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PREVENTING ABUSE BY CONTROLLING SHAREHOLDERS

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Abstract

This paper is a comment on Ronald Gilson and Alan Schwarz “Constraints on Private Benefits of Control: Ex Ante Control Mechanisms versus Ex Post Transaction Review”. Together with that paper it will appear in the *Journal of Institutional and Theoretical Economics* 169 (1) in 2013, in a special issue devoted to Behavioral Theory of Institutions. I argue that the arguments of Gilson and Schwarz are convincing, but that the underlying assumptions may be stronger than the authors suggest. In particular, the G&S paper adopts a US shareholder perspective on corporate governance and is based on standard rationality assumptions. In this comment, I discuss whether and to what extent the recommendations are relevant in the EU context and whether the paper’s conclusions are robust when insights from behavioral economics are included.

Keywords: Corporate Governance, Behavioral Economics

JEL Codes: G30, G38, K22, D03

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1. INTRODUCTION

Ronald Gilson and Alan Schwartz argue, forcefully and convincingly, that:

- (i) Instead of regulating corporate control structures *ex ante*, it is preferred to focus on mechanisms that prevent excessive consumption of private benefits of control (PBC) *ex post*;
- (ii) To achieve the first best, one needs an effective judicial system in which an expert corporate court can quickly resolve intra-corporation conflicts;
- (iii) Where such a court exists, a legal system that allows parties to contract around defaults is preferred to a mandatory system that specifies standards for how much PBC consumption can be allowed;
- (iv) Where such a specialized corporate court does not yet exist, such as in the EU, it is recommended to create one and to allow firms to opt into its jurisdiction; hence, rather than harmonizing substantive corporate law, one harmonizes the dispute resolution process, with the specialized court applying the law of the country of incorporation.

I find the author's arguments to be convincing; at least, their conclusions follow from the facts they present and the assumptions they make. There can, however, be discussion about whether these assumptions are as weak as is claimed. As is more common for papers in law than for papers in economics, the present contribution is advocacy: the aim is to suggest an improvement for existing policy, and to get that seriously discussed and ultimately implemented. That goal is not served by a "two-handed" paper which expresses doubts and stresses potential weaknesses of the proposal. My task as a discussant is to point these out, if such exist. The comments below should be viewed in this light. It should also be borne in mind that I am not a real expert in corporate governance, and that, within law and economics, my academic work and practical experience has been limited to the field of competition policy. The opportunity to comment on this paper, however, allowed me to read into the literature and to reflect on this important topic.

I will briefly take up four topics. I start out with some general comments on corporate governance. Next, I provide some more detailed comments on specific aspects of the paper. Thirdly, I discuss elements of behavioral economics. I conclude with some observations of a more legal nature that are related to the authors' proposal for establishing a specialized European court for resolving corporate governance disputes.

2. CORPORATE GOVERNANCE

Corporate governance deals with the question of how to organize a company so as to ensure that it is well-managed. As Gilson and Schwartz (from now on G&S) note, this has two aspects:

- (i) Management should do the right things, that is, it should not act in its own interests, but in the interests of “the firm”;
- (ii) Management should do these things well.

I note that this formulation is sufficiently flexible as to also incorporate aspects of “managerial irrationality” (such as overconfidence), hence, although not stressed, some behavioral aspects are covered as well. In fact, a controlling shareholder (CS) could be very effective in combatting managerial overconfidence.

I agree with G&S that “the market” is best at monitoring whether management works well and that courts may deal with the first issue: does the management live up to its fiduciary duties? Of course, in the Anglo-Saxon world, the interest of “the firm” just means the interests of the shareholders. Shleifer and Vishny (1997) accordingly write that “corporate governance deals with the ways in which suppliers of finance assure themselves of getting a return on their investment”. G&S likewise take this shareholder perspective. However, their recommendations concern the EU, in which several countries adopt the stakeholder model. In this case, the problem is different: how to ensure that a company is governed in the best interest of all stakeholders? For example, the Dutch Corporate Governance Code states that the management board and the supervisory board have overall responsibility for weighing all interests, ensuring the continuity of the enterprise, while aiming to create long-term shareholder value. With multiple goals, it

becomes more ambiguous what it means to be acting in the firm's interest. This could lead to more conflicts, with, possibly, a court having a more difficult task *ex post*. Whether this tilts the balance in favor or against *ex ante* measures, however, is not so clear. In any case, G&S do not address this aspect.

Another limitation of the paper is that it focuses almost exclusively on one aspect of corporate governance, the role of a CS. Oliver Hart (1995) has stressed that the various ways to deal with the agency problem are all imperfect, but that they may be complements. The question then becomes: what mix of instruments is best?

G&S are right that a CS has every incentive to monitor management and to force it to work well, but they acknowledge that the CS can also engage in self-dealing. With a CS, there is a second agency problem and this is even more difficult to regulate. Management and the CS can collude at the expense of the minority shareholders. As is clear from the paper, the intra-firm bargaining about appropriate levels of PBC can only work well when there is a board, which is independent of management and the CS, which faithfully represents the minority shareholders. While it is not stressed, the authors' proposal presumes that some other aspects of good governance are in place as well.

3. THE ANALYSIS; SOME OBSERVATIONS

G&S claim that, in several jurisdictions, including the EU, policy towards CSs is misguided as it is based on the assumption that PBC are negative *per se*; hence, policy aims to stamp out PBC consumption altogether. Whether that is indeed the case, I do not know, but I do agree that the G&S conceptualization of the problem ("The regulatory task [...] is to permit PBC consumption to the extent that the benefits to non-controlling shareholders from better monitoring exceed the costs") is preferable. Indeed, we should not forget that a CS can add value to a firm by breaking the free rider problem associated with the monitoring of management. A CS will want to receive appropriate compensation for these services and minority shareholders will be willing to pay as long as they themselves benefit. The paper also claims that PBC are needed in order to get the benefits of a CS, however, strictly speaking this is not true. Private provision of a public good can be

individually rational. If the CS improves firm value sufficiently, then the higher share price may be sufficient to compensate for the monitoring costs and the lack of diversification. Except in its strictest version, *ex ante* regulation need not lead to the exit of controlled firms. Similarly, the existence of controlled firms just shows that some balance between the benefits of the CS and the minority has been found, not that the equilibrium is optimal. With a larger share of the benefits going to the minority, maybe cost of capital would be lower and total firm value higher. Perhaps, some legislators are interested in ensuring that minority shareholders get a sufficiently high share of the efficiency gain?

I agree that the existence of a CS as such is not a problem; it is the bad things that the CS might do. The resemblance to competition policy is immediate: in the EU, having a dominant position is not forbidden, but abusing such a position is. In this area, competition law is the default and the EU turns to *ex ante* regulation only if it is clear that intervention *ex post* would fall short; for example, if the damage is irreparable. One wonders why and whether *ex post* policy is less effective in dealing with corporate governance issues, or whether the philosophy behind various branches of EU policy is inconsistent. Perhaps, enforcement of competition policy is simply better, which would support the G&S argument for the importance of specialized courts.

The paper acknowledges that the existence of a CS poses a heightened risk of self-dealing, and that such self-dealing is more difficult to regulate than that for management, as the standard is less precise. While for management, a deal should be done only if it would be done at arm's length, for a CS it should be more lenient. According to G&S, such self-dealing should be allowed, as long as it does not hurt the minority. Such an open standard clearly makes *ex ante* regulation unattractive. From an *ex post* perspective, one wonders about the counterfactual for evaluating the transaction. There seems quite some ambiguity and investors that do not like this, may prefer to invest elsewhere. In any case, this again shows the importance of both expert review and the existence of a trustworthy board that concludes the Coasian bargain on behalf of the minority shareholders. Where trust in boards or courts about curtailing excessive PBC consumption is low, *ex ante*

regulation may be preferable. Of course, a CS might also acquire a reputation of being trustworthy.

By means of a model, that paper shows that higher PBC give the CS stronger incentives to add value to the company. I find it interesting that this model focuses on the advisory role of the CS and not on its monitoring role. The question is whether, empirically, CSs often do this. Why would a CS not pursue such attractive opportunities with vehicles in which they have even larger share? I understand the model, but I have not yet been fully convinced by its relevance.

4. BEHAVIORAL ECONOMICS

Although this seminar is titled “Behavioral Theory of Institutions”, the G&S paper does not explicitly deal with behavioral aspects. The paper makes the standard assumption that all agents, including the outside investors, are rational and sophisticated and claims that these are weak assumptions. As opinions may differ on the latter claim, it appears worthwhile to investigate whether the paper’s conclusions are robust with respect to the rationality assumption.

Above, I already touched a few times on this question. I noted that, although not discussed explicitly, the paper takes the possibility of “managerial irrationality” into account. The paper covers both “bad management” and “bad behavior” and whether the first is caused by personal characteristics of managers or otherwise is irrelevant. Of course, whether, in dealing with this issue, a CS is more or less effective than, for example, a well-functioning supervisory board, remains outside of the present discussion.

In the above, I also already touched on less than fully rational investor behavior, the second type of “irrationality” that is discussed in the literature on behavioral corporate finance. (See Baker and Wurgler (2011) for a survey of this literature.) I have suggested that the results may be less robust in this direction. If outside investors care about “fair division” of the gains from CS monitoring, then they may shy away from investing in companies in which they think they will not be

getting what they deserve. If standards are vague or ambiguous, such effects may be magnified. Sophisticated investors will realize that the potential for excessive PBC consumption is real; if the CS does not keep its commitment and the safeguards stressed by G&S do not work, they will feel cheated. Consequently, “betrayal aversion” (Bohnet et al, 2008) may induce them to avoid the company in the first place. The literature provides abundant evidence for all kinds of “non-standard” preferences, both in the laboratory as well as in field situations; whether the insights from that literature are also relevant in this context, I do not know.

From a behavioral perspective, it is perhaps more relevant that we should not limit our attention to the organization and financing of the company, but rather look at a company as a whole and take all stakeholders into account. Ultimately, what counts is corporate performance and, as far as I understand, there is no consensus in the literature about how well good governance relates to good performance. Performance depends on many things, but productivity of the workforce is obviously an important element. Oswald et al (2009) shows that happier workers are more productive; if workers are of the opinion that they do not get a fair share of the cake that they helped generate, they may be unhappy and less productive. The work that Klaus Schmidt presented during this seminar goes in the same direction (Bartling et al, 2012). In short, even if behavioral aspects may not be relevant on financial markets, they may still be important for the overall question of whether CSs contribute to good corporate performance.

Interestingly, there only seems to be a very small literature dealing with behavioral corporate governance. For example, Camerer and Malmendier (2007) only has a very short section on this topic. It rightly stresses two elements related to the board: (i) the importance of the selection of board members and (ii) that external board members may be less likely to be overconfident about the firm’s projects. As they say: “The big question is ‘who is able to speak up in the boardroom.’” Morck (2008) addresses the question of why boards are not more effective in controlling the CEO. He stresses the natural tendency of people to be loyal, which may be an undesirable property to have when things go bad. Above, I have stressed the important role of the board of a company in protecting the interests of the minority shareholders. Board members should be loyal to the

company, but not necessarily to its management. Morck's insights, such as that loyalty develops as a result of personal contacts, hence, that it may be biased in favor of persons as compared to more abstract institutions, may be even more important when the board not only has to control the CEO, but also a powerful controlling shareholder.

5. ABOUT COURTS AND SPECIALIZED COURTS

“Stranger than fiction” is the impression that one is left with after having read accounts, such as Johnson et al (2000), Ferrarini and Giudici (2005) and Conac et al (2007), about how courts in several European countries deal with self-dealing of CSs. One can only be shocked about how easy it apparently is (or has been) to divert corporate assets at the expense of others. The message that comes out of this literature is that, although various countries have quite strict laws against self-dealing, either (i) these rules are not enforced, or (ii) courts interpret them very literally, so that in effect they have no bite. Hence, although it is not only a matter of enforcement (the rules should be drafted in such a way that they indeed capture the economics of the case), court enforcement seems more important, and this leaves very much to be desired.

Against this background, one well understands the proposal of G&S to create a specialized European Commercial court, to which parties could turn to have their intra-firm conflicts resolved by this court applying the law of the state where the firm is incorporated. G&S stress that the substantive law is less important, but I still wonder whether a specialized court will be able to deliver good services if it has to apply a law of bad quality. Relatedly, I wonder whether such a court can really be an expert with respect to several different laws. Could it enforce 27, and soon 28, different legal rules?

The proposal to focus less on *ex ante* regulation and to create a specialized European court has been made before. For example, Mendoza et al (2010) points to important, but hidden cost of strict regulation, concludes that more economic evidence is required before new corporate governance reforms are introduced and

suggests that policymakers should focus on existing minimum standards of corporate behavior supported by open norms, which offer more flexibility for courts. Realizing the weaknesses of current courts, these authors also suggest introducing a specialized European court for corporate governance and dispute resolution.

If one takes these suggestions seriously, the next question is whether such a court should be constructed from scratch, or whether some existing court could be transformed to subsume this function. The role of specialized courts has been discussed in OECD-forums, with one question being whether the Dutch Enterprise Court could play a similar role to the Delaware Court of Chancery in the US, Jacobs (2006). Hence, it seems that at least this court is a candidate. Whether this court could serve that function, I do not know, but it certainly has some desirable characteristics (Jitta et al, 2004, Kroese, 2007): it has experience with listed foreign companies (albeit with a registered office in the Netherlands), a business attitude, it has non-lawyers on board, and it decides quickly and in a non-bureaucratic fashion. Comparing this with the description of the Milan court in Enriques (2002), it seems that the contrast could not be larger.

6. CONCLUSION

The evidence clearly shows the need for improved corporate governance dispute resolution in Europe; hence, the suggestions of G&S are most welcome. In this comment, I investigated whether the conclusions of G&S are robust against introducing European institutional aspects (the stakeholder model) or elements of behavioral economics. Although final answers clearly cannot be given, it seems that, provided that the company board can be counted on to represent the interests of the minority shareholders, the proposals pass this first test.

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