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## ARTICLES

CONTROLLING SHAREHOLDERS  
AND CORPORATE GOVERNANCE:  
COMPLICATING THE COMPARATIVE TAXONOMY

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# CONTROLLING SHAREHOLDERS AND CORPORATE GOVERNANCE: COMPLICATING THE COMPARATIVE TAXONOMY

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*Corporate governance scholarship has shifted focus in recent years from hostile takeovers, which occur primarily in the widely held shareholder systems of the United States and the United Kingdom, to the comparative merits of the “controlling shareholder” systems that are the norm most everywhere else in the world. In this emerging debate, the simple dichotomy between controlling shareholder systems and widely held shareholder systems that has largely dominated the discourse is too coarse to allow a deeper understanding of the diversity of ownership structures in different national capital markets and their policy implications. In this Article, Professor Ronald Gilson seeks to complicate the prevailing analysis of controlling shareholders and corporate governance by developing a more nuanced taxonomy of controlling shareholder structures and examining the implications of this view on our understanding of widely held and controlling shareholder systems. Development of a new taxonomy begins with recognition of the controlling shareholder tradeoff: focused monitoring in return for some private benefits of control and at a cost in speed of adaptation. Building from this tradeoff, this Article looks closely at two central features of a more complex taxonomy: the concepts of controlling shareholders and of private benefits of control. In particular, the framework highlights the value of distinguishing between efficient and inefficient controlling shareholder systems, and between pecuniary and nonpecuniary private benefits of control. Together, the two distinctions reframe the taxonomy of shareholder distribution to distinguish between regimes that support companies with a diversity of shareholder distributions and regimes that support only companies with a controlling shareholder. This Article concludes by examining potential macroeconomic effects and policy implications and calling for research under this new framework to further the debate on controlling shareholder systems.*

## I. INTRODUCTION

The big issue in corporate governance scholarship is changing. Over the last fifteen years, the academic and policy debate has focused on hostile takeovers. The terms and tenor of the debate in the

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United States are by now numbingly familiar. The same pattern is now observable in Europe,<sup>1</sup> where the tone of the debate, if not necessarily its politics, seems to have moderated a great deal.<sup>2</sup>

As the issues surrounding hostile takeovers have clarified, attention has begun to shift from debating a phenomenon — observed largely in the United States and the United Kingdom, because only in those two jurisdictions is control of most public companies in the public float — to understanding the kind of control structure that dominates public corporations everywhere other than the United States and the United Kingdom. Put simply, public companies in the rest of the world typically have a single shareholder or group of shareholders with effective voting control, often but not invariably without corresponding equity holdings. Debate is now turning to the merits of these “controlling shareholder” systems, both on their own terms and in comparison to the “widely held shareholder” systems of the United States and the United Kingdom.

In this Article, I venture some early thoughts concerning how this inquiry might usefully be framed. The simple dichotomy between controlling shareholder systems and widely held shareholder systems that has largely dominated academic debate thus far seems to me much too coarse to allow a deeper understanding of the diversity of ownership structures in different national capital markets and of the policy implications of those structures. My goal here is to complicate the prevailing analysis of controlling shareholders and corporate governance by developing a more nuanced taxonomy of controlling shareholder structures, and then by examining the implications of this view on our understanding of widely held and controlling shareholder systems. Most importantly, I will argue that this familiar dichotomy is simply so coarse as to be wrong. I reach the conclusion, surprising in terms of

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<sup>1</sup> Fifteen years ago, European and American views differed quite dramatically. In the face of the mainstreaming of hostile takeovers in the United States and United Kingdom, Continental Europe had a radically different conception. Two quotations capture the tension of the period. The Chairman of Deutsche Bank described hostile takeovers as one of the “blunders of American capitalism.” Ernst-Ludwig von Thadden, *On the Efficiency of the Market for Corporate Control*, 43 KYKLOS 635, 635 (1990). French President François Mitterrand characterized hostile takeovers as “gangsterism and the law of the strongest.” *Id.*

<sup>2</sup> Marco Becht, an active participant in the European academic debate and a sophisticated observer of the politics of European corporate governance, recently described the now civilized role for hostile takeovers in Europe: “A European market for corporate control is seen as an integral part of a single capital market and a major driver of European competitiveness, innovation and growth.” Marco Becht, *Reciprocity in Takeovers* 11 (European Corporate Governance Inst., Law Working Paper No. 14/2003, 2003), available at <http://ssrn.com/abstract=463003>. To be sure, the European Parliament finally approved the aptly numbered Thirteenth Directive only in a substantially diluted form — the original European Commission proposal would have gone a great deal further in establishing a European market for corporate control — but at least the debate came to be framed in terms of subsidiarity and reciprocity rather than by epithets like “gangsterism.”

the current debate but straightforward in light of a more complicated taxonomy, that the appropriate distinction is between systems that support a diversity of shareholder distributions and systems that essentially support only controlling shareholder distributions. From this perspective, the United States and Sweden, typically thought of as, respectively, the quintessential widely held and controlling shareholder systems, have much more in common with each other than Sweden has with most other controlling shareholder systems.

Important early work on controlling shareholder regimes has taken two general directions. The first, reflected in a series of articles by Professors Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny,<sup>3</sup> linked the breadth of shareholder distribution to the quality of a jurisdiction's law. In this account, controlling shareholder regimes exist in jurisdictions whose legal systems do not protect minority shareholders from dominant shareholders' diversion of private benefits of control. As a result, a controlling shareholder who takes a company public will not part with control; if she does, someone else will purchase control in the market and exploit her. The second direction finds the explanation for concentrated ownership patterns in politics. In an important book, Professor Mark Roe identified social democratic politics as the driving force toward ownership concentration.<sup>4</sup> Where labor, through politics, speaks with a unified voice, capital must concentrate to respond effectively.

While they provide important insights, neither scholarly direction sufficiently explains the patterns of shareholder distribution we observe. As Professor Roe notes, we observe controlling shareholder regimes in jurisdictions with good law, so law cannot completely explain the distribution.<sup>5</sup> At the same time, we observe controlling shareholder regimes in countries without serious social democratic movements, so politics is likely not all of the answer either. Additionally, because both approaches are essentially path dependency accounts — the initial condition, whether quality of law or character of politics, dictates the pattern of shareholder distribution — they lack an efficiency account of the success of some controlling shareholder regimes. As I have argued elsewhere, “the path dependent characteristics of a given national governance system confront the disciplining effects of the operative selection mechanisms. In the end, institutions are shaped by a form of corporate governance plate tectonics, in which the demands of current circumstances grind against the influence of initial

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<sup>3</sup> See sources cited *infra* note 20.

<sup>4</sup> MARK J. ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE: POLITICAL CONTEXT, CORPORATE IMPACT (2003).

<sup>5</sup> *Id.* at 5.

conditions.<sup>6</sup> Thus, a more complete explanation for the distribution of shareholdings must incorporate politics, law, and efficiency, together with the serendipity of each country's initial condition.

My effort to complicate the analysis of controlling shareholders and corporate governance proceeds as follows. Part II sets out some necessary background concerning both the phenomenon to be explained and prior efforts at explanation. Part III provides a framework to structure the analysis: the controlling shareholder tradeoff. Part IV begins to complicate the controlling shareholder taxonomy by defining good law functionally rather than formally, and then distinguishing between two very different kinds of controlling shareholders: efficient and inefficient. The result is to replace the sharp dichotomy between controlling shareholder and widely held shareholder distributions with two more textured categories: controlling shareholder regimes with functionally bad law and regimes that have functionally good law and support a diversity of shareholder distributions. This second group includes both Sweden, which is characterized by companies with controlling shareholders, and the United States, which is characterized by companies with widely held shareholdings. Part V continues the effort at complication by distinguishing between two different kinds of private benefits of control: pecuniary and nonpecuniary. This distinction provides insights into the macroeconomic consequences of even efficient controlling shareholder systems and into the dynamics that influence the systems' stability. Part VI concludes with a brief consideration of some policy implications that arise from a more complicated taxonomy of controlling shareholders.

## II. BACKGROUND: FACTS AND GENERATIONS OF SCHOLARSHIP

At the risk of belaboring a familiar point, it is helpful to start by recounting the actual ownership structure of publicly traded corporations. Over the last ten years, important empirical work has revealed that, excluding the United States and the United Kingdom, the worldwide corporate governance landscape has a monolithic feature: control of publicly traded corporations is typically lodged in a single individual, family, or group.<sup>7</sup> Professor Marco Becht, for example, reports

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<sup>6</sup> Ronald J. Gilson, *Corporate Governance and Economic Efficiency: When Do Institutions Matter?*, 74 WASH. U. L.Q. 327, 332 (1996).

<sup>7</sup> See, e.g., Marco Becht & Colin Mayer, *Introduction to THE CONTROL OF CORPORATE EUROPE* (Fabrizio Barca & Marco Becht eds., 2001); Stijn Claessens, Simeon Djankov & Larry H.P. Lang, *The Separation of Ownership and Control in East Asian Corporations*, 58 J. FIN. ECON. 81 (2000); Mara Faccio & Larry H.P. Lang, *The Ultimate Ownership of Western European Corporations*, 65 J. FIN. ECON. 365 (2002); Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999); Jeremy Grant & Thomas

that 82.5% of German listed companies, 65.8% of Italian listed companies, and 64.2% of Swedish listed companies have a blocking shareholder minority of at least 25%.<sup>8</sup>

Moving the control level up to a majority lowers the percentage of listed companies with a control block to 64.2% in Germany, 56.1% in Italy, and 26.3% in Sweden,<sup>9</sup> but the importance of controlling shareholders remains dramatic. In nine East Asian countries, Professors Stijn Claessens, Simeon Djankov, and Larry H.P. Lang found that a single shareholder has control in more than two-thirds of listed firms.<sup>10</sup>

TABLE 1. CONTROL BLOCKS IN SELECTED COUNTRIES<sup>11</sup>

	Germany	Italy	Sweden	East Asia
Block Controlling $\geq 25\%$	82.5%	65.8%	64.2%	---
Block Controlling $\geq 50\%$	64.2%	56.1%	26.3%	67.8%

It is also commonplace in Europe for control by a dominant shareholder to result from structural devices that leverage voting rights above the level of equity investment. For example, Table 2 shows that 66.1% of listed Swedish companies, 51.2% of listed Swiss companies, 41.4% of listed Italian companies, and 17.6% of listed German companies issue dual classes of common stock, with one class having dramatically higher voting rights.<sup>12</sup> Control also frequently is enhanced

Kirchmaier, Who Governs? Corporate Ownership and Control Structures in Europe (June 7, 2004) (unpublished manuscript), available at <http://ssrn.com/abstract=555877>.

<sup>8</sup> Becht, *supra* note 2, at 19 fig.1 (citing THE CONTROL OF CORPORATE EUROPE, *supra* note 7).

<sup>9</sup> *Id.* at 19 fig.2 (citing THE CONTROL OF CORPORATE EUROPE, *supra* note 7).

<sup>10</sup> Claessens, Djankov & Lang, *supra* note 7, at 92 tbl.3, 93-94.

<sup>11</sup> *Id.*; Becht, *supra* note 2, at 19 fig.2 (citing THE CONTROL OF CORPORATE EUROPE, *supra* note 7). The data for the United States and the United Kingdom are dramatically different. In the United Kingdom, only 15.9% of public companies have a 25% control block, and only 2.4% have a 50% control block. In the United States, the comparable figures are 7.6% and 1.7% for NYSE-listed companies, and 5.2% and 2.0% for NASDAQ-listed companies. Becht, *supra* note 2, at 19 fig.2 (citing THE CONTROL OF CORPORATE EUROPE, *supra* note 7). Of S&P 500 companies, 34% have some amount of founder family ownership, with the holdings averaging 18%. Ronald C. Anderson, Sattar A. Mansi & David M. Reeb, *Founding Family Ownership and the Agency Cost of Debt*, 68 J. FIN. ECON. 263, 269 (2003); see also Randall Morck & Bernard Yeung, *Family Control and the Rent-Seeking Society*, 28 ENTREPRENEURSHIP THEORY & PRAC. 391, 392 tbl.1 (2004) (reporting that four of the twenty largest publicly traded corporations in the United States have families with share blocks of 20% or more).

<sup>12</sup> Faccio & Lang, *supra* note 7, at 385-86. The general magnitudes are consistent across sources. See, e.g., *id.*; Morten Bennedsen & Kasper Meisner Nielsen, *The Impact of a Break-*

through the use of pyramids and multiple control chains.<sup>13</sup> The pattern is repeated in East Asia.<sup>14</sup>

TABLE 2. USE OF DUAL CLASS STOCK TO LEVERAGE VOTING RIGHTS<sup>15</sup>

	Sweden	Switzerland	Italy	Germany
Percentage of Listed Companies with Dual Class Stock	66.1%	51.2%	41.4%	17.6%

When faced with the empirical reality that systems in which control of most listed companies is in the public float are the exception rather than the rule, scholars' and policymakers' initial reactions reflected a teleological view of the evolution of capital markets. They saw a U.S./U.K.-style widely held distribution of stock ownership and control as the end point of corporate governance development; progress consisted of accelerating what selection would make inevitable. Although there were some early skeptics who argued for the continued vitality of alternative systems — Professor Masahiko Aoki with respect to “J-model” governance in Japan<sup>16</sup> and Professors Julian Franks and Colin Mayer with respect to “inside systems” in Europe<sup>17</sup> were among the most tenacious — the belief that widely held shareholder systems are superior seemed to influence global policy. A preference for dispersed shareholdings was plainly evident in the International Mone-

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*Through Rule on European Firms*, 17 EUR. J.L. & ECON. 259, 263 tbl.1 (2004). In Sweden, for example, Professor Rolf Skog reports that controlling shareholders in companies with dual class shares have 41% of the votes but only 25% of the equity. Rolf Skog, *The European Union's Proposed Takeover Directive, the “Breakthrough” Rule and the Swedish System of Dual Class Common Stock* 12–13 (2003) (unpublished manuscript, on file with the Harvard Law School Library).

<sup>13</sup> See Faccio & Lang, *supra* note 7, at 390 tbl.8. For example, of the firms in Germany with a family control block of 20%, 14.57% use a pyramid structure to leverage their equity. For Italy, the figure is 20.34%. *Id.* See generally Grant & Kirchmaier, *supra* note 7, at 8, 14–15 (discussing the use of a pyramid structure); Randall Morck, Daniel Wolfenzon & Bernard Yeung, *Corporate Governance, Economic Entrenchment and Growth* 6–36 (Nat'l Bureau of Econ. Research, Working Paper No. 10692, 2004), available at <http://www.nber.org/papers/w10692> (same).

<sup>14</sup> Stijn Claessens et al., *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, 57 J. FIN. 2741, 2742 (2002) (“East Asian firms also show a sharp divergence between cash-flow rights and control rights — that is, the largest shareholder is often able to control a firm's operations with a relatively small direct stake in its cash-flow rights.”).

<sup>15</sup> Faccio & Lang, *supra* note 7, at 385–86.

<sup>16</sup> See Masahiko Aoki, *Toward an Economic Model of the Japanese Firm*, 28 J. ECON. LITERATURE 1 (1990).

<sup>17</sup> See Julian Franks & Colin Mayer, *Capital Markets and Corporate Control: A Study of France, Germany and the UK*, 5 ECON. POL'Y 189 (1990).

tary Fund's and the World Bank's responses to the 1997–1998 East Asian financial crisis; the institutions conditioned financial assistance not just on macroeconomic criteria, but also on corporate governance reform.<sup>18</sup> The same preference also seems to explain the centrality of breakthrough rules in the debate over the European Commission's 2002 proposal for a Thirteenth Directive on takeovers.<sup>19</sup>

In turn, this critical view of controlling shareholder regimes received academic support from a growing “law and finance” literature that sought to reveal the empirical links between the quality of legal regimes on the one hand, and the nature of national capital markets and corporate governance systems on the other.<sup>20</sup> For present purposes, a particular claim is central to these accounts — that a controlling shareholder structure is associated with “bad law.” In jurisdictions in which minority shareholders are not protected from controlling shareholders extracting large private benefits of control, the argument runs, entrepreneurs will not part with control through public offerings for fear of subsequent exploitation by an investor who could assemble control through the market and extract private benefits, unchecked by the legal system. Under this analysis, controlling shareholder systems will be characterized by weak equity markets — too much liquidity tied up in control blocks — and by large differences in the value of controlling and minority blocks as a result of private benefit extraction by the controlling shareholder.

This brings us to an emergent generation of scholarship that stresses two themes. The first, largely positive, argues that the parsi-

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<sup>18</sup> See, e.g., John M. Broder, *Asia Pacific Talks Vow Tough Action on Economic Crisis*, N.Y. TIMES, Nov. 26, 1997, at A1; Timothy Lane et al., *IMF-Supported Programs in Indonesia, Korea, and Thailand: A Preliminary Assessment* 72–73 (Int'l Monetary Fund, Occasional Paper No. 178, 1999), available at <http://www.imf.org/external/pubs/ft/op/op178/OP178.pdf>. Ronald Dore captured something of the tone of this perspective in relation to Japan:

What . . . all these slogans [concerning Japanese capital market reform] add up to is a general belief that (1) the principles according to which the typical neoclassical economics textbook says the economy ought to work are a priori correct principles, (2) those principles are best exemplified in the American economy, (3) the rightness of those principles is further confirmed by American success, and (4) Japan's present plight is not just a cyclical phenomenon and a debt-deflation hangover from the bubble; it is the natural and wholly just retribution visited on Japan for not following those principles.

Ronald Dore, *Japan's Reform Debate: Patriotic Concern or Class Interest? Or Both?*, 25 J. JAPANESE STUD. 65, 66 (1999).

<sup>19</sup> As sent to the European Parliament for approval in 2002, the proposed Thirteenth Directive limited the operation of structural features like dual class common stock with different voting rights when a bidder secured more than 75% of the target's equity. The result would have been to move the European corporate governance environment in the direction of the U.S./U.K. pattern. A more detailed discussion of the Thirteenth Directive appears *infra* pp. 1676–77.

<sup>20</sup> See, e.g., La Porta, Lopez-de-Silanes & Shleifer, *supra* note 7; Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3 (2000); Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998); Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997).



mony of the law and finance taxonomy — which asks only whether a national system is characterized by controlling shareholders — camouflages a much more complicated reality. In fact, countries with good law and countries with bad law both may have controlling shareholder systems.<sup>21</sup> For example, both Mexico (with bad law) and Sweden (with good law) have controlling shareholder systems. Moreover, countries with controlling shareholder systems experience dramatically different levels of private benefit extraction.<sup>22</sup> Mexican controlling shareholders are said to expropriate more than a third of the value of the company, while expropriation by their Swedish counterparts is limited to 1% of company value.<sup>23</sup>

To complicate matters further, controlling shareholders come in different forms — for example, families as opposed to widely held corporations — and hold control through different devices. As we have seen, some controlling shareholders' control is matched by their equity investment, while others' control is leveraged through structural devices like dual class stock and pyramids. Early empirical studies suggest that, at least in some countries, the level of private benefit extraction differs among different types of controlling shareholders. Benefit extraction is lower when the controlling shareholder's stock is widely held than when it is family owned, and when the divergence between control and equity is smaller.<sup>24</sup>

Recognizing the various types of controlling shareholders and their potential for impacting minority shareholders differently gives rise to a second, and as yet more tentative, theme in the new generation of controlling shareholder scholarship: what, after all, is wrong with controlling shareholder systems? Here the concern is normative. If controlling shareholder regimes do not *necessarily* lead to the extraction of large private benefits of control at the expense of minority shareholders, is there really a problem? In turn, this point reads back on the

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<sup>21</sup> See ROE, *supra* note 4. Professor Roe's emphasis on politics as a determinant of shareholder distribution focuses on good law jurisdictions, but it is equally applicable to bad law jurisdictions. The demand for law is, tautologically, politically driven. Thus, as we will see later, there will be a political story in every jurisdiction. For example, political motivations are an important influence on business in countries without a social democratic tradition. See, e.g., Pramuan Bunkanwanicha & Yupana Wiwattanakantang, *Tycoons Turned Leaders: Investigating the Incentives for Holding Public Office* (Oct. 1, 2005) (unpublished manuscript), available at <http://www.fma.org/Chicago/Papers/TycoonsTurnedLeadersMarch2005.pdf> (concluding that Thai companies whose executives become high political officials outperform similar companies).

<sup>22</sup> See *infra* pp. 1654–55.

<sup>23</sup> See Tatiana Nenova, *The Value of Corporate Voting Rights and Control: A Cross-Country Analysis*, 68 J. FIN. ECON. 325, 334 tbl.3 (2003).

<sup>24</sup> See Claessens, Djankov & Lang, *supra* note 7 (discussing divergence between ownership and control in East Asia); Karl V. Lins, *Equity Ownership and Firm Value in Emerging Markets*, 38 J. FIN. & QUANTITATIVE ANALYSIS 159 (2003) (discussing the relationship between shareholder control structure and corporate valuation in a variety of nations).

law and finance lock-in theme. If private benefits of control are so low that controlling shareholders need not fear subsequent dilutive private benefit extraction if they part with control, why do we still observe a pattern of concentrated shareholdings? This theme surfaced clearly in Sweden's energetic defense of its dual class voting structure during the European debate over the Thirteenth Directive.<sup>25</sup>

So where does this recitation of familiar facts and emerging scholarly themes leave us? When the world seems more complicated than what our theory can explain, we probably do not yet understand the world. Put differently, perhaps the mistake is in thinking that the critical factor in understanding corporate governance systems as different as those of Asia, Latin America, Europe, and Scandinavia is their shared controlling shareholder systems broadly defined.<sup>26</sup> And if this is the mistake, then we need a richer taxonomy of controlling shareholder systems than we are currently using. In this Article, I propose a first step in responding to that deficiency by looking more closely at two central features of a more complex taxonomy: the concepts of controlling shareholders and of private benefits of control. Both complications provide useful insights into the role of controlling shareholders in corporate governance, and into the distribution of different shareholder systems across different countries.

### III. A FRAMEWORK FOR ANALYSIS

The first step in complicating the taxonomy of controlling shareholders is to understand what Professor Jeffrey Gordon and I have called the controlling shareholder tradeoff.<sup>27</sup> The role of controlling shareholders lies at the intersection of two elements of the agency problem that is at the core of public corporation governance. The first element is the familiar agency problem that arises from the separation of ownership and control. This problem is the target of governance devices like hostile takeovers and independent directors that have been the focus of so much attention over the last twenty years. While important techniques, these efforts to bridge the separation have significant limitations. Getting the incentives right for independent directors by, for example, paying them enough to secure their full attention may

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<sup>25</sup> See Skog, *supra* note 12.

<sup>26</sup> Tolstoy's complication of the dichotomy between good and bad families captures the point nicely: "Happy families are all alike; every unhappy family is unhappy in its own way." LEO TOLSTOY, *ANNA KARENINA* 3 (Constance Garnett trans., Random House 1939) (1877). While jurisdictions with widely distributed shareholder systems likely share a common set of characteristics, the intuition is that controlling shareholder regimes differ in important ways among themselves.

<sup>27</sup> The following discussion draws on Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785 (2003).

be inconsistent with their independence. Takeovers, in turn, are rather blunt instruments: they are responsive to only some kinds of governance problems,<sup>28</sup> and the large premium necessary for success both emphasizes their large transaction costs and makes them appropriate only for very large problems.

From this perspective, a controlling shareholder may police the management of public corporations better than the standard panoply of market-oriented techniques employed when shareholdings are widely held. This point motivates the efficiency defense of controlling shareholder systems. Because she holds a large equity stake, a controlling shareholder is more likely to have the incentive either to monitor managers effectively or to manage the company itself and, because of proximity and lower information costs, may be able to catch problems earlier. Rather than being the result of functionally bad law, a controlling shareholder system is in this view an alternative to the frictions associated with ameliorating the separation of management and control that inevitably arises from widely held shareholdings.<sup>29</sup>

The second element of the public corporation agency problem is the conflict between a controlling shareholder and noncontrolling shareholders over the extraction of private benefits of control — benefits to the controlling shareholder not provided to the minority shareholders (and that drive the bad law/controlling shareholder regime nexus). Thus, controlling shareholder monitoring as a means to ameliorate managerial agency problems also comes with frictions. Conditional on maintaining control, the less equity the controlling shareholder has, the greater the incentive to extract private benefits; increased productivity accrues to shareholders in proportion to their equity, while private benefits of control are allocated based on governance power. In other words, a controlling shareholder may increase productivity by effectively managing the company or by effectively monitoring managers, but also may take more than her share of the gain.<sup>30</sup> As we see in Part

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<sup>28</sup> For example, the hostile takeover may be an effective device for breaking up inefficient conglomerates that require a purchaser to possess little internal information. In contrast, takeovers may be less effective in fixing the problems of a single business requiring deep local knowledge of the business that may not be available to an outside owner.

<sup>29</sup> This view is consistent with empirical findings that firm value increases with the level of inside ownership, at least over the lower ranges. See, e.g., Rafael La Porta et al., *Investor Protection and Corporate Valuation*, 57 J. FIN. 1147 (2002); John J. McConnell & Henri Servaes, *Additional Evidence on Equity Ownership and Corporate Value*, 27 J. FIN. ECON. 595 (1990); Randall Morck, Andrei Shleifer & Robert W. Vishny, *Management Ownership and Market Valuation*, 20 J. FIN. ECON. 293 (1988).

<sup>30</sup> This view is consistent with empirical findings that firm value decreases with the difference between equity ownership and voting control. See, e.g., Claessens, Djankov & Lang, *supra* note 7; Lins, *supra* note 24; Paul Gompers, Joy Ishii & Andrew Metrick, *Incentives vs. Control: An Analysis of U.S. Dual-Class Companies* (Nat'l Bureau of Econ. Research, Working Paper No. 10240, 2004), available at <http://www.nber.org/papers/wq10240>.

IV, leveraged control may create an incentive to adopt strategies that reduce productivity when private benefits of control are increased sufficiently.

While these two elements appear distinct, there is a point of tangency between them. Because controlling shareholders must bear the direct costs of monitoring, liquidity, and nondiversification from holding a concentrated position, some private benefits of control likely are necessary to induce a party to play that role. Thus, from the viewpoint of public shareholders, the two elements of the corporate agency problem present a tradeoff. Public shareholders will prefer a controlling shareholder as long as the benefits from the reduction in managerial agency costs exceed the detriment of the controlling shareholder's extraction of private benefits.

Framing the controlling shareholder structure as an alternative to governance techniques such as independent directors and takeovers, the attraction of which depends on a tradeoff between increased monitoring and increased private benefit extraction, provides a framework to understand better the complexity of controlling shareholder systems and the role of law. Different law may result in particular controlling shareholder systems having very different costs and benefits.

#### IV. COMPLICATING THE CONTROLLING SHAREHOLDER TAXONOMY: DIFFERENT KINDS OF CONTROLLING SHAREHOLDERS

The central implication of the controlling shareholder tradeoff framework is that simply having a controlling shareholder governance system is too general an observation to tell us very much. To be frank, it is hardly a startling intuition that a taxonomy that divides the world into two categories — the United States and the United Kingdom on the one hand, and everyone else on the other — does not tell us very much about the rest of the world. The payoff has to come from the complications that follow.

A first cut at a more complicated taxonomy recognizes that a national pattern of concentrated control of publicly traded corporations can be consistent with two very different equilibria. First, the ownership pattern may reflect a structure of *inefficient* controlling shareholders, in which bad law allows the cost of private benefit extraction to exceed the benefits of more focused monitoring of management — minority shareholders are net worse off from the controlling shareholder's monitoring effort. Alternatively, the ownership pattern may reflect a structure of *efficient* controlling shareholders, in which good law helps the benefits of more focused monitoring exceed the costs of private benefit extraction — minority shareholders are net better off from the controlling shareholder's monitoring effort. From this per-

spective, an inefficient controlling shareholder regime is a drag on the financial system, while an efficient controlling shareholder regime can be a preferred alternative to market-based monitoring.

This first step toward a more complex typology proves to have a good deal of explanatory value. Without the ambition of being exhaustive, I survey the implications that follow from distinguishing between inefficient and efficient controlling shareholder systems in the remainder of this Part.

### *A. Inefficient and Efficient Controlling Shareholder Systems and the Quality of Law*

First, a more complex taxonomy provides a context for understanding the more nuanced empirical studies of controlling shareholder systems and, in particular, how different legal and quasi-legal institutions support varying ownership patterns. For purposes of this inquiry, I have in mind a legal realist's concept of law that is broader than typically reflected in the law and finance literature. Good law limits private benefits of control to amounts that are smaller than the increased productivity from more focused monitoring. To accomplish this outcome, good law must specify substantive standards, require sufficient disclosure that those with the power to enforce the standards know of violations, and provide an effective enforcement process.<sup>31</sup>

Such a regime can be accomplished through detailed legislation, as with European laws governing corporate groups,<sup>32</sup> or by judicially developed principles of fiduciary duty, as in the United States.<sup>33</sup> In turn, standard setting can be accomplished by formal legal rules or, as is particularly important in the United Kingdom, through private regulatory organizations. Further, interactions with other social institutions can influence the effectiveness of legal rules. For example, social norms and the effectiveness of enforcement facilitate the specification of substantive standards. (The operation of one's conscience has particularly low transaction costs.)<sup>34</sup> Similarly, an energetic and uncen-

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<sup>31</sup> See Bernard Black, *The Core Institutions that Support Strong Security Markets*, 55 BUS. L. 1565, 1586–92 (2000).

<sup>32</sup> See, e.g., GROUPS OF COMPANIES IN THE EEC (Eddy Wymeersch ed., 1993).

<sup>33</sup> Vice Chancellor Strine's review of the behavior of Lord Black, the controlling shareholder of Hollinger, Inc., is a good example of judicial standard-setting. See *Hollinger Int'l, Inc. v. Black*, 844 A.2d 1022 (Del. Ch. 2004).

<sup>34</sup> See John C. Coffee, Jr., *Do Norms Matter? A Cross-Country Examination*, 149 U. PA. L. REV. 2151 (2001). Economists have examined this intuition empirically by studying the impact of differences between countries' dominant religions — presumably a powerful source of norms — on economic growth. See Rafael La Porta et al., *Trust in Large Organizations*, 87 AM. ECON. REV. 333, 336–37 (1997).

sored press is complementary to the formal disclosure process.<sup>35</sup> Although it is relatively easy to describe the requirements of good law in this broader functional sense, it is much more difficult to capture empirically except through simple backward induction<sup>36</sup> — countries with low private benefits of control must have functionally good law.<sup>37</sup>

Now recall that the initial claim made in the law and finance literature is that controlling shareholder systems are associated with functionally bad law: entrepreneurs retain control to protect themselves against private benefit extraction by someone who might subsequently assemble control if the existing controller gave it up. Having retained control, the entrepreneur then exploits it by extracting private benefits of control. This framework has clear empirical implications. In inefficient controlling shareholder systems, (1) the value of controlling shares should be dramatically greater than minority shares; and (2) the extent of private benefits will decrease with the amount of the controlling shareholders' equity holdings and increase with the difference between percentage of control and percentage of equity. In contrast, efficient controlling shareholder systems will be characterized by functionally good law: that is, law and related social institutions that effectively limit private benefit extraction to an amount sufficient to compensate a controlling shareholder for the costs of focused monitoring, but less than the benefit all shareholders receive from such monitoring. Thus, in efficient controlling shareholder systems (3) the value of controlling shares will exceed that of minority shares by a much smaller amount than in inefficient controlling shareholder systems.

The new generation of scholarship supports all three implications of the controlling shareholder tradeoff framework. The level of private benefit extraction should be reflected in the difference in value between controlling and minority shares; only the value of controlling shares includes the net present value of expected private benefits of control. As shown in Table 3 below, the level of private benefit extraction is large in functionally bad law regimes whether measured by the

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<sup>35</sup> See Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537, 577, 582, 586 (2004).

<sup>36</sup> For example, Professors Alexander Dyck and Luigi Zingales argue that a strong press is an alternative to good law; it may fill gaps in the formal disclosure regime and, by publicizing norm-violating conduct, fill gaps in the formal enforcement regime through public shaming. See *id.* Here I note simply that the public press is itself much more effective when there is an effective legal disclosure regime. Thus, one may reason backwards from the presence of an effective press to the existence of an effective disclosure regime.

<sup>37</sup> While the discussion in the text defines good law and bad law by reference to protection of minority shareholders from a controlling shareholder, one can also identify bad law for widely held shareholder systems. For example, takeover law that allows target directors to resist a takeover is bad law for widely held companies and irrelevant for controlling shareholder companies except to the extent that it reduces the value of widely held companies relative to companies with a controlling shareholder.

difference between the market price of high-voting and low-voting shares,<sup>38</sup> or by the size of the premium paid for a controlling block of shares.<sup>39</sup> Measured by market price differential, control represents approximately 36% of firm value in Mexico, 29% in Italy, and only 1% in Sweden.<sup>40</sup> Measured by the size of block premium to the value of firm equity, control represents 34% of firm value in Mexico, 37% in Italy, and 7% in Sweden.<sup>41</sup> Mexico and Italy are typically characterized as bad law states and Sweden as a good law state. The studies presenting each measurement method conclude that differences in the quality of law account for a large portion of the difference between countries.<sup>42</sup>

TABLE 3. PRIVATE BENEFIT EXTRACTION IN CONTROLLING SHAREHOLDER REGIMES<sup>43</sup>

	MEXICO	ITALY	SWEDEN
PBC Measured by Difference in Market Price	36%	29%	1%
PBC Measured by Control Block Premium	34%	37%	7%

A recent study of Southeast Asian countries, also characterized as having functionally bad law, provides empirical support for the relationship between the extent of private benefit extraction and both the size of controlling shareholders' equity holdings and the size of the difference between equity ownership and control. In systems in which controlling shareholder companies dominate, firm value increases with the equity share of the largest shareholder and decreases with the size of the difference between control rights and equity holdings.<sup>44</sup>

Finally, the link between the level of private benefit extraction and the quality of law appears in the results of another empirical strategy. A recent study of large publicly traded companies in South Korea, a

<sup>38</sup> Nenova, *supra* note 23, at 334–35 tbl.3.

<sup>39</sup> Dyck & Zingales, *supra* note 35, at 551 tbl.II.

<sup>40</sup> Nenova, *supra* note 23, at 334–35 tbl.3.

<sup>41</sup> Dyck & Zingales, *supra* note 35, at 551 tbl.II.

<sup>42</sup> *See id.* at 590; Nenova, *supra* note 23, at 348–49.

<sup>43</sup> Dyck & Zingales, *supra* note 35, at 551 tbl.II; Nenova, *supra* note 23, at 334–35 tbl.3. Private benefits of control in the United Kingdom and United States are less than 1% whether measured by difference in market price or premium for control blocks. *See* Dyck & Zingales, *supra* note 35, at 551 tbl.II; Nenova, *supra* note 23, at 334–35 tbl.3.

<sup>44</sup> *See* Claessens et al., *supra* note 14.

jurisdiction characterized by a controlling shareholder system, tracked the impact of a legal reform mandating a majority of independent directors — that is, a reform that added a component of good law. Controlling for measures of productivity and all other governance characteristics, Professors Bernard Black, Hasung Jang, and Woochan Kim found that large firms with a majority of outside directors, as required by the change in South Korean law, experienced a 40% increase in stock price.<sup>45</sup> Of particular significance, the increase in stock price did not result from increased firm productivity; companies did not become more productive because of the increase in the number of independent directors. Rather, the presence of a majority of outside directors appears to have caused the market to value more highly the company's existing cash flow. The authors interpret their results as showing the potential importance of outside directors — that is, functionally good law — in controlling private benefit extraction by controlling shareholders: “[Higher share prices] could be because outside directors may help to control self-dealing by insiders, which historically has been a serious problem in Korea.”<sup>46</sup>

In short, the controlling shareholder tradeoff framework implies a different relationship between the quality of law and controlling shareholder regimes. As a first step, this section demonstrates that the quality of law distinguishes between types of controlling shareholder regimes: functionally good law supports efficient controlling shareholder systems, while functionally bad law supports inefficient controlling shareholder systems. As a second step, in section IV.B I show that

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<sup>45</sup> See Bernard S. Black, Hasung Jang & Woochan Kim, *Does Corporate Governance Predict Firms' Market Values? Evidence from Korea*, 22 J.L. ECON. & ORG. (forthcoming Oct. 2006) (manuscript at 2), available at <http://ssrn.com/abstract=311275>. The authors do not address why the legal improvement actually worked. In a country like South Korea, where a controlling shareholder structure is commonplace and private benefits of control are large, one would expect that the new outside directors would not bring to their new job a commitment to constraining a pattern that was commonplace in the business community. Thus, while the empirical support for the important role of outside directors is strong, the explanation for that role remains interestingly ambiguous.

<sup>46</sup> *Id.* at 36. Making the same point a little differently, the authors state: “We do not find strong evidence that better governed firms are more profitable or pay higher dividends. Instead, investors appear to value the same earnings or the same current dividends more highly for better-governed firms.” *Id.* at 3. A similar result emerges in a recent study of market valuation of research and development investments in Europe. Professors Bronwyn Hall and Raffaele Oriani report that research and development investments by publicly traded Italian firms are not as highly valued by the market as similar investments by German and French firms. Bronwyn H. Hall & Raffaele Oriani, *Does the Market Value R&D Investment by European Firms? Evidence from a Panel of Manufacturing Firms in France, Germany, and Italy* 4–5 (Nat'l Bureau of Econ. Research, Working Paper No. 10408, 2004), available at <http://papers.nber.org/papers/w10408>. The authors attribute the difference to the potential for Italian controlling shareholders to appropriate the returns on the research and development investments. *Id.* at 5. The authors report that they “found a positive relationship between R&D and market value only after controlling for the eventual control by the major shareholder.” *Id.* at 23.



an efficient controlling shareholder system supports a diversity of shareholder distributions, including both companies with a controlling shareholder and companies with widely distributed shareholders, while an inefficient controlling shareholder system only supports companies with a controlling shareholder. As a third step, in section IV.C, I argue that this understanding of the relationship between quality of law and the character of a country's shareholder distribution undercuts the usual distinction between widely held and controlling shareholder regimes.

### *B. Functional Convergence and Diversity of Shareholding Concentration*

In an efficient controlling shareholder system, concentration of control operates as a cost-effective response to the managerial agency cost problem. It is observed when the benefits of more focused monitoring exceed the limited extraction of private benefits of control allowed in a country with functionally good law. This represents a form of functional convergence — within limits, different corporate governance systems may solve the same monitoring problem through different institutions.<sup>47</sup>

We can also expect diversity — different firm-level ownership patterns — within the same efficient controlling shareholder system. The efficiency advantages of having a controlling shareholder in a system with good law — a system that minimizes the potential for private benefit extraction — depend on the value gain that results from more focused monitoring of management performance than is possible with market-based techniques like independent directors and the market for corporate control.<sup>48</sup> Following Professors Harold Demsetz and Kenneth Lehn, the size of this value gain should in turn be sensitive to dif-

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<sup>47</sup> See Ronald J. Gilson, *Corporate Governance and Economic Efficiency*, 74 WASH. U. L.Q. 327, 332–33 (1996) [hereinafter Gilson, *Economic Efficiency*]; Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329, 332–33 (2001) [hereinafter Gilson, *Globalizing*]. For example, a controlling shareholder's extraction of private benefits of control can be constrained by rules against self-dealing, or by a mandatory bid rule that forces the controlling shareholder to increase its equity ownership and thereby decrease the lure of benefits distributed based on control rather than equity. Gilson, *Globalizing*, *supra*, at 336–37. Note also how this account intersects with Professor Mark Roe's political account of concentrated ownership. See ROE, *supra* note 4, at 16–25. Professor Roe explains why the politics of a particular country may lead to concentrated ownership. The efficiency account here helps explain why concentrated ownership regimes in some countries succeed economically and those in others do not — politics alone does not explain this difference.

<sup>48</sup> The focus on the benefits of monitoring performance rather than merely the costs of private benefit extraction distinguishes this discussion from that of Mike Burkart, Fausto Panunzi & Andrei Shleifer, *Family Firms*, 58 J. FIN. 2167 (2003), which treats monitoring as extending principally to the consumption of private benefits by a nonowner manager.

ferences in industry, companies, and controlling shareholders.<sup>49</sup> For example, focused monitoring by a controlling shareholder may have no comparative advantage over market-based monitoring when competition in the product market is sufficiently intense. In high technology industries characterized by intense product market competition and rapid technological change, we may observe companies with widely distributed shareholdings even in an efficient controlling shareholder system. These alternative monitoring techniques make even limited private benefit extraction unnecessary to pay for more focused monitoring.<sup>50</sup> Similarly, a firm's industrial organization may influence the effectiveness of different monitoring systems. Large private benefits of control require a mechanism to move large amounts of funds. The easiest way, short of simple theft, is to use transfer pricing favorable to the company in which the controlling shareholder has the larger equity interest. A controlled group of firms whose businesses do not lend themselves to intragroup supply transactions may credibly signal that private benefits of control are low.<sup>51</sup> This technique would be especially important to a company in a bad law country that did not wish to extract private benefits of control. A signal of this type depends on industrial organization, not on the legal system.

Diversity also may result from differences between particular controlling shareholders with respect to their taste for, or skill at, focused monitoring. Such differences may tip the balance between a controlling shareholder distribution and a widely held shareholder distribution for a particular company, so that some diversity of shareholder distribution may exist in an efficient controlling shareholder system even within the same industry. Thus, the controlling shareholder tradeoff framework predicts diversity of ownership structures within

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<sup>49</sup> See Harold Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 J.L. & ECON. 375 (1983); Harold Demsetz & Kenneth Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 J. POL. ECON. 1155 (1985) (finding breadth of shareholder distribution endogenous to the corporation's productive activity).

<sup>50</sup> For discussion of product market competition as a monitoring mechanism, see Mark J. Roe, *Rents and Their Corporate Consequences*, 53 STAN. L. REV. 1463 (2001), and Dyck & Zingales, *supra* note 35.

<sup>51</sup> It is important to stress that the signal's credibility depends on the structure of the controlled group rather than on the quality of a country's law. As a result, the technique is available to companies in inefficient controlling shareholder regimes. While the absence of intragroup transfers reduces the potential for private benefits of control, such transfers can also take place through "bail-out" mergers among companies in which the controlling shareholder owns more of a poorly performing target company than she does of the better performing acquiring company. See Kee-Hong Bae, Jun-Koo Kang & Jin-Mo Kim, *Tunneling or Value Added? Evidence from Mergers by Korean Business Groups*, 57 J. FIN. 2695 (2002) (adducing evidence of value transfers to controlling shareholders in mergers within Korean business groups, or *chaebols*).

an efficient controlling shareholder system. We should see companies with both controlling shareholders and widely held shares.<sup>52</sup>

In contrast, the controlling shareholder tradeoff framework predicts much less diversity of ownership structures within an inefficient controlling shareholder system. In the absence of constraints on pecuniary private benefit extraction by a subsequent acquirer of control, an existing controlling shareholder cannot part with control without running the risk of subsequent exploitation. The only viable strategy for a controlling shareholder who lacks the taste for control would then be to sell control to someone who would more effectively use that control, rather than dissipate control through a public offering. To be sure, this analysis does not rule out the presence of any widely held companies in an inefficient controlling shareholder regime. For example, companies that begin as widely held, perhaps through privatization, may survive, especially if the nature of the business restricts the opportunities for transferring value to a controlling shareholder. Nonetheless, we would expect there to be less diversity of shareholder distribution among companies in an inefficient controlling shareholder system than in an efficient controlling shareholder system.

TABLE 4. DISTRIBUTION OF CONTROLLING SHAREHOLDER AND WIDELY HELD COMPANIES IN SWEDEN AND ITALY<sup>53</sup>

	CONTROLLING SHAREHOLDER (FAMILY)	WIDELY HELD
Sweden	46.94%	39.18%
Italy	59.61%	12.98%

The available data support this prediction. Table 4 shows the percentage of widely held and family-controlled public corporations in Sweden, an efficient controlling shareholder system, and in Italy, an inefficient controlling shareholder system. While Sweden exhibits rough parity between publicly traded companies with a controlling shareholder and those with widely held shareholder structures, Italy

<sup>52</sup> Part V takes up in greater detail the importance of differences in tastes among controlling shareholders in an efficient controlling shareholder system.

<sup>53</sup> Mara Faccio & Larry H.P. Lang, *The Ultimate Ownership of Western European Corporations*, 65 J. FIN. ECON. 365, 379 tbl.3 (2002).

has close to five times more companies with controlling shareholders than companies whose shares are widely held.<sup>54</sup>

*C. Diversity and Recasting the Dichotomy Between Controlling Shareholder and Widely Held Shareholder Systems*

As I describe at the outset of this Article, the main theme of the new comparative corporate governance debate has been the difference between systems characterized by companies with controlling shareholders and systems characterized by companies whose shares are widely held. Recognizing that different distributions of shareholdings coexist in functionally good law jurisdictions calls into question the usefulness (and accuracy) of this central feature of the comparative taxonomy. In this standard framework, the United States is treated as the quintessential widely distributed system. However, the United States also has a large number of corporations with controlling shareholders. Most prominently as of late, both Google and Dreamworks went public with “Swedish” capital structures — the founders retained stock with many times the voting power of the class of common stock sold to the public.<sup>55</sup> Recent research indicates that in 1998 there were 255 U.S. publicly traded companies with dual class stock,<sup>56</sup> and that 34% of the S&P 500 companies have founder family equity ownership with average holdings of 18%.<sup>57</sup> From this perspective, the United States and Sweden no longer fall on opposite sides of a widely held/controlling shareholder dichotomy, but represent points on a single functionally good law continuum, with the placement of a jurisdiction at any point in time reflecting the particular history of the jurisdiction and the current dynamics of industrial organization and capital markets.

The idea that the appropriate taxonomic line is between countries whose systems support companies with diverse patterns of share dis-

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<sup>54</sup> Participants in Italian workshops where an earlier draft of this Article was presented expressed skepticism that as many as 12.98% of Italian public companies were widely held. A common argument was that the companies included in this number were either newly privatized entities whose special structure prevented the aggregation of control from the outside, or companies in which there was a de facto controlling shareholder whose identity and control arrangements did not appear in the public records.

<sup>55</sup> See Dreamworks Animation SKG, Inc., Registration Statement (Form S-1), at 89 (July 21, 2004), available at <http://www.sec.gov/Archives/edgar/data/1297401/000095012304008590/y98977sv1.htm> (stating that class B shares receive fifteen votes per share; class A and class C shares receive one vote per share); Google Inc., Registration Statement (Form S-1), at 86 (Apr. 29, 2004), available at <http://www.sec.gov/Archives/edgar/data/1288776/000119312504073639/ds1.htm> (stating that class B shares receive ten votes per share; class A shares receive one vote per share).

<sup>56</sup> Gompers, Ishii & Metrick, *supra* note 30, at 26 tbl.3.

<sup>57</sup> Anderson, Mansi & Reeb, *supra* note 11, at 269; see also Morck & Yeung, *supra* note 11, at 392 tbl.1 (reporting that 20% of large U.S. publicly traded firms have families with shareholdings of 20% or greater).

tributions on the one hand, and inefficient controlling shareholder systems on the other, finds further support in empirical research. Data suggest that companies with controlling shareholders, and especially family controlling shareholders, perform worse than comparable widely held companies in inefficient controlling shareholder systems,<sup>58</sup> but better than comparable widely held companies in efficient controlling shareholder systems, at least when the family member involved in the company's operations is the founder rather than an heir.<sup>59</sup> This outcome is consistent with the controlling shareholder tradeoff developed in Part III. Where functionally good law constrains the level of private benefits of control, minority shareholders benefit from a controlling shareholder's more focused monitoring, leading to better performance. Absent constraints on private benefits, minority shareholders are net worse off with a controlling shareholder. In countries in which good law supports diverse patterns of shareholding, the cost of a controlling shareholder increases when power shifts from the founder to an heir. Yet this is not a problem of the legal system, but a regression to the mean in the talents of the founders' families.

#### V. COMPLICATING THE CONTROLLING SHAREHOLDER TAXONOMY: PECUNIARY VERSUS NONPECUNIARY PRIVATE BENEFITS OF CONTROL

In Part IV, I extend the standard good law/bad law account of controlling shareholder systems by complicating the taxonomy to distinguish between efficient and inefficient controlling shareholder systems. I argue that an efficient controlling shareholder system has much more in common with a widely held shareholder system than with an inefficient controlling shareholder system: both widely held and efficient controlling shareholder systems support diversity in shareholder distributions among companies, while an inefficient controlling shareholder system does not. While this analysis puts the United States and Sweden on the same side of a functionally good/functionally bad law divide rather than on opposite sides of a divide based on the prevalence of controlling shareholders, there remains the question of the differences between the two systems. While we observe controlling shareholders in both systems, publicly held Swedish companies are characterized by controlling shareholders but U.S. public companies are characterized by widely held shareholdings.

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<sup>58</sup> Morck, Wolfenzon & Yeung, *supra* note 13; Mara Faccio, Larry H.P. Lang & Leslie Young, *Dividends and Expropriation*, 91 AM. ECON. REV. 54, 71-72 (2001).

<sup>59</sup> See Anderson, Mansi & Reeb, *supra* note 11, at 265; Ronald C. Anderson & David M. Reeb, *Founding-Family Ownership and Firm Performance: Evidence from the S&P 500*, 58 J. FIN. 1301, 1303 (2003); Morck, Wolfenzon & Yeung, *supra* note 13, at 15-17.

At this point, however, the good law/bad law distinction has exhausted its explanatory power. Within the spectrum of good law systems, we must look to other factors to explain the distribution of shareholdings. To some extent, the characteristics of particular companies may explain the distribution on a company-by-company, industry-by-industry basis. In some industries and in some circumstances, a controlling shareholder structure may be superior. In others, a widely held shareholder structure may prove advantageous. Finally, the two patterns of shareholdings may in some circumstances be functional substitutes; that is, they may have equivalent monitoring capacity. In the absence of extremely competitive markets and rapid technological or market change, the domain over which the two patterns are substitutes may be substantial.

In that circumstance, the ultimate outcome may be path dependent; that is, the pattern that develops will turn on a set of initial conditions driven by factors other than efficiency, and with the passage of time will prove costly to change even if a different pattern later becomes more efficient.<sup>60</sup> So, for example, recent studies of the origins of the shareholding patterns in the United Kingdom and Sweden, both functionally good law jurisdictions, stress local, nonefficiency factors as explanations for each jurisdiction's path toward a widely held or controlling shareholder system.<sup>61</sup> Once on that path, given a system of

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<sup>60</sup> The application of a path dependency analysis to explain differences in industrial organization dates to MICHAEL J. PIORE & CHARLES F. SABEL, *THE SECOND INDUSTRIAL DIVIDE* (1984), which sought to explain the U.S. pattern of mass production and the European pattern of smaller team-oriented organization based on nonefficiency grounds. For applications in the corporate governance context, see Lucian Arye Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 *STAN. L. REV.* 127 (1999).

<sup>61</sup> See Julian R. Franks, Colin Mayer & Stefano Rossi, *The Origination and Evolution of Ownership and Control* (Ctr. for Econ. Policy Research, Discussion Paper No. 3822, 2003), available at <http://ssrn.com/abstract=404720> ("[T]he U.K. is fundamentally different from most other countries."); Peter Högfeldt, *The History and Politics of Corporate Ownership in Sweden* (European Corporate Governance Inst., Finance Working Paper No. 30/2003, 2004), available at <http://ssrn.com/abstract=449460> (finding Sweden's shareholding pattern to be the result of a coalition between labor and family owners to socialize capital without public ownership). U.K. shareholding patterns resulted from the implicit contracts enforced by informal relations of trust and confidence that encouraged participation of largely local outside investors. Franks, Mayer & Rossi, *supra*; see also Brian R. Cheffins, *Are Good Managers Required for a Separation of Ownership and Control?*, 13 *INDUS. & CORP. CHANGE* 591 (2004); Brian R. Cheffins, *Law as Bedrock: The Foundations of an Economy Dominated by Widely Held Public Companies*, 23 *OXFORD J. LEGAL STUD.* 1, 12-14 (2003) (arguing that institutions other than the legal system promoted the widely held shareholding pattern in the United Kingdom). In both cases, the path dependency story is quite different than the law and finance story. In the law and finance account, the existence of good law gives rise to widely held and efficient controlling shareholder systems. In these path dependent accounts, the direction of causation is reversed, with initial serendipity giving rise to a shareholding pattern that then demands good law. In the Swedish case, once politics allowed the leading families to lock in control, a demand arose to assure that the locked-in controllers did not steal. See Högfeldt, *supra*. Professor John Coffee argues persuasively that this was the direc-

functionally good law, there is little to cause a change. Both systems support efficient production and will persist unless significant environmental changes or, as we will see, firm-specific problems substantially alter the balance. For example, in an efficient controlling shareholder system the frictions that hold the pattern in place include the lock-in effect of capital gains taxes on the sale of a controlling position.<sup>62</sup>

A more important determinant, however, grows out of the fact that even if functionally good law keeps the size of pecuniary private benefits of control small, it may do little about nonpecuniary private benefits. This distinction, I argue, is central to understanding the distribution of controlling shareholders and widely distributed shareholdings in a good law system. In particular, persistence in shareholder distribution in efficient controlling shareholder systems will strongly depend on the persistence of controlling shareholder tastes. Thus, the next step is to further complicate the controlling shareholder taxonomy by looking more carefully at the concept of private benefits of control, a central but to this point largely unexplored element of the analysis. Consistent with the vast majority of the existing literature, I have not as yet defined what I mean by private benefits of control. That now needs to change. For present purposes, I want to make a quite simple conceptual distinction, which may turn out to be somewhat less distinct in application, between two kinds of private benefits of control. The first is *pecuniary* private benefits of control; that is, the nonproportional flow of real resources from the company to the controlling shareholder. A familiar example is tunneling accomplished through intercompany dealings whose terms favor the company in which the controlling shareholder has the larger equity stake.<sup>63</sup> The second is *nonpecuniary* private benefits of control; that is, forms of psychic and

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tion of causation in the United States as well. John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 64–68 (2001). In Sweden, the account is consistent with Professor Roe's political theory; in the United Kingdom, it is not. The lesson may be that every country's initial conditions are unique even if the outcomes converge to one of a few patterns; politics affect the initial conditions in some countries but not in others.

<sup>62</sup> Capital gains taxes may reinforce the path dependency of controlling shareholder systems by imposing a substantial charge on a controlling shareholder selling her long-held position even if, in a world without taxes, changes in the economy would cause the controlling shareholder to sell. For example, the desire to restructure the ownership distribution of its corporations led Germany to debate elimination of the capital gains tax on the sale of long-held cross-holdings. See Gilson, *Globalizing*, *supra* note 47, at 340–42.

<sup>63</sup> See Simon Johnson et al., *Tunneling*, 90 AM. ECON. REV. 22, 22–23 (2000). In U.S. corporate law, the concept is similar (although termed “self-dealing”). The highest standard of judicial review is reserved for a transaction in which a controlling shareholder receives something of value to the exclusion and detriment of minority shareholders. See *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971).

other benefits that, without more, involve no transfer of real company resources and do not disproportionately dilute the value of the company's stock to a diversified investor. For example, control of a large company in a small economy may provide a desirable social status for the controlling family.<sup>64</sup>

The existing literature, both analytical and empirical, focuses almost exclusively on pecuniary benefits of control, although typically without acknowledging the distinction between the two categories.<sup>65</sup> This can be seen most clearly in the empirical literature. Whether measured by differences in value between high- and low-voting classes of common stock, or by the premium paid for a control block relative to the value of the entire firm, these amounts reflect the capitalized value of real resources diverted to the controlling shareholder at the expense of minority shareholders.<sup>66</sup> As we have seen, a number of studies show that the market values the same cash flows differently when produced by a company with an inefficient controlling shareholder as opposed to an efficient controlling shareholder.<sup>67</sup> The difference is pecuniary private benefits of control.

Focusing on pecuniary private benefits of control, however, raises a real quandary. The empirical evidence shows very low pecuniary private benefits in efficient controlling shareholder systems. But holding a controlling position imposes costs in illiquidity and lack of diversification on the controlling shareholder, in addition to the actual cost of monitoring. Why then do we ever observe controlling shareholders in countries with functionally good law — namely, those with widely held and efficient controlling shareholder regimes — if controlling shareholders can extract only limited amounts of pecuniary private benefits of control? Unlike in an inefficient controlling shareholder system, in this system controlling shareholders are free to sell their positions without fear of exploitation by a new controller. The answer lies in the realm of nonpecuniary private benefits of control. Almost tautologically, nonpecuniary benefits must play a prominent role in regimes in which functionally good law keeps pecuniary private benefits low.

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<sup>64</sup> A good analogy could be made to the difference between common values and private values in the economics of auctions. In a common value auction, the asset has the same value to all bidders. In a private value auction, the asset's value depends on the bidder. See R. Preston McAfee & John McMillan, *Auctions and Bidding*, 25 J. ECON. LITERATURE 699, 704–05 (1987).

<sup>65</sup> Professors Dyck and Zingales, *supra* note 35, at 542, are notable in that they recognize the difference between the two categories. Their principal aim, however, is only to show the importance of pecuniary private benefits of control — “that not all private benefits are psychic” — rather than to examine the implications of psychic benefits. *Id.* at 590.

<sup>66</sup> See *supra* pp. 1654–55.

<sup>67</sup> See *supra* pp. 1654–55. Professors Black, Jang, and Kim, *supra* note 45, at 9, provide the best example. The same cash flows increase firm market value as a result of an improvement in law that reduces the potential for controlling shareholders to capture pecuniary private benefits.



While a comprehensive exploration of nonpecuniary private benefits of control requires considerably more attention than I can devote here,<sup>68</sup> a hypothetical setting can serve to motivate the analysis. Suppose that a controlling family has a net worth of \$4 billion, all invested in the controlled firm. What does the family's utility function look like? What does the family maximize? Suppose that a potential acquirer will pay a \$300 million premium for the family's controlling interest because the acquirer can increase the company's productivity or capture synergies. The family confronts a tradeoff: control of a major industrial company versus a 7.5% increase in family wealth. Is maintaining the role of leading industrialists in a country, with the social and political access associated with that role, worth more than additional wealth at a point where decreasing marginal returns to wealth must surely have set in?<sup>69</sup>

To generalize the intuition, the existence of private benefits of control means that for the controlling shareholder the separation theorem does not apply; that is, the controlling shareholder's utility is affected by company decisions in ways other than through the decisions' impact on the company's stock price.<sup>70</sup> Thus, maximizing the controlling shareholder's utility may mean something other than maximizing the value of the corporation. As with complicating the concept of a controlling shareholder in Part IV, complicating the concept of private benefits of control has a number of interesting implications.

#### A. *Explaining the Difference Between the United States and Sweden*

The distinction between pecuniary and nonpecuniary private benefits of control helps explain the continuing differences between the incidence of controlling shareholders in the United States and Sweden. The United States is characterized by widely held shareholder distributions, while Sweden is characterized by controlling shareholder distributions, even though in both countries functionally good law supports, and we observe, both patterns of shareholdings. Controlling

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<sup>68</sup> For example, nonpecuniary private benefits of control may sometimes provide both psychic benefits to the controlling shareholder and real benefits to the company (and hence to the minority shareholders). Political influence is a good illustration. The ability to influence political action can provide great personal benefits. At the same time, that influence can also lead to the adoption of government policies beneficial to the company. Data from Thailand, for example, support this dual function. After company executives become high political officials, corporate performance improves relative to that of "unconnected" companies. See Bunkanwanicha & Wiwattanakitang, *supra* note 21.

<sup>69</sup> Professor Bruno Frey's work has been most prominent in stressing the importance of considering nonpecuniary benefits in economic analysis. See BRUNO S. FREY, *NOT JUST FOR THE MONEY: AN ECONOMIC THEORY OF PERSONAL MOTIVATION* (1997).

<sup>70</sup> See Ronald J. Gilson, *Separation and the Function of Corporation Law*, 2 BERKELEY BUS. L.J. 141 (2005) (discussing the role of the separation theorem in corporate law).

shareholders in countries with good law are compensated for the extra costs of their controlling position through nonpecuniary private benefits of control. Thus, the different patterns of shareholdings in the two countries should depend on the potential for such nonpecuniary benefits.

A first observation turns on the relative size of the two economies. Because the Swedish economy is relatively small, a group of fifteen families was sufficient to dominate. Being one of fifteen leading families provides a social and political position for which there is no counterpart in the United States, whose economy is simply too large for a small number of families to play a comparable national role. Neither Warren Buffett nor Bill Gates, for example, looks like an American version of the Swedish Wallenbergs. Thus, in the United States nonpecuniary private benefits of control are likely to be generally smaller and local rather than national, which suggests that we should observe fewer companies with controlling shareholders. The lower level of nonpecuniary benefits of control should also increase the rate at which controlling shareholders and their heirs dissipate control. Entrepreneurial companies making an initial public offering almost always have a controlling shareholder. As we see in section V.B, the rate of reduction in control by the entrepreneurs' heirs increases as the level of nonpecuniary benefits goes down.

A second observation builds on the first. We should observe controlling shareholders in those U.S. industries in which nonpecuniary private benefits of control are likely to be most pronounced. So, for example, one would expect to find controlling shareholders in major newspaper companies because running a major national newspaper puts one at the center of major public and cultural issues, with the potential to influence the outcome. And in fact, companies that operate the *New York Times*, the *Washington Post*, and the *Wall Street Journal* have controlling shareholders.<sup>71</sup> Studies report that a dual class capital structure like that of Dreamworks,<sup>72</sup> designed to facilitate maintenance of control without a controlling share of a company's equity,

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<sup>71</sup> See The Washington Post Co., Proxy Statement (Schedule 14A), at 3, 10 (Mar. 25, 2005), available at <http://www.sec.gov/Archives/edgar/data/104889/000118811205000530/tdef14a-4871.txt> (stating that all class A shares are owned by the descendants of Katharine Graham, who together name seven of ten directors); Dow Jones & Co., Proxy Statement (Schedule 14A), at 36 (Mar. 18, 2005), available at <http://www.sec.gov/Archives/edgar/data/29924/000119312505054765/ddef14a.htm> (stating that family-controlled class B common stock has ten votes per share and common stock has one vote per share); The New York Times Co., Proxy Statement (Schedule 14A), at iii, 4 (Mar. 11, 2005), available at <http://www.sec.gov/Archives/edgar/data/71691/000104746905006126/a2149185zdef14a.htm> (indicating that family-controlled class B common stock selects nine of fourteen directors).

<sup>72</sup> See *supra* p. 1660.

disproportionately occurs in the printing, publishing, and communications industries, as well as in media firms<sup>73</sup> and sports teams.<sup>74</sup>

Thus, the incidence of controlling shareholders in the United States and Sweden, countries in which functionally good law supports both widely held and controlling shareholder distributions, reflects not only the serendipity of where the two countries started,<sup>75</sup> but the potential for continuing nonpecuniary private benefits of control as well.

### *B. Macroeconomic Implications of Nonpecuniary Private Benefits of Control*

The empirical evidence supports the proposition that minority shareholders are not uniquely disadvantaged in an efficient controlling shareholder system. Good law keeps diversion of pecuniary private benefits of control low and, in a reasonably efficient stock market, the costs of these payments for focused monitoring, as well as the risk that the talent of future generations of managers will regress to the mean, will be priced. Unlike in inefficient controlling shareholder systems, here minority shareholders are playing in a basically fair game.

The inquiry, however, does not end with the position of minority shareholders. The significant role for nonpecuniary private benefits of control has macroeconomic effects that impact a country as a whole. I take up three such situations.

Consider first the failure of separation just discussed. Some controlling shareholders' preferences may simply reflect misjudgment or overconfidence. To the extent that the controlling shareholder or her heirs wish to go on directly managing the company, there may be a powerful inclination to overinvest in the company's existing businesses — those with which the family manager is more comfortable — even though other opportunities that require different managerial skills may offer higher returns. Alternatively, the controlling shareholder may prefer to enter new businesses about which she knows little but that are alluring personally; the transformation of the businesses in which companies associated with the Bronfman family engaged — from liquor and oil to entertainment — is an example.<sup>76</sup> To the extent these

<sup>73</sup> Examples include most large U.S. cable television companies. Gompers, Ishii & Metrick, *supra* note 30, at 9–10, 25 tbl.2.

<sup>74</sup> See John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301, 1343 & n.156 (2001); Demsetz & Lehn, *supra* note 49, at 1168–71; Laura Casares Field, *Control Considerations of Newly Public Firms: The Implementation of Antitakeover Provisions and Dual Class Shares Before the IPO 19*, 40 tbl.8 (Feb. 10, 1999) (unpublished manuscript), available at <http://www.ssrn.com/abstract=150488>.

<sup>75</sup> See *supra* p. 1662.

<sup>76</sup> Prior to 1981, Seagram Company Ltd. produced alcoholic beverages. In a series of transactions beginning in 1981, the company diversified, ending up as the largest (24.2%) shareholder of DuPont. In 1995, at the initiative of the next generation of the controlling Bronfman family, Sea-

actions are motivated by nonpecuniary benefits of control, the fact that they reduce value may matter a great deal to the country as a whole even if minority shareholders accurately predict the controlling family's preferences and abilities.

A second implication of the failure of separation relates to the likelihood of declining skills in successive generations of family managers — the operation of the gravity of generations. Even if the risk of underperformance over time is priced, that underperformance still operates as a drag on the economy through the misallocation of resources. Recent empirical work shows that per capita GDP is highly and significantly negatively correlated with the extent of family control over a country's private sector.<sup>77</sup> The underperformance appears to worsen as control passes from founding entrepreneur to heir. Professors Randall Morck, Daniel Wolfenzon, and Bernard Yeung report that Canadian "heir controlled firms are less profitable than otherwise comparable firms in the U.S. and in Canada."<sup>78</sup> Data for Sweden, a functionally good law jurisdiction, appear consistent. Minority share discounts in Swedish family complexes seem related to factors other than pecuniary private benefits of control.<sup>79</sup>

The U.S. data concerning the impact of the shift from founder to heir are more mixed. While an early study suggested that family-owned firms performed worse than widely held firms,<sup>80</sup> recent work is more tentative; it suggests that family-controlled firms may outperform nonfamily-controlled ones, but that the advantage disappears when the heir serves as CEO (although performance remains no worse than that of nonfamily firms).<sup>81</sup> This description is consistent with an efficient

gram sold its DuPont stock back to DuPont and used the proceeds to enter the entertainment business by buying, among other companies, MCA, the owner of Universal Studios. See Anthony Bianco, *Deal Time at Seagram*, BUS. WK., June 26, 2000, at 58, 61, 64.

<sup>77</sup> Morck & Yeung, *supra* note 11, at 393, 394 tbl.2.

<sup>78</sup> Morck, Wolfenzon & Yeung, *supra* note 13, at 16. The result generalizes: countries in which the billionaire heirs' wealth is large relative to GDP grow more slowly than those in which the wealth of the founders is large relative to GDP. Randall K. Morck, David A. Strangelano & Bernard Yeung, *Inherited Wealth, Corporate Control, and Economic Growth: The Canadian Disease?*, in CONCENTRATED CORPORATE OWNERSHIP 319, 319 (Randall K. Morck ed., 2000).

<sup>79</sup> See Martin Holmén & John D. Knopf, *Minority Shareholder Protections and the Private Benefits of Control for Swedish Mergers*, 39 J. FIN. & QUANTITATIVE ANALYSIS 167, 190 (2004) (basing the evidence on intragroup mergers within family-controlled pyramids); Martin Holmén & Peter Högfeldt, *Pyramidal Discounts: Tunneling or Agency Costs?* 9 (European Corporate Governance Inst., Finance Working Paper No. 73/2005, 2005), available at <http://ssrn.com/abstract=676506> (same).

<sup>80</sup> See Randall Morck, Andrei Shleifer & Robert W. Vishny, *Management Ownership and Market Valuation*, 20 J. FIN. ECON. 293, 311 (1988) (concluding that performance of older firms is worse when the firm is run by a member of the founding family).

<sup>81</sup> See Ronald C. Anderson & David M. Reeb, *Founding-Family Ownership and Firm Performance: Evidence from the S&P 500*, 58 J. FIN. 1301, 1303 (2003); see also Ronald C. Anderson & David M. Reeb, *Founding-Family Ownership, Corporate Diversification, and Firm Leverage*, 46

controlling shareholder structure that loses its advantage, but does not deteriorate substantially, when management passes to the next generation. There is a plausible explanation for the difference in performance — both overall and with respect to the slower deterioration after management shifts from founder to heir — between family-controlled and widely held companies in the United States and controlling shareholder firms in other countries with functionally good law (countries that support both widely held and controlling shareholder distributions). The United States, unlike for example Canada or Sweden, is not characterized by pyramid ownership structures through which families control multiple levels of firms. Controlling families in the United States typically do not leverage their equity to control more than one company.<sup>82</sup> Thus, outside the United States, the effect of less skilled heirs managing a company is both exacerbated by the greater difficulty of running a diversified company and multiplied over a larger asset base.

A final implication may be the most significant. As Part IV suggests, efficient controlling shareholder systems have greater diversity in patterns of shareholder distribution. Part of this diversity is positive — driven by the fit between particular companies and industries on the one hand, and the monitoring techniques associated with controlling shareholder or widely held shareholder distributions on the other. But part of this diversity may be negative — reflecting the absence of market pressures on controlling shareholders to respond to changes in the external economic environment and of market mechanisms to impose those changes from the outside when the controlling shareholder fails to respond.

The insulation of the controlling shareholder from market pressure is not always bad. As I have argued previously, “institutions matter when they fit existing industrial technology.”<sup>83</sup> The stability that a controlling shareholder can provide may be quite effective when, as with the happy match between Japanese corporate governance and industrial organization over a large part of the post-War period, it supports firm- and team-specific worker human capital investment, and the industry experiences largely linear technological change.<sup>84</sup> The converse, however, is also true: “[I]nstitutions matter when they do not fit with the industrial technology demanded in a state of the world dif-

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J. L. & ECON. 653, 679 (2003) (demonstrating that U.S. family-controlled firms are less diversified than widely held firms).

<sup>82</sup> Morck, Wolfenzon & Yeung, *supra* note 13, at 6 (“[B]lock holders in the US seldom control more than one corporation.”).

<sup>83</sup> Gilson, *supra* note 6, at 341.

<sup>84</sup> See Ronald J. Gilson & Mark J. Roe, *Lifetime Employment: Labor Peace and the Evolution of Japanese Corporate Governance*, 99 COLUM. L. REV. 508, 508 (1999).

ferent from that which gave rise to the governance institutions in the first place.”<sup>85</sup> When companies and industries must adapt quickly to large and abrupt changes in the economic environment, the stability associated with an efficient controlling shareholder system becomes a barrier to necessary adaptation; in this circumstance, a widely held shareholder system, with control open to the market, likely will be more efficient.<sup>86</sup> In particular, a widely held shareholder system facilitates a dynamic cycle between public and private ownership that polices adaptivity. When a public company experiences managerial underperformance, the private equity market can mount an acquisition through buyout funds that will put into place a highly incentivized, intensively monitored governance structure that is suited to fixing the problem. Then, because the buyout funds typically must liquidate after ten years, the now “fixed” company is taken public again to allow the distribution of liquid assets to the buyout fund’s investors.<sup>87</sup> If it is difficult to design a system with both the adaptivity of a widely held shareholder system and the stability of an efficient controlling shareholder system, the choice will depend on one’s predictions of the future: will the environment be one that favors adaptation or stability? The public/private dynamic found in widely held controlling shareholder systems may serve to balance this tradeoff.

*C. Ameliorating Influence I: The Potential Instability of Efficient Controlling Shareholder Systems*

Some factors work to ameliorate an efficient controlling shareholder system’s insulation from market pressures for change. Precisely because nonpecuniary private benefits are idiosyncratic to the particular controlling shareholder and because the identities of controlling shareholders change with generations, it is plausible to expect changes in the value of the nonpecuniary private benefits of control over time, whether from lifecycle changes, increased wealth within a single generation, or intergenerational changes in tastes or abilities. At some point, the wealth gain from adaptation reflected in a large acquisition

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<sup>85</sup> Gilson, *supra* note 6, at 341.

<sup>86</sup> See *id.* at 336–38; Ronald J. Gilson, *The Political Ecology of Takeovers: Thoughts on Harmonizing the European Corporate Governance Environment*, 61 *FORDHAM L. REV.* 161 (1992). This concern with the barriers to adaptation in efficient controlling shareholder systems recently has received broader attention. See, e.g., HANS TSON SÖDERSTRÖM ET AL., SNS ECONOMIC POLICY GROUP REPORT 2003: CORPORATE GOVERNANCE AND STRUCTURAL CHANGE (Hans Tson Söderström ed., 2003); Raghuram Rajan & Luigi Zingales, *Banks and Markets: The Changing Character of European Finance* (Nat’l Bureau of Econ. Research, Working Paper No. 9595, 2003), available at <http://www.nber.org/papers/w9595>.

<sup>87</sup> See generally RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 398–453 (2d ed. 1995) (describing the structure and operation of private buyout funds).

premium, or an increase in market value from giving up control and hiring professional managers, outweighs the nonpecuniary private benefits of control that a controlling shareholder experiences — a process that can be expected to accelerate as succeeding generations experience greater regression to the mean in managerial skills<sup>88</sup> and as the number of family members actively involved in the company increases.

As a result, efficient controlling shareholder systems will tend to deteriorate simply from the gravity of generations. For example, the recent SNS Economic Policy Group report notes with respect to Sweden that “[o]nly a few of the ‘fifteen families’ who used to dominate Swedish industry remain major owners in a position of control.”<sup>89</sup> To the extent that the deterioration is driven by a control premium that increases with the value that would result from change, the timing of the deterioration at least may be influenced in the direction of efficiency: the greater the efficiency gain from adaptation, the faster the deterioration of the controlling shareholder system.<sup>90</sup>

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<sup>88</sup> See Francesco Caselli & Nicola Gennaioli, *Dynastic Management* (Nat'l Bureau of Econ. Research, Working Paper No. 9442, 2003), available at <http://www.nber.org/papers/w9442> (modeling inefficiency of family control as a function in part of the degree of inheritability of talent across generations).

<sup>89</sup> SÖDERSTRÖM ET AL., *supra* note 86, at 13. Professor Peter Högfeldt describes the extent to which the Wallenberg group in Sweden recently has withdrawn control from a significant number of companies. Högfeldt, *supra* note 61, at 14–15. Speaking of the change in the role of the Wallenberg group, Sweden's deputy finance minister recently described a secular reduction in their and other Swedish family groups:

They [the Wallenbergs] have been enormously important, no doubt. They continue to be quite important, but less important than they were . . . . They are increasingly being challenged by other power centres in the Swedish economy. The dynastic model is unlikely to survive in the years and decades ahead, particularly with the amount of European integration we are now seeing and the efforts to reach a level playing field in the European economy.

Christopher Brown-Humes, *Can the Next Wallenberg Generation Maintain Its Status and Influence?*, FIN. TIMES (London), July 12, 2004, at 13 (alteration and omission in original) (quoting Gunnar Lund) (internal quotation marks omitted). The recent reduction of the disparity in voting rights between stock classes in the Wallenberg company Ericsson, from a ratio of 1000 to 1 to a ratio of 10 to 1, reflects this process. See Press Release, Ericsson, The Work Group Presents a Proposal To Reduce the Differences in Voting Rights in Ericsson to 1:10 (Feb. 19, 2004), available at <http://www.ericsson.com/press/20040219-074630.html>. As a result, the voting rights of Wallenberg entities have been reduced to around 40%. See Högfeldt, *supra* note 61, at 15. Daniel Fristedt and Sven-Ivan Sundqvist show that seven of the ten largest Swedish shareholders are non-family institutions like pension and mutual funds. DANIEL FRISTEDT & SVEN-IVAN SUNDQVIST, OWNERS AND POWER IN SWEDEN'S LISTED COMPANIES 10 (2004). Leading Swedish corporate lawyers confirmed this point anecdotally by lightly remarking that Sweden is still controlled by fifteen people, but these people are now heads of pension funds rather than heads of families. Interview with Gunnar Nord, Robert Ohlsson, and Rolf Skog, in Visby, Swed. (May 2004).

<sup>90</sup> At the same time, the political forces that in Professor Mark Roe's account lead to stable concentrated shareholdings, see ROE, *supra* note 4, may be declining in importance as a result of globalization and the resulting decrease in labor influence. See Brown-Humes, *supra* note 89.

This assessment is consistent with another recent characteristic of the Swedish system. Despite the dominant role of controlling shareholders, Sweden has experienced a high level of takeovers, by definition friendly. Professor Rolf Skog reports that of the 245 Swedish listed companies that were taken over between 1990 and 2002, 157 or 64% had dual class stock with different voting rights, roughly the same percentage as companies with dual class stock among all listed companies.<sup>91</sup> Whether a company had a controlling shareholder, therefore, appeared not to affect the incidence of corporate takeovers. This suggests that the situations in which the size of the offered premium exceeds the controlling shareholder's nonpecuniary benefits of control may track the situations that give rise to takeovers more generally.

*D. Ameliorating Influence II: Public Pressure on Efficient Controlling Shareholders*

There is reason to think that external pressure may operate as a constraint on controlling shareholders. Academics have considered the role of public opinion primarily as a force for reducing pecuniary private benefits of control in bad law countries, essentially as a substitute for an effective legal system.<sup>92</sup> Public opinion-driven policing of nonpecuniary private benefits of control, however, may prove more difficult. For public opinion to operate as a constraint, two conditions are necessary (although not necessarily sufficient). First, the controlling shareholder's conduct must be observable to the public, which is why the most promising empirical study of the role of public opinion as a constraint on private benefits of control uses newspaper circulation as a measure of public opinion.<sup>93</sup> Second, and for present purposes more difficult, there must be a shared public conception that the observed behavior is wrong. This is plausible with respect to pecuniary private benefits of control — the principle that “thou shalt not steal” is surely widely shared, and diversion of company cash flows for the benefit of a controlling shareholder may well be understood as stealing. However, the range of behaviors that provides nonpecuniary private benefits of control may lack the same public consensus. Thus, the extent to which public opinion acts as a constraint on nonpecuniary private benefits of control likely is quite sensitive to the particular manifestation of the private benefit and to local culture. For example, the extent

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<sup>91</sup> Skog, *supra* note 12, at 15.

<sup>92</sup> For example, see Professors Dyck and Zingales, who use the importance of newspapers (circulation per 100,000 inhabitants) as a measure of the force of public opinion in a jurisdiction. Dyck & Zingales, *supra* note 35, at 582–86. They find that one standard deviation increase in circulation reduces the value of control measured by pecuniary private benefits by 6.4%. *See id.*

<sup>93</sup> *Id.* at 582.



to which nepotism is viewed as improper may differ widely among jurisdictions.

More importantly, the characteristics that give rise to nonpecuniary private benefits of control are plainly culturally influenced. For example, the maintenance of family control — the private benefit of being a leading family — may be more highly valued in Asia than it is in the United States. Thus, Asian controlling shareholders may be willing to forgo more potential value to keep control in the family, and the public may be sympathetic to that preference, with the result that a controlling shareholder pattern may persist longer in Asian than in Western countries. To be sure, culture and economics are related in complicated ways. In inefficient controlling shareholder systems, a cultural attribute that assigns great value to the nonpecuniary private benefit of maintaining family control reinforces the economic motivation to maintain control to avoid being exploited later as a noncontrolling shareholder. Conversely, the continued globalization of commerce, which increases the opportunity cost of maintaining family control through forced competition with more efficiently organized companies, will inevitably erode the cultural assessment of the value of control. As yet, however, we know very little about the dynamics of the interaction between culture and economics in determining the sources and relative value of nonpecuniary private benefits of control.

## VI. IMPLICATIONS AND CONCLUSION

In this Article, I argue that a good deal can be learned by looking at the usual taxonomy of controlling shareholders through the framework of the controlling shareholder tradeoff: focused monitoring in return for some private benefits of control and at a cost in speed of adaptation. In particular, the framework highlights the value of distinguishing between efficient and inefficient controlling shareholder systems, and between pecuniary and nonpecuniary private benefits of control. Together, the two distinctions reframe the taxonomy of shareholder distribution to distinguish between regimes that support companies with a diversity of shareholder distributions and regimes that support only companies with a controlling shareholder. I now conclude by briefly considering two policy implications — the first broad, the second narrow — that are suggested by this more complicated controlling shareholder taxonomy.

### *A. Eliminating Inefficient Controlling Shareholder Systems: Better Law or More Market Exposure?*

One straightforward implication of a more complicated taxonomy is the need to eliminate inefficient controlling shareholder systems. This can be attempted by three different, but not mutually inconsistent, strategies. First, an inefficient system can be attacked directly by

improving the legal system to constrain pecuniary private benefits of control to levels that, net of these costs, leave minority shareholders better off as a result of focused monitoring. At that point, the country will have transformed into an efficient controlling shareholder system that is supported by nonpecuniary private benefits of control, which are subject to the ameliorating influences discussed in Part V. Second, an inefficient system can be attacked indirectly by changing legal rules and supporting institutions to increase the exposure of control to the market. Third, improved access to global capital markets may in some circumstances provide a self-correcting market solution for inefficient controlling shareholder systems, acting to dissipate a controlling shareholder's position in just those circumstances when the social costs of underperformance are the greatest.

1. *Improving the Legal System.* — Improving the legal system generally involves eliminating deficiencies in three areas: the standards that make significant pecuniary private benefits of control unlawful; the disclosure process that allows those with the power to enforce the legal standards to observe pecuniary private benefits of control; and the public and private enforcement mechanisms available to prosecute violations. This process can be slow, and it certainly requires a political moment when the public perception of the need for reform outweighs the influence of entrenched inefficient controlling shareholders, but there is some evidence that it can happen.<sup>94</sup>

Recent reform in Italy may be a case in point. Recall that empirical studies show that in Italy private benefits of control amount to as much as 29% to 37% of total firm value.<sup>95</sup> In 1998, Italy adopted legislation that made it significantly easier for minority shareholders to pursue derivative litigation against management appointed by a controlling shareholder.<sup>96</sup> Professors Dyck and Zingales report a dramatic drop in the level of pecuniary private benefits of control after the reform, although the results can only be suggestive given the very small sample.<sup>97</sup> Effective January 1, 2004, Italy implemented substantial

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<sup>94</sup> The Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.), provides an example of how legal reform can increase constraints on pecuniary private benefits of control even in a country with functionally good law. The statute's focus on internal controls and on officer certification, coupled with increased penalties and rigorous enforcement, makes the kind of transfers associated with pecuniary private benefits of control much more difficult.

<sup>95</sup> See *supra* pp. 1654-55.

<sup>96</sup> Article 129 of Decree-Law No. 58, Feb. 24, 1998, Gazz. Uff. No. 71, Mar. 26, 1998, allows shareholders with at least 5% of the outstanding stock to sue the directors on behalf of the corporation. *Id.*; see also Marco Venturuzzo, *Experiments in Comparative Corporate Law: The Recent Italian Reform and the Dubious Virtues of a Market for Rules in the Absence of Effective Regulatory Competition*, 40 TEX. INT'L L.J. 113, 140 (2004).

<sup>97</sup> Dyck & Zingales, *supra* note 35, at 570. Unfortunately, the Dyck and Zingales sample contains only six observations of a controlling shareholder block sale before the 1998 reform, and

additional reforms to its legislation governing groups of companies dominated by a controlling shareholder.<sup>98</sup> In addition to expanding the circumstances in which voting control imposes liability on the controlling shareholder for mismanagement, the legislation imposes broader disclosure obligations for transactions with the controlling shareholder.<sup>99</sup> With respect to decisions actually influenced by the controlling shareholder, the legislation requires disclosure of the reasons behind such decisions.<sup>100</sup> While these reforms do respond to the demands of substantive standards and disclosure necessary to a good law regime, it remains uncertain whether the need for strong enforcement will be met. In the end, the effectiveness of enforcement depends on matters of civil procedure and judicial efficiency, about which commentators have expressed reservations.<sup>101</sup> Further, the enforcement effect of nonjudicial institutions, like the public press, depends on cultural beliefs regarding whether pecuniary private benefits of control are improper.

Notwithstanding the potentially important but still uncertain efforts in Italy, legal reform may move quite slowly in some countries. As may turn out to be the case in Italy, even if legislation states standards of conduct more aggressively and requires more effective disclosure, reform may still founder on the enforcement process.<sup>102</sup> If, for example, a country lacks a sophisticated, independent, and effective court system, it may be a time-consuming process to create one, even if political barriers can be overcome. Without effective enforcement, improved standards and tougher disclosure rules are unlikely to be enough.

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only two after the reform. *Id.* at 570 n.22. Additionally, Professor Marco Ventoruzzo states that the new power to bring a derivative suit had “never been used” as of late 2004. Ventoruzzo, *supra* note 96, at 141.

<sup>98</sup> Decree-Law No. 6, Jan. 17, 2003, Gazz. Uff. No. 17, Jan. 22, 2003; see also Umberto Tombari, *The New Italian Company Law: An Emerging European Model?* (May 2003) (unpublished manuscript, on file with the Harvard Law School Library).

<sup>99</sup> See Guido Ferrarini, Paolo Giudici & Mario Stella Richter, *Company Law Reform in Italy: Real Progress?*, 69 RABELS ZEITSCHRIFT FÜR AUSLÄNDISCHES UND INTERNATIONALES PRIVATRECHT 658, 692 (2005) (F.R.G.).

<sup>100</sup> *Id.*

<sup>101</sup> See *id.*

<sup>102</sup> Professors Guido Ferrarini and Paolo Giudici make this point explicitly with respect to the Parmalat scandal:

As we show, Italian substantive rules cannot be blamed for what happened. Indeed, we argue . . . that the existing Italian substantive rules that were in place during Parmalat’s last decade were sufficient and, somewhat surprisingly, were even more severe than those in the US. If gatekeepers were undeterred, do not blame Italian substantive rules, blame enforcement.

Guido Ferrarini & Paolo Giudici, *Financial Scandals and the Role of Private Enforcement: The Parmalat Case 3* (European Corporate Governance Inst., Law Working Paper No. 40/2005, 2005), available at <http://ssrn.com/abstract=730403>.

2. *Increasing Exposure of Control to the Market.* — In these cases, the second strategy — legal reform that exposes controlling positions to the market — may be more effective. Here, the most obvious example is the mandatory breakthrough rule proposed by the Winter Report and partially reflected in the 2002 Commission draft of the Thirteenth Directive.<sup>103</sup> Under the Winter Report's proposal, if a bidder secures 75% of the target's equity, then the extra votes of a high-voting class would be ignored for such things as election of directors.<sup>104</sup> The effect of the rule would be to sharply limit the extent to which a controlling shareholder could use certain devices to lever its equity into control; a minimum of 25% of the equity value plus one share would be necessary to command a majority of the vote.<sup>105</sup> Importantly, however, the coverage of the proposed breakthrough rule is only partial. Many European companies' controlling shareholder structures are based on devices that heavily leverage the controlling shareholder's equity through the use of pyramids instead of or in addition to dual class common stock or other voting rules that are the object of the breakthrough proposal. Pyramidal structures would not be affected by the proposed rule,<sup>106</sup> thereby reducing its impact even if the Thirteenth Directive had fully followed the Winter Report's recommendation.

For present purposes, the proposed breakthrough rule had two important characteristics. First, it was to be imposed on a European level, thereby at least partially bypassing the political obstacle of controlling shareholder influence over a particular country's legislature.<sup>107</sup>

The second characteristic is more speculative. The Thirteenth Directive as imagined by the Winter Report might have had the interesting effect of a quite different impact on inefficient and efficient controlling shareholder systems. For inefficient systems, control is opened up to widely held corporate bidders, who will be in a position to purchase 75% of the equity at a premium that shares the gains from eliminating pecuniary private benefits of control with minority shareholders — much like shareholders participated in the gains resulting

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<sup>103</sup> Comm'n of the European Cmty., High Level Group of Company Law Experts, *Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids*, at 29–36 (Jan. 10, 2002) (prepared by Jaap Winter et al.), available at <http://ssrn.com/abstract=315322>.

<sup>104</sup> The Commission's proposed directive prohibited the operation of restrictions on the number of votes a shareholder could cast regardless of the number of shares owned (voting caps), but did not endorse the Winter Report's proposed limit on multiple classes of voting shares with different voting rights — the breakthrough rule. See Comm'n of the European Cmty., *Proposal for a Directive of the European Parliament and of the Council on Takeover Bids*, at 25–26, COM (2002) 534 final (Oct. 2, 2002), available at [http://europa.eu.int/eur-lex/en/com/pdf/2002/com2002\\_0534en01.pdf](http://europa.eu.int/eur-lex/en/com/pdf/2002/com2002_0534en01.pdf).

<sup>105</sup> *Id.*

<sup>106</sup> *Id.*

<sup>107</sup> To be sure, individual states can and do drag their feet on adopting legislation implementing a directive.

from 1980s-style takeovers motivated by the desire to eliminate the misuse of free cash flow.<sup>108</sup> In the free cash flow–motivated takeover, the bidder shared the gains from redeploying free cash flow through the premium paid for the target’s stock; the remainder went to the acquirer through improved target performance. In an inefficient controlling shareholder takeover, the bidder would share the gains from eliminating pecuniary private benefits of control through the premium paid for 75% of the company’s equity.<sup>109</sup>

In contrast, the breakthrough rule’s threat to control in efficient controlling shareholder systems would be substantially more muted. Because of the low level of pecuniary private benefits of control in an efficient controlling shareholder system, there would be no easy source of premiums for would-be bidders. To be sure, controlling shareholders would sometimes have to increase their equity ownership to 25% plus one share to protect control, thereby increasing the control costs of focused monitoring and in particular circumstances shifting the outcome of the controlling shareholder tradeoff, but European Union-wide, the balance would seem to be positive.

3. *The Operation of the Capital Market To Dissipate a Controlling Position.* — That leaves the third, market-based approach to improving the operation of inefficient controlling shareholder systems. In these systems, poorly managed companies and those from whom controlling shareholders have siphoned pecuniary private benefits of control may require additional capital, especially to respond to the globalization of their markets and to new, more efficient foreign competitors. For these companies, internally generated funds will be insufficient, requiring recourse to the capital market. In this context, external suppliers of debt or equity can be expected to insist on a means to dissipate the controlling shareholder’s influence if poor performance threatens the new investment. I suggested the use of performance-based conversion as a means of constraining controlling shareholders four years ago.<sup>110</sup> Just such a technique was used recently with respect to a prominent controlling shareholder in Italy. In order to raise \$3 billion from Italy’s largest banks to finance a 2002 restructuring,

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<sup>108</sup> See GILSON & BLACK, *supra* note 87, at 398–453.

<sup>109</sup> The threat of a hostile bid, the strategy of which is to reduce target company pecuniary private benefits of control, may give rise to a virtuous cycle. For controlling shareholders who wish to maintain control and retain at least nonpecuniary private benefits, the best strategy may be to eliminate pecuniary private benefits themselves before the hostile takeover comes. This was the U.S. experience with free cash flow–motivated leveraged buyouts (LBOs). To forestall a hostile bid, companies voluntarily took the steps an LBO bidder would have taken after a successful bid, thereby eliminating the source of the premium. See Bengt Holstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, 15 J. ECON. PERSP. 131 (2001).

<sup>110</sup> See Gilson, *Globalizing*, *supra* note 47, at 347–49.

Fiat was required to accept debt that was convertible into Fiat shares if certain financial targets were not met.<sup>111</sup> If the debt was converted following poor performance, the controlling Agnelli family's ownership in Fiat would be diluted from 30% to 22%. In fact, the performance targets were not met, and the lending banks together became Fiat's largest shareholder with a 30% interest.<sup>112</sup> The Agnelli family, through its holding company, then invested €535 million to increase its shareholdings back to 30%.<sup>113</sup> The result was a sharp increase in the controlling shareholder's equity, reducing the attractiveness of private benefits of control.<sup>114</sup> From this perspective, globalization, even without additional regulatory initiatives, will operate independently to undermine inefficient controlling shareholder systems.

*B. Understanding the Dynamics of Efficient  
Controlling Shareholder Systems*

The most serious policy concern with efficient controlling shareholder systems is that controlled firms adapt less quickly to changes in the economic environment. Because their private benefits of control are largely nonpecuniary, controlled firms in efficient controlling shareholder systems may be less nimble than widely held firms in responding to changes in the economic environment. The market for corporate control can force a widely held firm to internalize change; nothing plays a similar role in a controlling shareholder regime save the market mechanism, which in an efficient controlling shareholder system can be expected to operate rather slowly because of the absence of the financial drain of tunneling. At the same time, we also see that the importance of nonpecuniary private benefits of control may make efficient controlling shareholder systems less stable.<sup>115</sup> From the perspective of the controlling shareholder, the relative value of nonpecuniary private benefits of control — the balance between nonpecuniary private benefits and the pecuniary gains from a more adaptive control structure — can shift with the identity and generation of the controlling shareholder.

At this point, however, we can do little more than identify the tension, rather than either effectively model or empirically test the relationship. And this is an appropriate point with which to conclude. To better understand the macroeconomic impact of efficient controlling

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<sup>111</sup> Alan Cowell & Eric Sylvers, *Fiat Is Trying To Get Back in the Fast Lane*, INT'L HERALD TRIB. (Paris), June 1, 2004, at 1.

<sup>112</sup> *Id.*

<sup>113</sup> Adrian Michaels, *Agnellis To Pay €535 Million To Keep Lead Fiat Stake*, FIN. TIMES (London), Sept. 17, 2005, at 8.

<sup>114</sup> See *supra* p. 1649.

<sup>115</sup> See *supra* p. 1670-71.

shareholder systems, we need to better understand the micro-level dynamics of this ownership structure. As the focus of corporate governance scholarship shifts to controlling shareholder systems, we need to think small.