Corporate Governance, Corporate and Employment Law, and the Costs of Expropriation

Giulio Ecchia*       Martin Gelter†
giulio.ecchia@unibo.it  martin.gelter@wu-wien.ac.at

Piero Pasotti‡
piero.pasotti@unibo.it

September 2008 - Very preliminary. Do not cite or circulate without permission!

Abstract

It is one of the well-known cornerstones of corporate governance that (minority) shareholders are subject to a risk of being expropriated by the controller of the firm, i.e. either entrenched management under a dispersed ownership structure or a controlling shareholder under concentrated ownership. On the other hand, economic theory has increasingly begun to recognize the role of employees and other “non-shareholder constituencies” during the past years. While potential shareholders may be reluctant to invest if they are adequately protected against private benefits of control, stakeholders may be deterred from investing if they are subject to the risk of ex post opportunism (e.g. holdup).

Although both aspects may be important to corporate governance, their interaction has not yet been thoroughly investigated. In our model we study the incentives that influence the decision by the controller of the firm (either a controlling shareholder or manager) to divert resources from (other) shareholders and employees. We also analyze how these incentives vary, between firms, according to the specific corporate governance structure chosen by a certain firm and the degree of protection granted by the law. The effectiveness of diversion (i.e. the amount taken from the prior expectation of dividends or wages and additional implicit benefits) depends on the effectiveness of corporate law and employment law respectively against the taking of private benefits of control (to the detriment of shareholders) or the exploitation of (e.g.) holdup situations (to the detriment of workers).

*University of Bologna
†Vienna University of Economics and Business Administration and ECGI
‡University of Bologna
Naturally, the incentive of the controller to expropriate labor depends on his share in the firm, since shareholders (as a group) are the beneficiaries of holding up labor. Ex post, minority shareholders will therefore want the controller to exploit labor. Because of his increased financial incentive, a controlling shareholder will ceteris paribus have a larger financial incentive to hold up employees than a mere manager with a negligible share in the firm. By contrast, some of the corporate governance literature presupposes that large shareholders are better able to “bond” with labor than dispersed ones, while other authors emphasize that dispersed ownership helps managers to form long-term relationships with the firm’s stakeholders, and that large shareholders may be in a better position to exploit them. We elucidate the circumstances under which each of these two assumptions is correct. Furthermore, our model shows that employees will not only benefit from labor law, but also from corporate law protecting minority shareholder against expropriation, since it will reduce the financial incentive of a controlling shareholder to exploit employees. It also highlights how corporate law and labor law are interdependent in their effects on expropriation of both groups. Moreover, this interdependence has different effects depending on the corporate governance structure chosen by the company.

The more careful analysis of our paper suggest that the crucial factor is not concentrated ownership as such (to the contrary), but other factors that can be identified as private cost of expropriation borne by the controller (be it a controlling shareholder or manager). For example, the literature on family firms suggest that controlling families may have a “taste” for a certain social position in the community and therefore be reluctant to take an overly tough stance vis-à-vis employees. Similarly, a controlling manager may have a taste for empire building and therefore be reluctant to initiate redundancies and plant closures. Similar reasons for private costs of expropriation can be brought with regard to shareholders. The cost of expropriation therefore creates a commitment against expropriation that may encourage workers to make specific investment and investors to buy shares.

However, in some cases the private cost of expropriation that we identify as an important factor for the protection of shareholders and employees might be substantially reduced (or even negative). For example, the decreased probability of a hostile takeover in a corporate governance system with dispersed ownership and an effective market for corporate control could be seen as a negative private cost of expropriation that makes ex post opportunistic situations more likely.

By varying the degree of ownership concentration and the amount and sign of the controller’s private cost of expropriation, our model is able to explain the interaction of corporate and employment law in corporate governance systems and firm-level structures, such as Berle-Means firms (both with entrenched managers and an effective market of corporate control), publicly traded and privately held family firms, firms controlled by financial investors (including hedge funds), and professional partnerships such as law firms.

JEL Classification: G30, K22
1 Introduction

1.1 Motivation

Economic theory has increasingly recognized the role of labor in corporate governance during the past two decades. Employees (or other stakeholders) may sometimes be deterred from making beneficial firm-specific investment if they are insufficiently protected from holdup through which shareholders will expropriate their (quasi-)rents (Shleifer & Summers, 1988). At the same time, the bulk of the corporate governance literature is concerned with private benefits of control, which allows the controller of the firm to usurp part of the corporate patrimony that minority investors would have expected to participate in (Shleifer & Vishny, 1997).

While it is well known that agency problems differ strongly between firms with concentrated and dispersed ownership, differences in the firm’s interaction with other stakeholders, such as labor, are a much less researched issue. While some authors have suggested that large shareholders may be better able to expropriate non-shareholder constituencies (Charreaux & Desbrières, 2001:758; Jackson, 2005:116), another part of the literature hypothesizes that large shareholders may be better able to commit to the firm in the long run, thus assuring to stakeholders that specific investment can safely be made without needing to fear ex-post expropriation of rents (e.g. Aguilera & Jackson, 2003:183; Woolcock, 1996:451). This proposition may seem counterintuitive, considering that shareholders presumably are the financial beneficiary of holdup of stakeholders. Large, controlling shareholders (or coalitions of large shareholders) who are able to influence management, could therefore both be in a good position and have strong incentives to expropriate labor. While it remains unclear how large shareholders manage to signal their commitment to labor, the literature suggesting that this type of commitment is prevalent seems to presume that managers in dispersed ownership systems are forced by market mechanisms, most of all by hostile takeovers, to expropriate labor where shareholders can benefit from it financially (e.g. Franks & Mayer, 1998:728-729).  

However, in recent years legal scholars have increasingly found that managers in the US, the paradigmatic dispersed ownership system, are typically relatively insulated from shareholders and often do not have strong incentives to pursue shareholder wealth maximization. In particular, there is persuasive empirical evidence that Delaware corporate law has developed to offer managers highly effective means to shield themselves against hostile takeovers (Bebchuk et al., 2002). Scholars of comparative corporate law point out that the US corporate governance system, taking both the law and financial structures into account, provides an unusual degree of insulation of managers (Hansmann & Kraakman, 2004:53-54). While this aspect of US corporate governance often leads to con-

---

1This is the situation envisioned by the seminal contribution of Shleifer & Summers, 1988 regarding hostile takeovers in the US.

2In fact, the situation seems to be very different in the UK, the second important dispersed ownership system, where takeover law has provided obligations for managers to stay neutral
siderable criticism (e.g. Bebchuk & Cohen, 2005), others have attempted to find efficiency explanations (Bainbridge, 2003, Elhauge, 2005). Most interestingly, on the basis of Rajan & Zingales’ seminal contribution to theory of the firm (Rajan & Zingales, 1998), Margaret Blair and Lynn Stout have developed a team production theory of corporate law (Blair & Stout, 1999, Blair & Stout, 2006), the core claim of which is that the insulation of managers from shareholders is efficient because it protects employees from holdup. Similarly, others have suggested that taking the firm public reduces the possibility of stockholder intervention, thus effectively allowing managers and/or employees some leeway to capture private benefits if the firm is successful (Burkart et al., 1997, Brealey et al., 2006:949). However, this kind of argument has problems in firms or corporate governance systems characterized by concentrated ownership. In such systems, other mechanisms such as codetermination or employment law may help to protect stakeholders from holdup (cf. Fauver & Fuerst, 2006:679-680; Armour & Deakin, 2003:445-452). On the basis of these theories, it has been suggested that pro-employee laws may be relatively more desirable in corporate governance systems with concentrated ownership than in dispersed ones, and in dispersed ownership systems with more vibrant markets for hostile takeovers than in ones where managers can effectively shield themselves. Comparative patterns of employment law in large developed economies appear to confirm this hypothesis (Gelter, 2008).

The two views just described seem to be irreconcilable at first glance, as two mutually exclusive phenomena (the presence of large blockholders or ownership dispersion) are interpreted as the solution for the problem of long-term commitment to stakeholders. Our paper seeks to provide a reconciliation on the basis of an identification of the reason why the “controller” of a firm (either a manager or a large shareholder) should refrain from expropriating either shareholders or stakeholders, or both. We argue that expropriating either shareholders or stakeholders is not free. Depending on the respective corporate and labor laws, some resources must be invested in expropriation. Many of these costs are borne by the firm. While the controller always can expect some financial benefit from expropriation, we argue that sometimes she has to bear part of the costs of expropriation herself, which creates a countervailing incentive. On the basis of these costs, whose real-life interpretation we discuss in some detail below, we identify various prototypical “structures” of firms that depends on the nature and amount of the cost portion borne by the controller. At the same time, our model shows how the expropriation of (minority) shareholders and stakeholders are connected. In the presence of a positive cost of expropriation, employees benefit from laws intended to protect shareholders, and vice versa.

in takeover contests since the late 1960s. See Armour & Skeel, 2007.
2 Our model

2.1 General framework

Our model attempts to integrate specific investment by workers, holdup of workers by the controller of the firm, and expropriation of minority investors by the controller of the firm. The controller, to which we refer to as the manager, could either be senior management in a publicly traded firm with dispersed ownership, or a large blockholder (or a coalition of large blockholders) effectively controlling a firm with concentrated ownership. In the second case, conflicts of interests between a third-party manager and the controlling shareholder are largely negligible. Typically, conflicts of interests between controlling and non-controlling shareholders are considered to be the relevant agency conflict under concentrated ownership. We assume that management is under direct control of the controlling shareholder. In our model, the two archetypal cases are distinguished by the amount of shares held by the manager.

In either case, we assume that the manager needs outside shareholders to finance the firm, and employees to make firm-specific investment (e.g., in human capital). Following these investments, the firm operates and produces a surplus. The manager subsequently decides how to allocate the surplus between outside investors, employees, and himself. Both investors and employees have a baseline expectation what share of the surplus they expect. The manager can decide to withhold part of the expected share from these groups, to which we refer as “minority expropriation” and “employee exploitation” respectively. However, exploitation of either group is costly, and the manager is further constrained in doing so by corporate law and employment law.

Wages are often understood to consist of a fixed claim only. However, in our model, the wage accorded to employees and their baseline expectation is assumed to include rewards that are part of an implicit contract, such as e.g. certain types of retirement benefits, expectations regarding job security and advancement within the corporate hierarchy, and the safety of working conditions.

We devise two models:

a) a simplified model where the level of production is given and the majority shareholder (manager) has to choose the level of worker and minority expropriation

b) an extended model where the value of the production depends upon the effort put by the workers. This model is a two stage game where the effort of workers is perfectly observable and

1. workers chose the optimal level of effort (amount of costly specific investment)
2. the majority shareholder (manager) chooses the level of worker and minority expropriation
Since everything is observable and workers are rational, the level of effort they will choose in the first stage will depend upon the level of exploitation the managers will choose in the second stage.

The value of the output produced by the firm will be $x$. Once the output is produced, the manager can decide to put up some effort to expropriate the workers (exploiting hold up situations, etc.).

The wage earned by the worker is a share $\omega$ of the output. $w = \omega x$. The effort made by the manager to exploit workers determines $\omega$, $\omega = \overline{w} - (1 - p_L) \gamma(c_L)$, where $\overline{w}$ is the share of revenues used to pay workers if the manager do not invest in workers exploitation, $p_L \in [0, 1]$ is the degree of protection accorded to workers by employment and labor law. In our model, employment and labor law are understood to either prevent exploitation outright (e.g. by making it hard or costly to make workers redundant), or by giving considerable bargaining powers to workers and unions, such as mandatory codetermination, consultation requirements, or the requirement to negotiate a costly social plan for redundant employees. $c_L$ is the amount of resources spent to expropriate the workers and $\gamma > 0$, $\lim_{c_L \to \infty} \gamma(c_L) = 1$. Depending on the particular circumstances of the case (explained below), this cost will be born by the firm or by the manager himself.

Once the wages have been paid, what remains are the profits: $\pi = (1 - \omega) x - c_c - c_L$.

Profits have to be shared between the manager and minority shareholders. The manager can spend resources to expropriate minority shareholders. The amount of dividends earned by minority shareholders is $d_m = f \pi$, where $f = (1 - \overline{f}) - (1 - p_c) \delta(c_c)$. $\overline{f}$ is the share of capital owned by controlling shareholders, $p_c \in [0, 1]$, is the degree of protection accorded to minority shareholders by corporate law. The rules of corporate law we attempt to capture are the ones usually described as “shareholder protection” in the literature, such as the ones preventing or penalizing asset diversion or dilution of stock value (see generally Djankov et al., 2008). $c_c$ is the amount of resources devoted to minority shareholder exploitation and $\delta' > 0$, $\delta'' < 0$, $\lim_{c_c \to \infty} \delta(c_c) = 1$. Again, the cost of expropriating may either be born by the firm or the manager himself.

Using this framework, we analyze the interaction between labor law and minority shareholder’s protection. In particular, we argue that these two bodies of law interact so that

1. when the degree of shareholder protection changes (e.g. as the result of a change of corporate law), the amount of worker exploitation is affected as well. Likewise, when the degree of workers protection is changed, the amount expropriated from minority shareholder is also affected.

2. the exact type interaction between these two bodies of law is firm specific and depends on the type of controlling shareholder or manager effectively controlling the firm.
Furthermore, our analysis shows the significance of the size of the controlling block on the expropriation of workers, and the importance of who bears the cost of expropriation of either of the two “weak” groups.

In the subsequent sections, we distinguish various cases, each of which is interpreted to represent specific types of firms. The cases are distinguished on the basis of whether managers personally bear a cost of expropriating (minority) shareholders and/or employees. Within each section, we can distinguish between firms where managers own only a small stake (dispersed ownership) and firms where they own a large one (concentrated ownership). Our model shows that, in either case, a private cost of expropriation that cannot be shifted to the firm protects both minority shareholders and employees.

2.2 Firm controlled by financial investors (no private cost of expropriating either minority shareholders or labor)

In the first case, the cost of both expropriating shareholders and of exploiting labor is borne by the firm. Typically, tunneling transactions out of the firm that will harm small shareholders (both under dispersed and under concentrated ownership) will require complex transactions, and the advice of skilled professionals (such as lawyers or accountants) how to circumvent the law. Part of the resources spent on tunneling will therefore not correspond to an advantage to the manager, but simply be a deadweight loss. The same may applies with regard to the expropriation of workers. Firing workers, or even just threatening them with redundancy e.g. to obtain concession from a union, may result in transitory costs, such as reassignment of tasks within the firm or transaction costs resulting from negotiations. We assume that all of these costs are borne by the firm. The manager has no personal cost. There is not even a non-pecuniary cost from reduced reputation or from violations of social norms. The manager does not care whether employees or shareholders suffer because his personal wealth is not affected.

In cases of concentrated ownership, a plausible interpretation could be that large firm is a financial investor, such as a private equity investor, who is only interested in profits. Since the fund does not care about the non-monetary benefit of control and has direct power over the manager, it can divert company resources and use them to cover the costs of exploiting workers and minority shareholders.

In a firm with dispersed ownership, managers would have no social norms reinforcing long-term interaction with workers, and no interest in empire-building. The manager also does not have to fear any indirect repercussions from harming shareholders, for example because there is no market for corporate control.

**Lemma 1** In the absence of private costs of expropriation, there is a partial separation between the effects of corporate law and employment law:

1. If minority shareholder protection increases, the share of minority dividends expropriated by the controlling agent decreases, but the expropriation of workers is unaffected.
2. On the contrary, if labor protection increases, both the share of wages expropriated and the share of minority dividend expropriated decrease.

3. If $\overline{f}$ increases then the expropriation of workers is unaffected but the degree of minority expropriation decreases.

**Proof.** The maximization problem faced by the manager is

$$\max_{c_e, c_L} D_L = (1 - f) \pi$$

$$\max_{c_e, c_L} D_L = \left[ \overline{f} + (1 - p_c) \delta(c_e) \right] \left\{ [1 - \omega + (1 - p_L) \gamma(c_L)] x - c_e - c_L \right\}$$

$$\delta'(c_e) = \frac{\left[ \overline{f} + (1 - p_c) \delta(c_e) \right]}{(1 - p_c) \left\{ [1 - \omega + (1 - p_L) \gamma(c_L)] x - c_e - c_L \right\}}$$

$$\gamma'(c_L) = \frac{1}{(1 - p_L) x}$$

Other than in the following cases, in the absence of private costs of labor expropriation managers will always expropriate labor as much as possible, even if his share in the gain is very small, since he will only benefit from it financially.

### 2.3 Family firms and managerial firms (positive cost of expropriating labor)

In this case, the cost of expropriating shareholders is borne by the firm, while the cost of expropriating labor is borne by the manager. As in the previous section, tunneling transactions will cost the firm because of the deadweight loss resulted from the necessity to devise complex transactions to conceal self-dealing.

Other than in the previous section, we assume that the cost of exploiting workers is partly borne by the manager personally, and not taken out of the corporate cash box. Depending on the structure of the firm, there can be various explanations for this. Our model describes two distinct corporate archetypes.

First, in cases where $\overline{f}$ is high, the manager would be a **controlling shareholder**, more specifically an **entrepreneurial family**, as it is commonly the case in some Continental European countries such as Italy. The literature on family firms suggests that families sometimes enjoy non-pecuniary benefits from control, such as national or regional prestige (Burkart et al., 2003). Expropriating employees could harm that reputation and make the social life of the family’s members in the city or region dominated by the company less pleasant. Furthermore, entrepreneurial families may enjoy reigning over a large retinue of employees and therefore suffer a cost from if it lost some of them.

Similarly, the firm could be a government entity. Political decision-maker may be penalized by voters if they expropriate employees (resulting in the loss of jobs) (Gelter, 2008).
Second, where $\overline{f}$ is low, the model could apply to what is known as a Berle-Means firm (Berle & Means, 1932), in which a publicly traded firm is effectively controlled by managers holding only a small share of stocks. Blair & Stout, 1999 suggest that the insulation of US boards of directors (and managers) from shareholders influenced by corporate and securities law may be efficient because it protects employees from holdup, thus facilitating specific investment by various stakeholder groups (Blair & Stout, 2001:438-441). The reason why employees trust managers under this theory is that these stand to lose something if they expropriate labor. For example, there may be social norms that encourage directors to maintain a reputation of trustworthiness. Furthermore, entrenched managers may have a taste for empire-building, which will often coincide with the interests of workers. In this interpretation of our model, $c_L$ would correspond to managers’ costs when they forgo these possibilities and violate social norms at work in this context. In fact, there seems to be empirical evidence that at least some workers and bondholders benefit from entrenched management (Gokhale et al., 1995; Chemla, 2005:379-380).

In our model, the personal costs of expropriation correspond to the introduction of $\alpha$, which describes the share of the costs of labor exploitation personally borne by the manager.

Note that we are not yet taking the possibility of an effective market for takeovers into account at this point. In this subgroup of cases, managers (and controlling shareholders) are fully entrenched, meaning that the desire to holdup workers will largely depend on financial incentives resulting from their ownership share. Their non-pecuniary cost protects employees from holdup.

Conceivably, the manager’s cost from expropriating workers could also be negative. This would mean that there are other factors balancing the pro-employee bias described above in the Berle-Means firm, such as social norms favoring a strong shareholder primacy norm. In the case of a government-owned entity, the cost may be negative because the predominant political preferences of voters are against government stakes in the industry (which may often have required subsidies from tax money in the past). In such a case, the government-appointed manager may have incentives to cut labor costs.

Besides, this, the existence of cost of expropriating labor also leads to a shielding effect for minority shareholders: The diminished holdup gains to shareholders also decrease the incentive to expropriate this group.

**Lemma 2** When the cost of expropriating labor is borne by managers, the shielding effects of corporate law and employment law are interrelated. Specifically

1. If labor protection increases, both the share of wages expropriated by the controlling agent and the share of minority dividends expropriated (by the controlling agent) decrease.

2. If the protection of minority shareholders increases, both the share of wages expropriated by the controlling shareholder and the share of minority dividends expropriated (by the controlling agent) decrease.
3. If private losses of worker expropriation \((\alpha)\) increase there is a first order reduction in worker’s expropriation and a second order reduction in shareholder expropriation.

4. If \(\bar{f}\) increases the rate of minority expropriation decreases but the rate of workers expropriation increases.

**Proof.** The maximization problem faced by the manager is

\[
\max_{c, c_L} D_L = (1 - f) \pi - \alpha c_L
\]

\[
\max_{c, c_L} D_L = [\bar{f} + (1 - p_c) \delta(c_c)] \{[1 - \varpi + (1 - p_L) \gamma(c_L)] x - c_c\} - c_L
\]

whose first order conditions are

\[
\delta'(c_c) = \frac{1}{(1 - p_c) [1 - \varpi + (1 - p_L) \gamma(c_L)] x - c_c} \bar{f} + (1 - p_c) \delta(c_c)
\]

\[
\gamma'(c_L) = \frac{\alpha}{(1 - p_L) [\bar{f} + (1 - p_c) \delta(c_c)] x} + \frac{1}{(1 - p_L) x}
\]

In particular, an important result is that labor is not only protected by employment law, but also by corporate law. The better protection of minority shareholders, and thus the reduction in potential holdup gains reaped by himself, makes it less attractive for the manager to expropriate employees.

On the flip side of the coin, the impact of labor protection on minority shareholders is less clear: Overall, minority shareholders do not necessarily benefit from increased labor protection, since it is only there share that decreases: The could still benefit if holdup leads to an overall increase in shareholder value.

### 2.4 “Partnership”

We now introduce costs of expropriating shareholders. Here, the firm directly pays (with a reduction in profits) the costs of labor exploitation. The controlling shareholder (manager), on the other hand, pays the cost of exploiting minority shareholders. This situation may e.g. be interpreted as a professional partnership, where partners are in a long-term relationship and typically will care about each other, therefore making expropriation of other partners costly.\(^3\) On the other hand, shareholders may care little about employees (e.g. associates in a law firm that have not yet reached partner status, where, according the conventional wisdom, the turnover is very high).

The introduction of a private cost of exploiting minority shareholders is shown by \(\beta\), which describes the share of the cost borne by the manager.

\(^3\)The existence of a “manager” that could exploit other partners may seem unlikely at first glance, since normally no individual partner will have a controlling stake. However, several partners could form a coalition against another one e.g. to expel him from the firm. The key issue with regard to expropriation here is whether the partner is able to take his clients with him to a new firm or not.
Lemma 3  When the manager bears the cost of expropriating shareholders, but not of labor, there is a partial separation between the bodies of law.

1. If minority shareholder protection increases, then the share of minority dividends expropriated by the controlling agent decreases, but the expropriation of labor is unaffected.

2. On the contrary, is labor protection increases both the share of wages expropriated and the share of minority dividend expropriated decrease.

3. If private losses of shareholders expropriation ($\beta$) increase, there is a first order reduction in worker’s expropriation and a second order reduction in shareholder expropriation.

4. If $\bar{T}$ increases the rate of workers expropriation is unaffected but the rate of minority expropriation increases

Proof. The maximization problem faced by the manager is

$$\max_{c_c,c_L} D_L = (1 - f) \pi - \beta c_c$$

$$\max_{c_c,c_L} D_L = \left[ \bar{T} + (1 - p_c) \delta (c_c) \right] \left[ 1 - \omega + (1 - p_L) \gamma (c_L) - c_L \right] x - c_c$$

$$\delta' (c_c) = \frac{1}{1 - p_c} \frac{\bar{T} + \beta + (1 - p_c) \delta (c_c)}{\left[ 1 - \omega + (1 - p_L) \gamma (c_L) \right] x - c_c - c_L}$$

$$\gamma' (c_L) = \frac{1}{(1 - p_L) x}$$

In this case the degree of minority shareholders exploitation is determined only by the level of protection granted to minority investors. The opposite does not apply: the degree of workers exploitation is a function of both workers and investor protection.

2.5  Closely-held family firms and widely-held firms in which managers have pro-shareholder incentives

In this case, the manager personally pays both the cost of exploiting workers and minority shareholders. In the concentrated ownership situation the most intuitive interpretation would be a closely-held family firm. Minority shareholders who may be exploited may be family members or friends with a longstanding social relationship to the controller. The manager’s utility function would therefore also be altruistic with respect to this group.

Also consider the possibility that the cost of exploiting minority shareholders is negative. This would mean that the shareholder-manager tunneling assets out
of the firm could have an advantage the firm does not have, e.g. resulting from a synergy effects that increase the value of assets when used outside the firm.

In the context of a publicly traded firm with dispersed ownership, the private cost of expropriating shareholders could be the result of institutions that align the interests of managers with those of shareholders, such as a functioning a system of executive compensation, or an effective market for takeovers. Arguably, such factors are much less present in the paradigmatic dispersed ownership system, the US, than previously thought. In recent years, scholars have suggested that compensation schemes actually found in practice are rather a rent-seeking device for managers than a solution to agency problems, since managers themselves have considerable influence on the design of compensation packages (Bebchuk & Fried, 2003). Furthermore, Delaware corporate law provides nearly perfect takeover defenses, namely the combination of staggered boards and poison pills (Bebchuk et al., 2002). By contrast, takeover law in the UK, the second important dispersed ownership system, is entirely different, as the City Codes on Mergers and Takeovers has provided an obligation for managers to stay neutral in takeover contests since the late 1960s (Armour & Skeel, 2007). As a leading scholar of UK company law puts it, when facing a hostile bid, “the directors of the target are thrown back on their powers of persuasion” (Davies, 2003:717). Thus, UK directors may face a more significant cost in the form of an increased probability of a hostile takeover when they expropriate minority shareholders. Furthermore, they may reap a benefit when they expropriate employees, as this will increase short-term shareholder and thus reduce the probability of a hostile takeover. In our model, this implies that the manager’s personal cost of expropriating labor is negative.

**Lemma 4** When the firm is a closely held family firm then there is not separation between the two bodies of law. Specifically,

1. if labor protection increases, both the share of wages expropriated by the controlling agent and the share of minority dividends expropriated (by the controlling agent) decrease.

2. if the minority shareholders protection increases, both the share of wages expropriated by the controlling agent and the share of minority dividends expropriated (by the controlling agent) decrease.

3. if private losses of worker expropriation ($\alpha$) increase there is a first order reduction in worker’s expropriation and a second order reduction in shareholder expropriation.

4. if private losses of shareholders expropriation ($\beta$) increase there is a first order reduction in worker’s expropriation and a second order reduction in shareholder expropriation.

5. If $\tilde{F}$ increases the rate of minority expropriation decreases and the rate of workers expropriation increases.
Proof. The maximization problem faced by the manager is

$$\max_{c_c, c_L} D_L = (1 - f) \pi - \beta c_c - \alpha c_L$$

$$\max_{c_c, c_L} D_L = \left[ f + (1 - p_L) \delta (c_c) \right] \left[ 1 - \omega + (1 - p_L) \gamma (c_L) \right] x (e) - c_c - c_L$$

$$\delta' (c_c) = \frac{1}{1 - p_c} \frac{\delta (c_c)}{1 - \omega + (1 - p_L) \gamma (c_L)}$$

$$\gamma' (c_L) = \frac{1}{1 - p_L} \frac{\alpha}{f + (1 - p_c) \delta (c_c)}$$

2.6 Extention with workers’ effort

In the following section we extend our results assuming that the choice of expropriation affects the effort put by the workers. The output of the firm will be $x (e)$, where $x' > 0$. Once the output is produced, the manager can decide to put up some effort to expropriate the workers (exploiting hold up situations, etc.).

For sake of simplicity let us assume that $x (e) := \sqrt{e}$. In this case the worker will choose the optimal amount of effort in order to maximize his own utility

$$e^* = \arg \max u = w (e) - e$$

Thus

$$e^* (c_L, p_L) = \frac{1}{4} \left[ \omega - (1 - p_L) \gamma (c_L) \right]^2$$

$$x^* (c_L, p_L) = \frac{1}{2} \left[ \omega - (1 - p_L) \gamma (c_L) \right]$$

This implies that both the effort provided by the workers and the productivity of the firm are affected by the degree of labor protection, but are non affected by the degree of minority protection. This somehow an obvious result since the productivity of the firm is not affected by the provision of capital.

If this is the case, then the manager will choose the level of worker expropriation according to the effects on the effort provided by the workers.

2.6.1 Firms controlled by financial investors

Lemma 5 In the absence of private costs of expropriation, there is a partial separation between the effects of corporate law and employment law:

---

4 The reason why we have chosen this formulation is mainly for sake of simplicity, but it can be seen an implicit assumption regarding the efficiency of capital markets. In fact, if capital markets are efficient, there cannot be any shortage of capital to the firm if the return it pays is in line with the average rate of return on the market (adjusted for the risk level)
1. If minority shareholder protection increases, the share of minority dividends expropriated by the controlling agent decreases, but the expropriation of workers is unaffected.

2. On the contrary, if labor protection increases, both the share of wages expropriated and the share of minority dividend expropriated decrease.

Proof. The first order conditions become

\[ \delta'(c_c) = -\frac{\left[ \mathcal{J} + (1 - p_c) \delta(c_c) \right]}{(1 - p_c) \left[ (1 - \varpi + (1 - p_L) \gamma(c_L)) x^*(c_L, p_L) - c_c - c_L \right]} \]

\[ \gamma'(c_L) = \frac{4x^*(c_L, p_L)}{(1 - p_L) \left[ \frac{1}{2} (1 - p_L) \gamma(c_L) - \frac{1}{2} \varpi + 4x^*(c_L, p_L) \right]} \]

\[ \Box \]

2.6.2 Family firms and managerial firms

Lemma 6 When the cost of expropriating labor is borne by managers, the shielding effects of corporate law and employment law are interrelated. Specifically

1. If labor protection increases, both the share of wages expropriated by the controlling agent and the share of minority dividends expropriated (by the controlling agent) decrease.

2. If the protection of minority shareholders increases, both the share of wages expropriated by the controlling shareholder and the share of minority dividends expropriated (by the controlling agent) decrease.

3. If private losses of worker expropriation (\( \alpha \)) increase, there is a first order reduction in worker’s expropriation and a second order reduction in shareholder expropriation.

Proof. The first order conditions are

\[ \delta'(c_c) = \frac{1}{1 - p_c} \left[ 1 - \varpi + (1 - p_L) \gamma(c_L) \right] x^*(c_L, p_L) - c_c - c_L \]

\[ \gamma'(c_L) = \frac{2x^*(c_L, p_L) \left( \alpha + \left[ \mathcal{J} + (1 - p_c) \delta(c_c) \right] \right)}{(1 - p_L) \left[ \frac{1}{2} (1 - p_L) \gamma(c_L) - \frac{1}{2} \varpi + 4x^*(c_L, p_L) \right]} \]

\[ \Box \]

2.6.3 “Partnership”

Lemma 7 When the manager bears the cost of expropriating shareholders, but not of labor, there is a partial separation between the bodies of law.
1. If minority shareholder protection increases, then the share of minority dividends expropriated by the controlling agent decreases, but the expropriation of labor is unaffected.

2. On the contrary, is labor protection increases both the share of wages expropriated and the share of minority dividend expropriated decrease.

3. If private losses of shareholders expropriation ($\beta$) increase, there is a first order reduction in worker’s expropriation and a second order reduction in shareholder expropriation.

**Proof.** The maximization problem faced by the manager is

$$
\delta'(c_c) = \frac{1}{1 - p_c} \frac{1}{2} \left[ 1 - \omega + (1 - p_c) \gamma(c_c) \right] x^*(c_c, p_L) - c_c - c_L
$$

$$
\gamma'(c_L) = \frac{4x^*(c_L, p_L)}{(1 - p_L) \left[ \frac{1}{2} (1 - p_L) \gamma(c_L) - \frac{1}{2} \omega + 4x^*(c_L, p_L) \right]}$$

2.6.4 Closely-held family firms and widely-held firms in which managers have pro-shareholder incentives

**Lemma 8** When the firm is a closely held family firm then there is not separation between the two bodies of law. Specifically,

1. if labor protection increases, both the share of wages expropriated by the controlling agent and the share of minority dividends expropriated (by the controlling agent) decrease.

2. if the minority shareholders protection increases, both the share of wages expropriated by the controlling agent and the share of minority dividends expropriated (by the controlling agent) decrease.

3. if private losses of worker expropriation ($\alpha$) increase there is a first order reduction in worker’s expropriation and a second order reduction in shareholder expropriation.

4. if private losses of shareholders expropriation ($\beta$) increase there is a first order reduction in worker’s expropriation and a second order reduction in shareholder expropriation.

**Proof.** The maximization problem faced by the manager is

$$
\delta'(c_c) = \frac{1}{1 - p_c} \frac{1}{2} \left[ 1 - \omega + (1 - p_c) \gamma(c_c) \right] x^*(c_c, p_L) - c_c - c_L
$$

$$
\gamma'(c_L) = \frac{4x^*(c_L, p_L)}{(1 - p_L) \left[ \frac{1}{2} (1 - p_L) \gamma(c_L) - \frac{1}{2} \omega + 4x^*(c_L, p_L) \right]}$$
3 Conclusion

Our paper has attempted to elucidate factors that may eliminate incentives for controlling shareholders and managers to engage in self-dealing behavior to the detriment of minority shareholders and in taking holdup and other opportunities to exploit stakeholders, particularly labor. In particular, the previous literature has often assumed that either managers of Berle- Means firms or large blockholders are better able to provide credible commitment that allows stakeholders to make firm-specific investment. Large ownership stakes may of course create an incentive to exploit labor, since the financial benefit from it is comparatively large. However, the most important factor for both managers or blockholders is private costs of expropriation. For example, the CEO of a managerial firm may enjoy empire-building or social prestige from controlling a large number of employees, which will create a disincentive against holding up labor. Similarly, a blockholding family may enjoy social prestige within the local community, as a result of which they will refrain from exploiting labor’s firm-specific investment. For analytical purposes, we have also extended the concept of costs of expropriation to the exploitation of minority shareholders through private benefits of control. For example, in a family firm, the controlling shareholder member may be reluctant to expropriate his family members because he fears social repercussions.

We have provided an analysis showing different combinations of costs of expropriating minority shareholders and labor. Our future research aims at expanding this approach and linking it to the evidence about different types of firms and cross-country structures of corporate governance.

References


<table>
<thead>
<tr>
<th>Reference</th>
<th>Description</th>
</tr>
</thead>
</table>


