The Law and Economics of Corporate Governance

Changing Perspectives

Edited by
ALESSIO M. PACCES

In association with the Belgian–Dutch Association for Institutional and Political Economy

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An introduction: changing perspectives on corporate law and economics

Alessio M. Pacces

1. SYNOPSIS

This book includes the proceedings of the conference on 'Changing Perspectives on Corporate Law and Economics', held in Rotterdam on 6 November 2008 in honour of one of the founders of the economic analysis of law, Guido Calabresi. The collection is made up of six main contributions and six shorter comments by the speakers who acted as discussants. The subject matter of the book – corporate governance – is one of the most heated topics in the economic analysis of law. In the aftermath of the largest global financial crisis after the 1930s, the negative consequences of which we are still experiencing, the connection between law and corporate finance has been evident from the news. More generally, this connection is extremely important for the governance of enterprises, which affects not only the financial markets, but also the efficiency of production, economic growth, and the overall well-being of our societies.

In addressing the above issues, this book takes an interdisciplinary perspective. Economic analysis of law is a fruitful intellectual challenge for economists and lawyers alike. It offers new views on legal and economic theory, questioning or reinforcing the traditional ones. It enhances the quality of counselling available to individuals and businesses. It allows policymakers to design better rules for society. Above all, in corporate governance, research, practice, and lawmaking are all based on the interaction of economics with the law. The present collection of chapters is an exemplary illustration of the virtues of this approach.

Within law and economics, corporate governance can be approached from different angles. The contributions to this book perform in-depth theoretical and empirical analyses from which different regulatory implications are derived. Some provide fresh empirical evidence on controversial theories of corporate law. Others attempt to develop new theoretical insights for addressing unresolved problems of corporate governance. They all analyse the economics of corporate governance with a view to how it should, or should not, be regulated. The coverage of the book is very broad in this respect. It ranges from regulatory competition to harmonization of company law; from the law and economics of mergers and acquisitions to the risks of overregulating the market for corporate control; from enforcement of investor protection to the balance between authority and accountability in the corporation. These are all hot issues in the international debate, and they are more intimately related with each other than might appear at first glance. This book shows, like the conference before it, that economic analysis of law provides economists and lawyers with a single framework for discussing diverse issues in corporate governance.

Perspectives on corporate law and economics are changing though. This is the leitmotiv of this book, as it was of the conference. Perspectives differ between the economic and the legal standpoint. They vary from continent to continent, from country to country. They evolve over time. This book includes the views of three scholarly generations of corporate law and economics, from its very founder – Henry Manne – to the younger researchers in the field. Economists and legal scholars contribute to this collection of chapters in a balanced proportion. Their views are based on different geographical experiences and cultural backgrounds. The authors are all top scholars in corporate law and economics, affiliated to highly prestigious universities around the world. While all the chapters take an international approach to the corporate governance debate, different countries are represented among the authors. These are Britain, Italy, Germany, the Netherlands, and the United States. This additional layer of diversity offers a unique opportunity to compare the views of corporate governance from the two sides of the Atlantic and of the Channel.

As the following overview is going to illustrate, this combination of changing perspectives yields a number of new insights into the functioning of corporate governance and its legal underpinnings. Unsurprisingly, they also identify many interesting avenues for future research.

2. REGULATORY COMPETITION: EFFICIENCY OR PATH-DEPENDENCY?

The first contribution to this book (Carney et al.) tackles one prominent issue in the Law and Economics of Corporate Governance: the competition for corporate charters. Following Tiebout's (1956) celebrated insights, economic analysis of corporate law has focused on the competitive dimension of the production of legal rules in those countries where companies can choose to incorporate under different sets of rules. In particular, this debate was initiated in the US where the 'Internal Affairs Doctrine' allows companies to choose between the corporate laws of 50 federal states, regardless of where they actually do business. While this process has apparently led the vast majority of publicly held companies in the US to incorporate under Delaware law (Bebchuk and Cohen 2003), the determinants of this outcome are far from settled.

In principle, under freedom of incorporation, jurisdictions can compete on offering companies the set of rules best suited to their needs. They have prominent incentives to offer attractive terms to companies, since incorporations bring revenues in the form of both taxes and increased demand for local services. The long-standing question is whether this competitive process unravels efficiently. The two opposite views on this, originally articulated by Cary (1974) and Winter (1977), are that regulatory competition leads to a 'race to the bottom' or to a 'race to the top'. On the one hand, states of incorporation may compete by offering rules that are attractive for those who control the (re-)incorporation decision – most prominently, corporate management – at the expenses of shareholders and other stakeholders. On the other hand, the quality of corporate charters and of the rules governing them is priced by efficient stock markets, and this guarantees that corporate jurisdictions compete on offering efficient terms for protection of shareholders and, when it is relevant, of stakeholders. In an influential paper, Romano (1985) found evidence of a race to the top. Her results have subsequently been questioned on different grounds, most prominently that US states do not actually compete with each other (Kahan and Kamar 2002) and that firms incorporated in Delaware do not (or at least, no longer) exhibit statistically significant excess values on the stock market (Subramanian 2004).

Carney at al. bring fresh insights to the debate. Their contribution is essentially twofold. On the one hand, they show that Delaware law scores worse than other jurisdictions on exactly those substantive aspects that would support winning a race to the top, namely flexibility and predictability of corporate governance regulation. On the other hand, they identify the reason for Delaware's success in attracting incorporations. This is US corporate lawyers' limited knowledge of better alternatives. As a result, Delaware's primacy as supplier of corporate law in the US does not reflect any virtuous or vicious competitive process, but only the 'bounded rationality' of American lawyers due to the biases in their education.

These results are derived from a combination of different methodologies. In contrast to the majority of previous studies, Carney et al. open the 'black box' of corporate law. They do not infer superiority of one jurisdiction over another, based on market outcomes. Instead, they look at the details of Delaware law in a number of critical situations (for example, mergers and sale of assets) that may occur during the operation of a company. In these situations, Delaware law is extremely intricate and this results in the outcome of corporate litigation often being unpredictable. One prominent source of indeterminacy in Delaware law is the celebrated Business Judgment Rule, a norm of judicial abstention from second-guessing directors' choices as to how to conduct the corporate business. Delaware's courts are courts of equity, which encourages judges to undertake an *ex post* and fact-intensive review of directors' actions that undercuts the deference of the Business Judgment Rule. Under Delaware law, this doctrine features so many nuances and exceptions that shareholder litigation occurs nearly every time it is invoked. This stands in sharp contrast to the race to the top explanation of Delaware's superiority in attracting incorporations. Short of reducing transaction costs in the relationship between the company and its investors, incorporating in Delaware means facing a number of legal rigidities (selective application of the Business Judgment Rule) and uncertainties (on the meaning and the scope of the Business Judgment Rule) in corporate governance. Why then does Delaware still outperform its competitors?

Carney et al. answer this question in a most original fashion. In US law schools, they report, prospective lawyers do not study any corporate law other than those of Delaware and (normally, but not always) their home state. It may well be that Delaware managed to secure its competitive advantage by offering companies more efficient rules in the past, but this need not necessarily be the case – to be sure, it is *not* the case when we look at how Delaware law has evolved. Due to their education bias, lawyers tend to recommend incorporation under the law they are familiar with. Only in a specific subset of circumstances is this their home state. Most often, given the existing network effects favouring Delaware law at the initial public offering (IPO) stage and the narrow specialization of lawyers handling IPOs, they recommend Delaware law because they *mistakenly* believe that it is the best to secure deals and to handle litigation. In fact, they know little, if anything, about potential alternatives that may effectively reduce transaction costs. This understanding of the US incorporation puzzle by Carney et al. is supported by two complementary empirical investigations, a survey of lawyers' motivations in advising (re-)incorporation and a regression analysis of Delaware incorporations depending on the state of origin of the company and of its legal counsels.

In his comment on Carney et al., Kroeze takes stock of these arguments for analysing regulatory competition in European company law. The situation on this side of the Atlantic is notably different from the US. There is no 'Internal Affairs Doctrine', but rather, the opposite 'Real Seat Doctrine' (mandating incorporation where the firm effectively carries out its main business) holds in most European member states. There is no Federal Constitution, but rather, a Treaty whose implementation by European courts and legislature has to struggle with individual resistance from the member states. Finally, there is no homogeneous set of property and contract law, but rather, the company law of most member states is embedded in their particular private law. Therefore, it could seem that regulatory competition in European company law is less developed than in the US. However, when we look at it more carefully, this competitive process exhibits a number of similarities (as well as differences) between Europe and the US.

After initial attempts to harmonize company laws in order to promote freedom of establishment of European companies without running the risk of a race to the bottom, European law seems to have taken a more decisive stance in favour of regulatory competition. To be sure, whether regulatory competition is effectively in place in European company law is still uncertain (Kraakman et al. 2009). However, developments in case law by the European Court of Justice (ECJ) have broadened the conditions for freedom of incorporation (for example, C-212/97 *Centros* of 1999; C-208/00 *Überseering* of 2002), albeit still incompletely (see C-210/06 *Cartesio* of 2008). Moreover, the EU legislation has recently taken positive steps in the direction of creating a level playing field (through the various initiatives adopted within the framework of the Company Law Action Plan of 2003 – COM/2003/0284) and of facilitating re-incorporation (most prominently, through the Directive 2005/56/EC on cross-border mergers). This suggests that, soon enough, Europe may experience competition in the production of corporate law very similar to what – for good or evil – we have been observing in the US. Then the warning by Carney et al. stands: competition may not occur on the merits, but rather, be driven by path-dependency. In this case – Kroeze observes – some member states stand to lose in the establishment of the network effects that, at least according to the American experience, has proved persistent. The difference is that, in Europe, the set of rules that minimizes transaction costs in dealing with shareholders and stakeholders has yet to be identified. When market forces are allowed to make this selection, companies are not expected to choose rigidity and indeterminacy. As a result, the Netherlands, which shares with Delaware not only a tradition of flexibility, but also a process whereby this flexibility has degenerated into more interventionist courts and unpredictability of litigation outcomes, is ‘doomed to fail in a competitive environment’.

Beyond this, Kroeze is sceptical that situations of bounded rationality on the part of legal counsel can last for long. Rather, he seems to suggest that market mechanisms will, in the end, restore the lawyer’s incentive to select the best (that is, the most efficient) corporate law for incorporation. States, in turn, will compete to offer the most efficient set of rules. This argument parallels the debate on the effectiveness of arbitrage in securities markets, which is particularly topical in these times of financial crisis (Posner 2009). As arbitrageurs, lawyers may not respond immediately to changes in the relative quality of legal products, partly because – as Kroeze nicely puts it – 'they prefer a greater risk of being wrong collectively than a smaller risk of being wrong alone'. But, as Shleifer and Vishny (1997) show for arbitrage, this outcome only holds so long as the number of 'smart traders' is insufficient to make trading on fundamentals profitable. Therefore, it can be expected that choice of law will continue to be driven by efficiency concerns as soon as a sufficient number of players (lawyers or the companies they advise) realize that there are more profitable alternatives than relying on a flawed Delaware law. There is one important element of regulatory competition, surprisingly neglected in this debate, which points exactly in this direction. Regulatory competition is not just a horizontal process between states, but also a vertical process between the prevailing state jurisdiction and the federal legislature that may pre-empt it when it turns out to be unsatisfactory. This has recently turned out to be a key element of regulatory competition in the US (Roe 2008), and – as the following contributions show – it seems to be even more relevant in Europe.

3. EUROPEAN LAW AS A VEHICLE FOR REGULATORY COMPETITION

In Chapter 2, Eidenmüller et al. investigate the size and the determinants of a unique phenomenon on both sides of the Atlantic. This is the *Societas Europaea* (SE), which is a pan-European model of incorporation available for companies established in any of the EU member states. Established by Regulation 2157/2001/EC and effective since 2004, the SE has long been considered a failure of European lawmaking. And yet, after a somewhat disappointing start, the SE has turned out to be surprisingly popular among European companies, at least in certain European countries (most prominently, Germany and the Czech Republic). Eidenmüller et al. do not only document the success of the SE with empirical data. Perhaps most importantly, they analyse the variety of choice of this corporate form across European jurisdictions to infer the determinants of this success. As it turns out, the SE is illustrative of the ongoing process of framework harmonization of European company law and of its ability to lead to regulatory competition in a very special fashion.

The SE does not offer a fully-fledged alternative to the national models of incorporation. Rather, it provides a number of options, some of which may not be available under the law of the company's state of origin. Likewise, the SE does not allow opting out of the 'Real Seat Doctrine'. Although the SE allows transference of the company's registered office, the latter must still be located where the company has its main place of business. Finally, in a number of respects, the SE is governed by the corporate law of the state where the company has its registered office. Little wonder that, in view of the costs of setting up the SE as opposed to its limited benefits, commentators have been sceptical about the practical utility of this form of incorporation (Bratton et al. 2009). The study by Eidenmüller at al. proves that they have been wrong. The options for corporate governance made available by the SE may be limited, but they matter a lot. The attempt by the European legislature to mediate between different national traditions, especially regarding board models and the involvement of employees in corporate governance, has transformed this example of framework harmonization into a 'vehicle for legal arbitrage'. Despite the evolution of ECJ case law, restrictions on re-incorporations still make it difficult for European companies to shop around among jurisdictions for suitable legal solutions. Transforming (or merging) into a SE provides an alternative. Formally, it is a model of incorporation partly governed by European law. In practice, however, it is a synthesis of different European models, which allows companies to opt out of some of the rigidity of their national corporate laws, while exploiting the advantages of relocating to a more favourable tax jurisdiction (Enriques 2004).

Eidenmüller et al. are the first to test this proposition empirically, through a combination of regression analysis and a survey of the motives for establishing SEs in Germany, which aims to compensate for the small sample size in statistical inference. In spite of this difficulty, their results are statistically robust and highly plausible. The choice of SE seems to be effectively motivated by legal arbitrage, albeit with some qualifications. The SE is most prominently a vehicle to reduce the impact of mandatory co-determination at the board level and to opt out of a mandatory two-tier board structure. This is consistent with the popularity of the SE, especially in those jurisdictions that feature these restrictions. However, neither the data nor the survey support the hypothesis that the SE is used to shop for more attractive company laws in general. This may have to do with the limitations on choice of law resulting from the Real Seat Doctrine. Noticeably, this factor does not undermine the tax incentives for relocation through the SE. Taxes remain a major driver of corporate mobility in the EU, which explains why the small European jurisdictions have the highest rates of SE incorporations to population.

Within these limits, the SE does promote regulatory competition in

European company law. Surprisingly enough, the European legislature has achieved this result by stepping into the competition directly. In contrast to the US picture, where federal legislation enters only as a potential competitor, the European approach to regulatory competition is based on a formal mandate to harmonize national laws. As previous attempts to establish a common European company law failed, framework harmonization has now become an instrument for allowing the selection of the best rules by market forces. Vesting different national traditions as eligible options under European law has proved more successful than forcing their mutual recognition or identifying their common core by binding legislation.

The comments by Leyens intervene exactly at this point. With special regard to Germany, the study by Eidenmüller et al. shows that publicly held companies suffer from a number of national legal restrictions that may undermine their competitiveness. The SE as a 'vehicle for legal arbitrage' has finally shown that companies may wish to opt out of these restrictions in the interest of their investors, but without jeopardizing the position of other stakeholders (more precisely, the employees). The choice as to board structure is not available to public companies governed by German law as opposed to companies registered in other European jurisdictions. Albeit repeatedly denounced by German legal scholars, this rigidity was ignored before the introduction of the SE showed that German companies too are willing to choose a one-tier structure. A similar argument applies to co-determination, which leads to impressively high numbers of directors sitting on the supervisory board. The empirical evidence on the use of SE shows that German companies are actually willing to negotiate with employees different, and less burdensome, forms of participation in corporate governance. Only within the limit of these negotiations, do the SE regulations allow for co-determination to be opted out of. But while the data provide unequivocal evidence of the efforts by German companies to devise more flexible solutions through the SE, most of the national rigidities remain. In only one case – Eidenmüller et al. report – the SE has allowed opting out of co-determination entirely. And none of the companies subject to co-determination has managed so far to opt for a one-tier board structure. Legally, this circumstance may frustrate the requirement that the SE allow an effective choice of board structure.

According to Leyens, it will eventually be the ECJ that restores the full potential for regulatory competition established by the SE against the rigidities maintained by the member states. Yet the outlook may be even more promising than that. One of the goals of the SE was to facilitate cross-border mergers. Eidenmüller et al. show that the experiment has been successful (also) in this respect. The matter has been subsequently addressed by a potentially more powerful piece of EU legislation, which does not require the establishment of a corporate vehicle governed by European law. This is Directive 2005/56/EC on cross-border mergers, which has removed the national constraints on this technique for re-incorporation (see Kraakman et al. 2009). Whether and how one can expect cross-border mergers to lead to selection of the most efficient rule in European company law is an empirical question, addressed by the following contributions.

4. HOW DOES LAW MATTER? EVIDENCE FROM CROSS-BORDER MERGERS AND ACQUISITIONS

Economists are usually less insistent on the details of the law. Rather, they focus on the overall effects of legal institutions on economic performance. In this perspective, Martynova and Renneboog (Chapter 3) investigate the question of whether the wealth effects of cross-border mergers and acquisitions (M&A) in Europe are dependent on the quality of law. Their answer is positive, but more importantly, they show that – regardless of the direction of the acquisition – it is always the best law that prevails. This approach complements the legal debate reviewed so far. In particular, it supports the high expectations of academics and policymakers on the implementation of the European Directive on cross-border mergers. This offers the prospect of fruitful regulatory competition in European company law.

In their detailed empirical study, Martynova and Renneboog disentangle the effects of company law standards on both the bidder and on target returns after the announcement of a takeover. To this end, they have constructed a set of indices of quality of corporate law independent from those prevailing in the law and finance literature (La Porta et al. 1998; Djankov et al. 2008). As with previous studies, they find that 'law matters' – that is, it does affect economic results. However, both the 'measurement' of company laws and the setting in which their impact is tested are novel. With regard to the quality of law, the authors study the effects of three different indices of investor protection: the first is an index of *shareholder powers*; the second is an index of *minority shareholder protection* from expropriation; the third is an index of *creditor rights*. All indices are interacted with an enforcement variable to account for the relative efficiency of the judicial systems. More importantly, the indices account for the legal changes that have occurred every fifth year over the past 15 years, which allows a more precise estimate of the differences in investor protection between the bidder and the target company at the time of a takeover.

These differences in corporate governance standards may, in principle, have opposite effects when a change in control occurs. Martynova and

Renneboog distinguish between *spillover* (positive and negative) and *bootstrap* effects. Positive spillover depends on the target benefiting from the higher standards of investor protection of the bidder, either because the target is merged with the bidder (and therefore, changes nationality) or because the change in control is sufficient for the target to adopt the higher standards on a voluntary basis. Spillover can be also negative, when the corporate governance standards of the bidder are lower than the target's and the latter is merged with the former. However, in this case, the bidder may alternatively decide to bootstrap to the higher standards of the target on a voluntary basis. This bootstrap effect is also possible as an alternative to each company's sticking to its own standard when acquisitions are partial. Which of these effects prevails in cross-border M&A is ultimately an empirical question.

Carefully controlling for endogeneity and omitted variables in multiple specifications of their regressions, Martynova and Renneboog show that upgrading to the higher investor protection standards dominates this setting. Positive spillovers are unambiguously borne out by the empirical evidence. Negative spillovers are not. On the contrary, when the bidder's standards are lower than the target's, neither of them experiences lower returns upon announcement of the takeover – which supports the bootstrap effect in both full and partial acquisitions. This suggests that, all else being equal, cross-border M&A are an instrument for shareholders to reap the benefits of higher investor protection, regardless of whether the enhancement derives from the bidder's or the target's jurisdiction. This virtue of the market mechanisms is confirmed by the likelihood that companies are engaged in a cross-border, rather than a national, acquisition. This likelihood is higher the lower the shareholder powers under either the bidder's or the target's jurisdiction, although minority shareholder protection has exactly the opposite effect on bidders (high protection of minority shareholders makes national acquisitions more expensive).

In his comment, de Jong makes two important additions to these findings. First, he notes that spillover and bootstrap effects are only presented in terms of statistical significance. However, the framework set up by Martynova and Renneboog also allows the economic magnitude of these effects to be estimated. Despite his limited access to the data, de Jong manages to perform an interesting exercise, showing that the direction of the acquisition matters after all. Specifically, it is not a matter of indifference whether the bidder comes from a high-standards jurisdiction or the other way round, for the magnitude of the wealth effects is expected to be substantially larger under the first hypothesis. Secondly, de Jong notices that the increased sophistication with which the quality of law is measured relative to the first attempt by La Porta et al. (1998) still does not account for firm-specific choices regarding compliance with standards higher than those mandated by law. This may be particularly relevant in the case of cross-listing.

More generally, the measurement of quality of law based on numerical indices makes two conceptual issues problematic. One is the inclusion of all the relevant legal information, which is an extension of de Jong's argument that goes much beyond the relevance of listing rules and corporate governance codes. The other, which is surprisingly taken for granted by both, is the judgement as to what 'good' corporate governance regulation is. Renneboog and Martynova draw an important distinction between protection of minority shareholders and empowerment of shareholders as a class. Similar distinctions, traditionally supported by the comparative legal literature (for example, Kraakman et al. 2009), are becoming increasingly important in empirical corporate law and economics (for example, Djankov et al. 2008). So far, however, the alternative specifications of investor protection have been too greatly correlated with each other to allow for separate empirical analyses. Whether, and to what extent, protection of shareholders in corporate governance requires their legal empowerment remains a theoretical question, to which we now turn.

5. BACK TO CORPORATE GOVERNANCE BASICS: MARKETS OR LAW?

Commentators tend to disagree on what constitutes 'good law' in corporate governance and on the virtues of the market mechanisms in selecting the most efficient rules. The question – do we need corporate law at all? – is hardly ever asked any more. Conceptually, however, this is a fundamental issue, and the very pioneer of corporate law and economics reminds us of its importance. In his contribution, Manne shows that, in corporate governance, legal rules may create more inefficiencies than they help to solve.

Taking stock of the 'corporate-governance-as-promise' approach recently proposed by Macey (2008), Manne warns in his usually provocative style that corporate governance needs little else than enforceable contracts, an active market for corporate control, and some insider trading in order to work efficiently. Any legal restriction on these market institutions undermines efficient separation of ownership and control, instead of promoting it. His argument is essentially threefold. First, there is actually no point in debating about the optimal structure, powers, and independence of board of directors vis à vis the rights of (minority) shareholders. Regulation can fare no better than the contractual arrangements devised by the company's founders, for the simple reason that they bear the wealth effects of these arrangements when the company's shares are sold to the investing public – regulators have far lower-powered incentives. Secondly, and similarly, any regulation of the takeover process can only lessen the power of this fundamental mechanism of corporate governance. Unbridled competition in the market for corporate control most prominently protects investors by disciplining the management and making sure that incumbents who fail to maximize shareholder returns are promptly replaced. While there might be good reasons for limiting contestability by contract, especially considering the price that founders have to pay for this deal, any regulation reducing the bite of the market for corporate control in the name of protecting minority shareholders turns to their very disadvantage – the more regulatory restrictions on takeovers, the lower the returns to shareholders of prospective targets. Finally, prohibition of insider trading only undermines the incentives to produce valuable information, which could be timely impounded in stock prices otherwise. Once again, under the false claim that this is aimed at protecting investors' 'fair play', regulatory restrictions on insider trading limit both insiders' and outsiders' ability to correct misperceptions of corporate performance to the ultimate advantage of shareholders as a whole.

Manne does not argue that corporate law is unimportant, but he stresses that its role should be limited to minimizing transaction costs. Enabling and default rules should suffice for this purpose, perhaps with the sole exception of 'real acts of misbehavior by directors' – a concept upon which he does not elaborate. Manne's trust in the contracting process goes as far as to admit – in contrast to Macey (2008) and the majority of commentators – that the corporate charter may exclude contestability of control at the outset. This is not particularly surprising, for Manne himself (1965) never argued for more contestability than companies are willing to choose. On this point, he is sympathetic to the work by Bainbridge (2008), to which he compares my own (Pacces 2007). Manne agrees that the decision as to whether to resist a hostile takeover could be left with the directors, if the contact so stipulates, for reasons of protecting managerial firm-specific investments that ultimately benefit shareholders as well. But he sees neither what role corporate law should play in this nor why other mechanisms (for example, insider trading) could not solve the problem of rewarding managerial firm-specific investments without interfering with the market for corporate control.

In my reply, I try to address these points. Manne's reasoning has an implicit Coasian flavour, which is one approach that other contributors to this book discuss at length (see Chapter 6 and Comment on Chapter 6). However, Manne overlooks two important issues. First, the virtues of the bargaining process between shareholders and the corporate management face the limitations of the contractual technology. These are most prominently due to the problem of contractual incompleteness, which explains why legal entitlements matter. This part of Coase's reasoning (1960) is often hidden behind the formulation of a theorem that he never stated. In corporate governance, this means that the failure to *enable* managerial empowerment through the legal system creates potential inefficiencies that cannot be remedied by contract. An illustration of this is that, in most parts of continental Europe, large shareholdings are the only way to secure control from outsiders' interference. Secondly, for exactly the same reason, the corporate contact cannot entirely protect non-controlling shareholders from expropriation. This holds for both the incumbent management and successful bidders in a takeover contest, provided that they have sufficient powers to alter the original terms of the contract with investors. Again, legal rules matter, but given the asymmetric distribution of powers between (actual and prospective) corporate controllers and non-controlling shareholders, investor protection needs to be mandatory. While this provides a good argument against insider trading, to the extent that it corresponds to an expropriation of outsiders' returns, it does not imply that regulation should weaken the market of corporate control by favouring minority shareholders in the distribution of takeover gains. Manne is quite right in contending that an active market for corporate control protects shareholders better than their legal empowerment, although I am sceptical that this can work efficiently in the absence of legal rules that both define control entitlements and limit their abuse.

6. POWERS VS TRIALS: ENFORCEMENT OF CORPORATE GOVERNANCE IN THE UK

The divide between shareholder protection and shareholder empowerment is one major issue in the analysis of UK corporate governance by Armour (Chapter 5). Moving away from the question, what is 'good law', Armour scrutinizes the patterns of enforcement of corporate governance regulation across its varied content (corporate law, securities regulation, takeover regulation). One emerging view in the international literature (La Porta et al. 2006; Djankov et al. 2008) is that investor protection under both corporate and securities law is most effective when it is enforced by private litigation. Apparently, effective private enforcement is also efficient for it allows higher separation of ownership and control, which in turn nurtures vibrant stock markets. Armour does not question the importance of enforcement of investor protection in corporate governance. However, he notices that while the patterns of separation of ownership and control in the UK are comparable to those in the US, in the former 'shareholder lawsuits are conspicuous by their absence'. In British corporate governance, investors are just protected differently from shareholder litigation. Partly (but minimally), this protection is based on public enforcement. Most importantly, the enforcement of corporate governance in the UK is 'informal' as it is carried out outside the courts by players who can credibly threaten the management refusing to comply with the rules protecting outside shareholders.

Armour himself notices that this enforcement pattern is based on corporate governance powers, rather than on procedural rules making shareholder rights actionable. Yet these rules exist, although, in contrast to the US, they are ill suited to mass litigation. In Armour's view, informal enforcement is still a form of enforcement, for it operates 'in the shadow of the law'. It is ultimately the latter that confers upon the main players of this mechanism – the institutional investors – the power to threaten managers credibly. In Britain, shareholders can oust incumbent directors any time, by outvoting them (which is an option for sufficiently large coalitions of institutional investors) or by setting up a hostile takeover (which directors have very limited possibilities to resist). Indeed, these legal entitlements of shareholders are protected by courts or by self-governing bodies (like the Takeover Panel) having no less power to sanction the ouster of recalcitrant management from the financial community. But the fact that these are entitlements to exercise governance powers, rather than to claim compensation for directors' misbehaviour, is not a matter of indifference. Armour shows that shareholders in Britain enjoy very little protection of their investment by courts and public authorities (that is, almost no private enforcement and quite negligible public enforcement), but they are otherwise very powerful in disciplining managers who fail to maximize their returns. Whether this solution is preferable to the US approach – allowing non-controlling shareholders little interference with management, but powerful instruments for litigation – is a question that Armour does not address.

Armour provides a distinctive roadmap of all the possible enforcement patterns available in UK corporate governance, both formal and informal. Description of the former combines essential legal information with a patient collection of data. The results, reported as an impressively low frequency of enforcement actions, show that shareholder litigation is effectively a dead letter in the UK. Public enforcement scores somewhat better, although the frequency of actions per year barely reaches two digits in most of the 'formal' settings. Informal public enforcement is a different story, dominated – as expected – by the activism of the Takeover Panel. But, with this exception, data on informal enforcement are naturally difficult to collect. At this point, the empirical evidence reported by Armour becomes mostly suggestive. The combination of legal and economic arguments is sufficiently convincing though. With respect to informal private enforcement, institutional investors and takeovers are the major players. While the latter leave some traces behind (perhaps raising the question why, just like in the rest of the world, the vast majority of takeovers in the UK are friendly), the former operate 'behind closed doors' (Stapledon 1996). And yet, the comprehensive voting guidelines and the otherwise inexplicable CEO turnovers are indirect evidence of institutional investors' activism in the UK.

In his comment, Pardolesi is somewhat sceptical that informal enforcement can effectively substitute for formal enforcement. Like many other legal phenomena, its relevance is hard to prove empirically – which casts doubts on the popularity of 'numerical comparative law' (Siems 2005), especially in corporate governance, over the past decade. More importantly, informal enforcement is conceptually difficult to disentangle from the more general categories of public and private enforcement. The last two are more intertwined than the current debate – mostly centred on antitrust law – tends to suggest. Aside from the specific experiences of private and public enforcement on either side of the Atlantic, it seems that efficient enforcement of law needs an optimal combination of the two. The proportions defining the efficient combination may vary according to the institutional context. In this perspective, informal enforcement is undoubtedly part of the equation. One can agree that, at one extreme, informal enforcement suffices to compensate for lack of formal enforcement. But the very notion of informal enforcement is ill defined, for it tends to encompass forms of private and public action that do induce compliance with the law, albeit without resulting in formal legal proceedings. On this basis, any statement of preponderance of one form of enforcement over another is arbitrary. Conversely, if we narrow down the definition of informal enforcement based on the pursuit of specific goals (for example, investor protection) without the involvement of the courts or regulatory agencies, its equivalence to formal enforcement is yet to be proved. Both entail costs and benefits, and a detailed analysis of them is necessary for a sound judgment of relative efficiency.

7. CORPORATE LAW AND ECONOMICS IN A THEORY OF THE FIRM

The last two contributions to this book look at the very foundations of corporate governance. Somewhat in the spirit of Manne (Chapter 4), legal rules initially disappear from the picture. But their absence does not last for long. Corporate governance is not analysed merely as the outcome of a market process, but rather, as an alternative to this process that *must* rely on a particular combination of public and private ordering. The corporation emerges for the same reason that market exchange is 'superseded' by authority in establishing a firm (Coase 1937): minimization of transaction costs. But the question still not completely answered by the law and economics literature is why the corporate form is chosen. In Chapter 6, Pagano endeavours to answer this question. Following Coase, he characterizes the firm as a centralization of market transactions. Where does the necessary authority come from (Alchian and Demsetz 1972)? Based on legal thought (Fuller 1969), the answer suggested by Pagano is decentralization of public ordering, which depends on the same problem of transaction costs as applied to lawmaking. The corporation emerges as a response to these two efficiency pressures. On the one hand, there is pressure to centralize transactions when they would be too costly to coordinate on the market. On the other hand, there is pressure to decentralize public ordering when it would be too costly to tailor legal rules to the specific requirements of firm production. Corporate governance is therefore a system of private ordering established by corporate law in order to satisfy these needs.

Guiding the reader through a fascinating theoretical journey, Pagano describes this result as a 'marriage' between the two fundamental contributions by Coase (1937) and Fuller (1969). The core of his argument is the – so far, neglected – link between them. To this end, he borrows from two additional contributors to Transaction Cost Economics. One is Williamson (1985), the very founder of this discipline and now Nobel Prize laureate for that reason. Surprisingly, the other (Calabresi 1970, 1991) is somebody who has hardly ever entered the debate on the theory of the firm, in spite of his laying down some of the very foundations of economic analysis of law. The marriage between Coase and Fuller is assisted by these two metaphorical best men, but it takes place in the framework developed by the latter. Telling enough, Coase and Fuller marry 'in the Cathedral', namely the ideal place where Calabresi and Melamed (1972) famously articulated their distinction between property rules and liability rules. Here is the missing link with the economic theory of the corporation identified by Pagano. Corporations are decentralized systems of private orderings for all transactions between insiders, which are governed by an internal set of property rules (that is, entitlements) in order to preserve relationship-specific investments. But corporations are also made accountable to society for these transactions via (joint) liability rules which enable outsiders to claim compensation for their own entitlements without undermining authority within the corporate enterprise.

Building on Coase (1937), the theory of the firm has been analyzing the consequences of the 'fundamental transformation' (Williamson 1985) that occurs after relationship-specific investments are made by two previously independent parties. After this transformation, the parties face a situation of bilateral monopoly where they are subject to mutual hold-up (Klein et al. 1978). The hierarchical structure of the firm solves this problem by centralizing distribution of the surplus ex post. But who decides? One intuitive answer, developed by the Property Rights Theory of the Firm (Grossman and Hart 1986; Hart and Moore 1990), is the owners of the firm. Yet – as Pagano notices – the answer is unsatisfactory, for it is mechanical (all decisions are effectively taken ex ante) and unidirectional (only the owners can be in control). In other words, the Property Rights Theory does not explain corporations as *governance* structures characterized by *separation* of ownership and control (Zingales 1998). Contrariwise, the transaction costs framework allows governance structures to be created on a purely contractual basis (Williamson 1991), without the limits (but also without the support) of property rights. Pagano attempts to fill this gap, hypothesizing a transfer of authority by decentralization of public ordering which goes beyond the existing set of property rights. With the help of Calabresi's (and Melamed's 1972) distinction between two ways to protect (alienable) entitlements, Pagano suggests that the state decentralizes to the corporation the definition of entitlements (property rules) within the firm. However, the corporation is exclusively responsible towards the rest of society for how these entitlements are exercised (liability rules). While legal personality is efficaciously presented as the unifying concept of power inside the corporation and responsibility outside it, Pagano's framework still raises a number of important questions for institutional analysis.

In his reply, van Oosterhout identifies a major weakness of Pagano's analysis. Pagano derives decentralization of public ordering as a necessary condition for the establishment of authority within the (corporate) firm. However, he fails to model the role of the government in this respect. Van Oosterhout observes that this cannot be taken for granted, for any form of private ordering arises as a delegation of powers from the state. This delegation may be implicit, but then its existence needs to be validated by unequivocal evidence. Except for his reference to the corporate legal personality, Pagano overlooks this fundamental issue. Yet legal personality tell us neither why courts should abstain from adjudicating controversial issues within the firm nor why third parties should be content with corporate liability for any misconduct by the firm's constituencies. To be sure, corporate law supports elements of each proposition, namely the Business Judgment Rule regarding courts' abstention and limited liability concerning the claims of third parties against shareholders. These elements are neither included in the notion of legal personality nor specifically discussed by Pagano. More importantly, as with legal personality, the above-mentioned circumstances are explicitly supported by legal rules and they only hold within the boundaries defined by public ordering (courts do adjudicate intra-firm controversies when the conditions of the Business Judgment Rule do not hold; and limited liability only protects shareholders). In conclusion, a theory of firm based on decentralization of public ordering cannot just assume delegation of authority, but must model it explicitly.

Despite these criticisms, Pagano's theory addresses and tries to solve one problematic issue touched upon by various contributions to this book. That is, how are entitlements created by corporate law and how are they allocated among the firm's constituencies in order to ensure that they receive sufficient protection in corporate governance? If anything, the foregoing discussion shows that we do not yet have an answer to this fundamental question. Corporate governance seems to be about protecting investors, and yet the relevant investments in the corporate enterprise are not necessarily made only by shareholders – the ultimate owners of the firm's assets. Opinions differ on how to balance the interests of different constituencies in corporate governance, and so do the corporate laws that address this question in different jurisdictions. This variety suggests that there is no optimal solution readily available – at least, not that we know of. But, exactly for this reason, corporate law may be even more important than is commonly understood. The persistence of alternative solutions in spite of the global pressures towards convergence of legal standards may just be explained by the theoretical gap identified by Pagano. We still do not know how corporate law does (and should) complement the property rights system (Pacces 2007).

8. CONCLUDING REMARKS

The main results of this study can be summarized as follows. First, regulatory competition is neither good nor bad for corporate law. It may simply be misdirected, but the question is for how long. Secondly, harmonization of company law is not just a substitute for regulatory competition. As the European experience shows, it can actually be a complement. Thirdly, we may not need to worry about the quality of corporate law rules, for takeovers naturally tend to select the best. The question is whether we understand which rules actually enhance firm value and how much. Fourthly, we may have forgotten that the best of all worlds is one featuring few, if any, mandatory rules in corporate governance. The only problem is how to make investors comfortable with unregulated control powers, takeovers, and insider trading, given the problem of contractual incompleteness. Fifthly, strong governance powers, as well as courts and regulatory agencies, may protect investors from expropriation, and perhaps even better. However, this pattern of 'informal enforcement' does not have clear defining boundaries, and thus it is hard to generalize outside the British context. Sixthly, corporate law may be understood as a decentralization of public ordering complementing the centralization of market transactions within the corporate enterprise. Unfortunately, we still know too little about whether, and under what conditions, corporate law can effectively establish a system of private ordering.

At the end of a long journey along these changing perspectives on corporate law and economics, it is not easy in summing up to do justice to the importance of each contribution. Perhaps a way out of this impasse is to stress the role of the interdisciplinary, international, and intergenerational approach of this book in its numerous achievements. The above results have one fundamental aspect in common. They are all derived by combining legal and economic analysis of the institutions of corporate governance. The authors' backgrounds differ as far as education, experience, and geography are concerned. This explains the selection of topics among the various issues debated in corporate governance, but not the choice of methodology for addressing them. Regardless of whether the contributions are authored by lawyers or economists, all evidence is reported and discussed with a rigorous empirical methodology. Equally impressively, lawyers and economists discuss legal and economic theory interchangeably. Economic analysis of law has thus established a common ground where changing perspectives on corporate governance are mutually reinforcing in the build-up of new knowledge.

Diversity between the contributors matters in two additional respects. Mapping the authors geographically, this book represents three major models of corporate governance in the developed world, namely the US, the UK, and continental Europe. Although all contributions take an international perspective, they naturally reflect the different relevance of corporate governance issues in the country of origin of the authors. Finally, the latter differ in terms of the generation of corporate law and economics they represent. The first generation reminds us of the importance of the origins of this debate (the market for corporate control), notwithstanding our improved understanding of the complexity of corporate governance. The second takes up the challenge of integrating new quantitative methodologies into the analysis of corporate law and of its economic effects. The third generation explores the recent developments in our knowledge of contracts, property rights, and their enforcement as applied to corporate governance. Once again, these changing perspectives add substantially to the coverage, depth, and quality of the debate.

One of the contributors (Pardolesi, in his comment on Chapter 5) concludes, 'A good paper raises more questions than it can solve'. The same conclusion applies to this book as a whole. A similar point was made by Guido Calabresi in the final address to the conference organized in his honour, where all the contributions to this volume were first presented. In view of the financial crisis, these questions were particularly relevant when that conference took place, and so are they at the present times of reflection on how to prevent this from happening again in the future. All the open questions raised in this book, identifying as many avenues for future research, revolve around the fundamental trade-off between authority and responsibility at both the firm and the government levels. It is thus no surprise that we have not yet found all the answers. Over the past decades, the 'giants' of law and economics have advanced our knowledge of this matter and they have stimulated us to carry their insights further. A few of them have joined this venture across the changing perspectives on corporate law and economics either in person (Calabresi), in letter (Manne), or just in spirit (Coase, Williamson). However little this book may contribute to the fundamental debate on how law can improve the welfare of society, we hope to be standing on their shoulders.

Rotterdam, November 2009
The Editor

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1. Delaware corporate law: failing law, failing markets

William J. Carney, George B. Shepherd and Joanna M. Shepherd

INTRODUCTION

For nearly a century Delaware's corporation law has dominated its market. The explanations given for its dominance have varied over the years, and new ones continue to be offered. At the same time that explanations for success have been offered, some commentators have criticized the quality of Delaware law, and have suggested that it is not ideal, and indeed, may be inferior to some other laws. We offer some additional evidence on this point and explore possible reasons for its continuing success in the wake of a decline in quality. Our study focuses on the role of lawyers as advisers on the choice of the state of incorporation.

1. DELAWARE'S DOMINANCE OF THE CHARTERING COMPETITION

Two of us have previously reviewed the history of the competition for corporate chartering business.[1] This competition was possible because virtually all American states followed the English choice of law rule, the 'Internal Affairs Rule', which applies the law of the incorporating jurisdiction to the governance of the corporation, rather than Europe's 'Real Seat Rule', which required incorporation at the location of the corporation's real headquarters.[2]

[1] William J. Carney and George B. Shepherd, The Mystery of Delaware Law's Continuing Success, 2009 U. Ill. L. Rev. 1. Much of the early part of this chapter is drawn from that article.

[2] William J. Carney, The Political Economy of Competition for Corporate Charters, 26 J. Legal Stud. 303, 312–15 (1997).

When New Jersey, the first mover in the American chartering competition, relinquished its advantage in a misguided movement at law reform in 1911, Delaware became the favored state for incorporation.[3] During the period 1996–2000, 58% of all publicly held firms, and 59% of the Fortune 500 Industrial firms were incorporated in Delaware.[4] During the period 1978–2000, 56% of all initial public offerings ('IPOs') involved Delaware corporations.[5] Delaware's share of IPOs listed on the New York Stock Exchange increased during the 1990s, a period of enormous growth in the number of companies (mostly high tech) going public, reaching 73–77% during parts of that decade.[6]

One author characterized Delaware's pre-eminence as stemming from the 'combination of its flexible corporate code, the responsiveness of its legislature, the wealth of legal precedent, its efficient and knowledgeable court system, and its business-like Secretary of State's office'.[7] Our previous work challenged the benefits of its corporate code, its legal precedent and its court system.[8] We argue that the principal feature of an efficient corporate law is to reduce the transaction costs of organizing and operating a business entity.[9] Romano's pioneering work identified this as the

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[3] Christopher Grandy, New Jersey and the Fiscal Origins of Modern American Corporation Law (1993).

[4] Lucian Ayre Bebchuk and Alma Cohen, Firms' Decisions Where to Incorporate, 46 J. L. & Econ. 383, 389–91 (2003).

[5] Robert Daines, The Incorporation Choices of IPO Firms, 77 NYU L. Rev. 1559, 1571 (2002).

[6] Daines, *supra* note 5 at 1572.

[7] Demetrious C. Kaouris, Note, Is Delaware Still a Haven for Incorporation?, 20 Del. J. Corp. L. 965, 1011 (1995). See also Guhan Subramanian, The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the 'Race' Debate and Antitakeover Overreaching, 150 Pa. L. Rev. 1795, 1810 (2002) (hereinafter 'Antitakeover Statutes').

[8] Carney & Shepherd, *supra* note 1.

[9] Delaware jurists have acknowledged this. Myron T. Steele & J. W. Verret, Delaware's Guidance: Ensuring Equity for the Modern Witengamot, 2 Va. L. & Bus. Rev. 189, 191 (2007) ('Moreover, this development is further complicated in Delaware's corporate law because the disputes are primarily economic, and thus require increased predictability and efficiency – since all parties typically hope to get back to the business of profit as quickly as possible, there is great benefit in being able to predict future outcomes.'); see also Frank H. Easterbrook & Daniel R. Fischel, The Corporate Contract, 89 Colum. L. Rev. 1416, 1444 (1989); Roberta Romano, Metapolitics and Corporate Law Reform, 36 Stan. L. Rev. 923, 949 (1984). We thus ignore arguments that might be made about benefits received by or costs incurred by third parties from the organization and operation of corporations because investors generally will be unlikely to attach much importance to third-party effects, at least to those unlikely to create liability.

primary motivator for changes in states of incorporation.[10] Thus, from the perspective of corporate managers, this characteristic is the mark of good corporate law.

Our view of the statistical evidence for Delaware law's superiority is that it is currently unpersuasive about the quality of law issues identified by Romano as critical. We agree with former Chancellor William Allen that '[b]y intruding on the protected space that the business judgment rule accords such decisions, courts create disincentives for businesses to engage in the risk-taking that is fundamental to a capitalist economy. Such intrusiveness also prolongs litigation without offsetting social utility.'[11] In the next section, we briefly review our previous work demonstrating how Delaware courts have become increasingly intrusive in their review of directors' decisions, thus increasing the uncertainty and raising the transaction and litigation costs facing managers of Delaware corporations.

2. A BRIEF AND UNFAVORABLE COMPARISON OF DELAWARE LAW

The principal difficulty we face in this section is that we are making qualitative rather than quantitative arguments. As a result, our results are not falsifiable, in a world of falsifiable literature about the chartering competition. We believe, nevertheless, that we have demonstrated that the quality of Delaware law, measured by the standards Romano has identified, has declined. We have at least come close enough to generate a response from Chancellor William Chandler to our first article.

2.1 What Do We Mean by the Quality of Law?

We argue that, once agency cost and minority protection questions have been dealt with, the principal feature of an efficient corporate law is to reduce transaction costs of organizing and operating a business entity.[12] Romano's pioneering work identified this as the primary motivator of changes in states of incorporation.[13] Thus, from the perspective of

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[10] Roberta Romano, Law as a Product: Some Pieces of the Incorporation Puzzle, 1 J. L., Econ. & Org. 225 (1985) (hereinafter 'Law as a Product')

[11] William T. Allen, Realigning the Standard of Review of Director Due Care With Delaware Public Policy: a Critique of Van Gorkom and its Progeny as a Standard of Review Problem, 96 Nw. U.L. Rev. 449, 450 (2002).

[12] See note 9, *supra*.

[13] Romano, Law as a Product, *supra* note 10.

corporate managers selecting a body of law under which to operate, this characteristic is the mark of good corporate law.

The great achievement of New Jersey and then Delaware was to expand the set of property rights of corporate actors, and thus to increase the flexibility of the corporate form to respond to changing business and market conditions. The history of American corporate law through at least the 1960s is characterized by the continuing expansion of property rights and flexibility for the corporate form. A recent study indicates that laws promoting corporate flexibility remain the most important single factor in selecting the state of incorporation for companies going public.[14]

2.2 The Empirical Evidence is Not Persuasive of Superiority

Early empirical studies generally supported Winter's 'race to the top' position, that shareholders either benefited, or at least did not suffer, when firms reincorporated in Delaware, generally thought to be the most flexible and enabling state.[15] Roberta Romano contributed importantly to the 'race to the top' literature with her survey of the reasons given by corporate officials for reincorporating in Delaware.[16] She found that executives were making the reincorporation decision in anticipation of major transactions where, presumably, Delaware law would reduce the anticipated costs of transacting.[17] She identified public offerings, mergers and acquisitions, and takeover defenses as the most frequent causes of reincorporation. We do not intend to challenge the results of her survey, but we do suggest that the executives who responded to her survey may have been systematically mistaken in their choices, or at least not prescient in predicting the development of Delaware law since her study.

There are those who claim Delaware law's superiority explains its dominance. Early reincorporation studies were inconclusive, showing, at best, that there were no significant losses from moving to Delaware.[18]

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[14] Marcel Kahan, The Demand for Corporate Law: Statutory Flexibility, Judicial Quality, or Takeover Protection?, 22 Journal of Law, Economics and Organization 340 (2006) (hereinafter, 'Demand for Corporate Law').

[15] These studies are summarized in Roberta Romano, THE GENIUS OF AMERICAN CORPORATE LAW (1993) at 19–24.

[16] Romano, Law as a Product, *supra* note 10.

[17] In the context of litigation expected in connection with contemplated initial public offerings or initiation or expansion of a mergers and acquisitions program, 'the ready availability of legal opinions and a well-developed case law, are, in fact, critical, for they can reduce the cost of doing business'. *Id.* at 250.

[18] Peter Dodd & Richard Leftwich, The Market for Corporate Charters: 'Unhealthy Competition' versus Federal Regulation, 53 J. Bus. 259, 277 (1980)

The debate generally rejected the race to the bottom hypothesis, because these studies do not produce negative price movements. The nature of the debate changed when Robert Daines employed Tobin's Q to measure value in Delaware corporations versus others.[19] He found that incorporation in Delaware added approximately 5% to the value of a firm. Other studies have disagreed,[20] although one study, which found a negative correlation between Delaware incorporation and value, employed different samples, time periods, and control variables.[21] The most recent study, by Guhan Subramanian, finds that Delaware firms were worth approximately 3% more than non-Delaware firms in 1991–93, and 2% more in 1994–96. Thereafter, the Delaware difference is statistically insignificant, and even turned negative in 1998–99.[22] The results over 25 years of empirical work thus remain inconclusive. We do not attempt to add to that body of literature. Our effort is qualitative, and thus suffers from the weakness of not being falsifiable, a weakness that seems inescapable in this context.

There is some evidence that Delaware's market power may be weakening. Subramanian found that during the 1990s Delaware obtained a 56% market share among reincorporations, down from an 80% to 90% share in earlier periods, and in contrast with Delaware's dominance of IPOs during that same period.[23] His study reveals that Delaware lost

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(average prediction error on announcement date is –0.01%, although there were significant price increases over the preceding 60 months); Allen Hyman, The Delaware Controversy – The Legal Debate, 4 Del. J. Corp. L. 368, 396 (1979) (no statistically significant price movement on or after the announcement date, although stock prices rose prior to the announcement date). But see Romano, Law as a Product, *supra* note 10 at 271, Table 12 (statistically significant gains of 3.8% in ten-day window around announcement date); Michael Bradley and Cindy A. Schipani, The Relevance of the Duty of Care Standard in Corporate Governance, 75 Iowa L. Rev. 1 (1989) (significant 1% rise on announcement date, following significant rise preceding that date); Jeffry Netter and Annette Poulsen, State Corporation Laws and Shareholders: The Recent Experience, 18, No. 3 Fin. Mgt. 28 (Autumn 1989) (positive returns around announcement date).

[19] Robert Daines, Does Delaware Law Improve Firm Value?, 62 J. Fin. Econ. 559 (2001).

[20] Lucian Bebchuk, Alma Cohen & Allen Ferrell, Does the Evidence Favor State Competition in Corporate Law?, 90 Cal. L. Rev. 1775, 1784–6 (2002) note that Daines' results are not consistent across the period studied.

[21] P. Gompers, J. Ishii & A. Metrick, Corporate Governance and Equity Prices, National Bureau of Economic Research, Working Paper No. 8449 (2001).

[22] Guhan Subramanian, The Disappearing Delaware Effect, 20 J. Law Econ. & Org. 32–59 (2004), available at http://www.law.harvard.edu/programs/olin_center.

[23] Subramanian, Antitakeover Statutes, *supra* note 7 at 1820–22; compare Dodd & Leftwich, *supra* note 18 at 263 (finding a 90% share in 1927–77; Romano, Law as a Product, *supra* note 10 at 1012 (finding an 82% share in 1960–82).

118 corporations while gaining 208 through reincorporation in the test period.[24] Subramanian offers an explanation that centers on the presence of more and stronger anti-takeover laws in other states, although this is countered by the poor performance of some states with the strongest anti-takeover statutes, where more corporations opt out of their coverage.[25]

All of the preceding literature, with minor exceptions, treats corporate law as a black box that generates more or less efficient outcomes for firms and investors. Lawyers have quite another perspective – that content, detail and certainty are important. We offer another explanation that attempts to synthesize Subramanian's work and Romano's earlier results: reincorporations of public companies occur when management is contemplating a major transaction, where litigation costs and uncertainty become important. If managers and their advisers are aware of the present difficulties with Delaware law governing important transactions, that may influence a move to other states. The rush to Delaware for IPOs during the same period becomes more puzzling in view of the evidence of its less dominant performance in the market for reincorporations. One possible explanation borrows from Coates' observations about adoption of anti-takeover defenses by IPO firms.[26] It may be that at least some groups of lawyers advising issuers on IPOs are less familiar with the difficulties of Delaware law involving mergers and acquisitions, if they are not specialists in those areas. We explore the evidence in Section 4 and 5.

2.3 Delaware's Indeterminacy Problem

There is much about Delaware corporate law that is efficient and attractive. Corporate law is largely about default rules, and in that sense can be considered trivial.[27] All other state laws share very much the same sets of rules, and we do not propose to discuss them here.[28] The interesting rules, from our perspective, are the mandatory rules, mostly involving fiduciary duties, that seem difficult if not impossible to contract around.[29]

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[24] Subramanian, Antitakeover Statutes, *supra* note 7 at 1821 (Table I).

[25] *Id*. at 1831 (noting much higher opt-out rates in Ohio, Pennsylvania and Massaschusetts).

[26] John C. Coates IV, Explaining Variation in Takeover Defenses: Blame the Lawyers, 89 Calif. L. Rev. 1301 (2001).

[27] Bernard S. Black, Is Corporate Law Trivial?: A Political and Economic Analysis, 84 Nw. U. L. Rev. 542 (1990).

[28] For a study of the similarity of most state law provisions, see William J. Carney, The Production of Corporate Law, 71 So. Cal. L. Rev. 715, 718 (1998).

[29] But see Larry Ribstein, The Uncorporation and Corporate Indeterminacy, 2009 U. Ill. L. Rev. 131, for the case of contracting around these duties in uncor-

The dominant phenomenon present in recent Delaware judicial decisions is loss of the faith of the courts in the good faith of directors and a significant erosion of the deference formerly granted under the business judgment rule. Thus the set of decisions now contestable in the Delaware courts has grown exponentially. This is not to say that directors' risk of personal liability has increased at the same rate, because most, if not all, Delaware corporations have availed themselves of the liability shield offered by Section 102(b)(7).[30] It was only after the first intrusion into the

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porations. While corporations can relieve directors of much liability risk in charter provisions under 8 Del. Code § 102(b)(7), this does not protect their decisions from being overturned. *See* Joseph Hinsey IV, Business Judgment and the American Law Institute's Corporate Governance Project: The Rule, the Doctrine, and the Reality, 52 Geo. Wash. L. Rev. 609, 611 (1984). Since Hinsey wrote, the protections given by § 102(b)(7) have become less certain. In *Emerald Partners v. Berlin*, 726 A.2d 1215, 1223–4 (Del. 1999), the Supreme Court held 'that an exculpation defense based on a charter provision authorized by section 102(b)(7) is an affirmative defense that the directors must bear the burden of establishing. Presumably that burden includes the obligation to negate the statutory categories of excepted-out conduct – specifically, breaches of the duty of loyalty to the corporation or its stockholders, acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law, and transactions from which the director derived an improper personal benefit.' William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and its Progeny as a Standard of Review Problem, 96 Nw. U. L. Rev. 449, 463 (2002). When taken with the recent holding of *Stone v. Ritter*, 911 A.2d 362 (Del. 2006) that a failure to provide proper monitoring is a breach of the duty of good faith rather than of the duty of care, the risk to Delaware directors may have been exponentially increased. Douglas Branson notes the tension between Delaware's flexibility, epitomized by its 'equal dignity' rule that allows corporations to achieve the same results by different statutory avenues, and the doctrine of *Schnell v. Chris-Craft Indus.*, 285 A.2d 437 (Del. 1971) that provides that inequitable action, no matter how much it complies with law, is impermissible. Douglas Branson, Indeterminacy: The Final Ingredient in an Interest Group Analysis of Corporate Law, 43 Vand. L. Rev. 85, 92–100 (1990).

[30] 8 Del. Code Ann. § 102(b)(7). Jonathan Macey argues that the Chancellor's decision exonerating Disney's directors for their remarkably generous, one might say wasteful, compensation decisions in the employment and termination of Michael Ovitz is evidence in support of Romano's theory that Delaware continues to offer companies predictability of law. Jonathan Macey, Delaware: Home of the World's Most Expensive Raincoat, 33 Hofstra L. Rev. 1131, 1132 (2005). We do not quarrel with Macey's observation that it was a foregone conclusion that Disney's directors would not be held liable for their actions, given the applicability of §102(b)(7). Macey is indeed correct that offering directors such safety even for the egregious mismanagement evidenced in that case provides a degree of certainty, but only for directors personally, and not for their decisions, as we

directors' domain, and a dramatic reaction in insurance markets and the market for directors that the Delaware legislature felt compelled to adopt this statute and provide liability protection against unpredictable intrusions into directors' judgments.[31] But since that adoption, the Delaware courts have recharacterized some director actions that one would have thought of as involving protected breaches of the duty of care as breaches of the duty of good faith, for which neither exculpation nor indemnification is available. The first two cases involved charges that directors had failed to create adequate systems to monitor lower-level employees for illegal activities, and since the directors won both cases, created only minor concerns about personal liability.[32] But recently, a vice chancellor characterized a board's acceptance of an attractive purchase offer that was on a take-it-or-leave it basis as a breach of the duty of good faith, because the board neither shopped for alternatives in the seven days it was given to accept, nor reserved the right to test the market after signing the agreement, over the absolute refusal of the buyer to grant such a right.[33] While the Delaware Supreme Court has taken the extraordinary step of granting an interlocutory appeal on this issue, it illustrates the uncertainty and potentially enormous increase in director liability possible under Delaware law.

One of the notable features of Delaware law has been its respect for the bright lines between separate sections of the statute, a rule of 'independent legal significance'. This allowed managers to choose the most advantageous method for accomplishing a desired result without worrying about complying with another and more restrictive statutory provision that would also allow one to reach the same result. Recent commentators have

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shall point out. Macey reiterates the hypothesis expressed in Jonathan R. Macey & Geoffrey P. Miller, Toward an Interest-Group Theory of Delaware Corporate Law, 65 Tex. L. Rev. 469 (1987), that Delaware corporate law seems designed to benefit the corporate litigation bar, rather than corporations or their shareholders, through what could be described as lengthy, expensive and embarrassing trials signifying nothing.

[31] Roberta Romano, Corporate Governance in the Wake of the Insurance Crisis, 39 Emory L.J. 1155, 1160 (1990).

[32] *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996); *Stone v. Ritter*, *supra* note 29. Most recently, Vice Chancellor Noble extended this doctrine to a board's decision to accept a high premium take-it-or-leave-it offer without an opportunity to shop for a higher bid either before or after accepting the offer. *Ryan v. Lyondell Chem. Co.*, 2008 Del. Ch. LEXIS 105. This case has been accepted for interlocutory appeal at this writing. Regardless of the outcome, it demonstrates the uncertainty and risks facing directors of Delaware corporations.

[33] *Ryan v. Lyondell Chemical Co.*, *supra* note 32.

noted the gradual erosion of the doctrine of independent legal significance over the past ten years.[34] These authors note that the courts have attempted to distinguish the cases disregarding the doctrine by claiming that it only 'applies to exercise of legal power. It does not apply to fiduciary review'.[35] Unfortunately, that rationalization does not apply to the Chancellor's most recent departure, which only involved the availability of appraisal rights, which did not address breaches of fiduciary duties.[36] There the Chancellor recharacterized a planned dividend as part of the consideration for a merger, thus subjecting the transaction to different rules.

A number of commentators have observed Delaware's warts. The first observation was by Macey and Miller, who observed that Delaware's high franchise fees apparently did not capture all available monopoly rents, but left some for the Delaware bar to claim, largely through costly litigation.[37] Branson claimed that the way these rents were collected was through the indeterminacy of Delaware legal rules, which were rife with open, indeterminate, fact-intensive tests.[38] More recently, Fisch and Kamar have separately discussed the details of this indeterminacy.[39]

Delaware law is so indeterminate that Delaware appellate and trial judges disagree on its application with relative frequency, their specialized expertise notwithstanding.[40] In some cases, the appellate decisions are sufficiently surprising that they generate considerable commentary

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[34] C. Stephen Bigler and Blake Rohrbacher, Form or Substance? The Past, Present and Future of the Doctrine of Independent Legal Significance, 63 Bus. Law. 1, 10–13 (2007).

[35] *Id.* at 16 n. 118, citing *SICPA Holding S.A. v. Optical Coating Lab, Inc.*, C.A. No. 15129, 1999 WL 10263, at *5.

[36] *La. Mun. Police Employees' Ret. Sys. v. Crawford*, 918 A.2d 1172 (Del. Ch.), *review denied sub nom. Express Scripts, Inc. v. Crawford,* 2007 Del. LEXIS 101 (Del. 2007).

[37] Macey & Miller, *supra* note 30.

[38] Branson, *supra* note 29 at 91.

[39] Jill Fisch, The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters, 68 U. Cinn. L. Rev. 1061 (2000); Ehud Kamar, A Regulatory Competition Theory of Indeterminacy in Corporate Law, 98 Colum. L. Rev. 1908 (1998).

[40] Vice Chancellor Noble's finding of a breach of the duty of good faith in *Ryan v. Lyondell Chem. Co.*, 2008 Del. Ch. LEXIS 105 has been criticized by Vice Chancellor Strine (without mentioning the case) in *In re Lear Corp. S'holder Litigation*, 2008 Del. Ch. LEXIS 121 and by Chancellor Chandler in *McPadden v. Sidhu*, 2008 WL 4017052 (Del. Ch.) (again without mentioning Ryan).

by both academics and practitioners.[41] Many of these decisions involved changes in Delaware's law,[42] and they occurred in areas involving review of important transactions, such as mergers and acquisitions.[43] The important observation here is not that the rules are difficult to discern once announced, but that new rules have been announced with remarkable regularity. These rules represent surprises for those who have recently

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41 See, for example, *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) ('*Transunion*') (cited in 1146 law review and periodical references); *Weinberger v. UOP, Inc.* 457 A.2d 701 (Del. 1983) (cited in 786 law review and periodical references); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) (cited in 967 law review and periodical references); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1985) (cited in 880 law review and periodical references) and *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003) (cited in 69 law review and periodical references) (LEXIS search conducted June 19, 2007).

42 Norman Veasey et al., The Role of Corporate Litigation in the Twenty-first Century, 25 Del. J. Corp. L. 131, 135 (2000).

43 See, for example, *Gimbel v. Signal Companies, Inc.*, 316 A.2d 599 (Del. Ch. 1974) (imposing a qualitative 'unusual transaction' requirement on a quantitative 'substantially all' requirement concerning shareholder approval of asset sales); *Singer v. Magnavox, Co.*, 380 A.2d 969 (Del. 1977) (imposing a 'business purpose' requirement for take-out mergers); *Katz v. Bregman*, 431 A.2d 1274 (Del. Ch. 1981) (holding that a shift in materials from steel to plastic, involving a bare majority of all assets, constituted a sale of 'substantially all' assets under the 'unusual transaction' standard); *Weinberger*, *supra* note 41 (rejecting the 'business purpose' test and imposing a new duty of fair dealing and fair price in takeout mergers); *Smith v. Van Gorkom*, *supra* note 41 (1985) (imposing a new standard of care for directors to be informed); *Unocal, supra* note 41 (imposing a new level of heightened scrutiny on takeover defenses before the business judgment rule might apply); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985) (imposing a relaxed version of 'heightened scrutiny' where the 'threat' was hypothetical rather than immediate); *Revlon*, *supra* note 41 (imposing a duty of 'scrupulous fairness' on boards attempting to sell a company); *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988) (imposing a requirement of demonstration of a 'compelling justification', even for a board acting in good faith, to defend a decision limiting shareholder voting power); *Paramount Communications, Inc. v. Time Inc.*, Del. Supr., 571 A.2d 1140, 1150 n. 12 (1989); (creating an exception from *Revlon* for 'mergers of equals'); *Barkan v. Amsted Industries, Inc.*, 567 A.2d 1279 (Del. 1989) (relaxing the 'auctioneering' duty articulated in *Revlon* in some cases); *Kahn v. Lynch Communication Systems, Inc.*, 638 A.2d 1110 (Del. 1994) (invalidating a special committee approval of a cash-out merger where the dominant shareholder threatened to make a legally permitted tender offer); *Carmody v. Toll Bros., Inc.*, 723 A.2d 1180 (Del. Ch. 1998) (invalidating a dead-hand shareholder rights plan); *Omnicare, Inc. v. NCS Healthcare, Inc.*, *supra* note 41 (applying *Unocal*'s 'heightened scrutiny' standard to review of a deal protection device in the sale of a corporation).

completed transactions that are now subject to challenge in an unexpected way, and new risks of liability for participants. To the extent they are fact-intensive, they make prediction more difficult for planners of transactions. They have been characterized as standards, and in one sense the notions of care, good faith and loyalty covered by fiduciary obligations are that, but they have devolved into a series of min-standards that could fairly be described as rules, as we shall demonstrate. The frequency of litigation in Delaware, often described as a blessing, might as easily be a handicap. As with viruses, the frequency of their replication creates the probability of every possible mutation occurring within a day, increasing the probability that some mutations will be drug resistant. So in Delaware, multiple decisions involving closely related fact patterns can lead to unfortunate results.

We now briefly explore some of the areas of Delaware law where uncertainty has delayed transactions and increased litigation costs to an extent that suggests that the executives responding to Romano's earlier survey might respond quite differently today – or that they ought to, if they were fully aware of these costs. We should emphasize that not all Delaware law is difficult and indeterminate – the business judgment rule (generally) remains alive and well in Delaware, at least outside the important area of mergers and acquisitions and monitoring for illegal corporate behavior.[44] But this general clarity in one area does not distinguish Delaware from other jurisdictions, which reach the same result.[45] Here we focus on important areas involving major transactions, the focus of executive reasons for migrating to Delaware in Romano's study, where indeterminacy can impose high

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[44] Except in those cases where the Delaware courts find that the board's decision-making process is not sufficiently deliberative – that is, resembling a judicial determination, as in *Smith v. Van Gorkom*, *supra* note 41, *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993) and *In re Emerging Communications, Inc. Shareholders Litig.*, 2004 Del. Ch. LEXIS 70 2004) (holding one independent director liable and charging him with knowledge that a price approved in a fairness opinion was too low, by virtue of his background as an investment adviser, although the result may have been different had he not received fees from the controlling stockholder). Some commentators took *dicta* in *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996) to impose a new monitoring duty to be informed about potential law violations on boards. Philip S. Garon, Michael A. Stanchfield & John H. Matheson, Challenging Delaware's Desirability as a Haven for Incorporation, 32 Wm. Mitchell L. Rev. 769, 819–20 (2006). They were correct. A year later, the Delaware Supreme Court characterized this as a duty of good faith. *Stone v. Ritter, supra* note 29.

[45] See generally William J. Carney, Section 4.01 of the American Law Institute's Corporate Governance Project: Restatement or Misstatement?, 66 Wash. U. L. Q. 239 (1988).

costs on transactions. We review the Delaware approach to take-out transactions, decisions involving control, and briefly examine some other areas.

2.3.1 *Weinberger*: the mother of all litigation?

Weinberger v. UOP, Inc. involved charges that a parent corporation's actions in cashing out minority shareholders of its subsidiary were tainted by the disloyalty of some of the subsidiary's directors, who were both parent employees and appointees on the subsidiary's board.[46] These directors produced information about the value of the subsidiary for the parent that they did not share with their fellow directors of the subsidiary or its public shareholders. This transaction was one in which these directors had a 'conflicting interest', which would mandate 'required disclosure' to the bodies making the decision – both the board and shareholders of the subsidiary.[47] The *Weinberger* opinion makes no mention of the statute, proceeding as if it were creating judicial standards.[48] Other decisions applying *Weinberger* take the same approach.[49]

The introduction of notions of 'fair procedures' into Delaware law, quite aside from those required by statute, opened the floodgates for uncertainty. In *Rabkin v. Philip A. Hunt Chemical Corp*; the Supreme Court declined to hold that appraisal was exclusive where a buyer of a majority interest that entered into a one-year standstill for any take-out began planning the take-out before the expiration of the year – apparently a plausible claim of unfairness, sufficient to avoid dismissal.[50] If the independent committee bargains too hard and deadlock is reached, the lesson of *Kahn v. Lynch Communications Systems Inc.* seems to be that the majority shareholder cannot bargain too hard in return – that a

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[46] *Supra* note 41. In fairness, *Schnell v. Chris-Craft, supra* note 29 is the real genesis of this change, permitting courts to set aside otherwise lawful transactions if they find unfairness, thus elevating equity over law.

[47] 8 Del. Code Ann. § 144(a).

[48] Section 144 focuses on directors' conflicts of interest, while despite the clear evidence of directors' conflicts of interest, *Weinberger*'s sweeping language suggests the duties were breached by the parent corporation rather than by the subsidiary's directors. If the rule becomes one of majority stockholder duties, then § 144 has no role to play. But the facts of *Weinberger* did not require such an expansive reading.

[49] *Rosenblatt v. Getty*, 493 A.2d 929 (Del. 1985); *Rabkin v. Philip A. Hunt Chemical Corp.*, 498 A.2d 1099 (Del. 1985); *Kahn v. Lynch Communication Systems, Inc.*, *supra* note 43.

[50] 498 A.2d 1099 (Del. 1985). In 2001, Justice Berger conceded that 'Rabkin, through its interpretation of *Weinberger,* effectively eliminated appraisal as the exclusive remedy for any claim alleging breach of the duty of entire fairness'. *Glassman v. Unocal Exploration Corporation*, 777 A.2d 242, 246 (Del. 2001).

threat of a tender offer at a lower price is 'unfair' and 'compromised' the ability of the independent committee to negotiate 'at arm's length'.[51] Vice Chancellor Strine has noted that *Lynch* complaints are not subject to dismissal, and thus always have settlement value.[52] The suggestion of arm's length bargaining under these conditions is an artificial construct of the Delaware courts that bears little relation to reality.

2.3.2 *Weinberger's* doctrinal consequences: posturing and exceptions

The consequences of this doctrine are several. First, the implication is that a buyer will be hard pressed to pay a control premium to a control shareholder if it also wishes to acquire the remaining minority shares at some lower price.[53] Second, a simulation of arm's length bargaining will shift the burden on fairness charges if the independent committee bargains hard, but not so hard that the control shareholder has to employ all of its negotiating power.[54] This proliferation of standards of review leads to concern among Delaware judges that overarching principles are being ignored in the formalism of the creation of numerous categories, which could in the long run lead to instability in Delaware law should the judges determine to unify the approach to transactions with like results.[55]

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[51] 638 A.2d 1110, 1121 (Del. 1994).

[52] *In re Cox Communs., Inc. S'holders Litig*., 879 A.2d 604, 605 (Del. Ch. 2005). ('Because that standard [of review] (as heretofore understood by practitioners and courts) makes it impossible for a controlling stockholder ever to structure a transaction in a manner that will enable it to obtain dismissal of a complaint challenging the transaction, each Lynch case has settlement value, not necessarily because of its merits but because it cannot be dismissed.')

[53] See, for example, *Rabkin, supra* note 49 at 1107, where frozen-out plaintiffs claimed a breach of fiduciary duty to pay the same price previously paid to the control shareholder, and the Supreme Court found an allegation of 'a conscious intent by Olin, as the majority shareholder of Hunt, to deprive the Hunt minority of the same bargain that Olin made with Hunt's former majority shareholder . . .'.

[54] Chancellor Allen warned against posturing when he wrote: 'This is not a call to pay even greater attention to appearances; it is advice to abandon the theatrical and to accept and to implement the substance of an arm's-length process [for special committees dealing with a management buyout]'. William T. Allen, Independent Directors in MBO Transactions: Are they Fact or Fantasy?, 45 Bus. Law. 2055, 2062 (1990).

[55] See, for example, Vice Chancellor Strine's concerns in *In re Pure Resources Inc. Shareholders Litig*., 2002 Del. LEXIS 630; *Sunderland v. Raider*, 808 A.2d 1205 (Del. 2002) concerning the disparate treatment of tender offers followed by short-form mergers versus § 251 long-form mergers. In other contexts, see the views of the Three Chancellors (William Allen, Jack Jacobs and Leo Strine) on distinctions between sales governed by *Revlon*, *supra* note 49, and mergers of equals governed by *Time-Paramount*, *supra* note 43.

Take-out mergers have been subject to *Weinberger*'s entire fairness standard for over twenty years. Phrases such as 'entire fairness' have a powerful ring. Who can be *against* fairness? Yet others have argued that fairness is an empty vessel, into which lawyers and judges can pour whatever content suits them and their clients from time to time.[56] When courts sanction a result achieved in one manner (tender offer followed by a short form merger), while closely scrutinizing a conventional freeze-out merger for fairness, it becomes clear that fairness in take-outs is a concept of variable content. It is difficult to discern how corporate managers and directors could find this a congenial legal setting.

2.3.3 *Weinberger's* practical consequences

By introducing a requirement of procedural fairness as well as fair price, the court opened Pandora's Box for corporate planners.[57] In the period 1999–2000, of 1048 fiduciary duty cases filed in the Delaware Chancery Court, 813, or near 78%, involved allegations of breach of fiduciary duty in acquisitions – the fruit of *Weinberger* and *Revlon*.[58]

2.3.4 Mergers and sales: proliferation of modes of review

For over a century and a half, the business judgment rule has been the principal bulwark against the second-guessing of directors' decisions.[59]

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[56] 'Fairness is an invulnerable position; who is for unfairness? But for lawyers fairness is "a suitcase full of bottled ethics from which one freely chooses to blend his own type of justice".' Frank H. Easterbrook & Daniel R. Fischel, The Corporate Contract, 89 Colum. L. Rev. 1416, 1434 (1989), at 703 n. 17 (quoting George Stigler, The Law and Economics of Public Policy: A Plea to the Scholars, 1 J. Legal Stud. 1, 2, 4 (1972)).

[57] See, for example, *Rabkin*, *supra* note 49 (holding that planning for a cash-out merger before a contractual bar expired violated the majority shareholder's obligation to pay a higher price if a take-out occurred *during* the bar period); *Kahn v. Lynch Communication Systems, Inc.*, 638 A.2d 1110 (Del. 1994) (holding that a threat of a tender offer at a price lower than that offered an independent committee in cash-out merger negotiations was unfair).

[58] Robert B. Thompson & Randall S. Thomas, The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions, 57 Vand. L. Rev. 133, 169 (Table 2) (2004); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, *supra* note 41 (imposing a duty of 'scrupulous fairness' on boards attempting to sell a company); *Weinberger*, *supra* note 41.

[59] Dennis J. Block et al., The Business Judgment Rule, 4 (1990). *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), described the business judgment rule as: '[a] presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company'.

Much of what we discuss below is the story about how this rule of judicial deference to decisions 'in the absence of any evidence of fraud, bad faith, or self-dealing in the usual sense of personal profit or betterment'[60] has morphed into a much diminished domain, as the Delaware courts have narrowed the presumption of good faith to allow much greater judicial intrusion into the board's decisions.

The Delaware Courts have developed different standards of review for a wide variety of circumstances where the business judgment rule's rule of deference formerly protected directors' decisions. As a result, a judge must first classify the actions under review in one of the increasing number of categories before applying the law. In a recent case, to the surprise of most observers, a majority of the Supreme Court characterized a deal protection device in a negotiated transaction following a good faith search for buyers as a defensive tactic, and struck it down under *Unocal*.[61] These surprises illustrate the perils of planning in a legal regime where broad fiduciary standards seem to have evolved into multiple, ill-defined, open-ended rules.

The number of categories into which transactions can be placed, with different consequences for burdens of proof and standards of judicial review, has proliferated.[62] One of us employs the chart shown in Figure 1.1 to illustrate the varieties in a course on mergers.

The most recent addition was a 2005 Chancery Court decision involving an arm's length acquisition in which a dominant shareholder received an interest in the buyer, where other shareholders did not, and *Weinberger*'s entire fairness rule was applied.[63] Similar problems arise where founders

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60 *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 64 (Del. 1989).

61 *Omnicare, Inc. v. NCS Healthcare, Inc.*, *supra* note 41.

62 For discussions by two Delaware judges of the possibility of courts successfully applying indeterminate standards, see Leo E. Strine, Jr., If Corporate Action is Lawful, Presumably there are Circumstances in Which it is Equitable to Take that Action: The Implicit Corollary to the Rule of Schnell v. Chris-Craft, 60 Bus. Law. 877, 881 (2005) ('Nearly thirty-five years ago, the Delaware Supreme Court emphatically rejected the proposition that compliance with the DGCL was all that was required of directors to satisfy their obligations to the corporation and its stockholders.') Justice Jacobs has characterized Delaware law as favoring the law side until about 1980, and equity thereafter. Jack Jacobs, The Uneasy Truce Between Law and Equity in Modern Business Enterprise Jurisprudence, 1 UCLA School of Law Program in Business Law & Policy Occasional Paper Series 7 (January 2006).

63 *In re LNR Prop. Corp. S'holders Litig.*, 2005 Del. Ch. LEXIS 171. Other cases in the chart include *Smith v. Van Gorkom*, *supra* note 41; *Paramount Communications, Inc. v. Time Inc.*, *supra* note 43; *Revlon, supra* note 41; *Omnicare*, *supra* note 41; *Blasius Industries, Inc. v. Atlas Corp.*, *supra* note 43; *Unocal Corp. v. Mesa Petroleum Co.*, *supra* note 41; *Weinberger v. UOP, Inc.*, *supra*

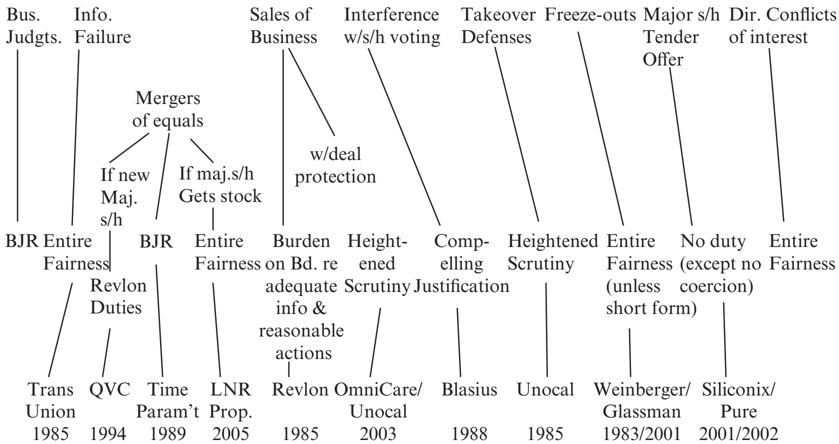

Figure 1.1 Modes of judicial review

hold super-voting classes of shares and receive different consideration.[64] Our point here is that categories developed in equity have taken on the property of bright-line rules, allowing practitioners to structure transactions to achieve the most relaxed standard of review available. We also observe that new categories are created with distressing regularity, providing surprises for both experienced practitioners and their clients. The following time line illustrates the frequency of surprises.

1983 *Weinberger's* entire fairness rule for parent-dominated mergers
1985 *Trans Union's* close scrutiny of board information before the business judgment rule can be applied;
Revlon's articulation of the 'auctioneering' rule for sales or break-ups;
Unocal's announcement of heightened scrutiny for takeover defenses;
1988 *Blasius* announced the requirement for a 'compelling justification' for board actions affecting shareholder voting;
1989 *Paramount v. Time* rejected the auctioneering rule for stock-for-stock 'mergers of equals';

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note 41; *Glassman v. Unocal Exploration Corporation*, *supra* note 50; *Paramount Communications Inc. v. QVC Network, Inc.*, 637 A.2d 34, 43 (Del. 1994).

64 *In re Tele-Communications, Inc. Shareholders Litigation*, 2005 Del. Ch. LEXIS 206 (2005).

1994 *Paramount v. QVC* held that a merger of equals doesn't exist when a controlling shareholder emerges from a merger;[65]
1996 *Solomon v. Pathe Communications Corp.* held that dominant shareholders do not owe fiduciary duties in tender offers to the minority stockholders;
2001 *Glassman v. Unocal* held that *Weinberger's* entire fairness doctrine does not apply to short-form mergers;
2002 *Pure Resources* qualified the tender offer privilege of *Solomon* to impose fiduciary-like conditions on the use of a tender offer.
2003 *Omnicare* held that a deal lock-up device may be judged coercive or preclusive under *Unocal*;
2005 *In re LNR Property Corp. Shareholders Litigation* treated an arm's length sale as a *Weinberger*-type transaction where the controlling shareholder, who received a pro rata share of the cash proceeds, was allowed to buy an interest in the purchasing entity;
2007 *La. Mun. Police Employees Ret. Sys. v. Crawford* treated a dividend declared in advance of a stock-for-stock merger which, by itself, would not have triggered appraisal rights, as part of the merger consideration, thus ignoring the independent legal significance doctrine.[66]

While experienced M&A lawyers may be able to cope with all of these changes,[67] the fact remains that each of them was a surprise at the time of announcement, and was applied retroactively. More surprises are sure to come.[68]

Even some present and former Delaware judges have expressed concern about the usefulness of at least parts of this taxonomy. William Allen, Jack Jacobs and Leo Strine (the 'Three Chancellors') wrote about the elevation of form over substance in the distinction between sales and 'mergers of equals', which are sufficiently close in result to suggest the

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[65] *Paramount Communications Inc. v. QVC Network, Inc.*, *supra* note 63.

[66] *Supra note* 36. The court justified this departure from independent legal significance on the basis that payment of the merger was conditioned on shareholder approval of the merger. 918 A.2d at 1191–2.

[67] See R. Franklin Balotti, Gazing into the Crystal Ball of Future Developments in Delaware Corporate Law: What if the Past is Not Prologue?, 15 No. 3 The Corporate Governance Adviser 3 (May/June 2007) (describing the standard features of deal terms in 2007).

[68] *Id.* at 3–4 and part II.C.6 *infra* (exploring whether disclosure obligations will expand beyond those currently required by Federal law). The *Crawford* decision, *supra* note 36 was noted by commentators as a surprise for experienced Delaware practitioners. See Bigler & Rohrbacher, *supra* note 34 at 4.

same type of review should be involved.[69] In doing so, these judges seem to have ignored the caution of the Delaware Supreme Court in 1963 against making fine distinctions based on elevating substance over form, when it stated that '[t]o attempt to make any such distinctions between sales under § 271 would be to create uncertainty in the law and invite litigation'.[70]

Delaware law on the requirement for a shareholder vote for the sale of 'substantially all' of a corporation's assets has long been murky, leading transactional lawyers wishing to avoid litigation to take an unnecessarily cautious course in advising clients in this area in order to avoid litigation.[71]

Finance offers some suggestions about the cost of Delaware rules. The Delaware courts have made it clear that when a selling corpora-

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[69] William T. Allen, Jack B. Jacobs & Leo F. Strine, Jr., Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law, 55 Bus. Law. 1287 (2001). Chancellor Allen became a professor of law before this article was written, and Vice Chancellor Jacobs is now Justice Jacobs.

[70] *Hariton v. Arco Electronics, Inc.*, 188 A.2d 123, 125 (Del. 1963) (rejecting the '*de facto* merger' doctrine adopted elsewhere.

[71] The Delaware courts have turned a quantitative standard, requiring a shareholder vote for the sale of 'all or substantially all' assets into a qualitative one that cannot be easily specified, since it seems to depend on such factors as whether the sold assets are operating or investment assets, and whether the sale was or was not one 'in the ordinary and usual course of business'. See, for example, *Gimbel v. The Signal Companies, Inc.*, *supra* note 43 and *Katz v. Bregman*, *supra* note 43. Experienced practitioners have observed that there is a broad area, probably involving asset sales of between 25% and 75% of assets, where predicting whether a shareholder vote is required in Delaware is extremely difficult. Leo Herzel et al., Sales and Acquisitions of Divisions, 5 Corp. L. Rev. 3, 25 (1982). In contrast, the Model Business Corporation Act now creates a bright-line safe harbor, so that no shareholder vote is required if the corporation is left with a significant continuing business activity, and no more than 75% of assets, measured by value and revenues produced, are sold. Model Bus. Corp. Act. § 12.02(a). Recently Vice Chancellor Strine, recognizing the confusion created by Delaware's standard, attempted to move the law toward a more quantitative and certain standard in *Hollinger, Inc. v. Hollinger International, Inc.*, 858 A.2d 342 (Del. Ch. 2004). After tracing the legislative history of the section from a simple 'all' to 'substantially all' in 1967, he employed dictionary definitions to suggest that 'substantially all' had to be much closer to 'all' than *Katz v. Bregman, supra* note 43, had suggested. 858 A.2d at 376–8. But in the end his opinion relied on some of the qualitative features of the *Signal* case he found 'more than a tad unclear', such as International's history of acquisitions and sales of large operations. *Id.* at 383. He conceded, '[i]t would be less than candid to fail to acknowledge that the § 271 case law provides less than ideal certainty about the application of the statute to particular circumstances'. *Id.* at 378.

tion's board enters into an arm's length merger agreement it is subject to a stockholder vote of approval. This, of course, is the rule in every jurisdiction. The important distinction is that in Delaware the board cannot commit not to talk to other prospective buyers; nor can it commit to submitting the matter to a stockholder vote even if a better offer comes along, if controlling shareholders have committed themselves to vote for the transaction.[72] The result is that a buyer has no confidence that what it believes to be a good deal for the sellers will result in a sale, because of the lag between signing a merger or sale agreement and closing. In effect, the selling corporation has a 'put' which it can exercise if no better offer comes along. The result of this curious set of rules of contract formation has been to require sellers to pay buyers for this put, in the form of break-up fees, stock options and similar arrangements. Currently break-up fees average about 3% of the value of the transaction.[73] These fees are paid, of course, only in those cases where the deal is not consummated because the seller received a better offer that it later accepted. Buyers forced to live with the uncertainty of having sold a put until the expected closing may also compensate themselves in other ways, such as a reduction in the acquisition price, if the size of the negotiated break-up fee is constrained by fear of judicial disapproval. Because this adjustment is not visible to outsiders, this cost is often ignored. But it is real and no doubt substantial – an uncertainty tax on all mergers and acquisitions with Delaware corporations.

Our Illinois article contrasts these developing Delaware rules with the approach of the Model Business Corporation Act, enacted in approximately thirty states.[74] We will not repeat that work here, except to note that the Model Act, with more bright-line safe harbors, attempts to achieve greater clarity, albeit, one could argue, at the cost of missing some behavior some might conclude should be sanctioned. Only a few state courts have begun down the road to heightened scrutiny exemplified by

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[72] *Omnicare*, *supra* note 41; *ACE Limited v. Capital Re Corporation*, 747 A.2d 95 (Del. Ch. 1999); *Phelps Dodge Corporation v. Cyprus Amax Minerals Company Shareholders Litigation*, 1999 WL 1054255 (Del. Ch. 1999); but see *In re IXC Communications, Inc. Shareholders Litigation*, 1999 WL 1009174 (Del. Ch. 1999) (permitting a no-talk clause at the end of an auction, a result probably rejected by Omnicare). In fairness, the target board approved the shareholder voting agreements in Omnicare in order to avoid the blocking effect of Delaware's 'business combination' statute, 8 Del. Code Ann. § 203.

[73] Houlihan, Lokey, Howard & Zukin, 2003 Transaction Termination Fee Study, at 2 (2004).

[74] Carney & Shepherd, *supra* note 1.

Delaware's *Unocal* decision.[75] For most states, the expected decision rule will be the business judgment rule.[76]

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[75] Citations to *Unocal* or its progeny in other state courts involving application of non-Delaware law are quite rare. *Katz v. Chevron Corp.*, 27 Cal. Rptr.2d 861 (Cal. App. 1994); *see also Heckman v. Ahmanson*, 168 Cal. App.3d 119 (1985). Kansas has copied the Delaware statute, so it is not entirely surprising that its courts would follow *Unocal*. In *Burcham v. Unison Bancorp, Inc.*, 77 P.3d 130 (Kan. 2003), the Kansas Supreme Court reviewed the criticisms and commentary about the *Unocal* rule before applying it. This may not exhaust the set of state court decisions, but most state trial courts do not publish opinions, so it is impossible to determine how many other decisions there are. Some federal courts applying state law have concluded that *Unocal* would apply in those jurisdictions. *International Ins. Co. v. Johns*, 874 F.2d 1447 (11th Cir. 1989) (applying Florida law)*; Dynamics Corp. of America v. CTS Corp.*, 637 F. Supp. 406 (N.D. Ill.), aff'd, 794 F.2d 250 (7th Cir. 1986), reversed on other grounds, 481 U.S. 69, 107 S.Ct. 1637 (1987) applying Indiana law); *R. D. Smith & Co., Inc. v. Preway, Inc.*, 644 F. Supp. 868 (W.D. Wis. 1986) (applying Wisconsin law); *Simon Prop. Group, Inc. v. Taubman Centers, Inc.*, 261 F. Supp.2d 919 (E.D. Mich. 2003) (applying Michigan law); *AHI Metnall, L.P. v. J.C. Nichols Co.*, 891 F. Supp. 1352 (W.D. Mo. 1995) (applying Missouri law); *but see Torchmark Corp. v. Bixby*, 708 F. Supp. 1070 (W.D. Mo. 1988) (applying Missouri law and declining to apply a *Unocal* standard to defensive tactics not taken in apprehension of a challenged takeover); *Hilton Hotels Corp. v. ITT Corp.*, 978 F. Supp. 1342 (D. Nev. 1997) (applying Nevada law); *but see Horwitz v. Southwest Forest Indus., Inc.,* 604 F. Supp. 1130 (D. Nev. 1985) (business judgment rule applied to adoption of a poison pill).

[76] Only one state court appears to have held that the business judgment rule applies to takeover defenses, following the general approach of pre-Unocal law in Delaware, as described by former Chancellor Seitz in *Johnson v. Trueblood*, 629 F.2d 287 (3d Cir. 1980) (applying Delaware law), which was essentially the business judgment rule subject to plaintiff's proof that entrenchment was a primary motive. *Shoen v. Shoen*, 804 P.2d 787 (Ariz. App. 1990). The Arkansas Supreme Court cited *Unocal* in a case that ultimately involved self-dealing by the defendant director – officers, but did not apply its standard of review. *Hall v. Staha*, 858 S.W.2d 672 (Ark. 1993). Numerous federal decisions prior to *Unocal* applied the business judgment rule to defenses. *Treadway Cos., Inc. v. Care Corp.*, 638 F.2d 357 (2d Cir. 1980) (applying New Jersey law); *Heit v. Baird*, 567 F.2d 1157 (1st Cir. 1977) (apparently applying Massachusetts law); *Treco, Inc. v. Land of Lincoln Savings & Loan*, 749 F.2d 374 (7th Cir. 1984) (applying Illinois law); *Martin Marietta Corp. v. Bendix Corp.*, 549 F. Supp. 623 (D. Md. 1982) (applying Maryland law); *Asarco Inc. v. Holmes a Court*, 611 F. Supp. 468 (D.N.J. 1985) (applying New Jersey law); *Minstar Acquiring Corp. v. AMF, Inc.*, 621 F.Supp. 1252 (S.D.N.Y. 1985) (applying New Jersey law, but striking down a poison pill on other grounds); *Buffalo Forge Co. v. Ogden Corp.*, 717 F.2d 757 (2d Cir. 1983), cert. denied 104 S.Ct. 550 (1983) (applying New York law); *Terrydale Liquidating Trust v. Barness*, 611 F. Supp. 1006 (S.D.N.Y. 1984) (applying Missouri Law); but see the post-*Unocal* decision in *AHI Metnal. L.P. v. J.C. Nichols Co., supra; Gearhart Indus. v. Smith, Int'l*, 741 F.2d 707 (5th Cir. 1984 (applying Texas law).

2.3.5 Litigation costs and delays

In the 1970s William Cary suggested that the Delaware judiciary, which he described as being drawn from the Delaware corporate bar, was complicit in the plan he saw to give managers increased flexibility and reduced accountability.[77] Everything that has transpired in the development of Delaware corporate law doctrine since then refutes his claim. Each of the areas of judicial intrusion into the directors' domain has resulted in fact-intensive tests and nuanced judgments, all of which require extensive discovery and sometimes lengthy trials. While Delaware judges proceed with dispatch in most cases, there are some terribly costly exceptions.

One is tempted to point to the most egregious examples of litigation costs in the Delaware courts, such as the Technicolor acquisition, which was completed in 1983, but involved ongoing litigation until the close of 2005 – Delaware's version of *Jarndyce v. Jarndyce*.[78] This boon to lawyers

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Two months after *Unocal* was decided the previous Delaware standard of review, described by former Chancellor Seitz in *Johnson v. Trueblood*, *supra*, was employed to review the actions of directors of a New York corporation, without citation to either *Unocal* or *Johnson v. Trueblood. Turner Broadcasting System, Inc., v. CBS, Inc.*, 627 F. Supp. 901, 910 (N.D. Ga. 1985). Other decisions applying New York Law have taken the same approach, with some citing *Johnson v. Trueblood. Norlin Corp. v. Rooney, Pace, Inc.,* 744 F.2d 255 (2d Cir. 1986); *British Printing & Communication Corp. v. Harcourt Brace Jovanovich, Inc.*, 664 F. Supp. 1519 (S.D.N.Y. 1987); *Samuel M. Feinberg Testamentary Trust v. Carter*, 652 F. Supp. 1066 (S.D.N.Y. 1987) (holding that a showing of entrenchment as a primary purpose denies defendants the benefit of the business judgment rule). Decisions of other federal courts have applied the business judgment rule post *Unocal*: *Bonner v. Law Companies Group, Inc.*, 964 F. Supp. 341, 343 (N.D. Ga. 1997) (applying Georgia law; *Munford, Inc. v. Valuation Research Corp.*, 98 F.3d 604, 611 (11th Cir. 1996) (applying Georgia law); *NCR Corp. v American Tel. & Tel. Co.,* 761 F. Supp. 475 (S.D. Oh. 1991) (applying Maryland law); *B.T.Z., Inc. v. Grove*, 803 F. Supp. 1019 (M.D. Pa. 1992) (applying Pennsylvania law) and *WLR Foods, Inc. v Tyson Foods, Inc.*, 869 F. Supp. 419 (W.D. Va. 1994), aff'd 65 F.3d 1172 (4th Cir. 1995), cert. denied 116 S.Ct. 921 (1996) (applying Virginia law). We make this claim based on the virtually universal adoption of this rule in all other contexts not involving conflicts of interest, and the adoption of statutes, cited below, that reaffirm this deference to directors' decisions in many jurisdictions. William J. Carney, Section 4.01 of the American Law Institute's Corporate Governance Project: Restatement or Misstatement?, 66 Wash. U. L. Q. 239, 268–71 (1988), at 268–71 (concluding that four American cases that might arguably have been a departure from the business judgment rule really involved conflicts of interest, citing Joseph Bishop, Sitting Ducks and Decoy Ducks: New Trends in Indemnification of Corporate Directors and Officers, 77 Yale L. J. 1078, 1095–9 (1968)).

[77] William L. Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 Yale L. J. 663 (1974).

[78] Charles Dickens, BLEAK HOUSE (New York: Cambridge Univ. Press 1987).

makes eight appearances in the reports of the Delaware Supreme Court.[79] The result: the dissenting shareholder received $5.41 per share more than the merger offered, on its 201 200 shares, for a total recovery of $1 088 492. It is difficult to imagine a more Pyrrhic victory. Running it a close second may be *Berlin v. Emerald Partners*, which makes its first appearance in a Chancery Court decision in 1988, followed by seventeen further appearances in LEXIS, culminating in 2003.[80]

Robert Thompson and Randall Thomas have provided data that corporate managers might regard as terrifying about the frequency of corporate litigation in Delaware. They reported 1280 corporate law complaints filed in the Delaware Chancery Court in 1999 and 2000.[81] Of those, 1003, or 78%, involved claims of breach of fiduciary duty, while the others were statutory, and might have involved such disputes as shareholders' demand for records.[82] Most of the cases, 824, involved class actions, most of which arise in the context of acquisitions, while 137 claims were derivative.[83] The authors point out that the number of complaints filed is much larger than the total number of lead cases, 1048 fiduciary duty cases being reduced to 348 total lead cases.[84] At the same time, their study misses actions involving Delaware corporations brought in other jurisdictions under the Internal Affairs Rule. Unfortunately, we have been unable to locate any systematic studies of derivative suits or shareholder class actions involving Delaware corporations brought in other jurisdictions.[85]

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[79] Variously titled *Cede & Co. v. Technicolor, Inc. or Cinerama, Inc. v. Technicolor, Inc.*, 542 A.2d 1182 (Del. 1988); 634 A.2d 345 (Del. 1993); 636 A.2d 956 (Del. 1994); 663 A.2d 1156 (Del. 1995); 684 A.2d 289 (Del. 1996); 758 A.2d 485 (Del. 2000); 875 A.2d 602 (Del. 2005); 884 A.2d 26 (Del. 2005).

[80] *Emerald Partners v. Berlin*, 1988 Del. Ch. LEXIS 39; *Emerald Partners v. Berlin*, 840 A.2d 641(Del. 2003).

[81] Robert Thompson & Randall Thomas, The Public and Private Faces of Derivative Lawsuits, 57 Vand. L. Rev. 1747, 1761 (2004).

[82] *Id.*

[83] *Id.* at 1762.

[84] *Id.*

[85] Romano, The Genius of American Corporate Law, *supra* note 15, at 41 found that out of a sample of 35 shareholder suits involving Delaware firms, 29 were brought in Delaware. We did a brief search on LEXIS, in Corporate Cases, Federal and State, using the search term 'corporation and minority and [shareholder or stockholder] and [freezeout or freeze out]' and retrieved 615 cases, of which we excluded those 225 cases in the federal courts, leaving 390 cases, of which 86 (22%) were in Delaware, followed by Massachusetts with 46 cases (11.8%), New York with 55 (14%) Pennsylvania with 15 (3.8%). Only California (12), Illinois (13), New Jersey (10) and Ohio (12) were in double digits. It seems likely that the Massachusetts numbers are influenced by the doctrine of fiduciary duties of

Elliot Weiss and Lawrence White add to this picture with a study of plaintiffs' attorneys' fees in shareholder class actions in the Chancery Court.[86] In 104 suits studied, a complaint was typically filed within several days after the announcement of a transaction, of which 51 (94% of the dismissals) were dismissed before any adverse judicial ruling was taken on the complaint. This suggests an automatic filing response where the legal categories of judicial review were promising – sales of control rather than mergers of equals, and especially those cases where the buyer had a prior ownership interest in the target.[87] The authors found little indication that plaintiffs' attorneys invested much effort in these cases. In the 48 settlements, the size of fees recovered was strongly dependent on whether the deal terms improved after suit was filed, although the authors found that 'plaintiffs' attorneys frequently were able to free ride on the improved terms negotiated by special negotiating committees or on the price improvements that resulted from competing bids . . .'.[88] For settlements that involved no price improvement, legal fees averaged $492 per hour, while for settlements in cases where there was price improvement, the average fee was $1800 per hour.[89] One author notes that where corporations are headquartered outside Delaware with principal counsel nearby, litigation costs in Delaware are further increased by the participation of both principal counsel and Delaware counsel.[90]

2.4 Who Competes, and Who Doesn't?

Our previous article treated the extent to which American corporate law is relatively uniform across the states, with divergences often driven by

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majority shareholders first enunciated in *Donahue v. Rodd Electrotype Co. of New England, Inc.*, 328 N.E.2d 505 (Mass. 1975). While Delaware may have a majority of the public corporations in the US, its total corporate count is likely not nearly as disproportionate to its population, since most non-public firms incorporate in their home states. Obviously these numbers tell us nothing about the cost of litigation in individual cases, but they are suggestive (as are Massachusetts' numbers) that open-ended legal doctrines intended to protect minority shareholders can create higher legal costs.

[86] Elliott J. Weiss & Lawrence J. White, File Early, Then Free Ride: How Delaware Law (Mis)Shapes Shareholder Class Actions, 57 Vand. L. Rev. 1797 (2004).

[87] *Id.* at 1825–8.

[88] *Id.* at 1829.

[89] *Id.* at 1830.

[90] Charles W. Murdock, Why Illinois? A Comparison of Illinois and Delaware Corporate Jurisprudence, 19 S. Ill. U. L.J. 1, 5 (1994).

innovations that are currently being dispersed across the states over time. Delaware, according to Romano's work, has been less a leader in innovation than a rapid responder. But there are some states where corporate laws are not driven by the Model Act, and often fail to provide a law as modern, bright line and at the same time flexible as the Model Act.

Since at least 1985, California, Illinois, New York, Ohio, Pennsylvania and Texas have been large exporters of incorporations, according to Romano.[91] Using more recent data, California is the largest exporter of incorporations, retaining only 27.77% versus an overall average of 38.1%.[92] Illinois is near the bottom in retentions, with only 11.2%.[93] New York does only slightly better, retaining 24.48%.[94] Until a recent push to modernize its corporate laws, Texas was not a competitor.[95] Texas retains a below-average number of incorporations for firms located in the state.[96] Pennsylvania, on the other hand, retains slightly more than the average percentage of its firms, 39.52% versus 38.10% overall.[97] Ohio is the standout in this group, retaining 54.69%.[98] Several of these states have suffered set-backs in the modernization process because other political interests have intervened.[99] Bebchuk et al. offer anti-takeover statutes as a partial explanation for these differences, with California having no such statutes and Pennsylvania and Ohio offering a panoply of bidder-unfriendly

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91 Romano, Law as a Product, *supra* note 10 at 247 (Figure 3).

92 Lucian Bebchuk, Alma Cohen & Allen Ferrell, Does the Evidence Favor State Competition in Corporate Law?, 90 Cal. L. Rev. 1775, 1813–15 (2002).

93 *Id.* at 1811.

94 *Id.* at 1812.

95 'Texas, while not yet nationally known as an up-and-comer in the market for corporate charters, is also making a push to capture newly incorporated and reincorporated companies.' David Mace Roberts & Rob Pivick, Tale of the Corporate Tape: Delaware, Nevada, and Texas, 52 Baylor L. Rev. 45, 47 (2000); see also Byron F. Egan & Curtis W. Huff, Choice of State of Incorporation – Texas Versus Delaware: Is It Now Time to Rethink Traditional Notions?, 54 S.M.U. L. Rev. 249 (2001) (suggesting that Texas law had been modernized over the preceding fifteen years, and provides more bright-line solutions than Delaware's judge-made law).

96 Bebchuk et al., *supra* note 92, at 1812 (Table 3) note that Texas retained the charters of only 23.72% of firms located in Texas.

97 *Id.*

98 *Id.*

99 Marcel Kahan and Ehud Kamar, The Myth of State Competition in Corporate Law, 55 Stan. L. Rev. 679, 731–2 (2002) (describing resistance in the Illinois legislature to permitting exculpatory provisions for directors after *Transunion* that delayed passage of legislation widely adopted elsewhere and the New York Bar's failure to obtain repeal of provisions making large shareholders liable for wage claims).

laws.[100] For these reasons, none of those statutes seems representative of the general range of corporation laws in the United States. Without examining the details of these statutes, one can conclude, using the black-box approach to corporate law, that these states have laws that are generally less attractive to those deciding where to incorporate.

3. CAN INDETERMINACY BE RECONCILED WITH EXCELLENCE? THE ROLE OF LAWYERS

3.1 Unpacking the Black Box of Corporate Law

The natural reaction of many economists and law professors with economics training is to conclude that, because Delaware has dominated the market for incorporations for eight decades, it must be better. We confess that we have held this view in the past. Economists are trained to assume that, absent a legally protected monopoly, the firm that dominates a market does so because it provides the best product or service at a price that captures this market share given the elasticity of demand that it faces from buyers, although this understanding is now qualified by knowledge of the first-mover advantage and path dependence. Most studies to date, other than Romano's, have treated corporate law as a black box, and have examined it by examining incorporations, migrations to another jurisdiction, or price reactions or differences based on the state of incorporation. Our earlier paper is an attempt to unpack the black box of Delaware law to examine the transaction costs that it creates. We did not attempt to conduct a similar study of the laws of other states. Our primary purpose in that article was to show that incorporation in Delaware had become relatively more costly than it was at the time of Romano's study. We declined to engage in a 'compared to what?' exercise, except to the extent that we could outline some major departures from Delaware's approaches. We hope to be able to do a brief comparison at a later date with some leading jurisdictions that are heavy losers of incorporation business to Delaware.

We confess that we were daunted by the prospect of arguing that Delaware corporate law no longer possessed many of the qualities long identified as explaining its dominant market position. Market failure

[100] Bebchuk et al., *supra* note 92 at 1813–15 (describing the competition as bilateral). See also Subramanian, Antitakeover Statutes, *supra* note 7 at 1801 (finding managers 26% more likely to remain in their headquarters state if the state has strong anti-takeover legislation).

arguments do not come easily to those trained in economics. But Delaware law no longer possesses the qualities that Romano's respondents identified as reasons to reincorporate there despite the continuing high rate of usage. We have identified a legal system dominated by notions of equity, eschewing presumptions of directors' good faith, where fine distinctions in the modes of judicial review have developed to the point where they have the qualities of rules rather than standards. At the same time, equity's demands for justice in individual cases leave room for courts to roam broadly to enunciate new modes of review, or new 'rules'. All of this increases the costs for corporations attempting to comply with the uncertain body of law that has resulted. How could this have happened?

While there are theories that suggest various forms of judicial behavior or bias might explain a decline in the quality of law, at this time we lack evidence to support or reject them, and decline to speculate about judicial behavior, or problems that may be endemic in a system of equity. We leave that for another day, and focus instead on the biases and preferences that may limit choice on the part of those primarily responsible for advising and choosing the jurisdiction in which to incorporate – the lawyers.

3.2 The Bias of Legal Education

With Daines and Romano, we observe that lawyers play an important role in the choice of incorporating jurisdiction.[101] Our hypothesis is that lawyers advising corporate clients drive this process for selecting the state of incorporation, and that lawyers suffer from bounded rationality: they do not fully understand the laws of all 50 states when choosing where to incorporate. That is, they choose either Delaware or their home state because they know little about the laws of other states.[102]

Lawyers know well the law of only these two states in part because that is the only law that they learn in law school. In their corporations courses, many law schools teach only Delaware law and perhaps the law of the state where the school is located. The law schools recognize that all students need to be familiar with Delaware law, because most publicly held corporations incorporate there. In addition, many schools may also teach their local state's laws or a close variation, the Model Business Corporation Act, because they know that many of their students may end up practicing in that state.

However, many top-ranked law schools do not teach the specific cor-

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[101] Daines, *supra* note 5 at 1580; Romano, *supra* note 10 at 273.
[102] Daines, *supra* note 5 at 1582–3.

porate law of states where the schools are located.[103] Recognizing that their students will practice in many different states, the schools teach only Delaware law and perhaps the Model Act. However, instruction in the Model Act does not provide familiarity with any state's specific law and varies substantially from the laws of leading commercial states that are big losers to Delaware, such as California, New York, Pennsylvania and Ohio. While there is a considerable degree of uniformity among those states using the Model Act as the basis for their statutes, it is not complete, due in part to local innovations.[104] We have previously argued that the Model Act benefits from a series of safe harbors that provide far more certainty than Delaware law in critical areas, but that is not enough to entice most to abandon Delaware.[105] If lawyers who graduate from top-ranked schools are to learn the corporate law of the states where they eventually practice, they must learn it on their own, after law school.

The backgrounds of securities lawyers may predispose them even further to favor Delaware for incorporation. Securities lawyers are likely to be drawn disproportionately from elite law schools.[106] Because the stakes in IPOs are so large and because securities law is so intricate, lawyers who represent issuers and underwriters disproportionately have studied at top law schools. Thus, many of the lawyers advising corporations when the corporations are deciding where to incorporate have studied in law school

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[103] One of us is guilty of this emphasis. Carney, MERGERS AND ACQUISITIONS: CASES AND MATERIALS (2d ed. 2007) contains 39 lead cases on corporate law, of which 32 are Delaware cases. This excludes cases interpreting contracts and those involving federal laws. This reflects not only the dominance of Delaware, but also the complexity of its doctrine.

[104] Carney, The Production of Corporate Law, *supra* note 28.

[105] Carney & Shepherd, *supra* note 1, Table A, following n. 179.

[106] We do not attempt to describe or identify 'elite' schools here. There are various ratings that accomplish that, from US News to Prof. Brian Leiter, and, we suspect, schools that self-style themselves as 'elite'. We only mean to suggest those schools that draw students broadly from the national market, expect them to move largely into high-paying jobs at large corporate law firms that provide the services we describe. Nevertheless, we provide one anecdote, using the 240 lawyers listed by Wachtell Lipton Rosen & Katz on their web page. http://wlrk.com/Page.cfm/Thread/Attorneys (last visited November 18, 2008). The top five schools listed by US News provide 154, or 64%, while the top ten schools provided 192, or 80%, based on first law degrees. Some of the remaining lawyers who held degrees from foreign schools held master's degrees from these elite schools. Aside from public universities in the top 20 schools (Michigan, Virginia, UCLA and Texas), only four lawyers graduated from state universities that would be more likely to teach local law. We recognize that a sample of one is necessarily biased, and that we choose one of the most selective law firms in the nation for our sample, but believe it is suggestive.

the specific law of only one state: Delaware. Further, their focus on the intricacies and complexities of a changing body of federal securities laws will dissuade them from investing heavily in the nuances of laws other than those of Delaware and their home state. It also focuses their attention on aspects of state law, such as legal capital rules, not germane to a 'deal' practise involving mergers and acquisitions, where Delaware's intrusions on directors' domain are the greatest.

In addition, lawyers may rationally learn the corporate law of Delaware and their home state because of network externalities.[107] Because so many companies are incorporated in Delaware, any securities lawyer will benefit greatly by learning Delaware law; indeed, it is essential to learn it. Romano observed that counsels who represent many corporations can economize on learning by having all clients incorporated in one state.[108] In contrast, the benefits of learning some other state's law are few. Because few firms incorporate there, issues of that state's law will seldom arise in the lawyer's practise.

We see then that, if the hypothesis is true, Delaware could maintain its dominance not because its law is superior, but because of path dependence. Lawyers choose Delaware for incorporation because they learned its law in law school or learned it on their own. Law schools teach Delaware corporate law, or lawyers learn it on their own, because most corporations choose it.

A cycle of mediocrity could roll along. Because law schools have time to teach only Delaware's corporate law, and because the benefits of learning Delaware law are so much greater than for the law of other states, an insuperable barrier to entry for new states into the market for incorporations arises.

4. THE EVIDENCE ABOUT LAWYERS' BOUNDED RATIONALITY

This section represents our first examination of data concerning the influence of lawyers on the choice of jurisdiction. This section has two parts. First, we report the results of a survey that we submitted to hundreds of lawyers who had represented issuers and underwriters in a subset of these IPOs. The survey asked questions about the lawyers' pat-

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107 Michael Klausner, Corporations, Corporate Law and Networks of Contracts, 81 Va. L. Rev. 757, 761–3, 774–80 (1995).

108 Romano, *supra* note 10 at 274–5.

terns of incorporation advice and the general reasons for such advice. Second, we analyze a commercial database of thousands of companies that have engaged in initial public offerings ('IPOs') of shares since the early 1990s.

The results from both parts suggest that an important factor that influences the choice of the state of incorporation is lawyers' ignorance of the law from states other than their home state and Delaware.

4.1 A Survey of IPO Lawyers

We decided that the best way to test our hypothesis that lawyers and their backgrounds, particularly their practise specialties and the location of their offices, influence their clients' choice state of incorporation was to ask the lawyers themselves.

4.1.1 Survey design

To choose the lawyers whom we would contact, we randomly chose a sample of IPOs from each year 1991 to 2001, and augmented the data on each IPO with information from the filings. These years represented the high-water mark in the IPO surge at the end of the past century, and also a period when Delaware's domination of IPO choices appeared to have reached its own high point. We obtained information from the form S-1, which each issuer in a public offering is required to file with the SEC.[109] We omitted smaller filings on Forms SB-1, SB-2 and Regulation A, on the theory that their relatively small size probably introduced differences that might skew results.[110] Among the other information in our database about each IPO were the names and addresses of the lawyer who had represented the issuing company and the lawyer who had represented the underwriter. We wanted to explore whether either or both might have had an influence on the incorporation decision.

We created a one-page survey questionnaire that asked questions about the lawyer's background, about the general patterns of the lawyer's choices and advice about state of incorporation, and about the choice for the specific IPO in our sample. The questions about general practises are an important check on the memories of lawyers who engaged in a particular transaction more than a decade ago. The questionnaire for the

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[109] US Securities and Exchange Commission, EDGAR Company Search, available at: http://www.sec.gov/edgar/searchedgar/companysearch.html.

[110] Smaller offerings are more likely to be marketed locally, and local lawyers for both issuers and underwriters may be less experienced at larger national offerings and thus with Delaware law.

underwriter's counsel is in Appendix A; the instrument for the issuer's attorney was similar.

We sent the questionnaire and a cover letter to 397 lawyers who had represented underwriters and 502 lawyers who had represented issuers. The smaller number of underwriters' lawyers represents the fact that more of these lawyers were repeat players in our sample (involved in more than one IPO). We received 242 completed questionnaires, 86 from attorneys for underwriters and 156 from attorneys for issuers.

4.2 Primary Result: Lawyers' Choose Delaware Because They Don't Know Other Law

The results strongly support our hypothesis that lawyers' ignorance of the law of states other than Delaware and their home state influences their advice about where to incorporate. Most lawyers in the survey indicated precisely that. The survey asked whether the following was true: 'I *don't* recommend incorporation in states other than Delaware or my state because I am relatively unfamiliar with the details of the laws and courts of these other states' (emphasis in original). Of the issuers' lawyers, 55% indicated agreement. There was agreement from 75% of underwriters' lawyers.[111] These response levels are belied by their responses to a second question, where 83% of issuers' lawyers and 97% of underwriters' lawyers stated they generally advised incorporation in Delaware (Table 1.2). The stronger pro-Delaware bias of underwriters' counsel was expected, because they tend to be more specialized in corporate finance and less so in deal work (Table 1.3).

The results provide support for the bounded-rationality hypothesis. An important reason why lawyers advise incorporation in either Delaware or the home state is that they are unfamiliar with the law of other states. The cycle then continues. Because Delaware is so dominant, many law schools teach only Delaware corporate law and perhaps some of the local state's law, if the school is either a state school or places most of its graduates locally rather than in a national market. Likewise, because Delaware law is so dominant, it is rational for lawyers to learn on Delaware law. Knowing only Delaware and perhaps some local law, the school's graduates can advise their clients to choose only one of these two bodies of law.

The results should not be interpreted to mean that lawyers who

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[111] Because we found that the jurisdiction had already been chosen for the IPO by the time the matter reached the underwriter (81% of the time) (Table 1.1), the underwriter's influence is less significant.

responded to our survey are ignorant or lazy. Corporate law is complex and intricate, and includes the judicial gloss on the statute, as well as case law interpreting and applying the business judgment rule and the duty of loyalty, to name a few non-statutory areas. It would be irrational for lawyers to devote the substantial time and resources to learning other states' law, especially because law schools do not teach it. It is rational for the lawyers *not* to know all states' corporate law. Because local lawyers will inevitably deal with local businesses that are incorporated locally, they must of course generally know the law of their own jurisdiction.

Delaware's dominance will be maintained even if its corporate law is inferior to other states' laws. Because of path dependence and lawyers' bounded rationality, lawyers will continue to recommend incorporation in Delaware. Aside from their own state's law, it is the only law they know. Thus, for each lawyer, Delaware has only to compete with the home state, rather than with all 50 jurisdictions. Romano described the efforts of other states as defensive moves to prevent further losses of corporations to Delaware.[112]

Looked at through another lens, lawyers' bounded rationality creates network externalities that benefit Delaware. Because Delaware's corporate law has become the standard and law schools therefore teach it, learning Delaware law is cheaper for lawyers than learning the law of other states; to learn other states' laws, the lawyers must learn it in their own time, outside law school.

Moreover, because of Delaware's dominance, a lawyer can spread the cost of learning Delaware law over many representations. That is, the cost per representation of learning Delaware law is low. This also means that the return in legal fees of learning Delaware law is high. In contrast, the cost per representation of learning another state's corporate law is high. The lawyer will expect to use the new knowledge only infrequently; most companies are still incorporated in Delaware. In contrast with Delaware, the cost per representation of learning the other state's law is high, and the return in legal fees is low.

This means that, because there are already so many Delaware incorporations and because so many others recommend Delaware law, it is profit-maximizing for new lawyers to learn only Delaware law. That is, Delaware enjoys the benefits of network effects.[113]

The market for incorporations is similar to the market for personal

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112 Romano, *supra* note 10 at 226. See also Kahan and Kamar, *supra* note 99; Bebchuk et al., *supra* note 92 (describing the competition as bilateral).

113 Klausner, *supra* note 107.

computer operating systems, which is considered a prime example of a market where pervasive network effects support Windows' dominance. Because Windows is dominant, it is rational for users and computer professionals to learn only Windows. Similarly, because Delaware corporate law is dominant, it is rational for issuers and legal professionals to learn only Delaware law. This is true regardless of whether Windows or Delaware law is a superior product.

Regardless of what label is placed on it and its impacts – bounded rationality, a cycle of mediocrity, network effects – lawyers' ignorance of the law of states other than Delaware and their home states creates an imposing barrier to entry for other states to enter the market for incorporations. It would make sense for computer users to switch from Windows to another operating system only if Windows became so inferior that the marginal costs of switching, including a multi-state search for the best law, were less than the marginal gains from using the superior product. If the payoff from switching jurisdictions occurs some years later when the corporation encounters a change of control transaction or other similarly contentious area of Delaware law, when another specialized lawyer is representing the client, the expected gains will be heavily discounted by the lawyer advising at the IPO stage.

4.3 Other Results

The survey's other results also provide interesting insights.

4.3.1 The specific IPO

The first results concern the lawyers' involvement with the specific IPO. As shown in Table 1.1, both underwriters' lawyers and issuers' lawyers overwhelmingly recommended Delaware law for the specific IPO that our questionnaire asked each lawyer about: almost three-quarters of each set of attorneys. However, of the remaining IPOs where Delaware was not recommended, the issuers' lawyer recommended incorporation in the issuer's home state relatively frequently. Issuers' lawyers stated that they recommended incorporation in the issuer's home state 12% of the time, compared to 2% for underwriters' lawyers.[114]

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[114] Recollections about how frequently the issuer's lawyer recommended incorporation in the home state apparently differed between the issuer's lawyers and the underwriter's lawyers. Compared to the 12% of issuers' lawyers who recalled recommending incorporation in the issuer's home state, 49% of the underwriter's lawyers indicated that the issuer's lawyer in their IPO had recommended the issuer's home state.

Table 1.1 Information about the specific IPO

	Underwriter's lawyer	Issuer's lawyer
	% affirmative responses	
My and my law firm's advice was to incorporate in Delaware.	71%	74%
My and my law firm's advice was to incorporate in the issuer's home office location.	2%	12%
The other party or its lawyer (issuer or its lawyer if underwriter's lawyer responding; underwriter or its lawyer if issuer responding) advised incorporating in Delaware.	30%	35%
The other party or lawyer advised incorporating in the issuer's home office location.	49%	1%
When my firm began representing the issuer, the issuer was already incorporated in the state that was later used for the IPO.	81%	40%
Venture capitalists with a stake in this corporation advised that it be incorporated in Delaware.	5%	14%

The results confirm that the issuer's lawyers often began representing the issuer long before the underwriter's lawyer became involved. Only 40% of the issuing companies had already incorporated in the state that they would use for the IPO at the time that the issuer's lawyer began representing the company. In contrast, by the time the underwriter's lawyers became involved, 81% of the companies had already incorporated in the state that would be used for the IPO. The issuer's lawyer had already helped the company reincorporate before the underwriter was hired and its lawyer became involved in approximately 40% of the cases, while a lawyer representing the issuer prior to the IPO recommended the state of incorporation 40% of the time.

The results suggest that the lawyers involved in the IPO view the influence of venture capitalists on the choice of state of incorporation as low. Although most of the companies ended up being incorporated in Delaware, only 5% of underwriters' lawyers and 14% of issuers' lawyers recall that venture capitalists recommended Delaware. Our regressions (Table 1.5) of a larger sample suggest the presence of venture capitalists made a greater difference than the lawyers suggest.

4.3.2 The lawyers' general patterns of advice

Turning to Table 1.2, although just under three-quarters of the lawyers recommended incorporation in Delaware in the actual IPO that we asked about, even more lawyers indicated that they generally advised incorporation in Delaware: 97% of underwriters' lawyers and 83% of issuers' lawyers agreed that 'I generally advise incorporation of public corporations in Delaware regardless of the corporation's location'.

A small but substantial fraction of issuers' lawyers had an exception to their normal recommendation to incorporate in Delaware: 13% of issuers' lawyers recommended incorporation in the lawyer's home state when the issuing company was also located there.[115] No lawyer in our survey recommended incorporation in a state other than Delaware or the *lawyer's* home state. This was true even if the other state was the issuing company's home state: 97% of underwriters' lawyers and 95% of issuers' lawyers were not comfortable with incorporating in the issuer's home state, if the home state were not Delaware or the lawyer's home state. These results contrast with the frequency of non-Delaware reincorporations, where Subramanian found Delaware's market share had declined to 56% in the 1990s, from 80% to 90% in earlier decades.[116] We suspect that this difference is explained by the lawyers driving the choices: Romano's work suggested that reincorporations were undertaken in anticipation of major transactions, such as mergers and acquisitions (M&A), precisely the area where we find Delaware law least attractive.[117] It may well be the case that M&A lawyers frequently recommend reincorporation outside of Delaware in today's world. This provides support for our qualitative critique of Delaware Law.

These results again confirm that lawyers' advice regarding incorporation is limited severely by their own ignorance of the law other than that of Delaware or their home state. Regardless of the virtues of other states' laws, lawyers almost never recommend incorporation in the other states. The only states that the lawyers recommend for incorporation are those about whose law the lawyers already know: Delaware or their home state.

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[115] We contrast this finding with higher percentages of non-Delaware incorporations found in other studies. One study during the 1990s found the peak Delaware IPO incorporation choices at 73–7%. Robert Daines, The Incorporation Choices of IPO Firms, 77 N.Y.U. L. Rev. 1559, 1572 (2002). We offer no explanation for this disparity, except differences in the samples.

[116] Subramanian, Antitakeover Statutes, *supra* note 7 at 1818–22 (finding substantial numbers of reincorporations to Maryland, Nevada, Massachusetts, Minnesota and New York, with a total of 15% of companies incorporated neither in their home state nor in Delaware).

[117] Romano, Law as a Product, *supra* note 10 at 250.

Table 1.2 General patterns of advice in other transactions

	Underwriter's lawyer	Issuer's lawyer
I generally advise incorporation of public corporations in Delaware regardless of the corporation's location.	97%	83%
I generally advise incorporation in my state of public corporations that are located in my state (where I work).	2%	13%
I generally advise incorporation in my state of public companies regardless of where they are located.	0%	3%
I generally advise incorporation in some other state than Delaware or my home state.	0%	0%
I generally *don't* advise incorporation of public corporations in Delaware.	0%	4%
I generally *don't* advise incorporation of public corporations in my state.	78%	50%
I'm generally comfortable with advising issuers located in my state to incorporate here, but not issuers located in other jurisdictions.	12%	35%
I'm generally comfortable with using the issuer's home state, wherever it may be, for incorporation.	3%	5%

Lack of a license in other states cannot explain this result, since non-Delaware lawyers recommending Delaware incorporation are typically not licensed in Delaware.

Finally, almost no lawyer recommended incorporation in the lawyer's home state unless the issuing company was also located there. We discuss possible explanations for this in Section 5, below.

4.3.3 The lawyer's practice

The lawyer's ignorance of, and refusal to recommend, the law of states other than Delaware and their home state cannot be attributed to the lawyers in our survey being inexperienced or part-time securities lawyers. Instead, these were seasoned lawyers in securities and corporate finance. As Table 1.3 shows, 77% of underwriters' lawyers and 55% of issuers' lawyers devoted more than half of their time to practicing securities and

Table 1.3 The nature of the lawyer's practice

	Underwriter's lawyer	Issuer's lawyer
I practice securities and corporate finance more than any other single area of law.	88%	72%
I practice securities and corporate finance more than most other attorneys in my office.	61%	36%
I practice securities and corporate finance less than half of my time.	6%	14%
I practice securities and corporate finance less than one-quarter of my time.	3%	2%
I work on mergers and acquisitions more than half of my time.	14%	37%
I work on mergers and acquisitions less than half of my time.	81%	56%
I work on mergers and acquisitions almost never.	5%	4%

corporate finance. Indeed, for 88% of underwriters' lawyers and 72% of issuers' lawyers, securities and corporate finance was their main practise area. Only 6% of underwriters' attorneys and 14% of issuers' attorneys practiced in these areas less than half the time. We have no explanation for the gaps between these two sets of numbers.

4.3.4 Comparing Delaware and other states

The survey's final section explores why lawyers overwhelmingly advise incorporation in Delaware. As shown in Table 1.4, the underwriter's lawyers agreed overwhelmingly with the usual reasons that are given for Delaware's primacy: that investors are more familiar with Delaware law; that Delaware deals well with proxies, shareholder meetings, and share transfers; that it handles mergers and acquisitions well; and that Delaware courts are superior for corporate disputes.

The issuers' lawyers agreed with Delaware's superiority too, for the most part, if not in quite as overwhelming numbers. Indeed, fewer then half of issuers' lawyers felt that Delaware was better than the lawyers' home states at dealing with proxies, shareholders' meetings, and share transfers. The more favorable relative view that issuers' lawyers have of their home states versus Delaware helps explain the last section's result that a substantial number of issuers' lawyers recommend incorporation in the lawyer's home state, when the issuer is also located there. A strong

Table 1.4 The lawyer's view of Delaware law and the law of his/her home state

	Underwriter's lawyer	Issuer's lawyer
My state is a better place than Delaware to incorporate for public companies.	3%	10%
A state other than my state or Delaware is the best place to incorporate for public companies.	2%	2%
Delaware is a better place than my state to incorporate for public companies because investors are more familiar with Delaware law.	92%	83%
Delaware is a better place than my state to incorporate for public companies because Delaware law is superior in dealing with proxies, shareholders' meetings and share transfers.	77%	48%
Delaware is a better place than my state to incorporate for public companies because Delaware law is superior in dealing with mergers and acquisitions.	86%	65%
Delaware is a better place than my state to incorporate for public companies because Delaware courts are more solicitous of shareholder rights in litigation.	4%	3%
I *don't* recommend incorporation in states other than Delaware or my state because I lack confidence in the laws of the other states.	62%	35%
I *don't* recommend incorporation in states other than Delaware or my state because I lack confidence in their courts.	65%	42%
I *don't* recommend incorporation in states other than Delaware or my state because I am relatively unfamiliar with the details of the laws and courts of these other states.	75%	55%

majority believed Delaware law was superior for mergers and acquisitions. Two of us found this surprising because of our critique of the quality of Delaware law in this area. There are several possible explanations for this response. First, we may simply have been wrong, which we reject for the moment. Second, as previously noted, these lawyers spend either little or no time on mergers and acquisitions, and are thus unaware of troubling developments in these areas. Third, these lawyers have a high degree of confidence in the speed and predictability of judicial decisions in Delaware. At the least, we question their judgment about the current quality and predictability of Delaware law.

The survey responses made clear that these lawyers do not recommend incorporation in Delaware to protect shareholder rights. Fewer than 5% of both groups thought that Delaware law was superior because it was more solicitous of shareholder rights in litigation. In view of the delays and costs imposed by *Weinberger v. UOP*, discussed *supra* in Section 2.3, which focuses on protection of minority shareholders in a way many states do not, this is further evidence that these lawyers do not regularly encounter the litigation spawned by this doctrine.

5. FURTHER CLUES FROM DATA ON INITIAL PUBLIC OFFERINGS

To explore further our hypothesis about the importance of lawyers to the choice of state of incorporation, we analyzed a large commercial database of detailed information on IPOs.

5.1 The Data and Theoretical Expectations

Combining data from the Securities Data Corporation (SDC)[118] with data from the SEC's EDGAR web site, we created a database of all US initial public offerings for the years 1990–2001. The data included the following information:

The location of the issuing company's principal corporate office;
The issuer's state of incorporation for the IPO;
The location of the lawyer for the issuer;
The location of the lawyers for the offering's underwriter.
Whether venture capital was involved in the IPO.

Our data set contained 4218 IPOs.

We then analyzed the data to determine whether they were consistent with our hypothesis that lawyers' ignorance of the law of states other than Delaware or their home state was important to the choice of state of

[118] SDC is a leading provider of data on mergers and acquisitions, new issues, and other factors relating to the issuance of securities.

incorporation. If our hypothesis was true, then we expected to observe the following patterns.

If the lawyers involved with an IPO were from the same state as the issuing company's home state, then we would expect this to increase the probability that incorporation would be in the issuing company's home state, rather than Delaware. Both the lawyers and the issuer are comfortable with the home state's law. This is consistent with our survey results from Section 4. There, 13% of issuers' lawyers recommended incorporation in the issuing company's home state, if that state was also the lawyer's home state.

The one exception to this would be if the lawyer's and company's joint home has notoriously defective corporate law. In this case, there would be a greater tendency to incorporate in Delaware. A common perception among corporate lawyers and academics is that this is the case for both California and New York.[119] Indeed, when companies that were initially incorporated in California and New York eventually go public, they change their state of incorporation at much higher rates than for most other states. Indeed, New York retains only 24.48%, versus an overall average for all states of 38.1%.[120] California does only slightly better, retaining only 27.77%.[121] It is especially important to account for the low esteem in which New York and California laws are held because many of the issuer's lawyers, underwriter's lawyers, and issuing companies themselves are from either New York or California.[122]

If the lawyers are from different states from the issuer, then we would expect the probability of incorporation in Delaware to increase. Again, this is the pattern seen in the survey results, where virtually no lawyer would recommend incorporation in a state other than Delaware if the lawyer and issuing company were from different states. The following are possible explanations for this.

The lawyers might recognize that, regardless of the merits of their home state's law, it would be awkward to suggest to the issuer that it abandon its home state, and instead incorporate in the lawyers' state. A Georgia

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119 Bebchuk et al., *supra* note 92, at 1811–12 (Table 3).

120 *Id.* at 1812 (Table 3).

121 *Id.* at 1811–12.

122 Of the 4218 IPOs, 1025 (24.3%) of the underwriters' lawyers were from California, 1598 (37.9%) of the underwriters' lawyers were from New York, 1104 (24.6%) of the issuers' lawyers were from California, 920 (22.3%) of the issuers' lawyers were from New York, 992 (23.5) of the firms were headquartered in California, and 376 (9%) of the firms were headquartered in New York.

lawyer will probably refrain from even attempting to convince a corporation with headquarters in Alabama to incorporate in Georgia, for three reasons. First, this might create the danger that the client will conclude that the lawyer suggests his home state for incorporation because he is ignorant of Alabama law. The lawyer will seek to avoid appearing ignorant to retain the client's confidence and legal business.

Second, the client might conclude that the lawyer is selfishly suggesting incorporation in his home state in order to increase his income. Incorporation in the lawyer's home state will increase the odds that the corporation will later need to hire the lawyer to interpret the lawyer's local law.

Third, incorporation in the lawyer's home state will increase the possibility that the corporation will be forced to litigate in a state other than its home state. Incorporation in a state creates general personal jurisdiction in that state, regardless of the corporation's level of contacts with the state. In contrast, the company's incorporation in its home state would create no additional personal jurisdiction anywhere; the presence of its headquarters already creates personal jurisdiction in its home state.

Likewise, if our hypothesis is correct, lawyers from different states from the issuer will not suggest the issuer's home state. They will refrain from recommending a body of law about which they know little; their lack of first-hand knowledge of the law might cause their recommendation to be flawed. In addition, recommendation of another state's law increases the risk that the lawyers will later lose the issuer as a client for corporate advice. The Georgia lawyer will recognize that, if the corporation from Alabama is incorporated in Alabama, it will tend to choose Alabama lawyers who are steeped in Alabama law and knowledgeable about Alabama judges.

Instead, the lawyer from a different state from the client will tend to suggest incorporation in Delaware. Incorporation in Delaware cannot be perceived as the lawyer selfishly choosing his home state, and the lawyer can probably claim expertise about Delaware law equal to that of lawyers in the client's headquarters state.

Virtually all corporate lawyers who represent publicly traded corporations are familiar with Delaware corporate law. Corporations courses in virtually all law schools teach Delaware corporate law, if for no other reason than the fact that most broadly marketed casebooks include a disproportionate number of Delaware decisions. Although most law schools also teach the Model Act, knowledge of the Model Act does not create specific familiarity with the law of any specific state; the version of the Model Act that states actually adopt differs from state to state, and judicial interpretations of the statute may vary.

In sum, if lawyers are comfortable only with the corporate law of Delaware and their home state, then we would expect the following:

1. If lawyer and company are from the same state, then this should increase the probability that that state will be chosen for incorporation, rather than Delaware.
2. If lawyer and company are from different states, then the probability of incorporation in Delaware should increase.
3. If the lawyer and company are from the same state, but that state is California or New York, then the probability of incorporation in Delaware should increase.

5.2 Results

The results were strongly consistent with our hypothesis. For choosing the state of incorporation, the lawyers matter. The lawyers and the lawyers' locations were central to the choice of the state of incorporation. And the patterns of incorporation followed our expectations closely. This was true for a wide variety of specifications.

First, the choice of state of incorporation was almost always between Delaware and the issuing company's home state. In 93% of the IPOs, incorporation was in either Delaware or the home state.

Likewise, the choice between Delaware and the issuer's home state followed the expected patterns. For example, column 1 of Table 1.5 reports the coefficients for a probit regression that explored the impact on the choice of state of incorporation of whether the issuing company and the underwriter's lawyer were from the same state. The coefficients indicate the variables' estimated impact on the probability that the firm will incorporate in Delaware.

All of the coefficients were statistically significant at the 99% confidence level.

The first coefficient in column 1 indicates that, in general, if the underwriter's lawyer and the issuing company are from the same state, then the probability that the company will incorporate in Delaware decreases substantially. Or conversely, if the lawyer and company are not from the same state, then the probability of incorporation in Delaware increases. This pattern is consistent with the following. Only if the lawyer is from the issuer's home state, and so is familiar with the state's law, will the lawyer recommend incorporation in the home state. In contrast, if the lawyer is not from the issuer's home state, and so is unfamiliar with that state's law, then the lawyer recommends incorporation in Delaware. This is consistent with the survey results above.

The exception to this rule is if the lawyer and company are both from New York: then, as the second coefficient in column 1 indicates, the probability of incorporation in Delaware increases. This is consistent with the

Table 1.5 Influences on state of incorporation

Variable	Column 1 Coefficient, Underwriter's lawyer regression	Column 2 Coefficient, Issuer's lawyer regression
Underwriter's lawyer and company from same state. That state not New York.	−0.20	−0.60
Underwriter's lawyer and company both from New York.	0.55	0.81
Venture capital firm involved	0.49	0.58

Note: Dependent variable is whether company is incorporated in Delaware.

following. Although the lawyer is knowledgeable about the law of the issuer's home state, the lawyer recognizes that the law is flawed. Therefore, the lawyer urges incorporation in Delaware, the other state whose law the lawyer knows. We have not yet run the regression for California, but we expect the results to be similar.

The third coefficient in column 1 indicates that, if a venture capital firm is one of the issuing company's shareholders, then the probability of incorporation in Delaware increases substantially. The common understanding is that venture capitalists are primarily focused on the success of the IPO, rather than on anything that might happen to the company after the IPO, such as mergers or takeover activity. This is because the venture capital firm almost always sells all of its stock during the IPO. And most venture capitalists (VCs) feel that incorporation in Delaware increases the IPO's marketability.[123]

This result contrasts with our inferences from the survey responses. The lawyers in the survey appeared to believe that venture capitalists' preferences played little role in the choice of state of incorporation. These regressions indicate that the lawyers may have underestimated the VCs' role, perhaps because the lawyers were so focused on their own roles.

[123] One of us experienced the power of the venture capitalists' views on incorporation in Delaware prior to a recent IPO. The lawyer advised incorporating in the issuer's headquarter state, only to be met by an objection from a foreign venture capitalist that 'everyone knows you can't go public unless you're incorporated in Delaware.' Two other venture capitalists on the board nodded their assent, and the discussion was over.

Column 2 of Table 1.5 reports the results for an identical regression as in column 1, except that it examines the impact of the lawyer for the issuer, rather than of the lawyer for the underwriter as in Table 1.1. The results are similar to the results for the underwriter's lawyers: the lawyer's being from the same state as the issuer decreases the probability that Delaware will be chosen, except for when the common state is New York. However, the sizes of the impacts for the issuer's lawyer are even larger. This suggests that, although both the issuer's lawyer and the underwriter's lawyer influence the choice of state of incorporation, the influence of the lawyer for the issuer is greater.

These results are robust. A broad range of other specifications yielded similar results.

6. CONCLUSION

If one accepts the conclusion of our earlier article that Delaware corporate law has declined in certainty and flexibility since Romano's survey in the 1980s, the continued pre-eminence of Delaware as a preferred jurisdiction seems puzzling. To be sure, Delaware's courts are efficient and generally decide cases with considerable expedition – a major concern in business and commercial disputes. The irony of this statement is that their efficiency and expertise arise because their judges get so much practise, from a continuing flow of disputes driven by the uncertainties and openness of Delaware law. We can only conclude that the lawyers making incorporation choices at the time of an IPO, in contrast to those choosing upon reincorporation, suffer from bounded rationality in choosing. This limitation may arise from one of two factors: their inexperience with M&A work or their ignorance of competing state laws other than those for their own states. These limits create powerful path dependence that may preserve Delaware's pre-eminent position regardless of what competing states may do.

APPENDIX A UNDERWRITER'S COUNSEL QUESTIONNAIRE

This IPO:

My and my law firm's advice was to incorporate in (check the box):
___ Delaware; ___ the issuer's home office location; ___ (other – please specify)_____.

The issuer or its counsel advised incorporating in (check the box):
___ Delaware; ___ the issuer's home office location; ___ (other – please specify)______.
___ When my firm began representing the underwriter, the issuer was already incorporated in the state that was later used for the IPO.
___ Venture capitalists with a stake in this corporation advised that it be incorporated in Delaware.

General Patterns of Advice in Other Transactions:

I generally advise (check one):
____ incorporation of public corporations in Delaware regardless of the corporation's location.
____ incorporation in my state of public corporations that are located in my state (where I work).
____ incorporation in my state of public companies regardless of where they are located.
____ incorporation in [name of state] __________________ regardless of where they are located.

I generally *don't* advise (check all applicable):
___ incorporation of public corporations in Delaware.
___ incorporation of public corporations in my state.
___ I'm generally comfortable with advising issuers located in my state to incorporate here, but not issuers located in other jurisdictions.
___ I'm generally comfortable with using the issuer's home state, wherever it may be, for incorporation.

The Nature of My Practice:

I practice securities and corporate finance (check all applicable):
___ more than any other single area of law.
___ more than most other attorneys in my office.
___ more than half of my time.
___ less than half of my time.
___ less than one-quarter of my time.
I work on mergers and acquisitions (check one)
___ more than half of my time; ___ less than half of my time; ___ almost never.

My View of Delaware Law and the Law of My Home State:

___ My state is a better place than Delaware to incorporate for public companies.
___ A state other than my state or Delaware is the best place to incorporate for public companies.

Delaware is a better place than my state to incorporate for public companies because (check all applicable):
___ investors are more familiar with Delaware law.
___ Delaware law is superior in dealing with proxies, shareholders' meetings and share transfers.
___ Delaware law is superior in dealing with mergers and acquisitions.
___ Delaware courts are more solicitous of shareholder rights in litigation.
___ Delaware courts provide for a speedier, more-predictable resolution of corporate disputes.
___ other reason (please specify: ________________________________.

I *don't* recommend incorporation in states other than Delaware or my state because (check all applicable)
___ I lack confidence in the laws of the other states.
___ I lack confidence in their courts.
___ I am relatively unfamiliar with the details of the laws and courts of these other states.
___ other reason (please specify) ________________________________.

Comment – Comparing company law in Europe and the United States: some remarks inspired by Carney et al.'s presentation[1]

Maarten J. Kroeze

1. INTRODUCTION

I am greatly honoured to discuss Carney's speech. His contribution to the expanding body of literature on Delaware corporate law is original and thought provoking. It is also highly relevant for Europe and for the Netherlands. In my reaction to his speech, I will explain why the topic of his contribution is relevant for Europe and the Netherlands. I will conclude with some comments on the subject of Carney's speech. I have to admit that this was not an easy task because the results of his research are convincing. Hopefully, my comments can add something to the discussion today. I would like to mention beforehand that, for the sake of discussion, I will speak without reservations on topics of Delaware law. Please note that I do not pretend to be an expert in the field of Delaware law.

2. FREEDOM OF ESTABLISHMENT: COMPARISON UNITED STATES – EUROPE

First of all I would like to make some remarks about Europe and some comparative remarks about Europe and the United States.[2]

[1] The presentation by William J. Carney was based on his chapter with George B. Shepherd and Joanna M. Shepherd, 'Delaware Corporate Law: Failing Law, Failing Markets', published in this volume, p. 23.

[2] Some of these remarks were published earlier in: M.J. Kroeze, H.M. Vletter-van Dort, History and Future of Uniform Company Law in Europe, European Company Law 2008, 114–22.

2.1 The Start of European Company Law

On 25 March 1957, the Treaty establishing the European Economic Community was signed. The purpose of the Community was to promote the harmonious development of economic activity throughout the Community. One of the means to achieve this is to create an internal market that is characterized by the abolition, as between Member States, of obstacles to the free movement of goods, persons, services and capital (Art. 3 EC Treaty). As of 1 December 2009 the Treaty on European Union (TEU) and the Treaty on the Functioning of the European Union (TFEU) entered into force. The European Community does not exist any more as a name or distinct legal person and has been completely replaced by the European Union. An important purpose of the European Union remains the establishment of an internal market without internal frontiers, in which the free movement of goods, persons, services and capital is ensured (Article 3 TEU and Article 26 TFEU). Article 49 TFEU (formerly Article 43 EC Treaty) governs the right of establishment of nationals of the Member States and of legal persons, including companies:

> Freedom of establishment shall include the right to (. . .) set up and manage undertakings, in particular companies (. . .) under the conditions laid down for its own nationals by the law of the country where such establishment is effected (. . .).

Article 54 TFEU (formerly Article 48 of the EC Treaty) states that:

> Companies and firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Union shall, for the purposes of this Chapter [Chapter 2: Right of Establishment], be treated in the same way as natural persons who are nationals of Member States.

Article 50 (1) TFEU (formerly Article 44 (1) of the EC Treaty) stipulates that the European Parliament and the Council (a body consisting of national ministers of the Member States) shall act by means of directives in order to attain freedom of establishment as regards a particular activity. Article 50 (2) TFEU (formerly Article 44 (2) EC Treaty) provides that the European Parliament, the Council and the Commission shall carry out the duties devolving upon them under the preceding provisions, in particular under (g), 'by coordinating to the necessary extent the safeguards which, for the protection of the interests of members and others, are required by Member States of companies (. . .) with a view to making such safeguards equivalent throughout the Union'.

This article provided the supranational basis for unification of large parts of the company law of the Member States. Article 50 TFEU (formerly Art. 44 EC Treaty) was originally included in the EC Treaty at the request of France.[3] Several large countries, including France, were afraid that US history would repeat itself in Europe, namely that a state with attractive company law would become the number one incorporation state and that companies incorporated under the company law of this state would develop activities all over Europe.[4] The French were also afraid that the lower level of protection of minority shareholders and creditors in some other countries would be disadvantageous if company activities were to be developed across national borders, for example in France. The best way to deal with this fear was to impose harmonizing measures at European level. The harmonization programme was an attempt to create federal-like standards for company law.

In 1961, the Council presented a general programme to remove the obstacles to the freedom of establishment. From 1968 onwards, more than ten directives and several regulations in the field of company law were adopted.[5] In the early 1990s, European activities had largely come to a standstill. It was clear to everyone that the crucial Fifth Directive on the structure of public limited companies and the powers and obligations of their corporate bodies (the first proposal on which saw the light in 1972) would not get beyond the stage of a proposal. The goal to achieve an exhaustive set of rules for the European Company was forcibly abandoned in 1989. With that, the main reason for this regulation, namely far-reaching uniformity, was abandoned as well. At the same time, work on the Tenth Directive on cross-border mergers had come to a standstill. The reason for this was the existence of profound differences of opinion on the way in which employee participation should be designed. Some

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3 On this subject see also: J.A. McCahery, 'EU Company law Harmonisation: The Political Economy of Economic Integration', in: *Europese integratie*, *Preadvies voor de Nederlandse Juristen-Vereniging*, vol. 1 (European Integration: Preliminary Advice for the Dutch Lawyers Association) 2006, 155–205; L. Enriques, 'Company Law Harmonization Reconsidered: What Role for the EC', 2005 (http://ssrn.com/abstract=850005); C. Kirchner, R. Painter and W. Kaal, Regulatory Competition in EU Corporate Law after Inspire Art: Unbundling Delaware's Product for Europe, 2004 (http://ssrn.com/abstracht=617681).

4 See C.W.A. Timmermans, 'Europees vennootschapsrecht', *SEW* 2002, 249.

5 Directives and regulations are legislative acts of the European Union. A directive is binding, as to the result to be achieved, upon each Member State to which it is to be addressed, but leaves to the national authorities the choice of form and methods of implementation. A regulation has general application. It is binding in its entirety and directly applicable to all Member States (Article 288 TFEU).

thought that the attempts at harmonization had failed. Timmermans, a judge at the European Court of Justice, has argued that the main reason for the failure was that the European Parliament, the Council and the Commission had never been able to reach agreement on the needs and objectives of the harmonization of company law. He also noted that the business community had never called for harmonization and that there was an impression that the lack of harmonization had never stood in the way of entrepreneurs.[6]

2.2 Freedom of Establishment in Europe and the United States

One may wonder whether harmonization leading to a uniform company law is a necessary condition to achieve the objective of free establishment in an internal market set by the EU. In fact, on the territory of the United States, 51 different company law systems function alongside one another.[7] Nevertheless, American companies within the United States are hardly inconvenienced by this diversity of law. On the territory of the European Union, despite the aforementioned attempts to harmonize, 27 different company law systems function alongside one another. Articles 49 and 54 TFEU guarantee the freedom of establishment of companies within the European Union. Nevertheless, the freedom of establishment of companies within the European Union is seriously hampered.

There are basically two reasons for the fact that what does not work in the European Union does work in the United States.[8] The first reason is that different company law systems in the United States have more in common with one another on a basic level than the different company law systems in Europe. Company law in the 50 American States and the District of Columbia may well be different, but the similarities between the different systems are striking (at least for an outsider). In the course of a century and a half, the systems have grown together to such an extent that they are founded on the same starting points and are largely interchangeable. This comes as a result of the common origin of the

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[6] C.W.A. Timmermans, 'Europees vennootschapsrecht', *SEW* 2002, 249.

[7] The company law of 50 states and the District of Columbia.

[8] For a comparison between the American and European situation, see: P. Leleux, 'Corporation Law in the United States and in the E.E.C., Some Comments on the Present Situation and Future Prospects', *CMLR* 1968, 133–76 and H. Merkt, 'Das Europäische Gesellschaftsrecht und die Idee des "Wettbewerbs der Gesetzgeber"', *RabelsZ* 1995, 545–68. See also M. Gelter, 'The Structure of Regulatory Competition in European Corporate Law', 5 *Journal of Corporate Law Studies*, 2005, 247–8.

principles of trust law and the law of representation, on which company law is based. It also has to do with the large extent to which State legislators have consulted with one another and with the regulation at federal level of, for example, securities law, tax law and a great many other regulations. The dominance of the law of the State of Delaware also plays a major part, as does a model company law, which the American Bar Association has drafted. This model Act, the Model Business Corporation Act, is followed wholly or partially in more than 30 States. Lastly, it is important to note that the American economy consists less of sub-economies than Europe, a single language is spoken, a common currency has existed for a very long time and there is a shared common law and a national American identity.[9]

The situation in Europe is very different from that in the United States. Notwithstanding the fact that there are 23 official languages in the European Union and that a European identity is not felt to be as strong as are national identities, there are fundamental differences in structure between forms of companies in the different Member States of the European Union.[10] For example, some Member States – including Germany and the Netherlands – have a statutory two-tier board model. This means that management and supervision of management are exercised by two separate bodies. Most other Member States use a one-tier board model. The managers in charge of the day-to-day company affairs and the supervisors have seats on one single board. Besides this fundamental distinction, there are a number of unique regimes at national level. For instance, Dutch law introduced a mandatory two-tier board regime for large companies. Part of this two-tier regime is that

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[9] Regarding harmonization in the United States, see the fine essay by Whitmore Gray, 'E pluribus unum? A Bicentennial Report on Unification of Law in the United States', *RabelsZ* 1986, 111–65 and Peter Winship, 'Unification of Law in the United States: an Updated Sketch', *Uniform Law Review* 1996, 633–51. See also M.J. Kroeze and H.M. Vletter-van Dort, 'Eenvormig vennootschap-srecht: een oud deuntje of toekomstmuziek, in: Eenvormig bedrijfsrecht: realiteit of utopie?', Bju: Den Haag, 2006, pp. 73–92 and W.W. Bratton, J.A. McCahery and E.P.M. Vermeulen, 'How Does Corporate Mobility Affect Lawmaking? A Comparative Analysis', 2008 (http://ssrn.com/abstracts=1086667).

[10] For a comparison between the American and European situation, see P. Leleux, 'Corporation Law in the United States and in the E.E.C., Some Comments on the Present Situation and Future Prospects', *CMLR* 1968, 133–76 and H. Merkt, 'Das Europäische Gesellschaftsrecht und die Idee des "Wettbewerbs der Gesetzgeber"', *RabelsZ* 1995, 545–68. See also M. Gelter, 'The Structure of Regulatory Competition in European Corporate Law', 5 *Journal of Corporate Law Studies* 2005, 247–8.

employees have influence on the composition of the supervisory board. Under German law, the supervisory board has a number of representatives which are directly elected employees. In British companies, on the other hand, employee representation through the means of company law is absolutely unacceptable. This causes problems for the freedom of establishment. Foreign companies might be formed to thwart employee participation.

In addition, the internal market does not prevent the existence of great differences in the European economic infrastructure in the various Member States. Tax legislation in Europe has only been harmonized in a fragmentary manner. The role of the different groups within companies, such as employers, employees and financiers, is also different in each country. In some countries, for example, the trade unions play an important role. In others, they do not. In the United Kingdom, a much larger percentage of companies is listed on the stock exchange than in other European countries. Of all acquisitions on the European stock exchanges, by far the most take place on the London Stock Exchange. In Germany, banks have great influence on how companies are run. They hold large packages of shares and they are often represented on the supervisory boards. In southern Member States, many of the companies are controlled by families. There are also great differences in the general private law of the different countries; for instance between France and Germany alone, but even more so between Britain and Ireland on the one hand and the continental legal systems on the other hand. In most European Member States, company law is embedded in national private law.

The second reason for the fact that what does not work in the European Union does work in the United States is that the US Constitution and US conflict law guarantee much better and more absolutely that there is freedom of establishment within the United States than the primary European Union law (TEU and TFEU) and the different national conflict rules have achieved up to now for the European territory. The development of the American freedom of establishment started more than 150 years ago as a direct consequence of large railway lines that were laid in the second half of the nineteenth century. The laying of railways itself was an interstate affair. More important, however, was that the presence of railways allowed interstate commerce to flourish. American States were then regularly faced with commercial activities of companies formed according to the laws of other States. It was not long before the first legal actions were a fact. In these actions, companies complained that they were faced with obstacles to commerce in States other than the one in which they were formed. They relied on the US Constitution in this context. In the American judicial system, the principles of freedom of establishment for companies were developed on the basis of that document.[11] For instance, on the basis of the commerce clause of the Constitution (Art. 1, Section 8, third paragraph of the Constitution of the United States of America), States may not hinder interstate commerce and, for example, may not take any measures that favour local companies over companies from other States.[12] The US Supreme Court has meanwhile added that discriminatory measures are also not permitted if a company from another State does not engage in interstate commerce, but only develops activities within the boundaries of another State.[13] A second means of constitutional protection is provided by the due process clause (14th Amendment).[14] On this basis, all persons – including companies – have a right to equal treatment and no one can lose his freedom or property without due process of law.[15] The third means of protection is the full faith and credit clause (Art. 4, Section 1).[16] On this basis, each State must recognize the laws of other States and court judgments passed in other States, without limitations.

In addition to these constitutional rules, all American States apply the

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[11] See P. Leleux, 'Corporation Law in the United States and in the E.E.C., Some Comments on the Present Situation and Future Prospects', *CMLR* 1968, 133–76. See also C.R. Huiskes, *De Europese vennootschap*, Zwolle: W.E.J. Tjeenk Willink 1993, 112–26.

[12] This was ruled in: *Bank of Augusta v. Earle*, 38 US (13 Pet.) 519, 10 L.Ed. 274 (1839); *Paul v. Virginia*, 75 US (8 Wall.) 168, 19 L.Ed. 357 (1868); *Railway Express Agency v. Virginia*, 282 US 440, 51 S.Ct. 201, 75 L.Ed. 450 (1931). The relevant part of the *commerce clause* reads: 'The Congress shall have power to (. . .) regulate commerce with foreign nations, and among the several states, and with the Indian tribes'.

[13] *Western & Southern Life Insurance Co. v. State Board of Equalization of California*, 451 US 648, 101 S.Ct. 2070, 68 L.Ed.2d 514 (1981): '[W]hatever the extent of a state's authority to exclude foreign corporations from doing business within its boundaries, that authority does not justify imposition of more onerous taxes or other burdens on foreign corporations than those imposed on domestic corporations, unless the discrimination between foreign and domestic corporations bears a rational relation to a legitimate state purpose'.

[14] The relevant part (Section 1) of the 14th Amendment reads as follows: 'All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws'.

[15] The groundbreaking judgments are: *Santa Clara County v. Southern Pacific Railroad Co.*, 118 US 394, 6 S.Ct. 1132, 30 L.Ed. 118 (1886) and *Minneapolis & St. Louis Railway Co. v. Beckwith*, 129 US 26, 9 S.Ct. 207, 32 L.Ed. 585 (1888).

[16] This provision reads: 'Full faith and credit shall be given in each State to the public acts, records, and judicial proceedings of every other State. And the

so-called internal affairs doctrine.[17] The question of the law applicable to the internal affairs of a company was not an issue at the time when companies developed activities only in the State where they were formed. There was no reason at all to apply any law other than the law of that State. The question of the applicable law – just as freedom of establishment – only became relevant when companies which were formed in one State developed activities in another.

2.3 The Current Status of European Company Law

From 2001, the European Commission has been working on its European programme with renewed enthusiasm, albeit from a different perspective. Harmonization – and thus uniformity – has now become less of an objective in itself. The new perspective is mainly aimed at guaranteeing and encouraging cross-border cooperation and freedom of establishment, whilst taking into account the differences existing among the Member States. This new approach was partly inspired by the important position that has been given to the so-called 'subsidiarity principle' in the (former) EC Treaty since 1992. Under the principle of subsidiarity, in areas which do not fall within its exclusive competence, the European Union shall act only if and as far as the objectives of the proposed action cannot sufficiently be achieved by the Member States, either at central level or at regional and local level, but can rather, by reason of scale or effects of the proposed action, be better achieved at Union level (Article 5 TEU).

At the end of 2001, the European Commission established the High Level Group of Company Law Experts. The High Level Group advised the European Commission on desired company law reforms. Based on this advice, the Commission presented its Communication on 'Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward' on 21 May 2003.[18] The Commission's action plan is a policy document which gives an overview of European ambitions. The action plan is intended to increase the efficiency and ability to compete of the European business community and is aimed at enhancing

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Congress may by general laws prescribe the manner in which such acts, records, and proceedings shall be proved, and the effect thereof.'

[17] Restatement (Second) of Conflicts of Laws, §§ 296–310 (1971). Regarding the *internal affairs doctrine*: see Deborah A. DeMott, 'Perspectives on Choice of Law for Corporate Internal Affairs', *L.& Contemp. Probs* (48) 1985, 161–98.

[18] *Communication from the Commission to the Council and the European Parliament – Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward*, COM/2003/0284.

the rights of shareholders and protecting employees, creditors and other stakeholders of an undertaking. This last objective sounds familiar. It is a phrase constantly repeated in the preambles of the European company law directives. The way to achieve that objective is, however, essentially different. It is aimed less at uniformity and more at interchangeability because it places the accent on facilitating cross-border entrepreneurship within Europe in order to improve the competitive position of Europe as a whole.

What is the status of freedom of establishment in Europe at this moment? To date, there has been no question of complete freedom of establishment for companies in the territory of the European Union. This has to do with the conflicts of laws rule applied by most Member States to determine which law applies to a certain company. Most European Member States apply the actual registered office doctrine as a conflict rule.[19] On the basis of this doctrine, the law applicable to a legal entity is that of the country in which the legal entity has its actual registered office. Actual registered office means the place of establishment of the management. The requirements of formation, organization and dissolution of the company are then governed by the law of the country in which the legal entity has its actual registered office. The actual registered office doctrine is based on nationalistic motives. The doctrine offers a country the possibility to keep foreign companies off its territory. This doctrine is not compatible with the text and tenor of the primary European Union law (TEU and TFEU). The European legislator has not been able to ban the doctrine of the actual registered office. Even the Regulation in which the *Societas Europaea* (hereinafter SE) was created (adopted in 2001) retains the actual registered office doctrine in Article 7, by requiring that the registered office must be located in the same Member State as its head office.

Just as in the United States, where the guarantee of freedom of establishment came from the highest court in the second half of the nineteenth century, in Europe the guarantee of freedom of establishment comes from the highest court. The European Court of Justice, in several ground-breaking judgments – namely the *Centros* judgment of 1999, the *Überseering* judgment of 2002 and the *Inspire Art* judgment of 2003 – took a course that was expected to mark the end of the actual registered office doctrine.[20] Some even argued – optimistically – that these judgments

[19] See P. Vlas, *Rechtspersonen*, Deventer: Kluwer 2002, no. 28–31 and 143–57.

[20] CJEC 9 March 1999, case C-212/97, ECR 1999, p. I–1459; CJEC 5 November 2002, case C-208/00, ECR 2002, p. I–9919; CJEC 30 September 2003, case C-167/01, ECR 2003, p. I–10155.

had already put an end to the actual registered office doctrine within the territory of the European Union. The importance of the case law of the European Court of Justice for freedom of establishment was once more emphasized in the *Sevic* judgment of 2005.[21] In this judgment, the European Court of Justice ruled that Articles 43 and 48 of the EC Treaty (now Articles 49 and 54 TFEU) are applicable to cross-border mergers. According to the Court of Justice, the German Commercial Register's refusal to register a cross-border merger is an obstacle to the freedom of establishment. A more restrictive interpretation of the EC Treaty (now the TFEU) than one could have expected on the basis of the aforementioned case law was given in the recent *Cartesio* judgment.[22] A Member State is still allowed to apply the actual registered office doctrine to companies that were established in that Member State. The European Court of Justice stated that a Member State has the power not to permit a company governed by its law to retain that status if the company intends to reorganize itself in another Member State by moving its seat to the territory of the latter, thereby breaking the connecting factor required under the national law of the Member State of incorporation. We will have to wait for future case law of the European Court of Justice and for the interpretation of this future case law by the highest courts in the individual Member States for more clarity on the freedom of establishment.[23] At this moment we can conclude that the European Court of Justice has done more for the freedom of establishment of companies in Europe than the European legislator.

This could change if the policy program of the European Union for 2010–14 (the Stockholm Program) is successfully implemented. The following statement is included in this program: 'The European Council considers that the process of harmonising conflict-of-law rules at Union level should also continue in areas where it is necessary, like separation and divorces. It could also include the area of company law, insurance contracts and security interests.'[24] The Commission has included the

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[21] CJEC 13 December 2005, case C-411/03 (*Sevic; Ondernemingsrecht* 2006, p. 115 ann. Schutte-Veenstra). See also G.-J. Vossestein, 'Companies' Freedom of Establishment after Sevic', *European Company Law* 2006/4, 177–82.

[22] CJEC 16 December 2008, case C-210/06.

[23] It is quite conceivable that some national courts will interpret the judgments of the European Court of Justice in the most limited way possible and the question is whether this interpretation will shortly be brought before the European Court of Justice, and if this happens, whether the limited interpretation will be quashed.

[24] The Stockholm Program has been published at: http://www.se2009.eu/polopoly_fs/1.26419!menu/standard/file/Klar_Stockholmprogram.pdf.

harmonization of rules on the law applicable to company law among its priority issues.[25]

Even so, one should not underestimate the importance of the attempts at the political-administrative level. I stated above that the company law in the 51 United States jurisdictions is different, but that it is striking how great the similarities are. In the course of a century and a half – in a national economy in which the same language is spoken and in which most of the legal system is the same – those systems have grown together to such an extent that they show a great resemblance to each other. In the United States, a stranger in town is still a familiar face. In addition to the legal recognition of real freedom of establishment – which we in Europe seem to be getting more and more – this similarity and interchangeability of companies is an important practical condition for freedom of establishment. Cross-border mergers and relocation of registered offices will be conceivable only if this does not have to be linked with too much legal juggling. Member States will only be willing to admit unconditionally companies from other European legal systems to their territory if there is at least a certain connection between these legal forms and their own legal systems. That this is the case is illustrated by the recently adopted EC Directive on cross-border mergers, which has been dusted off after more than 20 years.[26] In the explanatory memorandum to the Directive, the European Commission writes the following:

> At present, as Community law now stands, such [cross-border] mergers are possible only if the companies wishing to merge are established in certain Member States. In other Member States, the differences between the national laws applicable to each of the companies which intend to merge are such that the companies have to resort to complex and costly legal arrangements.

3. COMPARISON DELAWARE – THE NETHERLANDS

I will now make some comparative remarks about Delaware and the Netherlands. First of all, the Netherlands and Delaware have some things

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[25] Communication from the Commission to the European Parliament and the Council, An area of freedom, security and justice serving the citizen, COM (2009) 262 final.

[26] Directive No. 2005/56/EC of the European Parliament and of the Council of 26 October 2006 on cross-border mergers of limited liability companies (OJ 2005, L 310/1). See for an insightful article: L. Enriques, 'EC Company Law Directives and Regulations: How Trivial are They', 2005 (http://ssrn.com/abstract=730388).

in common. Not only is milk the national Dutch beverage, as it is officially in Delaware according to Section 312 of the Delaware State Code, the Netherlands is also a small state in a federation of larger states.[27] Before large parts of the state company laws in the European Union were harmonized, the Netherlands was sometimes characterized as the 'Delaware of Europe'. The Dutch legislator had implemented the internal affairs rule as far back as 1959 (in a Europe where the actual registered office doctrine was dominant).[28] Dutch company law was flexible and enabling in those days. There were, for example, no capital requirements and there was a lot of freedom for the incorporators to arrange the internal affairs of a company according to their wishes. The European harmonization programme took away – as one of its implicit goals – much of the original flexibility of Dutch company law.

Carney argues that the quality of Delaware company law is declining. I refer to his contribution in this book for the foundations of his argument. His assertion should also be a warning for Dutch company law. Just like Delaware, the Netherlands is one of the few countries in the world to have a specialized business court: the Companies and Business Court of the Amsterdam Court of Appeal.[29] The court plays an important role in shaping Dutch company law. The court is competent if there appear to be well-founded reasons to doubt the correctness of the policies or the conduct of a company. This is a vague standard. This contributes to the indeterminacy of Dutch law. The court can take far-reaching provisional measures and has done so in large cases during recent years on subjects such as the requirement for a shareholder vote for the sale of virtually all of a company's assets, takeover battles, conflicts of interests and a system of extra dividends for loyal shareholders.

The president of the Companies and Business Court is inspired by equity courts such as the court of chancery in Delaware, and Dutch scholars have argued that the case law of the Companies and Business Court in takeover battles is inspired by and resembles the case law of the Delaware courts.[30]

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[27] § 312 State Code: 'Milk shall be the official beverage of the State'.

[28] Arts 2 and 3 WCC. See P. Vlas, *Rechtspersonen*, Deventer 2002, no. 49–65.

[29] See also M.J. Kroeze, 'The Companies and Business Court as a Specialized Court', in: *The Quality of Corporate Law and the Role of Corporate Law Judges*, Amsterdam: ACCF/NMEA/OECD 2006, pp. 143–54 and M.W. Josephus Jitta (ed.), *The Companies and Business Court from a Comparative Perspective*, Deventer: Kluwer 2004.

[30] This reference is to President Willems, who has resigned as president in August 2009. See, for such a Dutch scholar: M.P. Nieuwe Weme, in *Het Financieele Dagblad*, 5 May 2007.

The complaint by some Dutch scholars and practitioners is that the standards of review in these proceedings are too vague and that the outcome of legal proceedings is highly uncertain. In addition to this, Dutch law does not have a business judgment rule. Liability issues are considered on the basis of a standard of 'serious culpability'. This is a vague substantive standard, which provides directors with little guidance and forces courts to assess a director's business decision substantively in hindsight.[31]

With Carney's warning in mind, the conclusion seems inescapable: the quality of Dutch company law is – just like the quality of Delaware company law – declining, and Dutch company law is doomed to fail in a competitive environment. The Netherlands has no pre-eminent position at this moment and cannot profit from path dependence. One first good step would be to implement an equivalent of the business judgment rule in liability proceedings. At present, there is an ongoing discussion in the Netherlands on the competence of the Companies and Business Court and its authority to take provisional measures has been limited (slightly) by the Dutch Supreme Court.

On the other hand, most disputes adjudicated by the Companies and Business Court are disputes in closed companies. Most of these disputes do not arise as a consequence of vague notions in the law. They are a consequence of personal conflicts between partners in a joint venture or between family members. In most of these cases, clear rules would not have prevented the personal conflict, and vague standards give the Companies and Business Court a broad authority to end these conflicts in a practical and case-specific way. This could be a reason to implement different standards for public and private company settings.

4. SOME REMARKS ON CARNEY'S CONCLUSION

I will conclude with some remarks on Carney's conclusion that lawyers driving the incorporation choice suffer from bounded rationality about alternatives to Delaware law that are likely to preserve Delaware's dominance, at least at the time of an IPO. That conclusion raises some questions. Could a real decline in the quality of the Delaware company law

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[31] It seems that the reversal rate of judgments by the Companies and Business Court is higher than judgments in other civil courts: K. Cools, P.G.F.A. Geerts, A.C.W. Pijls and M.J. Kroeze, *Het recht van enquête, Een empirisch onderzoek*, Deventer: Kluwer 2009, pp. 28–9. For a comparable observation on the Delaware Chancery Court, see the contribution by W.J. Carney, G.B. Shepherd and J.M. Shepherd in this volume.

system remain for such a long period a secret for practitioners? And would in-house company lawyers not be more critical than advisers with regard to the best possible company law system?

I will try to offer some complementary explanations. Delaware has a large financial interest in the incorporation business. Revenues from franchise tax and the turnover of professional services firms in the company law field are huge and form a substantial part of state revenues. Delaware therefore has a powerful financial incentive to have attractive and efficient company laws. The situation Carney and his co-authors describe in their written contribution, that several states have suffered setbacks in the process of modernizing their company laws because other political interests have intervened, is not likely to happen in Delaware. Political interests other than the interest to keep Delaware as the number one incorporation state hardly ever intervene in Delaware company law. It is Delaware's core business and a substantial and steady source of income.

A reason for the continuing success of Delaware could be that lawyers, although they are aware of the declining quality of Delaware company law, also know that the incentive to stop declining quality and restore quality could not be greater in any other state than in Delaware. This inherent incentive of the Delaware administration (and I assume also of the bar and the judiciary) is an aspect of the quality of its company law. Therefore, it could prove more efficient in the long run to incorporate in Delaware than in any other state.

I have a second complementary explanation. Suppose lawyers have the ambition to give the best possible advice to their knowledge. They will at the same time have the inclination to minimize the risk that this best possible advice is actually rather bad advice. In my opinion, these two factors discourage revolutionary choices and favour a choice for the company law of Delaware. Lawyers prefer the risk of being wrong collectively than being wrong alone and probably even prefer a greater risk of being wrong collectively than a smaller risk of being wrong alone.

I will mention two last (rhetorical) questions, which could be interesting for the discussion. First, are the buyers of shares in Delaware companies' IPOs also suffering from bounded rationality concerning Delaware company law? Second, if they are not, would not the market for corporate control – maybe when the current crisis is over – be the best way to evaluate the added value of Delaware company law?

2. Incorporating under European law: the Societas Europaea as a vehicle for legal arbitrage*

Horst Eidenmüller, Andreas Engert and Lars Hornuf

INTRODUCTION

When Council Regulation (EC) No. 2157/2001 on the Statute for a European Company (Societas Europaea – SE) became effective on 8 October 2004, the first supranational type of company entered the European stage. After one year, only 16 firms had ventured into the new territory. The European Company seemed to be the stillborn that many commentators had predicted. In the following years, however, the SE refuted the critics. With annual growth rates of around 100 per cent, the number of European Companies had eventually increased beyond 200 by April 2008.[1] If SE incorporations continue at the same pace, more than a thousand firms will have chosen this European corporate form by the year 2010.

The SE's growing success raises the question of what is driving SE incorporations. In this chapter, we argue that legal arbitrage – exploiting differences between the legal rules of different jurisdictions – is the primary motive for managers and shareholders to opt for the SE. Although the SE Regulation fails to provide a fully-fledged company law regime and refers

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[1] See *infra* sections 'Data from Company Registers' and 'Time Trend'.

many matters to the laws of the Member States, there might still be enough scope for legal arbitrage to render the SE more attractive than domestic companies of at least some Member States.[2] Since the European legislator created the SE to facilitate business activity in the European Union (EU) internal market, it seems straightforward (and even trivial) that the SE should offer certain advantages over national companies, particularly with a view to cross-border corporate mobility. Some commentators have even suggested that the opportunities for legal arbitrage extend far beyond the advantages envisaged by the European legislator. In their view, firms can use the SE corporate form to escape various restrictions of Member State law, even ones that do not relate to cross-border mobility (Enriques 2004a; Reichert 2008). By contrast, others have argued that the absence of specific tax rules for the SE, as well as the complexity of the incorporation process, work against potential cost savings and hence against legal arbitrage (McCahery and Vermeulen 2005; Bratton et al. 2008). Whether and in what regard the SE is indeed an attractive vehicle for legal arbitrage is an open and empirical question.

In attempting to resolve this question, we cannot rely on a large dataset that would allow us to apply advanced econometric techniques. Therefore, we decided to follow a dual empirical strategy. This approach allows us to compare the results of two distinct methods and to evaluate the robustness of our findings. In a first step, we conducted a structured telephone survey among German SE users[3] to ask them about their motives for choosing the European corporate form. In a second step, we broadened the scope of the analysis to the European Economic Area (EEA) by using a simple ordinary least squares (OLS) regression model. Both approaches are based on a unique dataset, drawing on information from national company registers as well as the Official Journal of the European Union (OJEU).

We find that the SE enjoys increasing popularity only in some jurisdictions. The evidence indicates that the domestic regulatory environment has a strong impact on SE formations. Legal arbitrage seems to be a primary motive for entrepreneurs using the new supranational legal form. More specifically, we find strong evidence that mandatory worker co-determination is driving SE incorporations – firms seek to reduce the effect of such co-determination regimes. The option to transfer the registered office, the availability of the one-tier board structure and the opportunity

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[2] By transferring the registered office to another Member State, the SE can also be used to shop for the most favourable gap-filling company law; see *infra* our hypothesis H3.2.

[3] See *infra* section 'Telephone Survey'.

to consummate a cross-border merger also seem to explain SE formations.

The chapter is structured as follows: we start out with a brief overview of the literature on corporate charter competition and legal arbitrage. In the following section, we suggest five hypotheses on the driving forces behind SE formations that guide our empirical analysis before introducing the dataset and the methodology used. The empirical results are presented subsequently, followed by a concluding section.

LITERATURE

Legal arbitrage can be defined as taking advantage of differences between legal regimes governing the same economic activities (or close substitutes). In the case of company law, legal arbitrage may occur, especially when firms can choose to incorporate in different jurisdictions without having to relocate their business activities. Corporate law arbitrage is a demand-side precondition for charter competition among jurisdictions: if firms do not react to differences in company law, there is no point in jurisdictions competing for incorporations.[4] Legal arbitrage, therefore, bears on the longstanding academic debate on charter competition. As is well known, Cary (1974) argued that corporate charter competition resulted in a 'race to the bottom' and thus justified federal intervention. The opposite claim was made by Winter (1977), who asserted that competition between states would tend to produce optimal legal rules, rendering federal regulation dispensable and even harmful. The debate since then has not led to firm conclusions. Evaluating the literature after 20 years, Bratton (1994) depicts corporate charter competition as a race to 'nowhere in particular', benefiting some stakeholders but not others. It has also been claimed that the dominant position of Delaware is mainly due to network effects (Klausner 1995) and not the result of superior corporate law. The empirical evidence on the effects of charter competition in the United States is similarly inconclusive. To analyse the efficiency of competing corporate law regimes, event studies have been used to determine how reincorporations – typically to Delaware – affect firm value. The available evidence tends to confirm that

[4] Note that legal arbitrage is not sufficient for charter competition (see Enriques 2004a): despite arbitrage activity, jurisdictions can still choose not to compete, for instance, because they lack incentives to attract incorporators or due to interest group pressure. Moreover, while 'legal arbitrage' is sometimes employed in a pejorative sense, we use it as a purely descriptive term.

reincorporations *enhance* shareholder value as measured by stock prices,[5] indicating that charter competition may lead to more efficient corporate law. However, the fact that Delaware offers relatively strong anti-takeover protection and that these provisions seem to be driving incorporations has shed doubt on these results (Bebchuk and Cohen 2003).

Until recently, charter competition was mostly irrelevant in the EU/EEA. European company law has been characterized as a long-term non-compete agreement among Member States (McCahery and Vermeulen 2005) under the influence of intense interest group pressure (Carney 1997). Beginning in 1999, a line of cases decided by the European Court of Justice (ECJ) has fundamentally transformed the corporate law landscape. Under the new case law, firms can incorporate in any Member State even if their business activities are located elsewhere in the EEA. Also, while transferring the registered office of an existing company to a different jurisdiction used to be difficult or even impossible (Enriques 2004b), the enactment of Cross-border Merger Directive 2005/56/EC and its transposition into Member State law will greatly facilitate such reincorporations. The emergence of charter competition in Europe is discussed, among others, by Eidenmüller (2007) and Tröger (2005). Empirical work on legal arbitrage and charter competition in Europe is sparse. Becht, Mayer and Wagner (2008) conducted a thorough and highly influential analysis. They identify minimum capital requirements and the regulatory burden on start-ups as a major driver for choosing a foreign corporate law. Apart from this, the empirical literature is confined to the burdensome task of collecting descriptive statistical data (see, for example, Niemeier 2007; Eidenmüller 2007).

The advent of the SE has extended the menu of options for incorporators. It has been suggested that the SE is an attractive vehicle for legal arbitrage, enabling firms to shop for a more favourable corporate law as well as to save on corporate taxes by moving to a different tax jurisdiction (Enriques 2004a; Reichert 2008). Indeed, the SE corporate form facilitates cross-border mergers as well as a transfer of a company's registered office; it allows public companies to switch to a one-tier board system, to reduce the size of supervisory boards in large firms and to avoid worker co-determination or freeze the existing level of co-determination in medium-sized firms (Reichert 2008). So far, there is only anecdotal evidence on whether and to what extent firms have exploited these potential advantages of the SE. Some commentators are sceptical as to its legal arbitrage

[5] Romano (1993) (citing event studies); Daines (2001) (using a different methodology); but see Subramanian (2004).

potential. Bratton, McCahery and Vermeulen (2008) claim that the SE has opened the door, but not widely enough to serve as a vehicle for legal arbitrage. They argue that switching to the SE is too expensive and future benefits for firms are largely uncertain.

The demand for the SE and whether it is driven by legal arbitrage (rather than, say, the SE's European image) has not been subjected to rigorous empirical scrutiny. Again, most empirical contributions have focused on keeping track of the number and regional dispersion of incorporations (Bayer and Schmidt 2008; Eidenmüller et al. 2008). In this respect, the website of the European Trade Union Institute in collaboration with the Hans Böckler Foundation now provides an up-to-date overview of SE incorporations that can be accessed at a fee.[6] Keller and Werner (2007, 2008) survey the design of worker co-determination adopted in individual SEs, thus providing case study evidence on one important aspect of legal arbitrage. A more comprehensive empirical analysis on the reasons for incorporations under European law and, more specifically, the use of the SE as a vehicle for legal arbitrage, is still lacking. It is to this that we now turn.

HYPOTHESES

The SE is in many respects comparable to a national public company. The taxation, insolvency rules and even a great deal of the applicable corporate law are rather similar to those governing an entity established under national law. Nevertheless, there are some crucial differences that make the SE a convenient vehicle for legal arbitrage. We will consider in turn the factors that seem likely to influence SE formations and formulate testable hypotheses.

Setting up a company inevitably involves paying fees and carrying a certain bureaucratic burden. The SE is no exception. As with any firm, incorporation costs[7] should be expected to hamper SE formations.[8]

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6 Available at http://www.worker-participation.eu.

7 We define 'incorporation costs' as the expenses, delay, risk and loss in flexibility incurred in setting up a company. A minimum capital requirement imposes incorporation costs in the sense that it restricts the company's flexibility. Of course, the amount of the minimum capital *as such* does not constitute a cost as it can be invested by the company.

8 See Djankov et al. (2002) (providing evidence that a higher regulatory burden on firm entry results from rent-seeking by politicians and bureaucrats rather than from an attempt to remedy market failures).

Depending on the method used and the size of the company, the costs of switching to the SE corporate form can be significant: Allianz SE and BASF SE have estimated their reincorporation costs at €95 million and €5 million, respectively.[9] From a legal arbitrage perspective, the most interesting question to ask is whether SE incorporation costs *differ* from those of competing national company forms. For instance, if an SE were less costly to incorporate than a company under Member State law, this would constitute an additional opportunity for legal arbitrage. Differences in incorporation costs have been shown to be a major driver of demand in charter competition between national jurisdictions (Becht et al. 2008). If, on the other hand, the European Company faces relatively higher set-up costs, the advantages offered by the SE must be larger to overcome this additional hurdle.

Founding a European Company requires registration in the company's home state. At first blush, this would seem to preclude any difference in incorporation costs between the SE and the national companies of its home state.[10] However, there are reasons to suspect that setting up an SE is more difficult and hence more costly because company registers and advisers are less familiar with it. Other things being equal, the European Company should flourish in jurisdictions that impose a relatively low excess burden on SE incorporations. We therefore hypothesise that the difference in incorporation costs between the SE and national companies has an influence on the number of SEs in a country.

H1 The excess costs of incorporating an SE as compared to incorporating a national company have a negative impact on SE formations.

Before incorporating as a European Company, management and employees are required to negotiate the terms of worker representation in the firm. Although employees can, under certain conditions, insist on preserving the

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[9] In the case of Allianz SE it should be noted that the conversion was undertaken as part of a major cross-border merger, which would always entail considerable transaction costs.

[10] Of course, incorporation costs can be reduced by registering the SE in another (low-cost) Member State. However, this would require (re)locating the company's head office in the state of incorporation; see SE Regulation, Arts. 7 and 64. Also, an existing company cannot be merged into an SE without the involvement (and hence the regulatory cost burden) of its home state; cf. SE Regulation, Art. 25. If the company is converted into an SE under SE Regulation, Arts. 2(4) and 37, it cannot, at the same time, transfer its registered office to another Member State; SE Regulation, Art. 37(3). For all of these reasons, we only consider *domestic* SEs as an alternative to *domestic* national companies.

level of board representation that prevailed before reincorporation as an SE, other less stringent or more flexible arrangements can be agreed upon (SE Employee Involvement Directive,[11] Article 4(2) and (3) and Article 7(2)). Even if pre-existing worker co-determination remains untouched, the SE will not be subject to size thresholds for enhanced co-determination requirements under national law.[12] For instance, if an SE is situated in Germany and grows beyond 2000 employees, it does not come under the enhanced 'equal co-determination' regime (cf., German Co-determination Act (Mitbestimmungsgesetz) §1(1)). Also, employees can only (if at all) insist on the same *proportional* representation on the board, whereas board size and hence the number of employee representatives can be reduced (see SE Employee Involvement Directive, Annex, Part 3, lit. b ('proportion')). The European charter can thus be used to loosen the grip of national co-determination laws. It seems plausible that shareholders and (perhaps) managers may seek to do just that (Charny 1991). Consequently, we expect them to use the SE as a vehicle to reduce the influence of national co-determination rules or even as an instrument to avoid them completely (where possible). Hence, the SE should be more popular in countries that have mandatory worker co-determination.[13]

H2 Countries with mandatory worker co-determination rules exhibit more SE formations.

The European legislator designed the SE specifically to cater to the needs of cross-border business activity in the internal market. It is therefore no surprise that the European Company facilitates corporate mobility within the EEA. Community law enables the SE to transfer its registered office to another Member State. National companies do not enjoy this freedom (Ringe 2007). This possibility, in and of itself, constitutes an advantage of the SE corporate form. Yet the ability to move freely throughout the internal market seems to be just a natural corollary of the SE being the product of Community legislation. It is more interesting to ask whether mobility between Member States offers additional opportunities for legal arbitrage between *national jurisdictions*. Perhaps most importantly, the corporate

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[11] Council Directive 2001/86/EC supplementing the Statute for a European company with regard to the involvement of employees.

[12] This follows from the SE Employee Involvement Directive, Art. 13(2), which precludes the general Member State rules on employee representation at board level.

[13] Furthermore, companies using the legal form of the SE should tend to have less stringent co-determination rules than comparable national corporations.

tax burden can differ significantly depending on where the company is located. Firms could use the SE corporate form to exploit differences in tax treatment by transferring the company's seat to a more favourable jurisdiction.

However, cross-border corporate mobility is not an exclusive privilege of the European Company. Due to the recent ECJ's case law, national companies are no longer barred from conducting all or part of their business activities abroad, provided that their home state permits such a move.[14] As a company's residence for tax purposes is usually determined by the place of its 'real seat' or effective management (instead of the registered office or applicable corporate law),[15] moving to a favourable tax jurisdiction does not necessitate a transfer of the registered office. In addition, after the adoption of the Cross-border Merger Directive in 2005 and its transposition into Member State law, national companies will be able to merge into an empty (special purpose) company of the target jurisdiction, thereby switching the applicable corporate law and – as a consequence – transferring the registered office.

While the SE's advantage over national companies has waned, it is, or may have been for some time, the safest choice to ensure corporate mobility within the EEA. When a national company relocates only its head office to another Member State, it still faces uncertainty over not only its tax treatment but also other matters of, *inter alia*, company and insolvency law.[16] Full-blown reincorporation has been made possible only recently; even now, the Cross-border Merger Directive has not been implemented in all Member States. In view of these pitfalls and ambiguities, a tax-related demand for company mobility may have driven (and may continue to drive) SE formations. As using the SE corporate form facilitates relocation in the future, we conjecture that jurisdictions with comparatively inauspicious tax conditions will exhibit more SE incorporations:

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[14] The home state can prevent its companies from shifting their head office abroad; see ECJ, Case C-210/06 *Cartesio Oktató és Szolgáltató bt* (2008).

[15] Cf. Art. 4(3) of the OECD Model Convention with Respect to Taxes on Income and Capital (as it reads on 15 July 2005).

[16] For instance, German companies still run a considerable risk of forced dissolution when shifting their head offices abroad. The issue is being addressed by §4a GmbHG, §5a AktG as amended by the 2008 Act to Modernise Private Company Law and to Combat Abuses (Gesetz zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen – MoMiG). At the European level, Art. 3(1), sentence 2 of Council Regulation (EC) No. 1346/2000 on insolvency proceedings establishes a presumption that the centre of a (company) debtor's main interests coincides with its registered office.

H3.1 More SEs will be formed in jurisdictions with less favourable company taxation.

Apart from company taxation, Member State jurisdictions also differ in other important aspects. Legal scholars have been particularly interested in how the SE can be used to engage in company law arbitrage (Bratton et al. 2008; Enriques 2004a). Although the European Company owes its existence to Community law, it is in great part governed by national company law rules because the SE Regulation often makes reference to the company law of the SE's home state, that is, the national jurisdiction of the company's registered office.[17] Shareholders and management can choose a jurisdiction to fill the gaps in the SE Regulation by transferring the registered office to the respective Member State. This might be a motive for choosing the SE in the first place. However, the choice of a particular gap-filling law cannot be made in isolation. As a tribute to the 'real seat theory', SE Regulation, Article 7, requires the registered office to be in the same Member State as the company's head office. While the same requirement applies, of course, to tax-induced relocations, incentives to exploit differences in company law might be weaker. While we tend to be agnostic, our working hypothesis is the following:

H3.2 Firms incorporate in the SE form to shop for an attractive gap-filling company law.

The SE Regulation itself offers individual companies a choice between a governance structure with one single board of directors (ineptly referred to as 'administrative organ' by the Regulation) or a separation between a management board ('management organ') and a supervisory board ('supervisory organ'). By contrast, only a few European jurisdictions give firms a choice between the one-tier and the two-tier board structure. Since the one-tier structure involves only a single corporate body, one would expect it to be less costly, at least with respect to direct costs. Start-up companies and closely held firms can gain flexibility and save on board compensation, while for them a separate supervisory board often does not accomplish much in terms of reducing agency costs. Hence, we hypothesise that the SE is especially attractive in countries that (with respect to public companies) provide solely for the two-tier system.

H4 The sole availability of the two-tier board system in a jurisdiction has a positive impact on SE formations.

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17 Cf. the general reference in SE Regulation, Art. 9(1)(c)(ii).

Finally, before the Merger Directive was enacted in 2005, the SE Regulation offered the only safe way to accomplish a transnational merger. This was no doubt a motive for the establishment of Allianz SE (Hemeling 2008). It is less clear, however, whether it is still an important reason for using the SE today. The Cross-border Merger Directive should provide national companies from different jurisdictions with a safe and tractable way to accomplish a merger in the future. Since the Directive has been implemented only recently (if at all), we expect that the SE was in fact used as a vehicle for cross-border mergers during our observation period.

H5 Firms use the SE corporate form to accomplish transnational mergers.

METHODOLOGY AND DATA

To test our hypotheses we adopt a dual research strategy. While econometric analysis is the preferred method of many economists, it does not follow that it is, or should be, the only empirical approach (Swann 2006). Using two different methods enabled us to overcome the dearth of data as well as to check the robustness of our results.

First, we rely on a structured telephone survey among German SE users. We were thus able to obtain information on issues where no dataset is available. For instance, the survey provides information on the content of co-determination agreements and the way they were reached. Furthermore, we were able simply to ask for the reasons why the SE corporate form had been chosen. We are well aware, of course, that surveys may suffer from misreporting by interviewees despite our firm assurance of anonymity. The fact that many participants expressed that worker co-determination – arguably the most sensitive issue in the interview – was a major reason for choosing the SE makes us believe that misreporting is not a serious problem. We confined the survey to Germany because it is a very popular jurisdiction for SE incorporations and because we could guarantee high-quality interviews.

Second, we investigate part of our hypotheses by means of a simple econometric model using a cross-section of the EEA countries. A major virtue of this approach is that we do not have to conduct field work in 30 different jurisdictions. We further benefited from the fact that the regression analysis allows us to make *ceteris paribus* statements so that we can estimate the influence of mandatory co-determination regimes on SE incorporations while controlling for the effect of tax rates and other variables that might affect these incorporations.

Table 2.1 Number of additional SE registrations in the national company registers as compared to the OJEU in June 2008

Register	Additional registrations
Czech Republic	43
Germany	19
Netherlands	4
Austria	3
Cyprus	2
Slovakia	2
Hungary	1
Denmark	1
Belgium	1
United Kingdom	1

Data from Company Registers

Both empirical approaches required us to identify the existing SEs (as of June 2008). Notice of each SE incorporation is supposed to be published in the OJEU according to SE Regulation, Article 14, which seems to imply (but does not state explicitly) that the national company register is responsible for forwarding the information to the EU Office for Official Publications. We doubted the quality of this data source because there are no legal consequences if an SE is not published in the OJEU. More specifically, an SE's coming into existence does not turn on the required publication. We therefore decided to collect the relevant information directly from the national company registers. In some Member States, the national register was easily accessible through its website. In other cases, we had to contact the company register or the respective statistical office by e-mail or letter. Matching our dataset with the information from the OJEU confirmed our suspicion: we did not find any SEs in the OJEU that did not show up in the Member State records, but we were able to identify a large number of incorporated firms that had not made it into the OJEU. Table 2.1 presents the number of incorporations which could be detected in the national company registers by June 2008 but did not show up in the OJEU. The OJEU has missed many SEs, particularly from the Czech Republic and Germany.

We supplemented the information gathered from company registers with responses from our survey, data from LexisNexis, and company websites. To the best of our knowledge, the resulting dataset on the European Company was the most complete to have been generated up until then.[18] Previous research had either focused solely on the OJEU or drew just partly on expert knowledge and national commercial registers (Bayer and Schmidt 2008). As the SE is growing more popular, it becomes increasingly difficult to keep track of incorporations in 30 different company registers. If the EU does not want to rely on a private data collection exercise like ours, it should require Member States to provide aggregated numbers on SE incorporations.[19]

Telephone Survey

To learn about the driving forces behind SE formations, we carried out a structured telephone survey asking individuals who were involved in the incorporation decision of German SEs about, *inter alia*, the principal motives for adopting the new supranational legal form. Although a telephone survey is more time-consuming than sending out a written questionnaire, it allowed us to increase the participation rate significantly. In addition, we were immediately able to clarify ambiguous statements so that we could generate the maximum number of usable answers. Twenty-six individuals agreed to be interviewed. Since some of the respondents represent several firms, for example, Allianz SE and Allianz Investment Management SE, we were able to cover 75 per cent of all SEs incorporated in Germany, which we consider to be a highly representative sample.[20] For the remaining 25 per cent, no contact details were available or the contacted person indicated that he or she did not wish to participate. All of the interviewees occupied a high rank in their respective organisation. In many cases, we talked to the CEO or a person who was directly involved in the SE formation process, often the company's legal counsel. When talking to providers of shelf companies,[21] we asked for the clients' motives for buying a SE. We were thus able to ascertain the intended uses of many shelf SEs which would turn into active SEs in the subsequent months. Interestingly, nearly all shelf companies had already been sold at the time of the interviews.

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[18] An up-to-date overview of SEs is maintained by the European Trade Union Institute and the Hans Böckler Foundation; see *supra* n. 6.

[19] The recent Commission proposal for a Council Regulation on the Statute for a European Private Company provides for such a requirement; see COM (2008) 396 final, Art. 46(1).

[20] The sample represents 74 per cent of active (that is, non-shelf) SEs in Germany.

[21] We define a 'shelf company' as a company which is to be sold to a firm or entrepreneur and which does not yet carry out any business activity. Companies that are used as a vehicle for holding assets, such as investment companies, are considered 'active', not 'shelf', companies.

All interviews were conducted during a narrow timeframe of three weeks in May and June 2008 to minimise the influence of periodic changes on the results. Each interview took approximately 20 minutes, during which 14 questions were discussed. To get consistent responses, a structured questionnaire had been designed and was completed by the interviewer during each interview. The first block of the questionnaire asked general questions about the firm, the formation process of the SE and whether a one-tier or two-tier board structure had been adopted. Two questions followed on the current size of the board and whether it had been changed upon registration of the SE. The interviewees were further asked to provide information about the fraction of worker representatives currently serving as board members. In each interview, we inquired about the motives for choosing the SE corporate form. If the respondent did not give a particular reason, we asked explicitly whether the following seven issues had played a role: the specific image of the SE in the marketplace, choice between the one-tier and two-tier board model, simplification of the company structure, worker co-determination, sale of shelf companies, the possibility of transferring the registered office and accomplishing a transnational merger. Most interviewees immediately offered their reasons for adopting the SE and did not change their response when we suggested other specific motives from our list. We also discussed some of the reasons in more detail: had the registered office already been transferred? Did the company plan to do so in the near future? How many employees worked for the firm? Was there an agreement on worker co-determination at board level? If so, what had been agreed upon? Finally, we discussed the risks associated with establishing an SE, as well as potential improvements in the SE company law regime.

Regression Model

In a second step, we combine the information from the company registers with other country-level data to run a simple regression model. Estimating a Probit or Logit model would require detailed firm-level data, which were not available for a sufficient number of SEs. Although we observe the number of incorporations in a given year, most of the institutional explanatory variables have no variance over time, which rules out a panel data analysis. We therefore apply an OLS regression since the small-sample properties of this estimator are generally known and estimation problems such as omitted variables can be easily evaluated. This is important as our sample consists of only 22 EEA countries, for which we were able to obtain the relevant data. At the same time, using more sophisticated techniques would arguably not add much to our analysis. Some of our independent variables are institutionally predetermined and therefore exogenous. Specifically, mandatory worker co-determination and the board structure of national companies had mostly been instituted decades before the European Company appeared on the stage. As to other factors, such as corporate taxes or growth of the national economy, it is extremely implausible that they are influenced by the number of SEs, given that all over Europe SEs still count in the hundreds. The direction of causality should therefore be unambiguous.

We have estimated the following equation:

$$\ln\left(\frac{\textit{number of SEs}_i}{\textit{total number of firms}_i}\right) = \beta_0 + \beta_1 \ln \textit{gdp0508}_i + \beta_2 \ln \textit{corptax}_i + \textit{deter}_i + \beta_4\, \textit{dualonly}_i + \beta_5\, \textit{business}_i + u_i$$

As a dependent variable we use the number of SE incorporations divided by the total number of firms (*rrse*). The numerator of this variable contains the number of SEs registered in each country by June 2008. A total of 16 European Companies had already transferred their registered office to another Member State by then. They were counted as belonging to the jurisdiction in which they were registered originally because we are most interested in what drives the incorporation decision in the first place.[22] We divided the number of SEs by the total number of firms in the respective (national) economy to control for differences affecting business activity generally. Such country-specific effects include the size of the national economy, institutional differences (for instance, tax law can make it attractive to hold assets in a company rather than individually), the amount of 'entrepreneurial spirit' or the regulatory burden on business activity. If, for reasons like these, a country has more firms, one would expect the number of SEs to be larger irrespective of legal arbitrage. The data on SE incorporations was gathered from the OJEU and the national company registers as described above. The number of firms in the economy was obtained from the OECD Structural and Demographic Business Statistics (SDBS).[23] To control for business cycle effects, we also use the variable *gdp0508*, which measures the average growth rate during the years 2005

[22] This is in line with the reasoning behind our Hypothesis 3.1 that firms choose the SE corporate form with a view to moving to another Member State later on.

[23] The OECD defines a firm ('enterprise') as 'a legal entity possessing the right to conduct business on its own; for example to enter into contracts, own property, incur liabilities for debts, and establish bank accounts. It may consist of one or more local units or establishments corresponding to production units situated in a geographically separate place and in which one or more persons work for the enterprise to which they belong.'

to 2008 and is based on real gross domestic product (GDP) growth rates from Eurostat.[24]

The remaining explanatory variables are intended to examine our hypotheses H1, H2, H3.1 and H4, as stated above. H1 is particularly difficult to test as we cannot think of a direct way to observe the incorporation costs incurred specifically by SEs and hence the cost differential between setting up an SE as opposed to establishing a company under national law. Our hunch is, however, that 'high-quality' jurisdictions that offer low incorporation costs to their own companies should also be more adept at handling the new SE corporate form. Based on this conjecture, we assume that a country's *general* incorporation costs, that is, the costs of setting up a (national) company, can also serve as a proxy for the cost differential between the SE and a national company. Put differently, if a country makes it difficult to incorporate under its own national law, it should be even more difficult to bring local counsel, notaries, company registers and so on, to deal with the unfamiliar and more complicated European Company.

We measure incorporation costs using data from the World Bank's 'Doing Business' Report.[25] Our first variable of interest (*business*) represents a ranking based on the Report's ease of doing business index. It reflects a cumulative measure of a country's regulatory environment, including the political and legal risks associated with business activities. We use *business* as a first proxy for incorporation costs. We test the robustness of our findings by investigating more detailed variables like the number of procedures (*proce*) and the time (*time*) it takes to start a business as a proxy for the bureaucratic burden a company has to deal with. We also consider the expenses of setting up a firm (*cost*) and the minimum capital requirement (*mincap*) as a percentage of income per capita that an entrepreneur must provide for a standardised company.[26] The information for these variables was taken from the 'Doing Business' sub-category 'Starting a business'.

To test the impact of mandatory worker co-determination rules (hypothesis H2), we include a dummy variable (*codeter*) in our model.

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[24] As the first incorporations occurred during 2004 and 2008 had not ended at the time of the study, we tried different intervals without obtaining a significant impact on the results.

[25] World Bank (2008), 'Doing Business', available at www.doingbusiness.org.

[26] For a definition of the 'standardised company', see Djankov et al. (2002). The minimum capital requirement was included as one of several proxies for the regulatory burden. The SE uniformly requires a minimum capital of €120 000 (SE Regulation, Art. 4(2)).

The variable jumps to 1 if the respective country has mandatory rules on co-determination for privately owned (that is, non-government) companies. The data were gathered from the European Trade Union Institute and the Hans Böckler Foundation (Kluge and Stollt 2006). Of course, a single dummy variable inevitably leaves out a lot of institutional detail. Hypothesis H3.1 is examined by including the national corporate tax rates (*corptax*) as provided by the European Commission[27] and KPMG International.[28] With respect to H4, we add another dummy variable (*dualonly*) that jumps to 1 if the respective country allows only for the two-tier board system. The data again come from the European Trade Union Institute (Kluge and Stollt 2006). Our variables are described in Table 2.2. Table 2.3 contains some descriptive statistics.

EMPIRICAL FINDINGS

Descriptive Statistics

Before turning to the question of what caused the incorporations, we present some descriptive statistics on our dataset for the European Companies now in existence.

Time trend

Figure 2.1 provides information on monthly and annual SE formations. In each of 2005, 2006 and 2007, the number of incorporations roughly doubled: in 2005, we have been able to identify 21 incorporations. One year later, 40 European Companies were formed, and in 2007 the figure rose to 85. In the first months of 2008, incorporations again reached two-digit figures, indicating that the previous year's value would be surpassed. If incorporations continue to grow at the same pace as in the last three years, there will be significantly more than one hundred incorporations in 2008.

Regional distribution

A look at the regional distribution of incorporations (Table 2.4) yields a surprising result. Apart from Germany, it is the Czech Republic that is home to the greatest number of SEs (Figure 2.2). In the course of one year (May 2007–May 2008), as many European Companies were registered

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[27] European Commission (2006).

[28] KPMG International (2008).

Table 2.2 Variables

Variable	Description
rrse	Number of SE incorporations by June 2008 divided by the total number of firms in the economy. The data on SE incorporations were hand-picked from the national company registers in the EEA. The number of firms was taken from the OECD Structural and Demographic Business Statistics.
gdp0508	Average real GDP growth rate for the years 2005 to 2008. The data comes from Eurostat.
corptax	Statutory corporate tax rates for the year 2006. The data were provided by the European Commission and KPMG International.
deter	Dummy variable reflecting rules on mandatory co-determination for privately owned companies (1 = mandatory co-determination required). The data source is the European Trade Union Institute and the Hans Böckler Foundation.
dualonly	Dummy variable reflecting whether the country allows for the one-tier board structure in public companies (1 = only two-tier board structure available). The source of the data is again the European Trade Union Institute and the Hans Böckler Foundation.
business	The rank of a country from 1 to 181 based on an index consisting of a simple average on each of 10 sub-indices covered in 'Doing Business'. The data were taken from the World Bank.
proce	Number of procedures needed to set up a firm. Procedures are defined as any interaction of the company founder with external parties (for example, government agencies, lawyers, auditors or notaries). Interactions between company founders or company officers and employees are not counted as procedures. Cf. http://www.doingbusiness.org/MethodologySurveys/StartingBusiness.aspx.
time	Median duration in calendar days that incorporation lawyers indicate is necessary to complete the required procedures. Cf. http://www.doingbusiness.org/MethodologySurveys/StartingBusiness.aspx.
cost	Fees for government agencies and legal or professional services, if required by law to set up a firm. Fees are reported as a percentage of income per capita. Cf. http://www.doingbusiness.org/MethodologySurveys/StartingBusiness.aspx.
mincap	The minimum capital requirement reflects the amount that a company founder needs to deposit in a bank or with a notary before registration and up to three months following incorporation. It is reported as a percentage of the country's income per capita. Cf. http://www.doingbusiness.org/MethodologySurveys/StartingBusiness.aspx.

Table 2.3 Descriptive statistics of key variables

	Mean	Standard deviation	Median	Minimum	Maximum	Number of observations
Number of SEs	7.2	17.1	1.0	0	74	30
Total number of firms	668076	692017	448746	22597	2279299	14
rrse (SEs / total firms)	2.46e–06	6.20e–06	1.53e-06	1.00e-14	309.80e–06	26
gdp0508	4.2	2.1	3.8	1.1	9.2	29
corptax	25.6	8.1	27.0	10.0	39.0	28
codeter	0.4	0.5	0.0	0.0	1.0	30
dualonly	0.4	0.5	0.0	0.0	1.0	26
business	32.4	22.5	26.0	5.0	100.0	27
proce	6.8	2.8	6.0	5.0	15.0	27
time	19.2	13.5	15.0	4.0	60.0	27
cost	6.6	6.8	4.2	0.0	23.3	27
mincap	37.2	39.9	31.1	0.0	196.8	27

in the Czech Republic as in Germany during the three-year period from October 2004 to October 2007. By the end of 2008, the Czech Republic had overtaken Germany, having incorporated more than a hundred SEs. It is noteworthy that many Czech SEs are shelf companies which are being offered on multilingual websites.[29] Nevertheless, there are also active European Companies registered in the Czech Republic. For instance, the Český Pivní Festival SE organises the beer festival in Prague and the NH Trans SE is a provider of specialised transportation services.

As of June 2008, one out of two SEs had its registered office in either Germany or the Czech Republic. Apart from these two countries, only Austria and the Netherlands have double-digit populations of European Companies. Italy, Spain and Poland, along with 12 other Member States, did not have a single SE registered by this time.

However, the total number of incorporations and of existing SEs shown in the first two columns of Table 2.4 may be misleading. Dividing the number of European Companies in a country by its population produces a different picture. With less than a single SE per one million inhabitants, Germany drops to the middle of the European league; France and the

[29] See http://www.eurospolecnosti.cz, http://www.czechcompanies.cz/en and http://www.smartcompanies.cz.

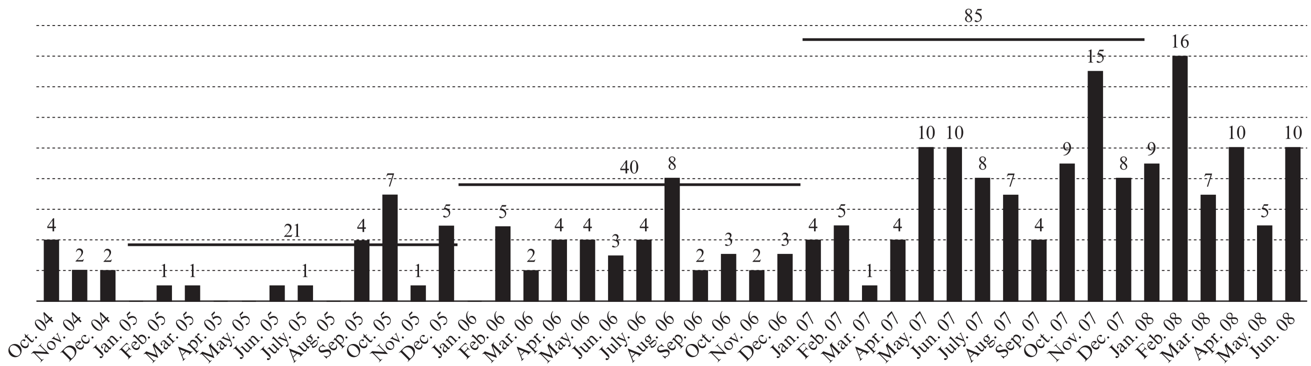

Figure 2.1 SE incorporations from October 2004 to June 2008

Table 2.4 Number of SE incorporations, existing SEs and existing SEs by population

SE incorporations		Existing SEs		Existing SEs / million population	
Germany	74	Germany	70	Liechtenstein	58.0
Czech Republic	62	Czech Republic	61	Luxembourg	20.6
Netherlands	19	Netherlands	15	Cyprus	6.3
Austria	10	Austria	11	Czech Republic	5.9
Belgium	9	Luxembourg	10	Estonia	2.3
France	7	Belgium	8	Austria	1.3
Luxembourg	7	France	7	Latvia	1.3
Sweden	5	United Kingdom	5	Netherlands	0.9
Norway	5	Sweden	5	Germany	0.9
Cyprus	3	Cyprus	5	Belgium	0.8
Estonia	3	Estonia	3	Norway	0.6
Latvia	3	Latvia	3	Sweden	0.6
Slovakia	3	Norway	3	Slovakia	0.6
United Kingdom	2	Slovakia	3	Hungary	0.2
Liechtenstein	1	Liechtenstein	2	France	0.1
Hungary	1	Hungary	2	United Kingdom	0.1
Finland	1				
Denmark	1				
Total	216	Total	213		

UK fall to the bottom of the table. The top of the list is now occupied by small countries. Liechtenstein and Luxembourg stand out, followed by Cyprus and the Czech Republic. As small jurisdictions can gain relatively more from engaging in regulatory competition, their pre-eminence is already indicative of our central hypothesis that the European Company is employed as a vehicle for legal arbitrage. This first impression is reinforced by the fact that the lead group of Liechtenstein, Luxembourg and Cyprus has attracted six European Companies from foreign jurisdictions through a transfer of the registered office (Table 2.5).[30] Only the UK has been more successful in this regard than each of the small jurisdictions. In total, we observed 18 transfers by 16 firms, with some more SEs already planning to move their registered office.

[30] Two of the European Companies moved to Luxembourg only to reincorporate from there to the Cayman Islands, thus providing 'smoking gun' evidence of legal arbitrage. See, on these cases, Heuschmid and Schmidt (2007) and Schmidt (2005).

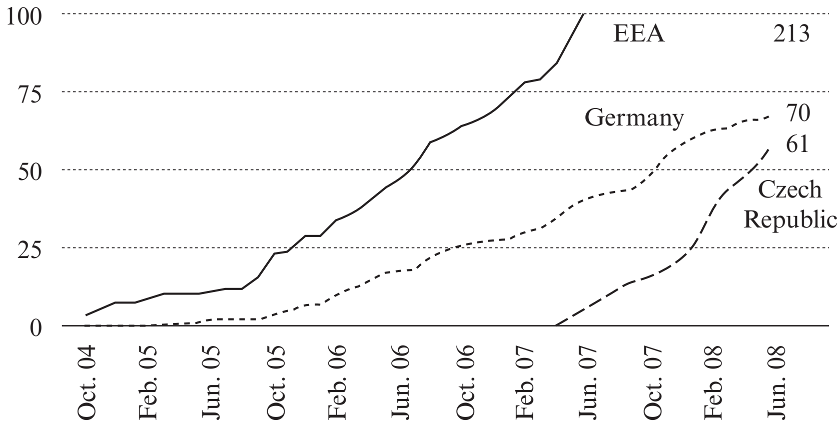

Figure 2.2 Existing SEs in Germany, the Czech Republic and the EEA

Table 2.5 Transfer of registered office of SEs

Moving out		Moving in	
Germany	4	United Kingdom	4
Netherlands	4	Luxembourg	3
Norway	2	Netherlands	2
Luxembourg	2	Cyprus	2
Belgium	1	Cayman Islands	2
Finland	1	Austria	1
Czech Republic	1	Germany	1
United Kingdom	1	Liechtenstein	1
Denmark	1	Hungary	1
Total	18	Total	18

Firm size

Our dataset has two measures of firm size: the number of employees and the subscribed capital. As the number of employees is only rarely published in the company register, we had to collect additional data from financial statements, company websites and LexisNexis. As a result, we have identified the number of employees for around one-third of the total number of 216 SEs. We were able to classify nearly all of the remaining firms as either shelf or investment companies that do not have employees.

Our data reveal that the SE is frequently used by small and medium-sized enterprises (SME). Based on the definition of the German Institut für Mittelstandsforschung (Institute for SME Research), 13 out of 69 SEs with employees are of 'small' and 29 of 'medium' size;[31] that is, almost two-thirds of them are SMEs. Apparently, SMEs manage to set up a European Company even though the SE Regulation requires that at least one party from another Member State must be involved to incorporate in the SE form.[32] We have learnt from the telephone survey that the cross-border requirement is often complied with by using a foreign special purpose vehicle, typically a private limited company (Ltd) from the UK.

Only six SEs have more than 10 000 employees group-wide (Figure 2.3). Among them are four German firms, namely Allianz SE, BASF SE, Fresenius SE and Porsche Automobil Holding SE. The remaining two are Strabag Bauholding SE from Austria and the previously Finnish and now Luxembourg Elcoteq SE.

A similar picture emerges when we consider subscribed capital (Figure 2.4). Out of 176 firms for which the relevant information was available, 111 have a subscribed capital of €120 000, the minimum amount required by the SE Regulation. Only three SEs show a subscribed capital exceeding €1 billion. These are (again) Allianz SE and BASF SE, as well as the French insurance company Scor SE.

Industry

We were able to categorise 122 SEs using the European NACE Revision 2 industry classification code (Table 2.6). Another 57 European Companies have been identified as shelf companies. For the remaining 34 SEs, no information was obtainable. About one-third of the SEs that we were able to classify belongs to the financial sector. Around half of them are investment funds or 'trusts' and similar financial entities. The remaining half is actively providing financial or insurance services. Again, the large share of the financial industry and investment funds in particular may be suggestive of legal arbitrage because the cost of relocating financial assets to a more favourable jurisdiction is especially low. The second largest group of SEs operates in manufacturing, which includes, among others, carmakers, component suppliers and chemical production. Finally, a significant

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31 Small enterprises are defined as having up to nine employees and less than €1 million annual turnover, while medium-sized enterprises have 10 to 499 employees and €1 to 50 million annual turnover. See Definition 01/01/2002, available at http://www.ifm-bonn.org/index.php?id=89 (accessed 15 October 2008).

32 Cf. SE Regulation, Art. 2. An exception is provided for in Art. 3(2), under which an existing European Company can set up subsidiary SEs.

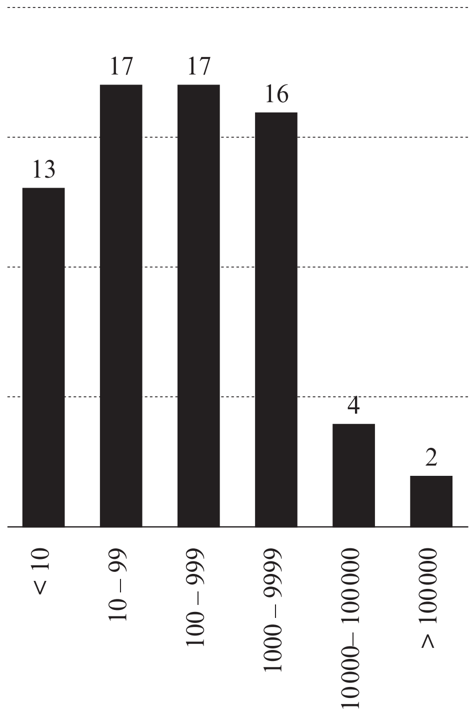

Figure 2.3 SEs by employees

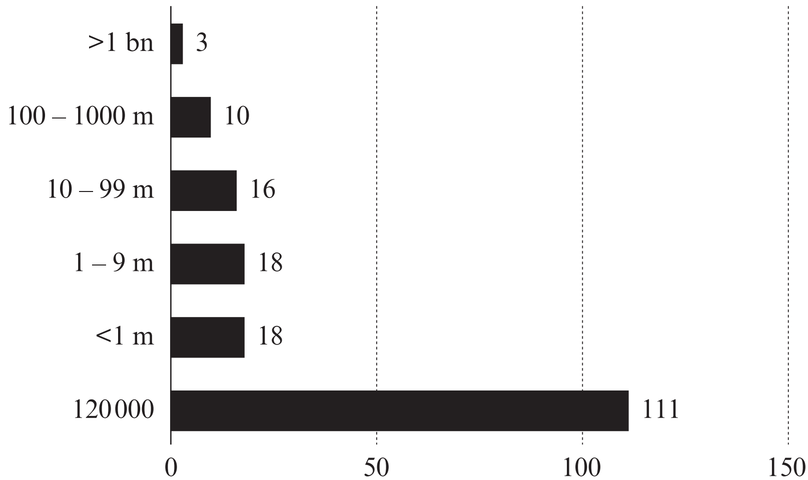

Figure 2.4 SEs by subscribed capital in Euros

Table 2.6 SE industry classification according to NACE Rev.2

Industries (N = 213)	
Section A: Agriculture, forestry and fishing	1
Section B: Mining and quarrying	1
Section C: Manufacturing	22
Section D: Electricity, gas, steam and air conditioning supply	1
Section E: Water supply; sewerage, waste management and remediation activities	1
Section F: Construction	5
Section G: Wholesale and retail trade; repair of motor vehicles and motorcycles	5
Section H: Transportation and storage	5
Section I: Accommodation and food service activities	1
Section J: Information and communication	12
Section K: Financial and insurance activities	43
Section L: Real estate activities	8
Section M: Professional, scientific and technical activities	11
Section N: Administrative and support service activities	1
Section O: Public administration and defence; compulsory social security	0
Section P: Education	1
Section Q: Human health and social work activities	2
Section R: Arts, entertainment and recreation	2
Section S: Other service activities	0
Section T: Activities of households as employers	0
Section U: Activities of extraterritorial organisations and bodies	0
Shelf companies	57
Unknown	34
Total	213

number of non-financial service providers have incorporated under the SE Regulation.

Board structure

Slightly more firms have opted for the one-tier instead of the two-tier board structure (Figure 2.5). Some firms set up a sole 'administrative organ' in Member States that, for their national companies, require a distinct supervisory board. As predicted by our hypothesis H4, these are mainly SMEs often having one dominant shareholder.[33] H4 is further supported by the

[33] One fairly well-known example is Adi Drotleff, who is both the CEO and controlling shareholder of the IT company Mensch und Maschine SE.

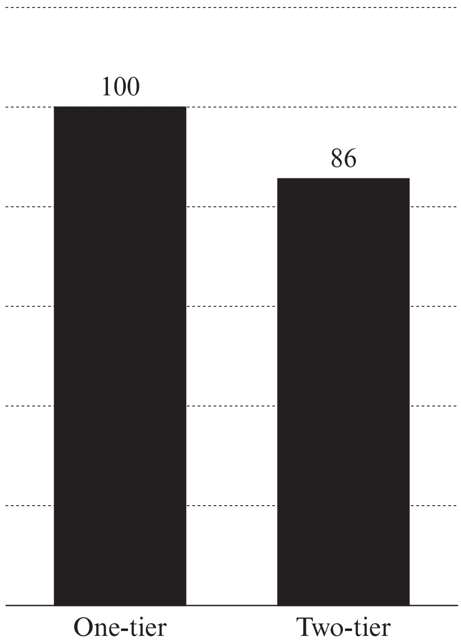

Figure 2.5 Board system

fact that so far not a single SE has adopted a two-tier board structure in a one-tier jurisdiction.[34] Finally, information collected from national company registers revealed that several two-tier firms reduced the number of directors on the supervisory board when incorporating as an SE. These were mostly large, publicly traded companies from Germany.

Incorporation methods

The SE Regulation provides five different ways to set up a European Company (SE Regulation, Articles 2 and 3): formation by merger, formation of a common subsidiary SE, conversion of an existing public company into an SE, formation of a holding SE and formation of a direct SE subsidiary, also known as secondary formation. The latter two methods appear not to be very popular, while the former three have been widely

[34] Some European Companies in the United Kingdom have a supervisory board, but only because they retained the two-tier structure after moving to the United Kingdom. In no case did a European Company actively seek a two-tier board structure in a jurisdiction adhering exclusively to the one-tier structure.

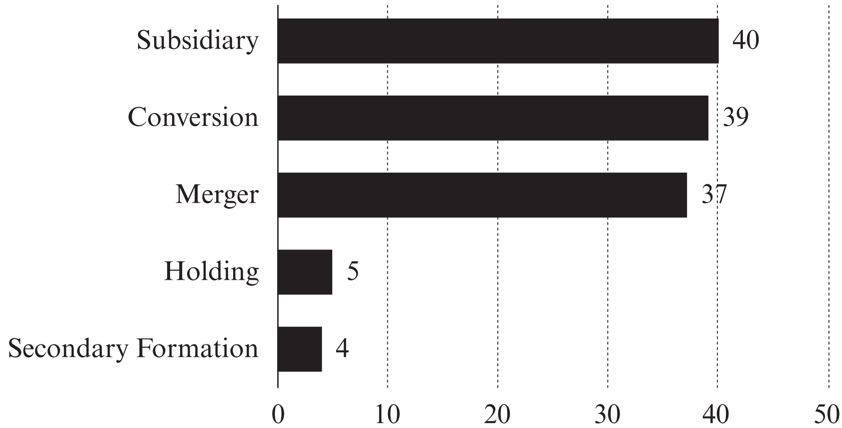

Figure 2.6 Type of SE formation

used (Figure 2.6). In at least 40 cases, SEs were formed as shelf companies and sold to end users. As we have learnt from our interviews, one method of producing shelf companies is to employ a foreign company as an 'incorporation vehicle' to comply with the cross-border requirement. Therefore, some of the 37 mergers and of the 40 formations of common subsidiary SEs likely did not serve a business purpose except that of accomplishing an SE incorporation.

Survey Results

According to our hypothesis H1, the differential in incorporation costs between the SE and national companies should have a negative impact on SE formations. The responses to our survey confirm this hypothesis. Many of our German interview partners mentioned that company registers, tax authorities and other government agencies are largely unfamiliar with the SE, making incorporation and operating the firm fairly difficult in some cases. Some respondents considered registration in the company register as a major risk factor associated with the incorporation decision. These statements underscore our intuition that there are specific costs of forming and operating a European Company and that the regulatory burden matters to SE users.

Hypotheses H2, H3.1, H3.2, H4 and H5 are at the heart of our research interest in the SE as a vehicle for legal arbitrage. The survey responses regarding the motives for choosing the SE corporate form (Table 2.7) bear on all of these hypotheses. As to H2, our respondents named

Table 2.7 Survey results: motives behind German SE formations

Motive	Positive response (N = 49)
Image of the SE	36
Board structure	30
Co-determination	29
Corporate mobility	26
Corporate structure	7
Planned merger	6

co-determination as a factor for 29 out of 49 SEs. Additional support for H2 comes from the fact that negotiations on employee involvement in the SE produced some very creative outcomes (Keller and Werner 2007): in some firms, employees acceded to a smaller 'Representative Body'[35] and a precise definition of its competences, while the company promised a higher frequency of meetings with management and offered employee representatives improved access to work sites abroad. At least one firm abolished co-determination completely in exchange for a 'social fund' on behalf of its employees (Rehberg 2008). At the same time, negotiations on worker co-determination were also mentioned as imposing a major risk of delay on the incorporation process. In sum, however, survey responses confirm that avoiding or reducing worker co-determination plays an important role for many SE incorporators.

Respondents representing 26 SEs brought up corporate mobility as another reason to opt for the European Company. This result seems to support both hypotheses H3.1 and H3.2. Yet, when our interview partners indicated plans to transfer the company's registered office, most of them identified tax-related advantages as the key motive. By contrast, none of our respondents cited an intention to seek a different gap-filling company law for the SE. On the contrary, many respondents would prefer a uniform SE company law so as to avoid legal frictions in the event of a relocation. Therefore, our survey evidence supports the tax law arbitrage hypothesis (H3.1), but not the notion that firms use the SE to shop for a more favourable company law (H3.2).[36]

[35] As compared to the size prescribed by the default rule of SE Employee Involvement Directive, Annex, Part 1, lit. e, the Representative Body is the SE equivalent of the European Works Council established by Council Directive 94/45/EC; cf. SE Employee Involvement Directive, Art. 13(1).

[36] Since the unobserved fraction of German SEs consists most likely of investment or shelf companies, we would rather expect to underestimate the importance of tax motives.

Another strong motive to opt for the SE corporate form is, according to responses for 30 German SEs, the desire to choose between the one-tier and the two-tier board structure. Taken together with our observation that SEs tend to opt out of, rather than into, the two-tier structure, this backs our hypothesis H4: SE incorporations are driven in part by the requirement in some Member States for a dual management/supervisory board for public companies.

In our survey sample of German SEs, the opportunity to consummate a cross-border merger under the SE Regulation (H5) seems to have played a role in only six SE incorporations. While this looks like a small number, it should not be read as evidence against H5: after all, the merger motive apparently mattered in more than 10 per cent of our observations. Given how important legal certainty is in a merger, it may well have been the decisive reason in the relatively few cases for which the merger motive was mentioned.

The central results of the survey are that incorporations were mainly driven by the availability of the one-tier board system, the freezing of mandatory worker co-determination and the reduction of supervisory board members, as well as the desire to transfer the registered office to another jurisdiction. For more than half of the firms, each of these reasons was a major argument for choosing the SE. In addition, three-quarters of the participating German SEs considered the European image of the SE as an important motive to select the new legal form. However, this is not a legal arbitrage motive in a strict sense.

To sum up, the survey results provide support for hypotheses H1, H2, H3.1, H4 and H5, but not for H3.2. In the next paragraph, we investigate whether these results hold more broadly in the EEA.

Regression Results

Keeping in mind the small size of our sample, we obtain surprisingly sound and robust results from the regression analysis (Table 2.9). All coefficients have the expected signs and some are statistically significant.[37] Our

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[37] We took the natural logarithms of the dependent variable *rrse* (number of SEs divided by total number of firms) and the two explanatory variables (*gdp0508* and *corptax*), which are measured at the interval level, as this improved the distribution of these variables and helped us to deal with outliers. Since the sample size is already rather small and we are dealing with almost the entire population, we decided to take the data as they were and did not drop the two outliers Germany and the Czech Republic. If a country does not have a single SE, we cannot take the natural logarithm of zero. Instead, we insert a very small number (10^{-14}).

hypothesis H1 on the excess cost burden for SE incorporations receives support in different specifications of our model: the general ease of doing business rank (*business*), the number of procedural steps (*proce*) and the time (*time*) to set up a business each turn out significant at the 1 per cent level; expenses (*cost*) and minimum capital requirements (*mincap*) are significant at the 5 or 10 per cent level, respectively.[38]

As regards H2, we begin the analysis by comparing the sample means of SE incorporations in jurisdictions with and without a worker co-determination regime (Table 2.8). On average, 14 SEs have been incorporated in countries with mandatory co-determination, whereas around two SEs exist in the other Member States. Using a simple t-test, we find that the two samples are different from each other with a significance level of 5 per cent. The coefficients on the co-determination dummy in the regression model are significant at the 1 per cent level. The economic effect of the co-determination regime is not only statistically significant but also large in magnitude. Looking at regression number three, which fits the data quite well, we find that mandatory co-determination increases the number of SE incorporations by 1150 per cent or around 12 times. Holding all other factors constant, if the UK switched to a mandatory co-determination regime, we would expect 24 SE incorporations there instead of two. In sum, our results confirm H2 quite well. Evidently, co-determination is driving SE formations not only in Germany, but in the EEA more generally.

The results on corporate tax rates are mixed, with half of the coefficients turning out to be significant. This is somewhat at odds with the responses from our survey, where taxation appeared to be the main reason for an anticipated transfer of the registered office. One could imagine that the statutory tax rate is not a very good measure of the actual tax advantages sought by firms that incorporate as SEs with a view to relocating at some time in the future. Alternatively, the mere option to move to another tax jurisdiction, while being on the minds of managers and shareholders, may not be a strong motive for choosing the SE corporate form.

Choosing a number closer to the range of positive values of *rrse* (for example, 10^{-8}) does not affect the statistical significance of our results, whereas an even smaller number would have worsened the distribution of the data. Because all country values of *rrse* are close to zero, their natural logarithm is negative. For this reason, the constant is not positive and should not receive an economic interpretation.

[38] When interpreting these results, one should keep in mind that we scale our dependent variable (the number of SEs) by the total number of firms. This control should already capture the impact of a country's incorporation costs on firms *generally*.

Table 2.8 Test of difference in means between co-determination and no co-determination

Country	SE incorporations	Country	SE incorporations
Austria	10	Belgium	9
Czech Republic	62	Bulgaria	0
Denmark	1	Cyprus	3
Finland	1	Estonia	3
Germany	74	France	7
Hungary	1	Greece	0
Luxembourg	7	Ireland	0
Netherlands	19	Iceland	0
Norway	5	Italy	0
Romania	0	Latvia	3
Slovakia	3	Liechtenstein	1
Slovenia	0	Lithuania	0
Sweden	5	Malta	0
		Poland	0
		Portugal	0
		Spain	0
		United Kingdom	2
Co-determination average	**14.46**	**No co-determination average**	**1.65**
Sample average			**7.20**
Test of means between subsamples (t-statistics)			
Co-determination		12.81**	

Note: ** Significant at the 5 per cent level.

The results for the board structure are not as expected. We hypothesised that the European Company should be more popular in countries where domestic company law required public companies to have two boards of directors (H4). However, the coefficient on the dummy variable *dualonly* is insignificant in all specifications. As the correlation between *dualonly* and *codeter* is only 0.14, multicollinearity seems not to be the reason why our regression analysis fails to support H4.

The coefficient on economic growth is insignificant most of the time. This is not entirely surprising as our dependent variable captures the relative share of SEs in the overall population of firms. It is hard to think of a reason why economic growth should lead to a *disproportionately* large number of SE incorporations.

Table 2.9 Regression results: driving forces behind SE formations in the EEA[1]

	baseline (1)	proce (2)	time (3)	cost (4)	mincap (5)
lngdp0508	3.634	4.380	10.693***	.851	.236
	(4.430)	(3.392)	(3.967)	(4.594)	(4.178)
lncorptax	14.876*	16.946***	19.013***	12.321	8.006
	(7.973)	(4.704)	(5.597)	(7.895)	(6.153)
deter	10.278***	10.555***	11.500***	10.660***	12.928***
	(3.950)	(3.152)	(2.643)	(3.819)	(3.479)
dualonly	2.240	2.175	0.670	2.974	2.231
	(2.989)	(2.595)	(2.173)	(3.329)	(3.877)
business	−0.195***				
	(0.067)				
proce		−1.661***			
		(0.460)			
time			−0.522***		
			(0.093)		
cost				−0.571**	
				(0.231)	
mincap					−0.062*
					(0.035)
cons	−71.705***	−74.240***	−89.457***	−63.008**	−50.691**
	(27.641)	(19.577)	(20.441)	(28.708)	(22.268)
N	22	22	22	22	22
Adj. R^2	0.545	0.566	0.769	0.519	0.419
F	24.513	23.963	37.378	21.094	12.519

Note: [1] We use robust standard errors to account for residual heteroscedasticity. *** indicate the 1 per cent, ** the 5 per cent and * the 10 per cent level of significance.

Looking for missing variables, we added legal origin, total GDP (at purchasing power parity) and three different measures of public sentiment towards the EU from Eurobarometer.[39] None of them yielded significant coefficients or had a major effect on our results. We left these variables out, as including all of them would have reduced the degrees of freedom. We also conducted a RESET specification test, which involves adding the explanatory variables in quadratic and cubic form. The test indicated that

[39] The idea behind the Eurobarometer variables is that the European image of the SE should be more attractive when public opinion is generally in favour of European integration.

we have not misspecified the model. As with every regression model, we cannot rule out that a crucial variable is missing from the model. However, the results from the telephone survey make us reasonably confident that this is not the case.

SUMMARY AND CONCLUSION

When the Societas Europaea was made available as a new legal form for European firms, it was quite unclear whether and to what extent it would be accepted by the market. Many had argued that its legal complexity would reduce the attractiveness of this new company type. It appears that the critics have been proved wrong. Based on a unique dataset that was collected from the Member States' national commercial registers, we observed a total of 216 SE incorporations by June 2008. Eighty SEs had been incorporated without having been published in the Official Journal of the European Union. The compounded annual growth rate of SEs between 2005 and 2007 was around 100 per cent. If the demand for SEs continues to grow at the same rate, we can expect around 300 SEs by the end of 2008 and more than a thousand SEs in 2010. Hence, the SE has become more and more popular as a corporate form, and the EU must be viewed as an emerging competitor in the market for corporate charters.

In this chapter, we have studied legal arbitrage as a motive for choosing the SE. We specified a set of hypotheses that reflect certain specific legal arbitrage motives, and we examined these hypotheses by employing a dual empirical strategy. We conducted a structured telephone survey among the German users of the SE and tested some of the hypotheses in a simple OLS regression model. Overall, we find that legal arbitrage plays a significant role in choosing the SE. More specifically, we find strong evidence for legal arbitrage with regard to mandatory co-determination. The SE is popular, especially in countries with mandatory co-determination at board level, and firms seek to reduce this effect or even avoid mandatory co-determination altogether by choosing the SE corporate form. We also find that the use of the SE seems to be motivated at least in part by enhanced corporate mobility with a view to corporate tax savings. By contrast, company law arbitrage – shopping for an attractive company law to fill the gaps of the SE Regulation – is not confirmed by our empirical analysis as a motive for choosing the SE. Our survey evidence from Germany also suggests that the SE may be preferred to a domestic public company because of the choice it offers between a one-tier and a two-tier board. Finally, incorporation costs seem to have hampered SE growth.

Clearly, the most striking finding is that the SE has become a vehicle to reduce the effects of mandatory co-determination at board level or to avoid such co-determination altogether. What the founding fathers (and mothers) of the SE had in mind was enhancing cross-border mobility and creating a uniform company law for cross-border business activities in the internal market. However, such a new company type could not be devised without creating certain differences in relation to national companies. As it turns out, the resulting legal arbitrage opportunities do not go unexploited. This is true especially with respect to mandatory co-determination at board level, which is often profoundly unpopular with shareholders and (perhaps rather less so) with managers. Member State legislatures have reason to be concerned if they want to shield their statutory rules against legal arbitrage. At the same time, they may also use it as a source of inspiration. Legal arbitrage demonstrates a demand for legal rules that differ from existing law. Our evidence suggests that national jurisdictions should consider possible changes, such as abolishing or reducing co-determination at board level or allowing for bargained solutions. Also, there seems to be a need for a one-tier board structure even in the large, public company form. Faced with legal arbitrage, Member States can and should reassess their legal infrastructure for public companies.

We should like to conclude with an outlook on a (possible) European private company (Societas Privata Europaea – SPE). The European Commission has recently published a proposal for an SPE Regulation.[40] If the EU manages to agree on an SPE statute, our results suggest that we will see a lot more legal arbitrage going on than under the SE Regulation. There are many reasons for this prognosis. First, the SPE will have no or only a very low minimum capital requirement. This implies that the SPE will be relevant for a lot more firms. Further, the absence of a minimum capital requirement or a low minimum capital requirement in itself will be a great driver for using the SPE in countries that have a high minimum capital requirement for closed corporations. Second, the SPE statute will probably restrict incorporation costs. It seems likely that the incorporation documents will be controlled either through notarial certification or by a competent public authority, but not both. Third, it also seems likely that the SPE – in contrast to the SE – will be allowed to have its registered office and its actual head office in different Member States. Hence, engaging in legal arbitrage by choosing a registered office in a particular Member State will be relatively cheaper – it will not be necessary to relocate the actual head office as well.

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[40] *Supra* n. 19.

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Comment – Empirical law and economics: the Societas Europaea and its use within Europe

Patrick C. Leyens

1. EMPIRICAL LAW AND ECONOMICS

Empirics and regressions have not always received much attention in the process of European private law harmonisation. Today, legal research has become more open to innovative methods, in line with the advance of the law and economics movement.[1] Perhaps the most commonly remarked upon weakness of the economic analysis of the law is that its findings are too far removed from corporate and commercial reality.[2] In his presentation,[3] Horst Eidenmüller shows *that* and *how* empirical research will help to satisfy our demand for information on the practical effects European private law harmonisation has on corporate practice.

With a view to European company law, the merits of the empirical method can be assessed from several different angles. To start from a historic perspective, early attempts to fully harmonise company laws in Europe failed.[4] Perhaps that was not only due to the too flowery dreams of the grandfathers of European company law. A better explanation seems

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[1] For a critical assessment, see Siems, 'Numerical Comparative Law – Do We Need Statistical Evidence in Order to Reduce Complexity?', 13 *Cardozo J. Int'l & Comp. L.* 521 (2005). On the state of law and economics research see Schäfer and Ott, *The Economic Analysis of Civil Law*, Cheltenham 2004, pp. 3, 11.

[2] Most prominent: Ronald H. Coase in his Nobel Prize lecture, Stockholm, 9 December 1991; available at http://nobelprize.org/nobel_prizes/economics/laureates/1991/coase-lecture.html (last visited: 14/08/2009).

[3] The presentation by Horst Eidenmüller was based on his paper with Andreas Engert and Lars Hornuf, 'Incorporating under European Law: The Societas Europaea as a Vehicle for Legal Arbitrage', published as Chapter 2 in this Volume.

[4] On the state of company law harmonisation in Europe, see Grundmann, *European Company Law*, Antwerp and Oxford 2007, paras 94 et seq.

to be that we simply did not sufficiently understand the path-dependent operation of our national company laws.[5] After it had been accepted that full harmonisation would not be feasible, attention turned to a framework harmonisation of European company law. The Societas Europaea (SE) is an example of this development. Framework harmonisation is vulnerable in many regards. The aspect highlighted by *Eidenmüller* is legal arbitrage. The absence of full harmonisation, however, leaves room for regulatory competition, with the possible consequence of 'better regulation'. Nevertheless, a core challenge for the future of European private law – company law and beyond – is to develop a better understanding of private institutional choice. With regard to the SE, in 2001 it was a common belief amongst scholars that this supranational corporate form would not become a relevant choice for medium-sized companies. Empirical findings suggest that we were wrong.

Against this background, the SE is a historic chance to demonstrate the merits of empirical analysis. The SE is a genuine European corporate form. Exploring national differences in the use and operation of the SE will possibly improve the information available to us on the relevance of laws and other conditions that influence the private choice of a corporate form.

2. BOARD MODEL CHOICE

The SE Statute provides two board model options.[6] SEs can opt for the internationally predominant one-tier board structures. In this model, the board of directors serves as the single company organ, with all the possible shortcomings deriving from the accumulation of management and control in one single company body. Alternatively, an SE can opt for the two-tier board model. In that model, management and control tasks are divided between two boards, the management and the supervisory boards, with all the possible disadvantages in terms of effective information available to internal supervisors.[7]

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[5] See Bebchuk and Roe, 'A Theory of Path Dependence in Corporate Ownership and Governance', 52 *Stan. L. Rev.* 127 (1999) and Bratton and McCahery, 'Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference', 38 *Colum. J. Transnat'l L.* 213 (1999).

[6] Council Regulation (EC) No. 2157/2001 of 8 October 2001 on the Statute for a European company (SE), OJ EC L 294/1 of 10.11.2001 (in the following: SE Statute), Art. 39, para. 5 and Art. 43, para. 4.

[7] For a comparative account, see Leyens, 'Internal Corporate Governance in Europe: Towards a More Market-based Approach', 4 *Kyoto J. L. & Pol.* 17, 23 (2007). In detail id., *Information des Aufsichtsrats: Ökonomisch-funktionale Analyse und Rechtsvergleich zum englischen Board*, Tübingen 2006.

Since the failure of the Fifth Directive, we know that a full harmonisation of board structures will not be an acceptable option for the European Member States.[8] The modern approach points towards greater flexibility in board model structuring. According to the Company Law Action Plan of 2003, a board model choice will be made available not only for SEs, but also for national forms of corporations.[9] The choice is already available in France, Italy and Portugal, to name only a few examples which underline the finding of a delayed implementation of the Action Plan.[10]

No doubt, national company laws should not restrict private parties in their choice of a corporate governance arrangement that suits the preferences of the private parties. In the past, extensive research on boards has been undertaken.[11] Today, legal commentators widely agree that national company laws should provide a board model choice, at least for listed companies. The reasons *why* a company opts for the one or the other board model, however, are still widely unexplored. Future empirical research should provide a better understanding of those reasons. Given the multitude of possibly relevant factors, it remains a demanding task to provide a comprehensive explanation. *Eidenmüller* draws our attention to national path dependencies. For Germany, one of those path dependencies is employee co-determination.

3. EMPLOYEE CO-DETERMINATION

The strong employee co-determination at board level is a German peculiarity:[12] companies with more than 2000 employees are legally

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[8] For details, see Grundmann, supra n. 4, paras 400 et seq.

[9] Commission of the European Communities, Communication from the Commission to the Council and the European Parliament of 21 May 2003, Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward, COM (2003) 284(01), p. 17. The Action Plan follows closely the recommendations of the High Level Group of Company Law Experts, 'A Modern Regulatory Framework for Company Law in Europe, European Commission', Brussels, 4 November 2002, p. 59, recommendation III. 9.

[10] See Hopt and Leyens, 'Board Models in Europe – Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France and Italy', *Europ. Comp. Fin. L. Rev.* 2004, 135, 139 and 156, and Leyens, supra n. 7, p. 21.

[11] On the one-tier model, see Davies, 'Board Structure in the UK and Germany: Convergence or Continuing Divergence?', 2 *Int'l Comp. Corp. L. J.* 435 (2001) and on the two-tier model, Lutter, 'Comparative Corporate Governance: A German Perspective', 2 *Int'l Comp. Corp. L. J.* 423 (2001).

[12] For details see Grundmann, supra n. 4, paras 418 et seq., 1165 et seq.

required to set up a supervisory board and to give half of the seats to employees (parity co-determination). Co-determination at board level certainly has its merits. The merits, however, come with severe implications for the internal corporate governance of German companies. The most important is the impact of co-determination on the information flow from the management board to the supervisory board. Understandably, the management board reduces the information supply to a co-determined supervisory board, especially with regard to major transactions or decisions with a significantly adverse impact on the workforce. Such impairments of the information flow limit the effectiveness of the supervisory board as a device for controlling the management board and they generally slow down decision making at board level.[13]

The laws on co-determination lead to the unacceptable board size of 20 supervisory directors. The size of supervisory boards is generally considered to be a major weakness of internal corporate governance in Germany. Despite several reforms within the last decade, the German legislator still ignores the problem.[14] The empirical findings show that the SE can be used and that it *is used* to reduce the size of supervisory boards. The tool is a special negotiating arrangement, which allows setting the level and mode of employee participation by private agreement.[15] It is perhaps conventional wisdom that it is easier to ignore well-thought-out arguments than to ignore hard facts. The empirical findings hence give new hope that the legislator will support a more operable approach to the protection of employees' interests than a parity co-determination at board level.[16]

From an international perspective, mandatory co-determination increasingly appears to be a relic of German post-war needs. Against a background of changing age patterns within our society, we observe the growing importance of private pensions, occupational pension schemes and, more generally, increasing investments by employees in capital

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13 Hopt, 'Labor Representation on Corporate Boards: Impacts and Problems for Corporate Governance, and Economic Integration in Europe', 14 *Int'l Rev. L. & Econ*. 203, 206 (1994).

14 On German company law, see Leyens, 'German Company Law: Recent Developments and Future Challenges', 6 *German Law Journal* (*GLJ*) 1407 (2005).

15 Directive 2001/86/CE of 8.10.2001 supplementing the Statute for a European company with regard to the involvement of employees, OJ EC L 294/22 of 10.11.2001, Arts 3 et seq.

16 Recently a working group presented a draft for the reform of German co-determination on board level, which seeks to introduce a private agreement and hence widely follows the example of the SE See *Arbeitskreis 'Unternehmerische Mitbestimmung',* Entwurf einer Regelung zur Mitbestimmungsvereinbarung sowie zur Größe des Aufsichtsrats, *Zeitschrift für Wirtschaftsrecht (ZIP)* 2009, 885.

market products. In the long run, this development will change the intuitive assumption of diametrically opposed interests of workforce and capital.

The empirical findings on the use and content of private agreements promise insights for modern ways of balancing employees' interests. According to Eidenmüller, in at least one case an SE has apparently completely abolished co-determination by private agreement. At first sight, it is hard to believe that employees will support such a drastic reduction of their influence – all the more so since the fall-back option provided by law is ultimately parity co-determination. Empirical evidence explains that a social fund can be used as adequate compensation. This is a stunning finding, especially for those who believed that German co-determination was the only way to safeguard the interests of employees.

4. OUTLOOK

To conclude, a brief look at the links between the research method, board structure and co-determination will explain the possible implications of future research on the SE. The SE Statute requires an *effective* board model choice. The data show, however, that companies which are subject to co-determination at board level do not opt for a one-tier board. Based on this observation, the future existence of co-determination could become a matter to be decided not by a German national court but in the final analysis by the European Court of Justice.[17]

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[17] See Hopt, Europäisches Gesellschaftsrecht und deutsche Unternehmensverfassung, *Zeitschrift für Wirtschaftsrecht* (ZIP) 2005, 461, 471 and M. Roth, Die unternehmerische Mitbestimmung in der monistischen SE, *Zeitschrift für Arbeitsrecht (ZfA)* 2004, 431, 444.

3. Spillover of corporate governance standards in cross-border mergers and acquisitions*

Marina Martynova and Luc Renneboog

1. INTRODUCTION

Cross-border merger and acquisition (M&A) activity has increased significantly over the last 15 years (Moeller and Schlingemann, 2005). Expansion through cross-border acquisitions enables companies to exploit differences in tax systems and to capture rents resulting from market inefficiencies, such as national controls over labour and resources markets (Scholes and Wolfson, 1990; Servaes and Zenner, 1994). An additional source of takeover synergy in cross-border M&As may be induced by improvements in the governance of the bidding and target firms as a result of spillovers of corporate governance standards between the two firms.

Wang and Xie (2009) show that both bidder and target firms benefit from corporate governance improvements in domestic US mergers and acquisitions. They use the firm-level shareholder rights indices of Gompers et al. (2003) and show that takeover synergies increase with the differences in the index between the bidder and the target. We hypothesize that the scope for potential improvements in corporate governance is even greater in cross-border M&As as the difference between the bidder and target quality of corporate governance is amplified by the significant variation in national corporate governance standards. Therefore, our main question is: do differences in the quality of corporate governance standards between the bidder and target countries explain part of the expected value creation

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in cross-border takeovers? In other words, is there a valuation effect of cross-border spillover of corporate governance standards (and more specifically of investor protection) ?

Why would we expect such a spillover valuation effect for corporate governance? In international law, a full takeover leads to a change in the nationality of the target firm such that the acquirer's corporate governance regulation will apply to the combined company, in effect replacing the target corporate governance (Bris and Cabolis, 2008). When the bidder is subject to better corporate governance regulation than the target, the acquisition may result in an improvement in corporate governance (for example, enhanced shareholder orientation) at the target. As improved governance is expected to generate additional value, the abnormal share price returns of both the bidder and target should reflect such value creation. We call this hypothesis the *positive spillover by law hypothesis*. 'Positive' refers to the corporate governance improvement for the target as a result of the full takeover by the bidder. In other words, the better the bidder's corporate governance, the higher are the returns to the bidder and target firms from the takeover. Likewise, we define the 'negative spillover by law hypothesis': when the bidder governance standards are below those of the target, the abnormal returns will be lower as the governance standards of the target will now be less strict.

A *negative spillover by law* effect is expected between a bidder in a country with low investor protection and a target in a country with stricter corporate governance regulation, as the induced poor investor protection by the bidder may lessen the quality of corporate governance of the target. This could reduce the value of the target assets in the hands of the bidder. However, there is an alternative hypothesis: bidders can abide by the stricter regulation that the target is subject to. We call this the *bootstrapping hypothesis:* bidders voluntarily bootstrap their corporate governance regulation to a higher level.[1] As such, firms can contract privately on the optimal level of investor protection.[2] If the bidder intends to pursue such

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[1] One could somehow compare this to the bonding hypothesis: some firms seek a cross-listing on an exchange with stricter investor protection/listing requirements. This allows these firms to commit credibly to protect the shareholders' interests (see, for example, Coffee, 1999 and Doidge et al., 2006). Such bonding is credible to the market as it involves high costs (complying with different accounting standards, listing regulation, governance standards) and comprises a legal obligation.

[2] A counter-example whereby a firm moves towards less shareholder orientation is given by Bris and Cabolis (2007): they show that Aventis, the firm arising from the merger of German Hoechst and French Rhone-Poulenc, borrowed from the corporate governance regimes of both firms, resulting in a more protected company than with the French default legal system of investor protection.

bootstrapping to a higher level of corporate governance, its value may actually increase, which will be reflected in the bidder share price at the time of the takeover announcement. Bootstrapping may occur in both full and partial acquisitions, but the valuation effect may be stronger in partial takeovers, whereby a stake of less than 100 per cent of the voting rights is acquired and the target continues to be listed on its national stock exchange.[3] The bootstrapping valuation effect may also be stronger in takeovers with all-equity offers or mixed bids as (some of) the target shareholders will then remain involved with the merged company and may actively resist managerial actions reflecting a reduced shareholder orientation (Starks and Wei, 2005).

International law prescribes that the positive spillover by law effect is to take place in a full takeover, which leads to a change in the target firm's nationality. Nonetheless, partial takeovers may also lead to a similar spillover effect, which we call the *spillover by control* hypothesis. Although the target firm is not fully absorbed by the bidder in a partial acquisition, the bidder may still impose its own corporate governance standards on the target, provided that the bidder standards are stricter than the target's. In contrast, if the bidder standards are less strict than the target's, the bidder has to comply (locally) with the target corporate governance law and the listing regulations (in case the target continues to be listed on a national stock exchange).

The main conclusion from our empirical analysis is that the positive spillover by law hypothesis is supported whereas the negative spillover by law hypothesis is not. The bidder and target takeover announcement returns are positive when the former's governance standards are stricter than the latter's. This implies that the stricter governance imposed on the target is expected to lead to value creation, possibly to an increased focus on shareholder value and a reduction in the managerial private benefits of control. In contrast, when the bidder corporate governance standards are less strict than the target's, neither the bidder nor the target returns are lower. While this evidence goes against the negative spillover by law hypothesis, it does not contradict our bootstrapping hypothesis: it seems

[3] In the case of cross-border mergers, a bidder is entitled to subject a foreign-owned subsidiary to its local corporate law, irrespective of the domicile of the subsidiary (Bris and Cabolis, 2008, citing Muchlinski, 1997). When less than 100 per cent of the shares of the target are acquired by the foreign firm, the target firm remains operating under the law of its home country. Furthermore, the extraterritoriality principle in international law states that a state can assert jurisdiction over its nationals abroad. However, the extraterritoriality principle does not apply when a foreign firm acquires 100 per cent of the company's shares.

that poor-governance bidders bootstrap to the better-governance regime of the target, experiencing a share price increase. Importantly, the effect is only valid for partial acquisitions or, in other words, in deals which still involve some of the target shareholders (who did not sell out) and in which the target firm remains listed on the stock exchange in the country of the target.

The spillover by control hypothesis holds when the differences between bidder and target governance regulation have a positive effect on the anticipated gains of partial takeovers. The spillover effect from a bidder from a country with stronger shareholder protection than the target explains part of the value creation expected at the announcement of the partial takeover. The potential benefits from the improvement of the target corporate governance are shared by both the bidding and target firms' shareholders: both bidder and target returns increase. Our results are robust with respect to several model specifications that control for potential endogeneity problems.

Our results also support the view that national corporate governance regulation has a significant impact on the flow of cross-border takeovers. In particular, we find that firms from countries with weak corporate governance regulation are more likely to invest abroad rather than domestically, confirming earlier results by Doidge et al. (2007) and Benos and Weisbach (2004). We also find that bidders are more likely to acquire firms abroad if minority shareholder protection in their home country is strong. This result is in line with the argument by Goergen et al. (2005) that strong protection of minority shareholders makes corporate takeovers costly and hence forces companies to look for potential M&A targets abroad, in countries with weaker (minority) shareholder protection. Strong creditor protection in the home country also has a positive effect on international takeover activity. This may result from the relation between creditor protection and a firm's access to debt financing (La Porta et al., 1998). Martynova and Renneboog (2007a) show that debt financing is indeed frequently used in cross-border M&As. Therefore, cross-border M&As are more likely to be made by bidders that have access to less expensive debt capital, which prevails in countries with strong protection of creditor rights.

Finally, most of our other results on the effect of the relative transaction size, free cash flow, hostility, means of payment, diversification strategies, stock-price run-up, differences in economic development, geographical closeness and language relatedness of the bidder and target, the level of corruption and other characteristics are in line with the findings in the earlier literature.

This chapter contributes to the literature in two ways.

First, we answer the question *how or through which channels cross-border mergers and acquisitions generate value*. It is not purely economic characteristics (of the bid, the target, and the bidder) but also the spillover of corporate governance standards between the bidder and the target that explain part of the takeover premiums or the anticipated value (abnormal announcement returns). The impact of national corporate governance standards on the shareholder wealth effect in cross-border M&As has been previously studied in Bris and Cabolis (2008) and Bris et al. (2008), Starks and Wei (2005), Kuipers et al. (2003) and Rossi and Volpin (2004). These five studies investigate the valuation effects of corporate governance on M&As from different perspectives and arrive at different results. Our chapter is closest to the study by Bris and Cabolis (2008) and Bris et al. (2008). The authors show that takeover premiums in cross-border deals increase with the difference in shareholder protection and the quality of accounting standards between the bidder and the target. They report that this effect is significant only in M&As when the target changes its nationality (full acquisitions). In contrast, our results reveal that the improvement in the target shareholder protection has a positive effect on takeover synergy irrespective of the type of takeover. Our results thus reveal that governance-related takeover synergies may not only arise from a *spillover by law* effect but also from *spillover by control* and *bootstrapping* effects.

The second contribution is that our analysis is based on new corporate governance indices. Our *country-level indices* are more elaborate than the indices developed by La Porta, Lopez-de-Silanes, Shleifer and Vishny (henceforth LLSV) and employed in the studies mentioned above. With the help of 150 corporate lawyers from 32 European countries, we have created a corporate governance database that comprises the main changes in corporate governance regulation in all European countries over the last 15 years. For each country, we quantify corporate law, stock exchange regulation and corporate practices,[4] and measure their effectiveness in mitigating the conflicts of interest between the various corporate constituencies: management, majority and minority shareholders, and creditors. Our indices reveal that corporate governance regulation has been substantially reformed in virtually every European country since the early 1990s. Therefore, it is important to note that, in contrast to previous studies, all legal indices employed in this chapter are time-varying and reflect changes in the legal environment.

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[4] We also capture generally accepted corporate practices in as far as they are stricter than the regulation. For instance, non-voting shares are legal in the UK, but are not used by any firm listed on the London Stock Exchange. Therefore, we consider the UK as a country where the one-share-one-vote is upheld.

There are several reasons why we focus on country regulation (rather than firm-level regulation). First, it is virtually impossible to code the content of corporate charters, to collect the amendments and to gather all major shareholder decisions of AGMs for such a large group of firms. These firms are situated in a heterogeneous group of countries with varying degrees of transparency and disclosure problems. Second, empirical evidence reveals a high correlation between corporate governance at the firm level and at the country level. Doidge et al. (2007) analyse the variation in a cross-section of firm-level corporate governance indices and conclude that most of the variation can be explained by country characteristics. They argue that countries matter so much because they influence the costs that firms incur to bond themselves to good governance and the benefits they receive from doing so. The authors also state that firms with concentrated ownership (de facto the vast majority of listed firms in Continental Europe) invest less in firm-level governance mechanisms, as the major shareholders monitor their firm's managers more effectively.

The remainder of the chapter is organized as follows. Section 2 describes the data sources and sample composition, section 3 presents the empirical results, while section 4 concludes.

2. SAMPLE DESCRIPTION

We select our initial sample of European acquisitions undertaken during the fifth takeover wave (1993–2001) from the Mergers and Acquisitions Database of the Securities Data Company (SDC).[5] The SDC data is filtered down to intra-European cross-border takeovers, whereby both the acquirer and the target are from countries within Continental Europe and the UK. Our sample also includes deals involving firms from Central and Eastern Europe (including Russia). For reasons of comparison, we also collect information on domestic mergers and acquisitions in Continental Europe and the UK. We retain only those cross-border and domestic M&As that satisfy the following requirements:

[5] The quality of the SDC data is verified by comparing its information on the announcement date, the company's country of origin, the transaction value, payment structure, share of control acquired, bid completion status, and the target's attitude towards the bid with information from the news announcements stored in LexisNexis, the *Financial Times*, and Factiva. We uncovered inconsistencies in one or more records in 36 per cent of the observations of the SDC database, which we subsequently corrected.

- The transaction involves a change in control;[6]
- The shares of the bidder or the target firm (or of both) are traded on a Continental European or UK stock exchange;
- Both parties participating in the M&A transaction are independent corporations;[7]
- Neither the bidder nor the target is a financial institution (bank, unit trust, mutual fund or pension fund);
- The period between two consecutive bids by the same acquirer is at least 300 trading days;[8]
- Financial and accounting data for at least one of the participants of the transaction are available in DataStream or in the Amadeus, Fame or Reach databases.

Our final sample of domestic and cross-border M&A announcements consists of 2419 deals involving firms from 29 European countries. Cross-border M&As represent one-third of the sample (737 deals). Table 3.1 reports the sample distribution by country of the bidding and target firms. The most active cross-border acquirers are British, German and French firms, which together account for 49 per cent of all cross-border M&As. Firms from the UK, Germany and France are also most frequently the targets in cross-border acquisitions (37 per cent of all cross-border M&As). Not to be underestimated is the cross-border M&A activity involving Scandinavian firms, which represent 23 per cent and 17 per cent of all cross-border acquirers and targets, respectively.

Domestic M&A activity by UK, German, French and Scandinavian firms substantially exceeds their involvement in cross-border takeovers. In contrast, companies from the Benelux countries, Austria and Ireland are more frequently involved in cross-border rather than in domestic M&As. Relative to the other major economies in Continental Europe, Southern Europe (Greece, Italy, Portugal and Spain) has a remarkably low level of domestic and cross-border takeover activity. In cross-border M&As, Southern European firms are more frequently targets (of German, British and French bidders) than bidders. Another interesting observation relates to the Eastern and Central European countries that have joined the

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6 We require either that the transaction leads to a combination of the firms or that the acquirer who held less than 50 per cent of the target's stock prior to the transaction acquires majority control.

7 The absorption of subsidiaries is not included, nor are divestitures and management buyouts.

8 The reason for this restriction is that we want to avoid contamination of the windows used to estimate the systematic risk.

European Union since 2004. Many firms from these new member states are acquired by West European bidders, predominantly from neighbouring countries (Scandinavia, Austria and Germany). In contrast, participation by Central European firms as bidders in cross-border acquisitions is small, as is the domestic takeover market in that region.

3. EMPIRICAL RESULTS

3.1 Variable Construction

The following subsections discuss the measurement of four categories of variables: (i) the bidder and target announcement returns (the dependent variables), (ii) corporate governance indices, (iii) measures of corporate governance spillover effects (our key explanatory variables) and (iv) bidder-, target- and deal-specific characteristics (our control variables). The definitions of variables and data sources are summarized in Appendix 1.

3.1.1 The bidder and target announcement returns

We measure the short-term wealth effects at the takeover announcement using the event study methodology. For each bidding and target firm, we compute the daily abnormal returns realized over the period starting one day prior and ending one day subsequent to the day of the public takeover announcement.[9] The takeover announcement wealth effect is the sum of these daily abnormal returns. We also consider longer event windows, such as [–5, +5] and [–60, +60]. Daily abnormal returns are the difference between realized and market model benchmark returns. Our market model is based on the MSCI-Europe index and its parameters are estimated over 240 days, starting 300 days prior to the acquisition announcement.[10] To test the significance of the estimated abnormal returns, we use both parametric and non-parametric tests as discussed by Brown and Warner (1985) and Corrado (1989), respectively.

As panel A of Table 3.2 shows, the three-day cumulative average

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[9] The event day is either the day of the announcement or the first trading day following the announcement where the announcement is made on a non-trading day.

[10] Our estimates of the abnormal returns are robust with respect to the geographical scope of the market index (local, European-wide, and worldwide index) and the estimation model of the benchmark returns (the estimated beta adjusted for mean-reversion (Blume, 1979), and non-synchronous trading (Dimson, 1979)). Changing the market index or the estimation model does not materially change any of the results in the remainder of the chapter.

Table 3.1 Sample distribution by country of bidding and target company in domestic and cross-border M&As

	TARGET FIRMS													
BIDDING FIRMS	AUS	BEL	BUL	CRO	CYP	CZR	DEN	EST	FIN	FRA	GER	GRE	HUN	IRE
AUS	11	–	–	2	–	2	1	–	–	–	12	–	2	–
BEL	–	23	–	–	–	1	–	–	–	14	4	–	–	–
BUL	–	–	0	–	–	–	–	–	–	–	–	–	–	–
CRO	–	–	–	0	–	–	–	–	–	–	–	–	–	–
CYP	–	–	–	–	3	–	–	–	–	–	–	–	–	–
CZR	–	–	–	–	–	9	–	–	–	–	–	–	–	–
DEN	1	–	–	1	–	–	30	1	3	4	2	–	–	–
EST	–	–	–	–	–	–	–	0	–	–	–	–	–	–
FIN	1	–	–	–	–	–	4	6	53	–	3	–	–	–
FRA	3	2	–	–	–	7	–	–	1	219	22	1	–	–
GER	9	4	–	–	–	4	–	–	1	10	174	–	1	1
GRE	–	–	–	–	–	–	–	–	–	–	–	1	–	–
HUN	–	–	–	2	–	–	–	–	1	–	1	–	4	–
IRE	–	1	–	–	–	–	2	–	1	–	–	–	–	11
ITA	–	–	–	–	–	1	–	–	–	7	5	–	–	–
LAT	–	–	–	–	–	–	–	1	–	–	–	–	–	–
LIT	–	–	–	–	–	–	–	–	–	–	–	–	–	–
LUX	–	1	–	–	–	–	–	–	–	1	3	–	–	1
NL	–	–	–	–	–	1	1	–	–	7	2	–	–	–
NOR	–	–	–	–	–	–	3	2	2	2	4	–	–	–
POL	–	–	–	–	–	–	–	–	–	–	–	–	–	–
POR	–	–	–	–	–	–	–	–	–	–	–	–	–	–
ROM	–	–	–	–	–	–	–	–	–	–	–	–	–	–
RUS	1	–	1	–	–	–	–	1	–	–	–	–	–	–
SLO	–	–	–	–	–	–	–	–	–	–	–	–	–	–
ESP	–	–	–	–	–	–	–	–	–	1	1	–	–	–
SWE	1	1	1	–	–	3	6	2	8	5	5	2	–	–
SWZ	2	–	–	–	–	1	–	–	–	7	6	–	–	–
UK	2	5	–	1	–	5	4	–	3	31	20	–	–	14
Total Cross-border* NUM	20	14	2	6	–	25	21	13	20	89	90	3	3	16
%	*2.7%*	*1.9%*	*0.3%*	*0.8%*	–	*3.4%*	*2.9%*	*1.8%*	*2.7%*	*12.0%*	*12.2%*	*0.4%*	*0.4%*	*2.2%*

Notes: The diagonal elements report the number of domestic acquisitions in a particular country. Off-diagonal elements report the number of cross-border bids involving bidding and target companies from the two corresponding countries. *Total** NUM counts total the cross-border M&As (excluding domestic deals); *Total** *%* shows the percentage of cross-border M&As involving firms from one country in the total number of cross-border M&As. The following country codes are used: AUS = Austria, BEL = Belgium, BUL = Bulgaria,

TARGET FIRMS															*Total* cross–border*	
ITA	LAT	LIT	LUX	NL	NOR	POL	POR	ROM	RUS	SLO	ESP	SWE	SWZ	UK	NUM	%
1	–	–	–	1	–	4	–	3	–	1	–	–	2	–	31	*4.2%*
1	–	–	–	2	1	1	1	1	1	–	–	3	1	3	34	*4.6%*
–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–
–	–	–	–	–	–	–	–	–	–	–	–	–	–	1	1	*0.1%*
–	–	–	–	–	1	–	–	–	–	–	–	1	–	–	2	*0.3%*
–	–	–	–	–	–	–	–	1	–	–	–	–	–	–	1	*0.1%*
3	–	2	–	1	4	1	–	–	–	–	–	3	–	6	32	*4.3%*
–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–
1	3	1	–	1	2	1	–	1	1	–	–	6	–	1	32	*4.3%*
13	–	–	1	5	1	6	1	2	1	2	8	3	5	26	110	*14.9%*
9	–	–	1	7	1	5	2	2	2	–	2	5	10	13	89	*12.1%*
–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–
–	–	–	–	–	–	–	–	–	1	–	–	–	–	–	5	*0.7%*
–	–	–	–	2	–	1	–	–	–	–	–	–	–	19	26	*3.5%*
39	–	2	1	–	1	1	1	–	–	–	5	1	–	3	28	*3.8%*
–	0	–	–	–	–	–	–	–	–	–	–	–	–	–	1	*0.1%*
–	–	1	–	–	–	–	–	–	–	–	–	–	–	–	–	–
–	–	–	0	–	–	–	–	–	–	–	–	–	–	1	7	*1.0%*
2	–	–	1	2	1	3	–	–	1	–	1	–	1	6	27	*1.3%*
–	–	–	–	–	58	2	–	–	–	–	–	13	–	4	32	*4.3%*
–	–	–	–	–	–	22	–	–	–	–	–	–	–	–	–	–
–	–	–	–	–	–	–	1	–	–	–	1	–	–	–	1	*0.1%*
–	–	–	–	–	–	–	–	2	–	–	–	–	–	–	–	–
–	–	–	–	–	–	–	–	–	10	–	–	–	–	–	3	*0.4%*
–	–	–	–	–	–	–	–	–	–	0	–	–	–	–	–	–
–	–	–	–	1	–	3	1	–	–	–	46	–	1	1	9	*1.2%*
2	1	1	–	4	16	4	1	–	1	1	–	102	2	2	69	*9.4%*
4	–	–	–	3	2	–	2	–	1	–	2	1	22	8	39	*5.3%*
8	–	–	1	18	7	5	2	1	1	–	14	12	5	838	159	*21.5%*
44	4	6	5	45	37	37	11	11	10	4	33	48	27	94	738	*100%*
6.0%	*0.5%*	*0.8%*	*0.7%*	*6.1%*	*5.0%*	*5.0%*	*1.5%*	*1.5%*	*1.4%*	*0.5%*	*4.5%*	*6.5%*	*3.7%*	*12.7%*	–	*100%*

CRO = Croatia, CYP = Cyprus, CZR = Czech Republic, DEN = Denmark, EST = Estonia, FIN = Finland, FRA = France, GER = Germany, GRE = Greece, HUN = Hungary, IRE = Republic of Ireland, ITA = Italy, LAT = Latvia, LIT = Lithuania, LUX = Luxembourg, NL = Netherlands, NOR = Norway, POL = Poland, POR = Portugal, ROM = Romania, RUS = Russia, SLO = Slovenia, ESP = Spain, SWE = Sweden, SWZ = Switzerland, UK = United Kingdom.

abnormal return (CAAR) is 0.83 per cent and 0.47 per cent for the subsamples of domestic and cross-border bidders respectively. Both figures are significantly different from zero at the 5 per cent level and the difference in the CAARs between the two subsamples is also statistically significant.[11] This result confirms the findings of recent empirical studies that cross-border bidders somewhat underperform their domestic peers (see, for example, Moeller and Schlingemann, 2005; Denis et al., 2002). In contrast, targets in cross-border takeovers experience significantly higher returns than targets in domestic bids. For the three-day window centred on the bid announcement, cross-border target firms accumulate abnormal returns of 12.55 per cent compared to 11.52 per cent for domestic targets. Goergen and Renneboog (2004) document similar differences for large intra-European M&As.

To investigate the influence of the legal environment on the takeover wealth effect, we compare the CAARs for subsamples of bidders (targets) across countries of different legal origins. Countries from the former communist block are classified according to their (staged) accession to the European Union. Panel B of Table 3.2 reveals systematic differences in the bidder and target CAARs by legal origin. Whereas bidders of German or Scandinavian legal origin earn significant positive returns in cross-border M&As, their counterparts of English or French legal origin earn more modest or even insignificant returns, and bidders from recent EU Accession countries incur negative returns. For the target firms, we observe that companies of English or Scandinavian legal origin yield the highest announcement returns, which are almost 2.5 times higher than the returns of target companies of French or German legal origin. Remarkably, the CAARs to the target firms from the former communist block countries are not significantly different from zero.

3.1.2 Corporate governance standards indices

To measure the quality of corporate governance standards in the bidder and target firms' countries, we construct a number of indices.[12] With the

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[11] We (conservatively) only report the non-parametric tests. The significance levels of the parametric tests corroborate the non-parametric tests but the former lead to higher levels of significance.

[12] These indices overcome some of the limitations of the LLSV indices. First, our indices are based on a broader definition of corporate governance regulation than that used by LLSV. Second, our indices are dynamic: they capture the many regulatory reforms on a yearly basis since 1990. Furthermore, we use the functional approach to construct the indices, which differs from the comparative approach employed by LLSV (1998). For a detailed discussion of the limitations and advantages of our indices, see Martynova and Renneboog (2007b).

Table 3.2 *Cumulative average abnormal returns (CAARs) to bidding and target firms in cross-border and domestic M&As*

	Cross-border M&As		Domestic M&As		*Diff.* Cross-Border –Domestic	
	Mean value	t-stat. [Nobs]	Mean value	t-stat. [Nobs]	Mean value	t-stat.
Panel A. Takeover Announcement Effect						
			The BIDDER CAARs:			
[–1; +1]	0.47[b]	*2.25 [653]*	0.83[a]	*3.95 [1456]*	–0.36[b]	*–2.17*
[–5, +5]	0.85[c]	*1.92 [653]*	0.76[a]	*2.56 [1456]*	0.09	*1.15*
[–60; +60]	–3.63[c]	*–1.80 [653]*	–2.49[c]	*–1.80 [1456]*	–1.14[a]	*–3.40*
			The TARGET CAARs:			
[–1; +1]	12.55[a]	*5.24 [296]*	11.52[a]	*7.42 [764]*	1.02[a]	*–2.65*
[–5, +5]	15.61[a]	*16.15 [296]*	12.17[a]	*2.60 [764]*	3.44[a]	*–3.54*
[–60; +60]	26.84[a]	*12.04 [296]*	24.99[a]	*10.22 [764]*	1.85[a]	*–3.53*
Panel B. Takeover Announcement Effect by Legal Origin						
		The BIDDER CAARs [–1, +1] by legal origin of the bidder country:				
English legal origin	0.36	*1.63 [173]*	0.50[a]	*2.69 [744]*	–0.14	*–1.30*
French legal origin	0.39[c]	*1.88 [181]*	0.91[b]	*2.32 [279]*	–0.52[b]	*–2.18*
German legal origin	0.66[b]	*2.08 [137]*	0.59[b]	*2.44 [184]*	0.07	*0.61*
Scandinavian legal origin	0.67[b]	*2.15 [149]*	2.29[a]	*3.17 [206]*	–1.62[a]	*–3.44*
EU 2004 Accession countries	–1.25[b]	*–2.03 [6]*	0.12	*0.56 [35]*	–1.37[a]	*–2.86*
EU 2007 Accession countries, Croatia, and Russia	–1.60	*–0.23 [4]*	–0.51	*–0.15 [8]*	–1.09	*–0.55*

Table 3.2 (continued)

	Cross-border M&As		Domestic M&As		*Diff.* Cross-Border –Domestic	
	Mean value	t-stat. [Nobs]	Mean value	t-stat. [Nobs]	Mean value	t-stat.
	The TARGET CAARs [–1, +1] by legal origin of the target country:					
English legal origin	19.42[a]	*7.52 [57]*	17.64[a]	*14.00 [306]*	1.78[b]	*2.44*
French legal origin	7.12[a]	*3.80 [52]*	2.82[a]	*3.18 [118]*	4.30[a]	*3.19*
German legal origin	7.06[a]	*3.46 [33]*	4.42[a]	*3.17 [48]*	2.64[a]	*2.53*
Scandinavian legal origin	17.32[a]	*7.95 [38]*	14.77[a]	*7.12 [76]*	2.55[a]	*2.72*
EU 2004 Accession countries	1.52	*1.53 [15]*	3.67[a]	*2.74 [11]*	–2.15	*–1.62*
EU 2007 Accession countries, Croatia, and Russia	–0.18	*–0.12 [8]*	–6.36	*–0.78 [5]*	6.18[a]	*3.11*

Notes: Panel A reports the average values of the CARs for bidding and target firms in cross-border and domestic acquisitions conducted in Continental Europe and the UK. The CAARs are reported in percentages. Panel B reports the CAARs for bidding and target firms in cross-border and domestic acquisitions classified by the legal origin of the bidder and target countries. Abnormal returns are computed as the difference between the realized and market model benchmark returns. For each firm, we calculate daily benchmark returns using MSCI-Europe index returns and the market model parameters are estimated over 240 days, starting 300 days, prior to the acquisition announcement. The t-statistics from the non-parametric test (Corrado, 1989) is reported to assess the significance of the CAARs. a, b, and c stand for statistical significance at the 1%, 5%, and 10% level, respectively. Nobs stands for the number of observations.

help of 150 corporate lawyers from 32 European countries (as reported in Appendix 2), we create a corporate governance database comprising the main aspects of and changes in corporate governance regulation in all European countries (including Central and Eastern Europe) since 1990. For each country, we quantify the regulation mitigating the conflicts of interests between the main corporate constituencies: management versus shareholders, majority versus minority shareholders, and creditors versus shareholders. We construct the following three indices (see also Martynova and Renneboog, 2007b). All these indices are rescaled to take values within the [0, 10] interval.

(i) The *shareholder rights* index is based on shareholders' ability to curb managerial opportunistic behaviour. The index measures the degree of *shareholder orientation* of a national regulation. The index increases with the number and quality of legal provisions that provide shareholders with effective power to appoint and dismiss the board of directors and to control most of the important corporate decisions on, for instance, equity issues or anti-takeover measures. We also take into account the regulatory provisions that ensure that the board of directors acts as an independent body operating on behalf of all shareholders and monitors top management. Provisions that address the quality of information on the management and the frequency of disclosure of accounting information are also considered. A higher index score represents a higher likelihood that management acts in the interest of shareholders and hence reflects better corporate governance standards with respect to shareholder protection.

(ii) The *minority shareholder protection* index hinges on the regulatory provisions that increase the relative power of the minority shareholders in the presence of strong majority shareholders. In a firm with concentrated control, it is possible that the dominant shareholder extracts private benefits of control by influencing managerial decisions for his own benefit (see, for example, Durnev and Kim, 2005). This may lead to the expropriation of minority shareholders' rights. We quantify the regulatory provisions related to minority shareholder protection (for example, board representation, minority claims, extraordinary general meetings, blocking minorities), the one-share-one-vote principle (dual class shares, voting caps, breakthrough rule, equal treatment principle), ownership transparency, and the relative decision power in case of a takeover threat. A higher index score signifies that minority shareholders' interests are better protected.

The shareholder rights and minority shareholder protection indices are positively correlated because they both reflect to some degree the underlying quality of shareholder protection in a country. However, they are based on different institutional characteristics.

(iii) The *creditors' rights* index hinges on the regulatory provisions that allow creditors to force repayment more easily, to take possession of the collateral, or even to gain control over the firm in case of financial distress. In creating this creditor rights index, we closely follow the approach of LLSV and investigate the regulation related to the violation of debt covenants (deviations from the debtor priority ranking in case of bankruptcy), the possibility for debtors to impose restrictions on borrowers (for example, limitations on filing for reorganization/liquidation), and creditors' rights in financially distressed firms (for example, automatic stay on assets). The index also captures the difference between creditor-oriented and debtor-oriented bankruptcy codes: we augment the creditor rights index for a country with a pure liquidation code by one, while leaving the index unchanged for a country with a debtor-oriented code.[13] The reason is that a bankruptcy code that facilitates reorganization focuses on corporate survival, usually at the expense of the (more senior) creditors. A higher index score reflects stronger creditor rights, that is, higher corporate governance standards with respect to creditor protection.

The constituents of each index and their coding are given in Appendix 3.

It is important to note that a system with strong legal enforcement may substitute for weaker regulation as well-functioning courts can effectively resolve disputes between corporate constituencies (LLSV, 1998). Conversely, a law designed to uphold the rights of, for example, minority shareholders may be eroded where the judiciary does not function effectively. To address these problems, we multiply the above indices by an index capturing the quality of law enforcement. We use the rule of law index developed by the World Bank, which we rescale to take values within the [0, 1] interval. The *rule of law index* measures the extent to which agents have confidence in and abide by the rules of society, which include the effectiveness and predictability of the judiciary and the enforceability of contracts. A higher score on the index signifies that a national judicial system is more effective.

Panel A of Table 3.3 reports the mean values of the corporate governance indices multiplied by the rule of law index. (Henceforth, when we refer to the corporate governance indices, we refer to the original indices multiplied by the rule of law index). The indices are reported by legal origin and for every fifth year over the period 1990–2005. The panel shows

[13] Chapter 11 in the US and administration in the UK are the prototype of a debtor-oriented code. In the 1990s, many bankruptcy codes have been reorganized and now frequently include two tracks: a debtor-oriented part and a pure liquidation code. We classify such bankruptcy codes as debtor-oriented.

Table 3.3 Corporate governance regulation indices

	English legal origin	French legal origin	German legal origin	Scandi-navian legal origin	EU 2004 Accession	EU 2007 Accession countries, Croatia, and Russia
	N = 2	N = 8	N = 3	N = 4	N = 9	N = 4
Panel A. Corporate Governance Indices by Legal Origin and by year						
SHAREHOLDER RIGHTS INDEX:						
1990	4.79	3.33	2.93	3.34	1.72	1.62
1995	5.21	3.39	3.21	3.55	2.23	1.72
2000	5.91	3.87	4.28	3.97	2.65	2.04
2005	6.13	4.57	4.66	4.18	3.34	2.86
MINORITY SHAREHOLDER PROTECTION INDEX:						
1990	4.25	2.69	3.14	3.21	1.51	0.68
1995	4.58	2.89	3.57	3.38	2.13	1.18
2000	5.20	3.37	4.52	3.60	2.78	1.96
2005	5.05	3.42	4.64	3.63	3.54	2.15
CREDITOR RIGHTS INDEX:						
1990	3.40	4.42	5.92	6.67	1.18	1.22
1995	3.40	4.43	5.92	5.33	3.51	2.27
2000	3.51	3.89	4.29	4.07	3.82	2.33
2005	3.41	3.48	4.11	4.03	4.10	2.61

Panel B. Corporate Governance Indices by the Bidder/Target Country in Cross-border and Domestic M&As

	Cross-Border M&As		Domestic M&As		*Diff.* Cross-Border – Domestic	
	Mean value	t-stat.	Mean value	t-stat.	Mean value	t-stat.
SHAREHOLDER RIGHTS INDEX:						
Bidder Country	4.37		5.11		–0.74[a]	*–3.22*
Target Country	3.74		5.11		–1.37[a]	*–2.84*
Diff. Bidder – Target	*0.63*[a]	*3.16*	–	–	–	–

Table 3.3 (continued)

	Cross-Border M&As		Domestic M&As		*Diff*. Cross-Border – Domestic	
	Mean value	t-stat.	Mean value	t-stat.	Mean value	t-stat.
			MINORITY SHAREHOLDER PROTECTION INDEX:			
Bidder Country	4.06		4.41		–0.35[a]	*–2.65*
Target Country	3.74		4.41		–0.67[a]	*–3.11*
Diff. Bidder – Target	*0.32*[b]	*2.31*	–	–	–	–
			CREDITOR RIGHTS INDEX:			
Bidder Country	3.71		3.43		0.28	*1.62*
Target Country	3.72		3.43		0.29	*1.61*
Diff. Bidder – Target	*–0.01*	*–0.04*	–	–	–	–
Num. of obs	737		1681			

Notes: Panel A reports the mean values of the corporate governance indices by legal origin and for every fifth year over the period 1990–2005. All indices are adjusted for the degree of law enforcement by country. *N* is the number of countries of a specific legal origin. Panel B reports the mean values of the indices for bidder and target countries by domestic and cross-border M&As. *a, b* and *c* stand for statistical significance at the 1%, 5% and 10% level, respectively.

that in 1995 – the reference year for the LLSV indices – our shareholder rights protection index ranks countries in a similar order as it does the LLSV anti-director index. That is, countries of English legal origin have the highest corporate governance standards with respect to shareholder protection. They are followed by countries of Scandinavian legal origin, and then by countries of French and German legal origin. The panel also shows that there have been substantial changes in corporate governance standards in virtually every country in Europe over the past 15 years. The changes relate to all three dimensions of corporate governance standards addressed in this chapter. However, in 2005, countries of English legal origin still provide the highest quality of shareholder protection. Over time, shareholder rights and minority shareholder protection have increased throughout Continental Europe and the UK, whereas creditor protection has been reduced in Western Europe. By 2005, many Continental European countries had improved their legal system and moved closer to the standards set by the English legal system.

Panel B of Table 3.3 shows the mean values of the corporate governance indices for the countries of bidding and target companies measured in the year of acquisition. It shows that, in contrast to targets in cross-border acquisitions, bidding firms are from countries with better legal protection of (minority) shareholders. This pattern is consistent with the evidence from Rossi and Volpin (2004): targets in cross-border acquisitions are typically from countries with poorer standards of shareholder protection than bidders. The difference in creditor rights between bidder and target countries seems to have no impact on the flow of cross-border M&As.

The correlation matrix in Table 3.4 shows that the value of the target shareholder rights index is positively correlated with bidder and target takeover returns. The value of the target minority shareholder protection index is also positively correlated with target returns, but is negatively correlated with bidder returns. The table also reports the correlations between the indices and the main variables that are used in the regression models below.

3.1.3 Corporate governance spillover effects

We measure the potential corporate governance spillover effect in cross-border mergers and acquisitions in two ways. First, we take the difference between the indices of the bidder and target countries (the differences approach). This variable captures the scope of the potential improvement (or deterioration) in corporate governance if the target firm were to adopt the standards of the bidder. The quality of corporate governance standards is measured by means of the three indices discussed above; we measure it with respect to the protection of shareholders, minority shareholders, and creditors (while taking into account the quality of the judiciary). Table 3.4 shows that the shareholder-rights difference is positively correlated with the target takeover returns.

Second, we construct indicator variables capturing the direction of corporate governance spillover effects: from the bidder to the target and vice versa (the indicator-variable approach). The indicator variable for the spillover of better governance standards from the bidder to the target equals one if the bidder index is above the median and the target index is below the median (the *positive spillover by law/spillover by control effect*), and is zero otherwise. The indicator variable for the spillover of better

Table 3.4 Correlation matrix

	(Bidder) CAR [–1, +1]	(Target) CAR [–1, +1]	(Bidder) Shareholder Rights Index	(Bidder) Minority Shareholder Protection Index	(Bidder) Creditor Rights Index	(Target) Shareholder Rights Index	(Target) Minority Shareholder Protection Index	(Target) Creditor Rights Index	Difference Bidder-Target Shareholder Rights Index	Difference Bidder-Target Minority Shareholder Protection Index	Difference Bidder-Target Creditor Rights Index
(Bidder) CAR	–	0.023	0.035	0.023	0.001	**0.066**[c]	**–0.054**[c]	0.017	–0.008	–0.044	–0.013
[–1, +1]		(0.814)	(0.376)	(0.763)	(0.998)	(0.053)	(0.066)	(0.653)	(0.533)	(0.259)	(0.744)
(Target) CAR	0.023Z	–	0.024	0.058	–0.099	**0.319**[a]	**0.226**[a]	0.056	**0.222**[a]	0.124	–0.076
[–1, +1]	(0.814)		(0.735)	(0.416)	(0.165)	(0.000)	(0.001)	(0.229)	(0.002)	(0.185)	(0.114)
(Bidder)	–0.031	**–0.166**[c]	**0.146**[a]	**0.110**[b]	–0.047	0.066	0.028	–0.079	0.054	–0.033	0.030
Q-ratio	(0.561)	(0.072)	(0.005)	(0.035)	(0.372)	(0.209)	(0.315)	(0.129)	(0.308)	(0.531)	(0.566)
(Bidder)	0.001	0.084	–0.001	–0.040	**0.178**[b]	0.027	0.057	–0.008	–0.019	–0.072	0.056
Leverage	(0.988)	(0.478)	(0.979)	(0.439)	(0.032)	(0.598)	(0.272)	(0.882)	(0.707)	(0.168)	(0.283)
(Bidder) Size	**–0.222**[a]	0.031	**–0.150**[a]	**–0.132**[b]	–0.001	–0.003	0.008	0.011	**–0.099**[c]	**–0.091**[c]	–0.009
(log TA)	(0.009)	(0.793)	(0.004)	(0.011)	(0.990)	(0.946)	(0.871)	(0.827)	(0.057)	(0.083)	(0.863)
(Bidder)	–0.063	0.058	0.057	0.081	0.044	0.039	0.055	–0.005	0.012	0.007	0.032
CFlow/TA	(0.230)	(0.218)	(0.272)	(0.118)	(0.401)	(0.458)	(0.284)	(0.925)	(0.814)	(0.900)	(0.545)
(Target)	**–0.228**[b]	–0.059	0.045	–0.042	0.057	–0.011	–0.016	0.007	0.033	–0.017	0.037
Q-ratio	(0.022)	(0.474)	(0.568)	(0.595)	(0.475)	(0.892)	(0.836)	(0.932)	(0.681)	(0.829)	(0.644)
(Target)	–0.011	0.024	–0.068	–0.096	–0.004	–0.021	–0.127	**0.113**[b]	–0.023	0.029	–0.077
Leverage	(0.914)	(0.766)	(0.380)	(0.222)	(0.959)	(0.794)	(0.102)	(0.047)	(0.772)	(0.711)	(0.325)
(Target)	**0.197**[b]	0.068	–0.007	–0.032	–0.105	0.045	–0.033	0.121	–0.037	0.003	–0.154
CFlow/TA	(0.045)	(0.406)	(0.928)	(0.684)	(0.180)	(0.567)	(0.678)	(0.122)	(0.641)	(0.978)	(0.048)

Equity Payment	–0.059	**–0.215** [a]	**–0.110** [b]	**–0.120** [b]	0.028	0.036	0.007	–0.000	**–0.096** [b]	**–0.092** [c]	0.018
	(0.254)	(0.005)	(0.019)	(0.011)	(0.552)	(0.447)	(0.878)	(0.999)	(0.043)	(0.053)	(0.702)
Public Target	–0.035	–	–0.030	–0.019	**0.131** [a]	**0.254** [a]	**0.222** [a]	0.031	**–0.193** [a]	**–0.188** [a]	**0.066** [c]
	(0.368)		(0.413)	(0.595)	(0.000)	(0.000)	(0.000)	(0.406)	(0.000)	(0.000)	(0.075)
Hostile Bid	**–0.093** [c]	**0.189** [a]	–0.032	–0.018	–0.041	**0.171** [a]	**0.138** [a]	0.046	**–0.138** [a]	**–0.121** [a]	–0.059
	(0.077)	(0.008)	(0.385)	(0.621)	(0.266)	(0.000)	(0.000)	(0.213)	(0.000)	(0.001)	(0.104)
M&A of 100%	0.036	**0.337** [a]	**0.094** [a]	**0.067**	–0.006	**0.274** [a]	**0.219** [a]	0.051	**–0.120** [a]	**–0.125** [a]	–0.041
	(0.353)	(0.000)	(0.010)	(0.067)	(0.859)	(0.000)	(0.000)	(0.163)	(0.001)	(0.000)	(0.267)
Diversification	–0.007	0.100	–0.003	0.008	0.025	**0.065** [c]	0.054	0.029	–0.046	–0.037	–0.004
	(0.857)	(0.163)	(0.928)	(0.829)	(0.495)	(0.075)	(0.137)	(0.432)	(0.208)	(0.310)	(0.914)
Relative Size	0.008	–0.083	**–0.219** [a]	**–0.167** [a]	–0.070	**0.132** [b]	0.088	0.085	**–0.224** [a]	**–0.181** [a]	**–0.107** [b]
	(0.878)	(0.151)	(0.000)	(0.002)	(0.193)	(0.015)	(0.104)	(0.117)	(0.000)	(0.001)	(0.049)
(Bidder) Runup	**0.129** [a]	0.141	0.039	**0.088** [b]	0.053	0.026	0.049	0.004	0.011	0.022	0.032
	(0.001)	(0.145)	(0.311)	(0.024)	(0.173)	(0.499)	(0.209)	(0.917)	(0.789)	(0.575)	(0.416)
(Target) Runup	–0.133	**0.137** [c]	–0.028	0.052	0.042	**0.347** [a]	**0.326** [a]	–0.017	**–0.272** [a]	**–0.202** [a]	0.042
	(0.171)	(0.056)	(0.690)	(0.468)	(0.557)	(0.000)	(0.000)	(0.813)	(0.000)	(0.004)	(0.562)

Note: a, b and c stand for statistical significance at the 1%, 5% and 10% level, respectively. P-values testing the difference from zero are given in parentheses.

governance standards from the target to the bidder (the *bootstrapping effect*) equals one if the bidder index is below the median and the target index is above the median, and is zero otherwise. Alternatively, this variable may indicate the spillover of the bidder's low governance standards to the target firm (the *negative spillover by law effect*), if its parameter estimate has the inverse sign. Overall, the indicator variables denote whether a bidding company is likely to improve or worsen its own governance and the governance in a target firm. It should be noted that the median value of each index is measured across all countries in a particular year and both the bidder and target indices are compared to the same median.

Table 3.5 partitions all M&As by the quality of corporate governance standards. It shows that the majority of cross-border bidders are from countries with superior standards of investor protection. More than 76 per cent of all cross-border bidders are from countries with a shareholder rights index above the median (panel A). This percentage is even higher (about 93 per cent) when we consider minority shareholder protection (panel B). Panel C shows that the sample is evenly split between bidders from countries with below- and above-median creditor rights. A similar picture arises for target companies: they tend to be from countries with above-median investor protection. These patterns stand in sharp contrast to those documented by Bris and Cabolis (2008), who find that the majority of bidders and targets are from countries with below-median investor protection. This difference may be due to sample composition. In contrast to Bris and Cabolis (2008), our sample excludes M&As that involve firms from outside Continental Europe and the UK. Another rationale for the observed differences is that our classification is based on our dynamic corporate governance indices, whereas Bris and Cabolis (2008) use the static LLSV indices.

Table 3.5 shows that bidders from legal systems with below-median investor protection mainly acquire target firms from systems with above-median legal protection (63.46 per cent). Similarly, target firms from legal systems with below average investor protection tend to sell their shares to foreign acquirers coming from systems with superior legal protection (80.71 per cent).

3.1.4 Other determinants of the bidder and target returns

We consider three categories of additional factors that may influence bidder and target returns: the characteristics of the bidder and target firms, the features of the takeover deal and the characteristics of the bidder and target countries.

Bidder and target characteristics The bidder characteristics that we control for are firm size, Q-ratio, leverage, cash flow, and pre-announcement

Table 3.5 Sample composition by quality of the bidder and target corporate governance systems for cross-border acquisitions

Panel A. Shareholder Rights Index

Frequency Percent Row Pct Col Pct		*TARGET FIRMS* Below Median	Above Median	Total
BIDDING FIRMS	Below Median	49 6.65% 27.84% 19.29%	127 17.23% 72.16% 26.29%	176 23.88%
	Above Median	205 27.82% 36.54% 80.71%	356 48.30% 63.46% 73.71%	561 76.12%
	Total	254 34.46%	483 65.54%	737 100.0%

Panel B. Minority Shareholder Protection Index

Frequency Percent Raw Pct Col Pct		*TARGET FIRMS* Below Median	Above Median	Total
BIDDING FIRMS	Below Median	16 2.17% 32.65% 11.85%	33 4.48% 67.35% 5.48%	49 6.65%
	Above Median	119 16.15% 17.30% 88.15%	569 77.20% 82.70% 94.52%	688 93.35%
	Total	135 18.32%	602 81.68%	737 100.0%

Panel C. Creditor Rights Index

Frequency Percent Raw Pct Col Pct		*TARGET FIRMS* Below Median	Above Median	Total
BIDDING FIRMS	Below Median	154 20.90% 44.38% 44.90%	193 26.19% 55.62% 48.98%	347 47.08%

Table 3.5 (continued)

Frequency Percent Raw Pct Col Pct		*TARGET FIRMS* Below Median	Above Median	Total
BIDDING FIRMS	Above Median	189 25.64% 48.46% 55.10%	201 27.27% 51.54% 51.02%	390 52.92%
	Total	343 46.54%	394 53.46%	737 100.0%

Note: Frequency denotes the total number of observations falling into a particular category. Percent denotes the percentage of a particular category's observations within the total sample. Row pct stands for the percentage of a particular category's observations in the total number of observations within the same row. Col pct stands for the percentage of a particular category's observations in the total number of observations within the same column.

stock price run-up. The size of the bidder is included as a proxy for managerial hubris (Roll, 1986), as larger acquirers tend to overpay in takeovers (Moeller et al., 2004). Therefore, the bidder returns are expected to decrease with firm size. The bidder Q-ratio is a proxy for the firm's growth potential and quality of internal corporate governance. Lang et al. (1989) and Servaes (1991) document higher returns for bidders with higher Q-ratios. In contrast, Moeller et al. (2004) find a negative relationship between bidder returns and Q-ratio for their sample of M&As from the 1990s. Therefore, the expected effect of the bidder Q-ratio on returns is ambiguous. We also include cash flow and leverage to control for acquisitions driven by free cash flow motives (Jensen, 1986). Bidders with high cash flow and low leverage are more likely to make value-destroying acquisitions. Finally, we include the bidder pre-announcement stock price run-up to control for the bidder's prior stock performance.

The target characteristics that we include as control variables are leverage and cash flow, as a bidder is likely to pay higher premiums for targets with lower leverage and higher cash flows. For the analysis of (public) target CARs, we also include the target Q-ratio and pre-announcement stock price run-up to control for its growth opportunities and prior stock performance respectively.

Deal characteristics Both the theoretical and empirical M&A literature have shown that the following transaction attributes affect the bidder and target takeover returns: the form of and the attitude towards the bid (opposed bids, unopposed tender offers, friendly M&As), the legal status of the target firm (listed versus privately held), the industry relatedness of the bidding and target firms (a focus versus diversification strategy by the bidder), the type of acquisition (full versus partial acquisition), the means of payment (all-cash, all-equity, mixed offer), and the relative deal size.[14] It is argued that the market interprets all these pieces of information as a signal of the quality of the bidding and target firms and of the potential value creation in the takeover, which triggers share price adjustments. Therefore, to capture the effect of this signal, we also control for the above deal characteristics in our models.

3.2 Controlling for Selection Bias

We recognize that a decision to participate in a cross-border acquisition is an endogenous choice made by the bidding and target firms and these endogeneity issues may affect the conclusions of our analysis. In particular, Rossi and Volpin (2004) find that bidders and targets from countries with high shareholder protection are more likely to be involved in domestic rather than cross-border M&As. Therefore, we expect that a cross-border acquisition involving a bidder or a target from a country with high shareholder protection will occur only if the takeover synergies are sufficiently high to overcome all additional costs arising from integrating with a foreign firm.[15] This implies a positive relationship between the bidder and target shareholder protection indices and the announcement stock returns.

Therefore, to control for the sample-selection bias, we employ Heckman's (1976, 1979) procedure. By applying a probit analysis to the sample of all European bidding firms involved in domestic and cross-border acquisitions, we estimate the probability that a firm will undertake a cross-border rather than a domestic acquisition. The resulting parameters are used to compute Heckman's λ (inverse Mill's ratio) for each bidding firm in our sample. We subsequently include Heckman's λ as an additional regressor into the regressions on the bidder returns. Similarly, we estimate the probability that a target firm is involved in a cross-border rather than domestic acquisition by computing Heckman's λ and including it in the target returns' regressions. Although the bidder

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14 For an overview of the evidence on the wealth effect of M&As and its determinants, see Jensen and Ruback (1983), Jarrell et al. (1988), Agrawal and Jaffe (2000), Bruner (2004), and Martynova and Renneboog (2008).

15 For a discussion of the additional costs associated with cross-border takeovers, see for example Denis et al. (2002) and Moeller and Schlingemann (2005).

and target selection equations seem very similar, they refer to different flows of foreign direct investments. The bidder equations estimate the determinants of the investment outflow from a country, whereas the target equations estimate the determinants of the investment inflow into the country.

The explanatory variables of the two selection equations (presented in Table 3.6) are based on previous studies on the determinants of foreign direct investments and international financial integration (see, for example, Pagano et al., 2002; Sarkissian and Schill, 2004; Claessens and Schmukler, 2007). First, we include the characteristics of the bidding/target firms (size, leverage, cash flow and Q-ratio) and the non-negotiated features of the intended takeover (public/private target, industry focus/diversification, the period within the takeover wave). Second, we also include macro variables such as GDP growth, income per capita and the level of corruption in the bidder/target country. We expect bidding firms to initiate M&As abroad (rather than domestically) when their home countries offer a poor investment environment, which is proxied by low economic growth and high levels of corruption. An underdeveloped M&A market resulting from various obstacles such as takeover-unfriendly regulation may be another reason that motivates firms to acquire foreign targets. Therefore, we also include a proxy variable for the scope of domestic M&A activity in the country. Finally, the impact of the regulatory environment on the decision to acquire abroad is captured by our corporate governance indices.

The estimates of the selection equations of the bidding and target firms reveal interesting results with respect to the impact of the regulatory environment on the flow of cross-border M&A activity (Table 3.6). In particular, a bidding firm is more likely to make a cross-border acquisition if it is from a country with low standards of shareholder rights. The result supports the view that firms from countries with weak corporate governance regulation are more likely to invest abroad rather than domestically (Doidge et al., 2007, Benos and Weisbach, 2004). We also find that bidders are more likely to acquire firms abroad if minority shareholder protection in their home country is strong. This result is in line with Goergen et al. (2005), who argue that strong protection of minority shareholders makes corporate takeovers very costly and hence forces companies to look for potential M&A targets in countries with weaker minority shareholder protection. Strong creditor protection in the home country also has a positive effect on international acquisition activity. This may follow from the positive relationship between creditor protection and a firm's access to debt financing (La Porta et al., 1998). Martynova and Renneboog (2007a) show that debt financing is frequently used in cross-border M&As.

Table 3.6 Heckman sample selection equations for bidding and target firms in cross-border M&As

	Probability of a bidding company acquiring a foreign firm (v. a domestic firm)		Probability of a target company being acquired by a foreign firm (v. a domestic firm)	
	Coeff.	Pr > ChiSq	Coeff.	Pr > ChiSq
Corporate Governance Regulation in the Firm Country:				
Shareholder Rights Index	**–0.3123[a]**	0.000	**–0.2149[c]**	0.092
Minority Shareholder Protection Index	**0.3945[a]**	0.009	–0.1311	0.596
Creditor Rights Index	**0.2804[a]**	0.000	**0.2962[a]**	0.000
Firm Characteristics:				
Q-ratio	**0.0229[b]**	0.022	0.0398	0.174
Leverage	–0.2117	0.590	–0.4936	0.346
Size (log TA)	**0.2159[a]**	0.000	**0.1949[a]**	0.000
Cash Flow/TA	0.5508	0.362	0.2502	0.770
Deal Characteristics:				
Public Target	**–0.4561[b]**	0.032	–	
Same Industry	0.0438	0.720	–0.0274	0.875
1997–1999	0.2326	0.114	**0.5145[b]**	0.019
2000–2001	**0.2987[b]**	0.049	**0.5936[b]**	0.011
Characteristics of the Firm's Country:				
Anti-corruption Index	–0.1045	0.418	**0.3511[a]**	0.007
Log GNP per capita	–0.3639	0.522	0.2862	0.284
GDP growth	**–0.1593[c]**	0.078	**0.2707[b]**	0.012
# Domestic Acquisitions / # Listed Firms 1 year prior	–0.0267	0.218	–0.0400	0.560
Intercept	**–2.9004[a]**	0.000	**–2.1785[a]**	0.003
Number of obs.	2271		760	
Pseudo-R^2	21.15%		270.08%	

Notes: This table shows the selection equations of sample selection models for the bidding and target firms. The selection equations model the probability that a bidder (target) firm participates in a cross-border (rather than domestic) acquisition. The depended variable equals one if the bidder (target) firm participates in a cross-border takeover, and zero if in a domestic takeover. The definitions of the included variables are given in Appendix 1. a, b and c stand for statistical significance at the 1%, 5% and 10% level, respectively.

Therefore, cross-border M&As are more likely to be made by bidders who have access to inexpensive debt capital, which prevails in countries with strong creditor rights.

Unsurprisingly, the selection equation for the target firms shows that a target is more likely to sell its shares to a foreign bidder if the standards of shareholder protection in the target country are low and the standards of creditor protection are high.

3.3 Regression Results

3.3.1 Bidder returns

The impact of corporate governance regulation on bidder returns We start our analysis with the bidder returns regressions, which include the bidder and target corporate governance indices in levels, while controlling for the fact that making a cross-border acquisition is an endogenous decision (selection bias problem). Model 1 of Table 3.7 shows that the effect of the bidder and target national governance standards on bidder returns is insignificant. The coefficients remain insignificant in model 2 after controlling for growth potential, leverage, share price run-up, means of payment and many other characteristics of the deal, the target, the bidder and the countries of the bidder and target. We also fail to find any significant coefficients when we re-estimate this model including one of the corporate governance indices at the time (see models 4–6). Overall, the evidence suggests that, apart from its impact on the decision to acquire a firm abroad (see Section 3.3), corporate governance regulation has no significant effect on the takeover returns to the bidding firm's shareholders.

Most of our results with respect to the control variables are consistent with previous empirical findings (see, for example, Moeller et al., 2004; Bris and Cabolis, 2008; Starks and Wei, 2005). Specifically, we observe that (i) bidder size has a significantly negative effect on bidder returns, suggesting that large bidders are more likely to make poor takeover decisions; (ii) the bidder Q-ratio has no significant effect on bidder returns; (iii) the proxies for free cash flow – the bidder cash flow and leverage – have the expected (but insignificant) impact on bidder returns (respectively, negative and positive effects) which indicates that there is little evidence that cross-border acquisitions occur as a result of empire building; (iv) bidder returns are significantly lower for hostile takeovers, suggesting that the bidder shareholders fear overbidding in case of opposition by the target firm; (v) the returns are also lower for acquisitions involving equity payments (signalling overvaluation of bidder shares), for public targets,

Table 3.7 The impact of corporate governance regulation on the bidder CARs in cross-border M&As

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Corporate Governance Regulation Effect:							
(Bidder) Shareholder Rights Index	0.0017 (0.329)	0.0020 (0.248)	0.0027 (0.253)	0.0029 (0.156)			
(Bidder) Minority Shareholder Protection Index	0.0043 (0.389)	0.0026 (0.771)	0.0022 (0.810)		0.0020 (0.753)		
(Bidder) Creditor Rights Index	0.0005 (0.726)	0.0012 (0.680)				0.0006 (0.830)	
(Target) Shareholder Rights Index	0.0021 (0.415)	0.0015 (0.511)	0.0018 (0.618)	0.0011 (0.314)			
(Target) Minority Shareholder Protection Index	–0.0013 (0.357)	–0.0032 (0.229)	–0.0034 (0.216)		–0.0030 (0.118)		
(Target) Creditor Rights Index	0.0004 (0.796)	0.0014 (0.551)				0.0019 (0.408)	
Bidder and Target Firms' characteristics:							
(Bidder) Q-ratio		–0.0003 (0.689)	–0.0002 (0.753)	–0.0002 (0.745)	–0.0003 (0.664)	–0.0004 (0.552)	–0.0013 (0.323)
(Bidder) Leverage		0.0044 (0.869)	0.0038 (0.883)	0.0029 (0.910)	0.0012 (0.963)	0.0024 (0.928)	0.0028 (0.568)
(Bidder) Size (log TA)		**–0.0012**[b] (0.031)	**–0.0012**[b] (0.034)	**–0.0012**[b] (0.019)	**–0.0009**[a] (0.005)	**–0.0009**[b] (0.029)	**–0.0018**[a] (0.006)
(Bidder) Cash Flow/TA		–0.0508 (0.326)	–0.0522 (0.309)	–0.0511 (0.318)	–0.0533 (0.299)	–0.0525 (0.306)	–0.0153 (0.780)
(Target) Leverage		–0.0303 (0.702)	–0.0355 (0.653)	–0.0117 (0.883)	–0.0162 (0.839)	–0.0021 (0.979)	–0.0730 (0.127)
(Target) Cash Flow/TA		0.0805 (0.569)	0.0724 (0.399)	0.0866 (0.251)	0.0911 (0.241)	0.0945 (0.336)	0.0582 (0.647)
Deal characteristics:							
Equity Payment		–0.0140 (0.268)	–0.0148 (0.239)	–0.0150 (0.232)	–0.0153 (0.223)	–0.0144 (0.253)	–0.0163 (0.122)
Public Target		–0.0077 (0.459)	–0.0065 (0.521)	–0.0069 0.491	–0.0055 (0.585)	–0.0043 (0.663)	0.0034 (0.924)
Hostile Bid		**–0.0302**[b] (0.021)	**–0.0311**[b] (0.015)	**–0.0314**[a] (0.010)	**–0.0291**[b] (0.029)	**–0.0269**[c] (0.062)	**–0.0419**[a] (0.006)
M&A of 100%		–0.0013 (0.892)	–0.0009 (0.918)	–0.0012 (0.897)	0.0003 (0.970)	0.0012 (0.895)	0.0016 (0.556)

Table 3.7 (continued)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Diversification		–0.0013	–0.0012	–0.0009	0.0002	0.0006	0.0007
		(0.886)	(0.894)	(0.916)	(0.977)	(0.945)	(0.935)
Relative Size		0.0238	0.0232	0.0240	0.0246	0.0242	0.0242
		(0.277)	(0.287)	(0.267)	(0.257)	(0.263)	(0.262)
(Bidder) Runup		**0.0352[a]**	**0.0361[a]**	**0.0360[a]**	**0.0358[a]**	**0.0354[a]**	**0.0360[a]**
		(0.009)	(0.007)	(0.006)	(0.007)	(0.007)	(0.006)
Bidder and Target Country characteristics:							
Same Language Group		**0.0010[c]**	**0.0012[b]**	**0.0011[b]**	**0.0012[b]**	0.0008	**0.0026[b]**
		(0.064)	(0.031)	(0.036)	(0.048)	(0.107)	(0.012)
Common Border		**0.0017[b]**	**0.0021[b]**	**0.0022[b]**	**0.0024[b]**	**0.0014[c]**	**0.0043[b]**
		(0.015)	(0.020)	(0.032)	(0.018)	(0.071)	(0.017)
(Bidder) log GNP per capita		0.0046	0.0038	0.0036	0.0038	0.0043	0.0175
		(0.316)	(0.415)	(0.422)	(0.385)	(0.368)	(0.211)
Difference (Bidder-Target) log GNP per capita		0.0020	0.0012	0.0013	0.0012	0.0024	0.0034
		(0.532)	(0.701)	(0.655)	(0.629)	(0.828)	(0.502)
(Target) Anti-Corruption Index		0.0003	0.0002	0.0004	0.0004	0.0002	0.0008
		(0.788)	(0.872)	(0.667)	(0.654)	(0.988)	(0.428)
Intercept	–0.0147	–0.0190	–0.0088	–0.0104	–0.0029	–0.0063	0.0023
	(0.426)	(0.554)	(0.750)	(0.635)	(0.917)	(0.679)	(0.753)
Heckman λ (inverse Mill's ratio)	**–0.0034[a]**	**–0.0032[a]**	**–0.0032[a]**	**–0.0033[a]**	**–0.0032[a]**	**–0.0034[a]**	**–0.0033[a]**
	(0.002)	(0.005)	(0.004)	(0.002)	(0.005)	(0.004)	(0.003)
Number of obs.	641	641	641	641	641	641	641
Adjusted-R^2	3.40%	5.33%	4.67%	5.55%	4.91%	4.85%	4.80%

Notes: This table reports the results of the OLS regression of the bidder CARs for the sample of cross-border takeovers. The dependent variable is the bidder CARs [–1, +1]. Variable definitions are given in Appendix 1. Seven different specifications are estimated. A Heckman sample selection is applied to correct for potential biases due to the bidder's endogenous choice of participating in a cross-border (rather than domestic) takeover. For each variable we list the coefficient and the heteroskedasticity-consistent p-value. a, b and c stand for statistical significance at the 1%, 5% and 10% levels, respectively.

for diversifying mergers (leading to a diversification discount), and for full takeovers; (vi) the bidder pre-announcement stock-price run-up has a significantly positive effect on the bidder announcement returns; (vii) bidder returns are also higher when the bidder and target countries are neighbours or belong to the same language group, as both may enhance transparency or induce trust;[16] (viii) the difference in economic development between the bidder and target countries is not correlated with bidder returns; and (ix) the level of corruption in the target country has an insignificant effect on bidder returns.

All estimated models reveal that Heckman's λ is significant, confirming that ignoring selection bias may induce estimation problems. To rule out any further possibility that our results are driven by the endogeneity of the control variables, we also re-estimate model 7 excluding corporate governance indices. Our results are supported.

The impact of corporate governance spillover effects on the bidder returns Whereas Table 3.7 concentrates on the impact of corporate governance regulation on bidder returns in cross-border acquisitions, we now switch to the question whether potential corporate governance spillover is reflected in the bidder returns. We do not report the parameter estimates of the control variables in Table 3.8, as they are similar to those reported in Table 3.7. As in previous sections, we correct the models of Table 3.8 for sample-selection biases. We now primarily focus on the potential improvement (or deterioration) in bidder and target firms' corporate governance standards as a result of the takeover and its effect on bidder returns.

In panel A of Table 3.8, we measure the scope for potential corporate governance spillover by the differences between the bidder and target corporate governance indices. In line with Bris and Cabolis (2008), the parameter coefficient shows that the shareholder-rights difference has a positive, albeit insignificant, effect on the bidder CARs. A significantly positive coefficient would be consistent with the spillover by law hypothesis, which states that the improvement in the corporate governance of the target firm via the transfer of bidder governance standards is a source of synergistic gains in corporate takeovers.

The insignificance of the coefficients may be due to the fact that it is not only bidding companies from countries with superior corporate governance standards that benefit from cross-border M&As, but also bidders from countries with low investor protection. These may bootstrap their corporate governance standards to a higher level, namely that of the target firm. To disentangle the different directions of the spillover effect, we apply an indicator-variable approach. Panel B of Table 3.8 reports the

[16] This result is interesting as it suggests that acquisitions of companies belonging to similar cultures lead to a higher value creation. The evidence is in the spirit of Guiso et al. (2006 and 2007) who show that international transactions are more common between firms from countries that display a higher level of cultural similarities.

Table 3.8 The impact of the corporate governance spillover effects on the bidder CARs in cross-border M&As

	(1)	(2)	(3)	(4)	(5)	(6)
Panel A. Differences Approach						
Corporate Governance Regulation Effect:						
(Bidder) Shareholder Rights Index	0.0012 (0.478)	0.0047 (0.242)	0.0055 (0.145)	0.0042 (0.231)		
(Bidder) Minority Shareholder Protection Index	0.0006 (0.368)	0.0019 (0.934)	0.0019 (0.852)		0.0020 (0.753)	
(Bidder) Creditor Rights Index	0.0001 (0.672)	0.0026 (0.504)				0.0025 (0.512)
Corporate Governance Spillover Effect						
Diff (Bidder – Target) Shareholder Rights Index	0.0005 (0.725)	0.0007 (0.777)	0.0001 (0.943)	0.0001 (0.914)		
Diff (Bidder – Target) Minority Shareholder Protection Index	0.0013 (0.757)	0.0035 (0.618)	0.0041 (0.555)		0.0040 (0.381)	
Diff (Bidder – Target) Creditor Rights Index	–0.0004 (0.796)	–0.0014 (0.551)				–0.0019 (0.409)
Characteristics of the bidder and target, the M&A deal, and the bidder and target countries	No	Yes	Yes	Yes	Yes	Yes
Intercept	Yes	Yes	Yes	Yes	Yes	Yes
Heckman λ (inverse Mill's ratio)	Yes	Yes	Yes	Yes	Yes	Yes
Adjusted-R^2	1.68%	4.82%	4.67%	4.55%	3.91%	3.85%
	(1)	(2)	(3)	(4)	(5)	(6)
Panel B. Indicator-variable Approach						
Corporate Governance Regulation Effect:						
(Bidder) Shareholder Rights Index	0.0001 (0.782)	0.0014 (0.557)	0.0009 (0.652)	0.0013 (0.649)		
(Bidder) Minority Shareholder Protection Index	0.0046 (0.395)	0.0022 (0.815)	0.0014 (0.879)		0.0016 (0.783)	
(Bidder) Creditor Rights Index	0.0020 (0.341)	0.0025 (0.478)				0.0017 (0.624)
Positive Spillover by Law/ Spillover by Control hypotheses (Spillover form Bidder to Target):						
(Target) Shareholder Rights Improvement	**0.0173**[a] (0.009)	**0.0166**[a] (0.008)	**0.0153**[a] (0.008)	**0.0148**[a] (0.007)		

Table 3.8 (continued)

	(1)	(2)	(3)	(4)	(5)	(6)
(Target) Creditor Rights Improvement	–0.0075 (0.344)	0.0014 (0.912)				–0.0017 (0.886)
Bootstrapping hypothesis (Spillover from Target to Bidder):						
(Bidder) Shareholder Rights Improvement	**0.0115** [b] (0.036)	0.0041 (0.218)	0.0042 (0.272)	0.0024 (0.589)		
(Bidder) Minority Shareholder Protection Improvement	–0.0001 (0.990)	0.0050 (0.720)	0.0036 (0.792)		0.0071 (0.591)	
(Bidder) Creditor Rights Improvement	–0.0013 (0.864)	0.0068 (0.588)				0.0058 (0.642)
Characteristics of the bidder and target, the M&A deal, and the bidder and target countries	No	Yes	Yes	Yes	Yes	Yes
Intercept	Yes	Yes	Yes	Yes	Yes	Yes
Heckman λ (inverse Mill's ratio)	Yes	Yes	Yes	Yes	Yes	Yes
Adjusted-R^2	2.13%	5.87%	4.65%	5.71%	4.54%	4.17%

Notes: This table reports the results of the OLS regression of the bidder CARs for the sample of cross-border takeovers. The dependent variable is the bidder CARs [–1, +1]. Variable definitions are given in Appendix 1. Six different specifications are estimated. A Heckman sample selection is applied to correct for potential biases due to the bidder endogenous choice of participating in a cross-border (rather than domestic) takeover or not. We do not report the parameter estimates of the control variables, as they are similar to those reported in Table 7. The indicator 'Yes' denotes that a particular control variable is included in the regression and 'No' that it is not. Panel A reports the regression estimates of the *differences*-approach while Panel B reports the estimates of the indicator-variable approach. For each variable we list the coefficient and the heteroskedasticity-consistent p-value. a, b, and c stand for statistical significance at 1%, 5% and 10% levels respectively. The number of observations in each regression is 641.

results of the regressions, which include an indicator variable capturing M&As involving a bidder with corporate governance standards above the median and a target with standards below the median. We also include an indicator variable that captures the opposite case: a bidder with low standards and a target with high investor protection. While the first variable is a proxy for an improvement in the target firm's corporate governance (the positive spillover by law and the spillover by control hypotheses), the second variable is a proxy for an improvement in the bidder's corporate governance (the bootstrapping effect) or for the dilution of the governance of the target if the bidder imposes its lower standards (the negative spillover by law hypothesis).

The regression results from models 1–4 (panel B) show that the coefficient on the indicator variable capturing an improvement in target shareholder rights is positive and statistically significant (at the 1 per cent level). This is consistent with the positive spillover by law (and spillover by control) predictions that acquisitions of firms with poor shareholder orientation by firms with a strong shareholder orientation generate abnormal returns for the bidder through the imposition of better corporate governance on the target.

Model 1 also shows that the bidder returns are positive and significant when the target has a stronger shareholder orientation than the bidder. The fact that the bidder shareholders react positively to this type of deal is congruent with the fact that the bidding firm may adopt a higher level of shareholder orientation on a voluntary basis.[17] This increased shareholder orientation is then anticipated by the bidder shareholders, as reflected in the announcement returns. However, the significance of this bootstrapping effect disappears after taking into account the characteristics of the target, the bidder, the deal and of the countries of the bidder and target.

3.3.2 Target returns

The impact of corporate governance regulation on target returns We first focus on whether corporate governance standards in the bidder and target countries have a significant effect on target returns (after controlling for the sample-selection bias described in Section 3.2). Table 3.9 shows that target returns strongly increase with the quality of shareholder protection in the target country. The coefficient on the target shareholder rights index is positive and statistically significant in all model specifications. The evidence suggests that target companies from countries with better shareholder protection are able to extract higher premiums from bidding firms, which is also consistent with Rossi and Volpin (2004), but not with Bris and Cabolis (2008).

When we focus on minority shareholder protection by excluding shareholder and creditor protection indices (model 5), minority shareholder protection in the target country is still positively associated with the target returns. This implies that powerful minority shareholders are able to extract an additional premium from the deal. Still, this finding is not corroborated when other measures of investor protection are included in the model.

[17] This result does not support the negative spillover by law hypothesis as under this hypothesis we would expect negative or at best insignificant bidder returns.

Table 3.9 The impact of corporate governance regulation on the target CARs in cross-border M&As

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Corporate Governance Regulation Effect:							
(Bidder) Shareholder Rights Index	**0.0169[c]**	0.0069	0.0029	0.0026			
	(0.087)	(0.324)	(0.434)	(0.659)			
(Bidder) Minority Shareholder Protection Index	0.0070	0.0254	0.0240		0.0119		
	(0.733)	(0.193)	(0.542)		(0.569)		
(Bidder) Creditor Rights Index	–0.0090	–0.0103				–0.0107	
	(0.202)	(0.354)				(0.332)	
(Target) Shareholder Rights Index	**0.0442[a]**	**0.0478[b]**	**0.0508[a]**	**0.0505[a]**			
	(0.003)	(0.015)	(0.008)	(0.001)			
(Target) Minority Shareholder Protection Index	0.0075	0.0015	0.0002		**0.0557[a]**		
	(0.771)	(0.576)	(0.596)		(0.005)		
(Target) Creditor Rights Index	0.0013	0.0016				0.0010	
	(0.890)	(0.891)				(0.930)	
Bidder and Target Firms' characteristics:							
(Bidder) Q-ratio		–0.0130	–0.0131	–0.0128	–0.0122	–0.0109	–0.0111
		(0.212)	(0.196)	(0.198)	(0.232)	(0.322)	(0.296)
(Bidder) Leverage		0.0655	0.0437	0.0041	–0.0674	0.0903	0.0847
		(0.777)	(0.844)	(0.984)	(0.754)	(0.686)	(0.697)
(Bidder) Size (log TA)		–0.0041	–0.0036	–0.0029	–0.0021	–0.0036	–0.0035
		(0.759)	(0.785)	(0.822)	(0.874)	(0.798)	(0.802)
(Bidder) Cash Flow/TA		–0.2838	–0.3063	–0.3223	–0.3135	–0.2952	–0.2973
		(0.343)	(0.289)	(0.237)	(0.279)	(0.323)	(0.307)
(Target) Leverage		–0.0169	–0.0018	0.0190	0.0429	–0.0034	0.0174
		(0.856)	(0.984)	(0.832)	(0.643)	(0.971)	(0.851)
(Target) Cash Flow/TA		0.1026	0.1377	0.1522	0.1969	0.1214	0.1681
		(0.559)	(0.431)	(0.377)	(0.266)	(0.502)	(0.350)
(Target) Q-ratio		–0.0018	–0.0018	–0.0016	–0.0015	–0.0015	–0.0015
		(0.393)	(0.382)	(0.457)	(0.489)	(0.499)	(0.481)
Deal characteristics:							
Equity Payment		**–0.0929[c]**	**–0.0938[c]**	**–0.0942[c]**	**–0.0989[c]**	**–0.1054[b]**	**–0.1067[b]**
		(0.078)	(0.069)	(0.065)	(0.054)	(0.039)	(0.033)
Hostile Bid		0.0892	**0.1012[c]**	**0.1021[c]**	**0.0996[c]**	0.0895	**0.1021[c]**
		(0.149)	(0.093)	(0.086)	(0.099)	(0.142)	(0.086)
M&A of 100%		**0.1408[b]**	**0.1430[b]**	**0.1452[a]**	**0.1545[a]**	**0.1648[a]**	**0.1682[a]**
		(0.015)	(0.011)	(0.009)	(0.005)	(0.001)	(0.001)
Diversification		0.0832	0.0864	0.0862	0.0864	0.0806	0.0841
		(0.264)	(0.253)	(0.250)	(0.253)	(0.170)	(0.257)

Table 3.9 (continued)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Relative Size		–0.0932	–0.0929	–0.0878	–0.0904	–0.0996	–0.0989
		(0.221)	(0.219)	(0.234)	(0.227)	(0.175)	(0.174)
(Target) Run-up		–0.1043	–0.1166	–0.1160	–0.1082	–0.0791	–0.0894
		(0.177)	(0.123)	(0.120)	(0.150)	(0.263)	(0.197)
Bidder and Target Country characteristics:							
Same Language		0.0117	0.0094	0.0076	0.0084	0.0009	0.0214
		(0.342)	(0.760)	(0.563)	(0.702)	(0.987)	(0.426)
Common Border		–0.0056	–0.0038	–0.0043	–0.0045	–0.0066	–0.0020
		(0.572)	(0.718)	(0.745)	(711)	(0.424)	(0.756)
(Target) log GNP per capita		–0.0018	–0.0016	–0.0021	–0.0018	–0.0012	–0.0036
		(0.342)	(0.486)	(0.505)	(0.280)	(0.798)	(0.222)
Difference (Bidder-Target) log GNP per capita		0.0108	0.0112	0.0118	0.0118	0.0102	0.0215
		(0.308)	(0.276)	(0.268)	(0.243)	(0.405)	(0.155)
(Target) Anti-Corruption Index		**0.0033[c]**	**0.0042[c]**	**0.0040[c]**	**0.0044[c]**	**0.0025[c]**	**0.0058[c]**
		(0.082)	(0.078)	(0.064)	(0.057)	(0.128)	(0.018)
Intercept	–0.1060	–0.0392	–0.0795	–0.1311	–0.1030	0.1026	0.0619
	(0.307)	(0.855)	(0.675)	(0.267)	(0.569)	(0.189)	(0.201)
Heckman λ (inverse Mill's ratio)	**0.0027[a]**	**0.0018[a]**	**0.0018[a]**	**0.0017[a]**	**0.0018[a]**	**0.0022[a]**	**0.0031[a]**
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
Number of obs.	296	296	296	296	296	296	296
Adjusted-R^2	10.21%	14.97%	15.03%	13.76%	13.36%	8.11%	9.15%

Notes: This table reports the results of the OLS regression of the target CARs for the sample of cross-border takeovers. The dependent variable is the target CARs [–1, +1]. Variable definitions are given in Appendix 1. Seven different specifications are estimated. A Heckman sample selection is applied to correct for potential biases due to the target endogenous choice of participating in a cross-border (rather than domestic) takeover or not. For each variable we show the heteroskedasticity-consistent p-value. a, b and c stand for statistical significance at 1%, 5% and 10% levels, respectively.

The degree of shareholder orientation in the bidder country has a positive effect on the target returns but only in model 1 of Table 3.9. This lack of a consistently significant impact of bidder shareholder protection on target returns is also documented by Rossi and Volpin (2004). They conclude that bidders from countries with better shareholder protection do not pay more for cross-border M&As than bidders from other countries. Overall, our evidence suggests that the corporate governance regime in the target (but not the bidder) country positively affects the target shareholders' returns.

As to the control variables, most of our findings are in line with those of other empirical studies on cross-border M&As (see, for example Harris and Ravenscraft, 1991; Dewenter, 1995). In particular, we observe that target returns are significantly higher in hostile takeovers and in full takeovers, and are significantly lower when equity is used as a means of payment and when corruption in the target country is high.

The impact of corporate governance spillover effects on target returns
Whereas Table 3.9 examines the impact of national regulation on target returns, we now analyse in Table 3.10 the impact of corporate governance spillover. Panel A of Table 3.10 reports that the target returns increase with the scope of potential shareholder protection spillover, as measured by the differences between the bidder and target shareholder rights indices. When a bidding firm is from a country with higher shareholder protection than the target, the bidder's (superior) corporate governance standard will be imposed – by law in the case of a full acquisition – on the target firm (the positive spillover by law effect) which leads to significantly higher target announcement returns. Similarly, in the case of a partial acquisition, the bidder firm may voluntarily impose its better shareholder protection standards on the target (the spillover by control effect), which leads to higher target shareholder returns. This implies that part of the synergies in cross-border acquisitions result from corporate governance improvements at the target. As the target shareholders anticipate this, they are able to claim part of the expected value improvement, given that they are sellers in a strong bargaining position.

Moreover, when we differentiate between the cases where the bidder is subject to stronger (weaker) shareholder protection than the target (panel B of Table 3.10), we find further confirmation of our result. Target returns increase when there is a positive spillover effect from the bidder to the target, that is, when the bidder is from a country with a stronger shareholder orientation. These results lend support to our positive spillover by law and spillover by control hypotheses. Interestingly, the evidence does not support the negative spillover by law hypothesis: in takeovers by bidders from countries with poorer standards, target returns are not significantly lower.

3.4 Additional Analyses

3.4.1 Does a change in target nationality matter?

Bris and Cabolis (2008) emphasize that target companies benefit from corporate governance spillovers only when the bidder acquires 100 per cent of the target firm's shares, that is, when the target firm de facto changes its nationality (spillover by law hypothesis). In the case of a full acquisition, the

Table 3.10 The impact of the corporate governance spillover effect on the target CARs in cross-border M&As

	(1)	(2)	(3)	(4)	(5)	(6)
Panel A. A Differences Approach						
Corporate Governance Regulation Effect:						
(Target) Shareholder Rights Index	**0.0612**[a] (0.007)	**0.0435**[b] (0.020)	**0.0463**[b] (0.013)	**0.0309**[b] (0.018)		
(Target) Minority Shareholder Protection Index	0.0146 (0.632)	0.0261 (0.515)	0.0292 (0.445)		**0.0402**[b] (0.025)	
(Target) Creditor Rights Index	0.0041 (0.701)	0.0018 (0.883)				0.0005 (0.968)
Corporate Governance Spillover Effect:						
Diff. (Bidder – Target) Shareholder Rights Index	**0.0169**[b] (0.017)	**0.0189**[a] (0.007)	**0.0168**[a] (0.002)	**0.0113**[a] (0.007)		
Diff. (Bidder – Target) Minority Shareholder Protection Index	0.0070 (0.733)	0.0159 (0.529)	0.0096 (0.670)		0.0016 (0.928)	
Diff. (Bidder – Target) Creditor Rights Index	–0.0089 (0.202)	–0.0095 (0.224)				–0.0092 (0.228)
Characteristics of the bidder and target, the M&A deal, and the bidder and target countries	No	Yes	Yes	Yes	Yes	Yes
Intercept	Yes	Yes	Yes	Yes	Yes	Yes
Heckman λ (inverse Mill's ratio)	Yes	Yes	Yes	Yes	Yes	Yes
Adjusted-R^2	10.18%	14.83%	14.75%	14.08%	13.70%	10.02%

	(1)	(2)	(3)	(4)	(5)	(6)
Panel B. Indicator-Variable Approach						
Corporate Governance Regulation Effect:						
(Target) Shareholder Rights Index	**0.0501**[a] (0.003)	**0.0295**[b] (0.022)	**0.0245**[b] (0.030)	**0.0144**[b] (0.032)		
(Target) Minority Shareholder Protection Index	0.0076 (0.794)	0.0231 (0.573)	0.0142 (0.716)		**0.0246**[b] (0.029)	
(Target) Creditor Rights Index	0.0117 (0.247)	0.0026 (0.824)				0.0041 (0.700)

Table 3.10 (continued)

	(1)	(2)	(3)	(4)	(5)	(6)
Positive Spillover by Law/ Spillover by Control hypotheses (Spillover form Bidder to Target):						
(Target) Shareholder Rights Improvement	**0.0107**[a]	**0.0111**[a]	**0.0177**[a]	**0.0229**[a]		
	(0.007)	(0.004)	(0.000)	(0.004)		
(Target) Minority Shareholder Protection Improvement	0.0301	0.0264	0.0248		0.0256	
	(0.415)	(0.508)	(0.539)		(0.519)	
(Target) Creditor Rights Improvement	0.0673	0.0729				0.0597
	(0.889)	(0.105)				(0.171)
Bootstrapping hypothesis (Spillover from Target to Bidder):						
(Bidder) Shareholder Rights Improvement	–0.0171	–0.0069	–0.0125	–0.0125		
	(0.605)	(0.854)	(0.741)	(0.733)		
(Bidder) Minority Shareholder Protection Improvement	0.0183	0.0109	0.0110		–0.0086	
	(0.584)	(0.774)	(0.774)		(0.816)	
(Bidder) Creditor Rights Improvement	0.0941	0.1104				0.1043
	(0.953)	(0.850)				(0.101)
Characteristics of the bidder and target, the M&A deal, and the bidder and target countries	No	Yes	Yes	Yes	Yes	Yes
Intercept	Yes	Yes	Yes	Yes	Yes	Yes
Heckman λ (inverse Mill's ratio)	Yes	Yes	Yes	Yes	Yes	Yes
Adjusted-R^2	11.71%	15.31%	15.53%	14.77%	12.99%	10.48%

Notes: This table reports the results of the OLS regression of the target CARs for the sample of cross-border takeovers. The dependent variable is the target CARs [–1, +1]. Variable definitions are given in Appendix 1. Six different specifications are estimated. A Heckman sample selection correction is applied to control for potential biases due to the target endogenous choice of participating in a cross-border (rather than domestic) takeover or not. We do not report the parameter estimates of the control variables, as they are similar to the ones reported in Table 3.9. The indicator 'Yes' denotes that a particular control variable is included in the regression and 'No' that it is not. Panel A reports the regression estimates of a *differences*-approach while panel B reports the estimates of an indicator-variable approach. Variable definitions are given in Appendix 1. For each variable, we show the heteroskedasticity-consistent p-value. a, b and c stand for statistical significance at the 1%, 5% and 10% levels, respectively. The number of observations is 296 in each regression.

target firm becomes a part of the bidding firm and hence will have to comply with the corporate governance regulation in the bidder country. To further test this hypothesis, we split our sample into full and partial acquisitions and we re-estimate the models from Tables 3.8 and 3.10. Table 3.11 shows that, irrespective of the type of takeover (full or partial), bidding firms from countries with above-median shareholder protection experience significantly higher returns when they acquire target firms from countries with below-median shareholder protection. The evidence supports the spillover by control hypothesis: a well-governed bidding firm improves the governance at the target firm in which it holds a majority stake such that the target firm's assets are used more efficiently and create more shareholder value.

Table 3.11 also unveils another interesting result: bidder returns are also higher in a partial acquisition involving a bidder from a country with below-median shareholder protection and a target from a country with above-median shareholder protection. We interpret the positive coefficients as evidence consistent with the bootstrapping hypothesis: poorly governed firms acquire well-governed firms to credibly bootstrap themselves to better corporate governance standards. They bootstrap the quality of their corporate governance standards by (voluntary) adherence to the higher shareholder protection of the target firm. Given that the nationality of the target firm does not change, and that part of the equity of the target firm is still held by its (old) shareholders, the bidder may feel pressurized by the target minority shareholders or voluntarily decide to emulate the high corporate standards in the country of the target firm. This is reflected in the bidder returns.

We also perform an analysis of the target returns for the subsamples of full and partial acquisitions in Table 3.12. We observe that partitioning our sample does not materially change our original results as the positive spillover by law hypothesis (full acquisitions) and the spillover by control hypothesis (partial acquisitions) are supported. Thus, the target returns increase with the scope of the potential corporate-governance improvement irrespective of the degree of control change (full versus partial takeovers): acquisitions by bidders with stronger shareholder protection create more value than other types of acquisitions irrespective of the takeover type (full or partial).

3.4.2 Bidder returns and the decision to participate in a takeover

In Section 3.2, we discussed the potential endogeneity problem associated with the bidder and target decision to participate in cross-border M&As and corrected for this by using Heckman's λ. While Heckman's λ allows us to control for the differences in cross-border and domestic acquisitions, this still ignores the fact that firms involved in a takeover (be it domestic

Table 3.11 The impact of corporate governance spillover on the bidder CARs in full and partial acquisitions

	M&A of 100% (Full Acquisitions)				M&A of less than 100% (Partial Acquisitions)			
	(1)	(2)	(3)	(4)	(1)	(2)	(3)	(4)
Corporate Governance Regulation Effect:								
(Bidder) Shareholder Protection Index	–0.0005 (0.986)	–0.0006 (0.734)	0.0004 (0.942)		0.0030 (0.422)	0.0017 (0.518)	0.0000 (0.995)	
(Bidder) Minority Shareholder Protection Index	0.0009 (0.413)	0.0011 (0.450)		0.0019 (0.819)	0.0029 (0.559)	0.0036 (0.624)		0.0036 (0.741)
(Bidder) Creditor Protection Index	0.0000 (0.987)	0.0003 (0.529)			0.0034 (0.125)	0.0022 (0.527)		
Positive Spillover by Law/ Spillover by Control hypotheses (Spillover form Bidder to Target):								
(Target) Shareholder Rights Improvement	**0.0134**[c] (0.081)	**0.0178**[b] (0.029)	**0.0170**[b] (0.022)		**0.0130**[c] (0.065)	**0.0137**[b] (0.037)	**0.0140**[c] (0.074)	
(Target) Minority Shareholder Protection Improvement	0.0059 (0.639)	0.0132 (0.378)		0.0097 (0.487)	–0.0064 (0.428)	0.0032 (0.728)		–0.0035 (0.968)
(Target) Creditor Rights Improvement	–0.0128 (0.380)	–0.0056 (0.752)			–0.0034 (0.681)	–0.0014 (0.904)		
Bootstrapping hypothesis (Spillover from Target to Bidder)								
(Bidder) Shareholder Rights Improvement	**0.0128**[b] (0.041)	0.0122 (0.206)	0.0107 (0.267)		**0.0217**[b] (0.014)	**0.0290**[b] (0.041)	**0.0285**[b] (0.028)	
(Bidder) Minority Shareholder Protection Improvement	0.0006 (0.968)	0.0041 (0.829)		0.0049 (0.786)	–0.0022 (0.788)	0.0013 (0.927)		0.0076 (0.556)
(Bidder) Creditor Rights Improvement	–0.0011 (0.447)	0.0032 (0.860)			0.0062 (0.438)	0.0034 (0.769)		

Table 3.11 (continued)

	M&A of 100% (Full Acquisitions)				M&A of less than 100% (Partial Acquisitions)			
	(1)	(2)	(3)	(4)	(1)	(2)	(3)	(4)
Characteristics of the bidder and target, the M&A deal, and the bidder and target countries	No	Yes	Yes	Yes	No	Yes	Yes	Yes
Intercept	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Heckman λ (inverse Mill's ratio)	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Number of observations	292	292	292	292	356	356	356	356
Adjusted-R^2	2.05%	4.05%	4.07%	3.27%	3.47%	4.29%	5.42%	3.59%

Notes: This table reports the results of the OLS regression of the bidder CARs for the samples of full and partial cross-border takeovers. The dependent variable is the bidder CARs [–1, +1]. Variable definitions are given in Appendix 1. Four different specifications are estimated. A Heckman sample selection is applied to correct for potential biases due to the bidder endogenous choice of participating in a cross-border (rather than domestic) takeover or not. We do not report the parameter estimates of the control variables, as they are similar to the ones reported in Table 3.7. The indicator 'Yes' denotes that a particular control variable is included in the regression and 'No' that it is not. For each variable we show the heteroskedasticity-consistent p-value. a, b and c stand for statistical significance at the 1%, 5% and 10% levels, respectively.

or cross-border) may be different from firms that stay clear of the takeover process. Factors such as financial constraints, growth opportunities and share price performance (most of which are likely to be associated with corporate governance regulation) are likely to be important determinants of the bidder decision (not) to participate in a takeover. In other words, we may observe fewer takeovers by bidders from countries with weak corporate governance regulation (in terms of both (minority) shareholder and creditor protection). To control for this potential bias, we estimate yet another Heckman's λ. Applying a probit analysis to the sample of all European public firms (with data available in Amadeus and DataStream), we estimate the probability that a firm will undertake an acquisition.[18]

[18] The regression results are not reported but available from the authors upon request.

Table 3.12 The impact of corporate governance spillover on the target CARs in full and partial acquisitions

	M&A of 100% (Full Acquisitions)				M&A of less than 100% (Partial Acquisitions)			
	(1)	(2)	(3)	(4)	(1)	(2)	(3)	(4)
Corporate Governance Regulation Effect:								
(Bidder) Shareholder Protection Index	**0.0439**[b] (0.021)	**0.0261**[c] (0.073)	**0.0377**[b] (0.036)		**0.0376** (0.035)	**0.0239** (0.050)	**0.0400** (0.022)	
(Bidder) Minority Shareholder Protection Index	0.0076 (0.904)	0.0159 (0.818)		**0.0115**[b] (0.042)	0.0174 (0.398)	–0.0039 (0.926)		**0.0204** (0.075)
(Bidder) Creditor Protection Index	0.0084 (0.567)	–0.0014 (0.928)			0.0098 (0.342)	0.0100 (0.484)		
Positive Spillover by Law/ Spillover by Control hypotheses (Spillover form Bidder to Target):								
(Target) Shareholder Rights Improvement	**0.0356**[a] (0.001)	**0.0198**[b] (0.045)	**0.0173**[b] (0.029)		**0.0266**[b] (0.043)	**0.0194**[b] (0.048)	**0.0226**[b] (0.034)	
(Target) Minority Shareholder Protection Improvement	0.0333 (0.290)	0.0516 (0.314)		–0.0235 (0.715)	–0.0019 (0.952)	–0.0111 (0.768)		–0.0329 (0.448)
(Target) Creditor Rights Improvement	0.0962 (0.097)	0.0929 (0.122)			0.0179 (0.657)	–0.0308 (0.587)		
Bootstrapping hypothesis (Spillover from Target to Bidder)								
(Bidder) Shareholder Rights Improvement	–0.0059 (0.896)	–0.0141 (0.765)	–0.0072 (0.878)		–0.0284 (0.427)	–0.0272 (0.658)	–0.0214 (0.673)	
(Bidder) Minority Shareholder Protection Improvement	0.0143 (0.757)	0.0037 (0.938)		–0.0049 (0.917)	0.0259 (0.465)	0.0250 (0.672)		–0.0207 (0.674)
(Bidder) Creditor Rights Improvement	0.0432 (0.356)	0.0454 (0.408)			0.0037 (0.919)	–0.0466 (0.409)		

Table 3.12 (continued)

	M&A of 100% (Full Acquisitions)				M&A of less than 100% (Partial Acquisitions)			
	(1)	(2)	(3)	(4)	(1)	(2)	(3)	(4)
Characteristics of the bidder and target, the M&A deal, and the bidder and target countries	No	Yes	Yes	Yes	No	Yes	Yes	Yes
Intercept	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Heckman λ (inverse Mill's ratio)	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Number of observations	121	121	121	121	72	72	72	72
Adjusted-R^2	12.13%	19.05%	18.34%	17.14%	13.73%	18.92%	20.14%	20.50%

Notes: This table reports the results of the OLS regression of the target CARs for the samples of full and partial cross-border takeovers. The dependent variable is the target CARs [–1, +1]. Variable definitions are given in Appendix 1. Four different specifications are estimated. A Heckman sample selection is applied to correct for potential biases due to the target endogenous choice of participating in a cross-border (rather than domestic) takeover or not. We do not report the parameter estimates of the control variables, as they are similar to the ones reported in Table 3.9. The indicator 'Yes' denotes that a particular control variable is included in the regression and 'No' that it is not. For each variable, we show the heteroskedasticity-consistent p-value. a, b and c stand for statistical significance at the 1%, 5% and 10% levels, respectively.

We perform two tests of the significance of this censoring problem. First, in the regression analysis of the bidder returns, we include the new Heckman's λ instead of the Heckman's λ estimated based on the equation that predicts a cross-border bidder. We find that the null hypothesis that the new Heckman's λ is insignificant cannot be rejected. This suggests that this type of sample-selection bias is not a significant problem in our sample and hence is not likely to cloud our estimation procedure. Second, we also re-estimate our regressions by including both the initial (cross-border takeover) and the new Heckman's λ (related to the general M&A decision). We find that whereas the former is still significant, the new Heckman's λ remains insignificant.

3.4.3 Means of payment effect of the offer

Starks and Wei (2005) hypothesize that the means of payment has a significant impact on the premiums paid in cross-border acquisitions. The argument is the following: when target shareholders accept equity in an all-equity or mixed offer, they remain involved in the merged firm and will demand additional compensation when the bidding firm is from a country with low shareholder protection. Thus, they require a higher premium to make up for the increased risk exposure due to the poor governance standards of the bidder (and hence the merged firm, if the bidder does not voluntarily bootstrap its governance standards). Thus, the takeover premium should be decreasing in the corporate governance quality of the bidding firm. Although our analyses include a variable capturing the means of payment, we re-estimate our models for subsamples of all-equity payment/mixed offers, and of all-cash offers. Unlike Starks and Wei (2005), we find that our results regarding the spillover by law and the bootstrapping hypotheses do not depend on the means of payment.

3.4.4 Further sensitivity tests

Our results are also robust to the following alternative specifications: (i) we measure abnormal returns over alternative event windows such as [–5, +5] and [–60, +60]; (ii) we employ industry-adjusted characteristics of bidding and target firms such as Q-ratio, leverage, size and cash flow; (iii) we control for both bidder and target collateral (the fixed assets) as a proxy for financial takeover synergies and access to debt financing; (iv) we include year and industry fixed effects; (v) we control for the bidder toehold in the target company accumulated prior to the initial takeover bid; and (vi) we control for the stock market 'bubble' period (1998–9).

4. CONCLUSION

We demonstrate that differences between the bidder and target corporate governance standards have an important impact on the returns from cross-border mergers and acquisitions. To proxy for the quality of corporate governance in the countries of the target and the bidder, we have developed, with the help of 150 lawyers in 32 countries, time-varying corporate governance indices capturing the changes in corporate governance regulation over the past 15 years. The indices cover three dimensions of corporate governance: shareholder rights, minority shareholder rights and creditor rights, while also embedding the efficiency of the judicial systems.

In a full takeover, the corporate governance standards of the bidder may be imposed on the target. When the bidder is from a country with stronger shareholder orientation, part of the total synergy value of the takeover may result from the fact that the stronger shareholder focus of the acquirer may generate additional returns due to better management of the target assets. We call this the positive spillover by law hypothesis. Given that this future value creation can be anticipated at the time of the takeover announcement, the abnormal returns will reflect this potential. We expect that both the bidder and target firms share the returns from improved corporate governance (improved shareholder rights protection) and that their relative bargaining power determines how these returns are shared. Our empirical analysis corroborates the positive spillover by law hypothesis: the better the bidder's corporate governance standards, the higher are the bidder and target takeover announcement returns.

While the positive spillover by law effect applies to full takeovers, we define the spillover by control hypothesis for partial takeovers (whereby a bidder acquires majority control, but buys less than 100 per cent of the voting rights). In partial takeovers, the bidder may impose its governance standards, which may yield positive returns if it is from a country that protects shareholder rights better than the target. The bidder may voluntary opt to apply such standards or may be pressurized by the minority shareholders of the target firm. Our results confirm the spillover by control hypothesis: both bidder and target returns are higher in a partial acquisition if the bidder is subject to stronger shareholder rights protection than the target.

In full takeovers where the bidder is from a country that protects shareholders less well than the target country, the negative spillover by law hypothesis states that the target and bidder anticipated gains will be lower given that the poorer corporate governance regime will be imposed on the target. The alternative bootstrapping hypothesis is that poor-governance bidders voluntarily bootstrap to the better-governance regime of the target, which yields a share price increase. Our evidence supports the bootstrapping hypothesis: the bidder abnormal returns are higher when a bidder with weaker shareholder orientation acquires a target with better standards. Importantly, the effect is only valid for partial acquisitions or, in other words, for deals which still involve some of the target shareholders (who did not sell out) and for which the target firm continues to be listed on the stock exchange in the country of the target. The results are robust with respect to several model specifications that control for potential endogeneity problems. We conclude that an improvement in corporate governance at the target firm is an important source of gains in cross-border M&As.

Overall, our results suggest that cross-border takeovers between bidders and targets with dissimilar corporate governance standards can generates synergies which are partially related to corporate governance improvements (especially those consisting of increases in shareholder rights).

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APPENDIX 1 VARIABLE DEFINITION

Variable	Definition
# Domestic Acquisitions / # Listed Firms 1 year prior	Number of domestic acquisitions in the bidder/target country during the year prior to the deal announcement divided by the number of listed firms registered in this country. Source: computed from SDC, DataStream.
(Bidder) Creditor Rights Improvement	Indicator equals one if the bidder creditor rights index is below the median index and the target index is above the median, zero otherwise. Source: Martynova and Renneboog (2007b) and Appendices 2 and 3.
(Bidder) Minority Shareholder Protection Improvement	Indicator equals one if the bidder minority shareholder protection index is below the median index and the target index is above the median, zero otherwise. Source: Martynova and Renneboog (2007b) and Appendices 2 and 3.
(Bidder) Shareholder Rights Improvement	Indicator equals one if the bidder shareholder rights index is below the median index and the target index is above the median, zero otherwise. Source: Martynova and Renneboog (2007b) and Appendices 2 and 3.
(Target) Creditor Rights Improvement	Indicator equals one if the bidder creditor rights index is above the median index and the target index is below the median, zero otherwise. Source: Martynova and Renneboog (2007b) and Appendices 2 and 3.
(Target) Minority Shareholder Protection Improvement	Indicator equals one if the bidder minority shareholder protection index is above the median index and the target index is below the median, zero otherwise. Source: Martynova and Renneboog (2007b) and Appendices 2 and 3.
(Target) Shareholder Rights Improvement	Indicator equals one if the bidder shareholder rights index is above the median index and the target index is below the median, zero otherwise. Source: Martynova and Renneboog (2007b) and Appendices 2 and 3.

Variable	Definition
1997–1999	Indicator equals one if the bid was initiated in the period between 1 January 1997 and 31 December 1999 (the climax of the fifth takeover wave); and equals zero otherwise.
2000–2001	Indicator equals one if the bid was initiated in the period between 1 January 2000 and 31 December 2001 (the decline of the fifth takeover wave); and equals zero otherwise.
Anti-corruption Index	The extent to which one can exercise public power for private gain It quantifies indicators ranging from the frequency of 'additional payments to get things done' to the effects of corruption on the business environment. The index ranges between 0 and 5, with higher values corresponding to the lower level of corruption. Source: The World Bank (http://www.worldbank.org/wbi/governance/).
CFlow/TA	Ratio of total cash flow (including cash flow from operating, financial and investment activities) to total assets, at the year-end prior to the deal announcement. Source: based on SDC and Amadeus/Fame/Reach and DataStream.
Common Border	Indicator equals one if the bidder and target are from countries that have a common border, and equals zero otherwise.
Creditor Rights Index	The value of the Creditor rights index (defined in Appendix 3) multiplied by the Rule of Law index. Source: Martynova and Renneboog (2007b) and Appendices 2 and 3.
Diff (Bidder-Target) Creditor Rights Index	Variable equals the difference between the bidder and the target creditor rights indices. Source: Martynova and Renneboog (2007b) and Appendices 2 and 3.
Diff (Bidder-Target)	The difference between the bidder and the target Minority shareholder protection indices. Source:

Variable	Definition
Minority Shareholder Protection Index	Martynova and Renneboog (2007b) and Appendices 2 and 3.
Diff (Bidder-Target) Shareholder Rights Index	The difference between the bidder and the target Shareholder rights indices. Source: Martynova and Renneboog (2007b) and Appendices 2 and 3.
Diversification	Indicator equals one if the bidder and target operate in different industries (their primary two-digit SIC codes are not equal), and equals zero otherwise. Source: based on SDC and Amadeus/Fame/Reach.
Equity Payment	Indicator equals one if the acquisition is fully paid with equity, and equals zero otherwise. Source: based on SDC, LexisNexis, Factiva, and Financial Times.
Hostile Bid	Indicator equals one if the initial takeover offer is met with a negative reaction by the management of the target firm or if a competing bid is made. Source: based on SDC, LexisNexis, Factiva, and Financial Times.
Leverage	Ratio of total (long-term and short-term) debt to total assets at the year-end prior to the deal announcement. Source: based on Amadeus/Fame/Reach and DataStream.
M&A of 100 %	Indicator equals one if the bidder fully acquires the target and hence holds 100 per cent of the share capital after the completion of the deal, and equals zero otherwise. Source: based on SDC, LexisNexis, Factiva, and Financial Times.
Minority Shareholder Protection Index	Variable that takes the value of the Minority shareholder protection index (defined in Appendix 3) multiplied by the Rule of Law index. Source: Martynova and Renneboog (2007b) and Appendices 2 and 3.

Variable	Definition
Public Target	Indicator equals one if the target firm was a stand-alone firm listed on a European stock exchange at the moment of the bid announcement, and is zero otherwise. Source: based on SDC and Amadeus/Fame/Reach.
Q-ratio	Ratio of market value of equity (ordinary and preferred) plus book value of total (long-term and short-term) debt over the sum of book value of equity and book value of total debt. The market value of equity is taken 60 days prior to deal announcement; book value of equity and debt are at year-end prior to deal announcement. Source: based on Amadeus/Fame/Reach and DataStream.
Relative Size	The ratio of the transaction value over the sum of the transaction value plus the bidder market value of equity and book value of total (long-term and short-term) debt. If the transaction value is undisclosed, we use the book value of the target firm's assets one year prior to the bid multiplied by the percentage of share capital acquired. Source: based on SDC, LexisNexis, Factiva, and Financial Times and Amadeus/Fame/Reach and DataStream.
Rule of Law Index	The Rule of Law index measures the extent to which agents have confidence in and abide by the rules of society; these also include the effectiveness and predictability of the judiciary and the enforceability of contracts. The index ranges between 0 and 5, with higher values corresponding to the better quality of law enforcement. Source: The World Bank (http://www.worldbank.org/wbi/governance/).
Run-up	Cumulative abnormal returns (CARs) of the bidder/target over the window [–60, –2] preceding the day of the deal announcement. Abnormal returns are computed with the market model adjusted for thin-trading and reversion to the mean. The market model's parameters are estimated over the period of 300 to 60 days before the M&A announcement; the market index is the MSCI Europe index. Source: based on DataStream.

Variable	Definition
Same Industry	Indicator equals one if the bidder and target operate in same industries (their primary two-digit SIC codes are the same), and equals zero otherwise. Source: based on SDC and Amadeus/Fame/Reach.
Same Language Group	Indicator equals one if at least one official language of the target country belongs to the same language group (Romance languages, Germanic (excluding English), Slavic, English) as that of one of the official languages of the bidder country, and equals zero otherwise. Source: based on SDC.
Shareholder Rights Index	The value of the Shareholder rights index (defined in Appendix 3) multiplied by the Rule of Law index. Source: Martynova and Renneboog (2007b) and Appendices 2 and 3.
Size (log TA)	Logarithm of the firm's total assets at the year-end prior to deal announcement. Source: DataStream and Amadeus/Fame/Reach.

APPENDIX 2 THE NAMES OF THE LEGAL EXPERTS WHO CONTRIBUTED TO THE CORPORATE GOVERNANCE DATABASE

Austria: Prof. Susanne Kalls (University of Klagenfurt), Prof. Christian Nowotny and Mr Stefan Fida (Vienna University of Economics and Business Administration);

Belgium: Prof. Eddy Wymeersch (University of Ghent, Chairman of the Commission for Finance, Banking and Assurance), Prof. Christoph Van der Elst (University of Ghent);

Bulgaria: Dr Plamen Tchipev (Institute of Economics, Bulgarian Academy of Sciences), Ms Tania Bouzeva (ALIENA Consult Ltd., Sofia), Dr Ivaylo Nikolov (Centre for Economic Development, Sofia);

Croatia: Dr Domagoj Racic and Mr Josip Stajfer (The Institute of Economics, Zagreb), Mr Andrej Galogaža (Zagreb Stock Exchange), Prof. Drago Čengić (IVO PILAR Institute of Social Sciences), Prof. Edita Culinovic-Herc (University of Rijeka);

Cyprus: Mr Marios Clerides (Chairman) and Ms Christiana Vovidou (Cyprus Securities and Exchange Commission);

Czech Republic: Prof. Lubos Tichy, Mr Martin Abraham, and Mr Rostislav Pekar (Squire, Sanders & Dempsey, Counsellors at Law), Dr Petr Kotáb and Prof. Milan Bakes (Charles University of Prague), Dr Stanislav Myslil (Čermák Hořejš Myslil a spol, Lawyers and Patent Attorneys), Dr Jan Bárta (Institute of State and Law, The Academy of Science of Czech Republic), Ms Jana Klirova (Corporate Governance Consulting, Prague);

Denmark: Prof. Jesper Lau Hansen and Prof. Ulrik Rammeskow Bang-Pedersen (University of Copenhagen);

Estonia: Prof. Andres Vutt (University of Tartu), Mr Toomas Luhaaar, Mr Peeter Lepik, and Ms Katri Paas (Law Office of Lepik & Luhaäär);

Finland: Prof. Matti J. Sillanpää (Turku School of Economics and Business Administration), Mr Ingalill Aspholm (Rahoitustarkastus/Financial Supervision Authority), Ms Ari-Pekka Saanio (Borenius & Kemppinen, Attorneys at Law, Helsinki), Ms Johan Aalto (Hannes Snellman, Attorneys at Law; Helsinki);

France: Prof. Alain Couret (Université Paris I- Panthéon-Sorbonne), Ms Joëlle Simon (MEDEF – French Business Confederation), Prof. Benoit Le Bars (MC Université de Cergy-Pontoise), Prof. Alain Pietrancosta (Universities of Tours and Paris I- Panthéon-Sorbonne), Prof. Viviane de Beaufort (ESSEC-MBA), Prof. Gerard Charreaux (Université de Bourgogne Pôle d'économie et de gestion);

Germany: Prof. Peter O. Muelbert (University of Mainz), Prof. Klaus Hopt and Dr Alexander Hellgardt (Max Planck Institute for Foreign Private and Private International Law), Prof. Theodor Baums and Mr Tobias Pohl (Johann Wolfgang Goethe University, Frankfurt/ im Main);

Greece: Prof. Loukas Spanos (Centre of Financial Studies, University of Athens), Dr Harilaos Mertzanis (Hellenic Capital Market Commission), Prof. Georgios D. Sotiropoulos (University of Athens);

Hungary: Dr Tamás Sándor (Sándor Bihary Szegedi Szent-Ivány Advocats), Dr Andras Szecskay and Dr Orsolya Görgényi (Szecskay Law Firm – Moquet Borde & Associés), Prof. Adam Boóc and Prof. Anna Halustyik (Corvinus University of Budapest);

Iceland: Mr Gunnar Sturluson and Mr Olafur Arinbjorn Sigurdsson (LOGOS Legal Services), Dr Aðalsteinn E. Jónasson (Straumur Investment Bank and Reykjavik University), Mr David Sch. Thorssteinsson (Iceland Chamber of Commerce);

Ireland Republic: Dr Blanaid Clarke (University College Dublin), Ms Kelley Smith (Irish Law Library, Barrister);

Italy: Prof. Guido Ferrarini and Mr Andrea Zanoni (University of Genoa), Dr Magda Bianco and Dr Alessio Pacces (Banca d'Italia), Prof. Luca Enriques (Università di Bologna);

Latvia: Prof. Kalvis Torgans and Dr Pauls Karnups (University of Latvia), Mr Uldis Cerps (Riga Stock Exchange);

Lithuania: Mr Virgilijus Poderys (Chairman) and Ms Egle Surpliene (The Securities Commission of Lithuania), Mr Rolandas Valiūnas, Dr Jaunius Gumbis, and Dr Dovilė Burgienė (Lideika, Petrauskas, Valiūnas ir partneriai), Dr Paulius Cerka (Vytautas Magnus University), Mr Tomas Bagdanskis (Tomas Bagdanskis, Attorney at Law);

Luxembourg: Mr Jacques Loesch (Linklaters Loesch Law Firm), Mr Daniel Dax (Luxembourg Stock Exchange);

Netherlands: Prof. Jaap Winter (De Brauw Blackstone Westbroek, High Level Group of Company Law Experts European Commission Office (Chairman), University of Amsterdam), Mr Marcel van de Vorst and Mr Gijs van Leeuwen (Norton Rose Advocaten & Solicitors), Mr Johan Kleyn and Dr Barbara Bier (Allen & Overy LLP), Dr Pieter Ariens Kappers (Boekel De Nerée), Prof. A.F. Verdam (Vrije Universiteit Amsterdam), Prof. Mr C.A. Schwarz (Maastricht University);

Norway: Prof. Kristin Normann Aarum (Oslo University), Prof. Tore Brathen (University of Tromsø), Prof. Jan Andersson (University of Bergen);

Poland: Prof. Stanisław Sołtysiński and Dr Andrzej W. Kawecki (The law firm of Sołtysiński Kawecki & Szlęzak), Mr Igor Bakowski (Gotshal & Manges, Chajec, Don-Siemion & Żyto Sp.k.), Dr Piotr Tamowicz, Mr Maciej Dzierżanowski, and Mr Michał Przybyłowski (The Gdańsk Institute for Market Economics), Ms Anna Miernika-Szulc_(Warsaw Stock Exchange);

Portugal: Mr Victor Mendes (CMVM – Comissão do Mercado de Valores Mobiliários), Mr Carlos Ferreira Alves (CEMPRE, Faculdade de Economia, Universidade do Porto), Prof. Manuel Pereira Barrocas (Barrocas Sarmento Rocha – Sociedade de Advogados), Dr Jorge de Brito Pereira (PLMJ – A.M. Pereira, Sragga Leal, Oliveira Martins, J dice e Associados – Sociedade de Advogados), Dr Manuel Costa Salema, Dr Carlos Aguiar, and Mr Pedro Pinto (Law firm Carlos Aguiar P Pinto & Associados), Mr Antonio Alfaia de Carvalho (Lebre Sá Carvalho & Associados);

Romania: Mr Gelu Goran (Salans, Bucharest office), Dr Sorin David (Law firm David & Baias SCPA), Ms Adriana I. Gaspar (Nestor Nestor Diculescu Kingston Petersen, Attorneys & Counsellors), Mr Catalin Baiculescu and Dr Horatiu Dumitru (Musat & Associates, Attorneys at Law), Ms Catalina Grigorescu (Haarmann Hemmelrath Law Firm);

Slovak Republic: Dr Jozef Makuch (Chairman) and Dr Stanislav Škurla

(Financial Market Authority, Slovak Republic), Dr Frantisek Okruhlica (Slovak Governance Institute);

Slovenia: Prof. Janez Prasnikar and Dr Aleksandra Gregoric (University of Ljubljana), Prof. Miha Juhart, Mr Klemen Podobnik, and Ms Ana Vlahek (Securities Market Agency);

Spain: Prof. Candido Paz-Ares (Universidad Autonoma de Madrid), Prof. Marisa Aparicio (Universidad Autonoma de Madrid and Universidad Pontificia Comillas de Madrid), Prof. Guillermo Guerra (Universidad Rey Juan Carlos);

Sweden: Prof. Per Samuelsson and Prof. Gerard Muller (School of Economics and Management at Lund University), Prof. Rolf Dotevall (Göteborg University), Dr Catarina af Sandeberg, and Prof. Annina Persson (Stockholm University), Prof. Björn Kristiansson (Linklaters Sweden);

Switzerland: Dr Urs P. Gnos (Walder Wyss & Partners), Prof. Gerard Hertig (Swiss Federal Institute of Technology – ETH Zurich), Dr Michel Haymann (Haymann & Baldi), Prof. Wolfgang Drobetz (University of Basel – WWZ), Prof. Karl Hofstetter (Universität Zürich), Prof. Peter Nobel and Mr Marcel Würmli (Universität St. Gallen);

UK: Prof. Antony Dnes (Bournemouth University), Prof. Dan Prentice and Ms Jenny Payne (Oxford University), Prof. Brian R. Cheffins, Mr Richard Charles Nolan, and Mr John Armour (University of Cambridge), Prof. Paul Davies (London School of Economics), Mr Gerard N. Cranley, Ms Holly Gregory, and Ms Ira Millstein (Weil, Gotshal & Manges), Ms Eva Lomnicka (University of London).

APPENDIX 3 DESIGN OF CORPORATE GOVERNANCE STANDARDS INDICES

The table shows how specific regulations are quantified to construct three corporate governance standards indices: the shareholder rights index, the minority shareholders protection index, and the creditor rights index. Some regulatory aspects are incorporated in several indices.

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1. ***The shareholder rights index*** reflects the shareholders' ability to mitigate managerial opportunistic behaviour. The index is constructed by combining the following 4 sub-indices:

1.1 The appointment rights sub-index is based on the rules to appoint and replace executive and non-executive directors. It measures the degree of alignment of the interests of management and shareholders. The regulatory provisions are quantified as follows:

- Employee representation: 0 if required, 2 if not.
- Nomination to the board by shareholders: 2 if required, 0 if not.
- Tenure on the board: 0 if more than 4 years, 1 if 4 years, 2 if less then 4 years.
- Cross-shareholdings:
  - Cross-shareholdings between 2 independent companies: 1 if regulated, 0 if not.
  - Maximum shareholding of a subsidiary in its parent company: 1 if regulated, 0 if not
- Election rules:
  - Proxy voting by mail: 2 if allowed, 0 if not.
  - Requirement to Deposit/Register shares prior to a general meeting:
    - Bearer shares: 0 if deposit is required, 1 if only registration of shares is required, 2 if none is required.
    - Nominal shares: 0 if deposit is required, 2 if deposit requirement is forbidden.

1.2 The decision rights sub-index captures the shareholders' ability to mitigate managerial discretion. The decision rights index covers regulatory provisions that mandate direct shareholder decision-making. The regulatory provisions are quantified as follows:

- Shareholders' approval of anti-takeover measures: 2 if required, 0 if not.
- Shareholders' approval of pre-emption rights: 2 if required, 0 if not.
- Percentage needed to call for extraordinary meeting: 0 if no rule or more than 20%, 1 if 20% or less but more than 5%, 2 if 5% and less.
- Voting caps: 0 if allowed, 2 if not.

1.3 The trusteeship sub-index measures the efficiency of the board of directors in monitoring the actions of CEOs. The following regulatory provisions are quantified as follows:

- Board independence:
  - 2 if CEO cannot be the chairman of the board of directors (in 1-tier board structure), 0 otherwise.

    - 2 if the overlap between management and supervisory board is forbidden (in 2-tier board structure), 0 otherwise.
- Employee representation: 0 if required, 2 if not.
- Separate board of auditors: 1 if required, 0 otherwise.

1.4 The transparency sub-index is based on the quality of information about company, its ownership structure, and management available to investors:

- Requirement to disclose managerial compensation: 0 if not required, 1 if required on aggregate basis, 2 if required on individual basis.
- Requirement to disclose any transactions between management and company: 2 if required, 0 if not.
- Frequency of financial reports: 0 if once per year, 1 if twice per year, 2 if more than twice per year.
- Comply or explain rule: 1 if the requirement is present, 0 otherwise.

The higher each index, the better is the protection of the shareholders.

2. ***The minority shareholders protection index*** is based on the regulatory provisions aimed at increasing the relative power of the minority shareholders in a context of strong majority shareholders. The index is constructed by combining the following 4 sub-indices:

2.1 Minority shareholders' appointment rights sub-index is based on the appointment rights that can be used to protect minority shareholders. These include rights to reserve seats on the board of directors for minority shareholders or to limit voting power of large shareholders. The regulatory provisions are quantified as follows:

- Minority representation on the board: 2 if required, 0 otherwise.
- Voting caps limiting power of large shareholders: 1 if voting caps are allowed, 0 if not.
- One-share-one-vote rule: 0 if both multiple voting rights and non-voting shares are allowed; 1 if one of the two is allowed; 2 if none is allowed.

2.2 Minority shareholders' decision rights sub-index captures the ability of minority shareholders to affect fundamental corporate transactions that require a shareholder vote. The regulatory provisions are quantified as follows:

- Supermajority requirement for approval of major company's decisions: 0 if 50% or less; 1 if more then 50% but less then 75%; 2 if 75% or more.
- Percentage needed to call for extraordinary meeting: 0 if the rule is not present or required percentage is 20% or more; 1 if the required percentage is between 20 and 5%; 2 if the percentage is 5% or less.

2.3 The minority shareholders' trusteeship rights sub-index indicates the extent to which the board of directors serves as a trustee for minority shareholder, that is the directors are independent from the firm's controlling shareholders. The regulatory provisions are quantified as follows:

- Nomination to the board by shareholders: 2 if shareholders voting to elect non-executive directors is not required (2-tier boards); 0 if required or 1-tier board.
- Board independence: 2 if CEO cannot be the chairman of the board of directors (in 1-tier board structure) or if the overlap between management and supervisory board is forbidden (in 2-tier board structure), 0 otherwise.

2.4 The minority shareholders' affiliation rights sub-index groups the remaining regulatory provisions aimed at protecting minority shareholders: the principle of equal treatment (or shared returns) and rights for entry and exit on fair terms. The regulatory provisions are quantified as follows:

- Equal treatment rule: 2 if required, 0 if not,
- Mandatory disclosure of large ownership stakes: 0 if disclosure is not required or the minimum percent is 25% or more; 1 if 10% or more (less then 25%); 2 if 5% or more (less then 10%); 3 if less then 5%.
- Mandatory bid rule: 0 if not required; 1 if 50% or control; 2 if between 50 and 30%; 3 if 30% or less.
- Sell-out rule: The squeeze-out rule is used as a proxy for the sell-out rule (assumption: sell-out is always in place if squeeze-out is adopted, with the same terms as squeeze-out): 0 if no squeeze-out; 1 if squeeze-out at 95% or more; 2 if squeeze-out at 90% or less.
- Minority claim: 0 if no; 1 if 10% or more; 2 if 5% or more; 3 if less then 5%.
- Breakthrough rule: 1 if required; 0 if not,

The higher each index, the better is the protection of the minority shareholders.

3. ***The creditor rights index*** is based on regulatory provisions that allow creditors to force repayment more easily, take possession of collateral, or gain control over firm in financial distress. The regulatory provisions are quantified as follows:

- Debtor-oriented versus creditor-oriented code: 1 if no reorganization option (liquidation only); 0 if reorganization + liquidation option;
- Automatic stay on the assets: 1 if no automatic stay is obliged in reorganization (if debt-oriented code) or liquidation procedure (if liquidation code); 0 otherwise;
- Secured creditors are ranked first: 1 if secured creditors are ranked first in the liquidation procedure; 0 if government and employees are ranked first;
- Creditor approval of bankruptcy: 1 if creditor approval is required to initiate reorganization procedure (if debtor-oriented code) or liquidation procedure (if liquidation code); 0 otherwise;
- Appointment of official to manage reorganization/liquidation procedure: 1 if it is required by law in a reorganization procedure (if debtor-oriented code) or a liquidation procedure (if liquidation code); 0 otherwise.

The higher the index, the better is the protection of the creditors

Comment – Discussion of 'Spillover of corporate governance standards in cross-border mergers and acquisitions' by Marina Martynova and Luc Renneboog

Abe de Jong

INTRODUCTION

The corporate governance structures and practices in companies are strongly influenced by the countries where firms are incorporated. Legal rights for shareholders, creditors and directors, the enforcement of these rights and prevailing practices determine the strengths of a country's governance regime. Cross-border mergers and acquisitions (M&As) provide a fascinating experiment where firms may face dramatic changes in their governance regimes. The acquired firm from a foreign country becomes subject to the governance regime of the domestic acquiring company. In their contribution to this volume, Martynova and Renneboog exploit the governance regime changes in this setting and empirically describe the value relevance of governance regime shifts and resulting spillover effects.

Martynova and Renneboog investigate cross-border acquisitions because the governance structures of the acquiring and acquired firms influence the valuation effects in the acquisitions. The idea is that acquirers from countries with strongly shareholder-oriented governance regimes will impose this regime on target companies from countries with weaker regimes. The authors refer to this hypothesis as the positive spillover by law hypothesis in full takeovers. For partial acquisitions, the spillover effect is expected to occur on a voluntary basis, which is referred to as the (positive) spillover by control hypothesis. Where the acquiring company is from a country with a weaker regime, the reasoning inverts. This leads to the negative spillover by law hypothesis for full acquisitions, where the target's stronger regime is overtaken by the weaker regime of the acquirer. Finally, the bootstrapping hypothesis, as an alternative to the negative spillover effect, states that bidders may voluntarily decide to abide by the stricter regulation in the target country. In this case, the acquisition enhances the governance quality of the acquirer, inducing a positive value effect.

The empirical analysis of Martynova and Renneboog is based on a sample of 2419 transactions initiated in firms from 29 European countries, of which 737 deals are cross-border transactions. First, the probability that firms initiate a foreign acquisition is measured, based on, among other factors, governance standards. Second, using standard event study analysis, short-term shareholder wealth effects and country-level governance data, the authors explain abnormal stock returns by the target and bidder country, shareholder rights, minority shareholder rights and creditor rights, controlling for firm, deal and country characteristics. The results demonstrate that firms that are incorporated in countries with weaker governance structures are more likely to acquire a foreign than a domestic company. At the same time, when minority shareholder protection is strong, firms are more likely to acquire foreign firms. The event study results support the positive spillover by law hypothesis and reject negative spillover. The key result is that the difference in governance affects both bidder and target returns positively, when the bidder is from a stricter regime than the target. The inverse result does not hold. The authors argue the latter effect is consistent with the bootstrapping hypothesis.

This discussion contains two comments. First, I will discuss the measurement of the governance characteristics. Then I will discuss the economic magnitude of the spillover effects documented in the chapter. Finally, I conclude.

MEASURING CORPORATE GOVERNANCE

In their analysis, Martynova and Renneboog use a country-level governance metric based on a survey of 150 corporate law experts from 32 European countries, which accounts for legal changes in the period 1990–2005. The commonly used data in other studies is based on La Porta et al. (1998). The three indices in Martynova and Renneboog are a major improvement on the La Porta et al. measures, for three reasons. First, three indices are used – shareholder rights, creditor rights, and minority shareholder protection – whereas La Porta et al. use only the first two measures. Particularly in the European setting with many block holdings, a distinction between general and minority shareholder rights is a major advantage. Second, the indices are much broader, that is, based on a larger set of underlying characteristics. Third, the indices are dynamic, that is, measured at yearly intervals from 1990 until 2005. The authors have made a major improvement in establishing these governance metrics; one can but hope that soon their analysis will be extended to include a broader set of countries than the 32 European nations.

In the control changes, ultimately, firm-level governance structures will determine the valuation effects. The authors justify their use of country-level governance data instead of firm-level characteristics in two ways. First, the large sample would make the collection of corporate charters and AGM decisions virtually impossible. Second, as demonstrated by Doidge et al. (2007), a large part of the variation in firm-level governance is explained by country characteristics. The purpose of Martynova and Renneboog's chapter is to analyse the spillover effects of corporate governance standards, which by definition provides the most powerful justification for the use of data on governance standards, that is, country standards. In future research, analysis of firm-level governance seems a promising avenue for a better understanding of the effects of governance in cross-border mergers and acquisitions. I will elaborate on this avenue below.

The country characteristics provide a minimum level of governance standards. In their charters and practices, individual firms can decide to improve governance beyond the minimum standards or decide to have the lowest level of governance. This choice obviously induces the strong correlation between firm and country governance metrics, as documented by Doidge et al. (2007). At the same time, the most interesting aspect of the determination of governance structures in firms is ignored, that is, the opportunity to comply with international best practices beyond the legally required minimum set of arrangements. It seems trivial that governance in firms is related to merger and acquisition activity. Firms with poorer governance (that is, at the country minimum level) are more likely to make acquisitions that are the result of insufficient disciplining, whereas better-governed firms (that is, above the country minimum) are more likely to make value-enhancing acquisitions. It is obvious that the above-mentioned distinction is most relevant in a country with low governance standards.

An important firm characteristic that may induce a difference between firm- and country-level governance is whether a firm has a cross-listing in a country with a regime that is of higher quality than the home-country regime. In this setting, the firm has to obey rules in a country other than the home country. Martynova and Renneboog do not refer to cross-listings in their analysis. The presence of companies with a cross-listing may explain the absence of strong effects for the negative spillover hypothesis. In particular, firms from countries with weaker regimes are more likely to have an underestimation of their governance quality due to not accounting for their cross-listing in countries with better regimes. In future studies, the inclusion of cross-listing information would allow an interesting expansion of the analysis.

WHAT IS THE ECONOMIC MAGNITUDE OF THE SPILLOVER EFFECT?

The results of the analysis are presented in terms of statistical significance. All hypotheses are tested by comparing the hypothesized valuation effects of corporate governance spillovers with the signs of the estimated coefficients from regressions of bidder and target returns. Because the main results are obtained for samples of 641 bidders and 296 targets, their statistical significance is likely to be determined not solely by the number of observations, but also by the magnitude of the effect. Therefore, as an addition to the chapter, it would be meaningful to describe the economic magnitude of the effects documented in the chapter.

The selection model for the probability that a bidding firm acquires a foreign firm versus a domestic firm is a probit regression with coefficient estimates of −0.3123, 0.3945 and 0.2804 respectively for the shareholder rights index, the minority shareholder protection index and the creditor rights index, all significantly different from zero at the 1 per cent significance level. The regression for target companies yields coefficients of similar magnitudes and signs, except for the minority shareholder protection index, which is negative and statistically insignificant. The indices are scaled to take values between 0 and 10 and adjusted for the quality of law enforcement. Although the distribution of the indices is not available, Table 3.3 allows a comparison of the six groups of countries with distinctly different index scores. For example, in 2005 the two English origin countries have the highest average shareholder rights index of 6.13, while the group of four EU 2007 countries has the lowest average index of 2.86. The difference is 3.27, which implies that, everything else equal, a bidding firm from one of the EU 2007 countries has a 16.2 percentage point higher probability of acquiring abroad (versus domestically) than its peers from the English origin countries.[1] Minority shareholder protection works the opposite way: due to higher minority shareholder protection in the region, an English origin firm has a 17.97 per cent higher chance of initiating an acquisition abroad compared with its EU 2007 peers (5.05 versus 2.15

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[1] The difference in probabilities is calculated as a difference between fitted values of Prob $[Y = 1 \mid X_1 = 6.13, \Sigma X_j \beta_j = 0 \text{ for all } j \neq 1] = \exp(-0.3123 \times 6.13) / [1 + \exp(-0.3123 \times 6.13)] = 0.1285$ and Prob $[Y = 1 \mid X_1 = 2.86, \Sigma X_j \beta_j = 0 \text{ for all } j \neq 1] = \exp(-0.3123 \times 2.86) / [1 + \exp(-0.3123 \times 2.86)] = 0.2905$. Note that these results are subject to a very strict assumption of $\Sigma X_j \beta_j = 0$ for all $j \neq 1$ which I made to simplify the calculations and because the distribution of other variables is not reported in the chapter. The estimated difference in probabilities may change once this assumption is relaxed.

index scores respectively). The creditor rights effect can be established by comparing the German origin countries with the EU 2007 group: the 1.5 difference in the creditor protection index scores between these two groups of countries (= 4.11 − 2.61) implies that foreign acquisitions by German origin firms are 8.46 per cent more likely than M&As by EU 2007 firms.

The key results on the valuation effect of the spillovers of corporate governance standards are presented in panels A and B of Tables 3.8 (bidder returns) and 3.10 (target returns). In panel A, the spillovers are measured by differences between bidder and target indices, while in panel B they are proxied by indicator variables. The indicator variables approach allows a differentiation between positive spillover (improvement) and negative spillover (deterioration) of corporate governance standards. For both bidders and targets, the main spillover valuation effect is due to the shareholder rights improvement in the target firm, which is proxied by an indicator variable that takes the value of one where the bidder's shareholder rights index is above the median and the target's index is below the median (see panel B of Tables 3.8 and 3.10). Table 3.5 shows that this situation applies to 27.82 per cent of all cross-border acquisitions (note that another 48.30 per cent of the sample has both bidder's and target's shareholder rights index above the median). In the regression of bidder returns, the estimated coefficient for the spillover indicator variable is 0.0173. In economic terms, this implies that in almost one-third of all cross-border mergers and acquisitions bidders earn 1.73 percentage point higher merger and acquisition returns because their better corporate governance standards may be transferred to the target firms. This premium for the corporate governance spillover is more than three times higher than 0.47 per cent, that is, the average merger and acquisition premium to all cross-border bidders (see Table 3.2). Because no further statistics are provided, we cannot compare this effect with, for example, the standard deviation.

For target returns, the analysis requires the joint assessment of the valuation effects of the target's shareholder rights standards and the potential spillover of new standards from the bidder, as both variables appear statistically significant in explaining target returns with respective coefficients of 0.0501 and 0.0107. First, the coefficient of 0.0501 for the target's shareholder rights index implies that a one-point increase in the index results in a 5.01 percentage point higher takeover premium accruing to the target's shareholders. Referring to the earlier comparison of firms from EU 2007 and English legal origin countries, the effect augments to (6.13 − 2.86) x 5.01% = 16.38%. On top of this effect, target firms also experience 1.07 percentage point higher returns if the bidder is from an above-median corporate governance regime, while the target is not. The two valuation effects appear sizeable when compared to the average takeover announcement returns to the target's shareholders of 12.55 per cent (see Table 3.2). Note that these two valuation effects are unlikely to occur simultaneously. Suppose a UK firm takes over a Russian firm: the valuation effect of the target's shareholder rights standards and the spillover of new standards from the bidder will be 5.01 per cent times the (low) index score for Russia plus 1.07 per cent because the bidder is from an above-median regime and the target from a below-median regime. Now imagine the inverse takeover, where a Russian firm buys a UK firm: the total effect will be 5.01 per cent times the (high) score for the UK, but since the bidder is from a below-median corporate governance regime and the target is from an above-median regime, a positive spillover effect is not feasible. Obviously, the target's corporate governance standards effect dominates the spillover effect in economic terms, even though both are statistically significant.

The discussion about the economic effects vis-à-vis statistical significance seems to be a valuable addition to the analysis. Although the authors have defined their hypothesis in terms of the absence or presence of significant effects, it is always insightful to assess economic effects in addition to the statistical analysis.

CONCLUSIONS

Martynova and Renneboog's chapter is an interesting analysis of the impact of a country's governance system on valuation effects of mergers and acquisitions. The documented effects demonstrate that governance has a sizeable impact on value. This discussion has aimed to add to their analysis by indicating the relevance of firm-specific governance measures and by describing the economic magnitude of the documented effects.

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4. Corporate governance – getting back to market basics

Henry G. Manne

1. INTRODUCTION

The subject of the governance of corporations with some non-controlling shareholders has come to the fore both politically and academically in recent years. These firms may be diffused-ownership, as characterizes many larger US companies, or they may be companies with a single controlling block of shares, whether owned or voted by individuals or intermediaries, as has largely characterized companies in Europe and most of the rest of the world. In either case, the fundamental problem of governance is always seen as how to protect the interests of the non-controlling shareholders (and in some cases stakeholders) from financial depredation by the controlling shareholders or the managers of the firm.

Anyone reading this chapter will immediately recognize this as the famous 'agency cost' problem identified nearly forty years ago by Michael Jensen and William Meckling,[1] though their immediate interest was less in the abusive behavior of controlling shareholders than it was with managers themselves. For our purposes right now, however, we may simply assume a concurrence of interests between those two, a condition we will relax as the story unfolds.

This conflict, or perhaps better, tension of interests was first noted without any supporting economic theory by Berle and Means in their classic *The Modern Corporation and Private Property* in 1933.[2] There the problem was seen largely as one of diffused shareholders being unable to coordinate their monitoring efforts effectively to prevent managers from

[1] Jensen, M.C. and Meckling, W.H. (1976), 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure', *Journal of Financial Economics*, 2, 305–60.

[2] Berle, A.A. and Means, C.G. (1933), *The Modern Corporation and Private Property*, New York: Macmillan.

running the business in their own interest rather than in the interests of the shareholders-owners-principals.

As an aside Berle and Means' 'solution' to this problem, though politically influential, has been so ineffective as to be largely insignificant for us today. Their idea was that corporations should be operated as small democratic states, and the electorates' control over the officials would be preserved by ramping up the institutions of democracy such as voting and full disclosure of corporate affairs. The former may be said to have resulted in the famous 'proxy solicitation rules' of the Securities and Exchange Act of 1934, and the latter by the massive disclosures required by both the 1934 and the 1933 acts.[3] While disclosure certainly has real significance in various aspects of corporate finance, it still has precious little impact on the democratic character of large corporations. I have addressed both these approaches in my writings over the years, and I won't repeat that analysis here. Suffice it to say that, since the advent of these regulatory ideas in the American New Deal of the early 1930s, the position of the non-controlling shareholder seems to have worsened and the position of the controlling shareholder or managers to operate at other shareholders' expense seems to have strengthened. The modern concern with corporate governance did not even begin until at least forty years after the advent of these approaches, and neither ranks high in anyone's list of proposed solutions to the agency cost problem today, though each is firmly imbedded in the sticky bureaucratic structure of our past corporate governance efforts.

In a superb new book by Professor Jonathan Macey of Yale Law School, there is a useful catalogue of corporate governance mechanisms.[4] The list includes: the SEC and organized stock exchanges, boards of directors, the market for corporate control, initial public offerings (IPOs), accounting, litigation, insider trading and short selling, whistle blowing, shareholder voting, credit rating agencies, stock analysts, hedge funds, and banks and other fixed claimants. I do not plan to address each of these mechanisms in this chapter, and, as I have already indicated, at least two of them, disclosure and voting rules, have already proved themselves unworthy of serious further effort at analysis. That does not mean that they do not continue to be promoted seriously by some who have addressed the governance question, especially the expansion of voting rights to non-shareholder

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[3] The Securities and Exchange Act 1934, creating the Securities and Exchange Commission (SEC), was preceded by the Securities Act 1933, requiring registration of tradable securities.

[4] Macey, J. (2008), *Corporate Governance: Promises Kept, Promises Broken*, Princeton, NJ: Princeton University Press, p. 50.

constituencies. It merely means that I no longer consider the proposals as worthy of further attention, as they have been tried and failed the test.

Other mechanisms in Macey's catalogue that I will not be addressing directly at this time are IPOs, litigation, credit rating agencies, stock analysts, hedge funds and banks. That still leaves a pretty big order for one chapter, since it includes boards of directors, the market for corporate control and insider trading. These three are connected, as I shall elaborate, and each of them is regulated to an enormous extent in every country with any significant corporate sector. Basically my position is the same as Professor Macey's, namely that there is no aspect of corporate governance that is not better left to private contracting and the play of market forces.

2. BOARD OF DIRECTORS

I will start with the board of directors, since the other two mechanisms are closely tied to each other, and this one sits a bit independently. In some ways, if we look at the long legal history of limited liability firms with multiple shareholders, we see that this was perhaps the first explicit governance mechanism. For all the debate surrounding the modern corporate board, no one denies that its fundamental role is to appoint and monitor the managers who run the day-to-day affairs of a business firm, whether a controlling shareholder is directly involved in the board or not. Certainly with a large number of shareholders, this role was dictated by the high coordination costs shareholders faced in trying to monitor managers directly. The power and responsibility of the board to appoint managers guaranteed continuity to an operation's management, especially in the simple situation, too infrequently noted today, where a founder-manager-controller dies, and the continuation of the business demands a quick and non-controversial method of continuing the managerial function.

The monitoring function has, of course, been the focal point of modern corporate governance concerns about the board of directors. Countries have ranged all over the legal map in the regulation of this function. We have laws that require independent directors (whatever that may mean in a real world of co-option of loyalties); laws that limit the term of directors and restrict who can be chairman of the board; laws that require labor to be represented on the board (here the concern is with stakeholders other than the minority shareholders); laws that require the board to exercise authority in matters previously handled by officers; a large extension of possible liability, including criminal, for directors' failure adequately to monitor management in various connections; limits on directors' salaries and perks; and heavy regulation of directors' role in takeover controversies.

Now there has never been, and probably can never be, a bright line drawn between the areas of responsibility that belong to the board and those that are rightly managed by the officers of the company. In practice the division of responsibility varies with personalities, firm size, share distribution and a number of other factors. Each firm is generally free to develop a set of norms that allows a smooth relationship to exist between the board and the managers. In fact one of the great mistakes of modern scholarship on corporations has been the failure to understand that the managers and the directors of a company form one team for the production of good overall management of the company and that the management function (here used in the technical economic sense of a function) was performed by this team with all the problems of valuation of inputs attendant upon team production.

Some scholars in this field have noted the relevance of the Alchian and Demsetz theory of team production for the corporation.[5] Unfortunately, they have often drawn the wrong conclusions because they did not see the board as merely a component part of the management function within the firm, but rather as existing solely or primarily to exercise the monitoring function. Perhaps the terminology created the confusion, since the term 'management' in legal policy discussions has a very different meaning than the term 'management' when seen as an economic function in the theory of the firm.

Consistent with this idea of the board as a component part of the management team is the idea that the exact form, size and power of the board should be left to the individual founders (including the negotiators of conditions in an IPO or a new debt offering), since this will largely be a market-determined decision that will naturally vary with different firms and different conditions. No regulation applicable to all firms can possibly be 'correct' (in the sense of economically efficient) for all of them, though a default position as stated in modern corporation laws may well be efficiency enhancing for those cases where the variations simply do not matter enough to warrant the cost of varying from any reasonable default position. But this is merely an argument for an optional default position not for a mandatory standard.

There is another problem with this particular kind of corporate governance regulation, though it is a problem with most government regulation

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5 Alchian, A.A. and Demsetz, H. (1972), 'Production, Information Costs, and Economic Organization', *American Economic Review*, 62, 777–95.

of business. It stops innovation dead in its tracks; it freezes into place one particular form or system of management that may or may not be the best that could ever be devised. Mandating the form and authority of the board of directors prevents experimentation. No one knows whether a better system could be invented, but we do know that with the regulations we have in place, the chances of any real innovation in the standard corporate managerial form is almost nil. For comparison, we might note that it took decades for most American states to allow the one-man board of directors, even in companies with only one shareholder!

The astute listener or reader will have noticed that I have ignored the hotly contested issue of 'shareholder primacy' versus 'director primacy', and I may be accused of implicitly joining the forces of the former group since obviously the mandated appointment of special directors to represent the interests of stakeholders other than the shareholders is not even intended to be economically 'efficient', that is, to be in the shareholders' interest primarily. It is designed to serve other interests of 'society' even if that is done at the expense of the shareholders. But I think that the whole argument about shareholder or director primacy is an unfortunate bit of semantic play that misleads the participants in the debate.

The very notion of primacy among these different parts of total corporate governance negates the idea of the corporation as an entity that evolves in a market context. All the parts fit together as well as the organizers can manage, and in a perfect market system there can be no conflict of interest, since the differences will all be worked out in a Coasian bargain reflected in various contracts and in the value of shares. I am now referring to a dream world in which, for instance, the role of a board confronting a tender offer, apparently the pivotal issue in the 'primacy' debate, are spelled out in the articles of the company or in IPO provisions (or in a default statutory or judicial rule). These provisions will be evaluated in the stock market, and, apart from fraud or extreme informational asymmetry, no one can be said to be hurt by allowing the tender offer to be advanced on any terms the raider sees fit so long as it is consistent with the article or by-law or IPO provisions previously agreed to.

The director primacy crowd, led by Professor Bainbridge,[6] and abetted in a most interesting fashion in the current work of Professor Pacces,[7] would give authority to the board to establish takeover defenses, to refuse

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[6] Bainbridge, S.M. (2008), *The New Corporate Governance in Theory and Practice*, Oxford and New York: Oxford University Press.

[7] Pacces, A.M. (2007), *Featuring Control Power: Corporate Law and Economics Revisited*, Rotterdam: Erasmus University.

the offer or to conduct an auction; while the shareholder primacy forces, led for some time by Easterbrook and Fischel,[8] and now perhaps by Professor Macey,[9] would exclude consideration of tender offers from the protection of the business judgment rule (for conflict of interest reasons) and require the directors to remain neutral in the ensuing fight.

As I have already indicated, I see no reason for this debate if markets are functioning effectively to value contractual provisions. These provisions may well take account of Professor Pacces' argument that managers must be protected because they have firm-specific capital which they would lose in a takeover (why takeover law should be the main vehicle for a solution to this particular business problem is not made clear), or the provisions may say that this company will allow an unfettered market for corporate control to prevail (that is, no interference by the incumbents allowed) in order better to monitor management's quality.

These are the two extreme policy positions being debated today, and yet either can be evaluated in the marketplace. The selection of one approach or the other is an organizational decision that is best left to private decision makers and the vagaries of infinite circumstances. One approach is not inherently superior to the other, and the infinite number of variations in circumstances can dictate one or the other approach for any given company at any given time. Mandatory regulation (but not a default statutory provision) of the board's role in this process is guaranteed to get it wrong much of the time, is guaranteed to protect the more politically powerful interests, is guaranteed to inhibit the discovery of new approaches and is guaranteed to create needless argument and litigation. Well, at least it is good for the trial lawyers!

3. MARKET FOR CORPORATE CONTROL

So having segued from the board as a monitor of managers to matters of the market for corporate control, let's look further at the regulation of that particular apparatus for corporate governance. Here it is important to note something rarely considered in this typically history-free discussion. The hostile takeover was not invented until there had developed a sufficient number of diffused-ownership corporations to make the investment in this highly innovative market scheme profitable. Consequently, it

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[8] Easterbrook, F.H. and Fischel, D.R. (1991), *The Economic Structure of Corporate Law*, Cambridge, MA: Harvard University Press.

[9] Macey, J. (2008), *supra* n. 4.

did not make its first appearance in England or Germany or France, where diffused ownership corporations in the early 1950s were still few and far between. It happened in the United States in the early 1950s.

For a variety of reasons, mostly related to the Internal Revenue Code, shareholdings were becoming more and more diffused in America by that time. This was ironic in one sense, since the work of Berle and Means, that so influenced early corporate governance regulation, was premised on the existence of diffused-ownership companies, even though at the time of publication of that work (1933), there were probably no more than five, or ten with the most liberal method of counting, corporations of this sort in existence, clearly not enough to make the development of the hostile tender offer economically feasible. Of course, control dealings between banks and individuals that held controlling blocks of shares were commonplace well back into the nineteenth, even eighteenth, centuries, and thus there had always existed a simple market for corporate control. It was not unlike that that prevailed on the European continent prior to the invention of the hostile takeover. The earlier market just did not contain the surprise hostile tender offer, or its later progeny, and no one demanded regulation, since all deals were the result of private negotiation.

Even though it was not invented by a scholar of corporate governance but by a buccaneering financier, the original form of the American surprise hostile tender offer was perfectly designed to respond to the complaint that Berle and Means popularized and which corporate scholars of all sorts fret about today. It was par excellence the market discipline for wayward managers, far more effective than the personnel employment market for managerial talent or the market for new capital or product competition (operating ultimately through bankruptcy procedures), though those operated as well. It only required a relatively efficient and liquid stock market to allow the market for corporate control to work for corporations with widely diffused shareholders. If the managers did anything that kept the price of the shares lower than a potential raider thought he could raise it to by better management (minus the cost of the takeover), the situation presented a positive investment opportunity. The incumbents would be gone in a matter of days (albeit occasionally with large golden parachutes if in their employment contract they successfully negotiated a large departure bonus) and a new management team installed.

Note that this is an all-purpose solution to the agency cost problem. It did not require that the managers behave illegally or in breach of fiduciary duties to become operational. A mere failure to engage in economically desirable actions that the raider thought would benefit the price of the shares (for example, a merger unattractive to the incumbents, or a liquidation that would cost the incumbents their jobs) could be enough to call the scheme into action. It thus reached deficiencies like simple inattention to work, matters that litigation, with its necessary business-judgment safe harbor, could never touch. It corrected misguided efforts (certainly from the shareholders' point of view) to benefit stakeholders at the expense of shareholders. It simply overwhelmed such piddling governance devices as the shareholders' proposal rule or mandated independent directors. It cut through often bizarre voting arrangements, so long as a number of voting shares sufficient to guarantee control were floating in the open market. And it provided constant pressure on managers at all levels, including the board, to maximize the share price. Nothing less than tolerable managerial skills and enormous effort could protect the incumbents from the tsunami of a surprise hostile tender offer.

But it was for just these otherwise desirable reasons that corporate incumbents (and their favorite bankers and other complementary functionaries) found it worthwhile to invest hugely in political 'goodwill', or lobbying or bribery, as the cynic might term it, to secure protective legislation. And the stakes were enormous, not only economically but socially. In America, as in most countries with a large corporate sector, business leaders were also prominent and politically influential citizens, while the so-called raiders were often socially marginal citizens at best. It was not without significance that the inventor of the hostile takeover, one Louis Wolfson, who early in life had been a professional boxer and a junk dealer, spent time in jail on a completely trumped-up securities violation case heralded by the managerial establishment of America. That prosecution had its intended effect. On his release from federal prison, Wolfson sold all his business interests and took up philanthropy and raising thoroughbred horses as his main activities. The stakes in the takeover political fights were high for the participants, but nothing compared to the trillions of dollars that investors and consumers (no opportunity for them to participate in Coasian bargaining) have lost as a result of takeover regulation.

The arguments offered for this anti-competitive and highly incumbent-protective legislation were, of course, arguments we still hear today for 'clean' corporate governance: protection of shareholders against the greedy pre-emption of better opportunities the shareholders might have either from the incumbent managers or from some white knight. And this is not even to mention labor unions' interest in not having plants moved to more efficient locations by raiders.

But one would have thought that this same scenario would not play out in Europe where the surprise hostile tender offer was generally an impossibility because of the normal distribution of shareholdings in publicly held companies. It would seem then that Europe would continue with the old system of negotiated deals for transfers of control that had prevailed there and in pre-1950s America. That is, the banks would provide all the energy needed for a market in corporate control to function. So why did most European countries join the American bandwagon of regulating many aspects of unsolicited tender offers?

I would guess that knowledge of the profitability of takeovers *both for the raiders and the shareholders* made these things contagious, and the virus of uninvited offers for control began showing up in Europe not too long after they emerged in the US, even though they took a different form from the original American 'midnight special' which could work only if more than 50 percent of the voting stock could be subject to a tender offer. Again, with all sorts of claims about protecting shareholders against selling too cheaply or getting less efficient managers or impoverishing workers or destroying national treasures (NB, with these arguments the stock market price is implicitly always wrong, certainly a far bigger stretch than even the most extreme efficient-market proponent's claim for always-correct market pricing), the regulatory machinery was geared up. The result in Europe as in America, as countless empirical studies show, has been a significant loss in share values, less efficiently run companies and abnormally high real compensation for incumbent managers (since the rents available as a result of the blocked competition are now higher, and these rents will largely be claimed by the incumbent managers in one form or another).

Implicit is what I have said in the last few paragraphs is a claim that a totally unfettered market for corporate control is literally all that is needed for near ideal corporate governance. And when I say 'unfettered', that includes the legality of the surprise hostile tender offer, with whatever conditions the raider wishes to include in the offer. No arguments about differential pricing of the same shares, lost opportunities for better offers, inefficient pricing by the stock market, antitrust barriers to mergers, failure to disclose the raider's plans for the company or information about the raider generally or any other of the purely self-serving arguments made by incumbent managers will be allowed to prevail.

Anything less than this is an economically unwarranted interference in an otherwise highly beneficial, though never costless, competitive market. The results will be far more costly than the various empirical studies that have looked at share values before and after tender offers suggest. Significant additional real loss will come in less effective management of all companies, less innovation, less risk taking, higher salaries generally, more crony capitalism, and increased probability of government corruption (how better can we describe the safety net that incumbent managers and trade unions have bought from willing legislators and regulators?).

If there is a highly competitive market for corporate control, there will be no need for any of the other mechanisms for corporate governance (other than those voluntarily adopted by contracts and norms). There can certainly be no further argument for detailed controls over the tenure and power and constituency of boards of directors, since the displacement of ineffective boards is at the center of the workings of the market for corporate control. There can be no further argument about whether shareholder interests or those of the board should dominate, since the market will answer that question in no uncertain terms. There will be far less pressure on courts to adjudicate the difficult issue of management discretion, since there will only be a need for courts to deal with real acts of misbehavior by directors.

One of the happiest results of a totally unregulated market for corporate control will be that the regulators can get out of the business of limiting or fixing executive compensation. If total compensation paid to all members of a given corporation's management team are higher than the competitive rate for such a team by an amount more than the cost of a takeover, all other things being equal, a tender offer will ensue, and the new managers will be certain not to exceed this compensation bar. Indeed the mere threat of a hostile tender offer will generally be sufficient to make the management team of board and officers make every effort not to exceed in aggregate the market cost of compensation, just as it will motivate them to keep the share value as high as possible.

A truly competitive market for corporate control would also obviate the current pressure to ramp up both civil and criminal liability of directors and managers, since most of the cases of bad behavior will be reflected in a lower share price and the increased risk of a successful takeover. Shareholder voting and the whole idea of corporate democracy pale into near insignificance as we realize that the vote carried by voting shares is merely the counter by which to determine who owns control and that, as such, these counters may be freely traded in an open market. Indeed, there is a very strong argument for allowing exchanges to conduct trading in votes alone, without the underlying share interest, something generally not legal today. Incidentally, consider what would be involved under the present regulatory regime in an effort to list votes as 'securities' on a registered stock exchange. This is a perfect example of how regulation inhibits innovation, often in the most unanticipated fashion.

3. INSIDER TRADING

And so we come to the last of the governance mechanisms to be considered in this chapter, insider trading, not one of the usual suspects. Indeed, the role of insider trading in corporate governance is often overlooked by writers in the field. A notable exception to this generalization is Professor Macey, who, in his new book on corporate governance, has an entire chapter discussing and comparing the roles of insider trading and whistle blowing as mechanisms for dealing with and uncovering corporate corruption. He points to the irony that the less effective of these two mechanisms, whistle blowing, is exactly the one that Congress (in the Sarbanes-Oxley Act) and many writers have glorified, while either ignoring or castigating the more effective of the two devices.

Professor Macey addressed the role of insider trading only in its relationship to corporate corruption. Ironically, this is a classic example of insider trading on 'bad' news that so infuriated critics of my original defense of insider trading. Some of those critics, who might have been willing to accept a little of my argument about compensating insiders for producing good news, gagged on the possibility of those same traders profiting from the creation of bad news. Even so stalwart a defender of unregulated markets as Michael Jensen argued that if any more reward was available for the production of bad news, then more of it would be produced, a simple (and uncharacteristically simple-minded) example of the forces of supply and demand at work.

Now it seems that with Macey's defense of insider trading, with its principal argument that insider trading restrictions should be relaxed in the case of trading on bad news, the tables are turned. (In fairness to Professor Macey, it should be noted that he seems to prefer a regime in which all insider trading, on good or bad news, will be managed exclusively by private agreement.) What was previously perhaps tolerable to at least a few writers, insider trading on good news, now becomes tolerable mainly in the case of bad news. I would suggest that this is a case of these writers being more influenced by recent scandals and new demands for improved corporate governance than by rigorous analysis of the issue. In fact, there is analytically very little difference between the two cases.

While we do wish to discourage corruption, we also wish to encourage good management practises. These are merely opposite sides of the same investment coin (one a buy and one a sell), though one side certainly achieves considerably more media and political attention than the other. Just as much money can be lost from failure to motivate profitable behavior as it can from failing to discourage non-profitable behavior. But for insider trading to perform either of these incentivizing roles, it is essential that the information actually moves the price of the stock in the correct direction. Without this last qualification, insider trading on bad news would fail to have the discovery effect necessary for policing the corrupt employees (as apparently happened with the insider trading of the secretary at Enron who blew the whistle), and insider trading would cease to be very profitable.

Now this is little more than a rehashing of the incentive argument I made for insider trading many years ago.[10] But it is freshened somewhat by its relevance for the current corporate governance debate, especially the part that sees whistle blowing as a desirable form of information disclosure. But I no longer consider this the most significant role for insider trading in the corporate governance picture.

In my recent article,[11] I was able for the first time to relate the insider trading debate to the corporate governance question. My argument was that the information conveyed by the more accurate pricing attendant upon allowing insider trading could play a large role in good corporate governance, and this in two distinct fashions, one relating to managers and the other relating to non-managing, controlling shareholders.

The first point in that chapter was that information useful for running a large, complex business comes to top managers in many ways, no one of which is totally satisfactory. But the importance of reliable information for good decision making is so critical than no source can be costlessly foregone. Relevant managerial information often originates deep in the bowels of a large organization and is greatly distorted and even sidetracked as it makes its way up through official channels in the prescribed fashion.

But if all employees, and for that matter anyone else with access to the information, is allowed to trade on the information, the indicated impact on stock price may occur very quickly and accurately. (I am making some assumption here about the 'wisdom of crowds' phenomenon, wherein more accurate pricing will result from a larger amount of trading.) Part of managerial skills will then be to understand and respond to stock price changes that indicate some new information about the company, even though the stock price change obviously cannot explicitly indicate what that information is.

While I have argued in the past that significant enforcement of insider trading laws is an impossibility, this does not mean that there is no effect on the information available to top managers as a result of the practise. My argument about the unenforceability of insider trading laws does not suggest that the enforcement efforts have no impact whatever. I meant

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10 Manne, H.G. (1966), *Insider Trading and the Stock Market*, New York: The Free Press.

11 Manne, H.G. (2005), 'Insider Trading: Hayek, Virtual Markets and the Dog that Did Not Bark', *Journal of Corporation Law*, 31, 167–85.

merely that someone will still frequently have access to valuable information before it is disclosed through public channels, but not necessarily the same ones who would have it with no rule against insider trading or at the same time.

What the enforcement efforts will do is to distort the channels through which price information moves to the market, by moving the trading from more to less reliable sources. This may have the effect of weakening or drying up some of the beneficial 'signaling' that previously speeded up the process of stock pricing. Thus managers will still have access to stock price information but later than and perhaps not as accurately as they would if no one was inhibited from trading by regulatory laws.

The second argument is considerably more significant. That is, that accurate and fast stock pricing is even more important, as a matter of corporate governance, for shareholders who ultimately control but do not manage than it is for the actual managers. Indeed, one of the greatest benefits that may come from an IPO of less than half the shares of a company may be the flow of information back to the control holder via stock pricing on the floating shares.

It is actually more difficult for non-managing holders of a control block of shares to secure accurate information than it is for the top managers of a company. Their information will normally be screened (and perhaps distorted) through an additional layer of interested parties, the top managers, before they receive it. And this will be particularly relevant in the case of the development of bad news, whether as a result of corruption or of mere inefficiency. This information problem obviously explains the demand for control holders (whether individual or an intermediary firm) to be represented on boards of directors, but even boards of directors, as the Enron case illustrates, may not be getting the information they actually need for making monitoring decisions about the day-to-day managers.

Thus it will always be in the interest of large, non-managing shareholders to allow insider trading. Oddly, this may well explain the stricter and more energetic enforcement of insider trading laws in the United States than in the rest of the world, since the incidence of such stock distribution is greater in countries other than the United States. Thus, the rest of the world simply has relatively more to lose by strict enforcement of its insider trading laws, and this could be reflected in the enthusiasm for these laws in the two parts of the capitalist world.

There is one further connection between insider trading and corporate governance that has been touched upon in the literature, but which is so important that it should at least be referred to in the present context. That is the importance of an 'efficient' stock market for the proper functioning of the market for corporate control, heralded at the outset of this chapter as the most significant mechanism of governance in diffused-stock ownership corporations. But, for reasons we have just seen, an efficient market is also of great importance where the control is held by one individual or a bank or other intermediary. Indeed, the very notion of a market for corporate control is premised on the idea of stock prices accurately reflecting underlying facts about a company (though this is not meant to suggest that raiders may not have access to other sources of information about target companies than the stock price or that raiders never make mistakes). To the extent that stock pricing is dependent on a flow of the most reliable information about a company, then insider trading is of utmost importance to the efficient functioning of the market for corporate control and, therefore, indirectly at least, to the most powerful corporate governance mechanism we have.

Comment – Corporate governance and Coase's legacy: a reply to Henry Manne

Alessio M. Pacces

Professor Manne makes a fundamental statement, which he articulates in the domain of three major items of corporate governance. The statement is that 'there is no aspect of corporate governance that is not better left to private contracting and the play of market forces' (p. 190 of this volume).[1] This is applied to boards of directors, the market for corporate control, and insider trading. I do not think that Professor Manne would maintain his fundamental statement even in those circumstances that most evidently call for regulatory intervention. That he admits, implicitly, when he supports the 'need for courts to deal with real acts of misbehavior by directors' (p. 197 of this volume). By speculating on the limits of contracting and the meaning of misbehavior, I will try to illustrate why – maybe unfortunately – there is more need for regulation in corporate governance than Professor Manne suggests. Incidentally, my considerations are based on a framework not very different from his. While I am honored to be cited by the very pioneer of corporate law and economics, I am afraid I do not fully share his trust in the unfettered functioning of markets and private contracting for efficient corporate governance.

1. It is in the tradition of law and economics that regulation must be justified by market or contracting failures. This goes back to Ronald Coase (1960), whose views – as he also made clear in his Nobel Prize Lecture (Coase 1992) – tend to be misinterpreted in various formulations of a theorem that he has never enunciated. Coase did point to the virtues of the contracting process in resolving the misallocation of resources, but he

[1] In stating this, Manne refers to Macey (2008) who, however, articulates his reasoning through a more comprehensive set of institutions of corporate governance. For reasons of space, I am not in a position to comment upon Professor Macey's work, and on how it compares with the arguments developed by Manne. I briefly discuss Macey's contention that corporate law is made exclusively of default rules at the end of this comment.

also showed a number of limits to this process. Short of being unimportant, law can (but does not necessarily do so) support and correct private contracting in two ways: (1) by providing the entitlements to be contracted upon; (2) by regulating those entitlements whenever private contracting fails to do that efficiently because of high transaction costs.

When applied to corporate governance, this framework generates two basic grounds for regulatory intervention (Becht et al. 2007). The first is that some of the people affected by the deal might be missing from the bargaining table. The second is that the terms of the original agreement might be altered via renegotiation at a later stage. Both arguments reflect a problem known as contractual incompleteness. Contracts are imperfectly state-contingent, and as a result, unforeseen circumstances confer upon some of the parties to a so-called 'nexus of contracts' unanticipated power over the division of the firm's surplus. Those who may be adversely affected by these dynamics are naturally reluctant to invest in a long-term relationship. This is most unfortunate in corporate governance, whose major goal is maximizing the flow of investments committed to welfare-increasing production.

2. The first reason for regulatory intervention (third-party effects) is more often characterized as externalities of the corporate contract on other stakeholders' contracts. I doubt whether Ronald Coase would share this view. Put as externality, the argument is not powerful enough to support any further protection of shareholders or stakeholders than private ordering would grant. Both categories of players have a wonderful opportunity to contract for their rights in corporate governance when the firm goes public. High transaction costs would not give them a second chance when – as Professor Manne nicely puts it – public corporations evolve as entities in the market context. But then, more than about externalities, the real question is whether the property rights system confers upon these players a sufficiently broad range of entitlements to contract upon in the corporate governance set-up.

I believe that corporate law does this by complementing the property rights system with entitlements to control power that are not necessarily confined to ownership (Pacces 2007). This is the case when voting rights can be separated from ownership (for example, different classes of shares), or control rights are generated independently of voting rights (for example, management's privileged access to the proxy machinery). Although the issue of enabling rules is dismissed as one of secondary importance by Professor Manne, I consider this the most powerful argument for relying upon the market mechanism. When shareholders and stakeholder can effectively choose the entitlements necessary for protecting their investments, we may infer their preferences from this choice and its impact on stock prices. Under the same condition, we can conclude that those who contract for control powers need to protect their firm-specific investment from unforeseen contingencies, whereas those who don't simply refrain from putting that at stake.

I share Professor Manne's concern that corporate laws may, and most often do, fail to support that freedom of contract, although I see at least one way in which law may do too little, instead of too much, in addressing corporate governance from this angle. Following Berle and Means (1933), American scholars tend to take transition to managerial capitalism for granted. The reason why this may not happen – as is still the case in most countries of continental Europe – is not just that regulation interferes too much with the market mechanism, but also that it fails to provide the players with a sufficient range of entitlements to bargain over. When we take a quick look at comparative corporate governance, we see that managers are in charge when corporate law effectively allows management-controlled directors to be empowered against shareholders. When it does not allow that, control powers need to be *legally* supported by ownership, and this is how corporate governance gets stuck in controlling shareholding structures, regardless of whether this is efficient (Cools 2005).

Professor Manne correctly connects this part of my work with Bainbridge's (2002) advocacy of 'director primacy' (including the argument that stakeholders would contract for board representation when this is needed for them to invest). But he overlooks an important difference. I do not consider directors as monitors, unless the contract or regulation specifically entrusts *some* of them with this task, exactly because I share Professor Manne's view that (most) directors are part of the management team. Boards of directors are mainly (albeit not exclusively, as I am going to illustrate in a moment) an instrument for the exercise of control powers. When corporate law makes them powerful enough relative to shareholders, we observe management-controlled companies. When corporate law does not allow directors' empowerment, boards will still be the center of managerial discretion, but they will have to defer to a controlling shareholder. What these two outcomes have in common is that corporate governance, like any form of firm governance, needs to feature a unique line of command in order to protect firm-specific investments. Again, based on the work by Ronald Coase (1937), authority is no less important than market exchange in a capitalist economy. A prominent consequence of separation of ownership and control is that authority cannot just be supported by property rights (Zingales 2000).[2]

[2] For a theoretical discussion of this problem, see Chapter 6 by Pagano and van Oosterhout's Comment on it in this volume.

3. The second ground for legal intervention in corporate governance (opportunistic renegotiation) is related to the previous illustration of corporate law's support for private contracting. The corporate contract may well reflect efficient choices when the firm goes public. However, on the one hand, what is efficient today may no longer be efficient tomorrow. Indeed, this is the reason why law needs to support discretionary control powers (be they vested in the management or in controlling shareholders). On the other hand, unfettered discretion includes the power to alter the terms of the original agreement in the face of changed circumstances, and this may too easily result in expropriation of other constituencies. Leaving stakeholders aside, I agree with Professor Manne's argument that non-controlling shareholders would not invest if they were not confident that this arrangement still protects them well enough. But I disagree that the market mechanism is sufficient for this purpose. However control powers are allocated, the market can no longer support long-term commitments when it is 'superseded' by authority (Coase 1937).

For investor protection, Professor Manne especially relies on a market for corporate control operated by hostile takeovers. We would not need much else to prevent controllers from misbehaving – he argues – if a raider were always in a position to take control away from a disloyal or under-performing management. As highlighted by Lucian Bebchuk (1987, 1999), there are two reasons why this is not necessarily true. To start with, in a regulation-free environment, there is no guarantee that a new controller will enhance shareholder value instead of profiting from expropriation of non-controlling shareholders. Indeed, unconstrained opportunities for expropriation are a sufficient condition for shareholders to be under pressure to tender at any price. Secondly, hostile takeovers are ruled out whenever those in control are in a position to extract private benefits by diverting resources from minority shareholders into their own pockets. Since the only way for incumbents to be compensated for these benefits is selling control at a premium, they are committed to keeping control uncontestable.

Corporate controllers are therefore not in a position to commit to a no-expropriation policy by exposing themselves to the (threat of) hostile takeover. Quite to the contrary, that commitment must already be in place for hostile takeovers to be viable. Would the corporate contract be enough to support it? I believe not, and the reason is that controllers cannot credibly restrain their discretion through a contract whereby all control powers (including that of adapting the contract to unforeseen circumstances) are allocated to them in order to promote firm-specific investments. This is how regulation enters the picture. In order to support credible commitments that non-controlling shareholder will still be dealt with fairly, restraints on the corporate controller's discretion must be mandatory – that is, they cannot be opted out of by the corporate contract or any of its amendments.

Professor Manne seems to concede that this may be a good reason for courts to perform a residual check on the corporate controller's misbehavior. I think that we might agree that the domain of this check should be diversion of corporate resources – that is, theft in broad terms – and little else. However, the implications of this contention for the regulation of corporate governance are more far-reaching than they may appear.

4. When managers or controlling shareholders are vested with unfettered discretion, the opportunities for turning this into stealing are ubiquitous. They range from daily operations to corporate control transactions. The problem is that value diversion is not easily distinguished from the legitimate exercise of business judgment. In order to make sense of the Business Judgment Rule – a norm that preserves outside shareholders' commitment to delegating discretionary management regardless of how badly it turns out in hindsight – courts rely on the procedural fairness of corporate decision-making. Even in the presence of conflicts of interest, courts rely more on validation by directors who are independent of those in control than on their own ability to second-guess business judgment. However, independent directors – whatever that means – are not there to interfere with the management, but only to make sure that investor protection does not come at the price of over-regulating managerial discretion. I believe this is a major challenge for regulation today, rather than just an option (which could be reneged upon at anytime) for the corporate contract.

A similar reasoning applies to takeovers. Hostile takeovers are at odds with the (economically justified) concern of managers and controlling shareholders over the stability of their control powers. This may be why we have only experienced this phenomenon in specific spatial and temporal circumstances. Takeovers can also induce corporate controllers to do their best when they are friendly (incidentally, it is worth noting that this used to be Professor Manne's contention in 1965). However, once again this requires regulation to cope with problems of credible commitment (or, in Coasian terms, transaction costs). Non-controlling shareholders can become suddenly powerful in the face of a tender offer, when they are allowed a free ride on the insurgent's profits. Little do they know that, by short-circuiting the takeover mechanism, their opportunism just results in more shirking by the incumbents. As Professor Manne contends, there are a number of free-market ways out of this. However, they all result in a situation in which shareholders are induced to tender at any rate (thereby reopening the door to shareholder expropriation). Regulation must find the right balance between the bidder's commitment to enhance the company's value, shareholders' commitment to let him/her appropriate takeover gains, and the incumbent's commitment to part with control when he/she is compensated for its current value. I believe that it can (thereby restoring the virtues of Coasian bargain), although I concede to Professor Manne that it can better do so by weakening, instead of strengthening, minority shareholders.

Let me discuss very briefly the third topic analyzed by Manne, insider trading. I note that Professor Manne's argument in favor of insider trading is twofold. On the one hand, it improves the speed with which information is impounded in stock prices. On the other hand, it rewards the originators of information. I believe that the two arguments are related, so I will just explain why I am not entirely convinced about the latter. The rewards at issue are connected with profits on the stock market. While it is true that high-powered incentives to information acquisition, processing, and verification enhance stock market efficiency (Gilson and Kraakman 1984), I see two reasons why insiders should be prevented from profiting from their advantage in this.

First, insider trading reduces the incentives of outsiders to engage in the same activity, and accordingly, their returns from investing and willingness to invest in the stock market. Insiders may earn more from selling non-controlling stock when they are (legally) committed to letting only outsiders trade on information advantages. Secondly, prohibition of insider trading does not mean that insiders are prevented from otherwise reaping the gains of their information collection (another way of looking at their firm-specific investments). They can, indeed, to the extent that they manage to keep information about the firm's potential secret and to share it only with bidders who know better how to turn this potential into stock returns. This will allow two separate bargains on control and ownership: the first, rewarding the incumbent via a control premium; the second, making sure that insurgents take over if and only if they can enhance stock returns more than the market already anticipates.

5. My disagreement with Professor Manne on the unlimited virtues of private contracting generated a lively discussion at the conference[3] where our opposing views were aired. Based on that discussion, I need to clarify an important issue. My contention that mandatory rules are needed for investor protection could apparently be falsified by the observation that, even in those jurisdictions where this protection is considered high, the

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[3] See my introduction to this volume (at p. 11).

so-called 'mandatory rules' are not effectively binding. This seems to hold especially in the US, where traditionally corporate law has been considered to be mainly a collection of default rules (Easterbrook and Fischel 1991). The argument becomes particularly powerful when it is related to the choice of legal form and, even more so, of the corporate jurisdiction. Regardless of whether the law governing business corporations features mandatory rules in any given jurisdiction, these cannot be regarded as effectively mandatory when they can be opted out of either by choosing another legal form or by incorporating in another jurisdiction. This situation characterizes all American corporate jurisdictions, and particularly, the one governing the vast majority of US publicly held companies – Delaware. Within the limits of freedom of incorporation under European company law, the same argument would apply to Europe (Kraakman et al. 2009). It is therefore highly questionable whether investor protection in corporate governance is owing to the mandatory character of fiduciary duties – especially in the celebrated version administered by Delaware courts (Coffee 1989). Even in Delaware, 'fiduciary duties exist unless the parties have explicitly contracted them away' (Macey 2008: 23).

The argument that fiduciary duties are no exception to the enabling character of corporate law has a long-standing tradition in the US. Advocates of this position (for example, Romano 1989) contend that rational shareholders of a publicly held company would neither invest in a company offering insufficient protections against expropriation nor rubber-stamp a charter amendment aimed at removing those protections. The corporate contract thus protects investors well enough, and the question whether fiduciary duties need to be mandatory is the wrong question. Investors would only opt out of them in exchange for equivalent or stronger protections, for they would be fools to confer upon the management an explicit license to steal. The argument has been rejuvenated in a most interesting fashion by Hansmann (2006), who likewise contends that corporate contracts are very hard to amend due to the hold-out powers of minority shareholders. For this reason, companies choose not to depart from the statutory defaults and rely on the legislator to adapt the contract to changed circumstances. De facto, this makes default rules nearly as binding as mandatory rules. Both the companies and their investors, however, could take a different course of action. They could depart from the statutory defaults and opt out of any mandatory rules by incorporating in legal forms or jurisdictions that do not impose them. The fact that the vast majority of publicly held companies in the US do not do so does not change the circumstance that corporate law is exclusively made up of default rules.

In both the traditional and the most recent configuration, the argument is extremely formalistic. It revolves around the hypothetical propositions that: (a) shareholders *could* opt out of the protection supplied by fiduciary duties; (b) shareholders *would not* opt out of their contractual protections altogether unless they were irrational. Both propositions are true in a static setting, but they cease to hold in a dynamic context. The reason is that, unlike what both Romano and Hansmann assume, US investors are no longer in control of the corporate contract after the corporation has been established and, more importantly, floated on the stock market. A number of legal institutions, originally subscribed to by the investing public (for example, the proxy machinery and the limitations on outside shareholders' initiative), allow the corporate contract to be adapted to changed circumstances without the investors' effective consent. Non-controlling shareholders are normally asked to vote on these fundamental changes, but their vote doesn't mean much. On the one hand, it can only be solicited by those in control of the corporation. On the other hand, it is cast in situations of asymmetric information and collective action problems that could not lead to efficient bargaining. As a result, fundamental changes occur without non-controlling shareholders being involved in the bargaining. In the absence of alternatives, the latter simply rubber-stamp the decisions made by those whom they entrusted with the powers to deal with unforeseen circumstances in the first place.

These powers are very broad, as is shown by the significant incompleteness of the corporate contract (Rock and Wachter 2001). There is a void at the heart of the corporate contract, and intentionally so. Borrowing from the law and economics of contract law, Macey (2008) contends that one prominent way for shareholders to opt out of fiduciary duties is to stipulate in the corporate charter how certain contingencies should be dealt with. But this is done no more often than a choice of legal form other than the business corporation, or incorporation in jurisdictions more liberal than Delaware. Normally, publicly held companies *choose* to be subject to a set of mandatory rules for this is the only way to guarantee outside shareholders against expropriation without having to give up the flexibility of the corporate contract in the face of unforeseen circumstances. The business corporation provides a better balance of flexibility and commitment than the more contract-intensive legal forms available in Delaware or anywhere else in the US. In setting up the governance structure of a soon-to-be publicly held company, the founders *could not* afford to opt out of fiduciary duties because otherwise, the management *would* too easily renege on any other contractual promise that investors be dealt with fairly after the company has gone public.[4] That outside shareholders *could* opt out of fiduciary duties, but they *would not* do so in the absence of equivalent contractual protections, thus becomes irrelevant. The natural incompleteness of the corporate contract leaves them with no real choice.

It is telling that the importance of mandatory rules to support credible commitments is recognized by the same legal scholars who otherwise question whether corporate law has any real mandatory character (Kraakman et al. 2009: 22–3). In fact, much in the vein of the economists in the law and finance strand of literature (Djankov et al. 2008), they argue that 'there may be often little practical difference between mandatory and default rules' (Kraakman et al. 2009: 25). I find this unconvincing. A brief comparison between the US and the UK on a key issue – removal of directors – shows that the distinction between default and mandatory rules does matter in corporate law.

Both the Delaware General Corporation Law (§ 141) and the British Companies Act (§ 168 and § 303) stipulate that directors may be removed by a shareholder vote without cause. However, while the former is a default rule, the latter is mandatory. The outcome for publicly held companies is exactly the opposite in the two situations. The majority of Delaware companies going public in the US opt out of the default rule, mainly through the establishment of staggered boards (Bebchuk et al. 2002).

Conversely, the non-waivable right to remove directors without cause lays down the very foundation of institutional investors' power in UK corporate governance (Armour, Chapter 5 in this volume). To be sure, this example differs substantially from fiduciary duties, since removal of directors protects investors by taking powers away from the management instead of by regulating their exercise. I have explained earlier in this comment why a more enabling approach to distribution of powers would be preferable. The point I am making here is that, no matter how investor protection is devised, it needs to be supported by mandatory rules. Commitments that non-controlling shareholders be dealt with fairly could not be taken credibly when they can be opted out of by the corporate contract and its successive amendments.

6. To conclude, it is worth stressing that there is a strong argument in favor of mandatory rules the protection of investors against expropriation

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[4] It could be argued that one alternative is to make the corporate contract more difficult to amend, for example by setting super-majority requirements. The disadvantages of this solution, which explain why it is hardly ever chosen by publicly held companies, are the same as for making the corporate contract more detailed to deal with future contingencies.

of the share of firm surplus they have originally contracted for. It becomes far shakier, if not untenable, when it is applied to ex-post bargaining over a surplus (or loss) generated by circumstances not fully anticipated by contract (for example, a takeover or a radical change in market conditions). Here I fully agree with Professor Manne that private contracting should be entirely relied upon. However, in the economics of incomplete contracts, this means that parties should have unlimited freedom to allocate entitlements to control powers ex ante. On the one hand, as I have said, this requires a bit more than freedom of contract in corporate governance. The available entitlements should be defined in the first place, and this is a major task for (enabling) corporate law. On the other hand, how can the control powers of managers and/or controlling shareholders be reconciled with the previous statement that outside shareholders should keep the share of surplus they have originally contracted for?

To this purpose, mandatory rules need to operate beyond corporate law and intervene also in the functioning of securities markets. What we can leave for the corporate contract to define are, for instance, the conditions for takeovers to be effected and for insiders to extract rewards from trading their shares. But in order for these conditions to hold throughout the company's lifecycle, a binding takeover and securities regulation must protect non-controlling shareholders from dilution through freeze-outs and withholding of key information on trading the company's stock. The metaphor of 'Securities Regulation as Lobster Trap' (Rock 2002) illustrates efficaciously how these protections complement corporate law's fiduciary duties in supporting credible commitments towards investors.

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5. Enforcement strategies in UK corporate governance: a roadmap and empirical assessment

John Armour*

INTRODUCTION

A great deal of attention in the past decade and a half has been devoted to the comparison of corporate governance regimes in countries around the world, and to the role, if any, played by law in facilitating deep and liquid securities markets. However, in both the analytic and empirical scholarship, the focus has mainly been on the role played by the substantive law. This, however, risks overlooking the divide, as Roscoe Pound memorably put it, between 'law in books' and 'law in action'.[1] The way in which rules are enforced will clearly affect agents' incentives to comply. The effectiveness of a regulatory regime, therefore, is a function of both substantive rules and enforcement mechanisms.

Recent scholarship has begun to address enforcement-related issues. Thus the authors of well-known cross-country empirical studies of 'law and finance' have included enforcement-related variables in their analyses.[2] Some have

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[1] R Pound, 'Law in Books and Law in Action', (1910) 44 *American Law Review* 12.

[2] S Djankov, R La Porta, F Lopes-de-Silanes, and A Shleifer, 'The Law and Economics of Self-dealing', NBER Working Paper 11883 (2005) (henceforth 'Self-Dealing'); R La Porta, F Lopes-de-Silanes, and A Shleifer, 'What Works in Securities Laws?', (2006) 61 *Journal of Finance* 1 (henceforth 'What Works?').

concluded that private enforcement in corporate and securities law – that is, civil litigation – is correlated both with deep and liquid securities markets and with dispersed stock ownership. Other work, however, questions whether the measures of 'enforcement' employed in these analyses are meaningful.[3]

The UK, as one of the countries in the world with the greatest degree of dispersion in stock ownership of listed corporations, is therefore an interesting case for analysis.[4] Shares in publicly quoted UK companies are, similarly to those in their US counterparts, dispersed amongst many holders.[5] The central problem of corporate governance for UK quoted firms is therefore rendering managers accountable to shareholders.[6] In contrast, for the UK's private companies, the central governance problems concern how to minimise the costs of conflicts of interest between majority and minority shareholders, and between shareholders and creditors.[7]

This chapter investigates the strategies employed for enforcing constraints on managerial agency costs in UK listed firms. It provides a roadmap of the enforcement mechanisms used, and a first approximation of their empirical significance. In so doing, two distinctions are drawn. First, in keeping with much of the existing literature, the relative contributions of public and private enforcers are compared. The resulting picture is that, contrary to leading accounts in the economic literature,[8] it is public rather than private legal enforcement which dominates in the UK. Indeed, to a degree that may be startling to observers whose experience of 'common law' enforcement is based on the US,[9] shareholder lawsuits

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[3] JC Coffee, Jr, 'Law and the Market: The Impact of Enforcement', (2007) 156 *University of Pennsylvania Law Review* 229; HE Jackson and MJ Roe, 'Public and Private Enforcement of Securities Laws: Resource-based Evidence', (2009) 87 *Journal of Financial Economics 207*.

[4] Indeed, it is singled out by La Porta *et al* ('Self-Dealing', *supra* n 2, 12–16) as an exemplar of the 'common law' approach.

[5] See R La Porta, F Lopez-de-Silanes, and A Shleifer, 'Corporate Ownership Around the World', (1999) 54 *Journal of Finance* 471, 492; M Becht and C Mayer, 'Introduction', in F Barca and M Becht (eds), *The Control of Corporate Europe* (Oxford: OUP, 2001), 19–30; M Faccio and LHP Lang, 'The Ultimate Ownership of Western European Corporations', (2002) 65 *Journal of Financial Economics* 365, 379–380; CG Holderness, 'The Myth of Diffuse Ownership in the United States', (2009) 212 *Review of Financial Studies 1377*.

[6] See R Kraakman *et al*, *The Anatomy of Corporate Law* (Oxford: OUP, 2004), 21–2.

[7] See PL Davies, *Introduction to Company Law* (Oxford: Clarendon Press, 2002), 215–17.

[8] La Porta *et al*, 'What Works?', *supra* n 2.

[9] For details of private enforcement activity in the US, see RB Thompson and RS Thomas, 'The Public and Private Faces of Derivative Lawsuits', (2004)

are conspicuous by their absence in the UK. In contrast, the most empirically significant enforcement agencies in relation to corporate governance are the Takeover Panel, the Financial Reporting Review Panel, and the Financial Services Authority.

A simple divide between public and private enforcement fails, however, to take account of the role played by the strong community of institutional investors in the UK. To put this in context, we distinguish between *formal* and *informal* enforcement. Institutional investors, who hold the majority of the shares in UK listed companies, have engaged systematically in the production of rules and norms that facilitate low-cost informal interventions in response to managerial failure. Moreover, an examination of the history shows that the currently significant public enforcement agencies in the UK owe their origins to private informal enforcement. Strong informal private enforcement has historically therefore been the flipside, in the UK, of weak formal private enforcement.

The rest of the chapter proceeds as follows. Section 2 outlines a taxonomy of enforcement strategies, with a view to developing a 'roadmap' of their deployment in the UK. Sections 3 to 5 then seek to give an approximate 'snapshot' of the current empirical significance of these strategies in the UK, focusing respectively on formal enforcement, public enforcement (formal and informal), and informal private enforcement. Section 6 concludes with a summary of implications.

2. ANALYSING AND MEASURING ENFORCEMENT STRATEGIES

2.1 A Taxonomy of Enforcement Strategies in Corporate Law

It is helpful to start with a conception of 'enforcement'. If we restrict the scope of the enquiry to 'legal' enforcement, then we have in mind some form of court proceeding. Within this, a distinction can be drawn between 'public' and 'private' enforcement, according to whether the party initiating the action is a state official or a private party. This distinction may matter economically because of differing incentives.[10] A public enforcer is usually paid a salary regardless of outcomes, whereas private enforcers

57 *Vanderbilt Law Review* 1747; J Armour, B Black, BR Cheffins, and RC Nolan, 'Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and United States', (2009) 6 *Journal of Empirical Legal Studies* 701.

[10] See La Porta *et al*, 'What Works?', *supra* n 2; Jackson and Roe, *supra* n 3.

	Public	Private
Formal		
Informal		

Figure 5.1 A simple taxonomy of enforcement strategies

are primarily motivated by the prospect of payments contingent upon success in litigation. We might therefore expect private enforcement to be more sensitive to changes in the costs of enforcement, and where these costs are low, to be more intensive than public enforcement. Moreover, public enforcement agencies are relatively centralised and subject to political control, whereas private claimants are not. Whilst this makes public enforcement easier to coordinate, detractors argue that these features also make public enforcers relatively easy to bribe.[11]

So far, we have a two-way taxonomy of legal enforcement, divided into public and private. Yet it seems artificial to restrict the scope of the enquiry to court proceedings. There are many other techniques that we may refer to as 'informal' enforcement, which secure compliance without recourse to legal proceedings. This gives a second dimension to the taxonomy, yielding a four-way categorisation, represented in Figure 5.1.

Informal *public* enforcement consists of interventions by public bodies that do not involve judicial or quasi-judicial proceedings. A public agency which relies largely on informal enforcement is able to economise on the considerable costs of legal proceedings. This permits more money in a fixed budget to be allocated to the detection of misconduct, as opposed to prosecuting those who have already been detected.[12] If informal sanctions are effective, such an approach may secure better levels of compliance than reliance on formal sanctions.

A common mode of informal enforcement is through the imposition of 'reputational' sanctions – for example, publishing a public statement that a firm has failed to meet a required standard, or – more strongly – exhorting other firms to avoid doing business with the wrongdoer. In environments characterised by repeated interactions between parties, the value of future business opportunities means that a reputation for not behaving opportunistically is important. Whilst reputational sanctions can be generated

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[11] See, for example, JR Hay and A Shleifer, 'Private Enforcement of Public Laws: A Theory of Legal Reform', (1988) 88 *American Economic Review* 398.

[12] P Fenn and C Veljanovski, 'A Positive Theory of Regulatory Enforcement', (1988) 98 *Economic Journal* 1055.

by disgruntled trading partners complaining about an actor's behaviour, they tend to work much more effectively in the presence of an objective and expert agency which investigates conduct and publicises results.[13] Consistently with this, empirical studies from other jurisdictions report that public censure by a regulatory authority has a negative impact on the censured party's stock price, even where no legal sanctions are imposed.[14]

Alternatively, the regulator might simply have a private conversation with a regulated firm, warning them of a failure in conduct and requesting that it be put right. Sanctions are simply threatened, rather than applied immediately. Such a threat will induce the firm to remedy a default, provided that this costs less than the harm which would be caused by sanctions. The threatened sanctions could include anything from legal proceedings to public censure alone. The agency can retain the option of using public censure as a sanction by not revealing the identity of the transgressing firm at the outset.

Turning to informal private enforcement, we have in mind here action taken by parties who contract with firms – their investors, customers, and suppliers.[15] Such parties can sanction a firm by reducing their willingness to contract with it – in the case of investors, refusing to buy shares, or selling those they already have. This will affect a firm's share price. As an alternative to refusing to deal with a firm altogether, private parties may be able to exercise contractual entitlements that have the effect of

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[13] See, for example, RC Picker, 'Simple Games in a Complex World: A Generative Approach to the Adoption of Norms' (1997) 64 *University of Chicago Law Review* 929 1225, 1239–40, 1286; J McMillan and C Woodruff, 'Private Order Under Dysfunctional Public Order' (2000) 98 *Michigan Law Review* 2421, 2426–30.

[14] BL Liebman and CJ Milhaupt, 'Reputational Sanctions in China's Securities Market', forthcoming (2008) 108 *Columbia Law Review* 929. Moreover, where sanctions are imposed for matters implying a breach of trust – fraud, for example – the drop in stock price frequently exceeds the expected value of the sanction, implying that the firm's reputation has been harmed by the signal of its propensity for opportunism: see CR Alexander, 'On the Nature of the Reputational Penalty for Corporate Crime: Evidence', (1999) 42 *Journal of Law & Economics* 489; JM Karpoff, DS Lee, and GS Martin, 'The Cost to Firms of Cooking the Books', (2008) 43 *Journal of Financial and Quantitative Analysis 581*.

[15] In relation to private parties, the distinction between formal and informal enforcement to some degree tracks the distinction drawn in the social norms literature between 'third party' and 'second party' enforcement: third parties being external to the interaction regulated by the conduct (courts and arbitrators), and second parties being themselves participants (visiting reputational sanctions): See RC Ellickson, *Order Without Law: How Neighbours Settle Disputes* (Cambridge, MA: Harvard University Press, 1991), 126–32.

sanctioning individuals whose conduct has failed to comply with desired standards of conduct. The most obvious in the corporate context is the removal of managers from office following a shareholder vote. These two modes – famously dubbed 'exit' and 'voice' by Hirschman[16] – can also work together, as in the context of a hostile takeover: a large number of investors sell their shares, dissatisfied with managers' performance, depressing the share price and making management vulnerable to displacement by a takeover.

When we focus on private enforcers, the choice between formal or informal mechanisms may make a difference, depending on the relative expertise of courts versus investors and other institutional features of the two mechanisms. In particular, the rules of civil procedure matter a great deal to the efficacy of formal private enforcement, whereas the identity of major investors makes a big difference to the success of informal private enforcement.

Expanding the frame of reference to include informal enforcement leads us into another analytic issue: whether 'enforcement' should be understood as relating solely to *rules*, or to encompass the enforcement of *conduct*. A rule-based account of enforcement posits a rule or code, breaches of which form the subject of enforcement activity. However, if we are willing to include 'informal' enforcement, then the actions or inactions that attract an 'enforcement' intervention may not always be so clear as to have crystallised in a rule or code. If both agent and principal 'know the score', they need not state the details of desired conduct in advance, and can obviate the *ex post* costs of articulating and verifying the desired conduct to a court. What is being enforced is not so much a rule as compliance with desired standards of conduct.

It may well be argued that a more appropriate term for such a mechanism is 'governance', rather than 'enforcement'.[17] Governance connotes the exercise of investors' entitlements regarding control of the firm. In

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16 AO Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States* (Cambridge, MA: Harvard University Press, 1970).

17 See, for example, OE Williamson, *The Mechanisms of Governance* (New York: Oxford University Press, 1996), 145–70. See also R Kraakman *et al*, *supra* n 6, 23 (distinguishing between 'regulatory' and 'governance' strategies for mitigation of agency costs). Another categorisation that might usefully be employed distinguishes based on the time of the intervention – that is, between '*ex post*' and '*ex ante*'. (see La Porta *et al*, 'Self-Dealing', *supra* n 2, 8–9; Coffee, *supra* n 3, 229). *Ex post* enforcement – as with a court case – imposes a sanction after a particular action has (not) been taken, with the goal of deterring (motivating) agents at the outset. *Ex ante* enforcement, on the other hand, is concerned either with precautionary rules, or with the application of standard-based constraints on actions

modern theories of the firm, such entitlements – ultimately based on the power to control the firm's physical assets – take on particular significance where the costs of enforcing desired standards of conduct through the courts are high.[18] Rather than take a misbehaving manager to court, investors simply exercise their entitlements to remove the manager from control of the firm. Yet this type of action depends, for efficacy, on an underlying threat of *court* enforcement: if necessary, specific relief to protect investors' governance entitlements.[19] One might ask why a discussion of enforcement should not restrict itself to formal (judicial) enforcement of this variety.

There are good reasons for not so restricting the analysis. First, informal enforcement or governance mechanisms are clearly substitutes for certain types of formal enforcement. Thus to focus on formal enforcement without recognising their role risks highly misleading comparisons. A second rationale for including informal enforcement is that, as we have seen, it maps onto public as well as private enforcers. This boundary is in fact porous: the history of the UK's experience suggests that informal private enforcement mechanisms may, over time, engender public enforcement of a progressively more formal variety. For example, the Takeover Panel existed for many years as a private trade association, with no recourse to legal sanctions.

For these reasons, the chapter proceeds with the two-by-two classification outlined above. Clearly, there are other ways of organising the material. Equally clearly, the boundaries between the categories are porous, so that a two-dimensional scatterplot might be a more precise analytical tool than a two-by-two matrix: most real-world systems are likely to be 'mixed' in the sense that they have some aspects of each of the four categories. However, the work to be done by the taxonomy here is simply to organise the material that follows, and to provoke thought about what can be learned from the UK's experience. To give an overview of what follows, Figure 5.2 shows a tentative allocation to our two-by-two taxonomy of the various mechanisms that will be discussed.

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before they are taken. Again, such mechanisms might alternatively be referred to as 'governance'.

[18] See O Hart, *Firms, Contracts, and Financial Structure* (Oxford: Clarendon Press, 1995).

[19] See EB Rock and ML Wachter, 'Islands of Conscious Power: Law, Norms and the Self-governing Corporation', (2001) 149 *University of Pennsylvania Law Review* 1619; J Armour and MJ Whincop, 'The Proprietary Foundations of Corporate Law', (2007) 27 *Oxford Journal of Legal Studies* 429.

	Public	Private
Formal	(i) Criminal penalties (BIS, FSA) (ii) Director disqualification (BIS) (iii) Public interest winding-up (BIS) (iv) Civil penalties for market abuse, breaches of listing rules (FSA) (v) Court remedial orders (Takeover Panel, FRRP)	(i) Minority shareholder lawsuits (ii) Securities litigation (iii) Insolvency litigation
Informal	(i) Private request for remedial action (FSA, FRRP, Takeover Panel) (ii) Public censure (FSA, FRRP, Takeover Panel) (iii) 'Cold-shouldering' (Takeover Panel)	(i) Stock price sanction (Combined Code) (ii) Executive turnover following inferior performance ('rights issue', hostile takeover) (iii) Shareholder voting (related party transactions)

Figure 5.2 The enforcement taxonomy applied to UK corporate governance

2.2. Measuring Enforcement

In comparing the 'significance' of different enforcement strategies, how should we proceed? One approach is to consider the law (or rules) on the books: that is, how extensive the enforcement powers of a particular actor, or group of actors, are at a point in time, and what remedies are potentially available.[20] This approach, however, suffers from a number of potential limitations. First, as elementary law and economics teaches us, the deterrent effect of a legal rule is a function not only of the size of the potential penalty, but of the probability of its enforcement.[21] Therefore, to understand the efficacy (or otherwise) of various enforcement strategies in a given context, we need to have some understanding of the relative frequency of their use,[22] and an understanding of the procedural and contextual factors that may affect this.

Restricting our focus to the law in books has another limitation. In the presence of informal enforcement, it may yield results that are not just misaligned with, but indeed wholly orthogonal to, reality. This is because the content of substantive rules will interact with the enforcement mecha-

20 See, for example, Djankov *et al*, *supra* n 2; La Porta *et al*, *supra* n 2.

21 See, for example, Gary Becker, 'Crime and Punishment: An Economic Approach', (1968) 76 *Journal of Political Economy* 169.

22 See sources cited *supra* n 3.

Table 5.1 Companies registered in the UK, 2001–2006 (thousands)

Year	Type of company					Total
	Private	Public	Listed			
			Official List	AIM	Total	
2001–02	1479.1	12.4	1.7	0.7	2.4	1491.5
2002–03	1627.9	11.8	1.6	0.7	2.3	1639.7
2003–04	1831.1	11.7	1.6	0.9	2.6	1842.2
2004–05	1968.5	11.6	1.4	1.2	2.5	1980.3
2005–06	2118.7	11.5	1.3	1.3	2.6	2130.2
2006–07	n/a	n/a	1.3	1.3	2.6	n/a
Mean	1805.1	11.8	1.5	1.0	2.5	1816.8

Notes: Figures rounded to one decimal place. Figures for 'listed' companies include only UK-incorporated companies. Figures for 'total' companies incorporated in UK are the sum of private and public companies incorporated in the UK.

Sources: DTI, *Companies in 2005–6* (2006); London Stock Exchange, *Official Statistics*.

nism. Informal enforcement strategies are less likely to lend themselves to the public articulation of particularised rules. Where such strategies predominate, therefore, the scope of the substantive rules may appear to be narrower.

The approach taken in this chapter, which is dictated largely by considerations of data availability, is in the first instance to focus on the *numbers* of enforcement interventions, across the range of different enforcement modalities observed in the UK. This is supplemented, where available, with data on the size, or quantum, of typical enforcement actions. The measures employed are clearly very rough, but the goal is modest: to provide a preliminary overview of the empirical incidence of the different categories of enforcement mechanism, so as to form the basis for further discussion about their respective significance.

To set the scene, it may be helpful to begin with a measure of the population of firms in the UK. As Table 5.1 shows, private companies vastly outnumber public companies. Moreover, the population of private firms has risen rapidly over the past five years, whereas that of public companies has remained almost constant. Public companies are *capable* of issuing shares to the public, whereas private companies are prohibited. As also shown in Table 5.1, only a minority choose to exercise this option, whether by listing on the Official List (the London Stock Exchange Main Market) or the Alternative Investment Market

(AIM).[23] Some modalities of enforcement encompass all companies; others relate only to listed firms. This means that, should we wish to interpret the significance of 'raw' numbers of enforcement interventions in terms of enforcement *rates*, care must be exercised in the selection of denominators.

3. FORMAL PRIVATE ENFORCEMENT

We begin with the modality of enforcement of constraints on managerial agency costs that is the focus of much of the existing law and economics literature: namely, formal private enforcement. In this section, we consider three different types of action that investors may bring against errant managers: (i) shareholder actions to enforce breaches of directors' fiduciary duties; (ii) securities litigation to enforce breaches of disclosure laws and (iii) insolvency litigation relating to breaches of directors' duties. In each case, we consider data on their incidence as revealed by the numbers of cases producing one or more judgment of some variety (final or interim).[24] The set of judgments sampled is that contained in the major databases: LexisNexis, Westlaw UK, and Lawtel.[25] It turns out that, in the UK, private litigation against directors of listed companies is conspicuous by its absence.

3.1. Minority Shareholder Actions

Shareholders in UK companies have the ability to bring a minority shareholders' action against errant directors in one of two forms: either as a derivative action, or in the form of a statutory petition for relief from 'unfair prejudice'.

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[23] The figures for listed companies in Table 5.1 exclude 'cross-listings' – that is, UK-listed firms incorporated in other jurisdictions – and are therefore a subset of the population of public companies.

[24] Cases which produce more than one judgment (for example, appellate decisions) are counted only once, and are recorded according to the date of the most recent judgment.

[25] These databases aim to cover all decisions (both final and interim hearings) in which a written judgment has been delivered, or where an official transcript has been authorised by the judge. Coverage prior to 1996 includes only decisions selected for inclusion in law reports. From 1996 onwards, the databases include transcripts of unreported decisions. This transcript coverage becomes comprehensive as regards the Court of Appeal and High Court from 2001, when standardised numbering of transcripts was introduced.

In a derivative action, a minority shareholder is authorised to commence litigation in the company's name. It is used as a means of redressing wrongs done to the company. The decision whether or not to commence litigation in the company's name is a corporate action, and one which is usually made by the company's board of directors, or failing that, by its general meeting.[26] A derivative action, if authorised, bypasses these procedures so as to permit a minority shareholder to bring an action on the company's behalf. As such, it constitutes an exception to the ordinary principle of corporate action – namely, majority rule.

English law traditionally took a very restrictive approach to derivative actions.[27] Although the position has now been altered by the Companies Act 2006,[28] it is necessary to describe the old law in outline because it governed all the actions reported in this section. In order to be permitted to bring a derivative action, it was necessary for a minority shareholder to establish, at a preliminary hearing,[29] a reason why the matter was not something that was capable of being properly resolved by the board or the general meeting.[30] Doing so would require the minority shareholder to show that the company was controlled by a party that had benefited from the alleged wrong to the company – thereby establishing a reason why the board and/or general meeting's decision-making apparatus could not be trusted to make the choice in the best interests of the company.[31] This ruled out actions in cases where the board breached their duties without conferring any benefit on a controlling shareholder,[32] because the harm would be felt proportionately by all stockholders and consequently the majority rule principle applied.[33] This requirement of 'wrongdoer control'

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[26] *Marshall's Valve Gear Co Ltd v Manning, Wardle & Co* [1909] 1 Ch 267; *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204, 221; *Breckland Group Holdings Ltd v London & Suffolk Properties Ltd* [1989] BCLC 100.

[27] *Foss v Harbottle* (1843) 2 Hare 461, 67 ER 89; *Mozley v Alston* (1847) 1 Ph 790, 41 ER 833.

[28] CA 2006 ss 260–64 (in force from 1 October 2007).

[29] *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204, 221; CPR, r. 19.9.

[30] See *Edwards v Halliwell* [1950] 2 All ER 1064, 1066–7; *Barrett v Duckett* [1995] 1 BCLC 243, 248. The mere possibility of the matter being resolved by a general meeting – as opposed to its in fact having done so – sufficed to bar a derivative action. This was to encourage the minority shareholder to bring his or her grievance before the general meeting for resolution according to the wishes of the majority.

[31] *Russell v Wakefield Waterworks Co* (1875) LR 20 Eq 474, 482.

[32] *Pavlides v Jensen* [1956] Ch 565.

[33] See *Prudential v Newman, supra* n 29, 212–19.

made the derivative action a wholly unsuitable mechanism for enforcing directors' duties in listed companies, where there is typically no controlling shareholder. In effect, the law forced shareholders to take action via the general meeting rather than the courts.

Minority shareholders considering a derivative action also face financial disincentives.[34] If such an action is successful, then the recoveries will go to the company. The minority shareholder's benefit will therefore only be *pro rata* to their shareholding. However, the 'loser pays' principle applies to costs. This means that if a derivative action is unsuccessful, the minority shareholder faces potential liability not only for their own legal costs, but for the defendant's as well. This asymmetry was partially mitigated in 1975, when the Court of Appeal in *Wallersteiner v Moir (No 2)*[35] ruled that a minority shareholder was, in an appropriate case, entitled to an indemnity from the company against litigation expenses incurred on the company's behalf in pursuing a derivative action.[36] However, any such entitlement would not be established before the initial application to the court for permission to commence a derivative action.[37] Hence the claimant shareholder would still bear a significant risk relating to the costs of the preliminary hearing.[38] This is unarguably a powerful deterrent.

In quantifying shareholder actions to enforce breaches of directors' duties, it is appropriate also to take into account use of the statutory remedy for 'unfair prejudice'.[39] This gives the court a wide remedial discretion in circumstances where the affairs of the company have been carried on in a way that is 'unfairly prejudicial' to the interests of a minority shareholder or the shareholders generally. The relevant provision, which was originally introduced in 1980,[40] then re-enacted as section 459 of the Companies

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[34] These have not been altered by the Companies Act 2006: see A Reisberg, *Derivative Actions and Corporate Governance* (Oxford: OUP, 2007), 166.

[35] [1975] QB 373.

[36] According to Buckley LJ, this would be if the action was one which, in the court's view, a reasonable independent board of directors would authorise on the company's behalf: *ibid.* 403. See also *Smith v Croft* [1986] BCLC 207, 217–21; *Jaybird Group Ltd v Greenwood* [1986] BCLC 319, 321; DD Prentice, '*Wallersteiner v Moir:* A Decade Later' [1987] Conv 167.

[37] CPR r. 19.9

[38] See Reisberg, *supra* n 34, 234–42.

[39] Companies Act 2006 ('CA 2006') s 994.

[40] Companies Act 1980 s 75. It replaced a previous provision (Companies Act 1948 s 210) which had required a minority shareholder to show 'oppression' by the majority and had been interpreted very restrictively by the courts: see DD Prentice, 'The Theory of the Firm: Minority Shareholder Oppression: Sections 459–461 of the Companies Act 1985', (1988) 8 *Oxford Journal of Legal Studies* 55.

Act 1985, is now section 994 of the Companies Act 2006. Although most petitions brought for such statutory relief have been based upon breaches of informal understandings between participants in 'quasi-partnership' companies,[41] it was established by the mid-1980s that a remedy might also lie for breaches of fiduciary duty by boards controlled by majority shareholders.[42] Over time, the circumstances under which an unfair prejudice petition could be used to remedy such wrongdoing by a majority have been clarified. As regards breaches of directors' duties, the contours came to look quite similar to those under which a derivative action may be brought. That is, the courts were willing to grant a remedy for wrongdoing by directors where this had also benefited a majority shareholder.[43]

The typical remedy for a petition based on unfair prejudice is an order for the majority shareholder to buy the minority's shares, rather than a remedy for the company. However, there is considerable overlap with the derivative action in cases where there has been misappropriation of corporate assets.[44] Where a petition is based on such misappropriation, the petitioner will usually seek such an order requiring the majority shareholder to purchase his shares at a price that reflects the value they held before the conduct began.[45] From the petitioner's point of view, this is economically equivalent to corporate recovery following a derivative action.[46] Alternatively, an order may be sought requiring the respondent to sell their shares to the petitioner, in which case the petitioner will also seek an order on the company's behalf to recover misappropriated corporate assets.[47] Whilst an indemnity for costs is not usually available

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41 See *O'Neill v Phillips* [1999] 1092; Prentice, *supra* n 40.

42 *Re A Company* [1986] BCLC 68.

43 Compare *Re Elgindata Ltd* [1991] BCLC 959, 993–4 (simple mismanagement does not constitute unfair prejudice) with *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354, 393–5, 404–7; *Bhullar v Bhullar* [2003] EWCA Civ 424, [2003] 2 BCLC 241 (misappropriation of corporate assets by respondent shareholder). See also *Re Saul D Harrison & Sons plc* [1994] BCC 475, 489–91, 499–500 (breach of directors' duties must be sufficiently serious as to be 'unfairly' prejudicial) and *Gamlestaden Fastigheter AB v Baltic Partners Ltd* [2007] UKPC 26, [2008] 1 BCLC 468, at [13] ('self-serving' negligence).

44 See CA 2006 s 996(2)(e). The court also has power to order litigation to be commenced in the company's name: *ibid*, s 996(2)(c). However, this would generate the unnecessarily expensive result of two sets of proceedings to yield one remedy, and courts have tended simply to order a remedy directly.

45 See *Re Little Olympian Each-Ways Ltd (No 3)* [1995] 1 BCLC 636; *Profinance Trust SA v Gladstone* [2001] EWCA Civ 1031, [2002] 1 BCLC 141 at [33]–[45], [59]–[61].

46 See *Prudential v Newman, supra* n 29, 223.

47 As in *Bhullar v Bhullar, supra* n 43.

Table 5.2 Decisions on UK minority shareholder enforcement of directors' fiduciary duties, 1990–2006

Year	All companies			Listed companies		
	Derivative	Unfair prejudice	Total	Derivative	Unfair prejudice	Total
1990	0	1	1	0	0	0
1991	0	1	1	0	0	0
1992	0.5*	0.5*	1	0	0	0
1993	0	0	0	0	0	0
1994	1	1	2	0	0	0
1995	1	1	2	0	0	0
1996	0	1	1	0	1	1
1997	1	1	2	0	0	0
1998	1	2	3	0	2	2
1999	2	1	3	0	0	0
2000	0	4	4	0	0	0
2001	2	2	4	0	0	0
2002	3.5*	0.5*	4	0	0	0
2003	4.5*	1.5*	6	0	0	0
2004	1	5	6	0	1	1
2005	5.5*	2.5*	8	0	0	0
2006	2	1	3	0	0	0
Mean	1.5	1.5	3.0	0.0	0.2	0.2

Note: * Scores of 0.5 indicate action framed jointly as derivative action/petition for relief from unfair prejudice.

Sources: Author's analysis of transcripts of decisions available on LexisNexis, WestlawUK, Lawtel.

to a minority shareholder bringing an unfair prejudice petition,[48] it was suggested by Arden LJ in *Clark v Cutland* that where the relief sought is in substance on the company's behalf then the petitioner may be entitled to an indemnity from the company.[49] As a result of these instances of overlap, it is apposite to bracket together unfair prejudice petitions alleging breach of duty by directors along with derivative actions.

Table 5.2 shows the reported incidence of derivative actions and unfair

48 *Re a Company (No 005136 of 1986)* [1987] BCLC 82.

49 [2003] EWCA Civ 810, [2003] 2 BCLC 393 at [35]. See J Payne, 'Shareholders' Remedies Reassessed' (2004) 67 *Modern Law Review* 500.

prejudice petitions concerned with remedying breaches of directors' duties (that is, fiduciary duties and/or duty of care) over the period 1990–2006. There were only three reported judgments during this period in which a minority shareholder action was brought in relation to misfeasance by the directors of a listed company.[50] In none of these cases were the claimants successful. This implies that the average amount of damages paid annually by directors of listed companies following minority shareholder actions is zero. Moreover, because minority shareholders have been unsuccessful in recorded litigation, it implies that there is likely to be little settlement bargaining taking place in the shadow of the law.

Petitions alleging unfair prejudice are in fact used to seek redress for a wide range of other forms of wrongdoing by majority shareholders against minorities.[51] The most common type of complaint alleges the existence – and breach – of some agreement or understanding between all the shareholders that is not reflected in the company's formal constitution.[52] Such unanimous understandings are practically impossible to sustain as regards listed companies, where shareholders' identities are constantly changing.[53] Nevertheless, as a check on the robustness of the findings in Table 5.2, the incidence of judgments in *all* minority shareholder petitions alleging 'unfair prejudice' is reported in Table 5.3.[54] This reinforces the findings in Table 5.2.[55]

It might be thought that the foregoing data under-represent the true level of private enforcement activity, as they include only those decisions which reached judgment. Claims which are settled do not, of course, appear on the official record in the same way, nor are the details of the settlements recorded. Further insight into levels of private enforcement activity may, however, be derived from two studies which have sought to examine the number of claims filed, as opposed to those resulting in a judgment of some type.

The first was a study conducted by the Law Commission into 'unfair

50 The status of companies as 'listed' was determined manually, as the vast majority of UK 'public' companies are not listed. Cases involving public companies ('plcs') were first identified, and the transcripts and contemporary newspaper reports were cross-checked for evidence as to their status as listed or unlisted companies.

51 See generally, PL Davies, *Gower and Davies' Principles of Modern Company Law*, 7th edition (London: Sweet & Maxwell, 2003), 517–23.

52 See *ibid* and sources cited *supra* n 41.

53 See, for example, *Re Blue Arrow plc* [1987] BCLC 585, 590.

54 In contrast, Table 5.2 includes only those petitions that related to breach of directors' fiduciary duties.

55 Table 5.3 reported three additional cases in relation to listed companies during the period 1998–2006. These involved allegations either of informal understandings between all the shareholders, or of breaches of the articles.

Table 5.3 Decisions on statutory petitions for relief from 'unfair prejudice', 1998–2006

Year	All unfair prejudice petitions	
	Total	Listed co
1998	4	2
1999	11	0
2000	11	0
2001	15	2
2002	6	0
2003	15	1
2004	16	1
2005	10	0
2006	13	0
Mean	11.2	0.66

Sources: Author's analysis of transcripts of decisions available on LexisNexis, WestlawUK, Lawtel.

prejudice' petitions filed with the Companies Court during the 1994 and 1995 calendar years, analysed following inspection of the court records.[56] These revealed a total of 156 petitions (that is, 78 each year) presented during this period, approximately seven times the mean annual rate implied from the reported case data. Of these, only six petitions (three per year) related to public companies. Just over a quarter of public companies are listed, so this implies just under one unfair prejudice petition – of any sort – filed against a listed company per year.

In a more recent study, Armour *et al* investigated numbers of claims filed in the Companies Court involving allegations of breach of duty by directors of public companies during the calendar years 2004 to 2006, again by searching records at the High Court.[57] They found a total of 11 claims brought by private parties (just under four per year) alleging breaches of duty by directors, of which three (one per year) were against directors of listed companies.[58]

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[56] See Law Commission, *Shareholder Remedies*, LCCP 142 (London: TSO, 1996), 235–38.

[57] Armour *et al*, *supra* n 9.

[58] *Ibid*, 716. Whilst all petitions for relief from unfair prejudice must be launched in the Companies Court, derivative actions may alternatively be commenced in the main list of the Chancery Division of the High Court. Armour *et al* also conducted a shorter sample of three months' worth of claims filed in the

These two studies encompass different categories of claim. The Law Commission include all unfair prejudice petitions – whether based on breach of duty by directors or not. In contrast, Armour et al include all claims brought by shareholders against directors for breach of duty, whether framed as a derivative action or as a statutory petition alleging unfair prejudice. However, the results of both studies reinforce the conclusion that the level of private enforcement of directors' duties by shareholder litigation is close to nil for listed companies.

3.2. Securities Litigation

Private rights of action against company directors also exist in relation to misleading statements or omissions in disclosures relating to securities. As regards primary disclosure, section 90 of the Financial Services and Markets Act 2000 ('FSMA') provides that an acquirer of securities who suffers loss as a result of a false or misleading statement, or an omission of required information, in any prospectus or listing particulars may recover damages from any person responsible, including both the issuing company and its directors. However, there are to date no recorded instances of judgments being given under this provision or its predecessor, section 150 of the Financial Services Act 1986. Two instances of actions being brought appear from an analysis of transcripts in online databases over the period 1990 to 2006.[59]

Alternatively, directors might face liability at common law for negligent misstatement,[60] or possibly deceit,[61] in respect of prospectus disclosure.[62]

Chancery Division during 2006 (*ibid*, 20–21). No claims against directors of a listed company were found.

[59] See *Re Barings plc (No 6)* [2001] 2 BCLC 159 at [4] (claim brought against Barings plc in 1996); *Axa Equity and Law Life Assurance Society plc v National Westminster Bank plc*, (CA) 7 May 1998 (unreported) (claim brought against Coopers & Lybrand).

[60] Under the principles articulated in *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465 and developed in *Caparo Industries plc v Dickman* [1990] 2 AC 605.

[61] *Derry v Peek* (1889) 14 App Cas 337.

[62] Liability for false or misleading statements or material omissions in respect of continuing disclosure was practically ruled out by requirements that the defendant must have known the identity of the claimant: see P Davies, *Liability for Misstatements to the Market: A Discussion Paper* (HM Treasury, London, 2007), 18–21. A statutory cause of action for misstatements in relation to continuing disclosure was introduced in November 2006: see Financial Services and Markets Act 2000 ('FSMA 2000') s 90A (inserted by CA 2006). However this liability falls only on the issuer, and not on individuals – such as directors – involved in making the statement (FSMA 2000 s 90A(3)).

Here, however, reviews of electronic databases reveal only three instances during the period from 1990–2006 in which claims resulting in a judgment were brought against directors for allegedly negligent misstatements in prospectus disclosures.[63] These results imply that levels of private enforcement of the obligations of directors of listed companies as regards mandated disclosures are also close to nil.

3.3. Insolvency Litigation

Corporate insolvency may be a trigger for litigation against errant directors. In addition to being able to enforce retrospectively any breaches of duty a director may have committed against the company,[64] an insolvency practitioner may also be able to utilise a range of causes of action that arise only in relation to insolvent firms, relating to actions that directors took, or ought to have taken, in the period immediately prior to the firm's demise. In particular, liability for fraudulent or wrongful trading may be incurred by directors continuing to trade at a point when there is no reasonable prospect of avoiding insolvent liquidation.[65]

Analysis of judgments delivered in UK cases during 2006 indicates that there were significantly more insolvency-related actions against directors than there were minority stockholder suits. In 2006, for example, in a year when there were just three judgments in minority shareholder suits against errant directors,[66] there were 11 judgments in suits launched by insolvency practitioners.[67] However, if attention is restricted to listed firms, only one case resulting in a judgment appears in the electronic databases during the entire period 1990–2006.[68] Similarly to minority shareholder actions and securities law claims, levels of private enforcement of the obligations

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[63] A survey by Ferran of LexisNexis revealed three cases: *Al-Nakib Investments (Jersey) Ltd v Longcroft* [1990] 1 WLR 1390; *Possfund Custodian Trustee Ltd v Diamond* [1996] 1 WLR 1351; and *Axa Equity and Law Life Assurance Society plc v National Westminster Bank plc,* CA 7 May 1998 (unreported) (E Ferran, 'Cross-border Offers of Securities in the EU: The *Standard Life* Flotation' (2007) 4 ECFR 461, 476–77). An extension of this survey to Westlaw UK and Lawtel did not reveal any further cases.

[64] See Insolvency Act 1986 s 212.

[65] Insolvency Act 1986 ss 213–14. Fraudulent trading connotes that the directors were aware of the company's true financial position; wrongful trading that they negligently failed to be so aware.

[66] See Table 5.2, *supra*.

[67] Author's analysis of LexisNexis, Westlaw and Lawtel transcripts.

[68] *Bairstow v Queens Moat Houses plc* [2000]1 BCLC 549, [2001] EWCA Civ 712, [2001] 2 BCLC 531.

of directors of listed companies consequent upon insolvency proceedings appear to be close to nil.

Having established the practical absence of formal private enforcement, we now turn to consider the incidence of public enforcement.

4. PUBLIC ENFORCEMENT

A number of mechanisms of public enforcement also exist in the UK, and, judging from their empirical incidence, they are rather more important in practice than those of formal private enforcement just described. There are four principal public enforcement agencies in relation to UK companies: the Financial Services Authority ('FSA'), the Financial Reporting Review Panel ('FRRP'), the Takeover Panel ('the Panel'), and the Department for Business, Innovation and Skills ('BIS'). The enforcement activities of each of these agencies comprise a mixture of formal and informal actions. We will consider the activities of each in turn.

4.1 The Financial Services Authority ('FSA')

In relation to listed companies, the FSA has responsibility for drafting and enforcing the Listing Rules, the Disclosure and Transparency Rules, and the Prospectus Rules.[69] It also enforces prohibitions on insider dealing and other forms of market abuse.[70] The FSA has very wide formal enforcement powers, including the ability to pursue both civil and criminal sanctions against wrongdoers.[71] It also has the ability to sanction professionals by prohibiting them from conducting investment business in the UK.[72] For listed firms, an analogous sanction is the power to require de-listing of securities.[73] The FSA also has power simply to issue a public censure,[74] which will have a reputational effect on the individual or firm concerned.

The FSA prefers where possible not to exercise formal powers, but rather to achieve a settlement with the defendant – which will be a matter

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69 FSMA 2000 Part VI, esp. ss 72, 77, 89, 91.

70 FSMA 2000 Part VIII, esp. ss 123, 129.

71 See FSMA 2000 ss 401–02 (criminal prosecution powers, particularly in relation to insider dealing under the Criminal Justice Act 1993 Part V), 91, 123 (civil penalties for breaches of Listing Rules or market abuse), 66 (civil penalties against authorised persons). See also ss 380–84 (ancillary powers to seek injunctions and/or restitution orders).

72 FSMA 2000 ss 56, 63.

73 FSMA 2000 ss 77, 87K–87L, 89L.

74 FSMA 2000 ss 66, 87M, 89, 89K.

of public record – or simply to send a private warning regarding the misconduct.[75] These more informal enforcement tactics are used where the defendant expeditiously remedies the wrong concerned and the FSA considers that they pose little risk of repeating the conduct.[76] The FSA only publicises cases that result in public censure, prohibition, or a civil or criminal penalty. The FSA does, however, publish statistics on the number of cases investigated by its enforcement department each year. These give an approximate upper bound on the number of informal engagements that take place each year in relation to the type of conduct in question.

4.1.1 Insider dealing and market abuse

Insider dealing is a criminal offence carrying a maximum penalty of seven years' imprisonment.[77] Further offences exist in relation to fraudulent misstatements and market manipulation.[78] The FSA took over from the DTI at the end of 2001 as principal prosecutor of these offences.[79] Moreover, since 2001, insider dealing and market manipulation have also formed a subset of a wider category of proscribed activities known as 'market abuse', punishable by the levy of an unlimited civil fine by the FSA.[80]

Criminal convictions for insider dealing are said to be difficult to secure, owing to the frequent complexity of the facts, and the need to satisfy the jury that the criminal standard of proof has been met.[81] Whilst the number of convictions shown in Table 5.4 is certainly modest, it is nevertheless higher than the numbers of instances of private enforcement reported in Table 5.2. One of the intended benefits of the shift to a civil penalty was the possibility of a greater 'strike rate' against defendants, as the civil burden of proof is lower.[82] Whilst the FSA does not appear to investigate many more cases each year than the DTI formerly did, it has been able to use the new civil enforcement powers to impose sizeable civil penalties. However, it is doubtful whether this has had much impact on the underlying level of misconduct. A recent FSA study reported that levels of unusual price movement *prior* to

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75 See FSA, *The Enforcement Guide* (London: FSA, 2007), 23–36.
76 *Ibid*, 34–36. See also FSA Handbook, DEPP 6.2
77 Criminal Justice Act 1993 Part V. See esp. s 61(1).
78 FSMA 2000 s 397.
79 See DTI, *Companies in 2002–3* (2003), 22. The Serious Fraud Office ('SFO') also has power to investigate and prosecute insider dealing where this involves serious or complex fraud: see Criminal Justice Act 1987 s 1(3).
80 FSMA ss 118, 123.
81 See H McVea, 'Fashioning a System of Civil Penalties for Insider Dealing: Sections 61 and 62 of the Financial Services Act 1986', [1996] JBL 344, 349–50.
82 M Filby, 'The Enforcement of Insider Dealing under Financial Services and Markets Act 2000', (2003) 24 *Company Lawyer* 334.

Table 5.4 Investigation and enforcement of insider dealing and market abuse, 1996–2007

Year	Investi-gations	Prose-cutions	Convic-tions	No. of civil penalties	Civil penalties/£k
1996–7	(21)[a]	*	*	n/a	n/a
1997–8	(22)[a]	*	*	n/a	n/a
1998–9	(15)[a]	*	*	n/a	n/a
1999–0	(18)[a]	*	*	n/a	n/a
2000–1	(3)[a]	(14)[a]	(10)[a]	n/a	n/a
2001–2	(8)[a]	(5)[a]	(2)[a]	n/a	n/a
2002–3	15	(5)[a]	(2)[a]	0	0
2003–4	30	(27)[a]	(3)[b]	3	985
2004–5	17	0	(1)[b]	10	17994
2005–6	22	1	1	3	13996
2006–7	22	0	0	6	8286
Mean	17.5	7.4	2.7	4.4	8252

Notes:

* Data not available.
Figures not in parentheses refer to investigation and enforcement activity conducted by the FSA relating to insider trading and market abuse since December 2001.

[a] DTI investigation and enforcement of insider trading carried out until December 2001, and prosecutions following on from that work.

[b] Convictions for insider trading secured following referrals by DTI to Serious Fraud Office (prosecutions initiated by DTI).

Sources: FSA, *Annual Reports*, 2001–2007; *Final Notices*, 2002–2004; DTI, *Companies in 2000–2006*; SFO, *Annual Reports*, 1997–2006.

takeover announcements for UK listed firms had not decreased since the introduction of the FSA's enforcement powers.[83] Such price movements are thought to be a likely indicator of insider trading activity.[84]

4.1.2 Enforcement of the Listing Rules

In addition to enforcing the market abuse regime, the FSA is also charged with enforcing breaches of the Listing Rules applicable to firms quoted on the Official List. Details of enforcement activity for the past five years are available from the FSA's Annual Reports, and are set out in Table 5.5.

[83] N Moneiro, Q Zaman, and S Leitterstorf, 'Updated Measures of Market Cleanliness', FSA Occasional Paper No 25 (2007).

[84] However it is of course possible that they simply reflect good 'guesswork' by sophisticated investors.

Table 5.5 FSA enforcement of breaches of the Listing Rules, 2002–2007

Year	Investigations	No. of enforcement actions	Civil penalties/£k
2002–3	12	1	0
2003–4	2	3	45
2004–5	7	3	550
2005–6	6	2	240
2006–7	3	1	250
Mean	6	2	217

Sources: FSA, *Annual Reports*, 2004–2006; *Final Notices*, 2002–2004.

To date, little in the way of formal enforcement activity appears to have been pursued by the FSA in relation to breaches of the Listing Rules. There have been more cases and higher levels of penalties imposed in relation to market abuse. Overall, however, the FSA's total level of enforcement activity still seems rather low.

4.2. The Financial Reporting Review Panel ('FRRP')

The Financial Reporting Review Panel is another public enforcement agency with an important role in constraining managerial opportunism in listed companies. It is one of several operating bodies working under the aegis of the Financial Reporting Council.[85] The FRRP was established in 1991 in order to investigate material departures from accounting standards by large companies,[86] and to persuade companies to rectify these where appropriate.[87] Should such persuasion fail, it was given power to apply to court for an order mandating revision of such statements.[88]

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85 This was set up in response to a number of corporate failures and scandals involving poor accounting and financial reporting during the 1980s. In particular, statutory recognition was granted to accounting standards produced by the FRC's Accounting Standard Board, and power was devolved to the FRRP to enforce breaches of these standards in respect of financial statements by companies.

86 This includes all public companies and large private companies. Responsibility for oversight of accounting requirements in relation to small private companies was left to the DTI (now BERR): see Memorandum of Understanding between the FRRP and the FSA, 6 April 2005, para 3.

87 See Financial Reporting Council, *The State of Financial Reporting: A Review* (London: FRC, 1991), 24–5, 49–50.

88 Companies Act 1989 s 12, inserting ss 245–245C into Companies Act 1985. Equivalent provisions now appear as CA 2006 ss 456–7. The FRRP was author-

For over a decade, the FRRP performed these functions on a reactive basis by launching investigations in response to investors' complaints about particular financial statements.[89] However, in 2004–5, following a review of financial reporting sparked by the Enron scandal, legislation was introduced requiring the FRRP to adopt a more pro-active approach to investigation in relation to listed firms.[90] The FRRP now scrutinises more than 250 sets of financial statements a year, which are selected on the basis of a risk assessment based on sectoral, firm-specific, and statement-specific risk factors.[91] Most of the accounts reviewed are of listed companies.[92]

Table 5.6 gives figures for the FRRP's enforcement activity since its inception in 1992. In no case has the FRRP yet relied on its power to seek a court order. Equally striking is the very low proportion of cases in which action is taken resulting in any form of public notice. For each public notice, there are approximately ten cases in which action is taken. In the vast majority of cases, therefore, companies under investigation remedy defective accounting practices without the need for a public notice. In other words, the bulk of the FRRP's enforcement activity is informal.[93]

4.3. The Takeover Panel

A third significant regulatory body, from the standpoint of listed companies, is the Panel on Takeovers and Mergers (the 'Panel'). The Panel, its Executive, and various Committees are collectively responsible for writing, adjudicating, and enforcing the City Code on Takeovers and Mergers (the

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ised to exercise these powers by the Companies (Defective Accounts) (Authorised Person) Order 1991, SI 1991/13.

89 See, for example, Financial Reporting Council, *Annual Review 2002* (London: FRC, 2003), 58–9; Financial Reporting Council, *Annual Review 2003* (London: FRC, 2004), 55–7.

90 The scope of the FRRP's investigatory role was also increased to include compliance with accounting requirements imposed by the Listing Rules as well as the general Companies Legislation. Companies (Audit, Investigations and Community Enterprise) Act 2004 s 14 (requiring prescribed body to 'keep under review' periodic accounts and reports that are produced by issuers required to comply with accounting requirements imposed by the Listing Rules); Supervision of Accounts and Reports (Prescribed Body) Order 2005, SI 2005/715 (naming FRRP as prescribed body).

91 See, for example, Financial Reporting Review Panel, *Activity Report 2006–7* (London: FRRP, 2008), 4–6.

92 *Ibid.*

93 See generally, K Cearns and E Ferran, 'Non-enforcement Led Public Oversight of Financial and Corporate Governance Disclosures and of Auditors', ECGI Law Working Paper No 101/2008, 20–27.

Table 5.6 Investigation of financial statements by the FRRP, 1992–2007

Year	Financial statements investigated		Action taken	Public notices issued	Court orders
	Following referral	Following pro-active selection			
1992	78	–	31	10	0
1993	45	–	42	9	0
1994	46	–	43	6	0
1995	43	–	34	4	0
1996	49	–	40	8	0
1997	24	–	32	5	0
1998	32	–	30	8	0
1999	29	–	26	2	0
2000	32	–	25	5	0
2001	53	–	27	7	0
2002	57	–	15	2	0
2003	51	–	36	2	0
2004–5	42	184	77	3	0
2005–6	60	224	64	3	0
2006–7	45	266	128	4	0
Mean	45.7	224.7	43.9	5.2	0

Notes: The number of cases in which action was taken in 2003 is not reported. The figure in this column for 2003 is an estimate based on the average ratio of cases investigated to action taken for years 1992–2002.

Source: FRRP, *Annual Reports*, 1992–2007.

'Code'), which governs the conduct of takeover bids in relation to domestically incorporated companies listed in the UK.[94] The Panel's operation is perhaps the best example of informal public enforcement in the UK. Informality is evident both as regards the Panel's status, and as regards its mode of operating. The Panel was, for most of its history since its inception in 1968, a purely self-regulatory organisation with no formal legal basis.[95] Over time, it came to be viewed as performing an essentially public

[94] Takeover Code, A3. Since 2006, the Code has also applied to companies incorporated elsewhere within the EEA which have a primary listing in the UK: *ibid*, A3–A4.

[95] See, for example, T Tridimis, 'Self-regulation and Investor Protection in the United Kingdom: The Takeover Panel and the Market for Corporate Control', (1991)

function,[96] and was finally put on a statutory footing in 2006 as part of the UK's implementation of the EU Takeover Directive.[97]

The Panel's mode of operating is also highly informal. The Code consists of a series of principles, fleshed out by more specific rules, and parties are expected to comply with its 'spirit' as well as the 'letter'.[98] As such, it is deliberately drafted so as to be over-inclusive, but with the understanding that waivers are frequently granted by the Panel. This encourages parties to consult with the Panel Executive *ex ante*, who make decisions regarding compliance in 'real time' during transactions.[99] The Panel publish in their Annual Reports data on the number of such *ex ante* rulings they are required to make each year. In the vast majority of cases, such guidance will be given in private, although in a few cases, the Panel will make a public ruling concerning the conduct of a particular bid situation.[100] Figure 5.3 shows (black line) the number of Panel engagements over time, and (dashed line) the number of actual bids made. This implies that nearly 50% of the Panel's activity relates to situations where a bid does not actually materialise. Moreover, the general picture that emerges is that such informal *ex ante* rulings by the Panel are, in numerical terms, the most significant form of regulatory activity in relation to UK listed companies.

The Panel also imposes *ex post* sanctions on parties who fail to comply with the Code or its rulings.[101] Similarly to the FSA and the FRRP,

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10 CJQ 24; TP Lee, 'Takeover Regulation in the UK', in K Hopt and E Wymeersch (eds), *European Takeovers: Law and Practice* (London: Butterworths, 1992), 133.

[96] *R v Panel on Take-overs and Mergers, Ex parte Datafin plc* [1987] QB 815.

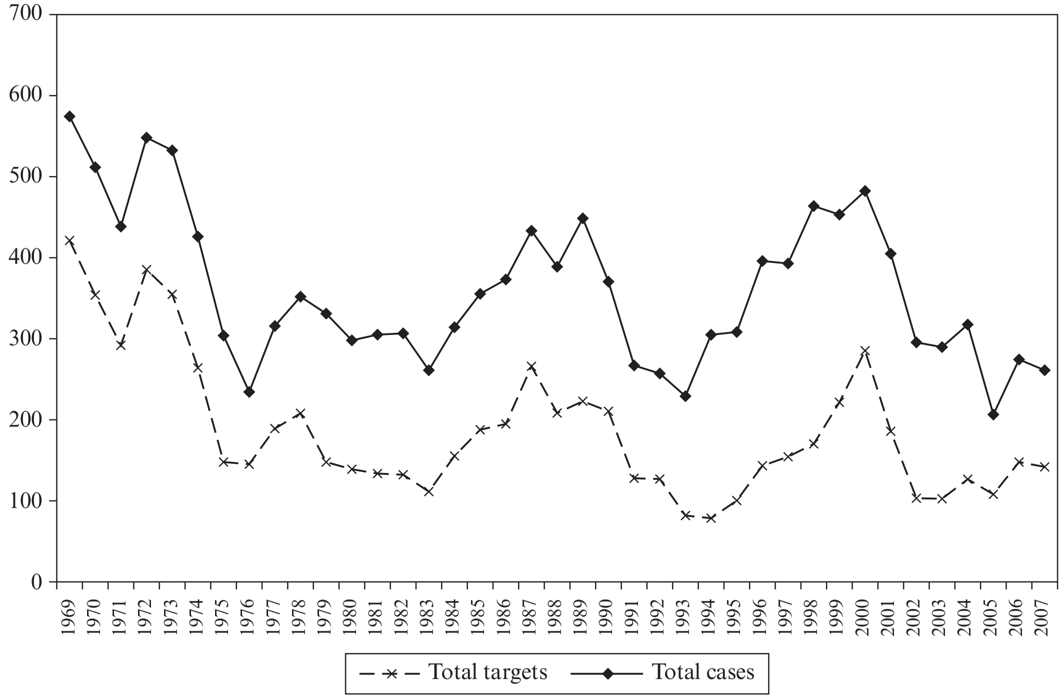
[97] CA 2006 Part 28.

[98] Takeover Code, A2.

[99] A party dissatisfied with a decision of the Executive may request a decision of the full Panel. An appeal from a Panel decision is available to the Panel's Hearings Committee, and then to the Takeover Appeals Board (see Companies Act 2006 ss 951, 957). It is also possible to seek judicial review of a decision of the Panel, but, in relation to decisions regarding the conduct of a bid, any relief will be in the form of prospective guidance, so as not to interfere with the outcome of events that have occurred: see *Datafin*, supra n 96, 842.

[100] For example, in relation to speculation surrounding potential interest by CVC Partners and others in J Sainsbury & Co plc, the supermarket, the Panel on 6 March 2007 gave CVC until 13th April 2007 to 'put up or shut up': that is, either to declare a firm offer for the company, or to decline to bid for a further year: see Takeover Panel, 'Sainsbury (J) plc', Panel Statement 2007/8; E Rigby and L Saigol, 'Pressure on CVC to Make Sainsbury Bid', *Financial Times,* 5 April 2007.

[101] See CA 2006 s 952. The same appeal structure (see *supra* n 99) is available regarding disciplinary decisions. Moreover, retrospective relief may also be available by way of judicial review in relation to such decisions, as this will not affect the outcome of any takeover transactions: see *R v Panel on Take-overs and Mergers, ex parte Guinness plc* [1990] 1 QB 146, 158.



Source: Takeover Panel, Annual Reports, 1969–2007. Total numbers of cases are not reported after 2004; figures given are estimates based on ratio of total cases to targets for period 1970–2004.

Figure 5.3 Ex ante *engagements by the Takeover Panel, 1969–2007* the Panel have a range of responses at their disposal, depending on the conduct of the parties. For minor breaches, a quiet reprimand in private is likely to be delivered. For more significant matters, a statement of public censure may be made. As well as general harm to reputation, a conclusive statement by the Panel that advisers were at fault may expose them to civil liability to clients who suffered loss in relation to the bid concerned. For example, following a public censure by the Panel of NM Rothschild & Sons Ltd in early 2007, it was reported that clients of the investment bank had sought to renegotiate their fees.[102]

In relation to bidders or targets that have breached the Code, the Panel may issue a direction, intended to bring to an end the non-compliant activity, or an order requiring a party in breach to pay compensation to those who have suffered loss as a result.[103] Such remedial orders may involve large sums of money. For example, Guinness plc was required to pay approximately £85m (around £185m in today's money) to former shareholders in Distillers plc, which it took over in 1986, in order to comply with a Panel ruling.[104]

In order to secure compliance with such remedial orders, the Panel also has at its disposal a battery of more severe regulatory sanctions. These include the threat of 'cold-shouldering' a delinquent party – in effect, excommunication from the London financial markets. This is done by prohibiting persons authorised to conduct investment business in the UK from acting for the party in question in future transactions regulated by the Code.[105] The Panel's rulings are endorsed by the FSA, with the result

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[102] See Takeover Panel, 'British Telecommunications plc offer for Plusnet plc', Panel Statement 2007/6, 2, 5–6; D Jordon, 'BT Reviews Rothschild's Fees as Takeover Panel Criticises Bank', *The Times*, 13 February 2007.

[103] See now CA 2006 ss 946, 954.

[104] See Takeover Panel, *Annual Report 1988–89* (London: Takeover Panel, 1989), 8. The breaches concerned failure to disclose purchases of shares in Distillers by a party acting in concert with Guinness.

[105] For example, the Panel's statement in relation to two Scottish financiers involved in numerous Code breaches in relation to an attempted takeover of Dundee Football Club plc in 1991, read as follows in the Panel's view neither Mr Drummond nor Mr Prentice nor any company which is in practice, directly or indirectly, controlled by either or both of them is likely to comply with the standards of conduct for the time being expected in the United Kingdom concerning the practices of those involved in takeovers and mergers. Therefore . . . persons or firms authorised to conduct investment business are prohibited from acting for Mr Drummond or Mr Prentice or companies which are . . . controlled by either or both of them in connection with transactions regulated by the City Code . . .': Takeover Panel, 'Mr Andrew P Drummond and Mr Robert D Prentice: Re Dundee Football Club plc', Panel Statement 1992/9, 15.

that authorised persons face withdrawal of their investment licences if they do business with a 'cold-shouldered' party.[106] This combination of sanctions has generally been sufficient to ensure not only that professionals who are members of the City's investment community comply with the Panel, but also any firm with a London listing or any overseas investor who wishes to do business in London again in the future.[107] Since 2006, the Panel has also had the ability to seek a court order to enforce its rulings, a power which it has not yet exercised to date.[108]

Figure 5.4 shows two measures of enforcement activity by the Panel: (i) the number of meetings held by the Panel annually to consider either Appeals against its decisions, disciplinary matters raised on its own initiative, or matters referred to it for decision by the Executive ('enforcement' meetings); and (ii) the number of firms or individuals receiving public censure from the Panel.

4.4. The Department for Business, Innovation and Skills ('BIS')

The fourth body responsible for public enforcement in relation to UK companies is the Department for Business, Innovation and Skills, known until 2007 as the Department of Trade and Industry ('DTI').[109] BIS is a department of the civil service, and has a wide range of enforcement powers, including the ability to launch investigations and inspections, to bring criminal prosecutions, and to disqualify delinquent directors. Its enforcement capabilities are handled by its Companies Investigation Branch, which since April 2006 has been part of the Insolvency Service, an executive sub-agency of BIS.[110]

BIS's enforcement activity differs from those of the other three agencies considered so far in two important respects. First, it is on the whole much more formal in character: all of the enforcement activity has a statutory basis, and almost all of it is publicly announced and subject to legal process. Secondly, almost all of BIS's enforcement takes place in relation to unlisted and private companies. Insofar as the enforcement of constraints on managers of listed companies is concerned, BIS is a

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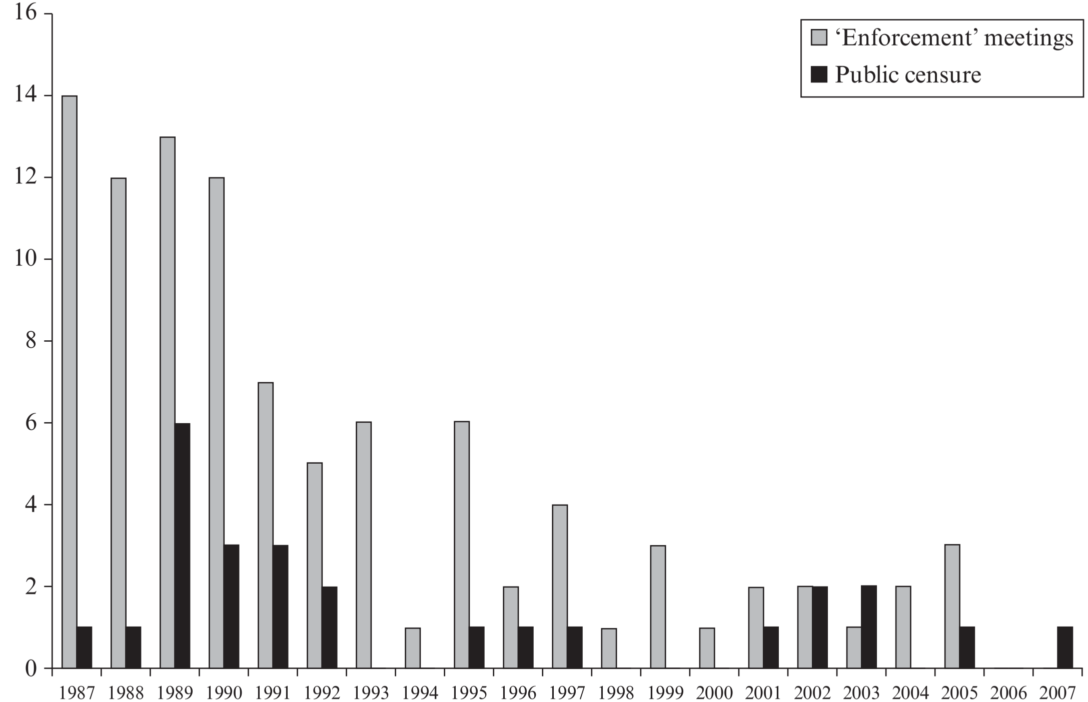
106 See FSA Handbook, MAR 4.3.

107 To be sure, a calculating 'one shot' player, who determines that they will cynically breach the Code and has no interest in returning to the stock market, will not be deterred by such threats. However, most bidders in control transactions are repeat players.

108 CA 2006 s 955.

109 Prior to 1970, the DTI was known as the Board of Trade.

110 See DTI, *Companies in 2005/6* (London: TSO, 2006), 7.



Sources: Takeover Panel, *Annual Reports* 1987–2006; *Panel Statements*, 1987–2006.

Figure 5.4 Takeover Panel ex post *enforcement, 1987–2006* minor player. We now consider the exercise of its various enforcement powers.

4.4.1 Investigations and inspections

BIS has powers under the companies legislation to order administrative investigations of any company.[111] Such investigations typically follow a complaint from a member of the public, and will be launched where there are reasonable grounds to suspect fraud, serious misconduct, or a material accounting irregularity.[112] If appropriate, BIS may follow up by initiating a prosecution of the directors and/or exercising its power to petition the court for the winding-up of the company in the public interest.

At first blush, the raw numbers of investigations reported in Table 5.7 seem relatively high. However, it should be borne in mind that these investigations are restricted to private companies. In the case of a listed company, the FSA investigates allegations of fraud in relation to investors, and the FRRP would deal with accounting irregularities. Given the size of the population of UK private companies, the 'investigation rate' is actually relatively low.

BIS also retains – at least in theory – a statutory power to order a more extensive form of enquiry, known as an 'inspection'.[113] In contrast to investigations, which are conducted in private, such an inspection involves a very public appointment of accountants and lawyers to conduct a detailed inquiry into the goings-on at a particular company and eventually publish a detailed report of findings. However, the cost and time associated with such an inspection, coupled with the availability of alternative enforcement mechanisms via the FSA, FRRP, and BIS's investigation powers mean that company inspections are now practically a dead letter.[114] The last time a new inspection was initiated was in 2000.[115]

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111 Companies Act 1985 s 447. These powers were extended in 2004 to permit the inspectors to require the disclosure of information as well as documents: see generally, DTI, *Companies (Audit, Investigations and Community Enterprise) Act 2004: A Guide to the New Investigations Provisions Introduced by the Act* (London: DTI, 2005); S Sheikh, 'Company Investigations: Powers for the 21st Century', (2002) 13 ICCLR 228. Part XIV of the 1985 Act has not been repealed by the CA 2006.

112 The largest category of referrals comes from the general public (60–80%) and the most frequent reason for referral is an allegation of fraud: see, for example, DTI, *Companies in 2004/5* (London: DTI, 2005), 9–10.

113 Companies Act 1985 s 432.

114 See, for example, Companies House, 'Tackling Corporate Abuse: Companies Investigation Branch (CIB) at Work', *Register* No 67, February 2007, 12–13.

115 See, for example, DTI, *Companies in 2003/4* (London: DTI, 2004), 17 (Table 2). Recently published reports include those on Queens' Moat Houses plc

Table 5.7 Company investigations, 1996–2006

Year	Requests	Investigations
1996–7	3294	220
1997–8	3673	238
1998–9	3659	220
1999–0	3632	209
2000–1	4010	175
2001–2	4433	160
2002–3	5256	419
2003–4	4732	200
2004–5	4272	171
2005–6	3702	148
Mean	4066	216

Source: DTI, *Companies in 2000–2006*.

4.4.2 Criminal sanctions and public interest winding-up

There are potential criminal liabilities associated with breaches of many aspects of the Companies Legislation. BIS initiates prosecutions by two primary routes. The first is where an investigation has taken place and evidence of criminal (in)activity is uncovered. The second is following a compulsory liquidation. Insolvency practitioners are required to investigate the reasons for the demise of companies they work on, and to submit their findings to the BIS, who can then decide whether or not to take the matter further.[116] BIS also has a statutory power to petition for the compulsory winding-up of a company in the public interest.[117]

The most frequent prosecutions against individuals associated with companies relate to the following categories of offences:[118] (i) failure to comply with Companies Acts requirements concerning accounting records;[119] (ii) fraudulent trading;[120] (iii) fraud or non-cooperation in

(530 pp), Mirror Group Newspapers plc (762 pp) and Transtec plc (452 pp). http://www.insolvency.gov.uk/cib/inspectorsreports.htm.

[116] Insolvency Act 1986 s 218(3); see also ss 132–3.

[117] Insolvency Act 1986 s 124A. See generally V Finch, 'Public Interest Liquidation: PIL or Placebo?' (2002) 5 *Insolvency Lawyer* 157.

[118] More frequent still are prosecutions of companies for regulatory offences such as late filing of accounts.

[119] CA 2006 s 387.

[120] CA 2006 s 993.

Table 5.8 DTI-initiated criminal prosecutions against company directors and public interest winding-ups, 2000–2006

Year	Accounting offences/fraud		Insolvency offences/ trading when disqualified		Public interest winding-ups
	Prosecutions	Convictions	Prosecutions	Convictions	
2005–6	159	66	228	133	46
2004–5	141	57	233	124	71
2003–4	156	60	205	134	80
2002–3	182	74	311	192	371
2001–2	212	84	350	231	107
2000–1	170	81	248	183	121
Mean	170	70	263	166	133

Note: For statistics relating to the enforcement of insider dealing, see, text to notes 77–82.

Source: DTI, *Companies in 2000–2006*.

the conduct of insolvency proceedings;[121] and (iv) being concerned in the management of a company whilst subject to a disqualification order or an undischarged bankrupt.[122] Summary statistics are shown in Table 5.8 (categories (i) and (ii) are grouped as 'accounting offences/fraud' and (iii) and (iv) as 'insolvency offences/trading when disqualified'). As with investigations, these data relate solely to private or unlisted companies, because equivalent enforcement in relation to listed companies is undertaken by the FSA and/or the FRRP.

A range of other proscribed matters also – at least in theory – attract criminal sanctions, in particular breaches of a number of directors' statutory duties.[123] However, prosecutions are in practice never brought for these offences.[124] Whilst an empirical study commissioned by the Law Commission in 1998–9 reported that legal advisers considered the exist-

[121] Insolvency Act 1986 ss 206–11.

[122] Company Directors Disqualification Act 1986 ss 11, 13.

[123] See, for example, CA 2006 ss 183 (failure to disclose interest in self-dealing transaction); 228, 237 (failure to keep copies of directors' service contracts or indemnity arrangements available for inspection); 248 (failure to keep minutes of directors' meetings); 291–3 (failure to circulate resolutions).

[124] Law Commission, *Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties*, LCCP 153 (London: TSO, 1998), 223 (noting that during period 1991–6, DTI records show only one prosecution for criminal offences resulting from breaches of directors' duties).

ence of criminal sanctions to assist in 'focusing minds' of directors,[125] it is perhaps telling that fewer than 50% of directors surveyed reported that their firms disclosed directors' service contract to shareholders for inspection, seemingly unaware of the fact that it was a criminal offence not to do so.[126]

4.4.3 Disqualification of directors

Empirically the most significant form of enforcement by BIS is disqualification of directors. This mechanism results in individuals being banned – disqualified – from either being a director, or being 'concerned in the management', of companies for a period of 1 to 15 years.[127] Disqualification follows automatically if an individual is convicted of certain offences in relation to the running of a company. The court also has power to disqualify a director of an insolvent company if satisfied he or she is 'unfit to be concerned in the management of a company'.[128]

Since 2001, it has been possible for BIS to follow an expedited procedure for disqualification.[129] Under this route, the director gives an undertaking not to participate in the management of a company for a specified period of time, and the court proceedings are dropped. In effect, it is a form of plea-bargaining, whereby the director avoids the prospect of an adverse costs award. As Table 5.9 indicates, this route now accounts for just under half of all disqualifications.

Unlike the investigation and prosecution powers, disqualification proceedings can in principle be pursued against (former) directors of listed companies.[130] Yet because most disqualification orders follow a corporate insolvency, and listed company insolvencies are very rare, there are very few

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[125] S Deakin and A Hughes, *Directors' Duties: Empirical Findings. Report to the Law Commissions* (1999), section 5.3.5, available at http://www.lawcom.gov.uk/docs/153study.pdf.

[126] *Ibid*, section 6.1; Companies Act 1985 s 318 (now s 228 of the 2006 Act).

[127] See generally, A Walters and M Davis-White, *Directors' Disqualification and Bankruptcy Restrictions* (London: Sweet & Maxwell, 2005).

[128] Company Directors Disqualification Act 1986 s 6. This latter power accounts for 80–90% of disqualifications (*Companies in 2005/6*, *supra* n 110, 23 (Table D1)).

[129] Company Directors Disqualification Act 1986 s 1A (inserted by Insolvency Act 2000).

[130] For example, several former directors of Barings plc were disqualified in 1998 for having failed to implement a system of control adequate to restrain the activities of Nick Leeson, whose 'rogue trades' brought down the bank: see *Re Barings plc (No 5)* [1999] 1 BCLC 433; [2000] 1 BCLC 523.

Table 5.9 Directors' disqualification, 1996–2006

Year	Total disqualified	Undertakings given
1996–97	1219	n/a
1997–98	1460	n/a
1998–99	1484	n/a
1999–00	1744	n/a
2000–01	1770	n/a
2001–02	1929	1213
2002–03	1777	1275
2003–04	1527	1154
2004–05	1317	967
2005–06	1197	900
Mean	1542	1102

Source: DTI, *Companies in 2000–2006*.

disqualifications of listed company directors.[131] Thus, Armour *et al* report that only one claim per year for disqualification of a director of a listed company was filed during the period 2004–06, based on an examination of all claims filed in the Companies Court.[132] BIS is not, therefore, an empirically significant enforcement actor in relation to directors of listed companies.

4.5 Summary

Part IV, when viewed alongside Part III, implies that public enforcement is much more empirically significant than is formal private enforcement. The number of instances of formal private enforcement, as far as we are able to estimate, is practically zero in relation to listed companies. If the focus shifts to public enforcement, then a different, and much more lively, picture emerges.

Table 5.10 gives an approximation of the relative empirical incidence of the various modalities of enforcement so far considered.[133] We

[131] See M Carapeto and L Stuflesser, 'The Information Content of Administration and Administrative Receivership Filings in the UK', working paper, Cass Business School (2006), 20 (approximately ten UK-listed firms entering receivership or administration each year during period 1996–2003).

[132] Armour *et al*, *supra* n 9, 24.

[133] These figures may over-estimate the contribution of the FRRP, some of whose investigations concern unlisted firms, and under-estimate the contribution of the FSA in relation to the Listing Rules, where the relevant population of firms does not include AIM-listed companies.

Table 5.10 Public enforcement activity in relation to listed firms, 2002–2007

Year	Listed firms (no)	Private enforcement	Public enforcement											
			Informal						Formal					
			FSA		FRRP		Panel		FSA		FRRP		Panel	
			No	Rate	No	Rate	No	Rate	No	Rate	No	Rate	No	Rate
2002–3	2251	0	27	1.2%	57	2.5%	290	12.9%	3	0.1%	15	0.7%	3	0.1%
2003–4	2550	1	32	1.3%	51	2.0%	319	12.5%	9	0.4%	36	1.4%	2	0.1%
2004–5	2537	0	24	0.9%	226	8.9%	240	9.5%	14	0.6%	77	3.0%	4	0.2%
2005–6	2606	0	28	1.1%	284	10.9%	317	12.2%	6	0.2%	64	2.5%	0	0.0%
2006–7	2613	0	25	1.0%	311	11.9%	303	11.6%	7	0.3%	128	4.9%	1	0.0%
Mean	2511	0.2	27.2	1.1%	185.8	7.4%	293.8	11.7%	7.8	0.3%	64	2.5%	2	0.1%

Notes: 'Listed firms (no)' shows number of UK-registered firms listed on Official List and AIM (from Table 5.1). 'Private enforcement' shows actions brought (i) by minority shareholders to remedy breaches of directors' duties (from Table 5.2); (ii) by investors alleging misdisclosure in relation to securities; and (iii) by insolvency practitioners to remedy breaches of directors' duties. 'Informal public enforcement' shows investigations launched by FSA and FRRP and guidance given by Takeover Panel (from Tables 5.4–5.6 and Figure 5.3). 'Formal public enforcement' is penalties imposed by the FSA and remedial actions by the FRRP and Takeover Panel, respectively (from Tables 5.4–5.6 and Figure 5.4). In each case, 'No' is raw number of engagements; 'Rate' is percentage of population of listed firms subject to investigation.

distinguish between formal and informal public enforcement: informal public enforcement consists of an investigation or guidance that results in no more than a private conversation between the regulator and the firm(s) in question. Formal enforcement, on the other hand, results in a public notice, award of compensation, or other remedial order. As can be seen, informal enforcement vastly outnumbers formal enforcement. By dividing the number of actions by the population of firms, we derive an approximation of the enforcement rate – that is, the proportion of listed firms subject to a particular type of enforcement in a year. This is only an approximation, because the data may contain an element of double counting: the same firm may be subject to more than one enforcement action during a given year.

The Takeover Panel has the highest informal enforcement rate, approximating to 12% of the population of listed firms in any year. The FRRP also has a relatively high informal enforcement rate, averaging 7.4% over the period, although there was a significant increase with the introduction of pro-active investigation in 2004, to nearly 12%. The FSA, in contrast, has a relatively low rate of informal enforcement, just over 1%. All three agencies have much lower formal enforcement rates; of these, the FRRP has the highest at 2.5%. By combining the average enforcement rates, we can derive an upper bound for the overall level of public enforcement activity: around 20% for informal enforcement and 3% for formal enforcement. Of course, there is likely to be double counting in these figure so the true levels will be somewhat lower. Nevertheless, it seems clear that to focus solely on formal enforcement, and on the FSA, as some commentators have done,[134] is to miss the bulk of the enforcement activity that occurs in the UK.

We now turn to informal private enforcement in the UK.

5. INFORMAL PRIVATE ENFORCEMENT

The structure of English corporate law, as we have seen, has tended to restrict shareholders from pursuing a derivative action if there is no blockholder.[135] Yet at the same time, it gives considerable power to the shareholders in general meeting. In the case of listed companies, this is further enhanced through various provisions of the Listing Rules, the Combined Code of Corporate Governance, and the Takeover Code. Together, these

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134 See Coffee, *supra* n 3, 268–72.

135 See discussion *supra*, text to notes 29–33.

combine to permit shareholders to control many aspects of the managerial agency problem without the need for litigation.

We can identify a variety of ways in which such informal 'enforcement' by investors takes place. One distinction concerns the action taken by the enforcer: whether to 'exit' by selling their shares, or use 'voice' by exercising control rights. We can also distinguish enforcement of rules – such as the Combined Code of Corporate Governance, which prescribes corporate governance practices without any associated formal enforcement mechanism – and enforcement simply of standards of good management.

5.1. Informal Private Enforcement of Corporate Governance Rules

As is well-known, the Combined Code on Corporate Governance sets out a number of substantive corporate governance requirements that apply to listed companies incorporated in the UK.[136] The Combined Code consists of a framework of over-arching principles, fleshed out by a series of more specific provisions. Key provisions include the separation of the CEO and Chairman of the board, the inclusion of a minimum number of independent non-executive directors, and the establishment of separate nomination, remuneration, and audit committees, which must be populated by a majority of independent directors.[137]

It is also well-known that the Code is not formally 'binding' on listed companies. The Listing Rules give firms the option to 'comply or explain' – that is, if they do not comply, they must give reasons for non-compliance.[138] Whilst it is therefore a breach of the Listing Rules for a firm to fail to state *whether* they comply, or *why* they do not comply, in practice there are no reported instances of the FSA taking action against companies for non-compliance with these requirements.[139] Notwithstanding the

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[136] See FRC, *The Combined Code on Corporate Governance* (London: FRC, 2006) ('Combined Code 2006'), available at: http://www.frc.org.uk/documents/pagemanager/frc/Combined%20Code%20June%202006.pdf.

[137] See Combined Code 2006, *supra* n 136, A.2–A.4, A.7, B.2, C.3.

[138] The Listing Rules require that listed companies incorporated in the UK state in their Annual Reports (i) how the *principles* of the Code have been applied (LR 9.6.8(5)), and (ii) a statement as to whether the *provisions* of the Code have been complied with or not, and if not, the reasons for non-compliance (LR 9.6.8(6)).

[139] See Weil, Gotshal & Manges, *Comparative Study of Corporate Governance Codes Relevant to the European Union and its Member States: Final Report & Annexes I–III* (Brussels: European Commission, 2002), 71; Financial Services Authority, *Annual Report 2004–5*, 140 (2005); Financial Services Authority, *Annual Report, 2005–6*, 141 (2006) (annual breakdowns of enforcement activity).

FSA's lack of enforcement, a high proportion of firms either comply with the Code's provisions, or explain why they do not.

Table 5.11 summarises findings reported in two empirical studies of compliance with the Combined Code. Most companies comply with most of the Code's provisions. Arcot and Bruno report that amongst FTSE 350 companies over the period 1998–2004, compliance levels increased over time, with the mean number of provisions with which companies were not in compliance in 1998 being 2.05, falling to 1.57 in 2004.[140] Moreover, the shift towards compliance was most rapid amongst those companies giving no, or poor-quality, explanations for non-compliance.[141] Yet if there is no FSA sanction for failure to state compliance, why has stated compliance increased over time?

Whilst a number of studies report no general link between stated compliance with provisions of the Code and operating performance,[142] Arcot and Bruno report that non-compliant firms that fail to explain their status tend to *under*perform the sample generally.[143] On the other hand, non-compliant firms that give detailed explanations outperform those that simply comply mechanistically. This implies that shareholder pressure has encouraged managers of previously non-compliant firms to get their firms to comply.[144] This is, in our terms, an example of informal private enforcement. It also implies that the optimal level of compliance is less than 100%:

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140 SR Arcot and VG Bruno, 'In Letter but not in Spirit: An Analysis of Corporate Governance in the UK', working paper, London School of Economics (2006), 56 (Table 7).

141 *Ibid*, 34.

142 See N Vafeas and E Theodorou, 'The Relationship between Board Structure and Firm Performance in the UK', (1998) 30 *British Accounting Review* 383, 395–9; C Weir, D Laing, and PJ McKnight, 'Internal and External Governance Mechanisms: Their Impact on the Performance of Large UK Public Companies', (2002) 29 *Journal of Business Finance and Accounting* 579, 594–603; C Padgett and A Shabbir, 'The UK Code of Corporate Governance: Link between Compliance and Firm Performance', working paper, University of Reading ICMA Centre Finance Discussion Paper No DP2005-17 (2005), 18–25; SR Arcot and VG Bruno, 'One Size Does Not Fit All, After All: Evidence from Corporate Governance', working paper, London School of Economics (2007), 18 (no link between stated compliance with provisions of Code and operating performance for samples of UK-listed firms, respectively in 1994, 1994–6, 2000–03, and 1998–2004).

143 Arcot and Bruno, *supra* n 142, 18–20, 24–5. This effect is reported both as regards operating performance and market value. See also Padgett and Shabbir, *supra* n 142, 18–25 (reporting positive correlation between stated compliance and total shareholder returns).

144 See also Arcot and Bruno, *supra* n 140, 31–4 (discussing anecdotal evidence of shareholder pressure for firms to state compliance).

Table 5.11 Compliance with the Combined Code, 1998–2004

Provision	% stating compliance	% non-compliance explained	
	PIRC (2004) 2003–4	Arcot & Bruno (2006) 1998–2004	
Separate CEO/Chairman	92	90	86
Proportion/No NEDs	97	95	74
Majority of NEDs independent	94	92	72
Service contracts	n/a	57	86
Nomination committee	85	88	91
Remuneration committee	87	87	69
Audit Committee	88	92	91
Mean	90.5	85.9	81.2
All provisions	47	33	83

Sources: PIRC, *Corporate Governance Annual Review 2004* (London: PIRC, 2004), discussed in I MacNeil and X Li, '"Comply or Explain": Market Discipline and Non-compliance with the Combined Code', (2006) 14 *Corporate Governance: An International Review* 486, 488–9; SR Arcot and VG Bruno, 'In Letter but not in Spirit: An Analysis of Corporate Governance in the UK', working paper, London School of Economics (2006), 57 (Table 8).

that is, different substantive corporate governance measures appear to be appropriate for different types of firm.[145]

5.2 Securing Compliance: The Exercise of Shareholder Power

We turn now to a different category of activity that helps to secure compliance by managers with pro-shareholder behaviour: that is, the exercise of governance rights by shareholders. As we have seen, such actions by some accounts should not be classed as 'enforcement' at all: they are, rather, the exercise of shareholders' rights under company law. Whether

[145] For example, the model of the independent director may be less helpful for high-growth firms; non-executive directors with a significant interest in the company may be better motivated to assist executives in strategy and in networking. See MA Lasfer, 'On the Monitoring Role of the Board of Directors: The Case of the Adoption of Cadbury Recommendations in the UK' (2004) 9 *Advances in Financial Economics* 287, 310–14 (adoption of Code's board structure recommendations negatively associated with operating performance for firms in high-growth sectors, but positively associated for firms in mature industries with free cash flow, for which monitoring by independent directors may be beneficial).

this is termed 'enforcement' or not is merely a semantic question: what matters for our purposes is that the exercise of such rights, or their threat, may be expected to modify managers' assessment of the likely payoffs from self-serving behaviour in just the same way as does a potential lawsuit. We now consider several features of the corporate governance environment within which UK listed companies operate that make such 'informal private enforcement' by shareholders a workable substitute for legal action.

5.2.1 Board vulnerability

It is a mandatory rule of UK company law that directors may be removed at any time by an ordinary resolution of the general meeting.[146] This makes 'staggered boards' – that is, a biennial or triennial rotating appointment procedure under which only a part of the board are subject to reappointment each year – ineffective to entrench boards, unlike the position in the US.[147] Moreover, a shareholders' meeting to vote on such a resolution may be requisitioned by 10% of the company's voting shares; being a meeting of the company, this would entail the proposed resolution being circulated at the company's expense.[148] A recent empirical study of shareholder meeting requisitions in the UK found that these tend to focus very closely on applications to remove or elect specific directors, and in a significant number of cases, the entire board.[149]

Non-voting and dual-class shares, another well-known entrenchment mechanism in other jurisdictions, are rarely used in the UK.[150] Whilst not expressly prohibited by the UK Listing Rules, they are strongly discour-

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[146] CA 2006 s 168.

[147] In the US, where there is no mandatory provision granting shareholders the right to remove directors, it may take two to three years to wrest control from a staggered board following a takeover: see LA Bebchuk, JC Coates IV, and G Subramanian, 'The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants', (2002) 55 *Stanford Law Review* 885.

[148] CA 2006 ss 303–05. Moreover, shareholders holding more than 5% of the voting rights in public companies may require resolutions to be put onto the agenda for the AGM, and circulated to shareholders in advance, also at the company's expense (CA 2006 ss 338–9).

[149] B Buchanan and T Yang, 'A Comparative Analysis of Shareholder Activism in the US and UK: Evidence from Shareholder Proposals', paper prepared for Oxford/Yale conference on UK-US corporate governance (2007), 44–5.

[150] See, for example, 'Error Deprives Schroders of FTSE 100 Place', *Financial Times*, 15 March 2007 ('Unusually for a UK company, Schroders has voting and non-voting shares.').

aged by the investment community.[151] A recent study by Deminor, a proxy voting consultancy, reported that in 2004, 88% of large listed UK companies conformed strictly to the 'one share, one vote' principle.[152] Although it is possible in theory to nullify the shareholders' power of removal with appropriately structured differential voting rights,[153] it would in practice be very difficult to market an IPO with such a capital structure, or to change the articles in a listed company so as to introduce one.

5.2.2 Takeovers

The board's vulnerability to removal by shareholders is coupled with firm restrictions on their range of responses to takeover challenges. The Takeover Code prohibits the managers of a target company, once a bid is launched or anticipated, from taking any actions that might have the consequence of frustrating its success, without first obtaining the consent of shareholders.[154] Figure 5.5 shows the total number of takeovers and hostile bids reported by the Takeover Panel for each year over the period 1992–2007,[155] plotted against the total population of UK-incorporated listed firms. During this period, an average of 6% of this population per annum was subject to a takeover bid, and 0.8% to a hostile takeover bid.[156]

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[151] See 'Views on Non-Voting Shares', *The Times*, 23 August 1957, 12; GP Stapledon, *Institutional Shareholders and Corporate Governance* (Oxford: Oxford University Press, 1996), 58–9; J Franks, C Mayer, and S Rossi, 'Spending Less Time with the Family: The Decline of Family Ownership in the UK', in RK Morck (ed), *A History of Corporate Governance around the World* (Chicago: University of Chicago Press, 2005), 581, 582–3; W Underhill (ed), *Weinberg and Blank on Takeovers and Mergers* (London: Sweet & Maxwell, 5th edition, 1989 & Supp. 2006), § 4–7077.

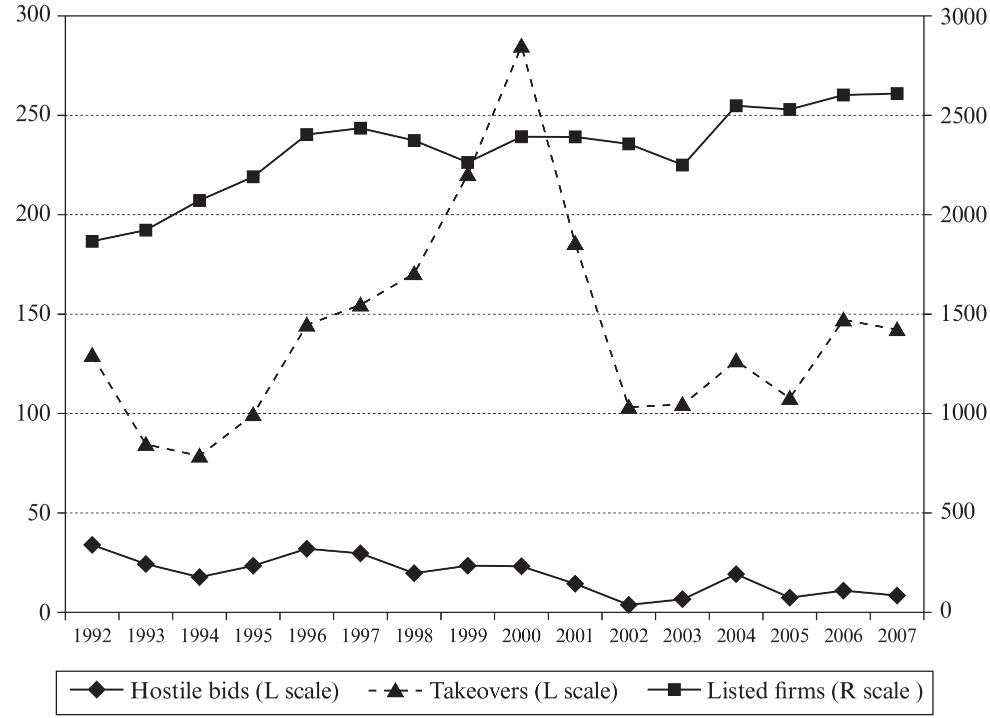
[152] Deminor, *Application of the One Share–One Vote Principle in Europe* (Brussels: Deminor, 2005), 17. Whilst in the region of 5% of UK companies still have some non-voting stock in issue (*ibid.*), the proportion has been declining over time, and those that remain are legacy issues, as opposed to new issues (Franks *et al.*, *supra* n 151, 603–4).

[153] As in *Bushell v Faith* [1970] AC 1099.

[154] City Code, GP 7 and Rule 21. See also J Armour and DA Skeel, Jr, 'Who Writes the Rules for Hostile Takeovers, and Why? The Peculiar Divergence of US and UK Takeover Regulation', (2007) 95 *Georgetown Law Journal* 1727, 1734–8.

[155] Bids are only counted as 'hostile' if the target management remains opposed until the bid is resolved.

[156] See also R Nuttall, 'An Empirical Analysis of the Effects of the Threat of Takeover on UK Company Performance', working paper, Oxford University (1999), 38 (Table 1) (approximately 1% of sample of firms during 1988–96 subject to hostile bid each year); *cf* Armour and Skeel, *supra* n 154, 1738 (reporting much lower proportion of takeover bids as hostile, based on transactions reported in *SDC Platinum* database).



Sources: Takeover Panel, *Annual Reports*, 1992–2007; London Stock Exchange.

Figure 5.5 Takeover bids against UK targets, 1992–2007

Whilst there has been a secular decline in the number of hostile bids over this period, there remains a significant probability that any listed firm may be subject to a bid. Moreover, the likelihood of a publicly traded UK firm being a takeover target, particularly of a hostile bid, appears to increase if its performance worsens.[157]

5.2.3 Shareholder decision rights

UK company law and the Listing Rules also contain a number of provisions geared towards ensuring shareholder involvement *ex ante* with respect to situations where agency costs are highest. Thus under company law, substantial property transactions and loans between a company and a director or associated company must first be approved by the shareholders in general meeting.[158] This is supplemented by more extensive continuing obligations for UK listed firms to seek shareholder approval in respect of certain transactions which may affect the value of their investments: namely, related party and significant transactions.[159]

Issues of fresh capital are also subject to shareholder control – first, through making new issues conditional on shareholder approval, and secondly through the use of pre-emption rights for existing shareholders.[160] The latter are supplemented by additional provisions in the Listing Rules for firms on the UK Official List.[161] Pre-emption rights may be waived by shareholder authorisation, requiring an ordinary resolution.[162] The grant of such a waiver is, however, subject to a well-established set of voting guidelines adhered to by institutional investors in the UK.[163]

The exercise of pre-emption rights also appear to perform a significant governance, or informal private enforcement, role. This appears to be

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157 J Franks, C Mayer, and L Renneboog, 'Who Disciplines Management in Poorly Performing Companies?', (2001) 10 *Journal of Financial Intermediation* 209, 238. However, target management are very likely to be replaced following a successful takeover, regardless of whether or not it is friendly, and of the firm's performance, suggesting that, as a disciplinary mechanism, the takeover bid is very unfocused: *ibid,* 233–4.

158 CA 2006 ss 190, 197.

159 LR 10, 11.

160 CA 2006 ss 549–51, 560–77.

161 LR 9.3.11–12. Moreover, shares may not be issued at a discount of more than 10% of their current market price unless as a 'rights issue' or specifically approved by shareholders: LR 9.5.10.

162 CA 2006 ss 570–71, LR 9.3.12(1).

163 For the latest version, see Pre-emption Group, *Disapplying Pre-emption Rights: A Statement of Principles* (London: FRC, 2006), available at http://www.pre-emptiongroup.org.uk/documents/pdf/DisapplyingPre-EmptionRightsStatementofPrinciples.pdf.

because the announcement of a 'rights issue' serves to concentrate investors' minds. A discounted rights issue creates a threat of dilution for investors who do not subscribe. On the other hand, for investors who do subscribe, it creates a potentially profitable investment opportunity. Crucial to the determination of how profitable the investment will be are the reasons the company is seeking further finance. Thus the period prior to a rights issue will typically be one in which there will be dialogue between a company and major institutional investors.[164] Seemingly for this reason, rights issues are strongly correlated with managerial turnover.[165]

5.2.4 Share ownership and voting patterns

Share ownership in the UK is dispersed by international standards.[166] Moreover, the ownership of shares in UK-listed companies is dominated by institutional investors, to a degree that has historically been unique.[167] Institutional investors' voting participation appears to have increased during the 1990s for all types of institution.[168] Some are more activist than others: insurance companies vote more frequently than pension funds, which in turn are more active than investment funds.[169] Voting tends to focus on issues which are generalisable across firms, allowing institutions to economise on their decision-making costs by adopting a standardised policy.[170] Listed firms commonly meet regularly with their major institutional investors, at which sessions executives will be quizzed by the institutions about governance practices, strategy and financial issues.[171] The exercise of 'influence' through such informal communication is usually

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[164] Stapledon, *supra* n 151, 129–30; P Myners, *Pre-emption Rights: A Final Report*, URN 05/679 (2005).

[165] Franks *et al*, *supra* n 157, 234–5; D Hillier, SC Linn, and P McColgan, 'Equity Issuance, CEO Turnover and Corporate Governance' (2005) 11 *European Financial Management* 515.

[166] See sources cited *supra*, n 5.

[167] See, for example, PL Davies, 'Institutional Investors in the United Kingdom', in DD Prentice and PRJ Holland (eds), *Contemporary Issues in Corporate Governance* (Oxford: OUP, 1991), 69.

[168] R Crespi-Cladera and L Renneboog, 'Corporate Monitoring by Shareholder Coalitions in the UK', ECGI Finance Working Paper 12/2003 (2003), 6.

[169] Stapledon, *supra* note 151, 92–8; Crespi-Cladera and Renneboog, *supra* n 16868.

[170] See Davies, *supra* n 167; BS Black and JC Coffee, 'Hail Britannia?: Institutional Investor Behavior Under Limited Regulation', (1994) 92 *Michigan Law Review* 1997, 2034–55; Armour and Skeel, *supra* n 154, 1771.

[171] See, for example, Stapledon, *supra* n 151, 101–6; J Holland, 'Influence and Intervention by Financial Institutions in their Investee Companies', (1998) 6 *Corporate Governance: An International Review* 249; A Pye, 'Changing Scenes In,

achieved in the *shadow* of shareholders' ultimate right to requisition a meeting and remove managers.[172] In cases of severe underperformance – the bottom decile of accounting performance or dividend yield – it appears that institutions will go so far as to provoke CEO turnover.[173]

5.3 Summary

English company law gives shareholders considerable power in relation to corporate managers. In this section, we have characterised the exercise of this power as a means of 'informal private enforcement', because it is a powerful means by which managerial compliance with pro-shareholder conduct is secured. We have seen that managerial 'discipline' by turnover is associated with financial underperformance, coalition formation between institutional investors, takeover activity, and the issue of seasoned equity.

6. CONCLUSION

We have sought to present an empirical assessment of the relative significance of different modes of enforcement in UK corporate governance. Three stylised facts emerge about the UK's approach to enforcement of constraints on managerial agency costs. First, formal private enforcement, in the form of shareholder litigation, is conspicuous by its absence. Contrary to some accounts in the economic literature, private litigation appears to play almost no role in controlling managerial agency costs in UK-listed firms.

Secondly, rather more work is done by public enforcement agencies – in particular, the FSA, FRRP, and the Takeover Panel – than is commonly thought to be the case. Each of these tends to engage with firms in a way that is characterised by informality – that is, relying wherever possible on private conversations and *ex ante* intervention to secure compliance, rather than aggressive pursuit of *ex post* sanctions. Of the three, the FSA makes the greatest use of formal legal sanctions, but the Takeover Panel

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From and Outside the Board Room: UK Corporate Governance in Practice from 1989 to 1999', (2000) 8 *Corporate Governance: An International Review* 335.

172 See *supra* text to nn 146–53; M Becht, J Franks, C Mayer, and S Rossi, 'Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund', ECGI Finance Working Paper 138/2006 (2006).

173 See Crespi-Cladera and Renneboog, *supra* n 168, 16–7; Franks *et al*, *supra* n 157, 229; MJ Conyon and A Florou, 'Top Executive Dismissal, Ownership and Corporate Performance', (2002) 32 *Accounting and Business Research* 209, 223–4.

and FRRP are responsible for far more informal interventions. A rough estimate suggests that up to 20% of listed firms may be subject to some type of informal engagement, and 3% to formal enforcement, from one of these public agencies each year.

Thirdly, we emphasise the significance of informal private enforcement through the exercise of shareholders' governance entitlements – whether through the exercise of voting rights or facilitation of the market for corporate control. These mechanisms, which are used to remove managers who have underperformed, induce high compliance rates with the non-binding Combined Code of Corporate Governance. They derive efficacy from the high proportion of shares held by institutional investors, who are relatively sophisticated repeat players in the corporate governance arena.

There are three important messages for policymakers. First, at least in the UK, private litigation matters far less as a means for controlling managerial agency costs than the economic literature currently suggests. Secondly, the fact that at different points in time, different enforcement strategies have predominated in the UK strongly suggests that there are substitution effects between enforcement strategies and complementarities with other aspects of the corporate governance regime. And thirdly, the significance of informal enforcement in the UK implies that inferences about a system drawn solely from low formal enforcement rates are likely to be misleading.

Comment on John Armour, 'Enforcement strategies in UK corporate governance: a roadmap and empirical assessment'

Roberto Pardolesi

The first thing to say is that John Armour is simply too smart, and his chapter too sophisticated for my almost naïve command of the issues canvassed in his pages. Given this huge handicap, I am forced to a candid admission: the best that I can do is to stockpile a few, scattered remarks and submit a couple of disingenuous questions.

Second, summing up very briefly the core of John Armour's argument. Much in the vein of John Coffee, he denounces the inanity of an approach focused entirely on the black letters of the law in the books, and stresses the crucial role of the enforcement strategies, the law in action. This is why he proposes an original taxonomy, based on a double-entry matrix for enforcement: *public/private*, on the one hand, and *formal/informal,* on the other. Relying on such a framework, he undertakes the ambitious project of evaluating the contribution of each of the cells of the matrix in the realm of the UK listed companies.

With the mastery of an economic scholar, John Armour, himself a lawyer, collects crude figures about private formal enforcement, a category including minority shareholder suits (the mythical derivative actions), securities litigation concerning misleading statements or omissions in disclosure, and insolvency litigation. His conclusion concerning the effectiveness of this kind of disparate pressure is merciless: it appears close to nil. With the sole exception of the US, this conclusion would obtain – I believe – for most jurisdictions I am aware of.

Having thus reneged on the expectations pertaining to the private side (when formal), John Armour moves to public enforcement, both formal and informal. He explores the records of the Financial Services Authority (FSA), the Financial Reporting Review Panel (FRRP) – with its informal ex ante rulings, by far the most significant regulatory activity relating to

UK listed companies – and the Department for Business Enterprise and Regulatory Reform (BERR). In doing so, he digs up data and figures not readily available, which is already a precious outcome, though the material turns out to be relatively scanty and meagre.

On this count, the overall conclusion is that public enforcement is much more penetrating than formal private enforcement: quite an obvious statement, I would observe, given that the latter, as we saw, is close to zero! At any rate, Table 5.10 portrays a picture that leaves no room for doubts: the scores are dramatically unbalanced, with informal public enforcement vastly outpacing the formal side.

The final shot is reserved for informal private enforcement, which, according to Armour, can take a number of different forms. Let me anticipate: this is a delicate matter, to which I will revert in a while. For now, it is worth noting that a striking feature in this latest instalment of John Armour's research is the disappearance of figures (with the exception of those supplied by two empirical studies on compliance with the Combined Code on Corporate Governance, and of some statistics on takeover bids for UK targets). No data is produced, only symptoms of informal interventions/reactions, bordering on anecdotal evidence. Again, this comes as no surprise: if the private initiative is definitely informal, it is exceedingly difficult to identify its tracks. But then – and looking at the whole – a methodological question arises: does a numerical approach, lacking empirical (and thus numerical) support, make sense? Aren't we left with an intuitive assessment of the quality, rather than the quantity, of enforcement?

Third, John Armour's roadmap prompts additional reflection. In particular, the strong invitation to look beyond formal enforcement does not line up with the prevailing attitude in the field. I should specify that the field itself does not exist, and a common thread among disparate experiences is still being sought. Yet, inspecting other areas where the protection of super-individual interests is the responsibility of public bodies and private actors hints at a better understanding of the possible strategies.

A telling example, as well as a kind of metaphor for our topic, is offered by the ongoing, sometimes hectic debate about the (private) enforcement of antitrust law. In this regard, common wisdom suggests that private litigation is pivotal in the US and, to a lesser extent, in the UK, whereas the civil law countries rely heavily on scrutiny by public agencies. Actually, US damage claims by private parties against companies involved in competition law infringements outweigh public enforcement by a ratio of about 20 to 1 (due, *inter alia*, to procedural tools such as class actions, contingency fees and treble damages). They appear to be significantly more effective at deterring illegal behavior than Department of Justice (DOJ) criminal antitrust suits. On the contrary, the European Union exhibits a prevailing attitude of administrative enforcement. The 2004 Ashurst study on private enforcement[1] found only 60 cases involving damages claims and 23 damage awards, plus settlements and arbitral awards, based on both national and EU competition law, and denounced the 'astonishing diversity and total underdevelopment' of antitrust private enforcement in Europe. These results may be, and have been, contested. Recent developments are observed in several countries, and the pressure exerted by the European Commission may produce further advancements. Yet it is evident that, on this side of the Atlantic, the public interest underlying antitrust prohibitions has often led to an emphasis on public enforcement of these rules, and that the current praxis is still centred upon the role of public authorities charged with the task of preserving market viability. In fact, leaving aside those who believe that private suits are irrelevant and, possibly, parasitically pernicious, most scholars distinguish between public enforcement, which pursues the social interest in safeguarding effective competition, and private enforcement, aiming to protect competitors and consumers' interests. This distinction – it is worth noting parenthetically – does not do justice to the role of civil courts when they enforce competition law in the context of private litigation, since, though deciding disputes *inter partes,* they must have regard to the wider impact on the market.

Despite this traditional divergence, one should realize that the lines between public and private enforcement may blur once the problem is analysed with a view to devising an optimal enforcement policy, which is likely to stem from some sort of combination of 'public'and 'private' features. After all, the crucial issue consists of the fact that, according to most economic evaluations, the cartel overcharge averages 25%, the collusion lasts no less than seven years and it is detected with a rate of 15%. This means that cartelizing is rewarding, and will keep being profitable until fines are not supported by actions for damages, never mind whether stand-alone or follow-on, so that the members of the cartel are obliged to disgorge the ill-gotten benefits of their banding together. Bearing this *caveat* in mind, it is fairly sensitive to acknowledge the considerable advantages of having a system for private actions in place. First, they help to ensure that the victims of unlawful conduct are compensated. Second, private enforcement of competition laws can be a formidable deterrent of such a conduct. Third, allowing private actions takes some of the enforcement burden off

[1] *Study on the Conditions of Claims for Damages in Case of Infringement of EC Competition Rules*. Comparative report prepared by D. Waelbroeck, D. Slater and G.E. Shoshan, 2004.

public competition agencies, which do not always have sufficient funding to pursue every matter that is worth pursuing. Private claims for damages caused by antitrust violations lead, if effectively designed, to an increase in the probability of detection of illegal conduct, accuracy of fact-finding, and deterrence; although this, in turn, would increase the workload for national courts and trial costs for private parties. The private side can provide, to say the least, a complement for public enforcement. This is why we should agree that the crux is not privileging either side, but fine-tuning the various parameters of the system.

Needless to say, this debate focuses on formal enforcement and its technicalities. Yet, John Armour's suggestion to look beyond formality, when transplanted into this area, seems worthwhile. In fact, there is a new (and somewhat controversial) brand of public enforcement, which does not end up with a final ruling. It is the relatively unchartered province of the commitments, proposed on a voluntary basis by firms involved in an investigation, and eventually endorsed (and made binding) by the Commission, or the National Competition Authorities, according to Article 9 of Council Regulation (EC) No 1/2003 of 16 December 2002, on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty.[2] The true believers submit that, as a consequence, scarce resources are no longer blocked in costly proceedings, and pro-competitive effects are promoted and promptly pursued. In some countries, Italy being in the forefront, this practice is becoming prevalent, triggering by-products that risk obscuring important aspects of the antitrust discipline.

Be it as it may, this kind of enforcement – whether we like it or not – should be factored in. But then, a difficulty materializes. Having undertaken the first step, what impedes further moves in the same direction? It is true that commitments represent the alternative outcome of a formal investigation, and are overseen by the public enforcers. Nonetheless, they are construed as a spontaneous expression of compliance with the law, and compliance has many facets. Suppose that the victim of an exclusionary conduct summons the dominant firm to quit the illicit behavior, and that its intimation succeeds: is this to be regarded as private enforcement? And, in the case of a positive answer, should its coverage be expanded in order to accommodate also wilful respect for the statutory provisions, or voluntary self-discipline for fear of being prosecuted or involved in a treble-damages suit?

Such a trajectory oversteps the traditional notion of enforcement as a whole made up of mechanisms, apparatuses and tools devoted to the goal of imposing adherence to law. Reverting to our theme, it leads to a

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[2] Official Journal L 1, 04.01.2003, pp. 1–25.

holistic idea of corporate governance, where ex ante regulation is given the strategic importance it deserves, though from a different perspective (and according to another taxonomy), encompassing every form of moral suasion. John Armour invites us to proceed, pointing out that informal enforcement/governance mechanisms are 'clearly substitutes for certain types of formal enforcement'. One can even agree, once the new frame is properly specified. Yet the price to be paid, because of the immensely enlarged coverage attributed to the notion, is high enough: any attempt to assess the contribution of the private sector is doomed to fail, for lack of workable coordinates (and boundaries).

Finally, John Armour aims to compare the relative contribution of private and public enforcement, and concludes that in the UK, 'contrary to leading accounts in the economic literature', public enforcement dominates the private counterparty.

In a sense, this conclusion is surprising. If, as already noted, consistent figures about the weight of informal private enforcement, in the diluted version sponsored by John Armour, are missing, the statement is hardly solid: how to credit it, if we simply don't know?

But the essential question lies elsewhere. One way of framing it would be to ask, what is the benchmark, the *tertium comparationis*? I wonder whether Armour assumes, with Shleifer and his co-authors in the Legal Origins venture,[3] that the Common Law is the best environment for the protection of investors, and just challenges their hypothesis that private enforcement in corporate and securities law is correlated with, and conducive to, deep and liquid securities markets with dispersed stock ownership. Let me make it clear: were this John Armour's opinion, I would disagree.

A better choice would be to adopt a more detached perspective, reshaping the question as follows. What is the ultimate goal to be achieved through public and/or private enforcement? Assuming that in the UK the former is more conspicuous, should we content ourselves with such an outcome? Or should we invoke additional tools for the weak side, in order to reinforce it? Is John Armour suggesting the way the law stands is appreciable and needs no radical change, or is he implying there should be a different balance?

To sum up, a good chapter raises more questions than it can solve. The gist of a valuable contribution is right there, in the capacity to open new frontiers and stimulate the need to know more. John Armour's contribution is a very good one.

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[3] See R. La Porta et al., 'The Economic Consequences of Legal Origins', 46 *Journal of Economic Literature*, 285, 2008.

6. Marrying in the Cathedral: a framework for the analysis of corporate governance*

Ugo Pagano

1. INTRODUCTION

On 2 July 1923, Alfred Sloan – the famous CEO of General Motors – wrote to a distressed Mr Kettering as follows:

> It was called to my attention recently that there were 143 copper cooled cars out in the territory and it appeared to be desirable to withdraw them and reassemble them. In other words, it was thought desirable, in view of the fact that there were more or less complaints, not dealing with the engine particularly but dealing with the whole car, that they should be taken in and an adjustment made. (Sloan 1963, p. 90)

Charles Kettering had been head of research for General Motors since 1920 and, also thanks to Alfred Sloan's efforts, he would remain in that position until 1947. However, at that time, Kettering was ready to resign. He believed that the copper-cooled car, which Kettering called the air-cooled car (and was later to be known by that name), was a major invention. It marked an improvement over water cooling systems because it avoided the problem of the water freezing in cold weather. Kettering, backed by Dupont, had pressed for the application of this technological innovation; but the results had been an outbreak of 'technological accidents' at GM. However, it was not clear whether the breakdowns were due

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to the immaturity of Kettering's new device or, rather, to poor implementation of the innovation by the production divisions.

In the same letter, Alfred Sloan defended the procedures that had induced GM to halt production of copper-cooled cars, and in his memoirs he added:

> The copper-cooled car had failed to meet the test of validity. It had failed at Oakland. It had been adjudged as needing further development by a joint study made by the chief engineers of Buick, Chevrolet and Northway – a highly competent group. Sample cars produced by Chevrolet, and sent into the field had been withdrawn because of serious defects. The problem was complicated by the uncertainties of a new chassis as well as new engine. We had to recognize that research engineers had little experience, relatively speaking in chassis design as compared with engineering staffs of the operating divisions. I had of necessity to respect all these facts and circumstances. (Sloan 1963, p. 89)

Even if much of the literature has related the famous GM–Fisher Body integration to hold-up problems, I will argue that difficulties like those considered above can explain most of the reasons for this famous merger.

On the hold-up interpretation put forward by the New Property Rights approach (Hart 1995), the problem arose when GM wanted to expand its production facilities. However, it is more likely that the main purpose of the merger was to integrate the Fisher brothers into the organizational structure created by Sloan. He pointed out that the increasing complexity of car design made it more difficult to ascertain the merits of successes and the responsibilities for failures, such as those involved in the production of the copper-cooled car. A turning point came when manufacturers decided to move from the production of open-body cars to closed-body ones. The latter made the distribution of the car's weight extremely important for its stability, and it required an integrated project and full cooperation among all the research and production units.[1]

With closed-body cars becoming the standard in the mid-1920s, any mistake, or any incompatibility among the views of the different departments, would have had much more dramatic consequences. According to

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[1] According to Sloan, even before the advent of the closed body, there was, of course a 'certain relationship between the various parts that was adhered to by almost every car maker for many years. The radiator, for example, had to be in line with the front axle, a relationship which was responsible for the height of the cars of the period. Inevitably, these fixed relationships between the axles and the body of the old car meant that the car had to be high. However, this did not matter much during the period when the industry principally was building open cars – that is, until the mid-twenties.' (Sloan 1963, p. 289).

Sloan, the switch to closed-body cars entailed that the managers, who were responsible for the production of the body of the car (the Fisher brothers), should be brought under the same organizational umbrella. Although GM already had control of Fisher Body (it owned 60 per cent of the company's shares), a merger was necessary to achieve the integration of activities required by the innovation and production processes of the closed-body era.[2]

> There were operating economies to be gained by co-ordinating body and chassis assemblies, and with the closed body becoming dominant in the industry, it seemed sensible to bring the body operation entirely under the General Motors Roof. And it was felt desirable also to bring the Fisher brothers into closer relationship with our organization (Sloan 1963, p. 184)

The importance of a closer relationship with the Fisher brothers was then given even greater emphasis.[3] The increase of co-specificity due to the advent of closed bodies implied that specific high 'second order' investments in the appropriate private ordering were necessary to obtain the smooth cooperation of the Fisher brothers with the other managers involved in construction of the new closed cars. In other words, the main purpose of the merger was to introduce a system of private governance where the fair exercise of power would decrease the risks faced by all the agents investing in co-specific human capital and produce an integrated product (such that individuals' production failures could not be easily evaluated by public courts or other agents external to the organization).

Since the conflicts concerning the copper-cooled engine, the develop-

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[2] Thus, the extra power to be gained with the acquisition of Fisher Body's physical capital could not be an important reason for the takeover. Not only did GM already own 60 per cent of the physical capital of Fisher Body, but the main purpose of the integration of Fisher Body into GM seems to have been a more complete 'acquisition' of the human capital of the Fisher brothers. Pagano (2000) made this point, unaware of the fact that Coase (2000), Freeland (2000) and Casamedus-Masanell and Spulber (2000) made similar criticisms of the standard account of the Fisher Body–GM relationship. The standard hold-up interpretation, used by Hart (1995), originated with Klein et al. (1978) and was developed by Klein (1988). Klein (2000) defends his hold-up interpretation.

[3] In the 1926 Annual Report of General Motors Corporation, the section referring to what had just become the Fisher Body Division of GM states: 'Of even greater importance is the bringing into General Motors operating organization in closer relationship, the Fisher brothers, through whose constructive ability, foresight and energy the institution bearing their name has been built up to the dominating position it now holds' (Dupont et al. 1927, p. 10).

ment of a private ordering internal to GM had made remarkable progress. Sloan had perceived the main problem as being 'one of conflict between the research organization and the producing divisions, and of a parallel conflict between the top management of the corporation and divisional management' (1963, p. 94), and he had decided that GM should be reorganized in two directions: decentralization of operating responsibilities to the peripheral units, and centralization of major policy formation to an Executive Committee. According to Sloan, the Executive Committee, 'which views the corporation as a whole and at the same time is closely familiar with operating problems, has a somewhat judicial function' (Sloan 1963, p. 458). Before Sloan's reorganization of GM, exercise of this judicial function had not been possible. The Executive Committee was composed of division managers, and there were no headquarters acting as intermediary between, and coordinator of, the various divisions. The result was a great deal of horse-trading among division managers. Each manager was ready to approve other projects on condition that he could get a favourable vote on his own project (Chandler 1962, p. 127; Bolton and Scharfstein 1998, p. 103). Under the organization introduced by Sloan, which would subsequently become the system most commonly used by large firms, the acquisition of other firms like Fisher Body did not cause a sharp increase in internal rent-seeking activities (Breton and Wintrobe 1982) or, to use Milgrom and Roberts's (1990) expression, an increased expenditure in influence costs.[4]

The efficiency gains consequent upon the acquisition of Fisher Brothers can be seen from two different, but complementary, perspectives. On the one hand, the acquisition involved the centralization of some market transactions within a larger firm. On the other hand, any controversy arising from the deal between GM and Fisher Body was decentralized from the jurisdiction of public courts to the 'judiciary powers' of the GM executive committee.

The first perspective, which will be examined in the next section, can be related to the Coasian (1937) notion that the firm should be viewed as a centralization of market transactions. The second perspective, which will

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[4] However, in the case of the Fisher division of GM, these influence costs were far from zero. The integration of the brothers in the organizational structure of GM was a very slow process. The six Fisher brothers were able to distribute themselves among top management and the management of the divisions. In this way, in the period 1926 to 1934, they retained control of the Fisher Body division and a monopoly over most of the knowledge concerning the production of the bodies of the cars. It is not surprising that, according to Freeland (2000), in 1934 they could still 'hold-up' GM, obtaining very high compensation for staying at GM.

be examined in Section 3, can be related to a view first advanced by Lon Fuller (1969) and which considers the firm as one of the possible ways of decentralizing the public ordering by setting up a private ordering like the one that Alfred Sloan introduced at GM.

The remaining sections will try to integrate these two views by relying on Guido Calabresi's (and Douglas Melamed's 1972) insight that courts manage 'ex-post' transactions for which ex-ante contracts have been impossible or too costly. I shall argue that Calabresi's Cathedral is the ideal setting for a marriage between Coase and Fuller. Under its hallowed roof, the Coasian internalization of transactions and Fuller's decentralization of the judicial function can be fruitfully integrated into a single framework yielding a better understanding of the evolution of large enterprises like GM. By virtue of this marriage, Fuller and Coase can deliver a rationale for the existence and size of the firm. In my view, their contributions, based on joint liabilities and unified ex-post exercise of power, offer a more useful framework for an understanding of corporate governance than the New Property Rights approach, which relies only on unified ownership and ex-ante bargaining.

2. COASE'S CENTRALIZATION OF TRANSACTIONS

Coase's 1960 article on the nature of social cost has become famous for the so-called 'Coase theorem' on externalities. However, Coase's world is the opposite of the world of Coase's theorem that relies on zero transaction costs. Indeed, later, in the same article Coase re-states the consequences of the assumption of positive transaction costs. He reiterates the point already made in his famous article of 1937 that the firm represents 'an alternative form of economic organization which could achieve the same result at less cost than would be incurred by using the market would enable the value of production to be raised'.[5] The firm is an organization, alterna-

[5] 'As I explained many years ago the firm represents such an alternative to organising market transactions' (Coase 1960, p. 115). Coase emphasizes how 'unified' private ownership of a factor of production allows the rearrangement of production to take place without bargains among the owners of the factors of production. He considers how a 'landowner who has control of a large tract of land may devote his land to various uses, taking into account the effect that the interrelations of the various activities will have on the net return of land, thus rendering unnecessary bargains between those undertaking the various activities' (Coase 1960, p. 116).

tive to both the market and the state, which enables the 'internalization' of (former) externalities.

As Coase pointed out in his 1937 article, the relevant comparison is that between the administrative costs of organizing a transaction within a firm and the costs of market transactions. He maintained that the former are likely to be lower than the latter whenever the 'contracts are peculiarly difficult to draw up and an attempt to describe what the parties have agreed to do or not to do . . . would necessitate a lengthy and highly involved document . . .'. The allocation of resources within the firm is not governed by the price mechanism which characterizes a market economy. In a market economy 'the direction of resources is dependent directly on the price mechanism' (p. 34) and 'the allocation of factors of production between different uses is determined by the price mechanism' (p. 35). If in a market economy the price of factor A becomes higher in X than in Y, then A moves from Y to X until the prices of X and Y become equal. By contrast, within a firm 'if a workman moves from department Y to department X, he does not go because of a change in relative prices, but because he is ordered to do so'. Coase defines firms as islands of central planning or, quoting D. Robertson (1928), as 'islands of conscious power' existing in 'the ocean of unconscious cooperation defining the market economy', and his question concerning the existence of the firm is rephrased in the following way: 'But in view of the fact that it is usually argued that co-ordination will be done by the price mechanism, why is such co-ordination necessary? Why are there these islands of conscious power?'

Coase answers that the explanation for the existence of firms is that the use of the price mechanism is costly and the allocation system used within the firm may be relatively cheaper. Discovering the relevant prices, and negotiating and enforcing contracts, are all costly activities required by the use of the price mechanism. They can be greatly reduced if firm-type coordination replaces the market system. But if firm-type coordination implies such a considerable saving of market transaction costs, why does the economy not become a single-firm economy or, in other words, the centrally planned economy advocated by Marx?[6] Or, to reverse the question, why do markets exist?

Coase's answer to this 'reversed question' is based on the idea that as firms expand, they are faced with increasing organizational costs. According to Coase, there are decreasing returns to management or to the entrepreneur's function. As the size of the organization increases, the

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[6] On the relation between Marx and New Institutional Economics, see Pagano (2007b).

entrepreneur is more likely 'to place the factors of production in the uses where their value is greatest, that is, fails to make the best use of resources' and smaller firms can compete him out of the market. 'Naturally a point must be reached where the costs of organizing an extra transaction within the firm are equal to the costs involved in carrying out the transaction in the open market or to the costs of organizing by another entrepreneur'. (Coase 1937, p. 43). In a competitive system, the expansion of the firm will halt at this point, which is characterized by the fact that organizational costs are minimized. The central planning occurring within the firm and the market activities existing outside it will therefore be combined in an optimal way. 'In a competitive system, there is an "optimum" amount of planning' (Coase 1937, p. 37).

In Coase's view, the optimal mixture of firm-type and market-type organization achieved by a competitive system will change over time because technological innovation is likely to alter the relative costs of these two ways of organizing economic activity. An increase (decrease) in the size of the firm will occur if a new invention makes firm-type organization cheaper (more expensive) than market-type organization. 'For instance, if the telephone reduces the costs of using the price mechanism more than it reduces the costs of organizing, then it will have the effect of reducing the size of the firm' (Coase 1937, p. 46). An optimization problem is continuously solved by the competitive system. The optimal mixture of planning and markets is recalculated and implemented whenever the technological data change.

Yet even this efficiency bias in favour of competitive markets is overcome in the 1960 article. After all, competition is only one of the many costly institutions whereby human activities can be coordinated; and, as Calabresi (1991) has pointed out, it cannot offer a 'super-market' in which it competes with the other institutions.

'But the firm', Coase observes, 'is not the only possible answer to this problem', for 'an alternative solution is direct governmental regulation' (Coase 1960, p. 116). Unlike a firm, government intervention is not subject to competition. Moreover, unlike a firm, the government can conscript and seize property, and it can deploy the police and other law enforcement agencies. However, Coase maintains that the government 'is, in a sense, a super-firm (but of a special kind) since it is able to influence the use of factors of production by administrative decisions' (p. 116). In some cases, 'the government has powers which might enable it to get things done at a lower cost than could a private organization . . .'. However, even aside from governmental mistakes, 'the governmental administrative machine is not itself costless' and it 'can, in fact, on occasion be extremely costly'.

Thus, the first part of his 1960 article (where the conditions of the so-called 'Coase theorem' would be satisfied) is only instrumental in moving towards a world where no organizational 'free lunch' is possible and all types of transactions are costly. The problem is 'one of choosing the appropriate social arrangement' in a world where 'all solutions have costs'. Moreover, given the nature of the problem, the existence of 'externalities' does not entail that the costs of setting up a 'social arrangement' to deal with these interactions will always outweigh the benefits. Thus, each institution, such as market contracts, firms, judiciary and the state, covers only a part of individual interactions; and, moreover, the overall mix of these 'social arrangements' is necessarily incomplete. In a Coasian perspective, the centralization of market transactions within firms like GM should be viewed within this complex framework of numerous and incomplete institutions.

3. FULLER'S DECENTRALIZATION TO PRIVATE ORDERINGS

Coase's journey starts from the world of costless decentralized markets of standard economic theory where a complete institution (complete markets) rules all human interactions. From this imaginary world, Coase sails towards understanding of the real-life complex world characterized by diverse and incomplete institutional orderings. While Coase proposes this fascinating voyage in the Realm of Economics, Lon Fuller makes a related journey in the Realm of Law, starting from a location that seems to be located at the antipodes of Coase's point of departure: a world of complete, consistent, and centralized public ordering.

According to Fuller (1969), the generality and reciprocity of commands defines the minimum moral contents for a legal system to be distinguished from a simple system of arbitrary commands. The basic concern of law-making is to subject human conduct to the governance of rules. Law-making is a purposive activity that may fail to a greater or lesser extent. Like any other purposive activity, law-making requires attention to be paid to certain practical precepts related to the ultimate purpose of the activity. According to Fuller (1969, p. 39), eight such precepts should be followed if the object of law-making is to be achieved:

(i) there must be rules;
(ii) they must be prospective, not retrospective;
(iii) the rules must be published;
(iv) the rules must be intelligible;
(v) the rules must not be contradictory;

(vi) compliance with the rules must be possible;
(vii) the rules must not be constantly changing;
(viii) there must be congruence between the rules as declared and as applied by officials.

According to Fuller (1969), these eight principles represent eight ways in which the enterprise of law-making may go astray. They indicate eight minimum conditions for the existence of anything that we would regard as law or a legal system. For example, a system where all the rules are kept secret, or where all the rules are retrospective, would not normally fit the definition of a legal system. Complete failure to comply with any one of the eight principles results in something that is not law at all. On the other hand, complete success is impossible to achieve for real-life human societies. When human societies aspire to subjecting human behaviour to the governance of rules, 'the principle of marginal utility plays an increasing role in our decisions'. In this case, 'something like an economic calculation may become necessary when a conflict arises between the internal and the external morality of law' (Fuller 1969, p. 44). Costly resources have to be expended to achieve the objectives of law-making: given the limitations of our resources and capabilities, the achievement of one objective implies the sacrifice of others. According to Fuller, there are 'trade-offs' not only between law and other objectives but also among the different objectives of law.

A conflict between the internal and external morality of law may easily arise. On the one hand, the 'internal morality of law' requires that the laws do not change too often: if they do, its rules cannot satisfactorily guide human behaviour (principle vii). On the other hand, 'it is obvious that changes in circumstances, or changes in men's consciences, may demand changes in the substantive aims of law, and sometimes disturbingly frequent changes' (Fuller 1969, p. 44).

However, 'antinomies may arise within the internal morality of law itself' because 'the various desiderata which go to make up that morality may at times come into opposition with one another'. For instance, consistency (principle v) and intelligibility of law (principle iv) are both important objectives of a legal system. However, an 'economic' trade-off between these two goals may well arise and 'it may become necessary to pursue a middle course which involves some impairment of both desiderata' (Fuller 1969, p. 45). In this regard, Fuller refers to a conversation that he had with a former Minister of Justice of Poland, who told Fuller that 'in the early days of the communist regime an earnest and sustained effort was made to draft the laws so clearly that they would be intelligible to the worker and to the peasant'. However, an 'economic' trade-off emerged.

'This kind of clarity could be attained only at the cost of those systematic elements in a legal system that shape its rules into a coherent whole and render them capable of consistent application by the courts' (Fuller 1969, p. 45). This made unavoidable some retreat whereby the 'marginal utility' of both consistency and clarity were taken into account. If law-making is the enterprise of subjecting human conduct to the governance of rules, it may be carried out with varying degrees of success. Which means that the existence of a legal system is a matter of degree.

A common ground between Coase and Fuller thus starts to emerge. In Coase, a system of markets cannot be taken for granted because costly resources are involved in the use of the market mechanism. According to Fuller, a system of complete rules of law cannot be taken for granted for similar reasons. According to Coase, the cost of using the market mechanism implies that institutions other than markets are used to coordinate human activities. Similarly, Fuller points out that more than one legal system may coexist: numerous public orderings (EEC, national states, regional and provincial governments) coexist with even more numerous private orderings, such as unions, universities, churches and firms.

The relatedness between Coase's and Fuller's theories becomes particularly clear when we consider the role that the firm – one of the possible private orderings – also plays in Fuller as an ideal destination for his journey. In a way that is similar to the state – the mythical King Rex considered by Fuller – the employer too may find it convenient to set up a legal system in miniature. However, when he tries to do so, like King Rex, he runs the same risks of failing to satisfy the eight principles that characterize a legal system.

The employer 'must not only invest some effort and intelligence in the enterprise, but its very success limits its own freedom of action. If in distributing praise and censure, he habitually disregards his own rule, he may find his system of law disintegrating and without any open revolt, it may cease to produce for him what he thought to obtain from it' (Fuller 1969, pp. 47–8).

In other words, in order to reap some benefits from a private ordering, the employer not only has to sustain the relative 'set-up' costs but must also incur the 'rigidity costs' of submitting him/herself to the rules that s/he has created. The effort may, however, be worthwhile because the 'public ordering' may be unable to provide the specific rules that may adequately regulate the principles of conduct that are appropriate to run that particular business.

Sloan's separation between executive committee and the other divisions can be seen as a Fuller-type decentralization of the judicial function to a private ordering. Before Fisher Body's transformation from an independent firm to a GM division, any disputes had to be adjudicated by public courts, which relied mainly on general rules and drew very little on inside information. The task was now decentralized to GM's executive committee, which had taken over the judicial function of the state.

4. MARRIAGE OPPORTUNITIES

Coase and Fuller reach the same conclusion that the internal structure of the firm may be rather important for the success of business activities. Their starting points seem to be located at opposite poles, however. The Coasian 'centralization' argument is founded on the costs that are otherwise sustained by separate economic agents performing 'decentralized' market transactions. If these costs were zero, one could not explain the existence of a costly institution like the firm.[7] By contrast, the Fuller 'decentralization' argument starts by considering the costs of a completely 'centralized' public ordering. If the costs of running and using a complete public ordering were nil, there would be no possible explanation for the 'set-up' and 'rigidity' costs that are sustained to run that particular form of 'private ordering' which defines the firm.

In other words, in Coase and Fuller, the firm seems to arise from two contrasting processes: in Coase it does so from a 'centralization' of market transactions, in Fuller from a 'decentralization' of the public ordering. However, the two processes refer to opposite sides of the same coin. Many of the costs of performing market transactions happen to coincide with the costs of using a 'pure' public ordering. When firms, unions, arbitrators and other forms of private orderings do not exist, the market transactions of agents can only be regulated and enforced by the public ordering. In this situation, the cost of defining and enforcing the rights of agents, their bargaining and their litigation costs, and many other costs besides, may be classified either as the costs of using the market mechanism or as the costs of using the public orderings. Alternatively, these costs can be classified under a single heading: they are the costs of using only 'public markets'[8] or, in other words, markets that are not supported by the numerous

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[7] On this point, see also Pagano (2007a) and Nicita and Pagano (2008).

[8] The term 'public markets' was suggested by the well-known concluding lines of Alchian and Demsetz (1972, p. 795), who observed: 'In contrast to markets and cities, which can be viewed as publicly or non owned market places, the firm can be considered a privately owned market; if so, we could consider the firm and the ordinary market as competing types of markets, competition between private proprietary markets and public or communal markets. Could it be that the market

'private orderings', like firms, that exist in all modern real-life capitalist economies.

For both Coase and Fuller, market contracts are necessarily incomplete. Public markets are costly. Their incompleteness would be a necessary feature of an optimal world where these costs are an endogenous aspect of the economic analysis. In an optimal world, public markets should only exist when their benefit is greater than the benefits of private orderings. Moreover, even in an optimal world designed by some omniscient god, the mix of private and public orderings should not aspire to perfection and completeness: all institutions are costly and the benefit of regulating human interactions should always be compared to its costs. An omniscient god, knowing that humans have limited resources, will find it unreasonable to allocate an unlimited amount of resources to a perfect and complete structuring of human interactions. Alternative uses (for instance, food production and health services) may be more compelling at the margin.

Summing up, a shared awareness of costs and of incompleteness engages both Coase and Fuller in a common journey from a world of decentralized markets and centralized public orders to centralized transactions and decentralized private orderings. In some circumstances, the firm may emerge as a system of centralized transactions organized within a private decentralized legal ordering.

Calabresi's[9] Cathedral can provide the setting for a marriage between Coase's and Fuller's theories. Calabresi has greatly enriched the transaction cost approach and our understanding of the multiple legal orderings by which human behaviour can be subject to the observance of rules. In one famous book (Calabresi 1970), he clarified how liability rules can reduce transaction costs in the case of accidents and how courts can operate as ultimate ex-post price setters for transactions which have been forced upon the sellers. Moreover, his contribution[10] has shown us the complexity of the institutions dealing with non-alienable resources.[11] Ordinary markets, liability rules and inalienable resources offer the foundations of a Cathedral that can be expanded to accommodate a fruitful analysis of other institutions.

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suffers from defects of communal property rights in organising and influencing uses of valuable resources?'.

[9] See Calabresi and Melamed (1972).

[10] See Calabresi and Bobbitt (1978).

[11] This greatly enriched the framework within which to study markets, firms, public and private orderings, and other institutions, and 'carried Coase further' by clarifying the complex relation between efficiency and distributive choices (Calabresi 1991).

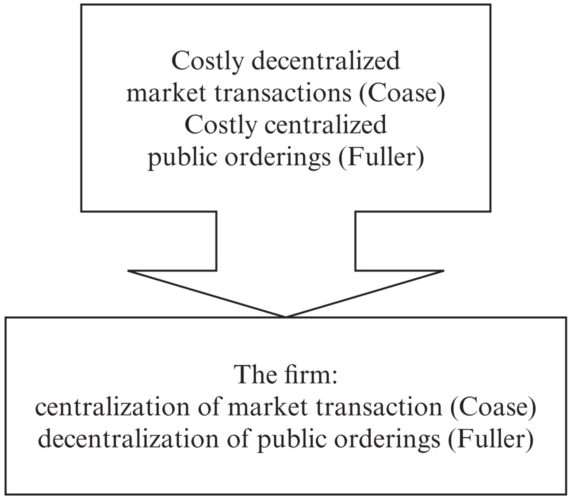

Figure 6.1 The Coase-Fuller engagement

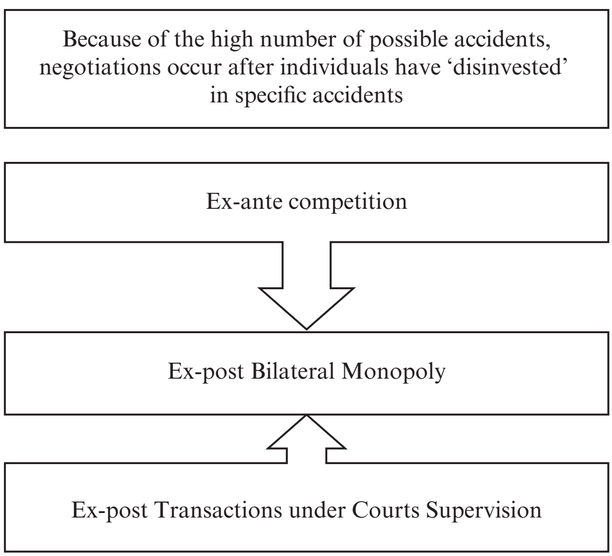

Figure 6.2 Calabresi's fundamental transformation

In Calabresi's framework some prices must be settled ex-post after some involuntary transactions have already taken place. In the typical case of accidents, it would be too costly to state prices before the accident took place and rely only on property rules or on transactions taking place in a framework of ex-ante complete contracts. In such a world, Calabresi suggests, liability rules become more advantageous than property rules. *Liability rules emphasize the role of courts having the ultimate power to set the prices of transactions that have already taken place in a situation of incomplete contracts.* Property rules have a clear advantage when it is possible to anticipate future events. In this case, entitlements will be transferred only under conditions that have been ex-ante agreed between buyers and sellers. By contrast, in many cases future interactions and events are impossible, or very costly, to forecast, and the entire bargaining process has to take place ex-post under the supervision and ultimate price-setting authority of courts.

In his celebrated work on accidents, Calabresi (1970) considered the different liability arrangements regulating the transfer of the entitlements between the culprit and the victim of an accident. In principle, in a world of zero transaction costs, property rules would be able to regulate an ex-ante exchange of entitlements in competitive markets. However, in the case of accidents, the costs of the ex-ante transactions among potential culprits and victims would be prohibitive. Such costs could only be saved by having transactions relate only to accidents that actually happen. However, after the occurrence of an accident, the transfer of entitlements has already taken place and the negotiation will necessarily happen in conditions of bilateral monopoly where competitive markets cannot help in setting prices and courts must assume this role. Calabresi's analysis highlights a 'fundamental transformation' in the nature of the possible contracting process: before accidents, the contracts between potential victims and culprits can be agreed in a competitive framework; by contrast, after accidents occur, the relation is transformed into a bilateral monopoly.

The Cathedral framework helps us to understand in which cases this role of public courts could be internalized within firms, as happened at GM after the copper-cooled engine problems arose. In this sense, the Cathedral offers the ideal setting for a Fuller–Coase marriage, whereby the firm arises as a system of unified liabilities (towards external agents) and as an island of conscious power (which must assign and adjudicate tasks and responsibilities among internal members sharing these liabilities).

However, marriages should not be rushed, and alternative arrangements must first be considered.

An alternative arrangement has, indeed, been offered by the New Property Rights approach. This has sought to marry standard economic theory – suitably modified with 'holes of incompleteness' – with the Coasian approach. The result has been a theory that views the firm as a unified ownership of assets and predicts that the agents best able to invest in human capital will own its assets. In the New Property Rights approach,[12] third parties cannot verify the efforts or the results obtained from investing in human capital. It is therefore impossible to write a complete contract. In these circumstances, each agent is exposed to the risk of non-cooperation by the other agents, and the first-best result cannot be achieved because public officials cannot impose penalties that eliminate the advantages of this type of behaviour. In this situation, the private ownership of physical capital can give the owners some advantages that would not arise in a situation of zero transaction costs (or of zero cost of verification by the public ordering). Owners are entitled to do with their goods whatever is not explicitly forbidden by contracts, and their residual liberties may well include actions that expose other agents to the negative consequences of the exercise of those liberties. Moreover, when this possibility is not explicitly ruled out by contractual obligations, private property gives the owners the right to exclude the other agents from the use of physical capital (also in the case when their human capital investment is specific to those inputs).

When contracts are incomplete, private property matters for human capital investments, and the ownership of physical capital becomes most valuable for those agents making the most substantial and specific investments in human capital. In the case of breakdown in cooperation, owners can at least count on the access to physical capital. Ownership increases bargaining power with respect to other agents and provides owners with a greater incentive to invest in human capital in comparison with the other individuals. Efficient allocations give ownership of assets to the agents best able to invest in specific human capital and the extent of ownership depends on the nature of the assets.

In this framework, it is possible to make sense of a U-shaped cost curve, which, in spite of its intuitive appeal, is otherwise hard to justify in standard neoclassical theory. The effect on costs of increasing the concentration of ownership is U-shaped because under ex-ante contractual incompleteness, *complementary assets should be owned jointly* but *independent assets should be owned separately*.

The fact that *complementary assets should be under common ownership* follows directly from the definition itself of complementarity. In the New Property Rights approach, two assets are defined to be (strictly) complementary if they are unproductive unless they are used together. In other words, access to both sets of (complementary) assets is the *conditio sine qua non* for any agent to benefit from increases in its marginal productivity. Starting from a situation of separate ownership, any form of integra-

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[12] See Hart (1995).

tion enhances efficiency because transferring ownership rights over one of the assets to either party increases the latter's marginal returns without decreasing the returns to the party excluded from ownership. This is because control of one of the assets alone has no effect on an agent's marginal productivity in the absence of an agreement with the agent controlling the complementary asset. Conversely, attributing ownership rights to different agents negatively affects actors' incentives since it increases the number of possible hold-ups. An analogous line of reasoning suggests that attribution of ownership rights over complementary assets to the same right-holder may have a positive impact on efficiency also because, under common ownership, outside agents have to negotiate with only one agent rather than two in order to use the assets.

By contrast, it is possible to show that *independent assets should be owned separately*. Here again the result follows from the very definition of 'independence'. Assets are independent when their concentration in the hands of one individual decreases the incentive to invest of one of the individuals deprived of the asset, without increasing the incentive to invest of the individual acquiring it. Thus, assets that are independent should be owned separately and the decentralization of ownership can be a means to provide greater incentives to invest in human capital.

The *complementarity–independence* argument gives a rationale for

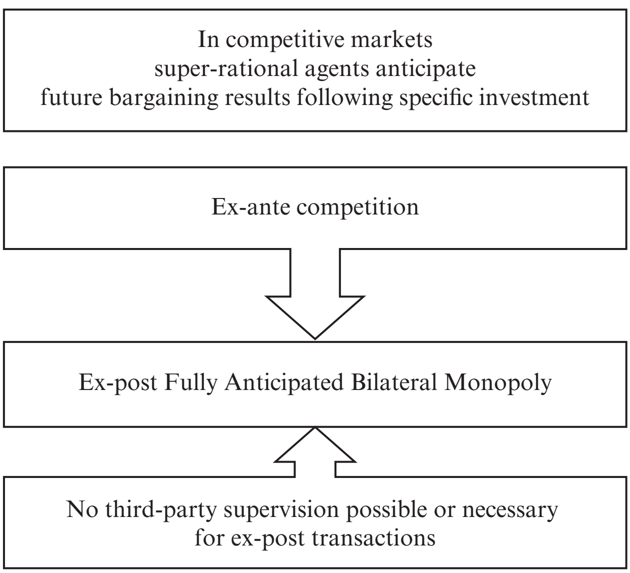

Figure 6.3 The New Property Rights fictitious transformation

the U-shaped curve: concentrating ownership decreases costs until one acquires complementary assets, but increases them when one starts acquiring independent assets. The argument explains how a change in technology, such as the switch from the production of open-body to closed-body cars would increase the complementarity of production plants and stimulate a GM–Fisher Body type merger.[13]

In the New Property Rights approach, similarly to the world of Calabresi accidents, there are two periods; and similarly to the Cathedral liability case, agents cannot write complete contracts in the first period. In both models, the first period is characterized by potential conditions of perfect competition and the second period by conditions of bilateral monopoly. However, whereas in the Cathedral setting some actions can occur in the competitive phase (contracts and accidents) and some others in the bilateral monopoly phase (bargaining by the agents and price setting by courts), in the New Property Rights approach all the action is squeezed into the first period (or in other words, into the competitive phase). This miraculous squeeze is obtained by making very special assumptions. In the competitive initial period, the agents perfectly forecast what will happen in the subsequent situation of bilateral monopoly, and they take all decisions (including the level of under-investment in human capital and the exchanges of non-human capital) at the start of their relationship. Since the agents perfectly anticipate all the decisions to be taken in the bilateral monopoly stage, no decision is really taken in this period. Thus the second period is a fictitious stage whose life can be entirely run ex-ante only in the minds of super-rational individuals.

The ex-post activity of the courts, which plays such an important role in the Cathedral, is useless in the New Property Rights framework because no unanticipated activity takes place at this later stage. It is also economically unfeasible because the model has implicitly ruled out all verification activities by dividing human actions into two extreme categories: those involving zero verification costs (exchange of machines) and those whose verification by third parties would require infinite verification costs (investment in human capital). On the one hand, the contracts concerning physical assets are complete, and they are enforced at zero costs.[14] On

13 Hart (1995, p. 7) observes that 'for a long time Fisher Body and GM were separate firms linked by a long-term contract. However, in the 1920s GM's demand for car bodies increased substantially. After Fisher Body refused to revise the formula for determining price, GM bought Fisher out'.

14 The idea that contractual terms are only specified at the beginning and are not implicitly altered by the evolution of a relation is criticized in the third section by Fuller (2001).

the other hand, the contracts concerning human capital investments are impossible because, while investments are observable for the contracting parties, third parties cannot verify them. As in a 'Swiss cheese', we observe smooth surfaces of complete contracts and perfectly carved holes of contractual incompleteness (Pagano 2000).

The 'Swiss cheese assumption' implies that third-party verification is either costless or infinitely costly, and it implicitly rules out the endogenous search for a reasonable degree of (in)completeness that could be achieved by the public ordering by means of investments in contract verification capabilities. In this way, it rules out Calabresi's liability rule and the price-setting role of public courts in ex-post conditions of bilateral monopoly.

Similarly in this framework, more investments by private agents (like Alfred Sloan) cannot increase the capacity to devise better working rules and to verify the behaviour of other agents more efficiently. In other words, in the New Property Rights approach, the firm cannot be explained as a private ordering where some agents make 'second-order' specific investments to manage some specific relations (or, in other words, develop specific organizational capital). The institutions of corporate governance, and all the investments made to overcome the problems of contract incompleteness, do not make any sense within the New Property Rights approach. The Coasian firm conceived as an island of power cannot exist because no power is ex-post exercised outside the competitive ex-ante setting. For the Coasian theory of the firm, the marriage with a neoclassical competitive setting with incomplete markets turns out to be unsatisfactory. It may generate an interesting theory of second-best ownership, but cannot deliver a theory of the firm. If such a marriage has already taken place, an amicable divorce is necessary. A new marriage between Ronald Coase and Lon Fuller must, finally, be arranged in the Cathedral.

5. MARRIAGE IN THE CATHEDRAL

The New Property Rights approach provides a bad marriage arrangement for the Coasian theory because, unlike Calabresi's liability analysis, its promised transformations are fictitious and misleading. The claim that future bilateral monopoly is included in the analysis turns out to be false. The fiction of hyper-rational agents, perfectly forecasting the future situation of bilateral monopoly, implies that no real fundamental transformation takes place. Good marriages require authentic transformations from pre-marriage competitive conditions to post-marriage successful monopolies.

Two witnesses are required in the Cathedral for a marriage to be valid. One has already been introduced in the person of Guido Calabresi. He is best able to tell us about situations in which fundamental transformations from competition to bilateral monopoly are the *unintended* results of accidents among unknown agents, and the ex-post action of public courts avoids serious ex-post problems. The other best man must necessarily be Oliver Williamson. He is the best person to certify the real existence of fundamental transformations from competition to bilateral monopoly which, unlike Calabresi's accident cases are the *intended* results of agents making specific investments. In this framework, all sorts of private orderings (including marriages) are constructed to avoid serious ex-ante problems.

Figure 6.4 shows Williamson's (1985) 'fundamental transformation' due to asset specificity. Before specific investments are made, the potential investors are agents acting in a competitive framework. By contrast, after the specific investments have taken place, the agents are engaged in a bilateral monopoly relationship where each agent can damage the other and where both agents are likely to be jointly liable for their efforts. In

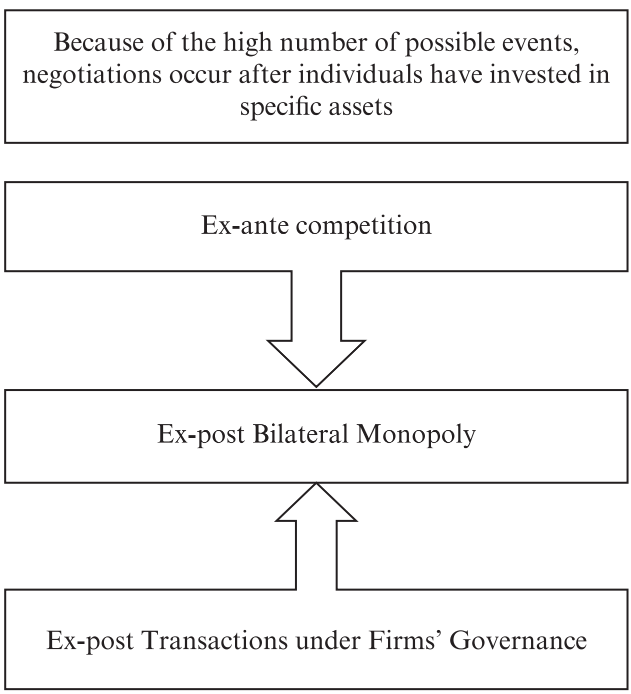

Figure 6.4 Williamsons's fundamental transformation

Williamson, too, this fundamental transformation requires some form of third-party governance.

Comparing Figures 6.2 and 6.4 reveals an analogy between the fundamental transformations of Guido Calabresi and Oliver Williamson. Unlike the case of Figure 6.3 schematizing the New Property Rights approach, Figures 6.2 and 6.4 bear witness to real-life transitions, both moving from competitive conditions to bilateral monopoly, which become two stages of the same process.

Specific investments play a well-known role in Williamson's fundamental transformation. Agents become aware that specific investments entail the impossibility of reallocating the investments made in the relationship outside, and when these types of investments are relevant and/or frequent, they try to centralize transactions in the hands of reliable private orderings.

Even if Calabresi's theory is not usually phrased in this way, it can be re-cast in terms of specific (dis)investment. Also the specific disinvestment caused by accidents cannot be reallocated in other accidents, and the agents are confronted with a typical bilateral monopoly related to asset-specificity.

Car accidents are typical cases in which specific (dis)investments are not repeated with the same partners. It is, indeed, very unlikely that one will be involved in frequent car accidents with the same person. However, the type of accidents that occurred at GM were frequent and with well-known partners. In this case, specific (dis)investments mean that it may become convenient to internalize courts and change to a system of joint liabilities towards outsiders. More in detail, the two cases are different for the following reasons.

In the first place, in cases like car accidents, the two agents are unlikely to have ever personally met in competitive markets with any awareness of their future roles. Thus, they are not able to agree on any contractual clause under competitive conditions that may constrain the future development of the relation under conditions of bilateral monopoly. One does not choose the victim or the culprit of a car accident. By contrast, one is likely to choose the persons and the (incomplete) contractual framework within which one can make specific (dis)investments occurring with predictable partners. Moreover, unlike the car accident case, choices made under competitive conditions may also include the choice of the third party who will have judicial power in the future situation of bilateral monopoly.

In the second place, not only the identities but also the duration is different in the two cases. In cases like car accidents, the ex-post relation lasts only for the time required to redress the damage, and there are none of the gains from continued cooperation that characterize co-specific investments. By contrast, in other cases of specific (dis)investments, while the relation develops, it is worthwhile investing in a 'second order' specific structure that governs relations with increasing insight.

Finally, lasting relations with predictable partners induce the a-priori supply of private governance structures. In an 'ex-ante' competitive market, the parties can choose the individuals who make 'second-order-specific investments' in the governance of their relationship. Moreover, the opposite possibility is also open in the case of frequent and voluntary specific investments: the persons who make second-order specific investments can set up governance structures that favour the first-order specific investments of the individuals joining them. Richard Posner (1981 and 1983) has maintained that public judges maximize the total wealth of the agents. While his theory is subject to several limitations and countertendencies in the public domain, it can find a partial and, somehow, more convincing application in the case of the private judges making second-order specific investments. Private judges may offer governance structures where individuals are able to make specific investments without fear of expropriation. In this case, some, and only 'ex-ante', competition may induce private judges – or, in other words, firms' top managers – to look for wealth-maximizing solutions. Even if internal rent seeking, information asymmetries and incentive misalignments set serious limitations on this tendency, private governance structures are also sensitive to this competitive pressure.

In the Cathedral, time cannot be squeezed into the present. Past, present and future all have equal dignity, and fundamental transformations must be taken seriously. Transitions from one fundamental transformation to the other must be taken even more seriously: they are the essence of the Fuller–Coase marriage.

Unlike the New Property Rights approach, the Coase–Fuller marriage delivers a theory of the firm, and not simply a theory of the optimal allocation of ownership. The restrictive assumption that verification costs are either zero or infinite is also removed, and the relative performance of the investments in verification of public and private orderings can be fruitfully compared. The firm emerges when a system of dispersed liabilities and public courts mutates into a system of joint liabilities and unified power where the management is able to exercise an internal judicial function.

GM as a whole was liable to its customers for providing an overheating engine. Alfred Sloan was well aware of the complications of dividing the responsibilities between Mr Kettering and the production engineers. Moreover, after the introduction of the closed body, it became impossible to distinguish between the effects of the engine and the body shape on the car's road-holding. Settling disputes judicially became extremely costly

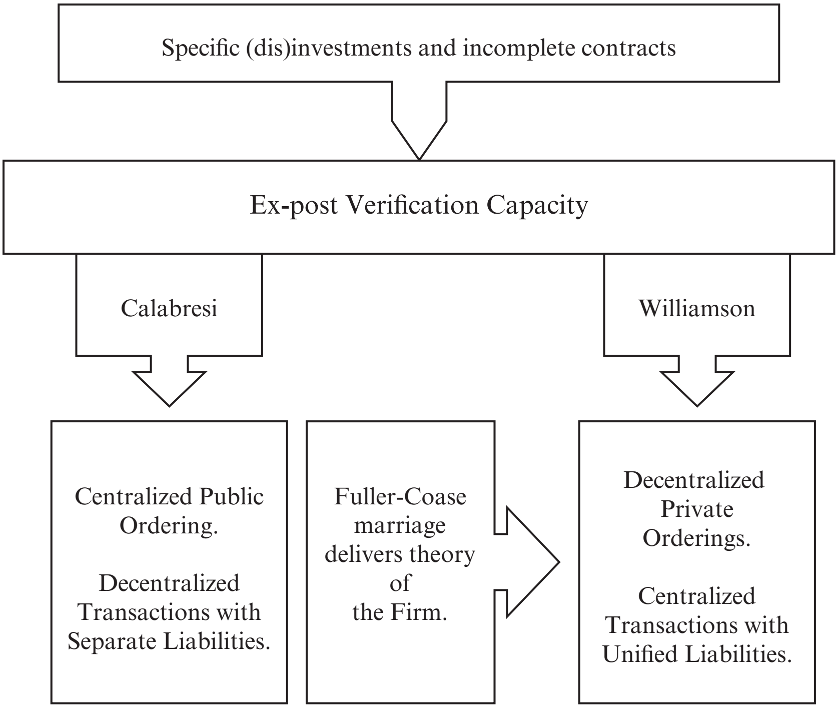

Figure 6.5 Marriage in the cathedral

because courts could not accumulate as much expertise as the top management of a unified firm in order to assess the responsibilities of the engine and closed-body production departments. A system of joint liability of GM and Fisher Body became necessary, and an internal system of governance became important to stimulate co-specific investments.

Two different orderings were devised for the two different types of accident. In case of car accidents possibly due to bad road-holding, the public courts still had the ultimate judicial power to ascertain the responsibilities of the new unified governance structures with respect to GM's customers. However, in order to assess the responsibility of a particular production department, it was now up to top management to settle disputes between the former GM and Fisher Body production units. As long as this system of unified and internally adjudicated liabilities was able to produce better results than market interfaces and public courts, the firm could expand, possibly well beyond the limits that the advantages of common ownership of productive assets would have allowed.

Joint liability and the internal adjudication of responsibilities are the essence of the firm and the foundations of corporate governance: they involve a centralization of transactions as well as a decentralization of some powers of a public ordering to private orderings amid recognition that business organizations are legal persons.

Legal personality is a crucial feature that most modern firms have taken from public orderings. When an institution is a legal person, it has an existence independent of its members. Therefore its rights and obligations do not terminate with the death of its human founders and members; it can sue and be sued in tribunals with respect to contracts as well to crimes, even in relation to its members; and it can own property in its own name.

The legal personality of an organization entails the limited liability of the shareholders and of the agents acting on their behalf. In other words, it implies the organization's full and joint liability for its actions, separating the responsibilities of the organization from those of its members. Individuals cannot be made personally liable for the debts of an organization, which, because of the joint stock principle, can be managed as a single unit by the individuals delegated to run it.[15]

It has been a great achievement of modern nations to separate the legal personality of the state from its rulers. Only when the state became liable for its obligations independently from its mortal representatives did a legal public ordering become possible. Only later were churches, universities, unions and firms also granted incorporation like the state. By the time Sloan was planning the merger with the Fisher brothers, firms could also freely choose to become legal persons and set up joint liabilities, with the internal attribution of responsibilities. At GM, the Coasian process of centralization of market transactions could go together with a Fullerian process of integration of liabilities in a sophisticated private ordering. Marrying in the Cathedral is not only about law and economics; it also involves two real-life historical processes. It involves opening up to a novel analysis of the corporation where the legal independence of the corporation (and the independence of its board) from the shareholder allows each shareholder to lock-in large specific investments (sometimes, unfortunately, specific disinvestments!) without being afraid of being deprived of co-specific capital (as could happen under a partnership arrangement). As Lynn Stout (2005) has convincingly argued, the legal independent personality of the corporation should be associated with a

[15] See Cerri (2007). Pacces (2007, Chapter 1) gives a complete analysis of all the conditions which define the modern corporation. After legal personality, the Berle and Means (1997) corporation has gradually evolved a well-defined identity and a unique set of intellectual assets which allows a well-defined path of intellectual development (Pagano and Rossi 2004).

third-party fair judicial role for its managers. As long as the managers of the corporation do not favour a particular constituency (for instance, its shareholders or, even worse, a group of shareholders), the corporation does not only allow the lock-in of specific physical capital, but also specific investments in the human capital of the other stakeholders. The managers of a corporate legal person should not simply behave as Coasian centralizers of market transactions but also as dispersed pieces of the body of the Sovereign.[16] They still retain some remains of its powers and of its fiduciary duties.

6. CONCLUSION

The chapter has advanced the view that the main reason for the existence of the firm is the unification and the internalization of liabilities. Corporate governance can be viewed as a centralization of market transactions and as a decentralization of a public ordering which enables the management of joint liabilities and the internal adjudication of responsibilities. Coase's and Fuller's contributions to the theory of the firm can be married within the architecture of Calabresi's Cathedral. Because of specific Willamsonian (dis)investments, fundamental transformations from competition to bilateral monopoly take place either in the public or in the private sphere. Marrying Coase and Fuller in the Cathedral can deliver an analysis of corporate governance founded on the comparative analysis of alternative forms of governance. The imaginary journey from decentralized transactions and centralized public ordering to centralized transactions and decentralized private orderings could lead to a better understanding of the various public and private governance systems. In particular, it can help us to analyse those institutions, like the corporation, which are located at their fuzzy boundaries.

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[16] This point was suggested to me by Professor Pier Giuseppe Monateri. For a recent comparison between the corporation and State bodies, see also Posner (2010) and Pagano (2010).

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Comment – Can the firm be seen to emerge out of a pincer movement of efficiency pressures?

J. (Hans) van Oosterhout

INTRODUCTION

Professor Pagano's chapter 'Marrying in the Cathedral: A Framework for the Analysis of Corporate Governance',[1] is the kind of rich and well-written think-piece one rarely finds these days in the peer-reviewed academic journals that publish work on corporate governance. Apparently, the double-blind review process that most of these journals rely on functions like a cookie-cutter in which rich and original inputs are 'fundamentally transformed' into the rather narrowly focused and often highly standardized outputs that most of these journals tend to publish. Yet in spite of the wealth of ideas, the fruitful associations and the elegant prose, Professor Pagano's chapter also raises a number of questions and issues to which I will attend in this short reaction. This by no means implies that I think ill of the chapter, or that I do not value the rich insights it develops. On the contrary, I just undertake to perform the kind of job that is expected of a discussant, although I will not deny that my focus on what I believe to be problematic in Professor Pagano's chapter also demonstrates the kind of character deformation that academics who, like myself, have never had a real job, often suffer from.

A PINCER MOVEMENT OF EFFICIENCY PRESSURES?

As I understand it, Professor Pagano's chapter has the rather ambitious aim of developing a theory of the firm. The thrust of the chapter is that

[1] In this volume, p. 264.

the firm emerges out of what can be seen a 'pincer movement' of efficiency pressures from two different directions; 'a centralization of market transactions . . . [and] . . . a decentralization of public ordering' (p. 274 of this volume). More specifically, 'the firm emerges when a system of dispersed liabilities and public courts mutates into a system of joint liabilities and unified power where the management is able to exercise an internal judicial function' (p. 284 of this volume). I will examine both arms of the pincer, not only to review the validity of each, but also to assess the innovation and contribution of the chapter as a whole.

CENTRALIZING TRANSACTIONS TO MANAGERIAL DECISION-MAKING WITHIN THE FIRM

Professor Pagano first argues that efficiency dictates that certain transactions are better centralized under managerial decision-making *within* the firm than carried out in a decentralized free market exchange. The reasons for these centralizing pressures from decentralized market exchange result from a comparative analysis of the transaction costs involved compared with the available alternatives, and they are familiar from the works of Coase (1937) and Williamson (1985). According to Coase, there are costs associated with using the market, just as there are costs involved in centralized managerial decision-making within the firm. Examples of the former are the costs associated with price discovery, the costs of drawing up contracts, and the costs of finding appropriate parties for exchange. Examples of the latter include the decision costs that managers must make to take informed decisions on the internal allocation of resources, and the costs associated with the risk of making wrong decisions.

In Coase's view, parties will continue to centralize transactions to managerial decision-making within the firm until the costs of internalizing one more transaction are equal to the costs of carrying out that same transaction through the market. More informative than this marginal analysis, which would only explain the size of the firm under different (technological) conditions, is the more qualitative 'discriminative alignment' approach developed by Williamson (1985). In this approach, 'transactions, which differ in their attributes, are aligned with governance structures, which differ in their costs and competencies, in a discriminating (mainly, transaction-cost-economizing) way' (Williamson, 1991: 277). As the resulting transaction cost theory of economic organization is widely accepted and receives support from the available empirical evidence (for a recent meta-analysis, see Geyskens et al., 2006), we tread on familiar terrain and all seems good and well.

A DECENTRALIZATION FROM PUBLIC ORDERING?

Things get more complicated in regard to the second arm of the pincer, however. Taking Lon Fuller's '*The Morality of Law*' (1964) as a point of departure, Pagano argues that the law, given its multiple constitutive virtues, such as the consistency and the intelligibility of law, cannot be seen to create a perfect form of public ordering. Trade-offs between the different virtues constitutive of law are practically inevitable, in the same way that the *internal* morality of law, that is, the degree to which law satisfies its internal constitutive virtues, must be weighed and traded off against the *external* morality of law, that is, the real-life social purposes that the law aims to serve.

So there is an analogy between the predicament of law as an instrument of public ordering and the market as a decentralized system of free and open exchange. Like the market, the law functions only at a cost that must be taken into account in shaping the basic institutional ordering of economic and social life. No institutional configuration will be perfect, and multiple institutional configurations may be equivalent in terms of the external social purpose they seek to promote (for an elaboration of this argument, see van Oosterhout et al., 2006), such as, for example, the maximization of social welfare (for example, Kaplow and Shavell, 2001). In so far as the conclusion of all this is that the real world is one of imperfect institutional alternatives (see, for example, Komesar, 1994), all remains good and well. There is nothing controversial in this conclusion, but neither is there much novelty here, as Coase has been arguing all along (Coase, 1988).

The problems in Professor Pagano's chapter really start when he builds upon this general and widely accepted insight to conceive of the *decentralizing* efficiency pressures that, in conjunction with the *centralizing* efficiency pressures from free market exchange discussed above, push towards the private ordering arrangement of the firm. Professor Pagano resorts to the often used and well-known GM–Fisher Body case in order to show that, at the time of the introduction of the closed-body car, it made sense for both GM and Fisher Body to unite in a commonly owned firm in order to create a privatized corporate adjudication system. This system could deal *internally* with the many problems and accidents that resulted from that innovation. Now I can see how the GM–Fisher Body example demonstrates how private parties can manage their *mutual* exchange and liabilities more efficiently by *centralizing* and *internalizing* them into a commonly owned firm. But I fail to understand how the introduction of this form of private ordering would instantiate a *decentralization* from public ordering, as neither the state nor the public judiciary is part of the theoretical equation that Professor Pagano develops.[2] Explicitly modelling the role of government – or any other form of public ordering – to be part of the equation is required not only to sensibly speak of decentralization, but also for two other reasons. First, one would need to explain why a private adjudicative system like the firm would be respected as such by public judges. Second, it is difficult to see how the firm, as a private adjudicative system that internalizes mutual liabilities between the constituent parties, could simultaneously constitute a system of joint liabilities to (third) parties external to the firm, without legal intervention by a government.

DELEGATING FROM PUBLIC TO PRIVATE ORDERING?

Admittedly, the GM–Fisher Body merger was intended, amongst other things, to internalize and privatize adjudication between Fisher Body and GM. Relying on public courts to adjudicate the disputes between GM and Fisher Body that arose from the closed-body car innovation would clearly be a less efficient alternative than any private ordering arrangement these parties would agree to set up, even if only because of the massive information and verification costs that public courts would have to incur to adjudicate such disputes. Yet the mere fact that these parties would agree to *centralize* dispute resolution in a jointly owned firm in no way guarantees that courts will not *actually* intervene in what then has become an internal corporate affair. This additionally requires public courts to develop and apply a doctrine of non-intervention, as it cannot be assumed that private ordering arrangements agreed to *ex ante* will always result in efficient and equitable dispute resolution between corporate constituencies *ex post* (see, for example, Zingales, 1998), for reasons that Professor Pagano himself elaborates rather extensively in his chapter.

Such a legal doctrine can be seen to exist, for example, in the so-called 'business judgment rule'. This is a doctrine under Delaware corporate law according to which Delaware judges are unwilling – but for a few exceptions – to review everyday managerial decisions on behalf of shareholders in derivative suits, regardless of whether these decisions actually harm the

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[2] That explicitly modelling government to be a party to the exchange, which results in the configuration of public and private ordering in society, is both possible and fruitful is demonstrated, for example, by Weingast (1997).

legitimate interests of shareholders (Bainbridge, 2003).[3] The issue here, to be sure, is that the existence of such a legal doctrine cannot be taken for granted, but is nevertheless necessary in order to fruitfully understand the GM–Fisher Body merger as *a decentralization* – or rather delegation (Bamberger, 2006) – from public to private ordering (van Oosterhout, 2009). Public courts will therefore need to be a part of the theoretical equation in order to speak sensibly of decentralization.[4]

THE FIRM AS SYSTEM OF UNIFIED LIABILITIES TO THIRD PARTIES?

If we grant, if only for the sake of the argument, that setting up a private adjudicative system between two parties could take place without the formal blessing of the public courts, there would still be another reason why institutions of public ordering need to figure explicitly in the theory of the firm that Professor Pagano develops. This reason has to do with Professor Pagano's claim that the firm can be seen to function as a single unified system of liabilities in regard to transactions with, and claims from, (third) parties external to it.[5]

Although it is far from clear from Professor Pagano's chapter, it is obvious that the internal private adjudicative system of the merged GM–Fisher body entity cannot adjudicate *claims from* (third) parties outside this entity, as private ordering arrangements can only bind those who voluntarily opt into them. But what may be less apparent is that even functioning as a single and unified legal agent *towards* third parties already requires (legislative) public ordering involvement. For a firm to function as a single and unified signatory in contractual relations, that can own assets separate from the assets of its owners, and be subject to claims from third parties, it would need to have legal personality. Yet legal personality is not something that parties to a private ordering can establish by themselves.

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[3] This still leaves open the issue whether this doctrine ought to be interpreted as an 'abstention' or non-intervention doctrine, or whether this doctrine amounts to an evolving standard of liability for corporate directors instead. See Bainbridge (2003).

[4] The real issue, of course, is that *normative* law and economics tends to understand courts as mechanically applying whatever efficiency dictates in individual cases, yet it should be clear that this assumption is never acceptable from the perspective of *positive* economic organization theory.

[5] In Professor Pagano's own words: 'the firm arises as a system of unified liabilities (towards external agents)' (p. 277 of this volume)

As Hansmann and Kraakman (2000) explain at length, legal personality is arguably the only feature of corporate law that cannot be established by contracting alone, and that the law, as an instantiation of public ordering, would have to provide. The reasons for this are rather complicated, so I will not discuss them exhaustively here.

The gist of the issue is that contracting into a private ordering arrangement cannot bind any party beyond the confines of that arrangement. Thus a contract between the partner-owners of a firm that establishes the same firm as a system of joint and unified liabilities to third parties will not be able to protect the going concern value of that firm against claims from the creditors of any of the partner-owners, simply because that contract does not bind the creditors. Legal personality, understood as 'affirmative asset partitioning' between the firm and its owners (Hansmann and Kraakman, 2000),[6] can hence only be established by the public ordering intervention of the law, and not by any private ordering established by contract.

EVALUATION AND CONCLUSION

I have argued that the pincer movement of centralizing and decentralizing efficiency pressures, from which the firm emerges in Professor Pagano's chapter, in effect collapses into the centralizing pressures that constitute only one arm of the pincer. The reason for this is that the theory of the firm developed by Professor Pagano does not include any role for public ordering from which the decentralization argument could be fruitfully conceived. Professor Pagano can be seen already to foreshadow this conclusion when he observes that the centralizing and decentralizing processes 'refer to opposite sides of the same coin' (p. 274 of this volume). In empirical science, phenomena that share the same *extension* ought to be theoretically treated as making up one and the same *intensionally* defined concept, unless one has solid theoretical reasons to provide this concept with different *intensions* in different explanations.

Yet, at the same time, I have also argued that law or public adjudication would need to be included in the theoretical equation in order to understand the firm as a system of joint and unified liabilities, both towards internal and external (third) parties. The former is the case because public

6 Professor Pagano also seems to confuse legal personality (affirmative asset partitioning) with limited liability (defensive asset partitioning), which are not quite the same thing. The first protects the claims of the firm's creditors against the claims from creditors of the firm's owners, the second protects the firm's owners from the claims against the firm (see Hansmann and Kraakman, 2000).

adjudication between parties involved in the firm cannot be pre-empted by the private ordering arrangement of internal adjudication, unless public courts develop and implement a non-intervention doctrine to that effect. The latter is true because a system of joint and unified liabilities for a firm would amount to that firm having legal personality, which is a status that cannot be created by contract, but which has to be established by public ordering legislation.

In spite of the elegant prose and the rich and insightful combination of different kinds of transaction cost analysis in Professor Pagano's chapter,[7] I remain unpersuaded as yet by its major line of argument. In my view, the chapter would either need to delete all talk of decentralizing efficiency pressures, or need to introduce public ordering explicitly as part of the theoretical equation. It should be clear that my advice as a discussant is to choose the latter option.

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[7] For reasons of brevity, I have not discussed Professor Pagano's treatment of the work of Guido Calabresi, nor his elaboration on the shortcomings of the property rights approach in the theory of the firm.

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