly, variety of corporate governance patterns along this dimension often holds irrespective of the quality of investor protection. There are examples of controlling shareholders in continental Europe whose ownership stake is no lower than the management’s in the largest American public companies (Morck et al. 2005). Non-controlling shareholders are comfortable with investing in both situations, and therefore they must feel protected enough. However, corporate controllers appear to be no less afraid of being ousted against their will than outside shareholder worry about being expropriated of their investment.

This paper attempts to explain why corporate controllers care so much about tenure, and how this affects corporate governance both positively and normatively. One obvious reason why manager and controlling shareholders entrench themselves is exploiting outside investors once they have their money, by extracting so-called private benefits of control (PBC). While this is certainly the most popular explanation of the conflict of interest between ownership and control of the corporate enterprise, it is not the only possible one. By departing from the standard principal-agent approach, I will show how private benefits of control can also play a virtuous role in corporate governance. To this purpose, I am going to present a richer taxonomy of private benefits of control than that usually considered in the literature. They include not only control perquisites and siphoning-off of corporate assets, but also a reward
for the controller’s specific investments that shareholders could not be committed to pay upfront when they buy outside equity. Once we manage to disentangle these three components, investor protection is definitely not all that matters in corporate governance. Allowing corporate controllers to extract further compensation in the form of PBC is at least as important. On the one hand, this may explain why, regardless of the ownership structure, corporate control turns out to be entrenched anyway. On the other hand, this perspective may shed a new light on the legal underpinnings of separation of ownership and control and the efficiency of corporate laws.

The paper is structured as follows. Section 1 summarizes the current debate about private benefits of control in Corporate Law and Economics, and highlights its shortcomings. Section 2 introduces a more articulated welfare analysis of PBC, based on a qualitative distinction between three categories of them. Section 3 discusses a stylized bargaining between an entrepreneur/manager and outside shareholders, under a number of simplifying assumptions. Simplicity of the discussion will make formalization unnecessary and help legal scholars to follow the reasoning up to the key implications of the bargaining outcome. Section 4 elaborates on this outcome with special regard to the ownership structure and the market for corporate control. The regulatory implications of this framework are discussed in Section 5. It will be shown that corporate law needs not only to support credible commitments against expropriation of outside shareholders, but also to provide managers with uncontestable control rights and with the opportunity to cash in the value of their specific investments when they accept to hand control over to a better manager. Section 6 concludes.

1. Corporate Governance and Private Benefits of Control

The very notion of private benefits of control is neutral as to the implications for shareholder wealth. By definition, the private benefits of a corporate controller include
anything that is not shared with non-controlling shareholders (Coates 2003). Extraction of private benefits harms shareholder only inasmuch as it reduces the actual or potential returns on their investment, which are named conventionally as *security benefits*. This need not necessarily be the case (Hart 2001; Holderness 2003). Some private benefits of control have no opportunity costs to outside shareholders, because either the controller is in the unique position to appropriate their value or, similarly, they would not have yet any value to non-controlling shareholders. In spite of this, mainstream economic theory holds that private benefits of control cannot but reduce the wealth of outside shareholders (Becht *et al.* 2002).

The reason is that the principal-agent framework within which corporate governance is analyzed just does not feature a different kind of private benefits – i.e., an agent can only extract them at the principals’ expenses. Over time, the attention of commentators gradually moved from extraction of non-pecuniary benefits, in the form of managerial perquisites (Jensen & Meckling 1976), to more tangible diversion of corporate assets and cash flow (Shleifer & Vishny 1997). PBC have thus became synonymous of weak shareholder protection by legal institutions, which, in turn, are responsible of suboptimal separation of ownership and control (La Porta *et al.* 1998), stock market underdevelopment (La Porta *et al.* 1997), and lower rates of economic growth (Levine 1999).

In this perspective, the impact of PBC on ownership structure have been investigated both theoretically (Bebchuk 1999) and empirically (Nenova 2003; Dyck & Zingales 2004). These studies have demonstrated that little, if any, separation of ownership and control can be expected when private benefits are high enough. The literature on private benefits of control proved somewhat more appealing than the “numerical comparative law” approach (Siems 2005) of *Law and Finance*. It included no less than a legal account of outside shareholder protection based on a very parsimonious selection of legal rules, and potentially much more. To the economists, this was a broader framework for analyzing the quality of institutions.
affecting corporate governance. To the lawyers, the focus on private benefits of control offered support of the ‘law matters’ thesis independent of how comparative corporate law was being twisted by empirical economists. On both sides, the bottom line was that high PBC explained ownership concentration and what is wrong with it, although a variety of legal and non-legal institutions might be responsible for this result.

Unfortunately, very few commentators in either law or economics have wondered why the prevailing ownership structure still differs across countries when private benefits of control are sufficiently low; and, more importantly, whether corporate law has anything to do with that. The problem is both empirical and theoretical. Cross-country estimates of private benefits of control have more weaknesses that can be reviewed here (Nicodano 1998; Nicodano & Sembenelli 2004). However, one major limitation of these studies is that only pecuniary private benefits are measured through different estimates of the so-called control premium – the difference in market price between controlling and non-controlling stock. Empirical evidence does not tell whether, and to what extent, these benefits amount to expropriation of minority shareholders. This parallels the limitations of the theory. While high private benefits of control always result in ownership concentration, ownership concentration is inefficient only when these benefits are extracted at the expenses of non-controlling shareholders. Only in this situation further separation of ownership and control would be in the interest of both controlling and non-controlling shareholders, but gains from trade are foregone due to inability of the latter to take a credible commitment that the former will not be expropriated (Bebchuk 1999). Conversely, when extraction of private benefits has no impact on security benefits, the ownership structure that supports their extraction has no efficiency consequence, but only distributional ones (Zingales 1995).

Whether private benefits of control can actually be so ‘innocuous’ to outside shareholders is controversial (Ehrhardt & Nowak 2003). Advocates of private benefits of control in
corporate governance have had so far a difficult case due to the apparently *im palpable* nature of anything that benefits corporate controllers without harming non-controlling shareholders. However, as Dyck and Zingales (2004) warned, our knowledge of private benefits of control is still too limited to draw definitive conclusions. Although the empirical evidence shows that not all private benefits are physic, and it strongly suggests that minority shareholders are being expropriated when their amount is sizeable, it cannot be excluded that *other* kinds of private benefits are also at play and may contribute to determining the different patterns of corporate governance that we observe around the world. Consideration for these PBC suggests that corporate law may also affect separation of ownership and control along further dimensions than expropriation of minority shareholders.

The idea that corporate governance is only adversely affected by PBC and the failure of institutions to curb their extraction faces important contradictions. There are some countries where the average size of private benefits is apparently low, legal and extralegal institutions consistently perform quite well in constraining expropriation, and yet ownership is significantly more concentrated than in Britain and in the US. Sweden is a case in point (Holmén & Högfeldt 2004), although a similar argument applies to other developed countries – e.g., as we will see, The Netherlands (Högfeldt 2005). According to Gilson (2006), the explanation is that private benefits also come in a non-pecuniary kind, which can be neither measured nor policed by legal or non-legal institutions, but result anyway in ownership concentration. Some businesses endogenously involve higher levels of non-pecuniary benefits (Demsetz & Lehn 1985), and ownership concentration is just the way to have them consumed efficiently. While attempting to answer an important question, Gilson’s analysis raises two different ones. First, if non-pecuniary private benefits of control are truly endogenous to the business, why are they so important in Sweden but not so much, for instance, in the US and in the UK? Second, even assuming that pecuniary private benefits are equally low, how can we
make sure that existing controlling shareholders maintain efficient levels of extraction of non-
pecuniary private benefits over time?

If it is not even non-pecuniary benefits that explain ownership concentration, what can? Cools (2005) suggests that the answer might still be corporate law, if only we approach it from a different angle. Corporate law may not only determine ownership concentration in that it fails to protect non-controlling shareholders from the consequences of abuse of control powers. Paradoxically, it may also determine an identical result in that it fails to support the exercise of these powers when they are not being abused by extraction of pecuniary private benefits. When control without ownership is not sufficiently supported by corporate law, ownership concentration remains the only viable solution for corporate governance.

Legal distribution of powers may be an important piece of the puzzle. It nicely tells us how separation of ownership and control may occur differently all else being equal, but still does not tell us why. Others have tried to answer this question. Rock and Wachter (2001) have based their analysis of distribution of powers under American corporate law on protection of managerial firm-specific investments. Although they do not explicitly mention private benefits of control, they argue that legal powers are efficiently allocated to the management in order to provide them with a reward for those investments in human capital, which could not be secured contractually. Within the Law and Economics scholarship, they are so far the only authors who have attempted a straight departure from the agency perspective and analyzed the corporation as a response to pervasive contractual incompleteness.

Corporate Law and Economics is deeply embedded in the agency theory of the corporation (Easterbrook & Fischel 1991; Kraakman et al. 2004). This view often neglects that agency costs are just a part of the economics of corporate governance, whereas contractual incompleteness is the ultimate reason why both control powers and their regulation matter (Hart 1995a; Zingales 1998). Yet the question of how ownership can be
separated from control still awaits a final answer in the economics of incomplete contracts. Perhaps the most important achievement of this literature is that ownership should be bundled with ‘residual’ control rights – i.e., the right to decide in every contingency not being previously contracted upon. According to the property rights theory of the firm (Grossman & Hart 1986; Hart & Moore 1990), control is allocated to the party whose investments enjoy the least contractual protection, and therefore this party should own the firm’s assets altogether. If we move from sole proprietorships to corporations, the implication of this theory is that shareholders as a group have residual control rights, although they need to delegate their daily exercise to professional management. While this solution protects shareholder investments from uncertainty, it does not also provide managers with the incentive to make investments whose reward cannot be secured contractually. Managers can be still regarded as shareholder agents on condition that such investments are ‘unimportant’ for the operation of large public companies as opposed to entrepreneurial firms (Hart 1995b). This assumption is unwarranted when corporate governance is understood as a separation between de jure and de facto authority (e.g. Tirole 2001). One way to operationalize this intuition is that residual rights of control are still delegated from the owners to the managers, but shareholders are committed to withdraw delegation only in certain states of the world (Burkart et al. 1997). Unfortunately, this framework allows no way out of a tradeoff between the shareholders’ security benefits and the managers’ private benefits of control – depending on the conditions under which shareholders can oust the incumbent management. This tradeoff is currently the most serious challenge for economic theory of separation of ownership and control (Bratton & McCahery 2001).

A further, neglected dimension of private benefits of control, which stand not in a tradeoff relationship with security benefits, could offer an alternative perspective. A few commentators have already suggested this. Zingales (2000) nicely characterizes PBC as
evidence of an *appropriability* problem concerning the value of corporate control, which has not yet been completely understood by the theory. Other commentators likewise depart from the standard principal-agent paradigm in order to investigate the determinants of entrenchment of corporate control, which seems to prevail around the world independently of the ownership structure (Hellwig 2000). Why is corporate control so important across the board? One proposed explanation is based on a *third* category of private benefits of control which are not featured by the mainstream agency theory, but are necessary to support entrepreneurial activities that financial markets are unable to reward (Mayer 1999). None of these contributions elaborates on how extraction of private benefits of control can be reconciled with the more traditional problem of maximization of shareholder value. This is a question of welfare assessment, which requires in turn a broader taxonomy of PBC.


In the relationship between corporate controllers and non-controlling shareholders, welfare analysis of private benefits of control may be based on the distinction between rents and quasi-rents (Marshall 1893; Klein *et al.* 1978). Quasi-rents are the prospective reward to inventiveness, whereas rents are the ongoing reward to incumbency. Two important strands of literature may be brought together in this way (Ricketts 2002): one is the theory of entrepreneurship; the other is the theory of the firm. Since Coase (1937), these two theories have hardly communicated with each other. The loopholes of the incomplete contract theories of the firm, when it comes to separation of ownership and control, leave ample scope for integrating entrepreneurship into the analysis of corporate governance.

In contract theory, quasi-rents are non-contractible rewards to investments in relationship-specific assets. Asset specificity gives rise to the well-known hold-up problem. The party whose assets cannot be redeployed outside the relationship risks being expropriated of her
investments, to the extent that their cost is sunk and unforeseen contingencies may result in ex post redistribution of the quasi-rents generated within the relationship. According to transaction costs economics, asset specificity determines a unique relationship between the investing party and the firm, which is thus characterized as ‘idiosyncratic’ (Williamson 1979). Firm organization promotes idiosyncratic investments in both physical and human capital in that it protects them from hold-up (Williamson 1991). According to the property rights theory, however, only the owners of the physical assets being specialized can appropriate rewards on idiosyncrasy (Grossman & Hart 1986). Both approaches try to explain why firms exist as a response to contractual incompleteness. Yet they do not entirely explain entrepreneurship, which involves the highly peculiar idiosyncrasy of inventiveness in management, but “for which ownership is never a condition” (Kirzner 1979:94). Corporate governance may still feature entrepreneurship in that framework. This requires that quasi-rents be allocated as a reward of managerial talent, independently of ownership of the underlying assets and of how they are combined within an organization. I define these quasi-rents as idiosyncratic private benefits of control. They depend on the identity of who controls the corporate enterprise and are supposed to reward the specialization of managerial talent to a combination of assets financed by separating ownership from control.

What idiosyncratic PBC exactly are is another question. Commentators name variously this kind of benefits, in order to distinguish them from outside shareholder expropriation, but mostly characterize them as the physical satisfaction of bringing a firm to success (Mayer 1999; Holderness 2003; Gilson 2006). This fits the definition of idiosyncrasy, although it is a rather weak account of rewards to entrepreneurship in a market economy. Idiosyncratic PBC have no market value so long as they account for pure entrepreneurship, which – in terms of contract theory – is neither observable nor verifiable. However, they suddenly become more tangible as soon as somebody is willing to take over. In that circumstance, which is of course
conditional on the venture being successful, idiosyncratic PBC become the value of corporate control. Therefore, idiosyncratic PBC are better characterized as a deferred compensation (Schnitzer 1995) for the investment of entrepreneurial talent in corporate governance, which will eventually materialize in the form of a control premium. This characterization has important consequences on welfare analysis.

Originally, idiosyncratic PBC are harmless to non-controlling shareholders. These are quasi-rents of no value to anybody but the entrepreneur. What makes entrepreneurs important in the economy is exactly that they foresee profit opportunities that markets are unable to price. At this stage, the value of corporate control to the entrepreneur is higher than to anybody else. This situation is allocatively efficient. Things may change over time. Eventually, another entrepreneur may qualify as a better manager; but protection of idiosyncratic PBC will still be a sufficient reason for the incumbent to prevent the insurgent from taking over. This outcome is apparently inefficient. However, Laffont and Tirole (1988) have demonstrated that allowing any better manager to take over firm control undermines the incentives of the incumbent management to make unobservable investments. So the question is whether the insurgent manager can induce the incumbent to part with control, by paying compensation for his idiosyncratic PBC, and still improve firm performance on the stock market. In this perspective, protection of idiosyncratic control rents is certainly efficient ex ante, for it promotes the investment of unobservable talent, and may turn out to be just a distributional issue ex post, when the value of corporate control has become observable to potential acquirers. Idiosyncratic PBC are therefore the ‘good’ ones.

Other kinds of PBC deserve a more severe judgment. To start, they have no quasi-rent feature, and so they qualify as just rents. Based on the agency theory of corporate governance, separation of ownership and control allows these rents to be extracted in two different fashions. One is outright diversion of firm’s assets and profits from non-controlling
shareholders. The other is distortion of management decisions aimed at maximizing consumption of control perquisites rather than the firm’s profits. Following Mayer (1999), I define the rents arising from the first kind of behavior as *diversionary* private benefits of control, and those arising from the second kind as *distortionary* private benefits of control.

Diversionary private benefits account for ‘stealing’ in its broadest characterization (Roe 2003). Welfare assessment of stealing is not a novel subject in Law and Economics. *Ex post*, stealing may look like a redistribution of resources that already exist, so that – paradoxically – it may seem neutral to overall social welfare. However, it is not for at least two reasons. The first is that any effort taken to implement or to prevent stealing is a waste of resources (Cooter & Ulen 2004). In corporate governance, there is an even more important reason for inefficiency: the risk that stealing is operated *ex post* reduces investors’ willingness to pay for non-controlling stock *ex ante*, thereby raising the cost of equity capital all else being equal (Shleifer & Vishny 1997). A rational corporate controller would be willing to commit to a no-stealing policy at the outset, in order to maximize the proceeds from the sale of non-controlling stock. However, to the extent that this commitment is not credibly supported by the legal system, diversion is always implemented *ex post* and less separation of ownership and control than would be optimal occurs *ex ante* (Bebchuk 1999). In this perspective, diversionary private benefits are certainly the ‘bad’ ones.

Distortionary private benefits of control crudely account for bad management of the firm’s resources. This is intuitively illustrated by a broad notion of ‘shirking’ (Roe 2003). A non-owner manager will always put a lower effort than he could in the management of the resources under control, and consume some of them in the form of perquisites. This is understood as an opportunity cost to shareholders. Under separation of ownership and control, extraction of perquisites will continue until it is worth far less to the controller than it costs to the owners as a whole. Therefore, distortionary private benefits are always extracted in an
inefficient amount, whether they are considered in an *ex ante* or in an *ex post* perspective. Unfortunately, there is not much we can do about it. Separation of ownership and control can only generate second best outcomes. This is perhaps the most important result of the agency theory of corporate governance (Jensen & Meckling 1976). Distortionary private benefits of control are nothing but an illustration of agency costs. In spite of their adverse effects on efficiency, they can only be characterized as ‘ugly.’

A number of market and non-market institutions are there to make sure that distortionary PBC are extracted in a limited amount, so that separation of ownership and control still allows capturing gains from trade (Roe 2005). Traditional models of asymmetric information rely on monitoring, financial commitments, and ultimately on incentive alignment. The optimal balance between production of security benefits and extraction of private benefits by the corporate management – i.e., minimization of agency costs – is derived at the outset, under the assumption of perfect foresight. The introduction of uncertainty in incomplete contracts models brings the problem closer to reality, but it also makes it more complicated. Putting the management on a consistent incentive scheme is not sufficient so long as all of the future contingencies affecting the conduct of business cannot be foreseen, let alone be contracted upon (Zingales 1998). At the end of the day, minimization of distortionary PBC will be a matter of (re)allocation of corporate control (Hart 1995b). No matter of how they were selected and used to perform in the past, managers are to be replaced as soon as they prove less competent, or just more prone to shirking, than the best management alternative available on the market. This is how takeovers provide the ultimate solution to adverse selection and moral hazard problems in spite of changed circumstances.

This perspective overlaps with how idiosyncratic PBC enter the framework. The market for corporate control is not only the place where the management is replaced when it is no longer efficient, but also the final source of reward for previous its firm-specific investments. While
the first is still apparently an agency problem, the second is certainly not. In order to understand the interaction between distortionary and idiosyncratic PBC in corporate governance, the mechanism of rewarding the investment of managerial talent in the form of private benefits requires a supplement of investigation.

3. *Who should be in charge of corporate governance?*

   The role of idiosyncratic PBC in separation of ownership and control is best understood under a few simplifying assumptions. First, I assume that outside stock is sold to a single, professional representative of the investing public, who takes care of contracting with an entrepreneur on behalf of dispersed shareholders. In other words, both shareholder collective action problems and agency costs in underwriting are assumed away from this setting. The first kind of problems mostly affects the takeover stage (Grossman & Hart 1980), but – as the following discussion will show – it becomes less important when shareholders as a group are not vested with residual rights of control. Agency problems in the provision of investment services are instead a matter of securities regulation, not of corporate law, and they are therefore outside the scope of this paper (Pacces 2000). The second assumption is that institutions (most importantly, the law) allow corporate controllers to take a credible commitment not to expropriate non-controlling shareholders. This rules out diversionary PBC, which do not only have very peculiar effects on both separation of ownership and control and takeovers, but also short-circuit any virtue of idiosyncratic PBC. These effects will be highlighted at a later stage, thereby suggesting that corporate law should have curbing diversionary PBC as a first priority, but not also as an exclusive goal. The third assumption is also about the law. I initially assume that corporate law features absolute freedom of contract in the allocation of residual rights of control; that is, I assume that corporate controllers can possibly be in charge with no ownership. More precisely, the hypothesis is that corporate law
provides a full range of control entitlements that can be variously combined with ownership. We will start by analyzing the theoretical determinants of separation of ownership and control under this assumption. How corporate law may effectively distort the outcome when this assumption is removed will be shown in section 5.

Let us consider the situation of an entrepreneur seeking outside finance. She may retain full ownership of the firm’s assets, and go for debt. Projects are always characterized by some specificity of assets and uncertainty in short-term revenues, and therefore they cannot be entirely financed in this fashion (Aghion & Bolton 1992). When our entrepreneur is wealth-constrained, she will have eventually to raise additional funds in the form of equity. No matter of how far this goes, clearly the entrepreneur will be no longer the sole owner of the firm’s assets. The question is whether she can still control how these assets are operated under these circumstances, and to what extent she should in her capacity as manager of a corporation partially owned by outside shareholders.

This is a problem of allocation of residual right of control. On both the economic and the legal side, students of corporate governance are reluctant to allow control rights to be allocated any separately from ownership (Hart 1995b; Easterbrook & Fischel 1991). Residual rights of control are indeed the essence of property rights. Only owners can have them, although they may delegate their exercise to agents with better managerial skills. The economic rationale of this solution is that owners have the best incentives to maximize the value of their investment. Quasi-rents on this investment (profits) are the ultimate source of firm value. Therefore, firm value will be maximized only when shareholders are entitled to an open-ended stream of profits and they are given ultimate authority over management to this purpose.

The very notion of idiosyncratic PBC as a further value to be uncovered through the entrepreneurial process makes this assumption unwarranted. This parallels a broader
discomfort of recent literature with the principal-agent approach to corporate governance (Zingales 2000). The investment of physical assets is not the only source of firm value. The experience of high-tech companies shows that human capital is at least as important (Rajan & Zingales 2000). Human capital, however, is only specialized to a combination of assets owned by shareholders on condition that quasi-rents can be appropriated in the form of private benefits. According to Rajan and Zingales (1998), the right to provide access to a critical resource confers upon providers of specialized human capital bargaining power over the ex post division of quasi-rents. Owners are no longer in the position to appropriate all of the quasi-rents when firm-specific investments by managers and employees have made their contribution critical for generation of firm value. On the one hand, this contribution cannot be costlessly replicated on the market. On the other hand, contributors can credibly threaten to walk away with their resource so long as it can be adapted to a different combination of assets. This is how stakeholders are empowered within modern organizations. Still, owners can retain residual rights of control, and they actually have to, in order to prevent quasi-rents from being dissipated by competition of stakeholders for private benefits.

This perspective neatly distinguishes the position of talented managers or employees from that of a shareholder agent. However, it is questionable that the power to grant access to a critical resource is also sufficient to secure a reward to entrepreneurship, at least when it is not backed by ownership of physical assets. The above view of the firm is ultimately based on a process of internal growth where the owners, through the selection of an appropriate hierarchy, are committed in every single period to allocate control and its rewards to the constituency that turns out to be providing the most valuable resource (Rajan & Zingales 2001). The same mechanism would not work in the perspective of external growth, where the owners are simply committed to sell control to the highest bidder for the company’s shares. While the firm hierarchy may still protect highly specialized employees in the event of a
takeover, it would certainly not protect also the manager placed on top of that hierarchy when she has no sufficient ownership to negotiate whether and on what terms a change in control should occur. The same fact that somebody else is bidding for the firm ownership in order to take over shows that the entrepreneurial skills controlled by the manager are no longer critical, and then she can be replaced costlessly.

This is a typical hold-up situation. A non-owner manager will refrain from specializing her talent to a given combination of assets, knowing \textit{ex ante} that the owners are in the position to appropriate the non-contractible quasi-rents by means of a change in control. So long as residual control rights are bundled with ownership, a takeover will always prevent the manager from claiming compensation of her entrepreneurial contribution in the form of private benefits of control. Still one may doubt that PBC are needed at all to reward management under these circumstances. Apparently, the owners may offer a more attractive contract to the manager (Hart 1995b). They may make her compensation fully contingent on the future realization of profits. This solution can take the form of one of the various pay-per-performance schemes that we observe in the corporate practice, or more simply result in shared ownership between controlling and non-controlling shareholders. Both alternatives are costly, in that either investors have to give up a share of their expected profits or a wealth-constrained entrepreneur can raise a limited amount of external funds in the form of equity. The advantage is that optimal profit sharing should induce both the manager and outside shareholders to invest their assets. Shareholders will be still in the position to auction control to the best bidder for corporate ownership. However, they are committed not to replace the manager without paying her the stipulated share of the firm value realized so far.

Pay-per-performance is no way out of the hold-up problem. It can only induce the manager to make investments whose reward is contingent on the future realization of profits. However, firm performance is a \textit{noisy} proxy of investment of managerial skill and effort (Laffont &
Tirole 1988). No matter of how valuable these investments are they will bring no reward to the manager until they have produced some verifiable surplus. The problem is that the value of these investments may become appropriable before it is reflected in stock price. Entrepreneurs are especially alerted to exploiting profit opportunities, which are available in nature, but are still unknown to others (Kirzner 1979). The value of successful entrepreneurship is bound to become ‘observable’ eventually, but it will only become ‘verifiable’ at a later stage. Since no enforceable contract can be written about the division of this value before it is realized on the stock market, the entrepreneur/manager can be expropriated of the same value when a control transaction occur in the meantime, and its surplus is just divided between the existing owners and a takeover bidder (Schnitzer 1995). This effect is highly specific to separation of ownership and control. Not differently from sole proprietorships, entrepreneurship generates quasi-rents. However, in corporate governance, these quasi-rents can be appropriated by who is entitled to decide upon a change in control and has, therefore, the power to bargain for a control premium.

Idiosyncratic PBC account exactly for these quasi-rents. In the absence of alternative property rights protection (e.g., through the patent system), rewards to entrepreneurial innovation cannot be secured through profit sharing. These are ‘profits in the entrepreneur’s head,’ which shareholders cannot be committed to reward ex ante. However, they are committed to realize them ex post in their capacity as owners, as soon as somebody is willing to bid for taking a chance on those profits. So why should any entrepreneur bother uncovering profit opportunities for others, if she can reap no benefits from this activity? Entrepreneurship can only be reconciled with separation of ownership and control if the manager keeps her entitlement to idiosyncratic PBC. Before a takeover bid, any effort intended to enhance idiosyncratic PBC is not reducing the verifiable part of the firm value, but is not yet increasing it either. However, when there is a takeover bid, the manager will have finally the
opportunity to cash in the value of idiosyncratic PBC as a deferred compensation for her firm-specific investments. To have this accomplished, the incumbent manager must be entitled to bargain with the insurgent the terms of the control sale. In order to make sure that, when control is transferred, reward to entrepreneurship is ultimately paid out of observable enhancements of firm value, control can only be ‘sold’ to the new manager on condition that she also successfully bids for the company’s stock. This constraint parallels the takeover practice and uncovers the rationale of the widespread prohibition of managers from selling just their office (Easterbrook and Fischel 1991). Even more importantly, appropriation of idiosyncratic PBC in a takeover requires that incumbent management be vested with residual rights of control.

As I showed, allocation of residual rights of control to corporate management is necessary to induce firm-specific investments that cannot be rewarded contractually. However, this apparently would expose powerless shareholders to hold up in any potential control transaction. This solution is unacceptable to the owners only in a purely theoretical scenario where the manager has no interest whatsoever in the security benefits. A non-owner manager featured with residual control rights will be unwilling to part with control unless she gets from the owners not only compensation for idiosyncratic PBC, but also the remainder of the transaction surplus (Zingales 1995). Given the prohibition of sale of office, a prospective bidder cannot avoid being stuck in the owner’s bargaining position, and this is sufficient to frustrate any takeover attempt. This result no longer holds when, as it normally happens, control rights are combined with an interest in the security benefits, namely stock ownership, stock options, and the like. When this is the case, both security benefits and private benefits are liquidated in a control transaction. Then the manager bears the negative effects of a hold-up strategy on her share of the security benefits. The current value of these benefits is all that she gets when she stays. However, the incumbent’s interest in security benefits can be sold at
a premium on condition that control is efficiently transferred to a successful bidder (Almazan & Suarez 2003).

When idiosyncratic PBC are compensated upfront, any takeover premium offered for the company’s stock would suffice to induce the incumbent manager to part with control, so long as she knows that expected profits (including her share of them) cannot increase any further under the current management. This outcome depends on two very reasonable assumptions. The first is that the incumbent manager believes that she cannot enrich her by any larger amount than the idiosyncratic PBC, which originally motivated the undertaking. The second is that the bidder for corporate ownership owners believes that, even when the incumbent’s PBC are compensated upfront, a new management can further increase firm value. As a result, the parties will bargain for the division of the extra surplus, but ultimately the transfer will take place anyway (Zingales 1995). In this scenario, the only transfers that do not take place are those whose surplus does not exceed the idiosyncratic PBC claimed by the incumbent manager (Schnitzer 1995). To the extent that these are due to incorrect beliefs of the entrepreneur about his own managerial capabilities, some efficient control transfers would be indeed foregone. This is, however, the price to pay for fostering entrepreneurial innovation in corporate governance.

4. Ownership structure and the market for corporate control: a Coasian view

Foregoing discussion shows that idiosyncratic PBC matter in two temporally distant, but conceptually very related, stages. The first is when ownership is separated from control. The second is when control changes hands. Entrepreneurs who make firm-specific investments that stock markets are unable to price at the outset will only go public when they can reasonably expect to cash in idiosyncratic PBC in the event of a takeover – i.e., when they are effectively tenured as corporate controllers. Rational outside shareholders will only accept
this arrangement to the extent that the expected return on their investment is still maximized. If we keep the assumption that no diversion from outside shareholders is allowed by the legal system, investors’ willingness to pay for non-controlling stock depends on the amount of distortionary PBC that the controlling entrepreneur is expected to extract in the form of control perquisites, mismanagement of free cash, or outright shirking. Room for distortionary PBC depends, in turn, on the distribution of security benefits between the controller and non-controlling shareholders and the likelihood that a change in control will occur when stock returns are not being maximized. In this simplified setting, both the choice of ownership structure and the functioning of takeovers are determined by the interaction between idiosyncratic and distortionary PBC.

In the presence of outside shareholders, a corporate controller may go for one of the following strategies. She may make highly firm-specific investments or, alternatively, she may shirk. The first strategy would be eventually rewarded by idiosyncratic PBC, on condition that corporate control can be sold at a premium. The second strategy would be immediately rewarded by distortionary PBC. Firm-specific investments are neither observable nor verifiable by outside shareholders, so that they will assume there is none and apply a discount on the price of non-controlling stock. The discount is decreasing in the ownership retained by the corporate controller: the lower her ownership stake, the higher the expected extraction of control perquisites (Jensen & Meckling 1976). However, since consumption of distortionary PBC is inefficient, at the going public stage corporate controllers should prefer to be committed not to extract any of them. As Grossman and Hart (1988) have shown, this result is achieved by selling all of the firm ownership to dispersed shareholders in such a way as to make corporate control perfectly contestable. Under a number of reasonable assumptions, this maximizes the entrepreneur’s proceeds from going public.
Very few firms in the real world go public in this fashion, and this only makes sense when idiosyncratic PBC matter enough to make contestability an unattractive strategy for entrepreneurs to go public (Hart 1995b). Entrepreneurs are unwilling to give up control together with ownership so long as they believe that the value of their firm-specific investments is not included in the price they can get for outside stock. Unfortunately, this also implies that no commitment can be taken that control changes hands as soon as incumbents fail to maximize shareholder value. It is exactly under these circumstances that outside shareholders will apply a discount on non-controlling stock, in anticipation of future consumption of distortionary PBC.

How far would separation of ownership and control go when both idiosyncratic and distortionary PBC are present? This depends on how much the entrepreneur values his firm-specific investments and outside shareholders fear extraction of control perquisites. Equilibrium in the sale of non-controlling stock will be reached at the point in which expectations about the future, observable stream of profits converge. Stock prices, however, differ in one important respect from the firm value: the profits that are not yet observable or verifiable, the ‘profits in the entrepreneur’s head’. At the going public stage these ‘profits’ must be equal to the discount on non-controlling stock. That is to say, the idiosyncratic PBC claimed by the corporate controller must be equal to the distortionary PBC anticipated by outside shareholders.

The difference in value between controlling and non-controlling stock might become more tangible only at a later stage. As soon as a third player is willing to pay for corporate control, this will be the control premium. Here is the point where the effects of the original choice by the corporate controller on whether to invest or to shirk materialize. She might have shirked much and invested little, but then the value of shirking to her will be easily compensated by the efficiency gains brought about by a more diligent manager – i.e., a takeover would be
most welcome for all the parties involved (Almazan & Suarez 2003). She might have shirked little and invested a lot, and then her effort will be compensated as soon as a brainy manager realizes the potential she has uncovered but the stock market has not yet priced – i.e., a takeover will provide both a reward for previously unobservable investments and the opportunity to further enhance stock returns (Schnitzer 1995).

The interaction between idiosyncratic and distortionary PBC becomes thus particularly interesting in the takeover stage. The market for corporate control is the place where entrepreneurs both earn a reward for their firm-specific investments and are replaced by a more efficient management. Apparently, however, these two goals are incompatible. Received wisdom is that takeovers promote efficiency in corporate governance by both disciplining extraction of control perquisites and selecting the best available option for firm management (Becht et al. 2002). Combination of disciplinary and allocative functions of the market for corporate control is achieved by letting ownership coalesce in such a way that shareholders can credibly threaten ouster of underperforming managers and effectively reallocate control to more competent ones. This requires takeovers to be operated against the incumbent management’s will, and thus to be ‘hostile.’ Hostility in takeovers is a prominent consequence of the assumption that shareholders, not managers, have residual rights of control. The most unfortunate implication of hostile takeovers is that managers are not allowed to earn any reward in the form of PBC, at least when this mechanism works as smoothly as the theory would like it to do.

Hostile takeovers do not only work imperfectly in the real world (Becht et al. 2002). They may hardly exist at all. Surely, takeovers cannot be hostile when corporate control is not contestable, which happens to be the case in the vast majority of publicly held corporations around the world (Becht & Mayer (2001); Morck et al. 2005). In all remaining situations, students of corporate governance may be so eager to identify the virtues of hostile takeovers
in curbing agency costs that they overlook at least one important circumstance: that most takeovers originally initiated as hostile are in fact concluded as a deal with the incumbent management (Schwert 2000). This shows that corporate controllers do have bargaining power in takeovers, and that contestability – at least in its ideal configuration – is just a myth. Still, this does not demonstrate that contestability would not be desirable for efficiency. Both legal and economics scholars recognize that corporate governance regularly allows controllers to extract private benefits of control by entrenching themselves. However, according to the mainstream ‘management entrenchment hypothesis’ (Morck et al. 1988), when control is entrenched shareholders lose twice: their shares are worth less because of excessive distortionary PBC being enjoyed; and they forego the opportunity of profitable tender offers by a more efficient management.

Valuable firm-specific investments by the incumbent management may just provide a countervailing benefit. That is to say, we leave in a world of tradeoffs, and then the only possible way to promote entrepreneurship in corporate governance is to allow corporate controllers to avoid tight discipline by the market for corporate control. This statement is essentially correct, but requires an important qualification. The agency framework from where this conclusion is sometimes derived (e.g. Burkart et al. 1997) only allows private benefits to be distortionary or diversionary (Mayer 1999). Since controllers can only extract rents by consuming perquisites or diverting resources from outside shareholders, the ultimate tradeoff in the market for corporate control is between the incumbent’s failure to maximize shareholder value and the insurgent’s ability to subsidize takeovers by diverting the efficiency gains to his own pockets (Bolton & von Thadden 1998). Here, however, I am still assuming that controllers are unable to extract diversionary PBC, and I will show that diversion of shareholder value is not only unnecessary for efficient operation of the market for corporate control, but also counterproductive. In fact, the introduction of idiosyncratic PBC as quasi-
rents determines a different tradeoff, between *ex ante* and *ex post* efficiency, where minimization of distortionary PBC is still obtains subject to the constraint of rewarding firm-specific investments by the incumbent management (Schnitzer 1995).

The market for corporate control provides a natural solution to the problem of distortionary PBC; however, this has little to do with hostility in takeovers. When the incumbent controller is underperforming relative to the next best management alternative available on the market, reallocation of corporate control can make all the players better off. What is crucial is the definition of gains from trade. They include the surplus that the insurgent is expecting to generate on the stock market (i.e., the opportunity cost of current mismanagement – distortionary PBC), but exclude the value of the incumbent’s firm-specific investments (idiosyncratic PBC). Gains from trade are positive only when distortionary PBC exceed idiosyncratic PBC; that is, when the insurgent attaches a higher value to corporate control than the incumbent. Any different specification of gains from trade would violate the incumbent’s preferences *ex post*, which would be in turn inconsistent with the assumption that these preferences matter *ex ante* for the application of entrepreneurship to the corporate enterprise. Gains from trade are also defined in such a way that the insurgent can only generate a takeover surplus by enhancing stock returns when she acquires sufficient ownership from both the incumbent and non-controlling shareholders. This fundamental insight dates back to Manne (1965), who introduced the notion of market for corporate control in the study of corporate governance. Appropriation of enhanced security benefits through coalescence of ownership provides both the private incentives for a takeover and the guarantee that changes in control are efficiency-enhancing. Ownership, however, is just the instrument of this mechanism, whereas control is the very asset to be exchanged. As a result, corporate control is allocated efficiently when the owners as a whole can profitably take over, but this does not imply that the value of corporate control already belongs to the owners.
Indeed, *purchasing* corporate control in combination with undervalued ownership is what takeovers are all about.

This point has been neglected by subsequent developments of the literature in the direction of a principal-agent framework. Manne’s contention is essentially that incumbents may already attach a value to corporate control. When this is the case, that value has to be compensated in the form of a control premium in order for takeovers to be regarded as Pareto improvements. In contemporary terminology, takeovers are considered to be efficient when they generate sufficient gains to offset both the current value of security benefits and the incumbent’s private benefits (Bebchuk 1994). This specification of social welfare allows for no hostility in takeovers unless private benefits can be dismissed as inefficient or irrelevant, in that either they are extracted from security benefits with a deadweight loss or they are nil. These are standard assumptions of the agency theory of corporate governance, which the introduction of idiosyncratic PBC as a further value to be appropriated on top of stock returns makes unwarranted. That being said, the market for corporate control need not feature any contestability and is more fruitfully interpreted as an application of the Coase Theorem (Coase 1960; Stigler 1966).

In the absence of transaction costs, allocation of control rights has only distributional consequences. When shareholders have residual rights of control, managers have to buy the entitlement to tenure. This transaction will be concluded efficiently when the expected contribution of managerial firm-specific investments to firm value is higher than the private benefits to be compensated in a future takeover. When managers have residual rights of control, shareholders have to buy the entitlement to replace management. This transaction will be concluded efficiently when the security benefits of a takeover are effectively higher than the private benefits necessary to compensate the contribution of managerial firm-specific investments to firm value that far.
Non-observability of managerial contribution to quasi-rents is the very source of transaction costs, which makes allocation of control rights relevant for realization of the efficient outcome. While the first contract would only be feasible in a world of perfect foresight, the second one is also possible in spite of high transaction costs. The difference is that side payments accounting for idiosyncratic PBC, which are clearly impossible \textit{ex ante}, can more easily occur \textit{ex post}. The launch of a takeover bid implies that the value of corporate control has become observable. When the bidder is committed to the acquisition of the company’s ownership, compensation of the incumbent’s idiosyncratic PBC would suffice for control to change hands efficiently. When confronted with such a bid, the corporate controller would not claim a control premium any higher than the security benefits that she expects to appropriate by taking the company private. Takeovers can succeed if and only if the bidder expects to generate higher security benefits. This demonstrates that the market for corporate control is efficiently operated by ‘friendly’ takeovers. More precisely, this arrangement guarantees a constrained-efficient outcome. Distortionary PBC are minimized by friendly takeovers subject to the constraint of compensation of idiosyncratic PBC. That is to say, the market for corporate control maximizes shareholder value subject to the constraint of rewarding entrepreneurship through the award of a control premium.

This result is very much in the spirit of the foundation of Corporate Law and Economics. Manne (1965)’s pioneering work on takeovers was also based on a Coasian approach. While it acknowledges the importance of the control premium, it contains no advocacy of hostile takeovers. Subsequent literature has often overlooked Manne’s warning that non-controlling shareholders’ entitlement to share in the control premium undermines the very functioning of the market of corporate control. Side payments most often underlie the takeover mechanism, and they go from shareholders to corporate controllers. Manne did not provide an explanation of why managers and controlling shareholders must be entitled to a control premium.
Idiosyncratic PBC are one such explanation. That being said, efficiency of the market for corporate control in the presence of idiosyncratic PBC depends on the assumptions of the simplified framework developed in this paper, which are worth briefly recalling.

The constrained-efficient outcome obtains on condition that outside shareholders are not allowed to free ride on the takeover gains (Grossman & Hart 1980). Formally, this depends on collective action problems being ruled out by assumption. Shareholders who are able to coordinate costlessly will let the bidder appropriate a sufficient share of the takeover gains so that she can offer a side payment to the incumbent controllers and still be better off. Even is this assumption is removed, holdout by dispersed shareholders is just a nuisance when control transactions are bargained for between the bidder and the incumbent management. Friendly takeover bids cannot make outside shareholders worse off when sale of office and extraction of diversionary PBC are effectively prohibited – as I have assumed they are. Holdout by non-controlling shareholders is therefore unnecessary for efficiency, and there are a number of legal techniques to prevent this from occurring. Of these, squeeze-out of non-tendering shareholders is “a simple and elegant solution of the free-rider problem” (Yarrow 1985:4). Discussion of this solution and its implications for takeover regulation is a matter for a separate inquiry (Amihud et al. 2004).

The absence of diversionary PBC is also crucial for idiosyncratic PBC to be cashed in efficiently through the takeover process. Foregoing discussion has shown that, contrary to what is often assumed, diversionary PBC are not necessary to subsidize efficient changes in control. Contrariwise, allowing diversion of shareholder value by the incumbent controller, the insurgent, or both, compromises the original selection of ownership structure and its efficient evolution through the takeover process. Outright diversion of shareholders’ money dominates the extraction of any other kind of PBC. When controllers cannot take a credible commitment that diversionary PBC will not be extracted if not in a limited amount,
entrenchment will still be the outcome. However, it will be aimed at protecting ongoing stealing or at preventing further looting from occurring by means of takeovers (Bebchuk 1999). The consequences of this are most unfortunate. Being unable to distinguish honest managers from thieves and looters, shareholders will just offer lower prices for non-controlling stock. Short of being able to cash in idiosyncratic PBC in markets for corporate control auctioning stealing instead of profit opportunities, most talented entrepreneurs will just refrain from entering the stock market in the first place. Markets can find little way out of this ‘lemons’ equilibrium (Akerlof 1970). Credible commitments that diversionary PBC will not be extracted in an ‘excessive’ amount are sometimes taken by significant investments in reputation. Eventually, this will come at the price of higher distortionary PBC. Takeovers, both friendly and hostile, are then unable to reallocate control efficiently without allowing for expropriation of minority shareholders. This is how the market for corporate control is ultimately understood as a tradeoff between diversionary and distortionary PBC (Bratton & McCahery 2001).

This paper shows that this tradeoff is unwarranted when the legal system is capable of curbing diversionary PBC without interfering with how the market allocates corporate control. This does not contradict the major contention of the ‘law matters’ thesis, but only refines its implications. Corporate law’s ability to prevent corporate controllers from stealing is precondition for efficient separation of ownership and control. This also provides a necessary condition for the market for corporate control to be efficiently operated by friendly takeovers. These conditions become sufficient when the policing of diversionary PBC does not also prevent controllers from extracting a compensation in the form of idiosyncratic PBC. Fiduciary duties imposed on either the board members of management-controlled corporations or on controlling shareholders can realistically hit the target. Hurdles in enforcement may require that only an upper bound on extraction of diversionary PBC can be
established. However, this would not undermine the ability of the market for corporate control to progressively transform idiosyncratic private benefits in security benefits, so long as takeovers do not allow for incremental expropriation of non-controlling shareholders. A thorough investigation of this dynamics is outside the scope of the present inquiry. What remains to be illustrated is how corporate law can allocate control rights to allow protection and cashing in of idiosyncratic PBC, while regulating this entitlement in such a way as to make sure that diversionary PBC cannot be extracted if not in a limited amount.

5. *Policy Implications*

I have illustrated how separation of ownership and control depends on three different, but complementary, categories of PBC. Law plays a crucial role in this mechanism, which was set aside so far by convenient assumptions. This role pertains to each category of private benefits. Idiosyncratic PBC can only be appropriated when residual rights of control are available to the management of shareholder-owned firms. Diversionary PBC are only curbed when control entitlements do not also allow expropriation of non-controlling shareholders. Distortionary PBC are only minimized when Coasian bargaining on both private and security benefits is enabled in the market for corporate control. Besides the second statement, this analysis departs from the mainstream approach to Corporate Law and Economics. The advantage of this interpretation is that it can provide an efficiency-based explanation of a number of real-world circumstances, which are considered as puzzling or suboptimal by the standard principal-agent approach to corporate governance. These are: (i) entrenchment of corporate control regardless of ownership concentration; (ii) ownership concentration also in the absence of expropriation of minority shareholders; (iii) side payments in takeovers operated under both dispersed and concentrated ownership. Ownership structure does not affect these circumstances, only the presence of private benefits do. However, the levels of each kind of
PBC set the constraints of efficient selection of ownerships structure. Whether the outcome is actually efficient depends on how corporate law regulates the extraction of each category of PBC.

Corporate law must make sure that entrepreneurs keep their entitlement to idiosyncratic PBC when they go public before rewards to their firm-specific investments have become verifiable (Coates 2003). The empirical evidence (Brennan & Franks 1997; Pagano et al. 1998; Daines & Klausner 2001) suggests that going public is in fact a step towards appropriation of this reward, which will be eventually accomplished through cashing in of a control premium. Virtually anywhere, corporate law supports this outcome by allowing companies to be controlled with 50% of the ownership rights. This solution, however, places a quite heavy financial burden on entrepreneurs who wish to grow relying on outside equity finance. Gains from trade are foregone when the marginal discount on non-controlling stock is lower than the per-share control premium accounting for idiosyncratic PBC. The reason is that the corporate controller can no longer protect this control premium when her ownership stake becomes insufficient to guarantee the entitlement to uncontested control rights, and has therefore to refrain from profitably placing further stock with the investing public. This is how the shortage of legal entitlements to corporate control determines suboptimal separation of ownership and control.

Corporate law is not so rigid, or at least does not need to be. With a few exceptions (Becht & Mayer 2001; Cools 2005) the literature on corporate governance tends to overlook one key feature of corporate law, which is distribution of powers. Because of the majority principle governing the corporate structure, a shareholder is already in control when she holds a half of the voting rights. This, which already allows firm control to be separated from property rights, does not necessarily require that a controlling shareholder owns 50% of the company. Corporate law may provide further entitlements to corporate control to the extent that it
allows derogations from the one share–one vote principle. These derogations, which are often viewed with skepticism by both economic and legal commentators, in fact ease the constraint of protection of idiosyncratic PBC on separation of ownership and control. This is efficient to the extent that further separation actually occur via voluntary exchange of non-controlling stock (Ferrarini 2006). This is but one aspect of legal distribution of corporate powers. Besides providing controlling shareholders with a higher proportion of voting rights that their ownership stake would grant, corporate law can provide additional entitlements to control rights, independent of voting rights. This is a legal precondition for management to be in charge of corporate decision-making without the support of a controlling shareholder. The economic rationale of this arrangement is that idiosyncratic PBC need still be protected, but they are low enough to allow ownership to be almost entirely placed with non-controlling shareholders. The legal bedrock is twofold (Cools 2005). On the one hand, management needs to be in control of how dispersed shareholders cast their votes. On the other hand, management must be in the position to prevent a controlling shareholder from emerging by effect of an unwanted takeover.

Disproportionality between ownership and voting rights is quite popular in continental Europe, in spite of the significant variety with which derogations from one share–one vote are allowed (Bennedsen & Nielsen 2005). A comprehensive review of this variety, and of its implications in the theoretical framework developed so far, is outside the scope of the present inquiry. Only a few circumstances are worth mentioning. Deviations from one share–one vote do not seem to undermine stock market performance. Quite to the contrary, two countries where these deviations are the most frequent – Sweden and the Netherlands – have both a very high stock market capitalization to GDP and extensive separation of ownership and control (ISS, ECGI, Shearman & Sterling 2007). There is hardly any evidence that shareholders of Dutch or Swedish companies are being expropriated by this arrangement. In
other countries where shareholder expropriation is perceived as a more serious problem, like in Italy, both disproportionality of voting rights and separation of ownership and control are significantly lower (Bianchi et al. 2005). Therefore, legal derogations from the one share–one vote principle do not themselves increase extraction of diversionary PBC, but only allow protection of idiosyncratic PBC when corporate law otherwise polices expropriation of minority shareholders.

This is just one view of the picture. The Netherlands also exhibits a significant proportion of management-controlled listed companies (de Jong et al. 2001), whereas there is virtually none of them in Sweden (Agnblad et al. 2001). The reason is that Dutch corporate law provides a broader range of entitlements to control rights (Schuit et al. 2002). Some of them, like the structured regime of appointment of two-tier board members, simply empower the management, at least on condition that no controlling shareholder is around; takeover defenses – upheld by Dutch courts – make sure that this condition is preserved until the incumbent management is not offered adequate compensation for parting with control. Other techniques, like the placement of shareholders’ voting rights in a trust and shares carrying special initiation and voting rights, are equally suitable to managerial and shareholder control. On the contrary, Swedish corporate law falls short of entitlements that may empower corporate management (Skog 1994). It only allows controlling shareholders to be in charge, thereby forcing separation of voting rights from ownership beyond what would be efficient (Holmén, & Högfeldt 2005).

Asymmetry in entitlements for managerial and shareholder control may explain other apparently puzzling circumstances. American law, at both the federal and the state level, is no more demanding on the one share–one vote principle than Swedish law. True, US tax law traditionally disfavors pyramidal group structures (Morck & Yeung 2005), but this is not sufficient to explain why also dual class security-voting structures are far less popular in
American stock exchanges. Differently from Swedish law, corporate law in the US also allows the management to be in charge. It so does by placing in the board of directors, instead of in the shareholder meeting, the center of authority over corporate decision-making (Bainbridge 2002). This gives corporate controllers two options. Either they retain sufficient ownership to act as controlling shareholders, with or without the aid of dual class shares, or they simply control the board. Management-controlled boards may disenfranchise non-controlling shareholders by determining when and how votes are cast through the proxy machinery and prevent would-be controlling shareholders from hostilely taking over thanks to the favorable attitude of the leading corporate jurisdiction – Delaware – towards takeover defenses.

Authoritative commentators in Law and Economics have studied these features of American law. Some of them have concluded that both managers’ control of the proxy machinery and their entitlement to takeover resistance undermine the efficiency of American corporate governance (Bebchuk 2005; Bebchuk & Cohen 2005), especially when compared with the British model that empowers shareholders by supporting none of these features. My conclusion is different on both prongs. Enabling managerial empowerment in the corporate structure is a legal precondition for the protection of idiosyncratic PBC in highly dispersed ownership structures. Unavailability of entitlements to managerial control is at least one reason why these structures have not emerged in continental Europe and certainly the determinant one where the extraction of diversionary PBC does not seem to be a problem. This argument is apparently not applicable to the UK, where corporate ownership is at least as dispersed as in the US, but managers are not as powerful. As it is often the case, appearance is misleading.

Managers are also powerful in the UK, although the source of their entitlement to control rights is more articulated than under American law. True, when British managers are in
control of the board, they are not in the position to disenfranchise outside shareholders (Davies 2002). However, these shareholders must have a reason to challenge the incumbent management’s powers. They would not have one unless they feel that they are being expropriated, through extraction of diversionary PBC, or that a better management alternative is available, because of inefficient consumption of distortionary PBC. Outside shareholders’ power to replace board members is quite effective in preventing expropriation, but not as much in determining a change in control (Stapledon 1996). The reason is that several layers of regulation of firms listed in the UK prevent controlling shareholders from appointing the majority of board members, so that takeovers need be operated via a going private transaction. However, board members jointly hold sufficient ownership to veto one such transaction anytime a takeover has not been previously arranged with them (Franks et al. 2001).

British managers are therefore no less entrenched than their colleagues in the US are (Weir & Laing 2003). The difference is that, in the UK, controlling shareholdings are not an option for governing a publicly held company. This is not only what ultimately gives a leverage to the incumbent management in the wake of a takeover bid, but also an important constraint on the ownership structure of British companies. According to the theoretical framework of this paper, this means that only businesses that feature relatively low levels of idiosyncratic PBC can be financed on the stock market. Highly innovative firms, and their entrepreneurs, should better stay private. This parallels the conclusion of a British commentator that regulation of corporate governance in the UK may undermine the financing of “activities that markets are unable to sustain” (Mayer 1999: 19).

The British example also offers the opportunity to highlight a potential conflict between protection of idiosyncratic PBC – through allocation of control entitlements – and the legal policing of diversionary PBC – by means of regulation of the same entitlements. Corporate law should pursue these two equally important goals independently. The popularity of the
‘law matters’ thesis in the study of corporate governance has determined an important misunderstanding: that the more minority shareholders are empowered relative to corporate management, the more efficiently they are protected against expropriation (La Porta et al. 1998; Djankov et al. 2006). This is both unnecessary and counterproductive. It is unnecessary because non-controlling shareholders need not interfere with the exercise of control powers, by either the management or a controlling shareholder, in order to shield themselves from expropriation. Corporate law can efficiently counter stealing when most dangerous transactions, falling under the broadest possible definition of self-dealing, are scrutinized for diversionary purposes. This scrutiny is actually very difficult, and the need to have it performed accurately explains why confusion between protection and empowerment of non-controlling shareholders is also counterproductive.

Powerful non-controlling shareholders may threaten the very exercise of entrepreneurial discretion in management (Rock & Wachter 2001). Not differently from the clients of lawyers or doctors, investors only challenge discretionary decision-making in hindsight, when they turn out badly. The difference with a standard principal-agent setting is that this may result in opportunistic behavior undermining the protection of idiosyncratic PBC. This is the reason why, differently from any other profession subject to fiduciary duties, courts abstain from second-guessing business judgment. They only impose liability on corporate controllers when non-controlling shareholders are expropriated of their investment because of a conflict of interest, not also when the value of that investment is not maximized. This principle, known in the US as Business Judgment Rule, is functionally upheld by other corporate jurisdictions (Kraakman et al. 2004). It is the evidence of a discretion-accountability tradeoff in regulating managerial behavior (Bainbridge 2002). In economic terms, this is a tradeoff between false positives and false negatives in enforcing the corporate controller’s fiduciary duties (Enriques 2000). This is the ultimate normative criterion in evaluating the legal policy towards
diversionary PBC. Its comprehensive application to the regulation of corporate control would require, however, a separate investigation.

Given the limited scope of this inquiry, I can likewise just hint on how corporate law may fail to deal with distortionary PBC efficiently. The rationale of the Business Judgment Rule explains why failure to maximize shareholder value cannot be ‘regulated’ in the first place (Roe 2003). Inefficient extraction of distortionary PBC is ultimately policed by the market for corporate control, and here is the place where regulation matters. The Coasian approach to takeovers advocated in this paper has indeed important implications for corporate law. Coase (1960) has shown that failure to account for transaction costs may result in both too much and too little regulation, but even more importantly in regulation being misdirected. The introduction of idiosyncratic PBC in the framework for analyzing corporate governance shows how the current approach to takeover regulation is actually affected by these problems. An efficient market for corporate control requires that idiosyncratic PBC be cashed in through side payments. Those payments exist in the real world, and take the form of control premiums or ‘golden parachutes’ depending on whether control is transferred from controlling shareholders or directly from the management. Conventional wisdom looks at them with suspicion. Lawyers often consider them as ‘bribes,’ while economists tend to regard them as evidence of shareholder expropriation.

The prevailing regulatory approach to takeovers parallels this skepticism (Kraakman et al. 2004). On the one hand, it tends to promote contestability like this was the only way to minimize extraction of distortionary PBC. On the other hand, it does not compromise on protection of minority shareholders for fear that diversionary PBC could be otherwise extracted via the takeover process. Economic theory has taken various steps to demonstrate that these two goals are jointly unattainable, so that the only feasible approach to takeover regulation is based on a tradeoff between diversionary and distortionary PBC (Burkart &
Panunzi 2006). I have shown that this tradeoff is unwarranted when also idiosyncratic PBC are allowed to enter the picture. On this basis, protection of minority shareholders through takeover regulation turns out to be most unfortunate. When this approach seeks to promote contestability, by exposing idiosyncratic PBC to *ex post* expropriation, it may just determine higher ownership concentration or prevent wealth-constrained entrepreneurs from going public. When this approach prevents takeover gains from being divided between the incumbent and the insurgent management, by disallowing the payment of control premiums and managerial severance payments, it may force corporate controllers to extract higher and higher distortionary PBC instead of profitably ‘selling’ control to a better manager.

The EC Takeover Directive contains an exemplary illustration of both regulatory strategies. The principle of board neutrality and the so-called breakthrough rule attempt to restrict the ability of both managers and controlling shareholders to entrench themselves. These rules only managed to be passed as an option for firms and member states. The regulatory challenge of control premiums was more successful: a very severe mandatory bid rule, requesting equal treatment of controlling and non-controlling shareholders, is now compulsory all over Europe. Both aspects of the European takeover regulation are misguided. Entrenchment, as I showed, obtains anyway in corporate governance whenever entrepreneurship needs be rewarded. Whereas denying that corporate control has a value, which is legitimately appropriated by who has invested in its production, does not make minority shareholders better off. It only undermines production and finance in a market economy.

6. **Conclusions**

This work attempts to shed a new light on the economics and the law of corporate governance. It so does by taking stock of the weaknesses of the standard account of how law
‘matters’ for separation of ownership and control. This account fails to explain comparative corporate governance in that both the ownership structure and the functioning of the market for corporate control do not entirely depend on the strength with which non-controlling shareholders are protected by corporate law. Short of claiming that legal protection of minority shareholders does not matter in corporate governance, this paper shows that protection and exchange of corporate control is at least as important and so are the legal institutions that support them. This result is derived by introducing a third category of private benefits of control (idiosyncratic PBC), which supplements the more traditional specifications as inefficient consumption of control perquisites (distortionary PBC) or outright expropriation of shareholder value (diversionary PBC).

The analysis departs from the standard principal-agent framework in that it assumes the idiosyncratic PBC account for a further value to be appropriated as a reward for application of entrepreneurship to the corporate structure. The quasi-rent nature of this value makes appropriation by the corporate controller a necessary condition for efficiency, which implies that residual control rights be allocated separately from ownership. This is required in order to overcome the non-contractibility problem in the takeover stage, where the value of control quasi-rents becomes observable by a bidder and is therefore subject to expropriation. Under the assumption that the non-controlling shareholders are unable to free ride on the takeover gains, the efficient outcome is derived as Coasian bargain between the incumbent and the insurgent over the value of corporate control. The bidder is allowed to reap the gains of a superior management subject to the constraint that previous firm-specific investments by the management are rewarded in the form of a control premium. Outside shareholders are at least as well off when the bidder can only gain from enhancing security benefits (reducing distortionary PBC) more than she has to pay as a control premium (idiosyncratic PBC).
Prohibition of sale of office and efficient policing of diversionary PBC by corporate law are sufficient conditions for this result to hold.

The implications of this framework for corporate law are more far-reaching that the standard ‘law matters’ thesis predicts. Formalization of how the three categories of private benefits interact with each other has been avoided just with the purpose to make these implications understandable to lawyers and policymakers. There is a compelling evidence that control is normally entrenched in order to protect its value, but this does not prevent efficient changes in control from taking place so long as a control premium is paid. This paper does not only show why this makes economic sense. It also shows how corporate law may distort separation of ownership and control, making ownership structures either more concentrated or more dispersed than it would be efficient, when it fails to provide entitlements to uncontested control to those who run the company independently of how much ownership they retain. Likewise, regulation may undermine the takeover process when it restricts side payments that ultimately support efficient bargaining upon the value of corporate control.

The bottom line is that protection of non-controlling shareholders is not all that matters for efficient corporate governance. Failure of corporate law to protect them from extraction of diversionary PBC actually undermines both separation of ownership and control and efficiency of the market for corporate control. Beyond that, shareholder protection would be more than the same non-controlling shareholders bargained for. Shareholder empowerment in corporate governance undermines the corporate controller’s ability to protect idiosyncratic PBC and restricts the choice of ownership structure accordingly. Seeking shareholder protection by disallowing the payment of a control premium only makes efficient changes in control more unlikely to succeed, thereby exposing investors to higher extraction of distortionary PBC. These conclusions are just suggestive of a more comprehensive revision of Corporate Law and Economics. I have just started embarking on this revision (Pacces 2007).
A more detailed discussion of how each category of PBC is and should be dealt with by corporate law will require a number of additional papers.

References


