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## CORPORATE LAW'S LIMITS

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## Corporate Law's Limits

Mark J. Roe\*

### ABSTRACT

*A strong theory has emerged that the quality of corporate law primarily determines whether securities markets arise, whether ownership separates from control, and whether the modern corporation can prosper. The theory can used convincingly explain why we see weak corporate structures in transition and developing nations, but less convincingly explains why concentrated ownership persists in continental Europe or why it became less important 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 they decide whether to diffuse ownership. Ownership cannot readily separate from control when managerial agency costs are especially high. And missing from current 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 direct legal inquiry. The consequence is that even if corporate law as usually conceived is “perfect,” it directly eliminates self-dealing, not managerial mistake. But managers can lose for shareholders as much, or more, than they can steal from them, and law directly 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 protected shareholders everywhere. 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 protected from controlling stockholder and managerial thievery, but uncontrolled agency costs though seem to be especially high in those very nations.*

\*Mark J. Roe is the David Berg Professor of Law at Harvard Law School and wishes to thank the John M. Olin Center for Law, Economics, and Business for financial support.

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## CORPORATE LAW'S LIMITS

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### INTRODUCTION

The critical precondition to developing modern securities markets, and the economic and technological benefits that go with good stock markets, most recent analyses posit, is a foundation of solid corporate and securities laws that protect stockholders from over-reaching dominant majority stockholders or controlling managers. Without such corporate law protections, securities markets, it is said, 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 to understanding the fragility of capital markets in transition and third-world economies. But it has been used, and probably over-used, to primarily explain the persistence of dominant stockholders and fragile securities markets in many of the world's richest nations in Europe and Asia. I say over-used, because there is too much that is critical to ownership separation that corporate law does not reach, and does not even seek to reach, in the world's richest, most advanced nations.

The conceptual problem is basic: Current academic thinking lumps together costly opportunism due to a controller's self-dealing and costly decision-making that inflicts losses on the owners. The first, self-dealing, corporate law seeks to control directly; the second, bad decision-making that damages shareholders, it does not.

Other institutions control the latter and their strength varies from nation-to-nation. Owners tend to stay as blockholders—and ownership does not diffuse, and securities markets remain weak—if they expect managerial agency costs to shareholders would be very high if ownership fully separated.

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Lost in the current academic debate (and perhaps lost to policy-makers at some international development agencies) is that corporate law does not even try to directly control the costs of straight-forward mismanagement. Other institutions do. For these other institutions (product market competition, incentive compensation, takeovers, shareholder primacy norms, etc.), corporate law (other than for takeovers) is usually just a supporting prop, not the central institution. And, even if one thinks law has an equal role to play in both—in motivating managers as well as in deterring insider machinations—the two, motivation and deterrence, depend on *differing* laws. These would vary in strength, because of differing national histories, politics, and economic conditions. Countries can, and do, better deal with one—motivation—than the other—deterrence. And when they do better with one than the other, they thereby affect which organization—close or diffuse ownership—is favored. One could get all of the corporate law institutions “right,” but if other institutions are missing that are needed to keep managerial agency costs low enough (or if other institutions in a society *raise* managerial agency costs), then ownership will not sharply separate.

Data supports the view that corporate law is secondary here: among the world’s richer nations, several by measurement have *good* minority stockholder protection. But despite protective results that keep potential over-reaching from majority stockholders in check, ownership has *not* yet neatly separated from control. Our task is to assess the theoretical implications of why ownership did not separate, since these counter-examples tell us that corporate law did not impede it.

Another way to conceive of my inquiry here: The fact that ownership did not separate from control in a nation does not tell us whether it did not separate because blockholder rampages are uncontrolled *or* because *managerial agency costs* would be far too high if ownership separated. *Each* could have prevented separation. Or one alone could have, with the other not standing in the way. If underlying economic, social, or political conditions make managerial agency costs very high, and if those costs are best contained by a controlling shareholder, *then concentrated ownership persists whatever the state of corporate law in checking blockholder misdeeds.*

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 raise the demand to build legal institutions that 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 employment relationships within the firm, is a third; a high level of social mistrust that impedes professionalization of management is 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, controllers obtain very high private benefits from control, because they divert firm value into their own pockets, then distant shareholders mistrust the insiders, and are unwilling to buy. Ownership concentration should, all else equal, persist. Good corporate law (or substitutes like stock exchange rules, contract, media glare, or reputational intermediaries) can, by reducing this potential for thievery, facilitate separating ownership from control.

But there is more to running a firm than controlling insider machinations, and it is the machinations that are corporate law's primary and direct focus. Managerial agency costs to distant shareholders come in *two* basic flavors: machinations and mismanagement. Law can reduce the first, but does little directly to minimize the second. Not yet fully recognized in the current literature is that American law *avoids* dealing with the second. This is basic to the study of the corporation in law school, basic to its operation in the courts, but not yet integrated into the academic and policy development literature: The business judgment rule has courts *refusing* to intervene when shareholders attack managerial mistake.

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 close ownership persists not because of weak corporate law, but 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 suggest why these costs to shareholders vary from nation-to-nation and firm-to-firm.

Moreover, by shifting our focus from legally malleable private benefits to managerial agency costs we can see why sub-standard corporate law persists in a few of the richer, well-developed nations. Low quality law can be a *symptom* of weak separation, not its base-line cause. *If managerial agency costs from dissipating shareholder value would be too high anyway* (because,

say, non-legal institutions keep them high, or fail to bring them down), then there's little reason for the players (public policy makers, investors, founders and block-owners) to build good corporate law, because it wouldn't be much used.

\* \* \*

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 is insufficient to induce ownership separation.

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, especially in understanding, say, the kind of business institutions that prevail in transition nations. 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 a deficient corporate law. Since several nations have, by measurement, good enough corporate law, but nevertheless have very little separation; 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 is 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 over-reaching, 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* if a close 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 basic shareholder protections seem adequate, stock can be and is sold, but ownership nevertheless does not separate from control. Something else has made concentrated control persist.

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 does not primarily determine whether it is worthwhile to build those enterprises. It is only a tool, not the foundation.

#### I. THE ARGUMENT: CORPORATE LAW AS PROPELLING DIFFUSE OWNERSHIP

Today's dominant academic and policy-maker 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 increasingly legal commentators have stated so.<sup>1</sup> One imagines the Nobel Prize winning Franco Modigliani 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."<sup>2</sup> Leading economists showed that deep securities markets correlate with an index of basic shareholder legal protections.<sup>3</sup> These protections are important: "[P]rotection of shareholders ... by the legal system *is central* to understanding the patterns of corporate finance in different countries. Investor protection [is] *crucial* because, in many countries, expropriation of minority shareholders ... by the controlling shareholders is extensive."<sup>4</sup> Leading legal commentators have signed on to the law-driven theory.<sup>5</sup>

At the same time, international agencies such as the IMF and the World Bank have admirably promoted corporate law reform, especially that which would protect minority stockholders.<sup>6</sup> The OECD and the World Bank have had major initiatives to improve corporate governance, both in the developing and the developed world.<sup>7</sup>

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1. La Porta, Lopez-de-Silanes & Shleifer (1999) La Porta et al. (1998), at 1136-37; Bebchuk (1999); Coffee (1999); Becht & Röell (1999).

2. Modigliani & Perotti (1998); see also Modigliani & Perotti (1997).

3. See La Porta et al. articles, cited supra note 1.

4. La Porta, Lopez-de-Silanes, Shleifer & Vishny, (2000) (emphasis supplied).

5. See Coffee (2001); cf. Bebchuk (1999).

6. Iskander et al. (1999).

7. OECD (1999a); Nestor (2000); Witherell (2000).



These are valuable initiatives. They could well contribute to reaching their goals of more stable enterprises and better economic performance, especially in transition nations. But corporate law, and the reach of government policy-makers through corporate law reform, has limits. And those limits are much closer in than the policy-makers and academic theory now discern. Here I demarcate those limits' boundaries in the world's richest nations beyond which corporate law ceases to be a primary institution.

#### 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 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.

Or, 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 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 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 owner considers whether to sell to diffuse stockholders. With no controller to divert value, the stock price could 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.<sup>8</sup> The controller refuses to leave control “up for grabs” because if it dips below 51% control, an outsider could grab control and reap the private benefits.

*B. The Attractions of a Technical Corporate Law Theory*

The quality of corporate law argument is appealing. Technical institutions are to blame, for example, for Russia's and the transition nations economic problems. The fixes, if technical, are within our grasp. Humans can shape the results. Progress is possible if we just can get the technical institutions right. If we don't see ownership separation in Germany, France, and Scandinavia, it must be because a technical-fix is missing, one we can handle as easily as downloading a computer program across the Atlantic. But if it turns out that deeper features of society—industrial organization and competition, politics, conditions of social regularity, or norms that support shareholder value—are more fundamental, we would feel ill at-ease because these institutions are much harder for policy-makers to control.<sup>9</sup>

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 is good for a nation to have it.

But we need *more* to understand why ownership does not separate from control *even where core 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*.

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.

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8. La Porta et al. series, supra note 1; Bebchuk (1999)1; Modigliani & Perotti, supra note 2.

9. To be clear, I am not speaking simply of corporate law as just the “law-on-the-books,” but as “law-on-the-books,” including securities law, and the quality of regulators and judges, the efficiency, accuracy, and honesty of the regulators and the judiciary, the capacity of the stock exchanges to manage the most egregious diversions, and so on. The best compendium of the legal and related institutions is in Black (2000).

## II. ITS LIMITS: THEORY

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

Managers would run some firms badly if ownership separated from control. Effective corporate laws constrain managers' *over-reaching*, 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 corporate law's business judgment rule to deflect direct legal scrutiny.

Consider a society (or a firm) where managerial agency costs from dissipating shareholder value would be high if ownership separates, but low if it does not, because a controlling shareholder can contain those costs. When high but containable by concentration, concentrated shareholding ought to persist *even if corporate law fully protects minority stockholders from insider's over-reaching*. Blockholders would weigh their costs in maintaining control (in lost liquidity and diversification) versus what they'd lose if managerial agency costs were high. Control would persist even if corporate law were good.

This is a basic but important point, and it is needed to explain the data that we look at in the next Part.

B. *Improving Corporate Law without Increasing Separation*

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

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 concentration persists 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.

A few words on the definitions: While no simple framework can account for every variation, this one is quite flexible. For example, one might think about founders who lose touch and who would be best replaced by professional managers open to new ideas. This possibility would not be outside, but indeed would fit the model: the sign on  $A_M$ , managerial agency costs, would change; instead of managers being a cost, they'd be a gain. And  $C_{CS}$ , the costs of concentration could also have its sign change from the normal expectation (that carrying a big illiquid, undiversified block of stock is costly): if taxes, say, would be imposed on a dominant blockholder who sold off his or stock, then concentration could end up cheaper than diffusion, on that side of the equation.  $C_{CS}$  would turn negative.

But let us put these aside to focus on the central tendencies here of private benefits of control and managerial agency costs: Consider the firm 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 she obtains one-half of  $V$ , plus her 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.) She retains control when the following inequality is true:

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

The left side 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. 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 in equation (1).<sup>10</sup> This is the conventional theory<sup>11</sup> that we next amend.

We amend by introducing  $A_M$ , managerial agency costs from dissipating shareholder value. If those managerial agency costs are non-trivial, then the controllers' proceeds from selling into the stock market would be  $(V-A_M)/2$ . Concentration persists if and only if

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

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

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

Or, further re-arranging, concentration persists if:

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

Quality-of-corporate-law theory predicts diffusion fails to occur when  $B_{CS} > C_{CS}$ , with corporate law the means of containing  $B_{CS}$ . That is correct, but incomplete. Where  $A_M$  is high, diffusion does not occur *even if  $B_{CS}$  is zero and corporate law perfect, 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 determine diffusion.<sup>12</sup>

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10. Some private benefits are matters of taste, preferences for power, family recognition in a family firm, etc. About this corporate law has less to say.

11. See Bebchuk (1999), who models the problem; see also Coffee, (2001); LaPorta et al. series, supra notes 1 & 4.

12. The best-developed model of the corporate law problem begins by assuming a population of firms that more valuable when diffusely-owned than when privately-owned. See Bebchuk (1999). As such, its author does not have to address managerial agency costs, since these are assumed away as central for the population under discussion. It is in that that assumption though, we are saying here, that the critical calculus occurs in whether firms go public. (Not all other analyses of the relationship between corporate law and ownership diffusion confine their inquiry so adroitly.)

*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). And it does so about equally.

*1. The business judgment rule.* This criticism is both right and wrong, but mostly wrong. The reason it is mostly wrong is simple. Managerial agency costs are the sum of managers' over-reaching (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.<sup>13</sup> But it is incorrect to think that law minimizes 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 interest*.<sup>14</sup> *But this is where the big costs to shareholders of having managerial agents lie, exactly where law falls silent.*

Conventional corporate law does little, or nothing, to directly reduce shirking, mistakes, and bad business decisions that squander shareholder value. The business judgment rule is, absent fraud or conflict of interest, nearly insurmountable in America, *insulating* directors and managers from the judge, and *not* subjecting them to scrutiny.

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....*<sup>15</sup>

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13. Fama (1980) (agency costs come from "shirking, perquisites or incompetence").

14. Dooley & Veasey (1989), at 521 (Veasey is now the Delaware Supreme Court chief judge); Bishop (1968), at 1095 (managers without a conflict of interest always win); Rock & Wachter (2001), at 1664-68.

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

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 to pay for their mismanagement: *Smith v. Van Gorkom*,<sup>16</sup> a decision excoriated by managers and their lawyers, and one promptly overturned.<sup>17</sup>

Nor should we think that this is a gap in American law, one that law would fill in if other institutions failed to control managerial agency costs. One *would not* want the judge regularly second-guessing managers. Most American analysts would assume that it would be costly for firms if judges regularly second-guessed managers' non-conflicted business decisions.<sup>18</sup>

2. *Controlling shareholders.* One might refine this analysis by accounting for controlling shareholder error. But the costs of these errors are usually thought 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 unconstrained managers).

#### D. Law's Indirect Capacity to Affect Agency Costs

We have thus far considered the effects on separation of conventional corporate law, the law of fiduciary duties, of derivative suits, and of corporate waste. Conventional corporate law can reduce over-reaching and, where it or a substitute fails to, separation should not be wide. But even if it succeeds, managerial agency costs to shareholders could be high and, when high, ownership cannot readily separate. Institutions other than conventional corporate law raise, lower, and control managerial agency costs, reducing them via competitive markets, shareholder wealth maximization norms, incentive compensation, hostile takeovers, and corporate transparency.

For these institutions, 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.

1. *Takeover law.* Takeovers are (properly) seen as heavily law-influenced. Private actors must commence the takeover, and then judge makes it harder or easier for them to succeed. But at least two reasons help us understand why takeover law—a type of corporate law, when we no longer keep a narrow

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16. 488 A.2d 858 (Del. Sup. Ct. 1985).

17. Del. Corp. Code § 102(b)(7).

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

view of what corporate law is—only goes so far. First, there's that persistent and substantial, premium. For quite some time an offeror has had to offer a 50% premium over the pre-offer trading price. Even if takeovers flatly barred managers from mismanaging the firm anything beyond that premium, then although takeovers keeps managers within a 50% boundary, other institutions (like product market competition, incentive compensation, professionalism, etc.) would be the institutions that kept most managers from straying so far. Takeovers would provide an outer boundary, but other institutions did the close-in work (or, since 50% of firm value is quite a lot, the medium-in and most of the big work).

One might reply to me here by saying that American takeover law is lax, and gives managers too much discretion. Better takeover law—such as that embodied in the British takeover code—would do the job better, keep managerial agency costs low, and facilitate separation.

This kind of rebuttal has two deep problems though: American takeover law might well fail to measure up, but America has now and has long had one of the strongest ranges of ownership separation: even if takeover law in the United States was, and is, imperfect for shareholders, it's in the United States where separation is strongest in the world's richest nations. This combination would, again, suggest that corporate law (here, in the guise of takeover law) isn't always the essential ingredient.

Moreover, comparing the United States here with Britain is instructive. Critics of American corporate law tend to point to the British takeover code as about as good as we can get.<sup>19</sup> But how much does that improved takeover law get Britain? I know of no deep measurement, so I undertook one of my own, measuring the premium in hostile offers. The Thomson Financial data yielded the typical premium for the United States—50%. And for Britain over the same time period, the premium turned out to be less—40%.<sup>20</sup>

That 10% differential should be belittled. Ten percent better management—if that's what better British law would yield—is huge. But 40%, the residual, is more (four times more!). And for that big residual, other institutions, institutions that get even farther afield from core corporate law must do the job, institutions like product market competition and the like.

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19. E.g., Bebchuk & Ferrell (1999), at 1193; DeMott (1983).

20. Thomson Financial (database) (accessed Oct. 2001). The comparison can be fine-tuned, by matching industries, firm-size, and other characteristics. But the persistence of the premium (the 10% gap is nearly constant over a couple of decades) suggests that refining the numbers will not change the fact that a substantial premium would persist even after American takeover law was perfected.



2. *Other institutions.* So, although ordinary but mistaken managerial business decisions and corporate transactions are immune from direct judicial attack, other institutions in society affect these business decisions and transactions; and law can facilitate or ban these other institutions. But in each case, the other institution (the competitive product market, the incentive compensation, the pro-shareholder norm) is the primary control, with law just assisting or impeding that institution. But for insider over-reaching, basic corporate law is a primary and direct deterrent. It is the judge who bars the transfers, orders recovery of the diverted value, and punishes the wrong-doer. The judge intervenes directly.

Consider product market competition, shareholder primacy norms, professionalism, incentive compensation, and transparency. Strongly competitive markets, for example, can be prodded along by good antitrust law, or lost by bad antitrust law. But the primary constraint on managers is the product market, not law.

And shareholder primacy norms, for example, can be facilitated or demeaned by legal pronouncements. But the norm, not the pronouncement, is what directly affects managerial performance. Or incentive compensation can be spurred, or taxed. But once again, it is not the tax rule that spurs managers directly, but the incentive compensation that pushes them.

Although law affects these institutions, law's effects here differ from the effects of conventional corporate law. First off, they do not directly invoke the core 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. One might now reply to me that antitrust law and tax law are "part of" corporate law, but most would say that this is a stretch, and a big one. Moreover, other institutions and economic features affect, say, competition. If the economy is, say, a small one or the technology is one not conducive to standard competitive markets, then even perfect antitrust law will leave many markets uncompetitive.

Importantly, law here does not 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. And these institutions (excepting perhaps basic transparency) have the potential to be politically

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charged, and in other nations one or the other or all four *are* politically charged.

*E. Even if Law Critically Affects Both*

One might reject the proposition that law is secondary in inducing good management for shareholders. Law affects these other institutions that control managerial agency costs (competition, compensation, and so on), and one might believe these laws to be central to whether public firms can arise and whether ownership can separate from control.

But even so, the structure of my argument—of *corporate law's* limits—persists: *Different* institutions and *different* laws affect managerial agency costs than the institutions and laws that affect insider machinations. The two sets are *not* identical. They barely overlap. If one society does better with one set than with the other, the degree of diffusion is deeply affected. Corporate law might minimize insider transactions, but the other laws might fail to reduce managerial agency costs.

That is, let us here assume *arguendo* that corporate law can if “unleashed” affects both private benefits and managerial agency costs. But if other institutions also affect managerial agency costs (but not private benefits, at all or not as much), then corporate law could be perfect but the nature of these other institutions would affect the strength of ownership separation, via their affect on managerial agency costs.

*F. Precision in Defining Agency Costs and Private Benefits*

A controller can reach into the firm to divert value away from the firm's stockholders. These are private benefits of control. A typical such diversion would be for the controller to fully own a private entity that sells product to the firm at inflated prices. *Dissipating* shareholder wealth is not the actor's goal; *shifting* that wealth to him or her is.

But to be precise here, dissipation *would* 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.

And managerial agency costs are the value that managers can dissipate in the firm, due to mistaken management. They might over-invest, under-invest, or mis-invest. They might over-pay suppliers or fail to adopt profitable technologies. They might react too slowly to changing market conditions.

But to be precise here as well, 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 the primary effect of the managerial agency costs is to dissipate value; the diversion managers get by working a little less hard is secondary to the dissipation of shareholder value.

*G. Ambiguity in the Legal Theory: Improving it Can Reduce Separation*

Thus far I have accepted the conventional wisdom that strengthening corporate law facilitates separation across-the-board, in rich, developed nations as well as in transition and developing ones. But 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*.

*1. The offsetting effects.* Recall the core corporate law argument. 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.

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. (Managers oftentimes seek such rules to entrench themselves, but such rules keep nasty raiders out as well.)

Consider the firm that is public, with pills, caps, and other charter terms that keep raiders out. Consider two nations, A and B, with A protecting minority stockholders imperfectly and less well than B. (Nation A 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 law nations could end up with *more* blockholders in those firms that go public. More controllers would be willing to go public, because better-protected investors would pay full pro rata value. More dispersed

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,<sup>22</sup> facilitating information flow from inside the firm to capital owners,<sup>23</sup> and making implicit deals with stakeholders when soft deals are efficient;<sup>24</sup> their one big bad activity is their stealing from the minority 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.

2. *Illustrating the countervailing movement.* Consider the impact of corporate law improvement on three categories of large-firm ownership:

1. Diffuse
2. Public, but with a dominant stockholder, and
3. Privately-held.

The quality-of-corporate law thesis assumes that law reform would, monotonically, increase diffusion. Without satisfactory corporate law protections, diffuse ownership would be unstable, with a raider able to capture control and siphon off private benefits. Large owners (in categories 2 or 3) therefore cede control only reluctantly. If a nation improves its corporate law, large owners' reluctance to cede control diminishes.

But now consider a nation that has plausible but flawed corporate law. Some firms are fully public firms in category 1, but most large firms stay in category 2 or 3. The diffuse firms use contract to keep out future blockholders, e.g., capped voting that stops blockholders from taking control. Some firms are sufficiently valuable when fully public that they can absorb the costs of these barriers to controller entry. But many firms stay in category 2 or 3, because the dominant owner cannot cheaply enough construct structures that minimize any future grab for the private benefits of control.

Corporate law (or a substitute, or its enforcement) improves. Current discourse focuses on the motivations of the owners in the middle category—those in category 2 that fear a loss of private benefits. No longer so fearing, they relinquish control. Ownership diffuses.

This though is not the only logical effect of improving corporate law. Consider first those firms that are already public. They have devices to

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22. Shleifer & Vishny (1986), at 465 (“our analysis indicates that [by monitoring managers] large shareholders raise expected profits and the more so the greater their percentage of ownership”).

23. Stein (1989) (diffuse ownership creates informational inefficiencies).

24. Cf. Shleifer & Summers (1988).

minimize the intrusion of blockholders, to impede a raider from entering to siphon off private benefits. But with private benefits less available, the firm could drop its barriers to entry, as the siphoning—possible when corporate law was weak—is less important when improved corporate law reduces the private benefits. A blockholder can enter if it can add value.<sup>25</sup>

This might be especially so if the reason the firm moved from category 2 to category 3 was because of reduced firm value *because* of the existence of private benefits. If shareholders and dominant stockholders were always wrestling for position, and sometimes engineering value-decreasing transactions (to remove value or to bond, in a costly way, not to), then the firm might have moved to diffuse ownership as the less costly alternative. With this drag on value—blockholder vs. diffuse stockholder infighting—removed, the firm could stabilize *with* a blockholder.

Other movement toward public firms with dominant blockholders could occur. Many firms might be in Category 3—privately-held—because the owners refuse to sell out at a discount. But with corporate law improved, the blockholder could sell, and investors could buy, confident that future over-reaching would be minimal. In the population of public firms, more would have dominating blocks because blocks would be less costly to all.

To illustrate, consider a nation with 30 large firms. Ten are diffusely-held, ten are public but with blockholders, ten are fully private. In the commonly used indices of diffusion, this nation would have a .5 (i.e., of the twenty largest public firms, ten have blockholders).

Corporate law improves. As suggested by current theory and intuition, ownership of five block-controlled firms fully separates. Owners can at last sell out at full value, because they need not worry any longer about a future raider grabbing control and the concomitant private benefits. The index of diffusion jumps to .75 (15 of the 20 public firms would be diffuse).

But consider the ten firms that were fully public. Five now can afford blockholders because the dissipation of value from infighting would decline, and the blockholder would add value. If this were the second move, then the index would *end up where it began*, at .5.

And of the ten firms that were fully private (category 3), five owners decide that they can take the firm public and, under the newly-improved corporate law regime, investors readily buy up the stock. When this third set of transactions is completed, that nation would have ten fully-public firms and

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25. Not all will, of course. Path dependence and positional advantage will deter many. See Roe (1996). The point is that the pressures here from improving corporate law do not all point toward greater diffusion.

fifteen public but block-held firms. The index of diffusion would have *dropped* from .5 to .4. Improving corporate law would thereby *reduce* the density of separation in that nation's public firms.

And the corporate transformations are still not finished. Some fully public firms might go private, because they know that one barrier to cashing in on any improvement in the firm value—the difficulty of taking the firm public later—has been removed. (Public to private to public ownership again is a recurrent phenomenon in the United States.)

To summarize: *One* effect of improving corporate law is to facilitate firms with blockholders to transit to fully diffuse firms. But that is only one of the effects; improving corporate law has other contrary effects on diffusion.<sup>26</sup> : Concentrated blockholders have two major roles inside the firm: they steal from fellow stockholders and they monitor managers. If law limits the negative possibility—less, or no, blockholder stealing, because law protects the minority stockholders—then that improved law should make minority stockholders *more* comfortable, *not less comfortable*, with blockholders. Improving corporate law should, in such settings, all else equal, *increase*, not decrease, the incidence of blockholding.

**Table 1. Indeterminate effect of better corporate law in rich nation.**

		Type of firm ownership			Index of concentration of public firms
		Diffuse Public	Blockholder but public	Fully private	
<u>Time 1. Country begins with serviceable but not excellent corporate law</u>					
1.	Initial ownership distribution	10	10	10	.5 (10/20)
<u>Time 2. Corporate law improves</u>					
2a.	5 blockholders sell out	15	← 5	10	.75 (15/20)
2b.	Caps, pills removed; 5 public firms get blocks	10	→ 10	10	.5 (10/20)
2c.	5 fully private go public but blockholder remains	10	15	← 5	.4 (10/25)
2d.	5 fully public go fully private in LBO's	5	15	10	.25 (5/20)

26. This probably is not just be theory: “The ... common stock held by a [U.S.] firm's officers and directors as a group rose from 13 percent [of a firm's stock] in 1935 to 21 percent in 1995.” Holderness (2001) (forthcoming). As corporate law improved in the United States in the 20<sup>th</sup> century through better securities laws and enforcement, for example, from passable to very good, blockholding increased.



This offsetting effect from improving corporate law does not tell us that improving it is bad. (Getting more public firms for a nation and separating ownership from control is not inherently good.) Ownership choice and shareholder welfare expand by improving corporate law. So improving it is worthwhile.

But one could not measure the increased quality of corporate law by measuring the change in the number of public firms and the density of separation over time. Corporate law might improve, *and its very improvement might diminish the density of separation*. This ambiguity is a theoretical issue, away from which we turn.

#### H. *The Tight Limits to the Purely Legal Theory*

Thus, the basic theory here is, 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 dissipate shareholder value if the controlling stockholder disappears. Even if better corporate law usually increases diffusion in rich nations with adequate but not outstanding corporate law (a proposition open to theoretical challenge), concentration might be due to high managerial agency costs and have little to do with core corporate law's constraints on insider machinations.

If distant shareholders fear unrestrained managers, the controller cannot sell stock at a high enough price and thus she keeps control to monitor managers or to run the firm.

### 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 (due to technology, say, or politics) then the diffuse owners may demand legal protections. Corporate law might follow, not lead, market development. But if, among nations with satisfactory corporate law, 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.

One must determine 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?<sup>27</sup>) A protection might be missing, but an even stronger substitute might be present. 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 contract, corporate charter terms, or business practices counter-act a deficient corporate law.

Undaunted by lawyers' skepticism that one can qualitatively assess corporate law directly, 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. They have argued convincingly that corporate law institutions are weak in many third world and transition nations, that these weaknesses cripple securities markets.<sup>28</sup> These studies have also been interpreted, less convincingly, as showing weak corporate law to be the primary culprit for the weak securities markets on the European continent. Not only do corporate players in France, Germany, and Scandinavia think their corporate law is fine, but they sometimes proclaim its superiority in some dimensions over the American variety.<sup>29</sup>

The indexers consciously do not seek to measure the bottom-line quality of each nation's corporate law but uses a few proxies: Possibly the index

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27. Art. L225-252 C. Com.; Art. 200, Decree No. 67-236 of March 23, 1967, J.O. March 24, 1967, p. 2843 (France); Stengel (1998) (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 is not used. *Id.*

28. La Porta et al. series, *supra* note 1, and the followers. Economically less developed countries have added reasons why they have not developed securities markets. Good securities and corporate rules might come with wealth, and not the other way around.

29. Tunc (1982) (French law bans dangerous transactions that American judges weigh, balance, and sometimes approve); cf. Agnblad, Berglöf, Högfeldt & Svancar (2001), at 229 (not even anecdotes of insider machinations in Sweden).



focuses on rules that are not at the core of shareholder protections, but rather on proxies for a total set of institutions that protect shareholders, a set for which there might be more direct measures. Refinement is possible.<sup>30</sup>

One can list differing rules, but it is hard 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 up front as necessary to build securities markets, or whether the rules are just the polish on financial markets that comes once deep securities markets exist for other reasons. Some rules are window-dressing, some 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, we could. In nations where the premium is high, we would surmise corporate law or its enforcement is inferior; in nations where that premium over the price available to diffuse stockholders is low, we would surmise it to be 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 into his or her own pocket. If the quality of corporate law principally determined separation, then nations with

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30. Wall Street lawyers would have reservations about heavily using preemptive rights, cumulative voting, and the minimum percentage needed to call a special shareholder meeting—items not likely to be near the top of most American lawyers' lists of Delaware corporate law's most important legal protections—and of partly abandoning Delaware law for the index. (The index uses Delaware corporate law except on the minimum percentage needed to demand a meeting. Delaware allows firms to decide the issue by specifying a low percentage in their charter, a right that, I understand, firms rarely use. Sticking with Delaware here would have made Delaware corporate law protection look mediocre, when it is probably petty good.) The point is not that Delaware is bad—the index probably hits the right bottom line—but that developing an accurate index is hard.

For a critique more skeptical than mine of the index, see Vagts. (2002) (forthcoming). Vagts argues that the coding judgments for the German index are incorrect. For instance, although German stockholders are viewed as unable to vote by mail, most send their instructions in to their bank (by mail) and the bank then votes the stockholders. Hence, German corporate law is "better" than the index suggests.

high gaps between the value of control and that of the minority stock would have more concentrated ownership than nations with smaller gaps.<sup>31</sup>

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

*1. Market measures of the value of control.* 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 4% of the firm's value.<sup>32</sup> For Italy parallel research suggests a premium of 25 to 30% or more,<sup>33</sup> a premium consistent with the quality-of-corporate-law theory (since ownership is concentrated there and corporate law apparently poor<sup>34</sup>).

But in Germany, the control block premium was recently, and surprisingly, found to be only about 4% of the firm's value,<sup>35</sup> a result in tension with the pure, unrefined corporate law theory, because German ownership is concentrated and it is a rich nation with the world's third largest economy.<sup>36</sup> 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 would not

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31. 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.

32. Barclay & Holderness (1989).

33. Nicodano & Sembenelli (2000). See also Zingales (1994) (premium for voting stock). The Italian number comes from the voting premium for dual-class common stock.

34. Enriques (2001).

35. Franks & Mayer (2001). Franks and Mayer show that big blocks trade at an average premium of 13.85% over the price of the minority stock. Nonselling stockholders gain over time about 2.34%. That means that, net, the selling blockholder gets 11.61% more than the minority stockholders (from 13.85% minus 2.34%). Since the average size of the block is 36.32% of the firm's issued stock, the new blockholder pays 4.05% of the firm's value to the old blockholder, to the exclusion of the minority stockholders (from 36.32% of 11.61%). If this represented the total private benefits of control (no more and no less), then the private benefits would be about 3.8% of the firm's value. (If the firm's total value is 100 plus the private benefits of 4.05, the diversion would be 4.05/104.5, or .038.)

36. The premium is the difference between block price and the trading value of the diffusely held stock. American blocks traded at a 20% premium over the price of diffuse stock, 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, the typical numbers, indicates the controller could grab 5% of the firm's value for itself.

reflect them. And firms for which blocks are sold could be those with low private benefits, while those where diversion is high do not trade. But even the reduced fact remains that for those blocks sold, the future private benefits are expected to be about equal to those expected in American block trades.

So, the block premium in Germany is about that of the premium in the United States, 4%. We should pause at this finding for Germany. That number suggests we'd need to refine the pure-form of the law-driven theory. If control blocks trade at such a low premium in the world's third largest economy, one that is a paradigm of concentrated ownership, *perhaps something else induces concentration to persist*.

An 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. That 4% 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.<sup>37</sup>

The low German 4% control premium also shows why constructing an index for corporate law quality is so hard. To divert big 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 a compliant board. Because the majority stockholder in the United States typically appoints the entire board, it typically can control the board. But in Germany the blockholder can *never* control the full board, because German law mandates that labor get half of it, and the practice is that banks holding their brokerage customers' proxies get some board seats. Other German corporate law features might be weak, thereby generating an appearance of weak corporate law protections in a cross-country index. But even so, the German blockholder 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 corporate law features that count.

Two other researchers use a differing methodology, but come up with similar data. They investigate the effects of ownership concentration in 100 of Germany's public firms. They conclude that moving a German firm from diffuse to concentrated ownership would double the value of the firm's

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37. FitzRoy & Kraft (1993); Gorton & Schmid (2000); Schmid & Seger (1998); but see Baums & Frick (1999), at 206; Frick, Speckbacher & Wentges (1999).

shares.<sup>38</sup> Increases in ownership concentration typically *benefit* the diffuse stockholders. That story fits poorly with a pure poor-corporate-law theory,<sup>39</sup> but nicely with refined version that includes a managerial agency cost theory.

The new German data on control block premium presents a counter-example to an unrefined law-driven theory. Counter-examples 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.* Corporate law's effectiveness can be roughly measured via the voting premium when the firm issues stock that votes and stock that does not vote. So, class A stock votes, class B stock does not, but both have the same dividend rights. (Variations abound.) A controller cannot reap benefits by controlling the class B stock, but can by controlling 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 B's, we have a measure of the value that the controller can surreptitiously divert from outside shareholders to herself. Good law should keep that value—and the differential—low. If we could measure the differences across nations, we would have an indicator of the quality of corporate law.

Unpublished voting premium data has recently become available. Table 2 shows the voting premium in the world's richer nations. Italy's and France's voting premium is high, America's low—a difference consistent with the legal theory, as Italy is said to have poor protections and has concentrated ownership, and the United States the converse. But this new data increases the tension for the pure legal theory; Germany is a weak corporate law nation in the finance economists' indices, but the dual class numbers here *again* show it protects non-voting stockholders rather well, vindicating defenders of the quality of German corporate law.<sup>40</sup> And not just Germany: Four Scandinavian nations also protected minority stockholders but have concentrated ownership.

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38. Edwards & Weichenrieder (1999). Other researchers recently found German bankers able to extract little in private benefits of control. Gorton & Schmid (2000a), at 70.

39. It could fit with the poor corporate law theory if a) corporate law was poor, but b) big blockholders desisted from transferring value to themselves, while c) small blockholders insisted on massively transferring such value. Plausible, yes (big blockholders incur more deadweight costs if the transfers demean total firm value), but this confluence would seem implausible as accounting for all, or even most of, the doubling of value to minority stockholders of blockholding.

40. One researcher found a higher German voting premium. Nowak (2002).

**Table 2: Voting premium and ownership separation**

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 Economics Paper Sept. 21, 2000); the ownership concentration data comes from La Porta et al., *supra* note \_\_\_\_\_. 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.

This dual class premium data casts doubt on whether a uni-variable 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—is not enough to allow crosschecks and controls to weight competing factors.

True, 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.<sup>41</sup>

41. Data measuring the value of the vote can be corrected to reflect that the minority voting stock represents the probably 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

Thus while this is the best data set available, it is imperfect. We can take comfort in that ancillary and qualitative information comports with the numbers. The American premium is low, and U.S. corporate and securities law is usually seen as highly protective. The German premium is low, as is the new parallel German control block data. And 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 Scandinavian 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.*”<sup>42</sup> 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....*<sup>43</sup>

The other Scandinavian nations have similar reputations, and they also have low premiums. 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 does not take majority control but more typically ends up with 5% of the cash flow and 25% (not a majority) of the votes,<sup>44</sup> leaving potential control in the other 75% of the votes.<sup>45</sup> The voting premiums in the world's poorer nations (not noted in Table 2), which one could believe to be in the process of developing securities markets, are high.

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the correction. See Zingales, *supra* note 33; Nenova, *supra*. Such calculations are inherently imprecise.

42. Bergström & Rydqvist (1990) (emphasis supplied).

43. Holmén & Högfeldt (1999), at 39.

44. Leser & Rocco, (2000, at 23.

45. The density of dual class usage *could* indicate which propellant—private benefits or managerial agency costs—is central. If control is usually had via dual class stock (or pyramids) that might indicate that extraction of private benefits is primary. But this would be so only if the controller pulls his or her wealth out of the firm. If managerial agency costs are high, control with *some* financial commitment is important for firm value: if wealth constraints mean the controller cannot commit most of the family's wealth and still influence managers, then dual class could be privately efficient for managerial agency cost reasons.

To repeat a proviso: I hardly mean that this data tells us that high-quality corporate law is irrelevant. Rather, some rich nations have high quality corporate law *but ownership still does not separate*. 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 already is good enough, subtle gradations in its quality do not determine whether ownership diffuses*. Something else is more important, with the leading alternative being that high managerial potential to dissipate precludes strong separation.

3. *Control block premium*. Other new data on corporate law quality is also suggestive, and unhelpful to an unrefined form of the corporate law thesis.

The premium in a block sale could reveal the quality of the governing corporate law. Consider a controller who owns 50% of a \$7,500 company with 100 shares, and sells her 50 shares as a block not at \$75 each, but at \$100 each, when the dispersed stock trades at \$50 per share. The \$50 per share premium could measure the private benefits of control, benefits that better corporate law would force the controller to share ratably with the firm's other stockholders. The controller could plausibly siphon off \$50/share x 50 shares in value, or \$2,500 of the firm's total value of \$7,500. The premium is 33% of the company's value.

If instead the controller's 50 shares sold for \$80 per share while dispersed stock sold for \$70 per share, then we could calculate that the market was expecting that the controller could siphon off \$250 (from 50 shares x \$10/share), or 3.3% of the firm's value. We would surmise that the first scenario is one of weak corporate law, the second of stronger corporate law.<sup>46</sup>

Economists have just accumulated such data, in an important undertaking. Here, in the last two columns, is what they have for the world's richer nations:

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46. We would have to be careful that we were not reading data in which *only* the control sale was regulated, while rampant shifts occurred elsewhere: If the relevant corporate law forced a mandatory bid for dispersed stock upon a control shift, the premium might be low, but incumbent controllers could still be otherwise shifting value. So the better data would measure the results before mandatory bids became common; or would measure control sales not subject to the mandatory bid, i.e., sales of less than the typical 30% trigger.) This data does so.

**Table 3. Control premia and ownership separation.**

Country	(1) Widely-held at 20% for Medium- sized Corporations	(2) Mean premium as a fraction of total equity	(3) Mean premium from col. 3, "corrected" for industry effects
Australia	0.30	0.02	0.04
Austria	0.00	0.38	0.34
Canada	0.60	0.01	-0.04
Denmark	0.30	0.08	0.03
Finland	0.20	0.10	-0.01
France	0.00	0.02	0.04
Germany	0.10	0.10	0.02
Italy	0.00	0.37	0.30
Japan	0.30	-0.04	-0.04
Netherlands	0.10	0.02	0.02
Norway	0.20	0.01	0.04
Sweden	0.10	0.06	0.03
Switzerland	0.50	0.06	-0.06
United Kingdom	0.60	0.02	0.04
United States	0.90	0.02	0.04
	med20	Block premium/ equity value	

Source: Alexander Dyck & Luigi Zingales, Why are Private Benefits of Control so Large in Certain Countries and What Effect Does this Have on their Financial Development (working paper, 2001).

A cursory examination shows *no* persistent pattern. If the sample only had, say, Austria, Italy, the U.S., and the U.K., we would get a nice pattern for the corporate law thesis: Austria and Italy have concentrated ownership and high sale-of-control premiums; the U.S. and the U.K. have low premiums and low ownership concentration. For these four nations, there's an excellent fit for a quality-of-corporate-law thesis, suggesting it has some importance.<sup>47</sup>

But the other wealthy nations *also* have low sale-of-control premiums, *despite* that most of them have *concentrated* ownership. Take a look at the

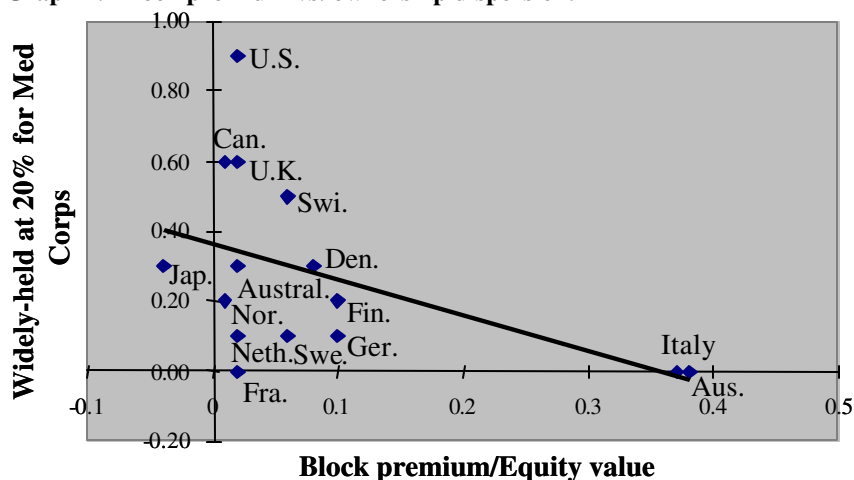
47. The last column in Table 3 adjusts the premium for industry type: some industries are more likely to "naturally" protect dispersed shareholders, other industries are riskier for them. The adjustments refine the index but do not radically change the results: Austria and Italy still have the largest premiums; the U.S. and the U.K. are still at the protective end of the spectrum. Some of the middle range nations change rank: Germany and Finland look more protective; most other changes meander.



Scandinavian nations again: low premium for control, high concentration. And take a look at Germany and Switzerland: fairly low premia, but concentrated ownership for Germany and middling-concentration for Switzerland. And in this sample, both the Netherlands and France, countries with concentrated ownership, do not look bad in protecting minority stockholders. Overall, the “sign” of the relationship is as corporate law theory would predict, but the significance is low, and the portion of the variation explained (12%) is quite low.

The following shows the relationships graphically and the statistical result: satisfactory, but “driven” by Austria and Italy.

**Graph 1. Block premium vs. ownership dispersion.**



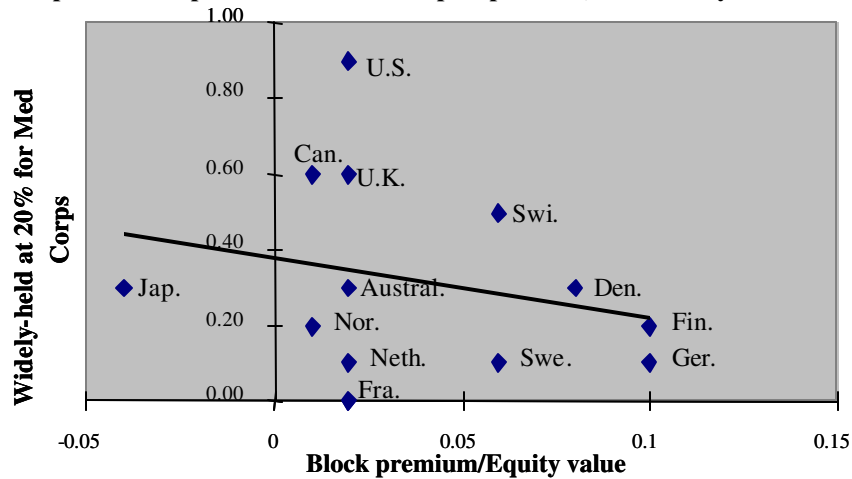
Technical data: med20 v. control premium

Regression  $y = -1.02x + .36$

Adj R-Sq  $-.12$

t-stat  $-1.71^*$

\* Not significant. P value = .11.

**Graph 2. Block premium vs. ownership dispersion (without Italy and Austria).**

Technical data: med20 v. control premium (without Italy and Austria)

Regression  $y = -1.58x + .38$

Adj R-Sq -0.02

t-stat -0.84\*

\* Not significant. P value = .42.

If control premia were our only measure of the quality of corporate law, we would be driven to conclude that that it only weakly explained variation in ownership dispersion in the world's richest nations.

4. *And the not-so-rich nations?* One might observe that many poorer nations have decrepit corporate law institutions. This is true, and possibly weak corporate law is keeping them back, but the coincidence of bad law and a bad economy does not tell us enough. To learn that, say, Afghanistan, has poor corporate law does not tell us whether its weak economy is primarily due to its weak corporate law or to its other weak institutions. If the other institutions, particularly the other property rights institutions, are decrepit, these may be the critical debilities preventing Afghanistan from developing the wealth and sufficiently complex private institutions that get it ready to start needing public firms and ownership diffusion. Only *then*, when it gets that far, will we be able to tell whether weak corporate law holds it back. The omitted variable might be weak property rights institutions generally, with weak corporate law institutions just a visible, and perhaps minor, surface manifestation of the deeper weakness.

In any case, we are here focusing on the world's richer nations, not its poorer nations. Even if corporate law is the institution holding back the transition and developing nation, the data indicates to us that it's not holding back every one of the richer nations from getting stronger securities markets and sharper ownership separation. Something else is.

5. *Enforcing contracts.* Bad law sufficiently explains weak securities markets where law is *so* weak that *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.<sup>48</sup> This is important because a) the quality of contract and corporate law ought to correlate 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.

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.<sup>49</sup> This casts more doubt on whether the quality of corporate law thesis explains enough of why ownership separates or does not in the world's richer nations. 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.

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 have been seen as much less business friendly.<sup>50</sup> That unfriendliness could have raised managerial agency costs, as we shall see in the next section

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. Were the demand for diffuse ownership sufficiently strong in such nations, investors and firms could try to build the institutions needed for good securities markets. If societies that successfully built other complex business and legal

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48. Black & Kraakman (1996) (Russia); Sachs & Pistor (1997), at 3.

49. O'Driscoll et al., (2001), at 18 (Denmark, Finland, Germany, Norway, Sweden, and the United States protect private property and contract strongly and have a largely efficient legal systems). The index, a crude one, purports to measure both property rights and “the ability of individuals and businesses to enforce contracts.” *Id.* at 57. Cf. Levine (1999), at 14-15, 20 (risk that government will not respect a contract it has signed: low for the United States, but *lower* for France, Germany, and Scandinavia).

50. Sachs & Warner (1998), at 24.

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 managerial agency costs theories into a two-step argument: When corporate law and court systems are decrepit, public firms will not emerge, because the system fails to protect minority stockholders. This describes many third-world and transition nations. 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 potential for low managerial agency costs to shareholders makes it profitable for the players to do so.

### 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. For firms for which managerial agency costs to shareholders would be high if ownership separated, ownership does not readily separate from control. For nations where these costs are systematically high, separation is more rare than where these costs are low. It is more rare *even* in nations where corporate law quality, as measured, is high. Corporate law is insufficient to induce separation. Other conditions have to be met. Here for the sake of completeness I briefly outline 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 would not be sought. Moreover, the distribution of wealth and income must be flat *relative to the demand for large firms*.<sup>51</sup> Strongly competitive product markets keep managerial agency costs lower than weakly competitive

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51. 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.

product markets. In the latter, managers have much slack; in competitive markets, they do not.

2. *Political preconditions.* Some modern 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 disrupting 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 compensation, hostile takeover, and strong shareholder primacy norms—are denigrated in the strong social democracies. Social policies there may raise the well-being of most people, but they would do so without much ownership separation in large firms.

In contrast, a more conservative nation typically would not drive a wedge between shareholders on the one side, and employees and managers on the other side. It would facilitate, or at least allow, shareholders and managers to ally themselves. When they are loosely 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.* It budged in recent years only as these nations' social democratic political parties shifted rightward.<sup>52</sup>

3. *Social preconditions.* Some societies are so in turmoil that complex 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 would not 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.

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52. The importance of left-right economic politics is developed in Roe (2002, forthcoming and 2000).

*D. Data on Explanations Beyond Law*

We have seen agency-cost- based theoretical limits to the legal theory. Can we measure these limits, however crudely? And, in the world's richer nations, can we measure, however crudely, whether corporate law or these other institutions seem to be primary drivers of separation?

Two institutions affect managerial agency costs and vary from nation-to-nation. One is conventional, one not. Competitive product markets are conventionally said to reduce managerial agency costs.<sup>53</sup> And, less conventionally, politics affects managerial agency costs, in that strongly social democratic nations historically pressed managers to side with employees when managers made operating decisions that would either favor employees or shareholders but could not favor both.<sup>54</sup> (The idea here is not that, say, business schools and leadership skills in these countries are technically weak, but that managers in such countries are pressed to run the firm other than purely in shareholder interests. Hence, the costs to shareholders of having managers run their firms are higher in nations where such political pressures are higher. That society and its citizens may in some ways be better off, but shareholders would find uncontrolled managers more costly to themselves, the shareholders.)

The quality of corporate law helps to predict the degree of ownership separation, as Table 4 shows. But the other social and political variables—measures of the political pressure on managers—*also* predict separation well, or better.

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53. See Roe (2001).

54. See Roe (2000, 2002).

**Table 4. Correlation matrix**

	Political indicators			Legal indicators			Competitive indicator	Dispersion and strength of stock market indicators	
	Political place	Employment protection	Gini	La Porta Law	Voting premium	Control Premium	Monopoly markup	Stock/mkt cap/GDP	Widely-held at 20%
Political place	1.00								
Employment protection	-0.41	1.00							
Gini after-tax	0.49	-0.53	1.00						
La Porta Law	0.39	-0.95	0.65	1.00					
Voting premium	-0.26	0.50	0.28	-0.39	1.00				
Control Premium	<b>-0.20</b>	0.70	-0.34	-0.76	0.42	1.00			
Monopoly mark-up	-0.57*	0.35	-0.42	-0.41	0.39	0.31	1.00		
Stock mkt. capitalization/GDP	0.55*	<b>-0.56*</b>	<b>0.64*</b>	0.70*	-0.23	<b>-0.48*</b>	<b>-0.80**</b>	1.00	
Widely-held at 20% for Medium Firms	0.67*	<b>0.84**</b>	0.67*	<b>0.87**</b>	<b>-0.46*</b>	<b>-0.46*</b>	-0.57*	0.73	1.00

\* Significant at .05 level.

\*\* At .01 level. (Not all significant correlations are highlighted.)

Sources for data: Political place comes from Thomas R. Cusack, *Partisan Politics and Public Finance: Changes in Public Spending in the Industrialized Democracies, 1955-1989*, 91 PUBLIC CHOICE 375 (1997); employment protection from OECD, THE OECD JOBS STUDY: EVIDENCE AND EXPLANATIONS—PART II—THE ADJUSTMENT POTENTIAL OF THE LABOUR MARKET (1994); GINI from Klaus Deininger & Lyn Squire, *A New Data Set Measuring Income Inequality*, 10 WORLD BANK ECON. REV. 565 (1996); La Porta law and widely-held at 20% from La Porta et al., supra note \_\_; voting premium from Nenova, supra Table 3; control premium from Dyck & Zingales, supra, Table 3; monopoly markup from Joaquim Oliveira Martins, Stefano Scarpetta & Dirk Pilat, *Mark-up Pricing Ratios in Manufacturing Industries: Estimates for 14 OECD Countries* (OECD Econ. Dep't Working Paper No. 162); and stock-market capitalization from OECD, FINANCIAL MARKET TRENDS, Feb. 1998.

Table 6 correlates a set of political, ownership, legal, and competitive variables. All three political variables predict ownership separation and of the depth of a nation's securities market. The two legal variables also predict separation and stock market depth, as does the measure of monopoly strength.

The correlation matrix shows politics persistently correlating with dispersion/: the more conservative the nation, the more dispersed is ownership. The matrix also shows the good quality corporate law correlates

with dispersion: the higher the quality of corporate law, the more dispersed is ownership.

We can do more with the statistics than say that each one predicts ownership separation. It's plausible that the three—corporate law quality, strength of product markets, and intensity of political pressure on managerial loyalty to shareholders—more together. Then one would we have to analyze whether a) one induces the other, or b) some underlying feature induces the three simultaneously. But we can try other tests, test that might tell us the relative strength in explaining ownership separation in the world's richest nations: We could begin with, say, a law-driven model and see if adding politics does much in explaining the degree of ownership separation. *When we add political variables to the corporate-law-driven "model," we get much stronger predictive power than we do with law alone.* Law alone does not do as well as law and politics. In several instances, politics dominates the legal explanation, as Table 5 shows. The point, again, is not that corporate law is irrelevant, but that at the level and quality we see in the world's richest nations, variation in corporate law ceases sometimes to be a primary explanation. Variation in other institutions—particularly institutions that affect managerial agency costs—take over to determine how much ownership separates from control.



**Table 5. Law and politics (as predicting ownership separation)**

Corporate law alone (via LaPorta legal quality index)	.53 .14 (3.69***)	Corporate law alone (via measured legal quality from control premium)	.18 -1.07 (-1.94*)
LaPorta law + Politics (via GINI)	.71** Law .10 Politics .03 (2.92*** 2.60**)	Measured legal quality + Politics (via GINI)	.54*** Law -.49 Politics .04 (-.96 2.57**)
LaPorta law + Politics (via political scientists' rankings)	.76*** Law .11 Politics .23 (3.60*** 3.30***)	Measured legal quality + Politics (via political scientists' rankings)	.55*** Law -.59 Politics .27 (-1.24 2.76**)
LaPorta law + Politics (via employment protection)	.71** Law -.03 Politics .03 (.57 -2.62**)	Measured legal quality + Politics (via employment protection)	.72** Law .43 Politics -.05 (.87 -4.39****)

\* Significant at the .10 level.

\*\* Significant at the .05 level.

\*\*\* Significant at the .01 level.

\*\*\*\* Significant at the .001 level.

The numbers beneath the  $R^2$  number in the one-variable model are, first, the coefficient and, next, its t-statistic, with the asterisks denoting statistical significance. The numbers underneath the  $R^2$  in the two-independent variable lines are, first, the coefficients for each variable, and, second, in parenthesis, the t-statistic for each coefficient. The first is the t-statistic of the corporate law variable, the second that of the political variable. Politics always significantly increases explanatory power. For four of our six cells left-right politics is a stronger determinant than the corporate law measure.)

For the two-variable  $R^2$ , significance means that adding the political measure significantly increases explanatory power.

Sources: The qualitative corporate law index is from La Porta et al, supra note 1. The measured quality of corporate law comes from Dyck & Zingales (2001). They measure the premium a blockholder gets on a sale of a block of stock over the trading value of minority shares. (A higher premium indicates weaker protection of minority stockholders than a lower premium.)

The GINI measure for left-right politics came from the Deininger-Squire OECD on-line compilation. They describe their data in Deininger & Squire (1996). The data measures income inequality after taxes, for each individual (as opposed to each household). A GINI number depends on assumptions and methodology. From the compilation I used, if possible, the 1991 Luxembourg Income Study data. For Austria, Australia, France, Switzerland, and the U.K., 1991 data wasn't available, so I used the latest Luxembourg 1980's data. For Japan no comparable data was available: no Luxembourg.

The political scientists' left-right rankings came from Cusack (1997), at 383-84, which arrays a survey from Castles & Mair (1984).

The left-right measure via employment protection came from the OECD's 1994 study, which ranked the relative ease of firing an employee in the OECD nations. OECD (1994), at 74.

(Slight differences between Tables 4 and 5 are due to our having data from a few more nations available for this F-test than for the range correlated in Table 5.)

So to briefly discuss these results. Take the legal theory: a qualitative index of corporate law quality, one used frequently now in the finance literature, predicts ownership separation plausibly, although weakly.<sup>55</sup> We see in Table 4 that the commonly-used qualitative corporate law index predicts the depth of separation. The measured quality—via the control premium—predicts separation, although more weakly.

But when we add political variables, we get more explanatory power than with law alone, than the legal test alone, often significantly so. Even if law is important, politics is independently quite important too. Or, if we viewed the world as more likely to start with basic left-right politics first, with legal institutions being partly derivative of the political equilibrium, then we'd see whether politics predicts separation (it does), and whether legal measures strengthen the prediction (sometimes).

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55. The voting premium data described in Table 2, however, does not predict separation as nicely as an index of corporate law rule; see Table 6, suggesting that improvements to the commonly used qualitative index are possible. But we stay with the standard index, to show that even when using it, other considerations are needed to explain ownership separation.

**Table 6. F-test: Politics and law**

Politics alone: GINI as predicting separation	.48***	Political place as predicting separation	.49***	Employment protection as predicting separation	.70***
GINI + LaPorta law	.71***	Political place + LaPorta law	.76***	Employment protection + LaPorta law	.76
GINI + Measured legal quality	.52	Political place + Measured legal quality	.55	Employment protection + Measured legal quality	.72

Significance and data sources are as from Table 6. Coefficients and t-statistics are omitted for brevity. Politics consistently predicts ownership separation; and, of the six combinations of law and politics, legal quality strongly buttresses the prediction two times, but does not significantly buttress it the other four times.

Overall: If one blindly followed the regressions, one could never here reject politics as significantly determining ownership separation. For four of the twelve cells one could not reject corporate law as a significant determinant; for eight of the cells one could reject it.

Roughly these results suggest that controlling insider over-reaching—the type of costs of public firms that law can reach—gets us (only) half-way to making public firms viable. But if the political environment impedes managerial-shareholder alliances, the second type of managerial agency costs would rise, and ownership could not easily separate from control.

### *Conclusion: Corporate Law's Limits*

I have here neither denied the value of strong corporate law that protects distant stockholders, nor denigrated its usefulness in building efficacious business enterprises, nor sought 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. If it is not present in a society, the society needs substitute institutions. 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.

I have instead sought to map out the limits to the quality-of-corporate-law argument. High quality corporate law is insufficient to induce ownership to separate from control in the world's richest, most economically-advanced

nations. Technologically-advanced nations in the wealthy West can have the potential for fine corporate law in theory, and several have it in practice, but ownership would *not* separate from control wherever managerial agency costs are high. And managerial agency costs, unlike insider self-dealing, are *not* closely connected with corporate law. Indeed corporate law's business judgment rule has corporate law *avoid* dealing with managerial agency costs.

Today's reigning academic theory—and the policy program of the international agencies—each 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 strong separation? Why are there so many rich nations with, by measurement and anecdote, low private benefits of control, high quality corporate institutions, and much minority stock, yet without ownership separation?

By examining a restricted sample of the world's richest nations we can move towards two conclusions, one strong and the other weak. The strong one focuses on the richer nations in the wealthy west: studies that examine corporate law the world-over tend to over-predict the importance of corporate law in the world's richest nations. It seems almost intuitive that these nations—where contract can usually be nicely enforced—shouldn't have much trouble developing satisfactory corporate law or good substitutes. Some, by measurement, already have. If ownership still hasn't separated widely, then other institutional explanations are probably in play. I hypothesized what some of these other institutional explanations might be. The weak conclusion focuses on the world's transition and developing nations: We cannot conclude that improving corporate law is irrelevant (because we've only examined here the restricted set of the world's richest nations). But we can offer the weak conclusion of the possibility that the development agencies may do everything right in getting the corporate law institutions of these nations ready for ownership separation, and it's at least possible that no one comes to the party.

The quality of conventional corporate law does not fully explain why and when ownership concentration persists in the wealthy West, because core *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. 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. Even if we believed law to be critical to building these *other* institutions, the analysis would persist because *different* laws support the agency cost controlling institutions (antitrust and product market competition; tax law and incentive compensation, etc.).

Moreover, even we expand corporate law into its broadest possible terms, we must see that two problems must be resolved inside the firm before ownership can separate: the private benefits of control must be reduced *and* managerial agency costs must be acceptably low after separation. Legal and other institutions might keep the first low, without getting the second one down low enough to facilitate separation. Variation in other institutions could explain why managerial agency costs aren't low enough. When it does, corporate law—even corporate law writ wide—no longer primarily determines the degree of separation.

A nation need not control insider machinations and motivate managers equally well; and to the extent it does one better than the other, concentration and diffusion are deeply affected: The diffusion decision is based on the *sum* of private benefits of control and managerial agency costs. Even if traditional corporate law drives private benefits to zero, concentration should persist if managerial agency costs are high.

Data is consistent. Several nations have, by measurement, good corporate law, but not much diffusion and hardly any separation. These nations also have a high potential for managerial agency costs: relatively weaker product market competition and relatively stronger political pressures on managers to disfavor shareholders.

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 is not even the principal one.

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