

Columbia Law School
The Center for Law and Economic Studies
435 West 116th St.
New York, NY 10027-7201

Working Paper No. 186

**The Quality of Corporate Law Argument
and its Limits**

Mark J. Roe
Columbia University
School of Law

February 15, 2001

*This paper can be downloaded without charge from the
Social Science Research Network electronic library at:
http://papers.ssrn.com/paper.taf?abstract_id=260582*

*An index to the working papers in the Columbia Law
School Working Paper Series is located at:
<http://www.law.columbia.edu/lawec/>*

The Quality of Corporate Law Argument and its Limits

Mark J. Roe

March 30, 2001

mroe@law.harvard.edu

The Quality of Corporate Law Argument and Its Limits

Mark J. Roe*

A strong theory has emerged in recent years that the quality of corporate law determines whether securities markets will arise, whether ownership will separate from control, and whether the modern corporation will prosper. The theory has been used convincingly to explain why we see weak corporate structures in transition and developing nations, less convincingly to explain why concentrated ownership persists in continental Europe, and probably incorrectly to explain why ownership separated from control in the United States. Surely, when an economically-weak society lacks regularity—a gap that may be manifested by weak or poorly enforced corporate law—that lack of regularity and that lack of economic strength precludes complex institutions like securities markets and diffusely-owned public firms. But in several nations in the wealthy west legal structures are quite good and, by measurement, shareholders are well-protected, but ownership has still not yet separated from control. Something else has impeded separation. We can hypothesize what that something is by examining the calculus of owners and investors when the decision is being made as to whether to diffuse ownership. Ownership cannot readily separate from control when managerial agency costs are especially high. And missing from current theory, empirical work, and discourse is the basic concept that even American corporate law—usually seen as high quality nowadays—does not burrow into the firm to root out those managerial agency costs that arise from mediocre business decisions. Judicial doctrine and legal inquiry attack self-dealing, not bad business judgment. The business judgment rule, under which judges do not second-guess managerial mistake, puts the full panoply of agency costs—such as over-expansion, over-investment, and reluctance to take on profitable but uncomfortable risks—beyond any direct legal inquiry. (This limit from the business judgment rule is not a “defect” in corporate law: aggressive judicial attack on managerial error would replicate the costs of government management of business. Something other than direct legal attack has to control basic managerial agency costs, because judicial action here is far too costly.) The consequence is that even if corporate law as usually conceived is “perfect,” it eliminates self-dealing, not managerial mistake. But managers can lose for shareholders as much, or more, than they can steal from them, and law controls only the second cost not the first. If the risk of managerial error varies widely from nation-to-nation, or from firm-to-firm, ownership structure should vary equally widely, even if conventional corporate law tightly protects shareholders. There is also good reason, and some new data, consistent with this analysis: by measurement several nations have fine enough corporate law; distant stockholders are well-protected from controlling stockholder and managerial thievery, but uncontrolled agency costs though seem to be especially high in those very nations.

* Columbia Law School. Thanks for research assistance go to Mark Brod and Karen Powell. And thanks for comments go to Lucian Bebchuk, Victor Brudney, John Coates, Einer Elhauge, Howell Jackson, Reinier Kraakman, Mitch Polinsky, and participants in workshops at the Harvard Business School, Stanford Law School, and the University of Southern California Law School.

TABLE OF CONTENTS

Introduction.....	1
I. The Argument: Corporate Law as Propelling Diffuse Ownership.....	6
A. Protecting Minority Stockholders.....	7
B. The Attractions of a Technical Corporate Law Theory.....	10
II. Its Limits: Theory	11
A. Where Law Does not Reach: How Managerial Agency Costs Impede Separation	11
B. Improving Corporate Law <i>without</i> Increasing Separation.....	13
1. <i>The model</i>	13
2. <i>An example</i>	15
C. Corporate Law's Limited Capacity to Affect Agency Costs	16
1. <i>The business judgment rule</i>	16
2. <i>Agency costs: shirking and stealing</i>	18
D. Law's Indirect Effect on Agency Costs.....	20
E. Precision in Defining Agency Costs and Private Benefits	21
F. Ambiguity: Improving Corporate Law Can <i>Reduce</i> Separation.....	22
G. The Tight Limits to the Purely Legal Theory.....	24
III. Its Limits: Data	25
A. Measuring Quality	25
1. <i>Corporate law: what counts?</i>	25
2. <i>Corporate law: the bottom-line</i>	27
B. Data: Nations with Good Corporate Law but <i>Without</i> Separation.....	28
1. <i>Trading control blocks</i>	28
2. <i>Dual class common stock</i>	30
3. <i>Enforcing contracts</i>	36
C. What Beyond Law is Needed for Separation in the Wealthy West?.....	38
1. <i>Economic preconditions</i>	38
2. <i>Political preconditions</i>	38
3. <i>Social preconditions</i>	39
Conclusion: The Quality of Corporate Law Argument and its Limits	39

Tables and Graphs

Table 1: When agency costs high, private benefits to controlling shareholder irrelevant	15
Table 2: Voting premium and ownership concentration	32
Table 3: Political placement as predicting separation of ownership from control.....	42
Graph 1: Voting premium fails to predict ownership concentration in 12 OECD nations.....	33
Graph 2: Left-right politics predicts ownership concentration in 12 OECD nations.....	42

Introduction

A powerful and important theory has emerged in the past few years that the critical precondition to developing modern securities markets, and the industrial, technological wealth that goes with deep and vibrant securities markets, is a foundation of highly developed corporate and securities laws that protect stockholders from the rampages of the dominant majority stockholders or controlling managers. Without such corporate law protections securities markets will not arise. And if corporate law is good enough in technologically-advanced nations, ownership will diffuse away from concentrated ownership into dispersed stock markets.

This perspective contributes greatly to our understanding why ownership and control do not separate in every nation, especially to understanding the fragility of capital markets in transition and third-world economies. But there is too much that is critical to separation that corporate law doesn't reach in the world's richest, most advanced nations. The current academic thinking lumps together costly opportunism due to a controller's self-dealing and costly managerial decision-making that inflicts losses on the owners. The first, self-dealing, law seeks to control directly; the second, bad decision-making that damages shareholders, it doesn't. Other institutions must control the latter and these institutions can, and do, vary from nation-to-nation and firm-to-firm. Owners tend to stay as blockholders—impeding the separation of ownership from control—if they expect managerial agency costs would be very high after full separation. Corporate law can directly control agency costs from stealing, but does not even try to directly control the costs of mismanagement. Corporate law or a substitute seems necessary to control the rampages of a controlling stockholder and to reduce the thievery of inside-managers, but good, even perfect corporate law isn't sufficient to induce separation even when technological conditions make a nation's firms ripe for separation.

Among the world's richer nations, several by measurement have *good* minority stockholder protection, which the quality-of-corporate law theory would predict should have long ago facilitated separating ownership from control. But despite protective results that keep the rampages of the majority stockholders in check, ownership has *not* yet neatly separated from control. Our task is to assess the theoretical

implications of why separation did not happen, since these counter-examples suggest to us that deficient legal protection was not necessarily the base-line impediment.

The fact that ownership did not separate from control in a nation does not tell us whether it didn't separate because blockholder rampages are uncontrolled or because managerial agency costs are potentially far too high. If underlying economic, social, or political conditions make managerial agency costs very high and containable only by a controlling shareholder, *then concentrated ownership will persist whatever the state of corporate and securities law in controlling blockholders and other insiders.*¹

I speculate on what underlying economic, political, and social conditions could make managerial agency costs persistently high. I also speculate on how a shrinking of these agency costs, one plausibly now going on in continental Europe, could induce a demand for legal change to facilitate separation. Many business features could keep agency costs higher in one nation than another: a weak product market is one; especially opaque businesses is another; an inability to use incentive compensation effectively because it would, say, disrupt relationships within the firm, is a third; a high level of social mistrust that impedes professionalization of management could be a fourth.

Corporate law, when it's effective, impedes insider machinations: it stops, or reduces, controlling shareholders from diverting value to themselves, and bars managers from putting the firm into their own pockets. When, for example, controlling shareholders obtain very high private benefits from control, because they divert firm value into their own pockets, then distant shareholders will mistrust the insiders, and ownership concentration should, all else equal, persist. Good corporate law (or substitutes like stock exchange rules, contract, media glare, or reputational intermediaries) can reduce this potential for thievery and, as such, facilitates separating ownership from control. Similarly, managers can divert value to themselves in the diffusely held firm and, if diffuse stockholders fear this diversion as well, they will be reluctant to trust the firm to managers. Good law can control this potential as well.

1. Endogenously determined: Harold Demsetz & Kenneth Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 J. POL. ECON. 1155 (1985).

But there is more to running a firm than controlling insider machinations. Managerial agency costs to distant shareholders come in *two* basic flavors: thievery and mismanagement. Law can reduce the first, but does very little directly to minimize the second. Not yet fully recognized in the current literature is that American law *avoids* dealing with the second. The business judgment rule has courts *refusing* to intervene when shareholders attack managerial mistake. Indeed, one might argue in only a modest over-statement that in modern American business history, there has been only one significant successful judicial attack on managers for mistake, that in *Smith v. Van Gorkom*, an attack the legislature promptly reversed.

It's business conditions, incentives, professionalism, capital structure, product and managerial labor market competition, and financial alignment with shareholders that directly impede managerial mistakes, *not* corporate law. Conventional, technical corporate law has little to say here. (True, law can create or destroy anything, so law isn't irrelevant, but it is a second-order phenomenon: other institutions primarily control managerial mistake.)

And today's corporate theory cannot explain why several wealthy European nations protect minority shareholders well, but nevertheless *still* have concentrated ownership. The most plausible theory is that separation hasn't occurred because a) managerial agency costs from dissipating shareholder value would be very high after full separation, and b) concentrated ownership reduces those costs to shareholders enough. I speculate on several reasons why these costs to shareholders vary from nation-to-nation and firm-to-firm. I also speculate and provide some crude data suggesting that these managerial costs are lower in the United States.

This then is the first limit to the quality-of-corporate-law argument: A good core of corporate law—that attacks and destroys insider thievery—is not enough to induce separation. Recognizing that it may well be necessary is an important contribution to our understanding of how and why financial markets do and don't develop. But managerial agency costs of another sort must also be contained—costs that come from dissipating shareholder value—and corporate law as conventionally understood does little directly to contain these managerial agency costs. When managerial agency costs are very high, ownership cannot readily be separated from control.

Moreover, by shifting our focus from legally malleable private benefits to managerial agency costs that dissipate shareholder value, we can understand why sub-standard corporate law persists in a few of the richer, well-developed nations. Low quality law might in some nations be a *symptom* of weak separation, not its base-line *cause*. If these kinds of managerial agency costs from dissipating shareholder value would be too high anyway for there to be much separation even if corporate law were perfect, then there's little reason for the players (public policy-makers, investors, owners) to build good corporate law, because it wouldn't be much used anyway.

* * *

A second, and secondary, theoretical limit afflicts the quality-of-corporate-law argument, in a way current theory does not yet recognize. High quality corporate law is consistent with diffuse ownership *and* it is *also* consistent with concentrated ownership. High quality corporate law makes distant stockholders comfortable with blockholders, because good law channels blockholders away from stealing from distant stockholders and into productive activity (such as overcoming shareholder free rider and informational problems or monitoring managers, for example). Channeling blockholders away from anti-stockholder action should mean in theory that improving the quality of corporate law could, all else equal, *increase* blockholding as easily as it could decrease it. Minority stockholders have less reason to fear the big blockholders when corporate law protects them. If the blockholders increase value, then we could see more of them develop, not fewer of them, as corporate law quality improved.

One last use of the quality of corporate law argument is its most plausible. It has been invoked to explain why stock markets have not prospered in the transition economies after large industry was privatized in Russia and Eastern Europe. Policy-makers posit that corporate law institutions must be in place before securities markets can develop further. Although this may be true for the transition economies, it hasn't been true for the world's currently developed nations. And when observers see corporate law as lacking in the transition economies, they are observing societies that lack basic regularity; it is the lack of regularity that precludes private institutions, like effective stock exchanges, reputational intermediaries, and private law institutions that could get a securities market up and running, with corporate law later

fixing up the rough edges. Moreover, by focusing so strongly on developing good corporate law institutions *first*, policy-makers could be using the wrong strategy: It did not happen that way before, and a better strategy (if not foreclosed by other impediments) may have been *first* to develop private enterprise (probably in closely held form) and *then*, when entrepreneurs sought to raise new capital, to merge, or to sell, *later* seek to build corporate and securities law institutions. Policy-makers are trying to use corporate law to bring about, or to make up for the lack of, fundamental change elsewhere in those societies, seeking to remedy their lack of regularity, their weak private institutions generally, and their worthless reputational and social capital. This effort to so use corporate law is laudable, perhaps even necessary as the only, or as the best, available tool, but we should appreciate that such efforts would not replicate what worked before, and would have corporate law do something new and much more ambitious.

Good corporate law that stymies a grasping controller, or good substitutes like effective stock exchanges, effective reputational intermediaries and the like, is good for a nation to have. It reduces the costs of running a large enterprise. But it's insufficient to induce ownership separation. It's thus at least possible that some reformers may be pinning their hopes too heavily on good corporate law to propel development in third world and transition countries.

My logic here is that the current wisdom and theory tell us that when the core of corporate law is atrocious, and substitutes unavailable, complex firms cannot be stabilized. This is true, and the empirical contributions here are considerable. But the *converse* of the current wisdom is believed as well, although it is false: Bad law impedes separation, but when there's no separation, law could be good with something else impeding that separation, not corporate law. Since several nations *have* protective corporate law but *limited* separation, this aspect of the conventional wisdom—if a rich nation gets good corporate law, separation will begin—is thus contradicted empirically, and we need some new theory to explain why.

* * *

A roadmap for this Article: I outline in Part I the quality of corporate law argument and why it is important. In Part II I show why when potential dissipatory managerial agency costs are perniciously high in a society, but containable by dominant stockholders, corporate law

quality is irrelevant or tertiary: even if it's good, ownership will not separate from control. (I distinguish two types of agency costs: those that shift value away from stockholders to controllers and those that dissipate shareholder value.) Conventional corporate law can contain managerial agency costs due to thievery, but does not directly contain managerial agency costs due to mismanagement. Concentrated ownership will persist in firms in high-agency-cost nations *even if conventional corporate law quality is high* as long the owner can contain enough of these costs. In Part III I show why the data indicates that the quality of corporate law argument, although it explains transition economies nicely, is over-stated for several of the world's richest nations: in too many of them, even with good shareholder protections, stock can be and is sold, but ownership doesn't separate from control. Something else has made concentrated control persist. I speculate what that might have been.

Lastly, I conclude. High quality, protective corporate law is a good institution for a society to have. It lowers the costs of building strong, large business enterprises. It can prevent, or minimize, controlling stockholder diversions, a necessary condition for separation. But among the world's wealthier nations, it doesn't primarily determine whether it's worthwhile to build those enterprises. It's a tool, not the foundation.

I. The Argument: Corporate Law as Propelling Diffuse Ownership

Today's most popular academic explanation for why continental Europe lacks deep and rich securities markets is the purportedly weak role of corporate and securities law in protecting minority stockholders, a weakness that is said to contrast with America's strong protections of minority stockholders. A major European-wide research network, leading financial economists, and leading legal commentators have stated so.² One can imagine the Nobel Prize winning Franco Modigliani

2. Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471, 492 (1999); Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1136-37 (1998); Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131, 1138 (1997); Lucian A. Bebchuk, *A Theory of the Choice Between Concentrated and Dispersed Ownership of Corporate Shares and Votes* (Harv. Law & Econ. working paper, Oct. 1998);

shaking his head in disappointment when writing that nations with deficient legal regimes cannot get good stock markets and, hence, “the provision of funding shifts from dispersed risk capital [via the stock market] ... to debt, and from [stock and bond] markets to institutions, i.e., towards intermediated credit.”³ In a powerful set of articles by prize-winning economists, we learn that deep securities markets correlate with an index of basic shareholder legal protections.⁴ Indeed these protections, we learn, are the sine qua non: “[P]rotection of shareholders ... by the legal system is central to understanding the patterns of corporate finance in difference countries. Investor protection [is] crucial because, in many countries, expropriation of minority shareholders ... by the controlling shareholders is extensive.”⁵ Leading legal commentators have abandoned their prior economic theories for the law-driven theory.⁶

A. Protecting Minority Stockholders

The basic law-driven story is straightforward: Imagine a nation whose law badly protects minority stockholders against a blockholder extracting value from small minority stockholders. A potential buyer fears that the majority stockholder would later shift value to itself, away from the buyer. So fearing, the prospective minority stockholder does

Marco Becht & Ailsa Röell, *Blockholdings in Europe: An International Comparison* (1998) (European Corporate Governance Network overview paper); Wendy Carlin & Colin Mayer, *Finance, Investment and Growth*, at 13, 33 (Oxford working paper) (Oct. 1998); John C. Coffee, *The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implications*, 93 NORTHWESTERN U. L. REV. 641 (1999).

3. Franco Modigliani & Enrico Perotti, *Security versus Bank Finance: The Importance of a Proper Enforcement of Legal Rules*, at 5 (working paper, November 1998); see also Franco Modigliani & Enrico Perotti, *Protection of Minority Interest and the Development of Security Markets*, 18 MANAGERIAL & DEC. ECON. 519 (1997).

4. See La Porta et al. articles, cited supra note 2.

5. Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, *Investor protection and corporate governance*, 58 J. FIN. ECON. 3, 4 (2000).

6. Compare Coffee, supra note 2 (law determines the degree of separation) with John C. Coffee, *Liquidity versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991) (owners' drive for liquidity induces them to forego concentrated ownership).

not pay pro rata value for the stock. If the discount is deep enough, the majority stockholder decides not to sell, concentrated ownership persists, and stock markets do not develop.

One can imagine a law-driven process. In the United States, in France, and in Germany, founding owners sell stock to minority stockholders, who naively buy from the controller. A few years later the controllers in each nation rob the minority stockholders through fraud (by lying about the true state of the firm and then afterwards buying up the stock cheap) or interested party transactions (by forcing the corporations to buy raw materials at inflated prices from firms in which the controllers have strong positions). Or the equivalent occurs: the founders sell out their entire position to the naive public buyers, but then a raider attacks, takes a control block, and shifts value from the remaining public stockholders to himself. In the United States, the supple, adaptive common law judge hears the case, bangs the gavel and does justice, protecting the minority stockholders; securities markets flourish. In France, Germany, and Italy, the civil law judges reason formalistically, dismiss the case, and fail to protect the minority stockholders; securities markets wither.⁷ Private institutions fail to develop to remedy the legal defects.

Theory can approach the problem from the owner's perspective. Posit large private benefits of control. The most obvious that law can affect are benefits that the controller can derive from diverting value from the firm to himself or herself. The owner might own 51% of the firm's stock, but retain 75% of the firm's value if the owner can over-pay himself or herself in salary, pad the company's payroll with no-show relatives, use the firm's funds to pay for private expenses, or divert value by having the 51%-controlled firm over-pay for goods and services obtained from a company 100%-owned by the controller. Strong fiduciary duties, strong doctrines attacking unfair interested-party

7. If the public stock-buyers are non-naive, the selling blockholders are not without self-help contractual remedies to stymie raiders. Capped voting, mandatory bids, and voidable interested-party transactions can reduce or end the buying stockholders' fears if the nation enforces contract satisfactorily, even if its corporate law is weak. Moreover, whether the common law—as opposed to other non-law-based institutions—did in fact well protect minority stockholders during the early development of the public firm is open to question. See Mark J. Roe, *The Quality of Corporate Law Argument and its Limits: History's Gaps* (working paper, 2000). But here we are making the quality-of-corporate-law argument, not yet evaluating it.

transactions, effective disclosure laws that unveil these transactions, and a capable judiciary or other enforcement institution can reduce these kinds of private benefits of control. (Private benefits also arise from pride in running and controlling one's own, or one's family's, enterprise. About this, corporate law has little direct impact.)

The sole owner calculates whether to sell her stock into the public markets, separating ownership from control. She knows that if she retains 51% of the firm's stock, that simple majority of the stock will control more, 75%, of the firm's value. But so do the potential buyers of a few shares of stock. They know that the 49% minority position will obtain only 25% of the firm's value. Hence, they will discount their purchase of stock by about half, paying in the aggregate only \$25 million for 49% ownership of a \$100 million firm.

With expectations rational on both sides, the founding owner sells just under one-half of the firm's voting stock for just under one-quarter of the firm's total value. This much is quick to see.

She later calculates whether to sell the remaining stock, the 51% control block. The owner, getting on in years, seeks to exit from the firm. She considers selling her 51% interest to diffuse stockholders during the next two years. With no controller to divert value, the stock price should reflect the firm's underlying value. But the rational buyers believe, so the theory runs, that the diffuse ownership structure would be unstable, that an outside raider would buy up 51% of the firm and divert value, and that the remaining minority stockholders would be hurt. Hence, they would not pay full pro rata value to the owner wishing to sell; and the owner wishing to sell would find that the sales price to be less than the value of the block if retained (or if sold intact).

Hence, the block persists.⁸ The controller is reluctant to leave control "up for grabs" because if the controller dips below 51% control of the operating company, an outsider could grab a majority and then reap the private benefits of control.⁹

8. See Bebchuk, *supra* note 2; Lucian A. Bebchuk, *A Rent Protection Theory* (working paper, 1999); cf. La Porta et al., *supra* note 2.

9. The literature focuses, correctly I believe, on corporate law's capacity to contain controlling stockholder thievery. Other features of corporate law—agency theory in determining who can represent the corporation, corporate transactional flexibility, limited liability—are down-played. Managerial capacity to mismanage the corporation is also down-played, but it is quite relevant. It tends, improperly, to be

Indeed, when the owner was first considering whether to go public the owner might have anticipated having to sell a block in the end anyway. So, anticipating a block sale, she may have concluded that the transaction costs of selling a few shares at a steep discount are high, the benefits low (a block must eventually be sold anyway), and therefore desisted from going public in the first place.¹⁰

B. The Attractions of a Technical Corporate Law Theory

From a policy perspective, one sees the appeal of the quality of corporate law argument. Technical institutions are to blame, for example, for Russia's and the transition nations economic problems. The fixes, if they are technical, are within our grasp. Human beings can control and influence the results. Progress is possible if we just can get the technical institutions right. If it turns out that deeper features of society—industrial organization and competition, politics, conditions of social regularity, culture in supporting or denigrating shareholder value, or the psychology of managerial professionalism—are more fundamental, we would feel ill at ease because these institutions are much harder to control. (To be clear here, I am not speaking simply of corporate law as just the “law-on-the-books,” but as “law on-the-books,” including basic securities law on-the-books, as well as the quality of the regulators, the efficiency, accuracy, and honesty of the court system, and so on.¹¹)

* * *

ignored in the current literature. I will seek to introduce it here to modern analysis of the ownership separation decision.

10. The text fairly states the theory. The theory does have some gaps. When the founder is in the second stage of selling out all of his or her stock, the potential stock buyers discount the purchase, the theory runs, because they anticipate a raider buying up the stock cheap and then diverting value to itself. But when raiders compete, the winning raider will bid the stock up to the value of the private benefits of control. Minority buyers would anticipate this competition and pay approximately full pro rata value for the stock when the founder sells. Similarly, when the seller first goes public, the first minority stockholders might also pay nearly full pro rata value, even if corporate law is weak, if the founder credibly commits not to divert value before giving up control.

11. The best description of the institutions that complement and substitute for basic corporate law is in Bernard S. Black, *The Core Institutions that Support Strong Securities Markets*, 55 *BUS. LAW.* 1565 (2000).

And as self-contained academic theory, there is little to quarrel with in the quality-of-corporate law argument. It is sparse and appealing. Good corporate law lowers the costs of operating a large firm; it's good for a nation to have it. But we need *more* to understand why ownership doesn't separate from control *even where the core of corporate law is good enough*. Where managerial agency costs due to potential dissipation are substantial, concentrated ownership persists *even if conventional corporate law quality is high*. There's too much that even good corporate law doesn't reach directly, such as management error and disloyalty without self-dealing. Corporate law can reduce the costs to minority stockholders of facing a controlling shareholder, but *it cannot directly reduce the basic business costs of centralized management anywhere nearly as much*. Other institutions, apart from conventional corporate law, reduce the basic business costs to minority stockholders of centralized management. Corporate law then becomes insufficient in fully explaining when ownership separates and when it doesn't.

Given the facts that we shall develop in Part III—there are too many wealthy, high quality corporate law countries *without* much separation—the quality-of-corporate-law theory needs to be further refined, or replaced. This we do next in Part II.

II. Its Limits: Theory

A. Where Law Does Not Reach: How Managerial Agency Costs Impede Separation

Managers would run some firms poorly if its ownership separated from control. Corporate and securities law, when they're effective, constrain managers and owners from stealing, but do much less to directly induce them to operate their firms well. A related-party transaction can be attacked or prevented where corporate law is good, but an unprofitable transaction law leaves untouched, with managers able to invoke the business judgment rule to ward off direct legal scrutiny.

Consider a society (or a firm) where managerial agency costs from dissipating shareholder value would be high if there's separation, but

low if there's no separation, because a controlling shareholder can contain those costs. When high but containable by concentration, one would expect concentrated shareholding to persist *even if corporate law fully protects minority stockholders from the ravages of dominant stockholders*. The relevant balance becomes the costs to the blockholder in maintaining control (in lost liquidity, lost diversification, etc.) versus their potential loss in value from managerial agency costs. Control would persist even if corporate law is good. The quality of conventional corporate law becomes irrelevant in determining the degree of separation: whether quality is low or high, separation will be minimal.

This is a simple point, and it is needed to explain the data that we look at in the next Part. One can speculate on bases for which managerial agency costs could be high in a society (or in a company): Culture, an all-purpose, hard-to-test explanation, is one, if some cultures make managers more disloyal, untrustworthy, and unprofessional than others. Opacity and complexity inside firms is another, if diffuse stockholders and intermediaries won't have a clue about what's going on in firms in some businesses in some nations, then ordinary monitoring tools for diffuse stockholders will be weak. Weak product competition is another, because capital and product market constraints on managers, imperfect in the first place, are weaker in such settings.¹² Or, if stakeholder pressures are high, concentration may persist to stymie managerial wavering: politics can raise agency costs, if politics presses managers to expand firms, to avoid lay-offs even if costly to shareholders, and to shrink from re-structuring if employees would be made to bear more risk and discomfort. These political pressures are low in the United States but higher in several nations.¹³ These agency-cost-raising stakeholder pressures on the firm are quite high in the nations that the data indicate in Part III *have* protective corporate law but nevertheless lack much ownership separation.

12. Mark J. Roe, *Rents and their Corporate Consequences*, 53 STAN. L. REV. ___ (2001).

13. Mark J. Roe, *Political Preconditions to Separating Ownership from Corporate Control*, 53 STAN. L. REV. 539 (2000).

B. Improving Corporate Law *without* Increasing Separation

The arguments in the prior section—that variance in managerial agency costs can drive ownership structure *even if conventional corporate law is quite good*³⁴ can be stated formally. High managerial agency costs precludes separation *irrespective of the quality of corporate law*.

1. *The model*. Let:

A_M = The managerial agency costs to shareholders from managers dissipating shareholder value, to the extent avoidable via concentrated ownership.

C_{CS} = The costs to the concentrated shareholder in holding a block and monitoring (that is, the costs in lost liquidity, lost diversification, expended energy, and, perhaps, error).

When A_M is high, ownership will persist in concentrated form *whether or not law successfully controls the private benefits that a controlling shareholder can siphon off from the firm*.

V = Value of the firm when ownership is concentrated.

B_{CS} = The private benefits of control, containable by corporate law.

Consider the firm that's worth V when ownership is concentrated. Posit first that managerial agency costs are trivial even if the firm is fully public. As such, the private benefits of control, a characteristic legally malleable and reducible with protective corporate law, can determine whether ownership separates from control. Consider the controller who owns 50% of the firm's stock. As such he obtains one-half of V , plus his net benefits of control. (In this simple first model, the value of the firm remains unchanged whether it has a controlling stockholder or is fully public; later we vary that value between going public and staying block-owned.) He retains control when the following inequality is true:

$$(1) \quad V/2 + B_{CS} - C_{CS} > V/2.$$

The left side of the equation is the value to the controlling stockholder of the control block: half the firm's cash flow plus the private benefits diverted from minority stockholders, minus the costs of maintaining the block (in lost diversification and liquidity). The right side is the value he obtains from selling the block to the public.¹⁴ Equation (1) states that as long as the private benefits of control (e.g., in value shifted from minority stockholders) exceeds the costs of control, then concentrated ownership persists. Because corporate law can dramatically shrink the private benefits, B_{CS} , corporate law matters quite a bit here in equation (1).¹⁵ This is the conventional theory that we shall next amend.

We amend by introducing A_M , managerial agency costs from dissipating shareholder value. If $\exists A_M$ of non-trivial size, then the proceeds to the controlling stockholder from selling his or her stock into the diffusely held stock market would be $(V-A_M/2)$. Concentration persists if and only if

$$(2) \quad V/2 + B_{CS} - C_{CS} > (V - A_M)/2.$$

Re-arranging: concentration persists if the net benefits of control ($B_{CS} - C_{CS}$) are more than the controller's costs of diffusion ($A_M/2$):

$$(3) \quad B_{CS} - C_{CS} > A_M/2.$$

Or, concentration persists if:

$$(4) \quad B_{CS} + A_M/2 > C_{CS}.$$

14. I use $V/2$, assuming for simplicity that there's no "hair-cut" when the block is sold to the public.

15. Some private benefits are matters of taste, preferences for power, family recognition in a family firm, etc. These are not readily containable by law; they might be better analyzed here as part of the costs of control, C_{CS} , as mitigating the usual costs (lost diversification, liquidity, etc.) They also might vary from firm-to-firm and nation-to-nation. And the capacity to off-load illiquidity and non-diversification might vary similarly. Where risks can be hedged, owners should indulge themselves and keep control more readily than where they cannot. See Ronald J. Gilson, [Private Benefits of Control] (working paper, 2000).

Quality-of-corporate-law theory predicts diffusion when $B_{CS} > C_{CS}$, with corporate law the means of containing B_{CS} . But we now can see the limits to the theory: With A_M high, diffusion won't occur *even if B_{CS} is zero, because A_M could take-over and drive the separation decision*. B_{CS} , the controlling shareholder's private benefits, are relatively unimportant if A_M is very high. Only when $A_M \rightarrow 0$ do legally malleable private benefits kick in as the critical determinant.

2. *An example.* Agency costs as impeding separation can be exemplified. Firm has value V of 150 under concentrated ownership, 100 if it's diffusely owned. Managers will not steal (law is good enough here), but they will be loose with shareholders' investment in the firm. They will over-expand, react slowly to changing markets, and avoid the tough decisions. Hence $A_M=50$. Consider two situations for private benefits to the controlling shareholder: in one it's high, equal to one-third of the firm; in the other B_{CS} is low, equal to zero.

Table 1: When agency costs high, private benefits to controlling shareholder irrelevant

	V, firm's value to shareholders	Value to 50% owner	Value to minority shareholders	Notes
<i>Private benefits low: $B_{CS}=0$</i>				
Concentrated ownership	150	75	75	
Diffuse ownership ($A_M=50$); controller sells block for 50	100	50	50	Management loses A_M
<i>Private benefits high: $B_{CS}=1/6$ of V</i>				
Concentrated ownership	150	100	50	
Diffuse ownership ($A_M=50$); controller sells block for 33	100	33	33	Raider grabs 33 (and perhaps A_M)

Separation *loses* shareholders 50 in profits. Because those lost profits (A_M) are high, at 50, they would seek, and pay for, a structure that would preserve those profits for shareholders. If blockholding avoids A_M (which it does as the model defines A_M : the agency costs that blockholding would avoid), and if the costs of blockholding, C_{CS} , are

low, blockholding will persist *irrespective of whether private benefits, B_{CS} , are 50, 25, or zero.*

True, if the costs of blockholding exceed A_M , or if the managers can (unusually) pay the original controllers for A_M , or if the efficiency benefits of diffuse ownership overwhelm A_M , then private benefits once again become relevant. The most plausible scenario under which they become relevant is, again, when $A_M \rightarrow 0$. But when A_M , the containable managerial dissipation, is very high, this managerial agency cost is the principal determinant of separation, of the quality of securities market and, to the extent corporate law is demand-driven, even of the quality of corporate law.

C. Corporate Law's Limited Capacity to Reduce Agency Costs

One might reply that core corporate law when improved reduces *both* the controlling stockholder's private benefits (B_{CS} , by reducing the controller's capacity to siphon off value) *and* managerial agency costs (A_M , by reducing the managers' capacity to siphon off benefits for themselves).

1. *The business judgment rule.* This criticism is both right and wrong, but mostly wrong. The reason it's mostly wrong is simple. Managerial agency costs are the sum of managers' thievery (unjustifiably high salaries, self-dealing transactions, etc.) *and* their mismanagement. Economic analyses typically lump these together and call them "agency costs." But agency costs come from stealing *and* from shirking. It is correct to lump them together in economic analyses *as a cost to shareholders*, because both costs are visited upon shareholders.¹⁶ But it is incorrect to think that law affects each cost to shareholders equally well.

The standard that corporate law applies to managerial decisions is, realistically, no liability at all for mistakes, absent fraud or conflict of

16. Eugene Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980) (agency costs come from "shirking, perquisites or incompetence").

interest.¹⁷ *But this is where the big costs to shareholders of having managerial agents lie, exactly where law falls into an abyss of silence.*

Conventional corporate law does very little, maybe nothing, to directly reduce shirking, mistakes, and bad business decisions that squander shareholder value. Elaborate doctrines shield directors and managers from legal action. The business judgment rule is, absent fraud or conflict of interest, nearly insurmountable in America. Directors and managers are protected from legal inquiry by the business judgment rule.

Consider this statement from a well-respected Delaware chancellor:

There is a *theoretical* exception to [the business judgment rule, protecting directors and managers from liability] that holds that some decisions may be so “egregious” that liability ... may follow even in the absence of proof of conflict of interest or improper motivation. *The exception, however, has resulted in no awards of money judgments against corporate officers or directors in [Delaware]. ... Thus, to allege that a corporation has suffered a loss ... does not state a claim for relief against that fiduciary no matter how foolish the investment....*¹⁸

One does not exaggerate much by saying that American corporate law has produced only one major instance in which non-conflicted managers were held liable for mismanagement: *Smith v. Van Gorkom*,¹⁹ a decision excoriated by managers and their lawyers, and promptly overturned by the state legislature.²⁰

17. Edward Rock & Michael Wachter, *Islands of Conscious Power: Law, Norms and the Self governing Corporation*, 149 U. PA. L. REV. ___ (forthcoming, 2001) (MS at p. 33); Michael P. Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW. 503, 521 (1989) (Veasey is now the Delaware Supreme Court chief judge); Joseph W. Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1095 (1968) (managers without a conflict of interest always win).

18. *Gagliardi v. Trifoods Int'l, Inc.*, 683 A.2d 1049, 1052 (Del. Ch. 1996) (Allen, J.) (emphasis supplied).

19. 488 A.2d 858 (Del. Sup. Ct. 1985). And not just Delaware and not just recently: “[I]t is only in a most unusual and extraordinary case that directors are held liable for negligence in the absence of fraud, or improper motive, or personal interest.” *Bayer v. Beran*, 49 N.Y.S.2d 2, 6 (N.Y. Sup Ct. 1944).

20. Del. Corp. Code § 102(b)(7). And thirty-eight legislatures, aghast at the possibility of directorial liability if their courts followed Delaware in *Smith v. Van*

And, as an aside, we should not think “oh, this is just a gap in American law, one that could be filled if other institutions didn’t sufficiently control these managerial agency costs. If the other institutions failed, corporate law would, and could, jump in.” One *wouldn’t* want the judge in there, regularly second-guessing managers anymore than one would want the commissar or the bureaucrats in there directing the managers. If judges in fact jumped in to try to control managerial error directly, one could add this to the model: a term C_J (or B_J), for the costs of judicial intervention (or B_J for the benefits of judicial second-guessing of managers). Most American analysts would assume that if judges regularly second-guessed business decisions, C_J would be positive and very high (and B_J would be negative and substantially so).²¹

2. *Agency costs: shirking and stealing.* Stated somewhat more formally: $A_M = A_{LD} + A_{MM}$, where total managerial agency costs are the sum of legally-controllable diversions, A_{LD} (stealing), and legally uncontrollable managerial error that dissipates value, A_{MM} (shirking in the economic literature). So substituting into (2) above, we obtain:

$$(5) \quad V/2 + B_{CS} - C_{CS} > (V - A_{LD} - A_{MM})/2.$$

Good basic corporate law reduces B_{CS} and A_{LD} , *but not* A_{MM} . And, with perfect corporate law, $B_{CS} = 0$ and $A_{LD} = 0$, which yields:

$$(6) \quad V/2 - C_{CS} > (V - A_{MM})/2.$$

Or:

$$(7) \quad A_{MM}/2 > C_{CS}.$$

Gorkom, passed similar exemptive legislation. See D. Gordon Smith, *The Shareholder Primacy Norm*, J. CORP. L., Winter 1998, at 277, 289 n.52. Corporate casebooks have to go back quite far to find other judicial attacks on managerial error, much less find managerial defeats. *Shlensky v. Wrigley*, 237 N.E.2d 776 (Ill. App. 1968); *Dodge v. Ford Motor Co.* 170 N.W. 668 (Mich. 1919).

21. See *Joy v. North*, 692 F.2d 880 (1982) (Winter, J.).

When (7) holds, ownership will not separate from control, even if a perfect corporate law reduces the private benefits of control to zero. *And corporate law does not directly affect A_{MM} .* Hence, good corporate law is insufficient to induce separation.

* * *

One might refine this analysis by adding a term to account for controlling shareholder error. One could, but the costs of these errors are likely to be smaller than legally uncontrollable managerial error. True, similar legal doctrines (the business judgment rule) shield the controlling shareholder from lawsuits for a non-conflicted mistake, but because the controlling stockholder owns a big block of the company's stock, it internalizes much of the cost of any mistake (unlike the manager). Because the controlling stockholders, in contrast to the managers, bear the costs of their error, they immediately internalize their errors, unlike managers who must be made indirectly to internalize them (via incentive compensation, labor market constraints and the like). Controlling shareholders who make undue errors, can sell their firm.²² Only if the compensating gains (such as power, prestige, and pride of ownership) exceed the costs of their errors (and the other costs of carrying the block), do they keep that block of stock. Managers who make errors do not face such immediate constraints and incentives.

Simply put: controlling stockholders impose the cost of their stealing on diffuse stockholders but absorb half of the cost of their own dissipation due to mismanagement. Controlling managers impose the cost of their dissipation, as well as of their thievery, on diffuse stockholders. Law reduces stealing, not unconflicted dissipation and mismanagement. The point is not that founders and blockholders never waste or make mistakes, but that they bear most of the costs of their waste, while managers do not.

22. That is, controlling stockholders might fall asleep, not manage, giveaway the store, or retire from active management without giving up their position to those who would manage. Cf. Harold Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 J.L. & ECON. 375 (1983). The usual economically-oriented analysis is that they internalize these costs and, prior to falling asleep, sell out their stock unless the shirking managers would cost them more than their sleepiness.)

D. Law's Indirect Capacity to Affect Agency Costs

We have thus far focused on conventional corporate law, the law of fiduciary duties, of derivative suits, and of corporate waste. We have seen that conventional corporate law can reduce stealing and, where it fails to, separation should not be wide. But even if conventional corporate law is successful, managerial agency costs to shareholders could be high if managers dissipate shareholder value and, when high, ownership cannot readily separate. Whether agency costs are high or not is a function of business conditions, opacity of the business, and the type of pressures put on the firm. Institutions other than conventional corporate law affect managerial agency costs, reducing them via competitive markets, shareholder wealth maximization norms, incentive compensation, hostile takeovers, and corporate transparency.

Here, law is also relevant. But its relevance is indirect. True, law can potentially encompass everything in a society. Law could ban the institutions that indirectly reduce agency costs. Anything can be taxed, destroyed, and prohibited.

That is, although ordinary but mistaken managerial business decisions and corporate transactions are immune from any direct judicial attack, other institutions in society affect these decisions and transactions; and law can facilitate or ban these other institutions. But in each case, the other institution is the primary control, with law just assisting or impeding. For insider thievery, basic corporate law is a primary deterrent. But consider five major direct constraints on managerial agency costs: product market competition, shareholder wealth maximization norms (and supporting institutions), incentive compensation, hostile takeovers, and transparency. Strongly competitive markets, for example, can be prodded along by good antitrust law, or lost by bad antitrust law.²³ But the primary constraint is the product market, not law, and law only acts as a secondary, and perhaps sometimes inconsequential means of enhancing or demeaning product competition. Shareholder primacy norms, for example, can be facilitated, or demeaned by legal pronouncements. Incentive

23. Strongly competitive capital markets can also constrain managers, but I do not add capital markets to the list where corporate law influence is weak: It's plausible that equity markets need good corporate law, although it's plausible that credit markets do not.

compensation can be spurred, or taxed. Hostile takeovers can be allowed, or banned. Transparency can be mandated, or muddled. Law obviously can be, or is, in play, albeit indirectly.

Although true, these indirect controls, and the possibility of law banning them, are quite different from conventional corporate law. First off, they do not directly invoke the currently in-vogue explanation for good corporate law, namely that it grows out of common law and the judge's capacity to control interested-party, conflict-of-interest transactions that divert corporate value into the controller's bank account. Most importantly, law here doesn't attack the cost to shareholders directly (as law does when the judge punishes a controlling shareholder who diverts value to herself). Law's role is not to attack directly but to enhance or impede the private institution that would reduce the dissipation. More generally, these institutions have the potential to be politically charged, and in other nations one or the other or all four *are* politically charged.

E. Precision in Defining Agency Costs and Private Benefits

B_{CS} we've defined as the private benefits that a controller can grab from the firm from diverting value away from the firm's stockholders. A typical such diversion would be for the controller to have a fully-owned private entity sell product to the firm at inflated prices. Dissipation of shareholder wealth isn't the actor's goal; shifting that wealth to him or her is.

But to be precise here as well, dissipation could still be a secondary result. To make the transfer from the firm into her own pocket, the controller might have to distort the firm's operations. But her primary goal is to divert, not to dissipate.

A_M we've defined as the value that managers can dissipate in the firm, due to mistaken management. They might over-invest, under-invest, or mis-invest. That might over-pay suppliers or fail to adopt profitable technologies. That might react too slowly to changing market conditions.

But to be precise here, diversion could still be a secondary result here too. The dissipation occurs because the managers could work a little harder, or a little longer, or take on the tough decisions. Their action is a kind of self-dealing, in that they benefit from the easier life.

But their primary effect of A_M is to dissipate value; the diversion managers get by working a little less hard is secondary to the dissipation of shareholder value.

F. Ambiguity: Improving Corporate Law Can Reduce Separation

So today's dominant theory is that when we observe concentrated ownership in rich nations, it is probably because they failed to build the needed corporate law. The relationship will be roughly linear: if other basic conditions are equal (state of the economy, level of technology, etc.), a nation whose corporate law better protects minority stockholders induces stronger securities markets and more diffuse ownership. Conversely, all else equal, a nation that poorly protects stockholders yields more concentrated ownership and weaker securities markets.

Thus far we have seen that half of the equation has been omitted, namely the potential variation in managerial dissipation of shareholder value, costs to shareholders that law does not directly control and indeed costs about which it avoids inquiry via doctrines such as the business judgment rule. Adding potential managerial dissipation back in makes the demand for separation vary widely even if corporate law protects minority stockholders from thievery and thereby eliminates any private benefits of control.

* * *

There is more. Even if managerial agency costs are constant (at any initial level of ownership concentration), a theory of separation based on corporate law is softer here than the dominant literature has it. Improving corporate law in the world's richest nations *is in theory as likely to increase blockholding as to decrease it*.

Recall the core corporate law argument from Part II. If minority stockholders are unprotected by corporate law, they will not buy or will only buy at a discount. With private benefits of control high, the controller *must* hold onto control, because those benefits cannot be sold (other than by selling the block intact), lest someone else be able to grab those benefits of control.

In such settings, distant investors invest reluctantly, fewer firms go public, and those that do will retain a concentrated owner. For some

firms, in some nations, when those firms do go public, they set up roadblocks to a raider entering, via poison pills, capped voting, and mandatory bid rules. (We should not doubt that managers oftentimes seek such rules to entrench themselves, but such rules keep nasty raiders out as well.)

Consider the firm that is public, with devices (such as pills, caps, and other charter terms) that keep raiders out. Consider two nations, A and B, with A protecting minority stockholders imperfectly but better than B. (Or consider a nation, A, that is moving through law-reform from imperfect but not atrocious minority protection to better minority protection.) *The minority protection argument tells us that minorities would feel more comfortable in “protective” nations, such as B, or the reformed A, than in non-protective nations, such as the old A.* Hence, the “better” corporate and securities law nations could, all else equal, if law were the driving force end up with *many more* blockholders in those firms that go public. More controllers would be willing to go public, because investors, feeling well protected, would pay full pro rata value for the minority stock that they would buy. More public firm stockholders would be willing to accept a blockholder, because better law would lower the blockholder’s capacity to rip them off.

Blockholders provide critical good services to the firm and one powerful bad service: the good ones are monitoring managers,²⁴ facilitating information flow from inside the firm to capital owners,²⁵ and making implicit deals with stakeholders when soft deals are efficient;²⁶ their one big bad activity is their stealing from the minority

24. Andrei Shleifer & Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461, 465 (1986) (“our analysis indicates that [by monitoring managers] large shareholders raise expected profits and the more so the greater their percentage of ownership”); Marianne Bertrand & Sendhil Mullainathan, *Agents without Principals* (working paper, 2000) (managers in firms with blockholding stockholders have less performance-based pay than managers in firms with blockholders).

25. MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* 260-61 (1994) (large owners can mitigate); Jeremy C. Stein, *Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior*, 104 Q. J. ECON. 655 (1989) (diffuse ownership creates informational inefficiencies).

26. Cf. Andrei Shleifer & Lawrence Summers, *Breach of trust in hostile takeovers*, in *CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES* 33-56 (Alan J. Auerbach, ed.) (1988).

stockholders. But if a nation's laws limit their potential to do bad without diminishing their ability to do good, then one could expect that nation's firms to get *more* blockholders, not fewer.²⁷

More starkly: concentrated blockholders have two major roles inside the firm: they steal from stockholders and they monitor managers. Minority stockholders would see a trade-off and reduce the price they'd pay accordingly: pay more to the extent monitoring raises firm value, but less to the extent the blockholder steals from the minority. But if law limits the negative possibility—less, or no, shareholder stealing, because law protects the minority stockholders—then that good law should make stockholders *more* comfortable, *not less comfortable*, with blockholders. Private owners would feel more comfortable in selling some stock because they would be able to get full, pro rata value for it, rather than the discount that buyers would insist upon in bad-law regimes. Improving corporate law should, in such settings, all else equal, *increase*, not decrease, the incidence of blockholding. But this indeterminate effect of improving corporate law is secondary to the main argument, which we restate next and then examine data.

G. The Tight Limits to the Purely Legal Theory

Thus, using purportedly poor minority protection from a controller's diversion of value to explain why blocks persist in Russia is convincing, but for Western Europe is fuzzy, or for a few nations maybe wrong. If blocks persist, one cannot *a priori* know whether they persist because minority stockholders fear the controller, or because they fear the *managers*, who might so dissipate shareholder value that they run the firm into the ground if a controlling stockholder disappears.

If they fear unrestrained managers, the controller cannot sell stock at a high enough price and thus she keeps control to monitor managers or

27. The controller maximizes the sum of two values: "best management ('social optimality') and ... the value of the securities ... ('private optimality')". Milton Harris & Artur Raviv, *Corporate Governance* 34 *Voting Rights and Majority Rules*, 20 J. FIN. ECON. 203, 205, 207 (1988). Good law by controlling "private optimality" will allow for more control blocks that, by better assuring best management, will yield social optimality. True, because the controller cannot capture all of the benefits of improving the firm, it invests suboptimally: if the controller owns 25% of the firm, it wants an expected increase in firm value equal to four times that of the resources it expends to improve the firm.

to run the firm. (Elsewhere I offer a theory of *why* managerial agency costs were systematically higher in continental Europe than in the United States: in continental social democracies, government policies favored employees over invested capital and demean pro-shareholder institutions—like shareholder primacy norms, transparent accounting, incentive compensation, and hostile takeovers—thereby rendering the diffusely-owned public firm unstable, especially if private stockholders could side-step enough of these pressures. But for this article's purposes, *any* reason for increased agency costs—weak product market competition, increased business opacity, weak professionalization of management—could explain the persistent concentration in the good corporate law countries, about which we turn to next.)

III. Its Limits: Data

If we could measure the quality of corporate law, then we could see whether ownership is concentrated where corporate law protects shareholders and diffuse where it does not. True, if diffusion correlated with high-quality law, the primacy of the law-as-cause thesis would not be proven: when ownership is made diffuse for some other reason (say, technology or, say, politics) then the diffuse owners may demand legal protections. Corporate law might follow, not lead, market development. But if, among the satisfactory corporate law nations, ownership is still concentrated in several, we would need more than just the legal theory to explain the result.

A. Measuring Quality

1. *Corporate law: what counts?* Judging how well corporate law protects minority stockholders across nations by examining their corporate law is hard. Not only must one judge which laws are critical (how did Britain succeed without a derivative suit, the very institution that plaintiff-oriented counsel in the U.S. would cite as a *sine qua non*? and one that France, seen as a weak corporate law nation by American analysts, allows?²⁸), but interaction effects can make a rule that is a

28. Art. 245, Law No. 66-537 of July 24, 1966; Art. 200, Decree No. 67-236, Mar. 23, 1967 (France); Arndt Stengel, *Directors' Powers and Shareholders: A*

loophole in one nation into a roadblock in another. Moreover, the rules-on-the-books could be identical in two nations but if the quality of enforcement (because of a corrupt, incompetent, or inefficient judiciary or regulatory system) might make the bottom line protections differ greatly. Or *practices* not required by a nation's corporate law could protect shareholders: a legal index might look bad, but the reality could be the opposite if contractual understandings or business practices counter-act a deficient corporate law.

Undaunted by lawyers' skepticism that one can qualitatively assess corporate law, several finance-oriented students of corporate governance built legal indices for many nations. They have accomplished a major undertaking, one that should embarrass many (of us) corporate law professors who have not even attempted what the financial economists have completed. These researchers have argued convincingly that corporate law institutions are weak in many third world and transition nations, that these weaknesses correlate with weak securities markets, and that the legal institutions are so decrepit that the public firm cannot arise or, if created by government fiat, cannot persist.²⁹ These studies could be interpreted (and have been interpreted), less convincingly, to suggest that weak corporate law is the primary culprit for the weak securities markets on the European continent. Not only do corporate players in France, Germany, and Sweden think their corporate law is fine, but they sometimes proclaim its superiority in some dimensions over the American variety.³⁰

The index doesn't seek to measure the bottom-line quality of, say, American corporate law directly: It's at least possible that the index

Comparison of System, [1998] I.C.C.L. REV. at 52 (Germany). Germany has the derivative suit in theory (in that the company must bring suit when 10% of the stockholders seek that it do so), but in practice it just isn't used. Id.

29. La Porta et al. series, *supra* note 2, and the followers. Economically less developed countries have added reasons why they haven't developed securities markets. Good securities and corporate rules might come with wealth, and not the other way around.

30. André Tunc, *A French Lawyer Looks at American Corporation Law and Securities Regulation*, 130 U. PA. L. REV. 759 (1982) (French law bans dangerous transactions that American judges weigh, balance, and sometimes approve); cf. Jonas Agnblad, Erik Berglöf, Peter Högfeldt & Helena Svancar, *Ownership and Control in Sweden-Strong Owners, Weak Minorities, and Social Control* (working paper, Feb. 10, 2000) (not even anecdotes of insider machinations in Sweden).

focuses on rules that aren't right at the core of shareholder protections, but is rather a proxy for a total set of institutions that yield good protection, a set for which there might be more direct measures. The index is a path-breaking and superb first effort, but fine-tuning might still be possible.³¹

Organized qualitative analysis challenges legal academics' preference for nuance and discussion.³² But anecdotes abound, and one can find anecdotes of fleeced minority stockholders on both sides of the Atlantic.³³ One can list differing rules, but it's difficult to know a) which rules are substitutes and, hence, which countries truly have gaps in protection, b) which rules really count, c) the extent to which players follow announced rules, and d) whether the rules in focus are the kind that securities market players demand once deep securities markets exist for other reasons. Some rules are window-dressing, some rules really bind. Which is which?

2. *Corporate law: The bottom line.* Can we *measure* the bottom-line, overall quality of corporate law? If we knew the nation-by-nation average premium for control and could compare it to the value of the traded stock, one would have a bottom-line number for the value of control in a firm. In nations where the premium is high, we'd surmise corporate law or its enforcement is inferior; in nations where that premium over the price available to diffuse stockholders is low, we'd surmise corporate law is superior.

Consider a firm worth \$100 million, with a 51% blockholder who values that block at \$60 million and minority stock that trades for an aggregate value of \$40 million. If we can observe those numbers, we have roughly measured the value of control: the controller plausibly pays the 10% premium (measured as a percentage of total firm value) because he or she can divert 10% of the firm's value from minority stockholders

31. Wall Street lawyers, for example, might have reservations about heavily using preemptive rights and cumulative voting—items not likely to be near the top of most American lawyers' lists of important legal protections—and using the Model Business Corporations Act, which is aspirational.

32. E.g., Tunc, *supra* note 26; Marchetti.

33. Cf. Floyd Norris, *Perelman's Plan: Take Profits While Public Owners Suffer*, N.Y. TIMES, Nov. 24, 2000, at C1; [Icahn & TWA]; JAMES B. STEWART, DEN OF THIEVES 119-27 (1992) (machinations of Victor Posner in NVF, DWG, Pennsylvania Engineering, APL, Royal Crown and Sharon Steel).

into his or her own pocket. If one could measure this difference across nations, then one would have a “bottom-line” number indicating the value of control. If the quality-of-corporate-law argument were correct and the principal determinant of separation, then nations with high gaps between the value of control and the value of the minority stock would have more concentrated ownership than nations where that gap is weak.³⁴

B. Data: Nations with Good Corporate Law but *Without* Separation

1. *Trading control blocks.* We have data on the value of a control block. Researchers have looked at the premium paid for a voting block over the pre-trading price. In the United States, it was found to be 20%.³⁵ For Italy parallel research suggests a premium of as much as 80%,³⁶ a premium consistent with the quality-of-corporate-law theory (since ownership is concentrated there and corporate law apparently poor).

But in Germany, the control block premium was recently, and surprisingly, found to be about 10%,³⁷ inconsistent with the corporate law theory, because German ownership is quite concentrated. (For technical reasons, explained in the footnote, the premium for Germany does not indicate its corporate law is better than that in the United

34. The measurement of the private benefits of control and, hence, of law's ability to keep those benefits low will be imperfect. Some of the premium could come from the cost of assembling a block. Some of the premium may come from the controller's power to decide, say, when to sell, although the sale would be made at a fair price for all. If the transaction costs are high, then a pre-assembled block should command a premium because it side-steps the transaction costs. Hence, high premia may over-state law's weakness because some fraction of the premium come from unrelated transaction costs, not from uncontrolled private benefits.

35. Michael Barclay & Clifford Holderness, *Private benefits from control of public corporations*, 25 J. FIN. ECON. 371 (1989).

36. Luigi Zingales, *The Value of the Voting Right: A Study of the Milan Stock Exchange Experience*, 7 REV. FIN. STUD. 125 (1994). The Italian number comes from the voting premium for dual-class common stock. More about that below.

37. Julian Franks & Colin Mayer, *Ownership and Control of German Corporations*, at 24 (working paper, 2000).

States, but that it's equivalent in quality.³⁸) To be sure here, the data could under-state the private benefits: benefits might have already been taken before the sale and, hence, the sales price wouldn't reflect them. And firms for which blocks are sold could be those with low private benefits, while those where diversion is high don't trade. But even the reduced fact remains that for those blocks sold, the future private benefits expected to be extracted are about equal to those expected in American block trades.

So, the block premium in Germany is about 10%. We should pause at this finding for Germany. That number casts doubt on the pure-form of the law-driven theory, because Germany, the world's third largest national economy, has very concentrated ownership. If control blocks trade at such a low premium there perhaps something else is driving the concentration.

A ready explanation for Germany is that German codetermination—by which labor gets half of the seats in boardrooms of large firms—fits snugly with concentrated shareholding as a counter-balance in large, especially large smoke-stack, industries.³⁹ That 10% premium is *less* than the decline in shareholder value measured when Germany enhanced its co-determination statute in 1976 and increased employee representation in the boardroom from one-third to one-half.⁴⁰

38. The premium is the difference between block price and the trading value of the diffusely held stock. The American 20% premium is for blocks of (typically) one-fifth of the firm's stock. If the premium represents what the controller can grab for itself, the blockholder would be able to grab 4% of the firm's value (one-fifth of 20%). German blocks are larger, with many equal to half of the company's stock. A premium of 10% for half of the company indicates the controller could grab 5% of the firm's value for itself.

39. Mark J. Roe, *German Codetermination and German Securities Markets*, in *EMPLOYEES AND CORPORATE GOVERNANCE* 194 (Margaret Blair & Mark J. Roe, eds. 1999).

40. Felix R. FitzRoy & Kornelius Kraft, *Economic Effects of Codetermination*, 95 *SCAND. J. ECON.* 365 (1993); Gary Gorton & Frank A. Schmid, *Class Struggle Inside the Firm?—A Study of German Codetermination* (University of Pennsylvania working paper, 2000); Frank A. Schmid & Frank Seger, *Arbeitnehmermitbestimmung, Allokation von Entscheidungsrechten und Shareholder Value*, 5 *ZEITSCHRIFT FÜR BETRIEBSWIRTSCHAFT* 453 (1998); but see Theodor Baums & Bernd Frick, *The Market Value of the Codetermined Firm*, in *EMPLOYEES AND CORPORATE GOVERNANCE* 206 (Margaret Blair & Mark J. Roe, eds. 1999); Bernd Frick, Gerhard Speckbacher & Paul Wentges, *Arbeitnehmermitbestimmung und moderne Theories der Unternehmung*, *ZEITSCHRIFT FÜR*

The low German 10% control premium also shows why constructing an index for corporate law quality is so hard. To really divert value, the controlling shareholder typically needs a big transaction—a buyout, a merger, a related party sale of good or services. And to get a big transaction through a firm, one needs board approval and, hence, a compliant board. Because the majority stockholder in, say, the United States, typically appoints the entire board, it's plausible to expect that an American majority stockholder can readily control a compliant American board. But in Germany the controller can *never* control the full board, because law mandates that labor get half of it, and the practice is that banks holding their brokerage customers' proxies get some of it. Other German corporate law features might be weak, thereby generating a low "index" of corporate law protections. But even so, the controller may be stymied in pushing a related-party transaction through because he or she *cannot* control the full German board. Interaction effects impede putting our finger on one or two key features as indicative of whether technical corporate law is overall good or bad.

The new German data on control block premium presents a counterexample, and a very big one, to the law-driven theory. Counterexamples are important, but perhaps there is some German-specific factor, not replicated elsewhere, that could make the theory generally true, but just inapplicable in Germany. To check, we turn to other data.

2. *Dual class common stock.* Control's value, and hence law's capacity in controlling the normal private benefits of control, can be roughly measured otherwise. Some firms issue dual class common stock. In its most basic form, class A stock votes, class B stock doesn't, but both have the same dividend rights. (Variations abound.) A controller cannot reap benefits by controlling the class B stock, but can by controlling the class A stock. Both are formally entitled to the same cash coming out from the company. If the value of class A stock is higher than that of class B's, we have a measure of the value of control and the value that the controller can surreptitiously divert from outside shareholders to herself. If we could systematically measure the differences from one nation to another nation, then we could measure the value of control and, hence, the quality of corporate law in

controlling the ravages of a dominant stockholder, as one Nobel Prize winner sought to do a few years ago.⁴¹

More specifically: Posit that the \$100 million company issues 500,000 shares of class A stock, which vote, and 500,000 shares of class B stock, which doesn't vote. Dividend and all other rights are equal. If the diversionary benefit of control is near zero, then the difference in the trading price of the class A and the class B stock should be near zero. If control confers the possibility of diverting \$10 million in value from the minority stockholders to the controller, then the class A stock should trade for about \$60 million in the aggregate, the class B for \$40 million. By measuring this voting premium in the world's richer nations, one would be measuring the value of control. The quality-of-corporate-law theory would then predict that, in gross, as the value of control went up, ownership concentration would increase. And vice versa: as the value of control decreased, controllers would loosen their grip and ownership would diffuse.

Financial researchers have measured this voting premium for several nations. Italy's voting premium is measured at 82%, America's at 5.4%, a difference again consistent with the legal theory, as Italy is reputed to have poor protections and has concentrated ownership, and the United States has the converse. But Sweden's voting premium is a low 6.5%, lower than those in Britain (13.3%). Yet the concentration indicators (Sweden high, Britain low) and legal priors—Britain is reputed to have good corporate law—are to the contrary of the legal theory.

The data here does not help the pure law-driven theory in explaining when ownership separates from control in the world's richer nations. Add to the low block trade premium in Germany and unexplained data increases. Corporate law quality alone does not seem to drive the separation decision in the world's richer nations.

How sound is the data? Although this is the standard voting premium data in the finance literature, it was accumulated by different researchers, at different times, using different methodologies. But

41. Modigliani & Perotti, *supra* note 3, at 525. Modigliani and his co-author sought to prove that the dual class premium varied with the quality of a nation's security market. They had a smaller, and less up-to-date sample of seven nation's voting premia. The current dual class data better measures the premia and the implied quality of legal protections, but as we shall see shortly it still *doesn't* predict the degree to which ownership separates from control.

unpublished voting premium data has just recently become available. Table I shows the voting premium in the world's richer nations. This new data creates added tensions: Germany shows up as a weak corporate law nation in the dominant indices from finance economists, but the numbers here *again* show it protects non-voting stockholders rather well, vindicating defenders of the quality of German corporate law. Four Scandinavian nations—Denmark, Finland, Norway, and, again, Sweden—all have *very* concentrated ownership, but they are *extremely* protective of minority stockholders, a relationship that the quality of corporate law argument alone cannot nicely explain.

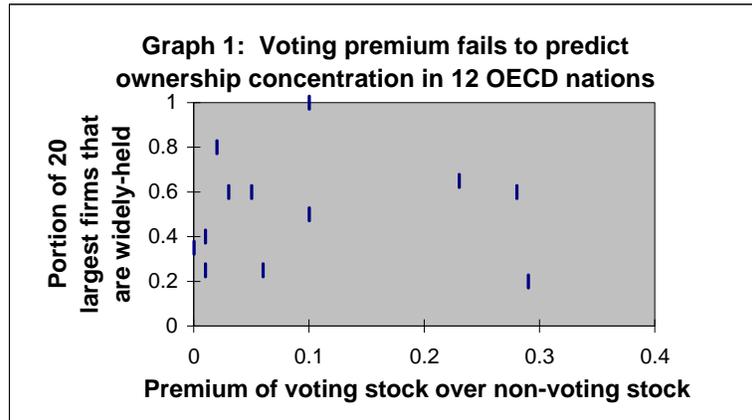
Table 2: Voting premium and ownership concentration⁴²

Country	Voting premium	Portion of large firms that are widely-held
Australia	0.23	0.65
Canada	0.03	0.60
Denmark	0.01	0.40
Finland	0.00	0.35
France	0.28	0.60
Germany	0.10	0.50
Italy	0.29	0.20
Norway	0.06	0.25
Sweden	0.01	0.25
Switzerland	0.05	0.60
United Kingdom	0.10	1.00
United States	0.02	0.80

Source: Voting premium data comes from Tatiana Nenova, *The Value of Corporate Votes and Control Benefits: A Cross-Country Analysis* (Harvard University working paper, Sept. 21, 2000); the ownership concentration data comes from La Porta et al., *supra* note 2, at __. The percentage of widely-held firms for a nation is the percentage of the nation's twenty largest firms that have a 20% or larger blockholder.

42. The voting premium measures the percentage excess of the trading price of voting stock over non-voting stock. Technical cautions for this data are raised and discussed *infra* at notes 43 and 49 and accompanying text (comparing price of minority of voting class to price of nonvoting stock).

In Graph 1 I plot the results to show visually the lack of a relationship between measured corporate law and ownership separation in the wealthy West. In rich nations, legal protection, as measured, does not correlate with the degree ownership separates from control.



(To repeat the complementary thesis that I'd offer: once a nation is capable of building passably good legal institutions, the quality of its corporate law fades in relative importance in determining separation to its politics. If something in that society keeps managerial potential to dissipate shareholder value high, then concentrated ownership persists as shareholders seek to control managers. One weakness that raises managerial potential to dissipate shareholder value is weak product market competition. Another pressure on managers that raises dissipation comes from stakeholders. Where stakeholder pressures are very high, one would expect a counter-coalition of shareholders to form, to buck managers up (or to facilitate deals that keep production humming). The data supports this politics-emphasizing theory: while the value of control doesn't predict ownership concentration in these nations, left-right politics does, as the data and graph in Table 3 and Graph 2 in the Appendix shows.)

This dual class premium data casts some doubt on whether a univariable model is enough to explain the richer nations' degree of ownership separation. True, further confirmation, with data collected by other researchers, should be added. And the number of observations—a

dozen or so of the richer nations—isn't enough to allow crosschecks and controls to weight competing factors.

And, the dual class data as measuring the value of control is soft. If the controller has a majority of the class A voting stock, then the researchers are observing the trading value of the minority stockholders on the class A level, and comparing that data to the trading value of the non-voting class B stock. But the minority class A stockholder is not a controller, it just has a chance of sometime joining a control block.⁴³

Thus while this is the best data set available, it is not perfect data. (Data sets never are.) We can take comfort in that ancillary information comports with the numbers. The American premium is low, and U.S. corporate and securities law is usually seen as highly protective. The Swedish premium is low as well, and Swedish researchers assert that there are not even anecdotal instances of controllers shifting value to themselves. Two [Swedish] researchers tell us that “the value of control does not derive from the possibility to expropriate the fringe of minority shareholders ... [but] has to be motivated by some other economic motives.”⁴⁴ Other Swedish researchers report that:

Outside shareholders do not refrain [from] investing on the Stockholm Stock Exchange since 55% of the Swedish population own shares ... and 33% of outstanding shares are owned by foreign investors... . [T]he ratio of the stock market capitalization held by minority shareholders in relation to GDP ... is 0.51 for Sweden compared to 0.58 for the U.S. ... [I]t is not likely that weak investor protection has hampered financial market development in Sweden....⁴⁵

43. Sophisticated statistical analyses could control some of this problem, by observing the value of the vote when control is incomplete, i.e., when there's a 40% shareholder and using a Shapley value to approximate the chance that the vote could be decisive for a controlling coalition. See Zingales, *supra* note 36. The fuller data set doesn't do this.

44. Clas Bergström & Kristian Rydqvist, *The Determinants of Corporate Ownership—An Empirical Study on Swedish Data*, 14 J. BANKING & FIN. 237 (1990) (emphasis supplied).

45. Martin Holmén & Peter Högfeldt, *Corporate Control and Security Design in Initial Public Offerings* 38, 39 (Stockholm School of Economics working paper, Dec. 15, 1999) (emphasis supplied).

The other Scandinavian nations have similar reputations, and they also have low premiums.⁴⁶ Moreover, the leading blockholding Swedish investor typically uses dual class stock, but not in a way that locks up control: the Wallenberg family holding company doesn't take majority control but more typically ends up with 5% of the cash flow and 25% (not a majority) of the votes,⁴⁷ leaving a potential for control in the other 75% of the votes. And the German premium is low compared to the usual prejudice, but it also comports with the more direct measure of control block premiums recently measured by two leading financial researchers, at 10%.⁴⁸ [And the voting premiums in the world's poorer nations (not reported here, since we are trying to understand the differences in the world's richer nations), which one could believe to be in the process of developing securities markets, are high.] Thus the dual-class data set plausibly *under-states* the value of control across the board, but the rankings seem roughly in order, and they may be hazily sketching for us something important about how corporate law quality isn't enough to determine the depth of a securities market in the world's richest nations.⁴⁹

46. Berglof article for the World Bank.

47. Eric Leser & Anne-Marie Rocco, *Les Wallenberg veulent faire cohabiter capitalisme familial et mondialisation* 34 *Un investisseur éclectique*, LE MONDE, Nov. 24, 2000, at 23.

48. Franks & Mayer, *supra* note 37, at 24. They attribute [ownership concentration] though to the high private benefits of control, although the number they found, 10%, is on the low-side world-wide. Other researchers have recently found German bankers able to extract little or nothing in the way of private benefits of control. Gary Gorton & Frank Schmid, *Universal banking and the performance of German firms*, 58 J. FIN. ECON. 29, 70 (2000).

49. And, as long as the "real" premium varies in tandem from nation-to-nation then, even if under-stated the comparisons can be made. We can take some further comfort with the data in that a well-known winner of the Nobel Prize thought it the best available way to measure legal quality. He was, however, working with what has become stale data. Modgiliani & Perotti, *supra* note 3, at 524-25.

Data measuring the value of the vote can be corrected to reflect that the minority voting stock represents the probability of joining a control group and not the direct value of control. The value of control rises or falls with the of the control block: in a country where 51% of the voting stock can control everything, the value of minority voting stock should approach that of non-voting stock; but if there are two voting blocks of 40%, the minority voting stock's value should reflect the value of control. Sophisticated tests can approximate the correction. See Zingales, *supra* note 36.

* * *

To repeat a proviso: I hardly mean that this data set tells us that high-quality corporate and securities law is irrelevant. Rather, it's that some nations have high quality corporate and securities law *but ownership still remains close* and securities ownership does *not* diffuse. The point in this Part is *not* that good corporate law is irrelevant in the world's richer nations—it keeps the costs of running a big enterprise low—but *when it's already pretty good, subtle gradations in its quality do not determine whether ownership will be concentrated or diffuse*. Something else is much more important, with the leading alternative hypothesis being that high managerial potential to dissipate precludes separation even if corporate law quality is high. The quality of corporate law becomes secondary to how well managerial agency costs to shareholders are contained.

3. *Enforcing contracts.* Bad law sufficiently explains weak securities markets where law is *so* weak that even *basic contracts* cannot be enforced—as they cannot be in contemporary Russia, many transition economies, and significant parts of the less developed world—thereby rendering complex corporate institutions impossible.⁵⁰ This is important because a) the quality of contract law one would surmise correlates with the quality of corporate law and b) much that is useful in corporate law can be built out of good contract law, either directly by public authorities or indirectly by private parties.

And many of the same nations that by measurement have good corporate law *also* have good contract law. All the Scandinavian nations, Germany, and several other continental European countries enforce contract *as well as* the United States does.⁵¹ This casts more doubt on

50. Bernard S. Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911 (1996) (Russia); Jeffrey D. Sachs & Katharina Pistor, *Introduction: Progress, Pitfalls, Scenarios, and Lost Opportunities*, in THE RULE OF LAW AND ECONOMIC REFORM IN RUSSIA 1, 3 (Jeffrey D. Sachs & Katharina Pistor eds., 1997).

51. KIM R. HOLMES, BRYAN T. JOHNSON & MELANIE KIRKPATRICK, 1997 INDEX OF ECONOMIC FREEDOM 160, 185, 199, 346, 422, 457 (1997) (asserting that Denmark, Finland, Germany, Norway, Sweden, and the United States have high levels of protection of private property and largely efficient legal systems); *cf.* Ross Levine, *Law, Finance, and Economic Growth*, 8 J. FIN. INTERMEDIATION 8, 14-15, 20 (1999) (indexing the risk that government will not respect a contract it has signed: low for the United States, but *lower* for France, Germany, and Scandinavia).

whether the quality of corporate law thesis explains enough of why ownership separates or doesn't in the world's richer nations. Several of these nations, as we've seen, also seem to protect minority stockholders well, although ownership hasn't yet separated. Contract law seems good, and corporate law, which also seems good, is in many dimensions a special form of contract law. Nations that can build one should be able to build the other. And the rudiments of a corporate law can, in primitive form, be built out of contract.

Studies of business climate are consistent: continental Europe and the Anglo-Saxon basic *business* institutions are generally seen as equally business-friendly, but the continental European *labor* markets are seen as much less business-friendly.⁵²

Nor is it logically correct to assume that where corporate rules are weakly enforced, that weakness is the *primary* cause for weak stock markets in nations that have already built satisfactory contract and property institutions. In such nations, were the demand for diffuse ownership sufficiently strong, investors and firms could try to build the institutions needed for good securities markets. If societies that successfully built other complex business and legal institutions, especially those that effectively enforce commercial contracts, did not try to build these corporate law institutions, then a deeper reason might explain why they did not try.

Thus, one could synthesize the legal and the politically-driven managerial agency cost theories into a two-step argument: When corporate law, contract law, and court systems are decrepit, politics is irrelevant. Public firms will not emerge, because the system fails to protect minority stockholders. But when either contract or basic corporate law becomes satisfactory, as it is in several western European nations and the United States, then whether a nation builds on what it has (by writing complex contracts, by further improving corporate law, or by developing the ancillary institutions such as stock exchanges or effective intermediaries), becomes a question of whether the underlying politics—and the underlying potential for low managerial agency costs to shareholders—make it profitable for the players to do so.

52. Jeffrey D. Sachs & Andrew M. Warner, *Executive Summary*, in WORLD ECONOMIC FORUM, THE GLOBAL COMPETITIVENESS REPORT 1998, at 24.

C. What Beyond Law is Needed for Separation in the Wealthy West?

I have argued here that corporate law could be fine and ownership might *still* not separate from control. Corporate law does not readily control the important managerial agency costs of dissipating shareholder value. For firms for which these costs to shareholders are high, ownership will not readily separate from control. For nations where these costs are systematically high, separation is rarer than where these costs are low. It is rarer even if corporate law quality is high. Corporate law is insufficient to induce separation. Other conditions have to be met. Here for the sake of completeness I briefly outline the other conditions.

1. *Economic preconditions.* Economic and technological conditions must yield a demand for public firms with lots of capital. If the economy is too poor to have such a demand (many nations still are in this category) *or* if the reigning technologies do not demand large economies of scale, then public firms won't be sought. Moreover, the distribution of wealth and income must be flat *relative to the demand for large firms.*⁵³ (*This latter might be better placed as a political-social condition.*)

2. *Political preconditions.* Some societies are rich, have technological demands for large firms, but their politics stymies separating ownership from control. In strong social democracies, politics drives a wedge between shareholders on the one side, and managers and employees on the other side. Politics there presses firms to expand, to avoid down-sizing, and to avoid taking risks with employment conditions. These are just the kind of goals that unconstrained managers were said to have in the United States, just the kind of things that the arsenal of agency-cost-reducing tools is designed to handle. And the tools that make managers tolerably loyal to shareholders in the United States—transparent accounting, incentive

53. Thus the United States has today a skewed distribution of wealth and income, but it has a very high demand of large-scale firms. In the nineteenth century the distribution was flatter, and, with the railroads creating a single huge market, the demand for large firms with widely gathered capital was even higher. If technology flattens and shrinks firms, making them more "pocket-sized" then wealthy people can control them more easily than if the optimal scale is very large.

compensation, hostile takeover, and strong shareholder primacy norms—are denigrated in the strong social democracies.

In contrast, more conservative nations don't drive the wedge between shareholders on the one side, and employees and managers on the other side, but facilitate, or at least allow, shareholders and managers to ally themselves. When they are tolerably allied, ownership and control can separate. In technical terms, managerial agency costs if unremittingly high can induce concentration to persist, rendering corporate law quality secondary.

In societies of the first type, concentrated shareholding is capital's next best means to control managers, and it persisted even after the other economic conditions for separation were met. *Moreover, it has persisted even in such nations that have good quality corporate law.* And it has tended to budge in recent years only as these nations' social democratic political parties have shifted rightward.

3. Social preconditions. Some societies are so in turmoil that private institutions cannot be built. Reputations are not worth developing, because no one is sure to be able to use the reputation once built. Private-ordering via, say, a stock exchange won't work, because investors lack confidence in the exchange and fear who might capture it. But once a society has sufficient regularity so that reputations, private institutions, and, if need be, corporate law can be built, then if political and economic conditions are otherwise ripe, large enterprises can arise and ownership can separate from control. If there's sufficient social and political regularity, corporate law or substitutes can arise to do the job.

Conclusion: The Quality of Corporate Law and its Limits

I have tried here neither to deny the value of strong corporate law that protects distant stockholders, nor to denigrate its usefulness in building efficacious business enterprises, nor to refute its academic utility in explaining some key aspects of corporate differences around the world. It is valuable in protecting distant shareholders, as it is often the lowest costs means to protect them. It is useful in thereby building big firms. And it is helpful in explaining corporate structures in the world's developing and transition economies, many of which cannot establish good corporate rules of the game. It may interact to some extent with economic conditions even in the world's richer nations by

lowering the costs of going public and separating ownership from control.

I have instead examined the limits to the quality-of-corporate-law argument. High quality corporate law is an insufficient condition for separating ownership from control in the world's richest, most economically-advanced nations. Technologically-advanced nations can have the potential for fine corporate law in theory, and several have it in practice, but ownership will *not* separate from control if managerial agency costs are high.

Indeed, good quality corporate law could in theory *help* strong blocks to persist: distant shareholders have less to fear from blockholders (when good corporate law prevents stealing), and the good quality corporate law channels the blockholders into increasing shareholder value. If managerial agency costs are potentially high in those nations, then blockholding will *increase* as corporate law improves, because corporate law will protect the diffuse stockholders while the blockholders increase firm value for all stockholders.

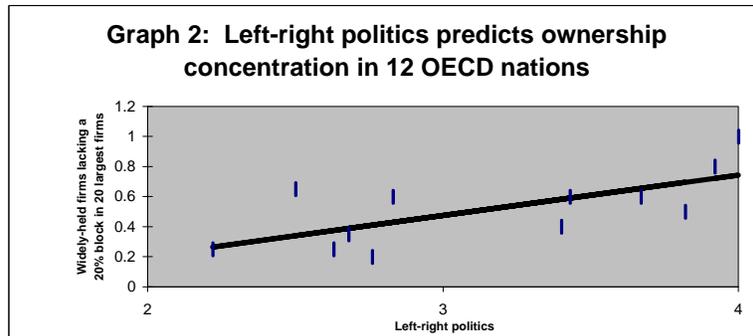
An academic theory explaining corporate structures as deriving primarily from corporate law's shareholder protections is a leap forward in our understanding of the rise and endurance of securities markets. But it still leaves too many unanswered questions. Why doesn't strong, pro-minority shareholder corporate law lead to *more* blockholders, not fewer because distant minority stockholders would have *less* to fear of controllers' trampling as law improved? Why do some rich nations lack even *a single anecdote* of over-reaching behavior from controllers' nevertheless lack diffusely held Berle-Means firms? Why are there so many rich nations with low control benefits by measurement, high quality corporate institutions, and much minority stock, yet without ownership separating from control?

The quality of conventional corporate law does not fully explain why and when ownership concentration persists. The basic reason here is that *corporate law does not even try to directly control managerial agency costs from dissipating a firm's value*. The American business judgment rule keeps courts and law out of basic business decisions and that is where managers can lose, or make, the really big money for shareholders. Non-legal institutions control these costs. (Law could indirectly facilitate or impede these non-legal institutions; but corporate law does not even try to directly reduce agency costs from mistake as

opposed to agency costs from stealing.) In nations where those *other* institutions, such as product competition or incentive compensation, fail or do less well, managerial dissipation would be higher and ownership cannot as easily separate from control as it can where dissipation is lower. Corporate law quality can be high, private benefits of control low, but if managerial agency costs from dissipation are high, separation will not proceed.

The quality of a nation's corporate law cannot be the only explanation for why diffuse Berle-Means firms grow and dominate. Perhaps, for some countries at some times, it's not even the principal one.

Appendix



Data sources: Ownership diffusion is from La Porta et al., supra note 2; the left-right political index is from Francis G. Castles & Peter Mair, *Left-right political scales: Some 'expert' judgments*, 12 EUROPEAN J. POL. SCI. 73 (1984). (t-statistic=3.01; p-value=.01.)

Table 3: Political Placement as Predicting Separation of Ownership from Control

Country	Portion of Largest Firms that are Widely-held	Left-Right Political Place in 1984
Australia	0.65	2.50
Canada	0.6	3.67
Denmark	0.4	3.40
Finland	0.35	2.68
France	0.6	2.83
Germany	0.5	3.82
Italy	0.2	2.76
Norway	0.25	2.63
Sweden	0.25	2.22
Switzerland	0.6	3.43
United Kingdom	1.0	4.00
United States	0.8	3.92