One Size Does Not Fit All:

Corporate Governance for "Controlled Companies"

Karl Hofstetter[1]

(Revised Draft, Harvard Law School, June 20, 2005)

[1] John Harvey Gregory Lecturer on World Organization, Harvard Law School, Spring 2005; Professor Zurich University; Executive Vice President & General Counsel, Schindler Holding AG, Switzerland.

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Abstract

Corporate governance discussions focus mostly on widely held firms. Controlled companies, e.g. family companies or listed subsidiaries, pose different challenges, however. Where a company is under the control of a large active shareholder, the "agency"- conflict between shareholders and managers is less pronounced. Yet, the power of controlling shareholders gives rise to another "agency"- issue: the potential conflicts of interest with minority shareholders. Thus, corporate governance rules that were developed for widely held firms may overshoot or undershoot in the context of controlled companies. Specifically adjusted rules might therefore be called for.

This paper analyzes the particular corporate governance issues faced by controlled companies with a functional, efficiency-based perspective. It conceptualizes the pros and cons of controlled company structures and tries to draw normative conclusions. Looking at regulatory regimes in the US, the UK, Germany or Switzerland, it argues for regulatory flexibility to allow controlled companies to choose specific corporate governance structures where this is in the interest of shareholders as a class. Furthermore, it posits that control premiums and dual class shares have a potential to efficiently promote controlling shareholder structures. Allowing controlling shareholders to recoup some of their costs of control as shareholders ("external costs of control") through control premiums ("external private benefits of control") adds to their incentive to produce benefits of control for all shareholders ("shared benefits of control"). Dual class share structures, in turn, allow controlling shareholders to protect (external) private and shared benefits of control when new financing needs arise.

I. Biases in Corporate Governance Discussions

The global discussion about corporate governance has been heavily influenced by the US. One indication of this is the fact that the term "corporate governance" was coined in the US and is now being used around the world. The US-inspired debate has unquestionably lifted the sensitivity for the typical principal/agency-conflicts in listed companies everywhere. In addition, it has greatly contributed to the emergence of more sophisticated rules and practices in coping with these conflicts. Yet, it has perhaps also given the debate a particular US-bent. This shows, inter alia, in the way the distinction between dispersed and controlled ownership structures in public companies is being dealt with.

The landscape of listed companies in the US is particular in at least one sense: most companies have dispersed shareholder structures. This means that they do not have large shareholders who actively manage them.[2] The situation is similar in the UK, but rather different in the rest of the world.[3] In Continental Europe, e.g., a much larger number of listed firms are "controlled companies", i.e. under the control of founders, families, parent companies or shareholder groups. [4] This means that shareholders have, at least potentially, a much greater influence on the course of these firms. It also means that the "agency"- conflict between shareholders and managers, which stands at the core of the corporate governance debate, is less pronounced. The power of controlling shareholders gives rise to another "agency"- issue, however: the potential conflicts of interest with minority shareholders.

The US-led corporate governance discussion took for a long time little note of the particular situation of controlled companies.[5] This is understandable given the salience of dispersed shareholder structures among listed companies in the US. It is also understandable given the fact that most of the highly publicized corporate governance scandals in recent years shook companies that did not have a controlling shareholder.[6] Comparative studies have, however, shown that shareholder structures of listed companies are different outside the US, with the UK being a notable exception. One could therefore expect the normative corporate governance debate to extend to the different issues faced by controlled companies. This has not really happened, at least not on a large scale.[7]

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[2] The first to point this out were Berle/Means (1932); cf. also Gadhoum et al. (2003).

[3] La Porta et al. (1999).

[4] "Controlled companies" can be defined as companies in which the management is in the hands or under the control of one group of shareholders, with the rest of the shareholders being in a minority position. In practice, listed companies can often be controlled with less than 50% of the votes. Depending on the circumstances, this can be with as little as 30%, sometimes even with 20% or less.

[5] Cf. the American Law Institute's Corporate Governance Project in the 1980s, the Blue Ribbon Report in the 1990s or the Sarbanes-Oxley Act in 2002, which all centered around widely held corporations.

[6] Including Enron, Tyco and WorldCom, but there were also major scandals involving controlling shareholders, e.g. Adelphia and Hollinger or Parmalat in Italy.

[7] There are important exceptions though, e.g. Kraakman et al. (2004); Ferrell (2004), cf. also Cheffins (2002), Bebchuk (1994, 1999).

Instead, a major part of the legal and economic research concentrated on explaining the different development paths of ownership patterns in the US and the UK as opposed to Continental Europe and the rest of the world. The underlying assumption often was that the dispersed shareholder structures in the US and the UK are a reflection of more advanced laws and markets and that, except for path dependency effects, the efficiency pressures of globalization will ultimately lead to a convergence of world-wide ownership patterns along US/UK lines.[8] As a result, controlling shareholder structures were often explicitly or implicitly portrayed as second-best.[9]

In the terminology of behavioral economics, the described current in this US-dominated debate can arguably be explained by "availability heuristics" and "endowment effects".[10] Given the perceived prevalence of dispersed structures in the US and their presumed contribution to the country's successful and dynamic economy, the tendency to focus corporate governance discussions on them and to see them as the ultimate stage in corporate ownership is perhaps plausible.

In the following, I will try to approach the corporate governance of controlled companies from another angle. I will first present the results of recent research on the patterns of international ownership and critically assess the various attempts to explain them (chapter II). I will then give an overview of some recent empirical research on the relative performance of controlled companies (chapter III). In chapter IV, I will conceptualize the particular advantages and disadvantages of controlled companies from a corporate governance perspective. I will identify three main categories of agency issues: internal private benefits of control, external private benefits of control and entrenchment (chapter IV). In chapters V to VII, I will analyze various rules that have been devised to address these issues. My main focus will be on the US and Europe, in particular the UK, Germany and Switzerland. I will be particularly critical with regard to rigid mandatory bid rules, as they threaten to undercut the potential efficiency of control premiums. In the same vein, dual class share structures and even pyramids deserve regulatory tolerance. Both can be seen as devices that efficiently perpetuate shared and private benefits of control in controlled company structures. I will also argue that rules which were developed to address the particular agency risks of companies with dispersed ownership do not necessarily have the same merits for controlled companies. As a consequence, such rules would have to be sufficiently flexible to allow for adjustments. In chapter VIII, I will summarize my conclusions.

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[8] E.g. Hansmann/Kraakman (2001).

[9] La Porta (1999), Morck (2004), cf. also Coffee (1999 and 2001).

[10] "Availability heuristic" is the tendency among human beings to judge things based on mental availability, i.e. their tendency to overestimate what is present and visible or what has been experienced by them recently. "Endowment effect" refers to the tendency among human beings to value a good that belongs to them more highly than the same good if it does not belong to them; cf. Jolls et al. (1998).

II. No End of History in Corporate Ownership Structures

1. Corporate Ownership Around the World

Corporate ownership structures around the World have a lot in common, but differ also in significant ways. First of all, the corporate form with its five basic features (legal personality, limited liability, transferable shares, board/management separation, investor ownership)[11] dominates the landscape of large enterprise almost everywhere. Furthermore, in practically all economies an important segmentation between listed and non-listed companies has taken root, whereby the largest companies tend to be listed, but the overwhelming majority, mainly the smaller and medium-sized firms, stay private. The number of listed firms is particularly large in the US and the UK. [12] This correlates with the high market capitalization in these two countries as a percentage of GDP.[13]

With regard to listed companies, some striking features have been discovered by scholarship in recent years. La Porta et al.[14] looked at ownership data in 27 wealthy economies. Using 20% of the voting rights as a proxy for control, they found that 36% of the firms overall were widely held, 30% were family-controlled, 18% were state-controlled and 15% were controlled in different ways, e.g. by another widely held corporation, a voting trust or a group with no single controlling investor. The authors therefore concluded that "by far the dominant form of controlling ownership around the world is not by banks and other corporations, but rather by families."[15] They also found stark differences between concentrations of ownership in the investigated countries. A regression analysis showed a correlation between the degree of concentration and their so-called "Anti-Director Index"[16], which was intended to capture the quality of the minority shareholder protection in the various jurisdictions. Countries with a common law history fared on average better in the "Anti Director Index" and had significantly higher ownership dispersion. Countries with a civil law background scored lower, on average, in the "Anti Director Index" and showed higher concentrations of ownership. The first group included the US and the UK, the second group included Continental Europe. The much discussed thesis of the paper was that since common law countries protected minority shareholders better than civil law countries, dispersed ownership could develop in the US and the UK, but has been lagging in the civil law countries of Continental Europe. The logical implication was that if minority shareholder protection could be improved in civil law countries, ownership structures would develop in the direction of the US and the UK.

[11] Cf. Kraakman et al. (2004), 5 – 15.
[12] Coffee (2001), 17.
[13] However, market capitalization as a percentage of GDP is not the highest in the US or the UK, it is e.g. higher in Switzerland, Id, 18.
[14] La Porta et al. (1999).
[15] Id., 496.
[16] The index ranged form 0 to 6 and was formed by adding one point if any of the following criteria were fulfilled: (1) the country allows shareholders to mail their proxy vote to the firm; (2) shareholders are not required to deposit their shares prior to a shareholders meeting; (3) cumulative voting or proportional representation of minorities in the board of directors is allowed; (4) an oppressed minorities mechanism is in place: (5) the minimum percentage of share capital that entitles a shareholder to call an extraordinary shareholders meeting is less than or equal to 10%; (6) shareholders have preemptive rights that can only be waived by a shareholders vote, Id., 478, Table I.

Subsequent academic research confirmed the differences between ownership structures in the US and the UK as opposed to other countries.[17] Becht/Roell depicted an "extraordinarily high degree of concentration of shareholder voting power in Continental Europe relative to the USA and the UK." [18]

Faccio/Lang[19] in a study of 5232 publicly traded corporations in 13 Western European countries found that 36.93 % were widely held, 44.29 % were family-controlled.[20] They, too, drew a clear line between the UK (incl. Ireland) and Continental Europe. They also found that financial and large firms are more likely to be widely held, while non-financial and small firms are more likely to be family-controlled. State control was found to be important for larger firms in certain countries.[21]

To be sure, looking at the US and the UK, there are also a number of companies with large shareholders. Leaving institutional shareholders aside, who play a particularly prominent role in the UK, there are numerous companies in both countries, particularly smaller ones, with large shareholders. Even sizeable, well known companies, Microsoft, WalMart, Ford, Berkshire Hathaway, Anheuser-Busch, Google, Marriott or Genentech being examples in the US, sometimes have dominant shareholders. [22] Vice versa, many companies listed in Continental Europe have dispersed shareholder structures. These are often the largest ones, as, e.g., in Germany[23] and Switzerland[24].

[17] The fact that ownership structures in the US and the UK are different from Continental Europe had been noted and discussed before, e.g. in Switzerland, cf. Kaufmann/Kunz (1991).
[18] Becht/Roell (1999), 1049.
[19] Faccio/Lang (2001).
[20] Using a control threshold of 20%, Id, 26, Table 3.
[21] Significant discrepancies between equity ownership and voting rights were noted in only a few countries, Id.
[22] Gadhoum et al. (2003) point out that even Berle/Means had evidence of only 44 out of 200 listed companies to be "management controlled", i.e. strictly widely held. Their own data of all listed US-companies for the year 1996, using 10 % of the voting rights as a control threshold, shows 59.74 % as "controlled" (79.72 % for Asia, 86.28 % for Europe). Using a 20 % threshold, the authors get 28.11 % "controlled companies" for the US (56.40 % for Asia, 63.07 % for Europe), Id., 29.
[23]Becht/Roell (1999), 1052, show that the concentration in the DAX 30 is notably lower than among all listed companies.
[24] Examples are Nestle, Novartis, UBS or Credit Suisse.

2. The Dynamics of Convergence and Path Dependencies in Corporate Ownership

Globalization has unleashed very powerful forces of competition which not only affect factors of production, but may also impact corporate as well as political structures. It is therefore not surprising that a lot of scholarly energy has been spent on speculations about the future of corporate governance around the world. Advocates of convergence, the most prominent being Hansmann/Kraakman[25], predicted the possible end of history in corporate law along Anglo-American lines. This would include the retraction of insider-dominated ownership structures.[26] The results of the analysis by La Porta et al. lend themselves to similar predictions.[27] Other scholars also sympathize with this strand of thought, even though their reasoning sometimes differs. Coffee[28], e.g., sees private action at work that includes bonding through cross-listings in US securities markets. Gordon[29], by contrast, emphasizes the role of widely held corporate ownership in overcoming economic nationalism. He sees such mechanisms as being particularly active in the context of the European integration project. Thomson[30], on the other hand, posits that convergence is simultaneously moving in two different directions: he finds decreasing ownership concentration in Continental Europe and increasing ownership concentration in the US and the UK. [31]

There are important skeptics of the convergence thesis, however. Bebchuk/Roe[32] and Roe[33] have put forward the notion of path dependence in various forms as a crucial factor in determining the directions of corporate ownership and governance in different countries. The argument put forward under this line of thought is that embedded structures of ownership perpetuate themselves on efficiency as well as political grounds. Existing ownership structures face exit barriers in the form of switching costs and might therefore efficiently survive in the face of strong convergence pressures. Dominant ownership structures may also entail vested political interests that can stop or drag legal changes towards different ownership constellations.[34] Hence, mechanisms of path dependencies offer a "historic" explanation for persisting patterns of corporate ownership. This explanation is quite different from the one advocated by La Porta et al. based on the civil/common law dichotomy.

The latter theory has taken a toll as a result of various studies in the UK showing that changes in ownership structures in the UK took root in the first half of the 20th century, i.e. prior to the

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[25] Hansmann/Kraakman (2001), 439 - 468.
[26] Id. 463; Panunzi et al. (2002) developed a model of succession for firms owned and managed by their founder. It predicts the emergence of the widely held professional corporation as the equilibrium outcome in an environment where law successfully limits the expropriation of minority shareholders.
[27] La Porta et al. (1999).
[28] Coffee (2001).
[29] Gordon (2003).
[30] Thomsen (2003).
[31] Cf. also Gilson (2004) and other contributions in Gordon/Roe (2004).
[32] Bebchuk/Roe (1999).
[33] Roe (2003); Roe (2005).
[34] Bebchuk/Roe (1999).

legal changes that affected the protection of minority shareholders decisively.[35] The reasons for the changes in the ownership structures of UK companies were apparently driven by intense M&A activities that developed in an environment of high trust.[36] Accordingly, cultural factors would also have to be taken into account when evaluating ownership structures.[37] As a matter of fact, looking at the results of a wide range of recent research, it seems plausible to assume that corporate ownership structures are influenced by many factors, including business performance, law, political structures, culture, history and possibly other factors as well.[38]

The multi-causality of ownership structures suggests that it is difficult to predict any clear or even linear evolution in corporate ownership. Observations of the actual market dynamics do not seem to reveal a clear pattern either. Trends towards more dispersed ownership certainly do exist as a consequence of privatizations and the growth, merger and acquisition activities of existing companies. Yet, trends towards ownership concentration can be observed as well. They may happen as a consequence of new IPOs, takeovers of dispersed companies by raiders[39], private equity investments in listed companies, spin-offs or the build-up of concentrated share blocks by institutional investors and managements. To be sure, not all such concentrations will lead to an increase in shareholder activity comparable to, e.g., the traditional family company. This is particularly true for institutional investors, whose relative apathy remains one of the hotly debated topics in modern corporate governance. Nonetheless, the dynamics in the market place, including the rise of private equity and leveraged buy-outs around the world[40], suggest caution in foretelling the convergence of corporate ownership structures along any patterns. No end of history seems in sight.

[35] Franks/Mayer (2005); Franks/Mayer/Rossi (2004); Cheffins (2001, 2000).
[36] Franks/Mayer (2005).
[37] Licht et al. (2001).
[38] Morck/Steier (2005).
[39] Cf., e.g., the build-up of a significant (and potentially growing) stake in GM by the investor Kirk Kerkorian, NY Times May 5, 2005: “Kerkorian Seeking to Buy 9% in General Motors”.
[40] Cf., e.g., the tender offers of Blackstone Group, a private equity firm, for the German chemical maker Celanese, NY Times May 21, 2005, or the US company Windham International, NY Times June 15, 2005.

III. Comparing Performance: Controlled v. Dispersed Ownership Structures

1. Empirical Studies

The lively debate about convergence has sparked a heightened interest in the performance of controlled as compared to dispersed ownership structures. A number of empirical studies have been carried out in recent years, looking at the relative operational and stock performances of controlled companies. A particular focus has been put on the most frequent form, the family company:

a) Studies showing positive relative performance by controlled companies

Anderson/Reeb and Anderson et al., in various studies of the S&P 500 companies, indicate strong positive correlations between family ownership and firm performance. [41] They found that, among the S&P 500, families were present in about one third of the firms with an average holding of about 19 %.[42] They further showed that:

- family firms were, on average, better performers than non-family firms; [43]
- family firms enjoyed a lower cost of debt than non-family firms;[44]
- family firms used less diversification than non-family firms, but were not limited to low-risk businesses or industries;[45]
- there is no evidence that continued family ownership in public firms leads to minority shareholder wealth expropriation;[46]
- moderate family board representation (but also a strong presence of independent directors) significantly improve family firm performance;[47]
- minority shareholders benefit overall from the presence of founding families.[48]

Ehrhardt et al.[49] identified 62 German family-controlled companies that were founded before 1913 and still in existence in 2003 with sales of more than 50 million Euro. They then constructed a matching sample of 62 non-family owned firms and compared them over a period of 100 years. According to their results, family businesses seem to outperform non-family firms in terms of operating performance. Yet family firms are shown to also grow more slowly, and their performance decreases over time.[50]

[41] Similar positive performance results were found in a study by the Wharton Business School, testing 132 companies with a family ownership of at least 10 % over a period of 20 years. These firms showed a return of 14 % per annum over the whole period as opposed to the S&P 500 returning 11 %, cf. Fortune Magazine, April 2, 2001, 78.
[42] Anderson et al. (2002), 1.
[43] Anderson/Reeb (2003b, 2003c).
[44] Anderson et al. (2003).
[45] Anderson/Reeb (2003).
[46] Anderson/Reeb (2003).
[47] Anderson/Reeb (2004, 2003b)
[48] Anderson/Reeb (2003).
[49] Ehrhardt et al. (2004).
[50] An earlier German study expresses doubts about the conclusiveness of measuring performance links between ownership structures and performance for various reasons, one of them being the role of banks, cf. Boehmer (1999).

Edwards/Weichenrieder[51] tested a sample of 102 listed companies from Germany for the years 1990/1992 and found positive correlations between concentrated ownership and performance, except if the largest shareholder was a non-bank enterprise or a public sector body. This suggests the necessity to differentiate between family-companies, subsidiaries in corporate groups and state controlled enterprises.

A recent study by Frey et al. [52], analyzing the relative share performance of family companies and non-family companies listed on the Swiss Stock Exchange, showed that the first outperformed the latter by a significant margin of more than 5: 3 in the period between 1990 and 2004.

Gleissberg[53], looking at 103 IPOs in Germany and 50 in Switzerland identified a robust correlation between ownership structure and company performance: the faster the controlling shareholder sold off his shares or was getting diluted after the IPO, the worse the performance of the company.[54]

Very positive performance results for listed family companies were reported by Sraer/Thesmar[55] for France from 1994 to 2000. The authors found that family firms largely outperformed widely held corporations. The result did not only hold for founder-managed firms, but also for heir-managed companies.

Ben-Amar/Andre[56] analyzed 238 acquisitions by 183 companies in Canada, where a large proportion of public companies have controlling shareholders. They found positive abnormal returns for family controlled firms and didn't find negative impacts of separations of ownership and control through dual class shares or pyramids.

Gompers et al.[57], in turn, showed a positive correlation between concentration of cash flow rights in the hands of controlling shareholders and firm value as well as performance, but negative correlations if voting rights are disproportionate, as is the case for dual class shares.

b) <u>Studies showing negative or mixed relative performance by controlled companies</u>

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[51] Edwards/Weichenrieder (1999).
[52] Frey et al. (2004); a recent article in the business journal "Bilanz" (February 2005) looked at the best performing companies on the Swiss Stock Exchange over the last 30 years and had 3 family companies among the top 5: Schindler (2d), Lindt & Spruengli (3d), Sika (5th); the two other companies are widely held: Novartis (1st), Nestle (4th).
[53] Gleissberg (2003).
[54] Of course, it could be suspected that the sell-off (in at least some cases) took place because the controlling shareholders knew about the worsening prospects of their company. Gleissberg seems to interpret the results of his study differently, though.
[55] Sraer/Thesmar (2004).
[56] Ben-Amar/Andre (2005).
[57] Gompers et al. (2003).

There are also studies showing negative performance implications of controlling shareholders. Holderness and Sheehan[58], in an early paper, posited that firms under family ownership create less economic value than non-family firms.

More recently, Grant/Kirchmaier[59], testing data on the 100 largest firms in five major European economies (Germany, UK, France, Italy, Spain), indicated mixed[60], overall rather negative correlations between ownership concentration and performance.

Villalonga/Amit[61], using proxy data on all Fortune 500 firms during 1994-2000, found a marked contrast between family-firms where the founder served as CEO or Chairman and family firms with a CEO belonging to the heir-generation. The first category performed better than non-family firms, the second category performed worse.[62]

Perez-Gonzalez[63], analyzing 192 successions in family-dominated companies listed in the US, found large relative declines in returns on assets and market-to-book ratios where CEOs related to the family were promoted. The declines were particularly significant in firms that appointed family-CEOs that did not attend a selective college.

Galve Gorriz/Salas Fumas[64], on the other hand, tested the relative performance of listed family firms in Spain during the period form 1990 to 2004. They found that family firms grew at a smaller rate, chose less capital intensive productive technologies, but were more efficient in production than non-family firms.

2. Interpreting The Results

Naturally, all described empirical results would have to be interpreted and controlled for various industries, market characteristics, laws and other factors.[65] Several of the mentioned studies tried to do this.[66] Other studies looked specifically at market characteristics and their correlation with

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[58] Holderness/Sheehan (1988), 345; cf. also Holderness/Sheehan (1998).
[59] Grant/Kirchmaier (2004).
[60] For France, e.g., the widely held firms were the worst performing ownership group, the group between 33.3 % and 50 % the best, Id. 12.
[61] Villalonga/Amit (2004).
[62] Hillier/McColgan (2004) report perhaps related "entrenchment effects" from a sample of 683 UK companies over a period of 1992 to 1998 showing that family CEOs were less likely to be removed after poor performance than non-family CEOs.
[63] Perez-Gonzalez (2002).
[64] Galve Gorriz/Salas Fumas (2005).
[65] Cf. Morck/Yeung (2004), with a highly critical perspective towards controlling shareholders.
[66] E.g. Galve Gorriz/Salas Fumas (2005), explaining their relatively lower scores for family companies in Spain as compared to family companies in the US, inter alia, with the differences in minority shareholder protections in these two countries.

ownership concentration and performance. Koeke/Renneboog[67], e.g., identified a positive relationship between productivity increases in markets subject to little discipline and control by insiders.[68] Gugler et al.[69] analyzing data from 19'000 companies from 61 countries found that performance differences related to a country's legal system were much more important than performance differences related to ownership structures.

Given the focus of this paper, the crucial question is, what normative conclusions we can draw from all these studies. If nothing else, it is at least the important recognition that there is no empirical basis for discriminating legally against controlled ownership structures. Instead, it seems plausible that controlled, as much as dispersed structures, have their pros and cons. The normative challenge therefore is to devise a regulatory level-playing field allowing both categories of ownership to compete on an equal footing.[70] This requires that the specific potentials and risks of controlled companies first be specified in order to be able to address them properly with legal rules.

IV. Identifying the Potentials, Costs and Risks of Controlling Shareholder Structures

1. The Potential of Shared Benefits of Control

Controlling shareholders offer specific advantages to the governance of corporations that can potentially generate significant benefits for all shareholders ("shared benefits of control"):

a) Monitoring advantages of controlling shareholders

Berle and Means[71], in their seminal work heralding the onset of the widely held corporation, assessed the presence of a controlling shareholder in these terms:

"*Presumably many, if not most of the interests of a minority owner run parallel to those of the controlling majority and are in the main protected by the self interest of the latter. So far as such interests of the minority are concerned, this loss of control is not serious. Only when the interests of majority and minority are in a measure opposed and the interests of the latter are not protected by enforceable law are the minority holders likely to suffer. This, however, is a risk which the minority must run; and since it is an inevitable counterpart of group enterprise, the problems growing out of it, though they may be most acute in isolated cases, have not taken on major social significance.*"

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[67] Koeke/Renneboog (2003).
[68] Similarly, Palmer (1973) showed that firms controlled by strong owners generated higher profits when the firms had market power, but ordinary profits when the firms hadn't.
[69] Gugler et al. (2003).
[70] Allowing capital markets to choose value maximizing structures on a case by case basis; cf. Demsetz/Lehn (1985).
[71] Berle/Means (1932), 68.

There is no question that the most obvious advantage of a controlling shareholder lies in the fact that he, as recognized by Berle and Means, has interests which are generally aligned with those of the shareholders as a class. Given the large stake that the controlling shareholder has typically invested himself, he also has the incentive to monitor the corporation and/or management closely and carefully. His voting power will allow him to intervene timely and forcefully if the company's performance drifts away. In addition, a controlling shareholder has the incentive and power to implement strategic and management changes even before dark clouds start to move in.[72] "Creative destruction" is, after all, the hallmark of the controller-entrepreneur. In addition, given the usual long-term investment horizon of controlling shareholders, strategies can be devised and defended with a higher degree of patience than would be possible in companies which are at the mercy of short-term oriented and arguably "inefficient" capital markets.[73]

Likewise, parent companies with a controlling stake in listed subsidiaries may be able to create synergies in monitoring subsidiary management, giving them similar comparative advantages in monitoring costs.

In comparison to the board and management members in widely held companies, a controlling shareholder can, therefore, have an edge in monitoring the company's performance due to his superior:

- monitoring incentives;
- monitoring power;
- monitoring quality;
- monitoring horizon;
- monitoring costs.

b) "Soft factor"-advantages of founder and family companies

The "hard" monitoring advantages are the most salient and perhaps also the most effective advantages of having a controlling shareholder. There might be other, less visible advantages, however. For family companies, anecdotal and empirical evidence indicates strong value attachments to the long-term success of family companies over several generations. Gallo/Cappuyns, interviewing 21 of 64 Spanish family-companies that are older than 30 years and among the Spanish top 1000 found in all of them a business culture dominated by what they called "*ELISA*"-values, i.e. *E*xcellence, *L*abor ethic, *I*nitiative for innovation, *S*implicity in lifestyle and *A*usterity.[74]

[72] Given his power, the controlling shareholder is not subject to the collective action and "hold up" problems that exist in dispersed ownership structures.
[73] E.g. Shleifer (2000), 1 - 27.
[74] Gallo/Cappuyns (2004).

Values may breed trust. Sraer/Thesmar[75] in their study indicating the superior performance of French family companies, posit that heir-managed firms have a comparative advantage in trust relationships with their labor force. In return for more (credible) job security, workers accept being paid less. The authors refer to this phenomenon as “implicit insurance contracts”.

The importance of cultural and other soft factors for the success of founder and family firms seems plausible. They perhaps capture what can be referred to as the “entrepreneurial spirit”. [76] Entrepreneurship might, in turn, be explained by long-term economic incentives, including reputation, but could also be rooted in other psychological and social drivers of human action.[77]

2. Private Benefits of Control

The power of controlling shareholders potentially reduces agency risks that exist in companies with dispersed shareholder structures. However, the same power also creates particular agency risks that would not exist in widely held companies. The term often invoked to refer to those risks is “private benefits of control”. Even though nowhere defined in a strict legal sense, this catch-all term seems to be commonly understood as including everything that controlling shareholders are able to get out of their position without minority shareholders receiving a proportionate share. There are, however, two categories of such “private benefits of control” that should be kept apart, “internal” and “external” private benefits of control.

a) Internal benefits of control

Capital investments by shareholders in the company are becoming assets of the company. As a consequence, they are taken away from the free disposal of the shareholders. Their use and ultimate pay back to the shareholders is subject to the constraints of corporate law. The same is true for any proceeds generated by such investments. The reach of the corporation also includes invisible assets that are the result of its ongoing operation, in particular information and opportunities. To be sure, the demarcation line between what belongs to the company and what belongs to its shareholders can sometimes be difficult. This is e.g. the case where shareholder assets and company assets have been jointly put to work, as is very often the case in corporate groups. Separating the two spheres can therefore become a conundrum and is part of the explanation for the emergence of corporate group laws, e.g. in Germany.

[75] Sraer/Thesmar (2004).
[76] It is said that there are, e.g., about 450 “world champions” among German family companies, i.e. companies which are the global leaders in their respective markets
[77] Behavioral economics, in particular, has shown that economic action is not only driven by rational utility maximization, but also by social and other human factors, e.g. Fehr/Schwarz (2002); cf. about potential ramifications of this for corporate governance in general Frey/Osterloh (2004) and Osterloh/Frey (2005).

At least conceptually, however, it is clear that there is a pool of capitalized and non - capitalized assets which are subject to the decision and pay-out rules of the corporation. Controlling shareholders can theoretically (and sometimes do practically) extract such assets to themselves disregarding applicable rules. Such extractions can take on different forms:

- outright "stealing" by siphoning off cash and other assets without any business justification whatsoever (e.g. looting of a company's bank accounts);
- transfer of assets to the controlling shareholders or to companies controlled by them under circumstances or at terms which violate the "arms length" principle (e.g. unsecured low - interest loans or excessive salaries to controlling shareholders in management positions, transfer pricing in corporate groups, including use of intellectual property and know how without proper consideration);
- implementing transactions in the interests of the controlling shareholders that do not affect the company directly, but impose liability risks on it without a concomitant benefit (e.g. tax evasion schemes in the interest of controlling shareholders);
- allocating without proper basis or approval business opportunities to shareholders that arose in the sphere of the company and were a result of the activities of the company;
- use of insider information in connection with the sale or purchase of shares in the market (e.g. purchase of shares prior to an imminent takeover bid by a third party, going private/freeze out transaction taking advantage of insider information about the "real" value of the company[78]).

In sum, internal private benefits of control can be defined to include all benefits a controlling shareholder can extract from the company as an insider, i.e. as an agent with access to the company's assets, information and opportunities, at prices or conditions more favorable to him than in an arms length transaction.

b) <u>External benefits of control</u>

Conceptually, shareholders as shareholders are pursuing interests "outside" the company. They are only acting "inside" the company (and are, therefore, bound to the interests of the company) to the extent that they are members of a company organ, e.g. the board of directors. Such activities are subject to fiduciary obligations and other constraints. Yet, the situation is quite different for the activities of the shareholders as shareholders. In that capacity they have wide latitude, and justifiably so, since this is basically the realm of the free employment and movement of capital.

As a consequence, controlling shareholders have (and should have) large discretion in creating value for themselves as shareholders. This includes the use of voting rights to make choices that

[78] Infra.

minority shareholders might consider suboptimal.[79] Examples are elections to the board of directors, changes to the company's articles of association, its governance and capital structure or mergers.

Similarly, controlling shareholders can sell their shares in the market or as a block. They may also choose to increase their stake in the company. All these decisions may be considered less than desirable from the point of view of minority shareholders. Yet, safe for specifically designed legal restrictions[80], they are merely subject to market forces.

It is not always easy to separate "internal" from "external" benefits that a controlling shareholder is getting out of his actions. Yet, at least conceptually, it is obvious that there are private benefits a controlling shareholder can get out of his shareholder activities, i.e. benefits that he would not receive if he were in a mere minority position. That includes the non-financial benefits he can, e.g., extract through the prestige of being publicly recognized as the founder or heir of an important enterprise. [81]

3. Private Costs of Control

As a counterpart to the private benefits of control, there are "private costs of control", i.e. costs that the controlling shareholder incurs, but which are not incurred by minority shareholders. To mirror the categorization of private benefits, these costs can also be subdivided into internal and external costs of control.

a) Internal costs of control

Internal costs of control arise in connection with the particular contributions of a controlling shareholder as a manager or inside monitor of the company. These contributions can, in principle, be properly compensated. Founders or family members in management positions can get market-clearing compensation packages.[82] The same is true for board members representing controlling shareholder groups or parent companies. Management and other shared services supplied by parent companies in corporate groups can also be charged at market prices. Internal costs of control can therefore be properly covered in separate arrangements and are hardly a justification for private benefits of control.

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[79] Ultimately, the majority rule in corporations is a concession to the collective choice problems that would otherwise exist. In that regard, there is no basic difference between controlled companies and dispersed companies. If there were a unanimity rule, the risk of minority hold-ups would exist in both.
[80] E.g. mandatory bid rules, cf. infra.
[81] Cf. also Gilson (2004b).
[82] Of course, such compensation can be higher than compensation paid to a third party manager in the same position, if the controlling shareholder, by virtue of his "entrepreneurial input", is able to manage the company better than third parties would. The determination of such premium, if any, is within the authority of the independent compensation committee, cf. infra.

b) External costs of control

The situation is different for external costs of control. These are the additional risks and costs a controlling shareholder assumes and incurs as a shareholder, independent of his involvement as a manager or board member. They might include the risk associated with the typical under-diversification of an entrepreneur who has a disproportionately large part of his wealth invested in the company, the stewardship costs of a parent company or the costs associated with the diminished liquidity of control blocks.[83] These costs might be difficult to measure. However, the incurrence of them could be crucial for the generation of the shared benefits of control for all shareholders.[84] Efficiency considerations, therefore, favor any solutions that would allow these costs to be recouped. One possibility are non-financial benefits of control, another are control premiums.[85]

4. Entrenchment Risks

Entrenchment by controlling shareholders can happen in at least three different instances: in a corporate crisis, in connection with the succession to the founder or another family member or in connection with strategic decisions, e.g. a decision to issue new equity for the financing of growth (leading to the dilution of control) or a decision to sell the company to a third party. All three instances involve the potential of the controlling shareholder destroying value or refusing to go along with value-enhancing proposals. Of course, in practice it will often be disputed as to whether the decision taken by the controlling shareholder is destroying or enhancing value. It is, in principle, the same issue as faced in takeover situations involving the board of widely held companies. There is one important difference, however: the controlling shareholder is to gain or loose the most of any decision with regard to the future direction of the company. It can therefore at least be assumed that his incentives are relatively better aligned with the interests of the minority shareholders than the incentives of an independent board. Yet the potential of negative entrenchment effects lingers nonetheless.

5. Legal Tradeoffs

The “shared benefits of control” - potentials associated with controlling shareholders and the risks of them reaping “private benefits of control” or entrenching themselves are, in principle, two sides of the same coin. They both grow out of the fact that controlling shareholders have the power to take decisions and that these decisions can be optimal or damaging from the point of view of shareholders as a class. The question therefore is, to what extent legal rules can reduce inefficient “private benefits of control” without sacrificing the “shared benefits of control”.

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[83] Cf. the detailed discussion of external costs of control in connection with control premiums, infra.
[84] Id.
[85] Id.

The described tradeoff reflects a general dichotomy in corporate governance: its "promotional" and its "preventive" function. The promotional function aims at creating room and incentives for corporate actors to create long-term value for shareholders, the preventive function aims at precluding corporate actors from doing the opposite: destroying value or diverting it to themselves.

In dispersed ownership structures, the promotional function is inherent in rules favoring incentive compensation for management, but also in rules aimed at the strategic value contributions of the board of directors. The preventive function is at the core of a whole panoply of corporate governance rules that serve as checks on management and the board. This includes mandatory disclosure, independence requirements for board members, board committees and auditors, rules about conflicts of interest, takeovers and the rights of shareholders to vote and to sue.

In controlled companies, the promotional function of corporate governance starts arguably at the stage of ownership formation. Assuming that concentrated ownership offers value potentials that dispersed structures do not, legal impediments to the formation or preservation of controlled company structures deserve being questioned. It is in this light that control premiums or dual class share structures will have to be broached.[86]

The preventive role of corporate governance rules is also somewhat different in controlled ownership structures. Given the alignment of interests among the controlling shareholder and the minority shareholders in their relationship with (third party) managers, corporate governance rules that were designed for dispersed ownership structures and concentrate on the agency-problem between shareholders and managers are not always the most appropriate. They might overshoot and thereby impose inefficient costs on controlled companies. However, there is also a potential for them to undershoot to the extent that they do not capture the agency-issues that can arise between controlling and minority shareholders.[87] This particular agency-conflict might require separate rules. "Freeze out" transactions are an example.[88]

There are various possible regulatory approaches with regard to the idiosyncratic corporate governance issues in companies with controlling shareholders. Different jurisdictions have chosen different paths. The following chapters will try to evaluate them, with a particular emphasis on the US and European jurisdictions like Germany, the UK and Switzerland. The assessment will be done using the three main categories of agency-issues in controlled companies identified earlier[89]:

[86] Cf. infra.
[87] This, too, would be inefficient and boil down to a subsidy of controlled as opposed to widely held structures.
[88] Infra.
[89] Supra.

- Internal private benefits of control;
- external private benefits of control;
- entrenchment.

V. Curbing Internal Private Benefits of Control

1. Disclosure

There are three principal areas of disclosure that matter for shareholders. The first includes financial disclosure as well as management reporting on strategy and operations, the second relates to corporate governance and the third covers conflicts of interest transactions:

a) Financial and operational disclosure

Disclosures on financial performance, on strategy and operations[90] have a high importance in dispersed ownership structures. They serve as the main basis for the assessment of management and of share value. Both can be considered as having a similarly important function in controlled companies. Even though one could argue that the control of management performance by minority shareholders is less crucial in controlled companies, at least the valuation of minority shares is equally important.

Ferrell[91] argues that mandatory financial disclosure for controlled companies also increases competition in capital and product markets. His rationale is that competition for capital will be enhanced because some firms will find their access to external finance improved as a result of being able to credibly commit to higher disclosure levels[92]. That, in turn, can be expected to promote competition in the product markets.

In addition, disclosure also helps mitigate the potential of insider trading, a risk that exists to similar degrees in widely held and controlled companies. Accordingly, financial and management reporting requirements are usually the same for both types of companies[93], and this seems justifiable.[94]

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[90] E.g. in annual reports, at annual press conferences, in road shows, conference calls with analysts or through press releases (ad hoc disclosures) on important events.

[91] Ferrell (2004).

[92] Ferrell, Id. 39, maintains that they would not be able to do that individually, because they have no way to commit credibly ex ante without a high perceived risk of them reversing their disclosure policy later.

[93] Sometimes, stock exchanges have separate segments for smaller companies with lower disclosure requirements. These segments might have higher numbers of controlled companies, but this can be explained by the fact that smaller companies are more likely to have controlling shareholders in general.

[94] An argument could perhaps be made, that given the presumable long-term horizon of, e.g., family companies, quarterly reporting requirements are an inappropriate and costly overkill for them, as has been maintained by the German family company Porsche. One possibility would be to grant opt out rights from certain disclosure rules to companies having received the approval of a qualified majority of their shareholders, as has been proposed for the disclosure of individual compensation under German law, cf. infra.

b) Corporate governance disclosure

The second area of disclosure relating to corporate governance has seen a significant rise in importance during the last years. The Combined Code in the UK, the Sarbanes-Oxley Act in the US and various corporate governance codes and stock market regulations in other countries have dramatically enhanced the requirements of listed companies to periodically report about their governance structures and policies. The legitimate interest of minority shareholders in receiving information about corporate governance is, in principle, the same for widely held and controlled companies. The relative importance of specific pieces of information could, however, differ. Information on major shareholders, board composition and board committees, auditor independence or shareholder rights have similar importance in both cases. Information on the compensation of third party managers or on takeover defenses have higher relative importance in dispersed ownership structures, whereas information on the percentage of ownership of the controlling shareholders[95] or on related-party transactions take on a particular significance in controlled companies. Yet, the differences are such that uniform disclosure rules are, for the sake of simplicity and comparability, justified. This does not exclude that specific opting out rules are provided for[96] or that a general rule of "comply or explain" is being applied to certain disclosure requirements.[97]

c) Disclosure of conflict of interest transactions

The third area of disclosure is concerned with conflicts of interest transactions. This has a particular significance in controlled companies, perhaps most notably with regard to transfer pricing in corporate groups. Given the power and influence of controlling shareholders and the concomitant risk of them "tunneling" cash or other assets to themselves or to entities belonging to them 100 %, disclosure of all material related party transactions, as provided for under the rules of US GAAP or IFRS, are pertinent.[98] For corporate groups there might even be more specific rules, e.g., the dependence report to the supervisory board under German corporate group law or the parent/subsidiary report as proposed under the former draft for a 9th Directive in the EU.

A particular form of conflicts of interest transaction is the use of insider information in the stock market. This risk is identical in controlled and widely held companies. Accordingly, trading

[95] What matters is the percentage of votes held by the controlling shareholder(s) overall, i.e. if there is cooperation among several of them, the total of all votes held by them. Internal facts of the group, including the individual stake held by each group member, have secondary meaning at best, favoring rules that give as much privacy protection as possible to, e.g., a family's internal arrangements.
[96] As in the proposed new German law on the disclosure of individual compensation for managers in listed companies, cf. infra.
[97] The principle, e.g., applies to corporate governance disclosure under the rules of the Swiss Stock Exchange, except for disclosure on compensation, which is mandatory, cf. SWX Directive on Information Relating to Corporate Governance; Hofstetter (2002), 74.
[98] Ditto Ferrell (2004).

restrictions apply indiscriminately to managers and controlling shareholders with access to insider information. The same is, in principle, true for the disclosure of stock market transactions by insiders.[99]

d) Compensation disclosure

A hotly debated topic in many jurisdictions, not so much in the US, is the disclosure of management compensation. It is located halfway between corporate governance and conflicts of interest disclosure. The reporting of management compensation has two aspects: it gives shareholders the possibility to convince themselves that management has appropriate financial incentives and that compensation is not used as a tool to loot the company. In the presence of a controlling shareholder who is not managing the company himself, the functionality of such disclosure could be questioned. It could be argued that the controlling shareholder, due to his own significant interest, has the right incentives to negotiate efficient management compensation arrangements. As a consequence, the negative fall out of the publicity of management salaries could be prevented.[100] To be sure, there may still be reasons for requiring disclosure even in those situations, e.g. allowing minority shareholders to better assess the supervisory work done by the controlling shareholder.[101] In any event, disclosure is obviously justified if the controlling shareholder is himself part of management. Even though his basic incentives to manage the company in the shareholders interest are hardly questionable, the potential of excessive compensation is almost the same as in widely held corporations.[102] Hence, the argument for applying identical compensation disclosure rules to widely held and controlled companies is quite strong.

Against this background, the newly proposed German law allowing listed companies to opt out of individual compensation disclosure by way of a shareholders resolution appears intriguing.[103] One alternative is to see it as a political concession to German family companies, in particular Porsche, which had been critical about other disclosure requirements of the German Stock Exchange.[104] Yet, there are better arguments to defend the rule. First, the requirement of a 75 %

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[99] To be sure, differentiations may be justified: Where transactions take place privately among insiders, e.g., by way of inheritance, gifts or other trades within a family pool acting as one controlling shareholder, disclosure would seem to have no compelling function. This could favor exemptions in the interest of protecting the privacy of controlling shareholder groups.

[100] This includes the potential spiraling-effect the publication of salaries has on other managers within and outside the firm. This psychological factor, very plausible to common sense, has been recognized by behavioral economics and boils down to the fact that people are as much concerned about their income relative to their group of reference as their income in absolute terms, cf. e.g. Frey/Stutzer (2001), 16.

[101] At least disclosure of the structure and amount of total compensation received by management overall.

[102] The fact that he also controls the board of directors through his election votes in the shareholders meeting arguably aggravates the situation, the fact that he has a significant part of his own wealth at stake and that management compensation has perhaps less of a relative importance for him mitigates it.

[103] Cf. Newsletter German Justice Department of March 11, 2005: Eckpunkte eines Gesetzesentwurfs "Individualisierte Offenlegung der Gehaelter von Vorstandsmitgliedern von Aktiengesellschaften".

[104] In particular quarterly reporting requirements, which it refused to issue, leading to its removal from the DAX, the basket of the 30 most important German stocks.

approval rate by the shareholders is quite high. Second, the opt out only applies to individual disclosure. The disclosure of total management compensation remains mandatory. Accordingly, the decision of the shareholders is limited to a choice between the risks of the controlling shareholder camouflaging excessive compensation to himself or his representatives in the overall amount of management compensation and the risks associated with, e.g., the potential upward spiraling-effects[105] of disclosing individual compensation packages. It is certainly possible to argue that shareholders will be better off long-term opting for the first.

2. Board of Directors and Board Committees

a) Board of directors

The task of the board of directors as the "first line of defense" for shareholder interests in corporations has again a "promotional" and a "preventive" side.[106] The promotional side aims at contributing to the creation of value for shareholders, the preventive side sets its sight on the risks of value destruction and value diversion. The legal tasks of boards of directors and supervisory boards sometimes differ as to the relative emphasis on those two aspects. The German supervisory board, e.g., has less of a promotional role and more of a preventive one. Boards in the UK and Switzerland, on the other hand, have a pronounced promotional role.[107] The broad authorities and strong fiduciary duties of the US board also include both aspects.

The promotional role of the board requires familiarity with the company's business, market and management. That would, in principle, give an edge to current or former insiders. The preventive role of the board, on the other hand, stresses the need for independence. This favors outsiders, i.e. non-executive or independent directors.[108] Recent corporate scandals and the subsequent wave of corporate governance regulation put the spotlight on the preventive role of the board. Legal rules, listing requirements and corporate governance codes have therefore shown a tendency to increase the required number of non-executives and independents on boards of directors.[109] Stringent independence rules apply to the various board committees, in particular the audit committee, the compensation committee and the nomination committee.[110]

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[105] Cf. supra.

[106] Cf. supra.

[107] The board's task of formulating the strategy is even considered a non-delegable task under Swiss law, Sec. 716a of the Swiss Code of Obligations.

[108] The fact that the German supervisory board has mainly preventive tasks, explains the mandatory legal rule that no members of the management board may at the same time be members of the supervisory board. The UK's Combined Code, on the other hand, stresses the need for a good mix of insiders and outsiders on the board of directors (Sec. A.3).

[109] The NYSE listing rules require a majority of independents (Sec. 303A.1 of the NYSE Listed Company Manual), the Combined Code recommends a "balance" of executive and non-executive directors, meaning that at least half should comprise non-executives (Sec. A.3) and the Swiss Code of Best Practice recommends a majority of non-executives (Sec. 12).

[110] The Sarbanes-Oxley Act requires that all members of the audit committee be independent (Sec. 301.3.A), the NYSE rules also require the members of the compensation and the nomination committees to be independent (Sec 303.4 and 5 of the NYSE Listed Company Manual).

Empirical research has so far not been able to establish a clear positive link between the presence of independents on boards of directors and company performance in general.[111] In addition, firms like Enron and WorldCom had boards where outside directors were prominent. Proposals have therefore been put forward in the US to increase the influence of shareholders on boards and board nominations.[112] Their rationale is based on the notion that "independence" as a requirement for board and board committee membership is, in fact, a mere proxy for the alignment with shareholder interests. All other things being equal, independent directors are, therefore, just a second best solution to having the shareholders themselves being represented on the board.

This insight has ramifications for companies with controlling shareholders. First of all, it is obvious that the presence of a controlling shareholder and of his representatives on the board of directors must be welcomed. His direct representation has the potential of strengthening both the promotional and the preventive role of the board. It is a first best solution in the sense of aligning the board with shareholder interests. There is, accordingly, a relatively weaker case for a requirement that the board be composed of a majority of independent directors with no relationship to either the company or the controlling shareholder.[113] The exemption from the independence requirements for "controlled companies"[114] in the NYSE listing rules therefore seems pertinent. The same is true for Sec. 28 of the Swiss Code of Best Practice which explicitly provides for proper adjustments to the corporate governance of companies with controlling shareholders.[115] That includes the composition of the board and its committees.

Having the founder or the corporate parent dominate the board of directors of a controlled company offers the chance of moving the company's agenda swiftly and decisively in the interests of shareholders as a class. To be sure, looking at the promotional side of the board's task, a controlling shareholder can benefit as much as anybody else from the input of persons with different backgrounds and fresh ideas. Hence, outside board members can also add value to the board of a controlled company. Empirical research strongly supports that view.[116]

[111] Clark (2005), 36 – 37; cf. also Bebchuk et al. (2004)
[112] E.g. Bebchuk (2005).
[113] The situation is likely different in companies where the state has a majority stake. The danger of political goals and power issues affecting the objectives pursued by the controlling shareholder militate in favor of strong independent membership on the board.
[114] In the NYSE-definition companies with a shareholder holding more than 50 % of the votes, NYSE Listed Company Manual Sec. 303A.
[115] Sec. 28 of the Swiss Code of Best Practice provides: "Companies with active major shareholders (including subsidiaries listed on the stock exchange)… may adapt….the guidelines", Hofstetter (2002), 72.
[116] Andersen/Reeb (2004, 2003b); cf. also Morck (2004b).

Looking at the preventive role of the board, the potential of diverging interests between the controlling and the minority shareholders, e.g. in conflict of interest transactions, calls for a proper counterweight. Outside directors who are independent from the controlling shareholder can again fulfill that function.[117] In sum, independent board members have their role cut out for them in controlled companies, too. The case for flexibility is stronger, however.

b) Board committees

Flexibility seems equally justified for the composition of board committees. Conceptually, the audit committee, the compensation committee and the nomination committee are strengthened if the controlling shareholder or his representatives participate in them. Shareholder interests, not independence is, again, what primarily matters. To be sure, the situation becomes more differentiated to the extent the controlling shareholder is himself involved in management. The implications are not identical for the three committees:

Assuming that the audit committee's primary function is the monitoring of major risks, including financial disclosure and the relationship with the outside auditor, the case for oversight by independent directors becomes stronger, the more the controlling shareholder is himself managing such risks. Still, given the fact that the controlling shareholder is himself to lose most if these risks materialize, his credentials to actively participate in the board's audit committee remain intact. It could therefore be perfectly reasonable if a corporate group, e.g., pooled its auditing process at the parent board level for the whole group, having auditing on the board of its listed subsidiary focus on transfer pricing issues and other potential conflicts of interest with the parent. Similarly, in a company controlled by its founder, the participation of the controlling shareholder in the audit committee could be justified on the grounds of his strong shareholder orientation and competence. Transactions and risk areas involving potential conflicts of interest would, however, have to be monitored by independents. This could, in principle, be a separate committee.[118]

The compensation committee is basically strengthened by the participation of the controlling shareholder, except when it comes to his own compensation and the compensation of persons close to him. That favors a wholly independent compensation committee in family companies where family members are participating in management. On the other hand, it should be possible in a corporate group to have the compensation committee of the parent also deal with the compensation packages of subsidiary management. The subsidiary board would, of course,

[117] Of course, they sometimes fail in it, as the Hollinger case demonstrates, where well known independent directors, including Richard Perle and Henry Kissinger, had repeatedly (and perhaps unknowingly) rubberstamped illegal diversions by the controlling shareholder, cf. Hollinger International, Inc., v. Black, 844 A. 2d 1022 (Del. Ch. 2004); Breeden (2004).

[118] E.g. a special committee or the compensation committee consisting of independents. All transactions between the founder and the company would have to be approved by it. In addition, the committee would have to get proper assurance that all relevant transactions are indeed presented to it.

still be ultimately responsible to approve the parent's recommendations with a view to the interests of subsidiary shareholders in general. However, with regard to management salaries, the interests of the controlling shareholder and the minority are, in principle, the same.

The role of the nomination committee does basically always warrant the participation of the controlling shareholder. There is no fundamental conflict of interest between him and the minority shareholders as far as nominations to the board are concerned. Of course, minority shareholders can have different preferences for candidates. It may be particularly pronounced in situations of crisis or succession at the helm of the company, with the risk of entrenchment on the part of the controller.[119] This is indeed an argument for a mixed composition of the nomination committee, allowing independents to air different proposals early on in the nomination process. On the other hand, in corporate groups the nomination process can, in principle, again be orchestrated on the parent level, with the subsidiary board having the last word before nominations go to the shareholders meeting.

As a result, the optimal composition of board committees depends very much on the specific circumstances of a controlled company. This favors broad flexibility, which is in fact what, e.g., the NYSE listing rules[120], the Swiss Code of Best Practice[121] or other European codes using the "comply or explain" concept provide for. [122]

3. Auditors and other Gatekeepers

a) Auditors

There are other gatekeepers besides the board of directors, the most important being the external auditor. Its role and independence has been one of the main topics in the aftermath of recent corporate scandals. Sarbanes-Oxley and its counterparts in other jurisdictions have all established new standards of independence for external auditors. While auditor independence from management is an undisputed necessity in widely held companies, the question of whether and to what extent auditors also have to be independent from controlling shareholders seems debatable. It resembles the issue of board independence. At the outset, it is clear that the auditor is accountable to the shareholders as a class. This certainly includes the major shareholder. To the extent that a controlling shareholder holds his investment passively, independence from him should therefore not matter.

[119] Cf. infra.
[120] NYSE Listed Company Manula Sec. 303.A.
[121] Sec. 28 Swiss Code of Best Practice.
[122] Flexibility is the hallmark of European corporate governance codes, e.g. the Combined Code; cf. NY Times, April 8, 2005, C1, "Corporate Rules in Europe Have Been Flexible, but Change is Coming"; cf. also Mayer (2003) strongly advocating the European approach and the Swiss in particular.

On the other hand, there is the potential that controlling shareholders may use their position to extract improper private benefits of control. In cases like Parmalat, Hollinger or Adelphia this has taken on fatal significance. Transfer pricing in corporate groups is another known area of potential improper benefit extraction. These risks favor rules requiring the independence of auditors not just from management, but also from controlling shareholders. This is in fact what rules generally provide for.[123]

b) Additional gatekeepers

Additional gatekeepers are banks and creditors, credit rating agencies and other capital market participants like financial analysts, the business media or transactional lawyers. The role they play with regard to controlled companies does not seem to be entirely different from their role in widely held companies. To be sure, where controlling shareholders, e.g., resort to increased credit financing in order not to dilute their control, creditors may assume a particularly significant risk position and a concomitant monitoring role. That such role is not always carried out successfully is evidenced by recent scandals like Parmalat in Italy or Erb in Switzerland[124]. At least for the US, however, data collected by Holderness/Sheehan showed that the leverage of controlled companies was on average lower than that of widely held companies.[125] Accordingly, it does not seem that creditors play a systematically more important monitoring role in controlled companies.

4. Specific Rules Against Self-Dealing

Insiders, whether they are controlling shareholders or managers, have special access to company assets, company information and company opportunities. There is, accordingly, a risk that they appropriate such goods to themselves instead of using them in the interest of all shareholders.[126] The risk exists in both controlled and widely held firms. Of course, it could be argued that it is potentially greater in controlled companies, because controlling shareholders hold ultimate sway over the board of directors, making the board a less effective monitor of their conduct.[127] By the same token, it could be argued that managers have a greater incentive to extract private benefits

[123] There is, of course, a question of whether these independence requirements work, as Coffee (2005) points out. He doubts it and suggests the idea of auditors appointed by minority shareholders only. This has certain parallels to the special investigator that can be requested by minority shareholders under, e.g., Swiss law (Sec. 697a et seq. Swiss Code of Obligations).
[124] A non-listed conglomerate with sales of more than three billion US Dollars which recently crumbled under a mountain of debt.
[125] Holderness/Sheehan (1998), 14.
[126] La Porta et al. (2000).
[127] This is why Coffee (2005), 11 et seq., suspects “private benefits of control” to be the major corporate governance fraud issue in controlled companies.

because they have less at stake in the company.[128] In addition, it could be said that managers are perhaps more inclined to fudge the numbers in order to protect their stock options.[129] That can, of course, be even more damaging to shareholder interests overall, as recent scandals like Enron, WorldCom and others have demonstrated.

There are no systematic data on the relative frequency and seriousness of self-dealing in controlled as opposed to widely held companies. Anecdotal evidence suggests that serious self-dealing can happen in both structures. Parmalat in Italy[130], Hollinger[131] or Adelphia[132] in the US epitomize the risks in controlled companies. Enron, Tyco and WorldCom have become symbols of the risks of self-dealing by managers in companies with dispersed ownership structures. In any case, it is evident that self-dealing inefficiently distorts rewards and incentive systems everywhere. The prevention of self-dealing in its various possible forms is therefore one of the main tasks of corporate law and corporate governance in general.

Legal systems have developed various specific rules against self-dealing, including restrictions on loans to insiders[133], insider trading rules[134] or procedural rules for transactions between companies and their insiders[135]. These rules tend to be applicable to all categories of insiders. There are accordingly few differences in their application to controlled and to widely held firms.[136]

Special rules with regard to the potential self-dealing of controlling shareholders do exist for corporate groups. The most prominent ones are those on transfer pricing. They have their roots in tax laws and tend to be highly sophisticated. Since their aim is to simulate "arms length" transactions, they are, mutatis mutandis, applicable in corporate law as well.

[128] It is interesting in that context to look at a survey of 200 CEOs in the NY Times of April 3, 2005, which shows that the two CEOs with the lowest total compensation (below 1 million $) were also the two CEOs with by far the largest wealth invested in their companies: Steven Ballmer of Microsoft and Warren Buffet of Berkshire Hathaway.
[129] Coffee (2005), 2.
[130] Ferrarini/Guidici (2005).
[131] Breeden (2002).
[132] Press release SEC April 25, 2005: "SEC and US Attorney Settle Massive Financial Fraud Case Against Adelphia and Rigas Family for $715 Million".
[133] E.g. the loan prohibition under Sec. 402 of the Sarbanes-Oxley Act.
[134] E.g. Sec 10b-5 of the 1934 Securities Exchange Act in the US.
[135] E.g. abstention rules or rules requiring the approval by special committees composed of disinterested persons.
[136] Differences could abound in connection with their enforcement, where rules are privately enforceable through derivative actions requiring board approval. Special rules are needed under these circumstances, preventing a board dominated by the controlling shareholder to suppress the action from going forward; UK law, in particular, has grappled with that problem, Davis (2002), 236 et seq.

VI. Monitoring External Private Benefits of Control

1. Corporate and Market Activities

External private benefits of control come out of the activities of controlling shareholders as shareholders.[137] These activities can be separated into corporate and market activities. Corporate activities occur in the context of shareholders meetings. They are, therefore, subject to the general rules and restrictions applicable to shareholder resolutions. Shareholder resolutions are governed by proxy rules and other procedural standards aimed at optimal decision-making with a view to the interests of all shareholders. Shareholder resolutions may also be subject to certain substantive standards, e.g. those provided for in German or Swiss law. In both jurisdictions, resolutions can be challenged on the grounds that they were arbitrary or violated the general principle of equal treatment among shareholders. Such restrictions, even though much looser than fiduciary duties imposed on insider conduct, can, inter alia, be understood as generic protections against ex post opportunism by controlling shareholders as shareholders and, as such, have efficiency potential.

There may be additional rules that matter specifically in the context of shareholder resolutions in controlled companies. One example are preemption rights and other legal safeguards protecting minority shareholders against dilution. They tend to be particularly strict in civil law countries like Germany or Switzerland, where the procedure of issuing new shares is highly regulated and, with few exceptions, in the mandatory domain of the shareholders meeting. This has the benefit of allowing minority shareholders to challenge such decisions both in the open forum of the shareholders meeting and before courts.[138] The same rationale applies to other fundamental decisions which European laws, unlike US law, assign to the shareholders meeting. This includes, inter alia, dividend pay-outs and all changes of constitutional documents, including by-laws.[139] To be sure, such laws typically leave the controlling shareholder wide discretion in taking decisions through majority votes. This seems appropriate as long as such decisions are within the range of expectations the minority shareholders had (implicitly) agreed to when the shares were issued to them. This can be assumed to be the case as long as the decisions meet certain basic tests of economic rationality within the limits of the law.

In addition, there might be shareholder resolutions where the controlling shareholder has a conflict of interest with his parallel position as a corporate insider. In these cases a "majority of minority rule" might apply, i.e. the controlling shareholder would be prohibited to vote.

[137] Supra.

[138] In addition, it also leads to some (cursory) government control by virtue of the requirement to have the resolutions registered with the commercial register as a condition for them to become valid. Under US law, legal controls and remedies would typically be limited to liability actions by minority shareholders.

[139] Other minority shareholder voting rights might affect board elections, such as Sec. 709 of the Swiss Code of Obligations: it gives the holders of shares that carry voting or dividend rights which are different from the shares of the controlling shareholder a right to appoint a board member; cumulative voting, as known in some US states, can have similar effects.

Examples are shareholder approvals of derivative actions under UK law,[140] "discharge" resolutions under Swiss law[141] or "freeze out" mergers.[142]

The market activities of controlling shareholders are subject to the general market rules that are applicable to all market participants alike. In addition, there is a question of whether specific legal rules should apply to the market conduct of controlling shareholders. One principal area of debate concerns control premiums in connection with the sale of share blocks.

2. Evaluating Control Premiums

a) Standard explanations for control premiums

The common wisdom among academic scholars has been that control premiums are a proxy for the private benefits of controlling shareholders.[143] No distinction is usually made between different categories of private benefits.[144] In addition, the general assumption seems to be that the existence of control premiums reflects an inability by legal systems to prevent private benefits of control. This implies that control premiums are, in principle, undesirable and inefficient or, at best, neutral.[145]

A recent empirical study by Dyck/Zingales measured control premiums in 39 countries using data from 393 sales of controlling blocks.[146] The premium was defined as the difference between the price for the controlling block and the post-sale market price of the shares. The study found on average premiums of 14%. Brazil was highest with 65%, Japan lowest with –4%. Countries on the higher end were the Czech Republic (58%), Italy (37%) or Mexico (34%). Countries on the lower end were the US (1%), the UK (1%) or France (2%). Somewhere in between were countries like South Korea (16%), Germany (10%) or Switzerland (6%). The authors tested several regressions and found, inter alia, that higher premiums and benefits are associated with less developed capital markets and more concentrated ownership. However, they shied away from rendering any judgment on the efficiency of control premiums.[147]

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[140] Davis (2002), 225 – 226.
[141] Sec. 695 Swiss Code of Obligations.
[142] Cf. infra.
[143] Barclay/Holderness (1989), 373 et seq.; Dyck/Zingales (2004), 541 et seq.; Ferrell (2004), 12; Coffee (2001b), 10; Bebchuk (1999), 24.
[144] Gilson (2004b), 22 et seq., is an exception, differenting between pecuniary and non-pecuniary private benefits of control.
[145] Easterbrook/Fischel (1991), 109 – 131, are an important exception, arguing strongly in favor of control premiums on efficiency grounds.
[146] Dyck/Zingales (2004).
[147] Id., 539, 541 (mentioning that they might merely have distributional consequences).

Bebchuk, on the other hand, modeled a "rent-protection theory" for the decision of a company's founder to keep control upon going public.[148] The model indicates that the founder's decision will be a function of the size of the private benefits of control he can extract from the company. When private benefits of control are large, leaving control up for grabs would attract rivals to get control and capture the private benefits. Furthermore, keeping control allows the founder to capture a control premium.[149] Hence, Bebchuk predicts that "in countries in which private benefits of entrenched control are large, …..ownership choices will be distorted" in favor of controlled company structures.[150] His policy conclusions are twofold, though:

- Given the perceived distorting effect of private benefits of control on ownership structures, he infers that "a corporate policy that lowers private benefits of control would bring us closer to efficient choices of ownership structures."
- Given the fact that benefits of control cannot be prevented totally, prohibiting or discouraging controlled company structures altogether would not be desirable, since this could lead companies not to go public at all. In addition, Bebchuk recognizes that it might not be "desirable to reduce private benefits all the way to zero", the reason being that "when the pressure of blockholders can improve incentives, having some private benefits of control might be necessary to induce them to hold a block and forego some benefits of diversification."[151]

Bebchuk's analysis renders at least two important insights:

- First, certain private benefits of control are desirable to induce controlling shareholders to bear specific private costs of control. In fact, it will be argued in the following that this is the basis for the potential efficiency of control premiums. A clear differentiation between internal and external private costs and benefits of control will be helpful in developing that argument.
- Second, benefits of control, even if considered undesirable, cannot be totally prevented. The larger they are, the more can be said in favor of the efficiency of controlled company structures. To be sure, this would just be "second best efficiency", the first best being a reduction of private benefits of control to a level such that shareholders are still willing to invest in control. The following analysis will limit itself to defining that first best optimum. This allows a depiction of the potential efficiency of control premiums even where internal private benefits are eliminated. It also implies that such elimination should indeed remain the goal of legal systems.

[148] Bebchuk (1999).
[149] Id., 1 et seq.
[150] Id., 30.
[151] Id., 31.

b) Control premiums as a potentially efficient compensation device

The external costs of control for a controlling shareholder can be significant and add up throughout the period during which he holds a controlling stake. They are likely to differ substantially depending on the type of control structure (e.g. single founder, family or corporate group) and can encompass the following:

- risks associated with the typical under-diversification of founders and families[152];
- risks associated with the diminished liquidity of control blocks[153];
- costs of keeping a shareholder group or family together (bonding costs);
- monitoring costs and costs of other activities as a shareholder (stewardship costs[154]);
- liability risks as a controlling shareholder (e.g. as a "deep pocket" or through "piercing the corporate veil"-concepts);
- costs and risks associated with the increased publicity as a controlling shareholder (hassle costs, personal safety risks).[155]

If a controlled company is being sold, there are specific contributions the controlling shareholder may make to the transaction, all of which can be added to the account of his external costs of control:

- timing, promoting and setting up the deal in order to get the maximum price for the company;
- negotiating the deal[156];
- assuming liability risks in connection with the sale, in particular if the controlling shareholder grants specific representations and warranties to the acquirer.[157]

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[152] Under-diversification should, of course, not be an issue in corporate groups with regard to subsidiaries, assuming the shareholders diversify themselves.

[153] The "block discounts" that sometimes have to be accepted if large blocks are being traded in the market are reflecting this risk.

[154] This is a term typically used in tax law and marks the costs that a parent company may not pass on to the subsidiary for tax purposes, another indication that these are external control costs.

[155] Taxes, too, could be a private cost of control to the extent they would be higher as a consequence of the block concentration (e.g. if capital gains taxes were levied on large control blocks only, as has been discussed for some time in Switzerland, where individuals do, in principle, not have to pay capital gains taxes). On the other hand, if taxes were lower as a consequence of the block-holding (as can, e.g., be the case for dividend deductions on income taxes) the tax reductions would enter the other side of the ledger as an external private benefit of control.

[156] Compensation for the fees of outside counsel, e.g. lawyers, might, to the extent they work on the transaction as a whole and not just for the controlling shareholders, be passed on directly to the company.

[157] The recent verdict of over 1 billion $ against Morgan Stanley in connection with an M&A transaction in which it was a mere advisor reflects the high risks at stake, cf. NY Times May 20, 2005.

How are these external costs of control being compensated for? Principles of non-discrimination and equal treatment generally prevent higher dividend payments to a controlling shareholder, unless he owns some type of preferred shares. Direct payments for external costs of control are not allowed either across jurisdictions and would be considered illegal self-dealing. The only options left for a controlling shareholder to be compensated for his external costs of control are in principle the following:

- Negotiate a preferred status (e.g. preferred shares) upon going public;
- get non-financial satisfaction from the reputation and prestige as the major shareholder of an important company (particularly if the company bears his name);
- be paid a control premium upon the sale of the controlling block.

Control premiums, often treated skeptically among legal academics[158], therefore appear as a potentially efficient (deferred) compensation device for the external costs of control of controlling shareholders. How can such a compensation mechanism be put to work in practice?

c) Looking at the buyer's side

The buyer who wants to buy 100 % of the shares typically values the company as a whole. That includes the synergies he hopes to make from the acquisition. He, of course, tries to minimize the price, but will always look at the total price he pays for all shares of the company. The distribution between the controlling shareholder and the minority does not concern him. In a functioning market environment, the buyer will therefore just pay the equilibrium price, meaning that every additional dollar he pays to the controller will be deducted from the price paid to the minority. For the buyer, a premium to the controlling shareholder, therefore, comes down to the same thing as a "golden parachute" or a "bonus" to the target management in a widely held firm[159]: it's part of the overall purchase price and that price is determined by the market.

There is a legitimate question mark behind golden parachutes and bonuses for target management in takeovers of widely held firms. One important consideration ought to be the contractual basis for such payment. If this is the case[160], an efficiency argument can be made that it was the result of a market arrangement. To be sure, the counterargument could be made as well: It could be questioned whether the arrangement was really made under free market conditions or whether there wasn't an element of coercion involved. But that, of course, could potentially be said about executive compensation in general.[161]

The argument for control premiums is less contestable: Assuming the controlling shareholder had never made any (explicit or implicit) promises to the contrary, it can be assumed that minority shareholders investing in a company with a controlling shareholder accept (and perhaps

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158 E.g. Clark (1986), 494 – 498; Coffee (2001b); Bebchuk (1994) and Bebchuk (1999); Ferrell (2004).
159 As was the case in the highly publicized Mannesmann takeover by Vodafone, cf. Gordon (2003), 37 et seq.
160 As it was not in the Mannesmann case, Id.
161 Cf. Bebchuk/Fried (2004), 61 et seq.

discount) the possibility of him selling out at some stage at a premium. Given his otherwise uncompensated external costs of control, this appears as a potentially efficient solution.

d) Bargaining power as a tool to extract a control premium

The external costs of control are, for the most part, sunk costs. Hence, in order to recover them in the form of a control premium, the controlling shareholder needs bargaining power in dealing with the potential acquirer. This bargaining power exists by virtue of the voting block the controlling shareholder brings to the table and without which no acquirer could get a hold of the company. The controlling shareholder is, therefore, in the driver's seat selling the company and can, accordingly, extract a premium from the acquirer. Given his bargaining power, is there a danger that the controlling shareholder may use his discretion in the negotiation process to overcharge for his costs of control? There are at least three factors acting as important counterweights:

- If the acquirer extends an offer to the minority shareholders, it can be refused. As long as the minority shareholders do not consider the offered price as being at least slightly higher than the net present value of their current claims on the future cash flows of the company, they will reject the offer. That puts a first limit on the control premium the controlling shareholder can charge.
- To the extent the minority shareholders are not accepting an offer, because it did not properly reflect their expected future cash flow claims, the acquirer will, in principle, be overpaying for the controlling shares, assuming his price calculation is (as it has to be) based on the value of the company as a whole.
- Another limit is put on the control premium through reputational markets for all actors involved in a sales transaction, including the controlling shareholders themselves, the acquirer, the banks, the transaction lawyers and others.[162]

[162] The relative importance of that factor will arguably be greater the greater trust levels and the tighter social controls are in a society.

e) Where does the control premium come from?

Assuming that no internal private benefits of control will flow to the acquirer through transfer pricing and other techniques, the size of the control premium he will be prepared to pay depends basically on two factors: the bargaining power of the controlling shareholder and the value the acquirer expects to generate over and above the value that would be generated by the current controlling shareholder. This includes first of all the synergies that the acquirer expects to be able to generate in his current sphere of activities.[163] Yet, it may also include part of the synergies the acquirer expects to generate in the target company. [164] Of course, if minority shareholders assessed these synergies in the same way as the acquirer, they would raise the price of their shares accordingly.[165] However, the acquirer will not (and will not be obliged to[166]) disclose all his expected synergies in the target.[167] He will perhaps also assess their likelihood differently than the minority shareholders.[168] He might therefore be able to buy the shares from the minority shareholders below their value to him, giving him surplus to be used to pay the control premium.[169] Even in a world with no internal private benefits of control, there will, accordingly, be sufficient resources out of which a rational acquirer might be able and willing to pay a control premium. [170]

To the extent the control premium indeed reflects the potential of controlling shareholders “looting” a company, the efficient answer to this is not a legal restriction of control premiums, but a strengthening of legal protections against “internal” benefit extractions by insiders in

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[163] If the acquirer is a corporation, e.g. synergies in the acquiring company; if the acquirer is an individual, e.g., the (non-pecuniary) benefits of owning the company (like the prestige that goes with ownership in a sports team).
[164] The demarcation between the spheres of the target company and the acquirer might be difficult in practice. Conceptually, the situation is straightforward, though: if the synergies accrue within the sphere of the target company, the new controlling shareholder or his representatives on the board would be obliged to leave the benefits to the target or to organize proper compensation, in which case the minority shareholders would receive a proportionate share.
[165] Since they would participate fully in them if they stayed on as minority shareholders.
[166] Depending on the applicable securities laws, he will be obliged to, e.g., disclose his planned strategic direction.
[167] And rightly so, giving him an incentive to invest in the takeover at all; cf. Easterbrook/Fischel (1991), 117 - 119.
[168] An empirical study about UBS in 1994 exemplifies this. BK Vision, in an attempt to get control over the strategy of the former UBS, had heavily bought registered shares with 5 times the voting rights of bearer shares and brought their premiums up to around 20 %. Nonetheless, the majority of the registered shareholders voted with the board of directors of UBS to repeal their voting privileges by converting their shares into bearer shares. In other words, these shareholders did not attach additional value to their registered shares because they did not believe in any benefits of UBS and its strategy being controlled by BK Vision. They, accordingly, voted to discard the premium on their shares. Cf. Loderer/Zgraggen (1999).
[169] The potential sharing of insider information between the controlling shareholder and the acquirer is, of course, a different issue. However, this can be dealt with through insider trading laws and a proper concept of fiduciary duties for insiders.
[170] A study by Nenova (2000) based on a sample of 661 dual-class firms in 18 countries, using data for 1997, showed significant price premiums for voting rights between 0 % for Denmark and 50 % for Mexico. Again, as in the case of control premiums, these value differentials can reflect the potentials of extracting internal private benefits of control (as suspected by Nenova). Yet they may also be interpreted as reflecting the expected synergy potentials as described above and, perhaps, the fact that voting privileged shares allow control to be built up faster and with a smaller equity investment.

general.[171] Curbing control premiums would in no way prevent such improper benefit extractions from happening[172], instead it might suppress potentially efficient control transactions.

f) Quantitative links between control premiums and external private costs of control

Except for the mechanisms and limits set out above, there are no other necessary links between the size of the control premium a controlling shareholder is able to negotiate and the size of the external private costs of control for which the control premium can be considered a (deferred) compensation. For lack of better alternatives[173], this still renders control premiums potentially efficient. There are also two additional implications:

- First, control premiums as a compensation device carry a random element. Controlling shareholders do not exactly know how large the control premium will be that they can expect to receive. In fact, this allows the conceptualization of the control premium as a flexible bonus or option for the controlling shareholder that may or may not materialize, but still have the desired incentive effects.
- Second, it could be that the prospect of a control premium is not sufficient to induce a controlling shareholder to invest in external private costs of control (e.g. in a developing country with very high country risks and therefore very high risks associated with the under-diversification of the controlling shareholder[174]). It might therefore be argued that in such case it could be efficient to let the controlling shareholder also collect internal benefits of control that are nowhere provided for.[175] This is doubtful, however, since such a standard would totally blur the concept of fiduciary duties and could give rise to uncontrollable abuses.

g) Alternatives to control premiums

Accepting the fact that control premiums have efficiency potential, the question remains why they aren't made an explicit part of the corporate contract at the time of the issuance of shares

[171] Supra.
[172] Because they would supposedly continue under the current controlling shareholder; the suggestion in Clark (1986), 497, to put a rule restricting control premiums on top of self-dealing prohibitions, would therefore "throw the baby out with the bathwater".
[173] Cf. infra.
[174] These risks might indeed be alternative explanations for the very high control premiums measured by Dyck/Zingales (2004) in emerging economies like Brazil.
[175] That is perhaps implied in the theory of Bebchuk (1999), 31.

to minority shareholders or, alternatively, why controlling shareholders do not always issue some type of preferred shares to themselves before selling stock to public shareholders.

To begin with, control premiums may become an implicit part of the corporate contract upon the issuance of shares to minority shareholders. As long as no other promises were made, minority shareholders have to reckon with the possibility that the controlling shareholder might sell his stake at a premium. As a consequence, minority shareholders have to factor this contingency into their calculus. This could lead to a discount in the price the minority shareholders are willing to pay for the shares of the company.

Under Swiss law, where the mandatory bid rule is a default provision for listed firms, the possibility of a control premium requires a specific clause in the articles of the company and may therefore become an explicit part of the corporate contract. Many companies with controlling shareholders did opt out of the mandatory bid rule in their articles of association.[176]

Still, why do controlling shareholders, instead of taking bets on an uncertain control premium, not just issue preferred shares to themselves and thereby secure a proper return on their external private costs of control? There are several possible reasons:

- First, uncertainty about the future private costs of control might advise against presenting a “fixed invoice” to minority shareholders ex ante. In view of the mechanisms that have a limiting effect on control premiums, leaving the price for control open until the sale of a block could, therefore, be in the interests of the controlling and of the minority shareholders alike.
- Second, issuing preferred shares creates two classes of shares, reducing the liquidity of the shares of the controlling shareholder such that he might not be able to sell his shares in the market if he, e.g., wanted to reduce his control block.
- Third, in a given share structure with only one class of shares, a controlling shareholder[177], faced with the choice of incurring specific external private costs of control, will not be able to convert his shares into preferred shares anymore. Nonetheless, potentials for substantial benefits of control might exist. In this situation, the prospect of a later control premium could tip the scale in favor of the controlling shareholder making the investment in specific private costs of control.

As a result, there are good reasons for leaving the possibility of control premiums to market forces and let the market decide which forms of compensation for the external private costs of control may be the most preferable.

[176] Cf. infra. The Swiss experience also indicates that control premiums are indeed on the minds of controlling shareholders upon going public. Interestingly, it could not be shown that the shares of such companies are discounted in any way, indicating that the net effect of control premiums for minority shareholders may at worst be neutral.
[177] E.g. an heir or a buyer having taken over from the founder.

3. Reassessing Mandatory Bid Rules

Against this background, mandatory bid rules that force the acquirer of a control block to also buy out the minority shareholders at a certain price appear questionable. The rule has its origin in the UK, but has also been spreading to Continental Europe. It is now part of the European Union's 13th Directive on Takeovers which has to be implemented in all member countries by May 20th, 2006.

Sec. 5 of the Takeover Directive requires an acquirer of securities in a company that give him "control" to extend a bid to all minority shareholders at an "equitable price". The definition of the percentage of voting rights that confer "control" is left to the member states. The "equitable price" is defined as the highest price paid by the acquirer or the parties acting in concert with him during a period of between 6 to 12 months prior to the bid. The member states may define the exact period and may also provide for upward or downward price adjustments by the supervisory authorities. The mandatory bid provisions do, however, not apply if the acquirer obtains control as part of a general, voluntary offer.

The strict mandatory bid rule in the UK has been a linchpin of the City Code on Takeovers and Mergers, a voluntary code among capital market participants that is generally complied with across the board.[178] The new EU Directive will now require the rule to be transferred into formal statutory law.

The EU and UK rules do appear overly rigid if put in the context of controlled companies. They might be justified in the case in which a new shareholder is building up a controlling position in a widely held company. In this case it could be argued that the minority shareholders are faced with a hitherto unknown controlling shareholder and the risk that he will extract improper (i.e. "internal") private benefits of control. They might therefore be given an option to exit or to stay on, depending on whether they anticipate net benefits for themselves in the new constellation.

If applied to companies that already have a controlling shareholder, the rule seems over-inclusive, since it interferes with a market-mechanism that balances external private costs with external private benefits of control. The potential consequences of that could, inter alia, be a suboptimal level of entrepreneurship or a suboptimal level of IPOs by entrepreneurs, putting a brake on innovation and the efficiency of capital allocation.[179]

[178] It defines "control" as being achieved once the acquirer holds 33.33% of the voting rights. The price to be offered to the minority shareholders is defined as the higher of (i) the market price at the time of the bid and the (ii) the highest price paid for the shares of the target during the last 12 months, with the takeover panel having discretion to grant proper adjustments in exceptional cases; cf. Rule 9 of the City Code on Takeovers and Mergers.

[179] To be sure, in a country like the UK, where the equal opportunity rule in connection with the sale of shares in acquisitions has had a long, market-developed tradition (cf. Franks/Mayer/Rossi [2004]), the mandatory bid rule appears in a different light than in a country where market structures had not developed nor anticipated such a rule and law imposes it nonetheless.

From this point of view, the flexible mandatory-bid rule under, e.g., Swiss law trumps the rigid EU-rule.[180] The Swiss rule provides for a bid to all shareholders after a threshold of 33.33 % has been passed. The offer price has to be at least equal to the current market price and not less than 25 % below the highest price paid for the shares of the company during the last 12 months. Yet, the rule allows companies to adopt a clause in their articles of association providing for an opt-out. This requires a majority vote by the shareholders, subject to the legal challenge that it was lacking legitimate justification.[181] The Swiss rule, therefore, allows controlled companies to clearly signal to their minority shareholders that the controlling shareholder might fetch a control premium if he decides to sell his block at any stage.[182]

4. Extending the Control Protection Strategy

Faced with the necessity to expand the company's equity base in order to finance further growth, a controlling shareholder might, in connection with an IPO or thereafter, have to choose between the following alternatives:

- dilute his control position by issuing new shares to the market;
- finance growth with higher leverage;
- opt for lower growth, financed internally with profits;
- issue equity with lesser voting rights, i.e. switch to a dual class share structure;
- use a pyramid system that allows him to finance a pro rata share of the new equity issue without introducing a dual class share structure.

Starting from the assumption that the alternatives of leveraging, not growing or growing more slowly are second best for the company, the issue boils down to the choice between dilution on the one side and a dual class or a pyramid structure on the other. The costs of dilution would be obvious:

- Loss of the prospect for the controlling shareholder to recoup (external) private costs of control, with the possible implication that investments in (future) private costs of control will not be made.

[180] Art. 32 of the Swiss Stock Exchange Law, cf. Hofstetter (2002), 35 - 37.

[181] In accordance with Art. 706 of the Swiss Code of Obligations, giving courts a handle to intervene if legitimate expectations of minority shareholders were ignored without a concomitant benefit for the corporation or the shareholders as a class, Hofstetter (2002), Id..

[182] An opt out prior to a listing may not be challenged for lack of a legitimate reason, which makes sense since no expectations of minority shareholders could have built up by then. Applying the same reasoning, the Swiss rule also provided for a two-year transition period after its adoption. During this period an opt out could be chosen without the risk of a legal challenge by minority shareholders, Hofstetter (2002), Id.

- Loss of the (future) shared benefits of control for all shareholders, i.e. the value-enhancing monitoring advantages of a controlling shareholder to efficiently police managers and drive performance.

From a normative point of view, the question is whether dual class share structures or pyramids offer efficient solutions to prevent these potential losses.

5. Dual Class Share Structures

a) Efficiency potential

Dual class share structures[183] can be used as devices to protect external private benefits of control, including control premiums.[184] They have efficiency potential to the extent that they promote shared benefits of control that outweigh the costs associated with dual class shares. The potential costs of dual class share structures are threefold:

- Weakened incentives of control: the larger the rift between the equity investment of the controlling shareholder and his voting rights becomes, the more his incentives will resemble those of third party managers.
- Increased entrenchment risks: in conjunction with the loosened alignment between the controlling shareholder's interests and those of the shareholders at large, the risk of entrenchment becomes potentially more serious.
- Higher risk of internal private benefit extractions: to the extent control can be used to extract internal private benefits of control, dual class share structures may amplify the incentives to do so.

Given the potential costs of dual class shares, it seems plausible that the higher the "wedge" between the relative equity investment of a controlling shareholder and his voting rights, the more such costs will materialize. Empirical studies seem to confirm this.[185]

These costs notwithstanding, dual class share structures can be expected to be efficient where the benefits of control for shareholders as a class are high. This could, e.g., be the case where a

[183] Dual class share structures can take on many forms and involve, e.g., multiple voting rights for a certain class of shares, non-voting stock or, as possible under Swiss law, voting restrictions for shareholders at a certain percentage level, with controlling shareholders being exempt, Hofstetter (2002), 24 – 27; cf. also the Deminor-study commissioned by the Association of British Insurers: "Application of the one share – one vote principle in Europe", March 2005.
[184] Another potential they offer is for controlling shareholders to better diversify and still keep control, i.e. to lower their private costs of control.
[185] Gompers et al. (2003).

company has to thrive in a highly dynamic “entrepreneurial” environment. The IT-sector might be an example. Therefore, the fact that a company like Google was listed with a dual class share structure should not be surprising. It could also explain why dual class listings in the US are on the rise, given the high share of IPOs coming from entrepreneurial sectors.[186]

Furthermore, dual class share structures can be expected to be efficient where private costs of control are high. This could, e.g., be the case where a founder or family has “sacrificed” substantial costs and opportunities in a longstanding effort to build, grow or keep alive a company controlled by them. Likewise, dual class share structures would appear to have efficiency merits in cases where the future private costs of control may be significant.[187]

b) Differentiating ex ante and ex post - introductions of dual class share structures

The normative conclusions that can be drawn from the above analysis are twofold. First, there is no efficiency basis for prohibiting dual class share structures by way of mandatory “one share one vote”-rules.[188] To the contrary, dual class share structures have a potential to serve as powerful devices to exploit the potentials of concentrated control structures and entrepreneurship. It therefore appears pertinent to basically leave the choice for or against dual class share structures to market forces. This poses few problems where companies list with such structures already in place. In this case, minority shareholders can assess costs and benefits ex ante and price the shares they acquire accordingly.

The situation is more differentiated when companies issue dual class shares subsequent to a listing. In this case, there is an obvious potential for opportunism and entrenchment that the minority shareholders cannot counter properly with either voice or exit. This is an area where law may legitimately intervene. The SEC’s disenfranchisement rule[189] seems optimal from that point of view. The same can be said about corporation laws that allow minority shareholders to challenge shareholder resolutions as discriminatory if they increase the relative voting power of the controlling shareholders through the issuance of dual class shares to them without proper justification.[190]

[186] In the year 2003, 16.5 % of IPOs in the US involved dual class shares, Business Week March 29, 2004, 60.
[187] The potential efficiency of dual class shares in at least certain instances are confirmed in economic models, cf. Hart (1995), 191 et seq.
[188] German law, which basically prohibits dual class shares, would not seem optimal from that point of view, cf. Sec. 2.1.2. of the German Corporate Governance Code of May 21, 2003: “In principle, each share carries one vote. There are no shares with multiple voting rights, preferred voting rights (golden shares) or maximum voting rights.”
[189] Cf. 17 CFR Part 240.
[190] Hofstetter (2002), 26.

c) Additional observations

Given the increasing potential costs of dual class share structures with rifts widening between equity investments and voting rights, it seems justifiable to set a legal maximum, beyond which dual class share structures may not develop. Some corporate laws have in fact done this.[191]

The basically favorable view of dual class share structures in controlled companies has to give way to a more skeptical view in dispersed ownership structures, where privileged voting rights are issued ex post as a defensive measure against potential takeovers. To be sure, if they have the opposite effect, i.e. if they make it easier for a shareholder to get control of a company, they can potentially be beneficial for minority shareholders, too.

6. Pyramids

a) Efficiency potential

Pyramids are corporate group structures, possibly involving several levels and allowing a shareholder to control a corporate organization with only a small percentage of the equity of the group. If he, for example, wanted to control just above 50 % of the equity at every company in a six-level pyramid, he would only have to own about 2 % of the overall equity. Pyramid structures, therefore, can be used as alternatives to dual class share structures in companies with controlling shareholders. La Porta et al., in fact, report that pyramids are more common around the world than dual class shares.[192] They are not widespread for tax reasons in the US[193], but are an important phenomenon in European countries, where several companies of a pyramid may be listed.[194]

Pyramids tend to be judged very critically.[195] The common wisdom is that they are merely an instrument to extract (internal) private benefits of control and therefore are widespread in countries with lax shareholder protection.[196] Almeida/Wolfenzon add an additional explanation. They posit that pyramidal structures grow if external funds are costlier than internal funds, allowing a controlling shareholder to invest in a project through his existing structure where an independent entrepreneur would not be able to raise funds.[197] This might explain why pyramids sometimes exist even though the wedge between the equity investment of the controlling shareholder and his voting rights is small.[198]

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[191] Swiss law, e.g., provides that privileged shares may grant a maximum of 10 times the votes of common stock, Art. 693 Swiss Code of Obligations.
[192] La Porta et al. (1999).
[193] Morck (2004).
[194] Report of the High Level Group (2002), 98.
[195] Bebchuk et al. (2000); Almeida/Wolfenzon (2005).
[196] Almeida/Wolfenzon, 1 et seq.; Bebchuk et al. (2000), 312.
[197] Cf. also Khanna/Palepu (1999), who argue that business groups arise to substitute for missing markets.
[198] Almeida/Wolfenzon (2005), 4.

Given the doubt about any fundamental efficiency merits of pyramid structures, there are incipient worldwide pressures to restrict or even dismantle them.[199] In the EU, proposals have been put forward to limit the listing of holding companies that serve as financing vehicles for pyramids, unless "a strong case is made as to the economic value" of the listing.[200] Taxation of inter-company dividends in line with US legislation is touted as another alternative.[201]

b) Ex ante investments in pyramids

In principle, the case for structural freedom in connection with pyramids is similar as with dual class shares: Pyramid structures allow a controlling shareholder to protect private and shared benefits of control. Once more, this militates in favor of a market approach, where choices are left to the shareholders investing into a particular corporate structure. This again requires a separation of ex ante and ex post-situations.

When minority shareholders take a decision to invest into a pyramid structure, it appears that the main requirement should be disclosure. As long as minority shareholders know the controlling shareholder and the extent of his equity exposure and voting power, an appropriate assessment of the potential risks and opportunities seems possible. It wouldn't appear to matter either, whether the buy-in is at the top or somewhere further down the pyramid. As long as the whole pyramid structure is fully transparent ex ante, capital markets can basically be expected to assess it properly.

There is one possible caveat, however. As the equity investment of the controlling shareholder in a pyramidal group gets smaller, his incentives will more and more resemble those of independent managers. Accordingly, there must be a critical point where the risks of control start outweighing the benefits of control from the point of view of minority investors anywhere in the pyramid. Hence, it seems justified to limit pyramid structures in similar ways as dual class share structures.

Technically this is more difficult, however. Tax laws requiring, e.g., a minimum percentage of inter-corporate share ownership in order to be able to deduct dividend payments within the group, are one possibility.[202] To be sure, such laws are over-inclusive as they also discourage potentially efficient group structures with less equity interface than is provided for in the tax rules. Another possibility are laws prohibiting the listing of finance companies which are part of pyramids.[203] If combined with a sufficiently detailed, but also flexible catalogue of exceptions, such rules could perhaps be tailored optimally.[204]

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[199] Cf. Bebchuk et al. (2000), 313-314.
[200] Report of the High Level Group (2002), 99.
[201] Morck (2004).
[202] That is the US approach stemming from the 1930s, cf. Morck (2004).
[203] This is the approach suggested by the Report of the High Level Group (2002), 99.
[204] The problem is always that such laws would have to differentiate between "pyramiding" and economically efficient group structures. This is, of course, difficult in practice and can lead to very high complexities posing a problem in their own right, cf. e.g. South Korean laws trying to curb certain chaebol structures.

c) Ex post pyramiding

A relatively stronger case for regulatory control can be made for the introduction of pyramid structures ex post. "Upward" pyramiding, i.e. the "leveraging" of voting control on the shareholder level[205] can be seen as similar to expanding the voting privileges of controlling shareholders in dual class share structures. However, since this is happening on the shareholder level and outside the shareholders meeting, no proper veto rights of minority shareholders can be devised. In addition, any intervention would gravely endanger the autonomy of controlling shareholders in financing themselves efficiently. Practically speaking, this favors regulatory restraint, relying on the effectiveness of general legal restrictions in connection with the establishment of pyramids, e.g. tax laws or listing requirements.[206]

"Downward" pyramiding, on the other hand, involves the same risks for minority shareholders as an acquisition of a majority stake in a company or the spin off into a new majority-owned subsidiary. These risks are, furthermore, not limited to controlled companies. They are equally relevant in companies under the de facto control of independent managers. In addition, the agency risks of such acts from the point of view of minority shareholders are not different from any other acts of the company, except that they may be of a particular magnitude. They could therefore warrant specific shareholder veto rights, as is, e.g. the case under the "Holzmueller"-doctrine in German law.[207]

7. Freeze-Out Transactions

a) Issues

Freeze out transactions can take on two basic forms: tender offers or mergers. Both are to be assessed critically from an efficiency standpoint, because they involve the risk of the controlling shareholder "coercing" the minority shareholders into selling their shares too low. Freeze outs became particularly popular after the decline of the stock markets in the beginning of the 21st century. As a consequence, they became a major legal topic on both sides of the Atlantic.[208]

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[205] By, e.g., bringing a control bloc of a (first) company into a (second) company as a contribution in kind, allowing the controlling shareholder to get control of such (second) company and at the same time having the cash funds of the second company at its disposal for subscribing to a new share issue in the first company.
[206] Supra.
[207] The doctrine refers to the Holzmueller-decision by the German High Court ("BGH"), BGHZ 83, 122; cf. Loebbe (2004),
[208] Cf. Subramanian (2004a), Subramanian (2004b) or the Macrotron decision in Germany, cf. Loebbe (2004), 1069 – 1071.

Freeze out transactions as such can make a lot of economic sense. They may allow the efficient total integration of a parent company and its subsidiary. They also solve the potential hold up problems a controlling shareholder can face with dissenting minority shareholders. In addition, they might give a controlling shareholder a chance to delist a company and save the significant costs of being public.[209] Modern laws, therefore, even provide for them legally in case the controlling shareholder owns a very high percentage, e.g. more than 90 or 95 % of the shares of a company.[210]

The most contested issue in freeze out transactions is the price at which the minority shareholders are able to sell their shares in a tender offer or are being cashed out in a merger. The problem stems from the fact that, typically, the controlling shareholder has access to superior information about the company and therefore is in a better position to assess the value of its shares. Conceptually, the issue is one of potentially extracting internal private benefits of control, since the controlling shareholder could be using information that he acquired as an insider. The same constellation exists in management buy out transactions. The question therefore is, how law can efficiently cope with this potential opportunism.

b) Rules

US law, in particular, has developed a myriad of rules. With regard to freeze out tender offers, SEC rule 13e-3 requires, inter alia, the disclosure of (independent) fairness opinions about the offered price. In addition, courts will review the fairness of the price under the limited appraisal test. The rules are more stringent for mergers. If the controlling shareholder owns less than 90 % of the shares, a majority vote by the shareholders is required and courts can thereupon assess the price under the entire fairness test applicable to related party transactions in general. This means that the company has to prove the fairness of the price and of the process in which it was determined. However, the burden of proof can be shifted to the minority shareholders[211] if the price determination was done within a structure that approximated an "arms length" transaction.[212] Another possibility to shift the burden of proof is to seek formal approval by the majority of the minority shareholders. On the other hand, if the controlling shareholder owns more than 90 % of the shares, no shareholder vote is required and courts apply a mere appraisal test.[213]

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[209] For additional reasons: cf. Kraakman et al. (2004), 142.
[210] Sometimes referred to as "squeeze out" laws.
[211] With the test remaining "entire fairness".
[212] By, e.g., leaving the decision to a special committee of independent directors.
[213] Cf. Kraakman et al.(2004), 143.

The laws in other jurisdictions have evolved in similar directions. In Germany, the “Macrotron” decision by the Federal High Court (“BGH”) has set a new standard for going private/delisting transactions by requiring a tender offer to the minority shareholders at a price that is subject to an appraisal review by the courts[214], and a majority decision by the company’s shareholders. In Switzerland, the Takeover Panel requires controlling shareholders in going private tender offers to attach an independent fairness opinion and to disclose certain key assumptions (e.g. the discount rate) underlying the opinion.

From an efficiency point of view, freeze out transactions have two problematic aspects: informational advantages of insiders and potential coercion. Their ramifications are slightly different for tender offers and mergers[215]:

- With regard to tender offers, insider advantages can be taken care of by insider trading restrictions for controlling shareholders and disclosure obligations. The proper level of such disclosure is, of course, always debatable. It seems appropriate, however, to request a heightened degree of disclosure in going private transactions as opposed to open market purchases by controlling shareholders. The reason lies in the potentially coercive aspect of such transactions. Faced with the choice of selling the shares to the controlling shareholder or being left in a market with very low liquidity and, perhaps, no listing, minority shareholders are caught in a “prisoners’ dilemma”.[216] This could lead them to sell at a suboptimal price, justifying in turn countermeasures in the form of heightened disclosure or other procedural protection devices, including shareholder votes or independent fairness opinions.
- With regard to mergers, the potential coercion is, on its face, particularly pronounced since the controlling shareholder can, in principle, cash out the minority shareholders at a price set by majority vote. This justifies deepened scrutiny of the “fairness” of the cash out price and/or additional procedural standards like approvals by special committees of independent directors or majority of minority votes as developed under US law.

As a result, there is a strong efficiency-case for regulatory involvement in going private transactions. That may include court evaluations of the price at which minority shareholders are being cashed out, even though procedural rules (including disclosure and shareholder voting) deserve preference over any authoritative guessing about the “iustum pretium”[217]. To the extent this is done anyway, valuations by courts should have to take into account control

[214] About the standards to be applied in the appraisal cf. the Altana - decision by the German Supreme Court of April 27, 1999 (BverfG, 1 BvR 1613/94).
[215] Of course, the two forms come de facto down to almost the same thing, justifying a convergence of the rules applicable to them, cf. Subramanian (2004b).
[216] To the extent that the acquirer will be able to force the remaining shareholders out with a "short form merger" or "squeeze out", the situation is further aggravated and boils down to a similar degree of potential coercion as in the case of freeze outs by mergers, infra.
[217] The “just price” that medieval common law grappled with at length.

premiums as potentially efficient devices to compensate the controlling shareholders for their costs of control.[218] Otherwise, going private transactions might be discouraged inefficiently in comparison with other control transactions, in particular the sale of controlled companies.[219]

VII. Mitigating Entrenchment Risks

1. Management v. Shareholder Entrenchment

Entrenchment risks are at the center of corporate governance discussions in dispersed companies. Managements protected by poison pills, staggered boards[220], voting restrictions[221] or other takeover defenses may potentially shirk or otherwise ignore shareholder interests. Empirical research, in fact, indicates more robust correlations between management entrenchment and firm performance than for other corporate governance phenomena.[222]

Management entrenchment is, in principle, not an issue in controlled companies, since close monitoring by controlling shareholders tends to stymie it at early stages.[223] This might in fact be the major explanatory factor for the superior performance of controlled companies in accordance with at least some empirical studies.[224] To be sure, the concentration of ownership entails a different entrenchment risk: one at the shareholder level. This is arguably less serious, given the fact that agency issues at the shareholder level are less pronounced than at the management level. Still, the entrenchment of controlling shareholders can become practical in situations of corporate crises, with regard to succession decisions or in the face of opportunities for growth or the sale of the company. They ultimately boil down to the potential of "political" or "irrational" behavior by

[218] The determination of the proper size of the control premium would conceptually have to simulate a sale to an independent third party in the same position as the current controlling shareholder. Control premiums in sale transactions of similar companies could serve as a reference. This also means that future costs of control and value creations by the controller as a consequence therof would not have to be shared with minority shareholders or at least not proportionately; cf. Easterbrook/Fischel (1991), 134 – 139.
[219] Cf. Gilson/Gordon (2003), arguing for the consistent treatment of different forms of control transactions involving controlled companies.
[220] Staggered boards are a specific US-phenomenon, since US law allows shareholder rights to be preempted such that the right to table certain amendments to the statute of incorporation can be left exclusively with the board. That would be against the notion of shareholder supremacy in other countries.
[221] This is a typical Continental European phenomenon, but not uniformly. It is legally possible in Switzerland, but not anymore in Germany, supra.
[222] Bebchuk et al. (2004), 6 - 11; Clark (2005), 42 – 43.
[223] There is, perhaps, an indication of that in a recent survey summarized in the NY Times of May 18, 2005, C3, showing that CEOs seem to have more job security in the US than elsewhere, including Europe, where controlling shareholder structures are more widespread.
[224] Cf. supra.

the controller.[225] The question then becomes how legal rules can mitigate the risks of entrenchment on the part of controlling shareholders. [226]

Where the controlling shareholder is, e.g., also the CEO and is the problem instead of the solution to the challenges faced by the company, fiduciary duties of himself and the board will at some point kick in and perhaps “help” him out. Shareholder discontent at shareholders meetings and in private encounters with the controlling shareholder or his board members might play a complementary role. [227] To be sure, the very self-interest of the controlling shareholder in preserving the value of his company should cause him to act earlier. Yet, there remains a residual risk. Bias and stubbornness can distort the judgment of the best entrepreneur and damage him as well as the minority shareholders.[228] For them, the last resort is exit, i.e. the sale of their shares.

2. Exit Measures

Of course, the exit of minority shareholders through stock market sales after the entrenchment occurred is not a first best solution, since prices will already have been affected negatively. Legal rules may therefore grant exit relief at an earlier stage and thereby mitigate potential entrenchment risks. Examples of such preventive exit rights are the appraisal rights of minority shareholders under US law (upon mergers) or German law (upon the integration of a company in certain forms of corporate groups[229]). Mandatory bid rules can be seen as having the same function or at least the same effect. They allow a shareholder to exit a company once a new shareholder has assumed control.[230]

Another exit-measure for minority shareholders are the company-dissolution actions sometimes provided for in corporation laws. They are an extreme device against the entrenchment of controlling shareholders.[231] These remedies have, however, only theoretical relevance in the context of listed companies where the sale of minority shares in the stock market always remains a preferable, less value-destroying alternative.

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[225] Of course, self-defeating behavior is as much a possibility in dispersed companies, where shareholders might be acting irrationally too, e.g. institutional shareholders driven by strategic political goals or mired in internal agency conflicts.

[226] In a wider sense, “entrenchment” can be seen as including all decisions by the controlling shareholder that are political-strategic and destructive to minority shareholder interests, including, e.g., a policy not to pay out any dividends in order to “starve” minority shareholders.

[227] This is a reason for requiring shareholder votes even for transactions where the controlling shareholder has de facto sealed the vote before the meeting.

[228] Similar rationales apply for other entrenchment scenarios, e.g. a succession crises or the refusal of a controlling shareholder to grow or sell his company.

[229] Sec. 305 (1) Company Act.

[230] There is also a cost side to such rules in that they impose additional transaction costs on controlling shareholders. In addition, to the extent that they restrict control premiums, they threaten to hamper the efficient exercise of entrepreneurial control by controlling shareholders. They should therefore be kept flexible or allow for proper opting out solutions by controlled companies; cf. supra.

[231] E.g. in Swiss law for minority shareholders representing at least 10 % of the votes, Sec 736 (4) Swiss Code of Obligations.

Other rules that can have the effect of breaking the entrenchment of a controlling shareholder are "sunset"-rules, like the so called "breakthrough rule" in Sec. 11 of the recently enacted 13th Corporate Law Directive on Takeovers in the EU. It suspends share transfer and voting restrictions in certain specifically described situations[232]:

- No transfer restrictions (including those in shareholders agreements[233]) apply vis-à-vis the offeror upon the publication of a tender offer;
- no voting restrictions apply for shareholder resolutions on defensive measures during the offering period;[234]
- in the first shareholders meeting called by the offeror after the bid to amend the articles of association or to appoint and remove members of the board[235], multiple voting shares are limited to one vote each;
- if, following a bid, an offeror holds 75 % or more of the capital carrying voting rights, no restrictions on either the transfer or the voting rights in connection with resolutions of the shareholders meeting on defensive measures shall apply any further, neither shall any "extraordinary rights of shareholders concerning the appointment or removal of board members provided for in the articles of association".

Art 11 of the 13th Directive represents a novel and differentiated attempt to cope with the issues surrounding the perennial topic of "one share one vote". It may well be an optimal approach to entrenchment in companies with dispersed shareholder structures. However, as shown earlier, "one share one vote" may be less than efficient in controlled companies.[236] A mandatory breakthrough rule would therefore potentially stifle efficient capital structures in controlled companies and threaten the benefits of control for controlling shareholders and minority shareholders alike. From an efficiency perspective, it seems that EU member countries should, therefore, be advised to opt out of Art. 11[237] allowing companies to opt back in individually[238] where the benefits of the rule outweigh its costs.[239]

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[232] The restrictions are subject to "equitable compensation" to be specified by the laws of the member states.
[233] There is a grandfathering clause for shareholders agreements entered into prior to the enactment of the 13th Directive.
[234] Equally, multiple voting shares are limited to one vote each; however, voting restrictions for shares with special pecuniary advantages (e.g. preference shares) remain in force.
[235] The offeror also gets the right to call a meeting.
[236] Cf. supra.
[237] As is possible under Art. 12.
[238] Art. 12 grants that power to the shareholders meeting.
[239] Coates (2003), too, expresses skepticism about the merits of a rigid break through rule in general.

VIII. Conclusions

Legal analysis can be empirical[240], normative or doctrinal. Many of the recent contributions to the US-led debate about controlled company structures have been empirical.[241] Normative conclusions were drawn only selectively.[242] European legal articles, on the other hand, tend to be merely doctrinal[243]. Their focus is on the interpretation of given legal norms, e.g. minority shareholder rights provided for in statutes. On both sides of the Atlantic, however, broad normative discussions about the merits and demerits of controlled company structures and their optimal regulation have not had center stage. This paper therefore has tried to take a broad view of controlled companies along normative lines, drawing general as well as specific conclusions for their governance and regulation.

The comparison of controlled with dispersed ownership structures showed different potentials and risks. Neither conceptual analysis nor empirical data favor one structure over the other. Both seem to have their comparative advantages, but their specific agency risks, too. Hence, selection should be left to the markets as arbitrators. Everything else would be a "pretense of knowledge".[244] The normative challenge therefore is to devise regulatory frameworks within which the open competition between different forms of ownership structures can take place without distortions. Such an approach presumes legal regimes in which both structures are treated equally. Equal treatment requires that unequal structures be treated unequally. Given the different risks and opportunities of dispersed and controlled ownership structures, legal systems would therefore have to provide for properly differentiated rules.

The particular potentials of controlled companies lie in the shared benefits of control they can generate for all shareholders. The main risks lie in the potential private benefits of controlling shareholders. However, an undifferentiated concept of "private benefits of control" could lead down the slippery slope of overregulation. Important distinctions need to be made before rushing to any normative conclusions. A primary one is the difference between internal and external private benefits of control. Only the first leave no doubt about the efficiency of legal intervention in the form of disclosure, minority shareholder rights, fiduciary duties and restrictions on self-dealing. The second, on the other hand, have to be assessed in light of their twin-counterpart: the external private costs of control. Where the shared benefits of control promise to be large, controlling shareholders might be willing to undertake them anyway. At the margin, however, these costs will not be incurred unless controlling shareholders have a sufficient prospect of recouping them. Control premiums allow that to happen.

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[240] This includes economic, sociological or historic studies, looking at legal structures as they are or were.
[241] E.g. La Porta et al. (1999); Gompers et al. (2003); Dyck/Zingales (2004); cf. also the important UK-contributions to that debate, e.g. Franks/Mayer (2005); Cheffins (2000, 2001, 2002).
[242] E.g. Ferrell (2004) with regard to disclosure or Cheffins (2002) in more general terms.
[243] "Stamp collections" in the (exaggerated) words of Ronald Coase.
[244] Cf. e.g. von Hayek (1944), 83 - 84.

Efficient legal rules, therefore, have to differentiate between different forms of private benefits of control. They might also have to take into account that there are various forms of controlled ownership, e.g. family companies or corporate group structures. Thus, corporate governance rules should not be geared to dispersed ownership structures and then imposed blindly on controlled companies across the board. Default rules allowing for opt-out solutions can offer the necessary flexibility. Corporate governance codes along the “comply or explain” - concept represent another regulatory technique that allows for proper adjustments in the context of controlled companies. These approaches recognize a fact that is as true in corporate governance as elsewhere: one size does not fit all.

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