CORPORATE LAW AND OWNERSHIP STRUCTURE: A DARWINIAN LINK?

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I INTRODUCTION

In the United States, securities markets are well-developed and major business enterprises tend to have widely dispersed share ownership. Things are different in most other countries,[1] although anecdotal evidence indicates that some sort of transition towards the US model could be occurring.[2] The work of various economists and legal academics implies that this 'convergence' trend will only continue if an appropriate regulatory framework is in place. The presumption is that the law 'matters', in the sense that a legal regime which allows investors to feel confident about owning a tiny percentage of shares in a firm constitutes the crucial 'bedrock' that underpins a US-style economy where widely held public companies dominate.[3]

This paper examines a pivotal, if poorly articulated, assumption embedded within the 'law matters' thesis. This is that diffuse share ownership offers inherent economic advantages that mean it is the 'natural' state of affairs for large business enterprises. Essentially, it is presumed that there is market-oriented momentum in favour of efficient corporate structures. This Darwinian impulse is weak, however, and inappropriate corporate law can sidetrack things easily. An agenda for law reform logically follows: policy-makers should create a regulatory milieu that provides a suitable platform for diffuse share ownership.[4] The corporate economy should then evolve 'naturally' and concomitantly deliver superior economic results.

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1 See below Part II.

2 Henry Hansmann and Reinier Kraakman, 'The End of History for Corporate Law' (2001) 89 *Georgetown Law Journal* 439; John Coffee, 'The Rise of Dispersed Ownership: The Roles of Law and State in the Separation of Ownership and Control' (2001) 111 *Yale Law Journal* 1, 16–21.

3 On the terminology, see Brian Cheffins, 'Law as Bedrock: The Foundations of an Economy Dominated by Widely Held Public Companies' (2002) forthcoming *Oxford Journal of Legal Studies* (copy on file with author) 2.

4 Ibid 8–9.

The opening sections of the paper place the law matters thesis in context by identifying its essential attributes and by discussing its policy implications. We consider next why the proposition that diffuse share ownership structures are associated with efficiency seems to be linked integrally to the law matters thesis. After this, the proposition that widely dispersed share ownership is the 'natural' state of affairs for large business enterprises is critiqued. We will see that a plausible case can be made that corporations with dispersed share ownership possess positive attributes that may give them a competitive edge. However, we will also take account of aspects of ownership structure that are sufficient to throw into question whether it is 'natural' for large business enterprises to have equity that is widely held. The paper concludes with some observations on the circumstances under which the introduction of stronger legal protection for minority shareholders might prompt convergence along American lines and on certain risks associated with law reform of this character.

II DISCOVERY OF THE LINK BETWEEN OWNERSHIP STRUCTURE AND CORPORATE LAW

The US experienced a 'corporate revolution' between 1880 and 1930.[5] At the beginning of this period, family control of industrial enterprises was the norm and there were only rare examples of companies with widely dispersed shareholdings and well-developed managerial hierarchies.[6] By the end, leading firms in a wide range of industries had widely dispersed share ownership, with investors each lacking a sufficient financial incentive to participate directly in corporate affairs.[7] Business decisions were left instead to professionally trained executives operating at the pinnacle of multi-layered managerial structures.

Adolf Berle and Gardiner Means, in a famous book published in 1932,[8] drew attention to the 'outsider/arm's-length' pattern of corporate governance that currently prevails in the US.[9] They said there was 'a separation of ownership and control' in America's larger public companies since share ownership was too

5 Walter Werner, 'Corporation Law in Search of its Future' (1981) 81 *Columbia Law Review* 1611, 1641–2; William G Roy, *Socializing Capital: The Rise of the Large Industrial Corporation in America* (1997) 3, 16–18. See also Alfred D Chandler, 'The Emergence of Managerial Capitalism' (1984) 58 *Business History Review* 473, 473 (declaring that 'a new type of capitalism emerged').

6 Werner, above n 5, 1636–40; Thomas R Navin and Marian V Sears, 'The Rise of a Market for Industrial Securities, 1887–1902' (1955) 29 *Business History Review* 105, 106–12.

7 Alfred D Chandler, *Scale and Scope: The Dynamics of Industrial Capitalism* (1990) 144–5; Mary O'Sullivan, *Contests for Corporate Control: Corporate Governance and Economic Performance in the United States and Germany* (2000) 75–7.

8 Adolf Berle and Gardiner Means, *The Modern Corporation & Private Property* (1932). On its importance, see, eg, Robert Hessen, 'A New Concept of Corporations: A Contractual and Private Property Model' (1979) 30 *Hastings Law Journal* 1327, 1329, saying it was 'the single most influential book ever written about corporations and one whose central thesis continues to dominate contemporary discussion'.

9 On the 'outsider/arm's-length' terminology, see Brian R Cheffins, 'Current Trends in Corporate Governance: Going From London to Milan via Toronto' (1999) 10 *Duke Journal of Comparative and International Law* 5, 12–13.

widely dispersed to permit shareholders to scrutinise properly managerial decision-making. Concerns about unconstrained executive power meant that the normative implications of Berle and Means' analysis were widely debated in the decades that followed.[10] Interested observers implicitly agreed, however, on an important point: fragmented share ownership was inevitable in major business enterprises.[11]

According to the prevailing orthodoxy, big companies would, by virtue of economies of scale, dominate key industries.[12] Since carving up equity claims into small units made it possible to amass larger amounts of capital than could be assembled by a handful of wealthy individuals taking large positions, dispersed ownership tended to follow.[13] Moreover, the separation of ownership and control which emerged was beneficial since executives were hired on the basis of their managerial credentials, not their ability to finance the firm or family connections with dominant shareholders.[14] Therefore, the American version of the public corporation was the logical winner of a Darwinian struggle between different forms of corporate structure.

Perhaps because of this seemingly compelling economic reasoning, Berle and Means' work fixed the image of the modern corporation as one run by professional managers who were potentially unaccountable to widely dispersed shareholders.[15] By the early 1990s, this image was beginning to show some wear and tear, with growing awareness that a separation of ownership and control was far from universal.[16] Still, as the decade drew to a close, there was relatively little empirical evidence on share ownership patterns in large companies in different countries.[17] Research done by economists Rafael La Porta, Florencio López-de-Silanes and Andrei Shleifer did a great deal to address this gap. Working with a sample of almost 700 companies from 27 of the richest of the

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10 For an overview of the debate, see Gregory A Mark, 'Realms of Choice: Finance Capitalism and Corporate Governance' (1995) 95 *Columbia Law Review* 969, 973, 975–6; Edward B Rock, 'America's Shifting Fascination with Comparative Corporate Governance' (1996) 74 *Washington University Law Quarterly* 367, 370–5.

11 Mark, above n 10, 973–4; Mark J Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (1994), ch 1; Craig LaChance, 'Nature v Nurture: Evolution, Path Dependence and Corporate Governance' (2001) 18 *Arizona Journal of International and Comparative Law* 279, 283, 287–8. But see Roberta Romano, 'A Cautionary Note on Drawing Lessons from Comparative Corporate Law' (1993) 102 *Yale Law Journal* 2021, 2034–5 (questioning the existence of the alleged consensus).

12 For further background on the economy of scale point, see Alfred D Chandler, 'The Competitive Performance of US Industrial Enterprises since the Second World War' (1994) 69 *Business History Review* 1, 2–3.

13 Margaret Blair, *Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century* (1993) 96; Robin Marris, *Managerial Capitalism in Retrospect* (1998) 6–7.

14 Henry N Butler, 'The Contractual Theory of the Corporation' (1989) 11 *George Mason University Law Review* 99, 107; Tony Jackson, 'Curse of the Family Firm', *Financial Times* (London), 9 June 1999, 26.

15 Rafael La Porta, Florencio López-de-Silanes and Andrei Shleifer, 'Corporate Ownership Around the World' (1999) 54 *Journal of Finance* 471, 471.

16 Ibid 472; Andrei Shleifer and Robert W Vishny, 'A Survey of Corporate Governance' (1997) 52 *Journal of Finance* 737, 754.

17 La Porta, López-de-Silanes and Shleifer, above n 15, 472.

world's economies,[18] they found that relatively few were widely held. In contrast to Berle and Means' image of ownership of the modern corporation, the firms in question typically had a dominant owner such as a family or perhaps the state.[19] Subsequent empirical studies have verified these findings.[20]

La Porta, López-de-Silanes and Shleifer did more, however, than offer an empirical account of patterns of corporate ownership. They also sought to identify variables that correlated with ownership dispersion (or lack thereof). Building upon earlier work with Robert Vishny, another economist,[21] they found that widely held firms were more common in countries with good shareholder protection.[22] In this context, the law was defined primarily in terms of voting rights (eg, regulation of arrangements displacing the principle of 'one share, one vote') and remedial rights offering shareholders protection against potentially oppressive conduct by those in control (eg, prejudicial dilution of existing ownership stakes).[23] La Porta, López-de-Silanes and Shleifer also discovered that dispersed ownership tended to be more prevalent in common law countries (those following judicially-oriented English legal traditions) than in civil law jurisdictions (those following a scholar and legislator-made tradition dating back to Roman law).[24] This outcome was not surprising since the three economists, together with Vishny, had found previously that common law countries are significantly more protective of minority shareholders than their civil law counterparts.[25]

A natural inference that can be drawn from the trends identified by La Porta, López-de-Silanes and Shleifer is that the quality of legal protection offered to minority shareholders helps to determine patterns of ownership and control.[26] Why should the law make so much difference? The essential insight underlying

18 Ibid 474–5.

19 Ibid 491–505, 511. The authors, in earlier work with Robert Vishny, made the same point by relying on a different set of data: Rafael La Porta et al, 'Law and Finance' (1998) 106 *Journal of Political Economy* 1113, 1146.

20 See, eg, Stijn Claessens, Simeon Djankov and Larry H P Lang, 'The Separation of Ownership and Control in East Asian Corporations' (2000) 58 *Journal of Financial Economics* 81; Marco Becht and Colin Mayer, 'Introduction' in Fabrizio Barca and Marco Becht (eds), *The Control of Corporate Europe* (2001) 1, 30–2; Mara Faccio and Larry H P Lang, 'The Ultimate Ownership of Western European Corporations' (2001) forthcoming *Journal of Financial Economics* (copy on file with author).

21 La Porta et al, 'Law and Finance', above n 19, 1145–51. The four have been referred to collectively as 'LLSV' or 'the Gang of Four': John C Coffee, 'Privatization and Corporate Governance: Lessons from Securities Market Failure' (1999) 25 *Journal of Corporation Law* 1, 1 (fn 2).

22 La Porta, López-de-Silanes and Shleifer, above n 15, 496–7.

23 La Porta et al, 'Law and Finance', above n 19, 1126–34.

24 La Porta, López-de-Silanes and Shleifer, above n 15, 505.

25 La Porta et al, 'Law and Finance', above n 19, 1117–34.

26 John C Coffee, 'The Future as History: Prospects for Global Convergence in Corporate Governance and its Implications' (1999) 93 *Northwestern University Law Review* 641, 643–4, 647–8; Rafael La Porta et al, 'Investor Protection and Corporate Governance' (2000) 58 *Journal of Financial Economics* 3, 4, 13–15; Antoine Rebérioux, 'European Style of Corporate Governance at the Crossroads: The Role of Worker Involvement' (2002) 50 *Journal of Common Market Studies* 111, 119. For perhaps the earliest articulation of the law matters hypothesis, see the remarks of Harold Demsetz in Larry E Ribstein (ed), 'Edited Transcript of Proceedings of the Business Roundtable/Emory University Law and Economics Conference on Remedies Under the ALI Proposals: Law and Economics' (1986) 71 *Cornell Law Review* 357, 384–5.

the law matters thesis is that, in an unregulated environment, there is a real danger that a public company's 'insiders' (controlling shareholders and senior executives) will cheat outside investors who own equity. To illustrate, in the US, the legal system regulates quite closely opportunistic conduct by insiders. According to the law matters explanation, minority shareholders feel 'comfortable' in this sort of 'protective' environment.[27] Such confidence means that investors are willing to pay full value for shares made available for sale, which in turn lowers the cost of capital for firms that choose to sell equity in financial markets. Public offerings of shares can easily follow. Moreover, most controlling shareholders will be content to unwind their holdings since the law will largely preclude them from exploiting their position. The conditions therefore are well-suited for a widely dispersed pattern of share ownership.[28]

In a country where the legal system offers little protection against cheating by insiders, the law matters thesis implies that the outcome must be different.[29] Potential investors, fearing exploitation, will shy away from buying shares.[30] Insiders, being aware of such scepticism, will decide not to sell equity to the public. They will opt instead to retain the private benefits of control and rely on different sources of finance, even if they have to forego pursuing potentially profitable opportunities in so doing. The Berle-Means corporation will therefore not become dominant.

III THE POLICY IMPLICATIONS OF THE LAW MATTERS THESIS

The law matters thesis has not met with unqualified acceptance. For instance, doubts have been cast on how accurately La Porta and his co-authors measured the quality of corporate law.[31] Moreover, it has been suggested that, to the extent that minority shareholder protection and ownership dispersion are correlated, the causation may operate in the direction opposite to that implied by the law matters thesis.[32] The point here is that diffuse corporate ownership may not arise from laws protecting shareholders. Instead, matters may work the other way around. Countries where a large number of companies have dispersed share

27 The terminology is borrowed from Mark J Roe, 'Political Preconditions to Separating Ownership from Corporate Control' (2000) 53 *Stanford Law Review* 539, 586.

28 Coffee, 'The Future as History', above n 26, 647, 652, 683; La Porta et al, 'Investor Protection and Corporate Governance', above n 26, 4–6.

29 Bernard Black, 'The Core Institutions that Support Strong Securities Markets' (2000) 55 *Business Lawyer* 1565, 1565, 1572–3, 1584–6, 1606.

30 The situation might be different if anticipated returns will be excellent, notwithstanding the risk of self-dealing: Peter Martin, 'Keeping it all in the Family', *Weekend Money, Financial Times* (London), 4–5 May 1996, 1.

31 Coffee, 'The Rise of Dispersed Ownership', above n 2, 4 (fn 6), 8; Mark J Roe, 'The Quality of Corporate Law Argument and its Limits' (Working Paper No 186, Columbia Center for Law and Economics, 2001) 25–8. On other methodological quibbles, see Frank Partnoy, 'Why Markets Crash and What Law Can Do About It' (2000) 61 *University of Pittsburgh Law Review* 741, 765–7.

32 Coffee, 'The Rise of Dispersed Ownership', above n 2, 7, 22, 60, 65, 69, 80.

ownership seem likely to have an influential constituency of investors. These, in turn, should be the jurisdictions where politicians are most likely to pass laws that protect shareholders.

Despite these potential caveats, the law matters thesis offers a message that policy-makers potentially ignore at their peril: countries will struggle to develop the sort of companies which dominate the US economy unless laws that protect minority shareholders are in place.[33] Recent economic trends reinforce the importance of this point. By virtue of the prosperity which the US enjoyed throughout the 1990s, the American version of capitalism became widely admired.[34] In particular, its rich and deep securities markets were perceived as being an important source of innovation and economic dynamism.[35] The success of the US correspondingly placed policy-makers in other countries under an onus to introduce beneficial features of the American model in their own jurisdictions.[36]

The law matters thesis dovetails neatly with the proposition that a switch towards the American approach would be beneficial. Again, a key implication of the thesis is that a suitable legal regime constitutes the crucial bedrock which underpins a system of ownership and control dominated by widely held companies. Assuming that a switch to this sort of US-style economy would be beneficial, it follows that policy-makers in countries where corporate governance is organised on an 'insider/control-oriented' basis should strive to create the correct regulatory environment.[37] This implies, in turn, that legislation should be enacted that will allow investors to feel sufficiently comfortable to purchase tiny stakes in widely held companies.

The ramifications of the law matters thesis are not merely theoretical. Instead, governments around the world are currently strengthening regulation affecting outside investors in order to bolster equity markets.[38] For instance, tentative steps are currently being taken to improve the legal protection available to minority shareholders in countries such as Germany,[39] Italy,[40] Japan[41] and Brazil[42] and stock market reform has been launched with the same goal in East

33 See Cheffins, 'Law as Bedrock', above n 3, 8–9.

34 La Porta et al, 'Investor Protection and Corporate Governance', above n 26, 18; 'The Rise and the Fall', *Survey: Global Equity Markets, The Economist* (London), 5 May 2001, 35–6.

35 Roe, 'Political Preconditions', above n 27, 542.

36 Hansmann and Kraakman, above n 2, 450–5.

37 On the 'insider/control-oriented' terminology, see Cheffins, 'Current Trends in Corporate Governance', above n 9, 32.

38 Henrik Cronqvist and Mattias Nilsson, 'Agency Costs of Controlling Shareholders' (Working Paper No 364, SSE/EFI Working Paper Series in Economics and Finance, 2001) 2.

39 See, eg, Uwe Seibert, 'Control and Transparency in Business (KonTraG): Corporate Governance Reform in Germany' (1999) 10 *European Business Law Review* 70.

40 See, eg, Gian Bruni, 'The New Consolidated Act on Companies Listed on the Italian Stock Exchange' (1998) 13 *Butterworths Journal of International Banking & Financial Law* 416.

41 See, eg, Alexandra Harney, 'Cracks Widen in Japan's Commercial Code,' *Financial Times* (London), 17 August 2000, 25.

42 See, eg, John Welch, 'Making Investment in Brazil Fair for the Little Guy', *Wall Street Journal*, 22 September 2000, A23.

Asia.[43] At the same time, leading academics who subscribe to the law matters thesis have been making the case for law reform to policy-makers in various countries that currently have weak securities markets.[44]

Since the thesis that dispersed share ownership is contingent upon laws protecting minority shareholders has powerful contemporary resonance, it is worthwhile considering its persuasiveness. One point that needs to be made is that strong corporate law is probably not a *necessary* condition for a corporate economy dominated by widely held companies. This is because substitutes, such as stock market listing rules and 'quality control' carried out by financial intermediaries, can provide investors with sufficient confidence to purchase tiny stakes in publicly quoted companies. Historical developments in the United Kingdom, which has a corporate economy dominated by widely held corporations, illustrate the point.[45]

Even if diffuse share ownership can become the norm in large business enterprises without strong legal protection for outside investors, the fact that law reform is being carried out with the intention of building strong equity markets leads one to wonder whether 'good' corporate law is a *sufficient* condition for the development of a corporate economy resembling the US model.[46] In other words, if a country's legal system closely regulates opportunistic conduct by insiders, will diffuse share ownership follow in due course? The law matters thesis, since it has been characterised largely in terms of substantive corporate law,[47] implies it might. The situation, however, is more complex since there are other variables at work.[48]

One such variable is the size of a country's economy. All else being equal, large companies are more likely to have dispersed ownership than small firms.[49] Also, bigger nations are more likely to have sizeable business enterprises than

43 Joe Leahy, 'Sharper Claws for Asia's Investors', *Financial Times* (London), 6 May 2002, 9.

44 See, eg, Bernard S Black, 'Strengthening Brazil's Securities Markets' (Working Paper No 205, John M Olin Program in Law and Economics, Stanford Law School, 2000); Financial and Corporate Restructuring Assistance Project, 'Corporate Governance in Korea at the Millennium: Enhancing International Competitiveness — Final Report and Legal Reform Recommendations to the Ministry of Justice of the Republic of Korea 15 May 2000 (with an Introduction to the Report by Bernard Black)' (2001) 26 *Journal of Corporation Law* 537; Faculty profile for Florencio López-de-Silanes, Yale School of Management <http://www.mba.yale.edu/faculty/professors/lopez.htm> at 30 August 2002, indicating that he has acted as an adviser to Russia, Peru, Malaysia, Egypt, Yemen, Colombia, Costa Rica and Mexico on corporate law and the regulation of financial markets.

45 Brian R Cheffins, 'Does Law Matter? The Separation of Ownership and Control in the United Kingdom' (2001) 30 *Journal of Legal Studies* 459, 472–6, 479–82.

46 See also Black, 'Strengthening Brazil's Securities Markets', above n 44, 2.

47 Roe, 'Political Preconditions', above n 27, 585; John C Coffee, 'Do Norms Matter? A Cross-Country Evaluation' (2001) 149 *University of Pennsylvania Law Review* 2151, 2154–5.

48 Black, 'Core Institutions', above n 29, 1565–6.

49 Benjamin Klein, 'Contracting Costs and Residual Claims: The Separation of Ownership and Control' (1983) 26 *Journal of Law and Economics* 367, 371; Jeffrey G MacIntosh and Lawrence P Schwartz, 'Do Institutional and Controlling Shareholders Increase Corporate Value?' in Ronald J Daniels and Randall Morck (eds), *Corporate Decision-Making in Canada* (1995) 303, 305. For empirical support for the proposition that corporate size affects ownership patterns see Claessens, Djankov and Lang, above n 20, 105–7; Steen Thomsen and Torben Pedersen, 'Industry and Ownership Structure' (1998) 18 *International Review of Law and Economics* 385, 389, 399.

their junior counterparts. It follows that there are limits on the extent to which share ownership dispersion will take place in small countries.[50]

Supporting institutions may also play a significant role.[51] This is because strong equity markets can be thought of as being 'almost magical'.[52] To elaborate:

> Investors pay enormous amounts of money for completely intangible rights, whose value depends entirely on the quality of information that the investors receive and on the honesty of other people, about whom the investors know almost nothing.[53]

Which institutions need to be in place to supplement good corporate laws? The legal system probably needs to provide appropriate backing for the legislation governing companies. For instance, 'surface' legal reforms that create protection for investors 'on the books' seem unlikely to make much difference if enforcement by regulators is lax.[54] The effect is likely to be the same if judges are corrupt, the courts have insufficient resources to process claims in a timely fashion or the judiciary lacks sufficient expertise to understand complex self-dealing transactions.[55] Moving beyond the legal system, it will be probably be helpful if there is an active financial press that can uncover and publicise instances of self-dealing.[56] Moreover, there might well need to be a culture of disclosure and a norm of honest dealing among corporate insiders, financial advisers, accountants and lawyers.[57]

Let us take it for granted that suitable supporting institutions are in place together with 'good' corporate law. The question posed earlier can now be asked in a somewhat different form: is the existence of this package a sufficient

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50 Lucian A Bebchuk and Mark J Roe, 'A Theory of Path Dependence in Corporate Ownership and Governance' (1999) 52 *Stanford Law Review* 127, 168; Mark J Roe, 'Rents and Their Corporate Consequences' (2001) 53 *Stanford Law Review* 1463, 1481; Brian Cheffins, 'Comparative Corporate Governance and the Australian Experience' in Ian Ramsay (ed), *Key Developments in Corporate Law and Trusts Law: Essays in Honour of Professor Harold Ford* (2002) 13, 31. For empirical data indicating that larger economies have lower ownership concentration, see La Porta et al, 'Law and Finance', above n 19, 1150.

51 Black, 'Strengthening Brazil's Securities Markets', above n 44, 1–2; Stephen J Choi, 'Law, Finance and Path Dependence: Developing Strong Securities Markets' (2002) 80 *University of Texas Law Review* 1657, 1694.

52 Black, 'Core Institutions', above n 29, 1565.

53 Ibid.

54 Ibid 1577, 1607; Choi, above n 51, 1695–7.

55 Black, 'Core Institutions', above n 29, 1589; Cheffins, 'Does Law Matter?', above n 45, 15; Bebchuk and Roe, above n 50, 155; Tatiana Nenova, 'The Value of Corporate Votes and Control Benefits: A Cross-Country Analysis' (2000) forthcoming *Journal of Financial Economics* (copy on file with author) 26–7, 36, 38–9, (finding that a substantial fraction of the private benefits of control blockholders enjoy can be attributed to the quality of law enforcement). A further refinement on this point would be that outside investors benefit from a judiciary that has the discretion, and will take the initiative, to deal firmly with investor expropriation. It may be that common law judges are better positioned to act in this fashion than their civil law counterparts: La Porta et al, 'Investor Protection and Corporate Governance', above n 26, 9, 12.

56 Black, 'Core Institutions', above n 29, 1590; Alexander Dyck and Luigi Zingales, 'Private Benefits of Control: An International Comparison' (Working Paper No 535, Centre for Research in Security Prices, University of Chicago Graduate School of Business, 2001) 4, 29–30, 33.

57 Black, 'Core Institutions', above n 29, 1590–1; Black, 'Strengthening Brazil's Securities Markets', above n 44, 1; Dyck and Zingales, above n 56, 3–4, 30–1, 33–4.

condition for the development of a corporate economy resembling the US model? In other words, if a country has corporate laws and related structures that permit outside investors to feel comfortable about purchasing tiny stakes in publicly quoted companies, will the Berle-Means corporation necessarily dominate? The discussion which follows suggests the answer is no. This is because an additional pivotal variable seems to be part of the equation. This is that the Berle-Means corporation needs to offer intrinsic economic advantages that will drive it to the forefront in a market economy.

IV THE DARWINIAN UNDERCURRENT OF THE LAW MATTERS THESIS

As we have seen, the conventional wisdom has been that the American version of the public corporation was the logical winner of a Darwinian struggle between different forms of corporate structure.[58] This, in turn, implied that the Berle-Means corporation was destined, in the fullness of time, to attain dominant status on a worldwide basis. The empirical work done by La Porta, López-de-Silanes and Shleifer and others undertaking similar studies cast doubt on this assumption. The data demonstrated that companies with widely held shares had not moved to the forefront. Instead, they were very much the exception in the vast majority of industrialised countries.

An inference that might have been drawn from the empirical research on share ownership patterns was that the Berle-Means corporation failed to become dominant because it does not offer the intrinsic economic advantages traditionally associated with it. However, La Porta, López-de-Silanes, Shleifer and others advancing the law matters thesis have tended not to focus on this possibility.[59] Instead, they have gone in a different direction. For them, corporate law constitutes the crucial variable, albeit with some recognition of the contribution made by suitable supporting institutions.[60] Essentially, the prevailing view in the law matters camp is that diffuse share ownership has not become the norm throughout the industrialised world because outside investors do not have the rights required for them to feel confident about purchasing tiny stakes in publicly quoted companies.

If law (and supporting institutions) constitute the pivotal variable the law matters camp says it does, the failure of the Berle-Means corporation to become dominant around the world can be readily accounted for. This type of business enterprise might well be the pinnacle of economic development. Nevertheless, strong corporate law must be in place before there can be any sort of fair contest between it and alternate corporate structures. Then, but only then, will market forces dictate the result. Assuming that the Berle-Means corporation offers

58 Above nn 11–14 and accompanying text.

59 The competitive fitness of the Berle-Means corporation has not been ignored entirely, however, by those who stressing the importance of corporate law. See, eg, Coffee, 'The Future as History', above n 26, 661–3.

60 On recognition of the role of supporting institutions, see, eg, Dyck and Zingales, above n 56, 3–5, 33–5.

inherent economic advantages, it will move to its appointed place at the forefront of the corporate economy.

Is this sort of Darwinian account a point of view to which law matters advocates subscribe? Leading proponents such as La Porta, López-de-Silanes, Shleifer and Vishny admittedly have not said a great deal about this point in their work. Still, this team of economists has observed that 'the shortcomings of investor protection ... appear to have adverse consequences for financial development and growth'.[61] This implies that countries which fail to protect outside investors are foreclosing the possibility of a move towards a corporate economy likely to deliver superior results, namely one dominated by firms with diffuse ownership structures.

Shleifer and Vishny, in a survey of corporate governance published in 1997, echoed much the same sentiments. They conceded that concentrated ownership may make sense under some circumstances. They implied, though, that legal protection for investors needs to be in place for a national economy to achieve its potential. Inadequate law, according to Shleifer and Vishny, will mean that a country will be 'stuck with family and insider-dominated firms receiving little external financing'.[62]

In a subsequent paper written with Mike Burkart and Fausto Panunzi, Shleifer articulated the Darwinian theme much more forcefully.[63] These authors sought to explain why large family-owned firms are an enduring phenomenon around the world and said that the answer is poor legal protection for outside investors. In so doing, they explicitly addressed the competitive fitness of the Berle-Means corporation. Burkart, Panunzi and Shleifer outlined an econometric model designed to demonstrate that 'when legal protection of outside investors is very good ... the best arrangement is a widely held professionally-managed firm'.[64] This model, they asserted, is 'consistent with the growing body of evidence that family management is generally inferior to professional management'.[65] They elaborated by saying that

> The separation of ownership and control is ... an indication of a superior corporate governance environment. The lack of such separation, and the prevalence of family firms, are evidence of financial underdevelopment.[66]

The subtext here is strongly Darwinian. Essentially, the message for countries that currently offer poor legal protection to outside investors is that their misguided policies have allowed inefficient family firms to remain pre-eminent. Serious adverse consequences necessarily follow. A nation's economy arguably

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61 La Porta et al, 'Law and Finance', above n 19, 1152. See also La Porta et al, 'Investor Protection and Corporate Governance', above n 26, 16–17.

62 Shleifer and Vishny, above n 16, 774.

63 Mike Burkart, Fausto Panunzi and Andrei Shleifer, 'Family Firms' (Discussion Paper No 1944, Harvard Institute for Economic Research, Harvard University, 2002).

64 Ibid 5.

65 Ibid 6.

66 Ibid 37. It is somewhat ironic that Shleifer has argued this position because in earlier work he contended that large shareholders can bring about value-increasing changes in corporate policy: Andrei Shleifer and Robert W Vishny, 'Large Shareholders and Corporate Control' (1986) 94 *Journal of Political Economy* 461.

depends on the drive and efficiency of its companies.[67] Hence, if a country's leading firms are performing at a sub-optimal level, presumably its overall economic performance will suffer. Policy-makers correspondingly are under an onus to respond.[68] With respect to the Darwinian version of the law matters thesis, this means that efforts should be made to foster a milieu where outside investors will feel comfortable about buying corporate equity. This is because market forces can then duly sideline inefficient family firms and end debilitating financial underdevelopment.

V THE COMPETITIVE ADVANTAGES ASSOCIATED WITH A SEPARATION OF OWNERSHIP AND CONTROL

The proposition that 'the best arrangement is a widely held professionally-managed firm'[69] cannot be accepted at face value. Instead, it must be recognised that the Berle-Means corporation has drawbacks and that alternate forms of business enterprise can possess compensating advantages.[70] The result might be that there is no meaningful correlation between ownership structure and corporate performance.[71] Alternatively, the Berle-Means corporation may have inherent advantages in some settings but constitute an inappropriate structure in others.[72]

We will see shortly why it cannot be taken for granted that the widely held professionally managed firm will yield superior economic outcomes. Still, before considering these factors, there needs to be due recognition of the advantages the Berle-Means corporation does offer. This section addresses the point.

As mentioned, a separation of ownership and control in large business enterprises can be beneficial because funding will be easier to secure.[73] The edge which the Berle-Means corporation has in this respect, however, is not simply access to large amounts of capital. Instead, there is also a climate conducive to risk-taking.[74] In a company where there is dispersed share ownership, most shareholders will have only a small percentage of their personal wealth tied up in the company. By virtue of this pattern of diversification, investors will expect management to undertake projects that could threaten the firm's viability if

67 Martin Lipton and Steven A Rosenblum, 'A New System of Corporate Governance: The Quinquennial Election of Directors' (1991) 58 *University of Chicago Law Review* 187, 192; Brian R Cheffins, 'Trust, Loyalty and Cooperation in the Business Community: Is Regulation Required?' in Barry Rider (ed), *The Realm of Company Law: A Collection of Papers in Honour of Professor Leonard Sealy* (1998) 53, 61–2. *Contra* Mark J Roe, 'Some Differences in Corporate Structure in Germany, Japan, and the United States' (1993) 102 *Yale Law Journal* 1927, 1977.

68 Bebchuk and Roe, above n 50, 134–5.

69 Burkart, Panunzi and Shleifer, above n 63, 5.

70 See below Part VI.

71 See below nn 140, 176–87 and accompanying text.

72 See below nn 163, 172–5 and accompanying text.

73 See above n 13 and accompanying text.

74 Eugene F Fama and Michael C Jensen, 'Separation of Ownership and Control' (1983) 26 *Journal of Law and Economics* 301, 306.

things go awry but are worth exploiting on a risk-adjusted basis because of potentially spectacular returns. Since maintaining a control block will force the largest shareholder to be poorly diversified, the thinking is likely to be different in a firm with a concentrated ownership structure.[75] The primary blockholder, by virtue of having most everything tied up in one company, will fear financial ruin and thus will tend to discourage the pursuit of risky but potentially lucrative business opportunities. There will be, in other words, a powerful incentive to 'preserve wealth rather than create it'.[76]

The benefits associated with the widely held company are not merely a manifestation of diffuse share ownership. Instead, handing managerial power to professional executives is also a potential source of strength.[77] Again, in a Berle-Means corporation executives can be hired purely on merit.[78] This, in turn, can foster a sensible division of labour. Those who purchase tiny holdings in a publicly quoted company are unlikely to have the time, inclination or expertise required to contribute positively to managerial decision-making. In contrast, the individuals hired as senior managers should have the aptitude and experience necessary to be effective corporate decision-makers. Also, they should have ample opportunity to become familiar with the operations of the company on behalf of which they act.

The evolution of corporate structures in the UK arguably illustrates the advantages associated with developing managerially-oriented hierarchies within companies.[79] Currently, as is the case in the US, there is typically a separation of ownership and control in large UK companies.[80] Still, in comparison with the US, there was a 'corporate lag'.[81] While America's 'corporate revolution' was concluding by 1930,[82] the Berle-Means corporation was probably not firmly entrenched in Britain until the 1970s or 1980s.[83]

According to Alfred Chandler, a noted business historian, postponement of adoption of the US version of managerial capitalism had drastic consequences for the UK.[84] He argued that Britain's industrial companies were laggards plagued by amateurish family leadership that paid the price by falling behind competitors in the US, Germany and ultimately other major industrialised

75 Dyck and Zingales, above n 56, 7.

76 'In the Family's Way', *The Economist* (London), 15 December 2001, 75. A related response might be to diversify within the business empire: see below n 126 and accompanying text.

77 Cheffins, 'Current Trends in Corporate Governance', above n 9, 14; Fama and Jensen, above n 74, 309; Robert C Clark, *Corporate Law* (1986) 23–4; John E Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (1993) 51.

78 See above n 14 and accompanying text.

79 For additional background, see Brian R Cheffins, 'History and the Global Corporate Governance Revolution: The UK Perspective' (2001) 43 *Business History* 87, 90–2.

80 Cheffins, 'Does Law Matter?', above n 45, 465.

81 Cheffins, 'History and the Global Corporate Governance Revolution', above n 79, 90.

82 See above nn 5–7 and accompanying text.

83 Cheffins, 'History and the Global Corporate Governance Revolution', above n 79, 89–90.

84 He has set out his thesis most forcefully in Chandler, *Scale and Scope,* above n 7, 291–4, 389–92. See also Chandler, 'The Emergence of Managerial Capitalism', above n 5, 495–8. Others have argued along similar lines. See, eg, William Lazonick, *Business Organisation and the Myth of the Market Economy* (1991) 45–9.

countries. Britain, in turn, suffered since its economic performance was chronically poor compared to its national rivals throughout much of the 20th century. Hence, while the Berle-Means corporation ultimately did become dominant in the UK, delay meant that market forces imposed a harsh and inevitable penalty.

While delegation of decision-making to an inner circle of professional managers is sensible, the arrangement has drawbacks.[85] Assuming that the executives who work for a widely held company own only a small percentage of the equity, they will receive only a tiny fraction of the returns derived from the profit-enhancing activities they engage in on behalf of shareholders. Those in charge therefore may be tempted to use their control over corporate assets to further their own interests at the expense of those who own equity. To the extent that top managers pursue their own agenda, they impose what economists refer to as 'agency costs' on these investors.[86]

Still, while there is an agency cost problem in widely held companies, it is not an inherently debilitating handicap. This is because various disciplining mechanisms serve to constrain self-serving managerial behaviour.[87] One is the labour market for executives (senior managers want to run companies well to impress potential alternative employers). Another is the market for a company's products or services (executives will lose their jobs if a decline in market share is sufficiently precipitous to cause the company to fail). Also significant is the capital market (companies which want to raise money receive less advantageous terms if there is evidence of mismanagement). Moreover, there is the threat of a hostile takeover bid, which occurs when a bidder makes an offer to the shareholders of a target company to buy their equity with a view to installing new executives. Hostile takeovers are a natural consequence of the dispersed ownership structure associated with the Berle-Means corporation: a bidder can acquire control by purchasing shares on the open market rather than by negotiating with a dominant shareholder.[88]

In the US, hostile takeovers were primarily a 1980s phenomenon. Merger and acquisition activity continued thereafter (sometimes at a frantic pace) but the vast majority of bids were nominally 'friendly'.[89] The new trend potentially could have increased the scope for managerial slack but it is doubtful whether this occurred. Instead, corporate governance adapted. This was because 'equilibrating devices' — agents of adaptive efficiency that force corporations to

85 Cheffins, 'Current Trends in Corporate Governance', above n 9, 14–15.

86 The leading work on agency costs is Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305.

87 See Helen Short, 'Ownership, Control, Financial Structure and the Performance of Firms' (1994) 8 *Journal of Economic Surveys* 203, 204–5; Brian R Cheffins, *Company Law: Theory, Structure and Operation* (1997) 117–19.

88 Geof Stapledon, *Institutional Shareholders and Corporate Governance* (1996) 228.

89 Marcel Kahan and Edward B Rock, 'How I Learned to Stop Worrying and Love the Pill: Takeover Law and Adaptive Behavior' (2002) 69 *University of Chicago Law Review* 871, 880–1.

respond to a change in the underlying economic environment[90] — served to keep executives largely focused on shareholder value.[91] For instance, corporate boards engaged in tighter monitoring of management as the influence of 'outside' directors increased.[92] Also, executive compensation was 'incentivized' dramatically as companies made much greater use of stock options and other forms of remuneration that were only supposed to yield benefits for executives if adequate returns were being delivered to shareholders.[93]

VI CONCENTRATED OWNERSHIP AND THE CASE AGAINST THE BERLE-MEANS CORPORATION

For the purposes of this paper, the elements of a Darwinian version of the law matters thesis are now in place. Essentially, the US-style public corporation derives powerful advantages through its ability to agglomerate capital and to exploit the benefits of specialisation of management and risk bearing. Still, 'it is a fragile contraption'[94] that can only achieve dominance when the law provides outside investors with sufficient legal protection to be confident about purchasing tiny stakes in large companies. Correspondingly, if a country fails to offer laws that make minority shareholders feel 'comfortable', it will be denied the economic benefits that the Berle-Means corporation can deliver. The point we take up here is the alleged competitive superiority of the widely held company. As we will see now, even if shareholders feel comfortable about owning tiny percentages of equity in publicly traded companies, this type of business enterprise may not possess inherent advantages that will guarantee dominance in a corporate economy.

To understand why a combination of dispersed ownership and managerial hierarchies is not necessarily the recipe for corporate success, the agency cost issue requires revisiting. Various market instruments do serve to deter self-serving managerial conduct in widely held public companies. They do not, however, entirely eliminate the problem. Instead, those in charge retain some scope to pursue their own agenda at the expense of shareholders.[95] Events at

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90 Ronald J Gilson, 'Corporate Governance and Economic Efficiency: When Do Institutions Matter?' (1996) 74 *Washington University Law Quarterly* 327, 336.

91 Kahan and Rock, above n 89, 881–4; Bengt Holmstrom and Steven N Kaplan, 'Corporate Governance and Merger Activity in the US: Making Sense of the 1980s and 1990s' (Working Paper No 01–11, MIT Department of Economics Working Paper Series, 2001) 15–22. See also John Plender, 'How the Mighty are Ambushed and Humbled', *Financial Times* (London), 13 May 2002, 26 (identifying aspects of a similar process in the UK).

92 Kahan and Rock, above n 89, 881–4; Holmstrom and Kaplan, above n 91, 19. For background on the monitoring role the board of directors can play, see Cheffins, *Company Law*, above n 87, 605–8.

93 Kahan and Rock, above n 89, 884; Holmstrom and Kaplan, above n 91, 16. On the role which executive pay can play in addressing agency costs, see Cheffins, *Company Law*, above n 87, 113, 678.

94 Roe, 'Political Preconditions', above n 27, 600.

95 Cheffins, 'Current Trends in Corporate Governance', above n 9, 16.

scandal-ridden US energy giant Enron illustrate the point.[96] As late as 2001, the firm was being praised for its overall corporate governance structure. By 2002, amid allegations of corporate greed and personal hubris, Enron became one of the largest ever bankruptcy filings.

Whereas the agency cost problem is, to some degree, endemic in a widely held firm, managerial fidelity is much less likely to pose a problem in companies where control ultimately rests in the hands of one party or a closely allied set of investors (eg, a family).[97] This is because large blockholders will tend to be better monitors than dispersed shareholders.[98] To elaborate, controlling shareholders are likely to have a financial stake which is large enough to motivate them to keep a careful watch on what is going on.[99] As well, these 'core' investors should have sufficient influence to gain access to high quality information concerning firm performance and to orchestrate the removal of disloyal or ineffective managers if things are going awry.[100]

An important related point is that the benefits associated with superior monitoring can potentially accrue without a large sacrifice in terms of managerial sophistication. With the Berle-Means corporation, an implicit assumption typically is that the benefits to be derived from reliance on professionally trained executives are integrally related to diffuse shareholdings. This, however, does not have to be the case.[101] Take the example of a family-owned company which has grown substantially as a result of success over a period of decades. With this sort of business, the day-to-day operations of the

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96 Andrew Cassel, 'Will Our Agents Serve Us?', *Philadelphia Inquirer* (Philadelphia), 22 February 2002, in Westlaw ALLNEWS database, 2002 WL 14964709; Karel Williams, 'Time to Curb Excesses of Power Elite', *Guardian* (UK), 25 February 2002, 21; Joann S Lublin, 'Boards Seek Advice to Avoid Their Own Enron-Style Mess', *Wall Street Journal*, 23 April 2002, B1. For a similar outcome in the UK, see Patience Wheatcroft, 'Pointing the Finger of Blame at Marconi', *Times* (London), 6 September 2001, 25 (discussing Marconi plc, a beleaguered telecoms equipment maker).

97 Cheffins, 'Current Trends in Corporate Governance', above n 9, 33.

98 Coffee, 'The Future as History', above n 26, 661; Allen Sykes, *Corporate Takeovers — The Need for Fundamental Rethinking* (1990) 12–13. Cf Ronald J Daniels and Paul Halpern, 'Too Close for Comfort: The Role of the Closely Held Public Corporation in the Canadian Economy and the Implications for Public Policy' (1995–96) 26 *Canadian Business Law Journal* 11, 19–20; Klaus Gugler, 'Direct Monitoring and Profitability: Are Large Shareholders Beneficial?' in Klaus Gugler (ed), *Corporate Governance and Economic Performance* (2001) 12, 12. But see Robert A Pollak, 'A Transaction Cost Approach to Families and Households' (1985) 23 *Journal of Economic Literature* 581, 587 (noting that monitoring will be attenuated when an executive is a family member); 'Under the Influence', *The Economist* (London), 17 November 2001, 79, 80 (saying '[i]t is a myth to assume that [a family blockholder] understands the business better than outside managers, especially as generations pass and the business changes').

99 Shleifer and Vishny, above n 16, 739, 754; Coffee, 'The Future as History', above n 26, 661–2; Ronald Daniels and Jeffrey MacIntosh, 'Toward a Distinctive Corporate Law Regime' (1991) 29 *Osgoode Hall Law Journal* 863, 884.

100 Daniels and MacIntosh, above n 99, 884–5; William W Bratton and Joseph A McCahery, 'Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference' (1999) 38 *Columbia Journal of Transnational Law* 213, 226; Sanford M Jacoby, 'Corporate Governance in Comparative Perspective: Prospects for Convergence' (2001) forthcoming *Comparative Labor Law & Policy Journal* (copy on file with author) 20.

101 Cheffins, 'History and the Global Corporate Governance Revolution', above n 79, 93. See also Jeffrey R Fear, 'Constructing Big Business: The Cultural Concept of the Firm' in Alfred Chandler, Franco Amatori and Takashi Hikino (eds), *Big Business and the Wealth of Nations* (1997) 546, 558–9.

company may ultimately become too complex for the head of the family to master everything. Also, as control passes from generation to generation, the heirs may not have the talent, dedication or inclination to take on a leadership role. Under these circumstances, a potentially successful strategy for the family will be to delegate managerial prerogatives to professionally trained senior executives.[102] These individuals can then make key decisions concerning production, distribution and the long-term allocation of resources.

The experience in continental Europe lends credence to the proposition that large blockholders can fit together with managerial hierarchies. According to Chandler, in the early decades of the 20th century, organisational sophistication within German companies gave the country a powerful competitive advantage and helped to ensure that the country swiftly surpassed Britain to become Europe's leading industrial nation.[103] The Berle-Means corporation had, however, little role in the process. Instead, then, as now, family control was a pivotal feature of German capitalism.[104] What, then, was the key advantage Germany had as compared with the UK? Chandler said it was that family owners in major German companies were much more willing to countenance the establishment of managerial hierarchies and to delegate decision-making prerogatives to senior executives.[105] Managerial sophistication correspondingly went hand in hand with concentrated ownership, with beneficial economic results.

The same story, it seems, can be told about contemporary Europe. According to a study of the large industrial corporation in Germany, France and Britain published in 2000, '[f]or strategy and structure, ownership does not matter'.[106] This is because in Germany and France '[f]amilies and entrepreneurs have learnt to love the diversified, divisionalized firm, putting aside any fears about control and overcoming inadequacies in managerial professionalism'.[107]

In addition to offering a potential edge with respect to monitoring, the presence of a blockholder such as a family can yield other competitive advantages. These stem primarily from continuity and a long-term orientation. Coming to terms with circumstances in the US and the UK helps to put matters in context. Allegedly, a drawback with the 'outsider/arm's-length' capitalism that prevails in the two countries is an unhealthy orientation towards counterproductive short-term thinking.[108] Financial institutions, which

102 BDO Stoy Hayward, 'Family Firms Opt for Outsiders' (Press Release, 1 October 2001), <http://www.bdo.co.uk/www/webcont.nsf> at 30 August 2002.

103 Chandler, *Scale and Scope,* above n 7, 393–4, 591–2.

104 Cheffins, 'History and the Global Corporate Governance Revolution', above n 79, 93.

105 Chandler, *Scale and Scope,* above n 7, 591; Alfred D Chandler, 'Response to the Contributors to the Review Colloquium on *Scale and Scope*' (1990) 64 *Business History Review* 736, 747.

106 Richard Whittington and Michael Meyer, *The European Corporation: Strategy, Structure, and Social Science* (2000) 213.

107 Ibid 212–13. The same process may be underway in East Asia and Turkey: 'The End of Tycoons', *The Economist* (London), 29 April 2000, 93; Leyla Boulton, 'Business Empires Face Change or Decline', *Financial Times* (London), 16 August 2000, 12.

108 Lipton and Rosenblum, above n 67, 202–18; Allen Sykes, 'Proposals for Internationally Competitive Corporate Governance in Britain and America' (1994) 2 *Corporate Governance: An International Review* 187, 188; Will Hutton, *The State to Come* (1997) 41–8.

collectively own much of the equity in American and British publicly quoted companies, have been identified as the primary source of this bias.[109] Fund managers who make investment decisions on behalf of these institutions allegedly worry greatly about annual and even quarterly performance targets.[110] Corporate executives, nervous about such potential impatience, reputedly react by making it their highest priority to produce better financial results in the present, even at the cost of sacrificing higher profits in the future.[111] Correspondingly, in order to deliver financial results that will be acceptable to the market, widely held corporations will under-invest in research and development, human capital, product development and supplier and distribution networks.[112]

As compared with a Berle-Means corporation afflicted with a myopic short-term bias, a company with a blockholder such as a family stands to benefit from having a different time horizon.[113] When a family is involved with a company, members are likely to see themselves as guardians of the firm's reputation and will worry about planning for the organisation to extend to the next generation.[114] This sense of family responsibility arguably means that business can be conducted on a more imaginative and instinctive basis than is possible in a widely held corporation where management is continually beholden to the 'bottom line'.[115] At the same time, a corporation with a distinct family aspect might be more willing to invest in and persevere with projects that do not

109 In the United States, institutional shareholders own approximately 50 per cent of the shares of the country's publicly quoted companies: Brian R Cheffins, 'Michaud v National Bank of Canada and Canadian Corporate Governance: A "Victory" for Shareholder Rights' (1998) 30 *Canadian Business Law Journal* 20, 52. In the UK, the equivalent figure is 70 per cent or more: Sir Ronald Hampel (Chair), *Report of the Committee on Corporate Governance* (1998) ¶ 5.1.

110 Lipton and Rosenblum, above n 67, 205–11; Michael E Porter, 'Capital Disadvantage: America's Failing Capital Investment System' (1992) 70(5) *Harvard Business Review* 65, 69–70; Ajit Singh, 'The Anglo-Saxon Market for Corporate Control,' in Candace Howes and Ajit Singh (eds), *Competitiveness Matters: Industry and Economic Performance in the US* (2000) 89, 93.

111 Sykes, *Corporate Takeovers,* above n 98, 17–18; Hutton, above n 108, 46–7; Michel Albert, *Capitalism vs. Capitalism: How America's Obsession with Individual Achievement and Short-Term Profit Has Led It to the Brink of Collapse* (Paul Haviland trans, 1993) 73.

112 Roe, *Strong Managers, Weak Owners,* above n 11, 13; Hutton, above n 108, 31, 44; Albert, above n 111, 73, 76–7.

113 Bratton and McCahery, above n 100, 226; Wayne Broehl, 'The Family Business' (1989) 18 *Business and Economic History* (2d series) 1, 5; Michael Skapinker, 'Why a Lasting Legacy is a Rare Achievement', *Financial Times* (London), 14 August 2001, 10.

114 See 'Under the Influence', above n 98; Mark Casson, 'The Economics of the Family Firm' (1999) 47 *Scandinavian Economic History Review* 10, 17; James Doran, 'Brands That Bolster the Family's Fortunes', *Times* (London), 8 July 2000, 27; Paul Betts, 'Family Companies are Ready for the Worst', *Financial Times* (London), 30 October 2001, 18.

115 Peter Dobkin Hall, 'A Historical Overview of Family Firms in the United States' (1988) 1 *Family Business Review* 51, 66; Peter Martin, 'An Adventure in Full Sail', *Financial Times* (US edition), 21 March 1996, 10; Paul Nesbitt, 'Family Business', *Accountancy*, 25 May 2001, 30, 31.

generate clearly measurable financial returns in the early stages.[116] Also, by virtue of continuity, those in charge should be well-positioned to develop strong personal relationships with key 'stakeholders' such as loyal employees, leading customers and valued suppliers. Corporate 'architecture' of this character can yield powerful competitive advantages that widely held corporations will find difficult to mimic.[117]

The foregoing should not be construed as any sort of unqualified endorsement of blockholder governance. For instance, to the extent that companies with dominant shareholders are insulated from stock market pressures, this may not be a good thing. While share prices may not constitute a fully reliable barometer of corporate performance, the fact that unbiased individuals are 'putting their money where their mouths are' provides the vital virtue of integrity.[118] Moreover, it cannot be taken for granted that financial markets impose an unhealthy short-term bias on American and British companies. Fund managers do take into account a variety of factors which are relevant over the longer term when they decide to buy and sell shares, such as the quality of management and the introduction of new product lines.[119] Also, at least in the US, empirical research suggests that share prices do not generally exhibit myopic behaviour, in the sense of overvaluing short-term earnings and undervaluing long-term earnings.[120] Moreover, contrary to what sceptics suggest, there is a positive correlation between strong equity markets and research and development expenditures.[121]

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116 Porter, above n 110, 73–4; Cally Jordan, 'Family Resemblances: The Family Controlled Company in Asia and its Implications for Law Reform' (1997) 8 *Australian Journal of Corporate Law* 89, 94. But see Clifford G Holderness and Dennis P Sheehan, 'The Role of Majority Shareholders in Publicly Held Corporations: An Exploratory Analysis' (1988) 20 *Journal of Financial Economics* 317, 339–40; Randall K Morck, David A Stangeland and Bernard Yeung, 'Inherited Wealth, Corporate Control, and Economic Growth: The Canadian Disease' in Randall K Morck (ed), *Concentrated Corporate Ownership* (2000) 319, 342–5.

117 Roe, 'Rents and Their Corporate Consequences', above n 50, 1475; Youssef Cassis, *Big Business: The European Experience in the Twentieth Century* (1997) 168; Erik Lehmann and Jürgen Weigand, 'Does the Governed Corporation Perform Better? Governance Structures and Corporate Performance in Germany' (2000) 4 *European Finance Review* 157, 162; Matthew Lynn, 'The End of the Family Business', *Sunday Business* (London), 21 May 2000, 5.

118 Cheffins, *Company Law,* above n 87, 57; Holmstrom and Kaplan, above n 91, 25; Bratton and McCahery, above n 100, 224. See also 'America's Fantastic Factories', *The Economist* (New York), 8 June 1996, 19, 20 (saying that 'in a system where managers are forced to go hat-in-hand to the markets for each investment buck, money flows to projects that offer the best possible returns').

119 Cheffins, *Company Law,* above n 87, 52; CBI City/Industry Task Force, *Investing for Britain's Future* (1987) 20. Cf Amar Bhide, 'Efficient Markets, Deficient Governance' 72(6) *Harvard Business Review* 129, 135–6 (arguing that the stock market does take into account how matters will develop over time but maintaining that executives face perverse incentives because investors are fickle).

120 Jeffrey Abarbanell and Victor Bernard, 'Is the US Stock Market Myopic?' (2000) 38 *Journal of Accounting Research* 221.

121 Maria Maher and Thomas Andersson, 'Corporate Governance: Effects on Firm Performance and Economic Growth' (2000) in Luc Renneboog et al (eds), *Convergence and Diversity of Corporate Governance Regimes and Capital Markets* (forthcoming, copy on file with author) 28.

Another point to bear in mind when assessing the impact of controlling shareholders is that they might, perhaps in collusion with management,[122] arrange to cheat others who own equity.[123] One way for a dominant blockholder to engage in this sort of private rent-seeking is to arrange to purchase additional shares on favourable terms not otherwise made available.[124] Another possibility is that the dominant faction will shift corporate value by orchestrating transfers between related companies that skim profits from a publicly quoted firm in favour of privately owned ones.[125]

Even if a company's dominant shareholder acts honestly, the manner in which business is conducted can be detrimental for others associated with the firm. For instance, fears a blockholder has about having everything tied up in a single business enterprise could create a bias in favour of diversification that yields an unwieldy conglomerate structure.[126] Moreover, the continuity and strong internal architecture associated with family dominated companies can constitute a serious liability if shifts in the business climate require a quick and bold reorientation of existing strategies.[127] Adverse consequences can also follow if a company is dominated by an entrepreneur who, motivated by vanity, sentiment or loyalty, continues to run the business after he is no longer suited to do so or transfers control to family members who are ill-suited for the job.[128]

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122 See Coffee, 'The Future as History', above n 26, 662; Lehmann and Weigand, above n 117, 162; Ronald J Daniels and Randall Morck, 'Canadian Corporate Governance: The Challenge' in Ronald J Daniels and Randall Morck (eds), *Corporate Decision-Making in Canada* (1995) 3, 12.

123 Becht and Mayer, above n 20, 6–7; Clifford G Holderness and Dennis P Sheehan, 'Constraints on Large-Block Shareholders' in Randall K Morck (ed), *Concentrated Corporate Ownership* (2000) 139, 139–40. Note, though, that if controlling owners want to attract new capital in the future, reputational constraints will help to deter them from extracting excessive benefits: Cronqvist and Nilsson, above n 38, 6–7; Dyck and Zingales, above n 56, 3–4, 29–30; Lucian A Bebchuk, Reinier H Kraakman and George G Triantis, 'Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights' in Randall K Morck (ed), *Concentrated Corporate Ownership* (2000) 295, 305–6.

124 Deborah DeMott, 'Agency Principles and Large Block Shareholders' (1997) 19 *Cardozo Law Review* 321, 333–4.

125 Becht and Mayer, above n 20, 6; Morck, Stangeland and Yeung, above n 116, 331; 'Asia's Stockmarket Nightmare', *The Economist* (New York), 20 December 1997, 107.

126 Fama and Jensen, above n 74, 306; Nicholas L Georgakopoulos, 'Corporate Defense Law for Dispersed Ownership' (2001) 30 *Hofstra Law Review* 11, 21–2; Henrik Cronqvist, Peter Högfeldt and Mattias Nilsson, 'Why Agency Costs Explain Diversification Discounts' (2001) 29 *Real Estate Economics* 85, 86, 92, 119. For further background on why diversification can be an attractive option for family-dominated companies, particularly in areas where macroeconomic conditions are problematic, see Michael Reid, 'Back on the Pitch', *Survey: Business in Latin America, The Economist* (New York), 6 December 1997, 8.

127 Cheffins, 'Trust, Loyalty and Cooperation', above n 67, 70–1; Morck, Stangeland and Yeung, above n 116, 342–5 (citing evidence indicating that heir-controlled firms are less innovative than other firms); James Keenan and Maria Aggestam, 'Corporate Governance and Intellectual Capital: Some Conceptualisations' (2001) 9 *Corporate Governance: An International Review* 259, 266. See also 'The Unwinding of Japan Inc', *Asian Wall Street Journal*, 30 November 2000, 8 (making the same point about Japan, where concentrated ownership results from cross-shareholdings between corporations rather than from family control).

128 Cronqvist and Nilsson, above n 38, 4, 7, 20–2; Daniels and Halpern, above n 98, 20–1; Casson, above n 114, 18; Harold Demsetz, 'The Structure of Ownership and Control and the Theory of the Firm' (1983) 26 *Journal of Law and Economics* 375, 383.

Establishing sophisticated managerial hierarchies and delegating decision-making prerogatives to senior executives is an obvious response when a family lacks a successor who is both astute and motivated enough to lead a company.[129] Still, ceding day-to-day control to professional managers is a painful step because of feelings of loss of power, respect and value.[130] Even if this obstacle can be addressed, recruiting and retaining talented managerial personnel can prove difficult for a company that has a major blockholder.[131] For instance, talented and ambitious executives might decline to join the firm because they fear being passed over for key posts in favour of less deserving family members.[132] Also, professional managers may prefer to forsake unwelcome meddling by the dominant faction and enjoy the relative autonomy offered by a company with dispersed share ownership.[133] Indeed, 'managing the family's relationship with the firm can be as hard as managing the business itself'.[134]

VII EMPIRICAL EVIDENCE CONCERNING OWNERSHIP CONCENTRATION AND CORPORATE PERFORMANCE

The foregoing discussion of the trade-offs between diffuse and concentrated ownership should be sufficient to demonstrate that it cannot be taken for granted that either is inherently superior.[135] A logical step to take, then, is to consider whether the relevant empirical evidence can shed light on the issue. We will do this now.

As a preliminary point, we should recall that the Darwinian version of the law matters thesis presumes that the Berle-Means corporation offers intrinsic competitive advantages. Again, the working assumption is that there is a 'growing body of evidence that family management is generally inferior to professional management'.[136] This implies, in turn, that firms with a separation

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129 Morck, Stangeland and Yeung, above n 116, 332–3; 'The Mighty Fallen', *The Economist* (New York), 14 September 1996, 68; Graham Bowley, 'Industry's Hidden Winners', *Survey on World Economy and Finance, Financial Times* (London), 19 September 1997, 12; Peter Marsh, 'Family Buzz in the Mittelstand', *Financial Times* (London), 20 December 2001, 20.

130 Philip Lawton, 'Berle and Means, Corporate Governance and the Chinese Family Firm' (1996) 6 *Australian Journal of Corporate Law* 348, 358; 'The Generation Game', *The Economist* (London), 4 March 2000, 91; 'The Chaebol Spurn Change', *The Economist* (London), 22 July 2000, 83.

131 Jordan, above n 116, 95–6.

132 Nesbitt, above n 115, 31; Reuven Brenner, 'Good Government and Good Business', *National Post* (Toronto), 27 July 2000, C15; Michael Skapinker, 'A "How To" Handbook for the Family Business', *The Economist* (London), 1 December 2000, 18.

133 Broehl, above n 113, 7; Jordan, above n 116, 96; Marsh, above n 129; Andrew Saunders and Matthew Gwyther, 'Fresh Blood', *Management Today* (London), April 2002, 58, 60 (saying that that the UK is the place to be for European executives who want to run a fully fledged stock market company).

134 'Lear's Curse', *The Economist* (London), 2 December 2000, 111, 112. See also Andrea Colli and Mary B Rose, 'Families and Firms: The Culture and Evolution of Family Firms in Britain and Italy in the Nineteenth and Twentieth Centuries' (1999) 47 *Scandinavian Economic History Review* 24, 42–3.

135 Coffee, 'The Future as History', above n 26, 662.

136 Burkart, Panunzi and Shleifer, above n 63, 6.

of ownership and control should be more profitable than those with concentrated ownership structures.

The empirical research on the effects of ownership structure on firm performance spans several decades.[137] Correspondingly, if diffuse share ownership and well-developed managerial hierarchies are in fact ingredients of corporate success, the superiority should, by now, be clearly evident.[138] There have indeed been some studies which indicate that manager-controlled firms outperform those with a concentrated ownership structure.[139] Still, this is not a prevailing pattern. Instead, according to a thorough survey of the topic published in 1994, '[t]he empirical research ... has failed to reach any conclusions as to whether the type of ownership structure does significantly affect performance'.[140]

A more recent synopsis, offered in 2001, casts even more doubt on the proposition that a separation of ownership and control offers a decisive edge. According to this survey, the 'results are ambiguous, but the preponderance of studies point to a profitability-enhancing role of owner control'.[141] Hence, while 'the sign and the magnitude of the relationship between owner control and performance is ... not unambiguously answered ... [t]he evidence supports the hypothesis large shareholders are active monitors in companies, and this entails beneficial effects for corporations'.[142] Overall, then, the empirical data on ownership and profitability is inconsistent with the assumptions about ownership structure that appear to underlie the Darwinian version of the law matters thesis.

Despite the empirical trends, it should not be taken for granted that the proposition that a separation of ownership and control contributes to corporate success has been refuted. Instead, it is possible that imprecise methodology has concealed the virtues of the Berle-Means corporation. For instance, with most of the empirical work that has been done, the underlying assumption has been that as shareholder concentration increases, performance improves (or declines) in a linear fashion.[143] There is some empirical evidence which suggests, however, the relationship might be "saw-toothed".[144] This means firm value increases with

137 Short, above n 87, 206.

138 With a significant number of studies, the working hypothesis was in fact the opposite. The assumption was that manager-controlled firms should have been less profitable due to agency costs: Short, above n 87, 204–6.

139 Gugler, 'Direct Monitoring and Profitability', above n 98, 14.

140 Short, above n 87, 206. For another survey offering the same verdict, see Clifford G Holderness, 'A Survey of Blockholders and Corporate Governance' (2002) forthcoming *Federal Reserve Bank of New York: Economic Policy Review* (copy on file with author) 9.

141 Gugler, 'Direct Monitoring and Profitability', above n 98, 14. For similar verdicts, see Vijay Jog and Ajit Tulpule, 'Control and Performance: Evidence from the TSE 300' in Ronald J Daniels and Randall Morck (eds), *Corporate Decision-Making in Canada* (1995) 105, 107–10; Øyvind Bøhern and Bernt Arne Ødegaard, 'Corporate Governance and Economic Performance: A Closer Look' (2001) (copy on file with author) 9.

142 Gugler, 'Direct Monitoring and Profitability', above n 98, 23.

143 Short, above n 87, 218–19.

144 See Shleifer and Vishny, above n 16, 759; Short, above n 87, 219; Klaus Gugler, 'Beneficial Blockholders versus Entrenchment and Rent Extraction?' in Klaus Gugler (ed), *Corporate Governance and Economic Performance* (2001) 26, 27–8 (offering an overview of the empirical work which has been done). On the 'saw-tooth' terminology, see Holderness, above n 140, 8.

growing 'insider' ownership until a breakpoint (eg, an ownership stake of 5 per cent), then decreases until another breakpoint (eg, 25 per cent) when firm value again increases in line with insider ownership.[145] Efforts made to test the robustness of this segmentation pattern suggest, however, that initial results might have been an accidental occurrence and thus reveal little about the relation between performance and ownership structure.[146]

Another potential difficulty with the empirical research to date on the effects of ownership and control structures on firm performance is that the vast majority of the studies analyse either US or UK samples.[147] Since these are the two countries where the Berle-Means corporation clearly dominates the corporate economy,[148] there is the possibility of a sample bias concealing the positive effects of a separation of ownership and control. After all, nations differ across various dimensions, including their location, their natural resources, their investments in human capital and their reliance on governmental coordination of the economy.[149] The possibility therefore exists that additional empirical research carried out over a broader geographical spectrum may reveal links between performance and ownership concentration that are concealed in an Anglo-American setting.[150] Empirical evidence from countries such as Austria,[151] Germany,[152] Italy,[153] Norway,[154] Spain,[155] and Turkey[156] supports this contention, although research from Canada,[157] France[158] and Japan[159] does not.

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145 See, eg, Randall Morck, Andrei Shleifer and Robert Vishny, 'Management Ownership and Market Valuation: An Empirical Analysis' (1988) 20 *Journal of Financial Economics* 293 (in this study, the focus was on the fraction of shares owned by management, not by a company's most significant shareholders); Randall K Morck, 'On the Economics of Concentrated Ownership' (1995–96) 26 *Canadian Business Law Journal* 63, 67–9.

146 Harold Demsetz and Belén Villalonga, 'Ownership Structure and Corporate Performance' (2001) 7 *Journal of Corporate Finance* 209, 230.

147 Gugler, 'Direct Monitoring and Profitability', above n 98, 14; Bøhern and Ødegaard, above n 141, 3, 10.

148 Additional contenders might be Australia and Canada: Cheffins, 'Comparative Corporate Governance', above n 50, 13, 17–19, 29–30.

149 Bebchuk and Roe, above n 50, 168. On government involvement in the economy as a variable, see Maher and Andersson, above n 121, 25.

150 Eric R Gedajlovic and Daniel M Shapiro, 'Management and Ownership Effects: Evidence from Five Countries' (1998) 19 *Strategic Management Journal* 533, 534.

151 Klaus Gugler, 'The Influence of Ownership and Control Structures on Corporate Performance in Austria' (2002) 5 *Corporate Governance International* 6.

152 Lehmann and Weigand, above n 117.

153 Madga Bianco and Paola Casavola, 'Italian Corporate Governance: Effects on Financial Structure and Firm Performance' (1999) 43 *European Economic Review* 1057.

154 Bøhern and Ødegaard, above n 141.

155 Rafel Crespi-Cladera, 'Spain' in Klaus Gugler (ed), *Corporate Governance and Economic Performance* (2001) 169, 172.

156 Burcin Yurtoglu, 'Turkey' in Klaus Gugler (ed), *Corporate Governance and Economic Performance* (2001) 176, 180.

157 Yun M Park et al, 'Executive Pay Practices of Firms with Dominant Shareholder CEOs: Self-Dealing or Efficient Contracting' (2002) (copy on file with author) 8.

158 Elizabeth Kremp and Patrick Sevestre, 'France' in Klaus Gugler (ed), *Corporate Governance and Economic Performance* (2001) 121, 123–4.

159 Stephen D Prowse, 'The Structure of Corporate Ownership in Japan' (1992) 47 *Journal of Finance* 1121.

An additional shortcoming with the empirical work that has been done is that little allowance has been made for the identity of the blockholders.[160] Shareholders owning the same percentage of corporate equity may conduct themselves differently.[161] Correspondingly, the empirical data may offer an impoverished understanding of what dispersed share ownership and fully developed managerial hierarchies can contribute.[162]

To illustrate, a plausible hypothesis is that a widely held company founded by an entrepreneur who continues to own a large percentage of the shares will tend to perform better than the same type of company where family heirs own the decisive block.[163] The basis for the distinction would be that the entrepreneurs who establish large and successful companies will have, compared with their offspring, greater discipline, focus and business acumen.[164] If this hypothesis is correct, large companies that have a founder as a dominant shareholder might be equally successful as similarly situated widely held firms (or even more so). Corporations with a second or third-generation family blockholder would, on the other hand, perform worse. There is empirical evidence from Canada that supports this contention[165] but some research on US companies does not do likewise.[166]

One additional variable that merits consideration is the type of activities in which companies are involved, particularly since there is research which suggests that corporate ownership structures vary in accordance with the industry involved.[167] As we have seen, firms with a dominant blockholder may be able to develop a strong corporate architecture more readily than their widely held counterparts.[168] Correspondingly, if the objective is to produce sophisticated, high quality goods, such companies might be better able to develop the dedicated and highly trained labour force that could be required.[169]

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160 Cronqvist and Nilsson, above n 38, 5–8; Gugler, 'Direct Monitoring and Profitability', above n 98, 22; Bøhern and Ødegaard, above n 141, 9; P Someshwar Rao and Clifton R Lee-Sing, 'Governance Structure, Corporate Decision-Making and Firm Performance in North America' in Ronald J Daniels and Randall Morck (eds), *Corporate Decision-Making in Canada* (1995) 43, 61.

161 Short, above n 87, 228; Gugler, 'Direct Monitoring and Profitability', above n 98, 22.

162 Cf Short, above n 87, 224.

163 Another distinction which might matter is whether the controlling shareholder is a family as opposed to another corporation. On why this might be the case, and for empirical evidence supporting the hypothesis, see Cronqvist and Nilsson, above n 38; Holderness and Sheehan, above n 116, 344–5; Lehmann and Weigand, above n 117, 162–3, 185–91.

164 Morck, 'On the Economics', above n 145, 78.

165 Daniels and Halpern, above n 98, 26–7; Morck, Stangeland and Yeung, above n 116, 334–8; Morck, 'On the Economics', above n 145, 79.

166 Daniel L McConaughy et al, 'Founding Family Controlled Firms: Efficiency and Value' (1998) 7 *Review of Financial Economics* 1.

167 Thomsen and Pedersen, above n 49.

168 See above n 117 and accompanying text.

169 Colin Mayer, 'Stock-Markets, Financial Institutions, and Corporate Performance' in Nicholas Dimsdale and Martha Prevezer (eds), *Capital Markets and Corporate Governance* (1994) 179, 191; Colin Mayer, 'Financial Systems and Corporate Governance: A Review of the International Evidence' (1998) 154 *Journal of Institutional and Theoretical Economics* 144, 159; Peter A Hall and David Soskice, 'An Introduction to Varieties of Capitalism' in Peter A Hall and David Soskice (eds), *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (2001) 1, 39.

Similarly, a firm with a large blockholder could be well-positioned to prosper if tight supplier and purchaser networks are necessary to exploit fully a complex manufacturing process.[170] More broadly, this type of company might have an edge whenever informal business networks are an ingredient of corporate success. For instance, if there is a family blockholder, those in charge should be well-positioned to nurture and stand by the personal links that provide the foundation for effective alliances.[171]

In the same way that there might be situations where firms with a dominant blockholder have a competitive advantage, there arguably are circumstances where the Berle-Means corporation has inherent strengths. For example, in those industries characterised by economies of scale, such as electronics, chemicals, and the refining and distribution of oil, the financial edge offered by ready access to equity markets could be decisive.[172] Also, widely held companies might well have the balance of advantage with activities requiring flexibility in the face of new technologies and markets.[173] On this count, 'core' investors might, on the grounds of tradition, be reluctant to abandon well-established methods of doing business, or be uncomfortable taking large risks because they are poorly diversified.[174] In contrast, key virtues which markets offer are an ability to absorb risks and a high degree of responsiveness to changing circumstances.[175]

A final point needs to be made about the evidence concerning ownership concentration and corporate performance. In our discussion of this issue, the implicit assumption has been that ownership structure can be expected to affect profitability. This may, however, be inaccurate, as indicated by the work of economist Harold Demsetz, writing alone and together with co-authors.[176] Essentially, Demsetz et al argue that the manner in which share ownership is configured will not dictate how well a business enterprise performs. Instead, circumstances affecting companies determine ownership structure. Correspondingly, seeking to detect whether the presence or absence of large blocks of equity will deliver improved corporate performance will likely be futile.

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170 Mayer, 'Financial Systems and Corporate Governance', above n 169, 159.

171 Martin, above n 115; Lawton, above n 130, 361.

172 Thomsen and Pedersen, above n 49, 388, 396 (not finding, however, statistical evidence to support the contention); Mary B Rose, 'Introduction' in Mary B Rose (ed), *Family Business* (1995) xiii, xxiv–xxv.

173 Thomsen and Pedersen, above n 49, 396; Mayer, 'Financial Systems and Corporate Governance', above n 169, 159; Colin Mayer, 'Corporate Governance is Relevant', *Mastering Strategy*, *Financial Times* (London), 11 October 1999, 14; Michael Mumford, 'Strategic Directions for Corporate Governance' (Working Paper No 2000/014, Working Papers in Accounting and Finance, Lancaster University Management School, 2000) 19–20 (comments of Colin Mayer).

174 On continuity and risk aversion in family-owned companies, see above nn 71, 72, 109, 121 and accompanying text.

175 'The Rise and the Fall', above n 34, 36–8; Colin Mayer, 'Developing the Rules for Corporate Governance', *Mastering Management, Financial Times*, 6 November 2000, 6; Klaus Gugler, 'Conclusion and Policy Implications' in Klaus Gugler (ed), *Corporate Governance and Economic Performance* (2001) 201, 205.

176 Demsetz, above n 128; Demsetz and Villalonga, above n 146; Harold Demsetz and Kenneth Lehn, 'The Structure of Corporate Ownership: Causes and Consequences' (1985) 93 *Journal of Political Economy* 1155. In the subsequent discussion, the ideas expressed by Demsetz and this group of co-authors are attributed to 'Demsetz et al'.

Demsetz et al reason that shareholders will ultimately adopt the ownership pattern that maximises expected return, given the interplay of market forces affecting a particular business enterprise. In other words, the market will bring forth ownership structures that are, at least approximately, appropriate for the companies in question.[177] Hence, the particular characteristics of a firm and its owners will dictate whether there will be a dominant blockholder or a Berle-Means corporation.[178] To illustrate, consider a corporation that is well-suited to exploit economies of scale and becomes very large. As the company grows, the price of a given fraction of the equity will increase. This higher price should, in itself, reduce the degree of ownership that is concentrated since wealth constraints will come into play.[179] Risk aversion should reinforce this effect. Investors will prefer, all else being equal, not to have all of their risk on one undertaking. The bias in favour of risk spreading should, in turn, foster dispersed ownership.[180]

A countervailing factor, according to Demsetz et al, could be the non-pecuniary income associated with the ability to deploy resources to suit one's personal preferences.[181] They argue that industries which offer considerable scope to indulge such whims ('amenity potential') are ones where tight control is more likely to exist. An example they provide is a mass media corporation, since the potential to influence public opinion could outweigh the utility associated with risk diversification.[182]

A corollary of this analysis of the causes of share ownership, as emphasised by Demsetz et al, is that there is no reason to expect a link between profitability and the degree of ownership dispersion.[183] Their reasoning on this point is that, regardless of the net cash flow particular firms might generate, there will be market-driven momentum in favour of whatever ownership structure is most suitable for a firm at any particular point in time. The dynamic involved will be that firms which maximise shareholder returns via appropriate ownership structures will be able to raise capital more cheaply and thus will disproportionately tend to survive.[184]

Demsetz et al acknowledge that the market in which ownership structures are formed will not be perfect.[185] Still, the momentum towards whatever format is suitable at a particular point in time will allegedly be strong enough to remove any predictable relation between profitability on the one hand and ownership

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177 Demsetz and Villalonga, above n 146, 231.

178 Ibid 210, 230; Demsetz and Lehn, above n 176, 1174.

179 Demsetz and Lehn, above n 176, 1158.

180 Ibid.

181 Ibid 1161–2; Demsetz and Villalonga, above n 146, 222–3.

182 Demsetz and Villalonga, above n 146, 223; Demsetz and Lehn, above n 176, 1162. For anecdotal evidence supporting this contention, see Jackson, above n 14.

183 Demsetz and Lehn, above n 176, 1174. Note that it does not necessarily follow that mechanisms of corporate governance are irrelevant to performance. On why, see Bøhern and Ødegaard, above n 141, 7.

184 For further background on the logic involved, see Yoshiro Miwa and J Mark Ramseyer, 'Financial Malaise and the Myth of the Misgoverned Firm' (Discussion Paper No 335, John M Olin Center for Law, Economics and Business, Harvard Law School, 2001) 3.

185 Demsetz and Villalonga, above n 146, 231.

diffusion (or concentration) on the other.[186] The fact that the empirical research that has been conducted does not offer definitive conclusions concerning the impact which ownership structure has on corporate performance means such reasoning can certainly not be dismissed out of hand.[187]

VIII REASSESSING THE DARWINIAN VERSION OF THE LAW MATTERS THESIS

Now that we have assessed the impact dispersed and concentrated share ownership can have on corporate performance, it is time to take stock. The Darwinian version of the law matters thesis, as exemplified by the work of Burkart, Panunzi and Shleifer,[188] essentially treats the separation of ownership and control as an indication of a superior corporate governance environment. Concomitantly, the prevalence of controlling factions in a corporate economy is a manifestation of financial underdevelopment. The prescription for a country thus afflicted is to improve the legal protection available to outside investors since this will provide a platform for the emergence of companies with diffuse share ownership. Assuming that other useful institutions associated with strong equity markets are in place, such reform will permit the Berle-Means corporation to operate on a level playing field. Since this type of business enterprise has inherent economic advantages, over time it will become a dominant feature in the corporate economy. Financial underdevelopment correspondingly will end.

As we have seen, however, the competitive superiority of the Berle-Means corporation cannot be taken for granted. Instead, there are trade-offs between diffuse and concentrated ownership which means that neither is inherently superior. Moreover, if Demsetz et al are correct, ownership structure may be irrelevant to corporate performance. What ramifications do these insights have for the law matters thesis?

Let us consider first the position if Demsetz et al are right. They say that the particular characteristics of a firm and its owners will dictate whether share ownership is concentrated or diffuse. Moreover, the outcome will not have any impact on firm profitability. What does this mean for a country that has traditionally offered weak protection to outside investors but is now introducing reforms that constrain significantly mistreatment of minority shareholders? Two

186 Ibid 230–1.

187 An obvious way to move things forward would be further empirical tests concerning the direction of causality between ownership concentration and firm characteristics. Calls have already been made for this type of work: Michael C Jensen and Jerold B Warner, 'The Distribution of Power Among Corporate Managers, Shareholders, and Directors' (1988) 20 *Journal of Financial Economics* 3, 14; Bernard S Black, 'The Value of Institutional Investor Monitoring: The Empirical Evidence' (1992) 39 *UCLA Law Review* 895, 921. For a study that constitutes a response and accords with Demsetz's theories, see Yoshiro Miwa and J Mark Ramseyer, 'Does Ownership Matter? Evidence from the Zaibatsu Dissolution Program' (Discussion Paper No 314, John M Olin Center for Law, Economics and Business, Harvard Law School, 2001).

188 Above n 63.

results can be expected to follow, one which will be consistent with the Darwinian version of the law matters thesis, and one which will not.

The result that will be consistent with the law matters thesis is that diffuse ownership will become more common. What should happen is that legal reform will change the returns that dominant shareholders will receive, and will do so in a way that causes at least some control blocks to unravel. To illustrate, assume that ABC Co is a publicly quoted company with 100 shares that operates in a country where, at least initially, legal protection offered to minority shareholders is weak.[189] One faction owns 50 of the shares and outside investors own the remainder. The controllers' equity is worth $70, or $1.40 per share. The outsiders' shares are worth $30, or $0.60 per share, with the total value of the company being $100.[190] The difference in value constitutes what is known as a control premium, with at least part of this reflecting the private benefits of control the dominant faction can extract at the expense of outside investors.[191]

Assume now that the country where ABC Co is based enacts new laws that enhance the protection available to minority shareholders. Since the controllers will have less scope to use their position to extract rents, the value of their shares falls to $55, or $1.10 per share.[192] The total value of ABC Co would remain $100, however, given that Demsetz et al say ownership structure is irrelevant to corporate performance. The outsiders' shares will therefore be worth $45, or $0.90 per share. The controlling faction, under such circumstances, may well calculate that since control offers such a tiny premium, it is time to obtain the benefits of liquidity and risk-spreading by unwinding the control block. The end result will be that ABC Co will still be worth $100 but outsiders will own all of the 100 shares, each with a value of $1.[193]

Extrapolating from this example, the analysis Demsetz et al offers implies that strengthening the legal protection offered to minority shareholders should cause some dispersion of share ownership. Vindication, then, for the law matters thesis? Not in its Darwinian form. This is because in a crucial respect the status quo would prevail: the value generated by the corporate economy would be unaffected. Again, the Darwinian version of the law matters thesis presumes that countries where blockholders dominate suffer from financial underdevelopment. Law reform is prescribed as the cure, with the anticipated result being better overall corporate performance. If Demsetz et al are correct, no such result should

189 The figures are borrowed, with various adaptations, from Bebchuk and Roe, above n 50, 143–4.

190 Although the figures chosen here are arbitrary, empirical studies suggest that the premium attached to controlling shares exceeds 25 per cent of equity value in a significant number of countries: Nenova, above n 55, 32, 38; Dyck and Zingales, above n 56, 14.

191 On the contribution which extracting private value makes to the control premium, see Roe, 'Political Preconditions', above n 27, 595; Dyck and Zingales, above n 56, 6–7.

192 While the number selected again is arbitrary, the choice is not unrealistic. According to some cross-border research, more than 70 per cent of the difference in private benefits of control can be explained by the nature of the legal rights outside investors enjoy: Nenova, above n 55, 38–9. Other cross-border empirical work suggests that legal variables are important, but not on this order of magnitude: Dyck and Zingales, above n 56, 32–3, 35.

193 A pro rata valuation of $1 per share is appropriate because each would benefit from a control premium reflecting the fact that there are votes attached to the equity. On this, see Nenova, above n 55, 6.

be anticipated. Again, the assumption that is made from this camp is that changes to ownership structure will not deliver stronger performance. By extension, a shift towards diffuse ownership that is prompted by law reform will not yield a better outcome for the corporate economy.[194]

Let us set aside now the position advocated by Demsetz et al and assume that the manner in which share ownership is configured *can* have an impact on how companies perform. This opens the possibility that a country which experiences a shift from concentrated to dispersed ownership will, consistent with the Darwinian version of the law matters thesis, benefit economically. Our analysis of the impact that ownership structure is likely to have on corporate performance suggests, however, that this outcome cannot be taken for granted.

Again, the empirical research that has been done has failed to generate any firm conclusions on the contribution ownership structure makes to corporate profitability.[195] For law matters advocates who assume that the introduction of reforms designed to protect outside investors will yield beneficial economic outcomes, this poses a problem. Such changes to the law may provide a suitable institutional platform for increased ownership dispersion. Still, since diffuse share ownership may not offer inherent economic advantages, it cannot be taken for granted that the Berle-Means corporation will in fact move to the forefront. Correspondingly, there will not be any cure for whatever financial underdevelopment might exist.

This prognosis may, however, not capture the full story. Instead, due account should be taken of the fact that there may be circumstances where dispersed ownership might offer advantages. For instance, it may be that companies with diffuse share ownership will tend to outperform companies with a second or third-generation family blockholder.[196] At the same time, the properties associated with strong equity markets may mean the Berle-Means corporation has the edge in those industries characterised by economies of scale and with activities requiring flexibility in the face of new technologies and markets.[197]

Assume, for the sake of the argument, that dispersed share ownership does offer a competitive advantage under certain circumstances. Assume also that a country offers little protection to outside investors and law does matter in this instance because it means companies with dispersed share ownership cannot emerge. The corporate economy of this country seems likely to suffer by virtue of the handicap. Companies with a second or third-generation family blockholder will, despite performing at a sub-optimal level, remain entrenched. Also, the fact that dispersed share ownership is not an option means that the country's ability to compete will be impaired when economies of scale or innovative capacity matter.

In the foregoing scenario, a story closely related to the Darwinian version of the law matters thesis can be told. If the country in question enacts laws that

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194 But see Demsetz, above n 128, 383 (arguing that allowing for fractional ownership makes investment funds available at lower costs to society).

195 Above nn 140–2 and accompanying text.

196 See above nn 163–6 and accompanying text.

197 See above nn 172–5 and accompanying text.

protect minority shareholders and fosters the development of supporting institutions, then it will become feasible for corporations with diffuse ownership to play a significant role. This means that, in companies which might otherwise suffer a penalty by virtue of having heirs in control, the unwinding of the potentially counterproductive control block could occur readily.[198] The same process might well occur when there are extra profits to be derived by developing economies of scale or by exploiting innovative technology. The upshot would be that in various contexts where a separation of ownership and control can be beneficial, law reform would permit the inherent advantages of the Berle-Means corporation to come into play.

Note that under these circumstances, the corporate economy would not be transformed in a wholesale fashion. Still, where diffuse share ownership offers an edge, a reconfiguration will take place based on the basis of competitive fitness. The ultimate result should be improved performance throughout the corporate sector, with attendant beneficial spin-offs for the economy at large.

We have now a reconfigured Darwinian version of the law matters that takes due account of the costs and benefits of the separation of ownership and control. Essentially, the story that can be told is that increasing the legal protection available to outside investors will constitute a useful addition to the 'organizational toolkit'.[199] The fact that it will be feasible for a separation of ownership and control to emerge readily will not mean that the Berle-Means corporation will become inherently dominant. Instead, a reconfiguration of ownership structures can be anticipated in certain sectors of the corporate economy, with beneficial results.

Still, we cannot quite end matters at this point. Instead, two caveats need to be made. One concerns the political milieu within which companies operate. Our discussion of the trade-offs between dispersed and concentrated ownership was implicitly premised on the idea that all firms within a country will encounter a level playing field in their dealings with the state. This assumption may not, however, be realistic. Instead, the possibility exists that companies with blockholders might have advantages in the political arena that could give them a decisive edge when diffuse ownership otherwise might be advantageous.[200] The key variable in this instance is that individuals owning large blocks of shares will be ideally situated to foster enduring personal links with politicians and

198 To illustrate using the ABC Co example set out above, the value of the company might be \$100 with a family blockholder owning 50 shares and \$150 with completely dispersed ownership. Again, before legal reform, the family's block of shares is worth \$70 (see above n 189 and text following). If legal reform completely eliminated any control premium, this block could still be sold for \$75, a profit of \$5. The change to the law should correspondingly be sufficient to induce structural transformation. It cannot be taken for granted, however, that a switch from concentrated to diffuse ownership will be on the cards where a company is worth more with dispersed share ownership. On this, see Bebchuk and Roe, above n 50, 145–7. On the outcome where a company is worth less with dispersed ownership, see Roe, 'Political Preconditions', above n 27, 595–7.

199 On the terminology, see Roe, 'Political Preconditions', above n 27, 600.

200 Marianne Bertrand, Paras Mehta and Sendhil Mullainathan, 'Ferreting Out Tunneling: An Application to Indian Business Groups' (2002) 117 *Quarterly Journal of Economics* 121, 146–7.

bureaucrats and thereby secure subsidies that are unavailable to other firms.[201] To the extent that reciprocity between public officials and blockholders does affect market outcomes within a country, reforms that strengthen protections made available to outside investors may fail to yield the hypothesised beneficial reconfiguration in ownership structures.

Fears about the detrimental impact of the 'crony capitalism' just described[202] should not be overstated, however, in this instance. Again, the country under consideration will have enacted laws that erode the private benefits of control. A reasonable assumption to make is that blockholders, being aware of the implications, will have used their political connections to lobby against such changes.[203] Reform, however, will have occurred regardless.[204] A fair inference to draw, therefore, might be that controlling factions within the country in question lack the political clout to ensure that their companies secure special favours from politicians and bureaucrats. Still, the experience in Canada, where minority shareholders are well protected and wealthy families retain at least some influence over public officials,[205] suggests that it is imprudent to remove politics from the equation too readily.[206]

The second caveat that must be borne in mind with respect to the revised Darwinian account offered here is that enhancing minority shareholder rights may have a potentially detrimental corollary: impeding the formation of and imperilling the survival of beneficial control blocks. If it is true that there is no economy-wide correlation between ownership structure and corporate performance but dispersed ownership does yield superior results in certain circumstances, it follows that there are situations where companies with blockholders have the edge. For instance, this might be the case where close relations with stakeholders or reliance on informal networks are ingredients of corporate success.[207]

To the extent that dominant shareholder factions might be an asset in various circumstances, it should be beneficial for a country to offer a regulatory

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201 Claessens, Djankov and Lang, above n 20, 109; Morck, 'On the Economics', above n 145, 82–3; Tarun Khanna and Krishna Palepu, 'Emerging Market Business Groups, Foreign Intermediaries, and Corporate Governance' in Randall K Morck (ed), *Concentrated Corporate Ownership* (2000) 265, 272. The competitive advantage which a well-connected family-owned firm has is likely to be particularly great in a country where the state seeks to coordinate economic development and is closely involved in the economy through ownership and/or credit allocation. See Bertrand, Mehta and Maullainathan, above n 200, 147; Richard Whitley, *Divergent Capitalisms: The Social Structuring and Change of Business Systems* (1999) 53, 57, 157–8.

202 On the use of this term with respect to blockholders and corporate governance, see Claessens, Djankov and Lang, above n 20, 109.

203 Bebchuk and Roe, above n 50, 159; Mark J Roe, 'Comparative Corporate Governance' in Peter Newman (ed), *The New Palgrave Dictionary of Economics and the Law*, (1998) vol 1, 339, 344.

204 On factors that could diminish the influence of controlling shareholders and thereby yield this result, see Cheffins, 'Law as Bedrock', above n 3, 23–4, 29.

205 On the protection of minority shareholders, see La Porta et al, 'Law and Finance', above n 19, 1130 (giving Canada the same score on 'antidirector rights' as the United States). On the political influence of wealthy families in Canada, see Morck, Stangeland and Yeung, above n 116, 347.

206 See also 'Timid Tigers', *The Economist* (London), 15 June 2002, 76 (describing how 'crony capitalism' remains prevalent in East Asia at the same time stock market reform is occurring).

207 Above nn 116–17 and accompanying text.

environment which allows scope for large blocks of shares to play a significant role. This will be a familiar refrain to those who have been following the debates concerning comparative corporate governance since the early 1990s. At that point in time, Germany and Japan seemed to be enjoying greater economic success than the US.[208] The promise of the German and Japanese systems, to some American eyes, was that they offered the benefits of 'dedicated capital' exemplified by close and active monitoring of management via shareholder coalitions and supervision by banks.[209] A popular belief was that American companies were potentially disadvantaged because legal regulation forced US shareholders to remain diffuse and passive. The policy prescription that followed was that the US should offer a hospitable legal environment for blockholder governance.[210]

Those advocating reform did not necessarily want America to foster actively concentrated share ownership.[211] Instead, there was a potentially attractive middle ground: offer scope for variation and foster competition between organisational forms.[212] To quote Edward Rock, a US law professor:

> If different governance structures are possible, and if different structures have different advantages and disadvantages in different contexts, then why not let them compete within the U.S. system, and not just in the competition between the United States and Germany and the United States and Japan?[213]

Now that we have taken into account the potential attractions associated with offering a hospitable environment for a full range of ownership structures, let us return to the caveat about beneficial control blocks we are considering. As Professor Rock has acknowledged, there may be limits on the extent to which a country's legal system can foster competition between different ownership structures.[214] For present purposes, what matters is that following the policy prescription implied by the law matters thesis — promoting the rights of outside investors — may undercut the feasibility of blockholder governance.

Colin Mayer, an economist, has made just this argument with respect to the UK, stating that 'the promotion of stock-markets and minority interests may have had a serious cost in discouraging the close involvement of insider groups in corporate activities'.[215] Mayer cites the enactment of legislation prohibiting

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208 Lipton and Rosenblum, above n 67, 218–19.

209 Rock, above n 10, 379. For examples, see Porter, above n 110, 70–2; Joseph A Grundfest, 'Subordination of American Capital' (1990) 27 *Journal of Financial Economics* 89, 98–9, 105.

210 Porter, above n 110, 79–80, 82; Bhide, above n 119, 130, 138–9; Grundfest, above n 208, 107. For a more prescriptive policy agenda, see Sykes, 'Proposals for Internationally Competitive Corporate Governance', above n 108, 191–3.

211 See, eg, Roe, *Strong Managers, Weak Owners*, above n 11, 263, 277–8.

212 'Owners versus Managers', *The Economist* (New York), 8 October 1994, 20; Mark Roe, 'The Political Roots of American Corporate Finance' (1997) 9(4) *Journal of Applied Corporate Finance* 8, 19–20; Frank Easterbrook, 'International Corporate Differences: Markets or Law?' (1997) 9(4) *Journal of Applied Corporate Finance* 23, 29; Kenneth Scott, 'Institutions of Corporate Governance' (1999) 155 *Journal of Institutional and Theoretical Economics* 3, 11.

213 Rock, above n 10, 381.

214 Ibid 381, 391. See also Bhide, above n 119, 138; Stephen M Bainbridge, 'The Politics of Corporate Governance' (1995) 18 *Harvard Journal of Law & Public Policy* 671, 731–2.

215 Mayer, 'Stock-Markets', above n 169, 193.

insider dealing, arguing that such regulations may hinder blockholding because of a fear of the consequences of being a party to privileged information.[216] He also mentions rules enforced by the Takeover Panel, a 'referee' for takeover offers involving UK public companies, that require a shareholder which accumulates a large stake in a quoted company to make a full bid for all of the shares.[217]

Let us draw together our reassessment of the Darwinian version of the law matters thesis. Once the costs and benefits of dispersed ownership are taken into account, a potentially appealing way of thinking about the law matters thesis is to assume that enactment of laws protecting minority shareholders will foster beneficial competition between organisational forms within a corporate economy.[218] Still, creating a hospitable environment for dispersed share ownership may discourage the close involvement of insider groups in corporate governance. Since, at least under some circumstances, blockholders can make a positive contribution to corporate performance, a country that strongly promotes the interests of minority shareholders could suffer some adverse economic consequences.[219]

IX CONCLUSION

At present, a popular thesis is that the 'law matters' in the sense that the quality of legal protection offered to minority shareholders helps to determine patterns of ownership and control. To the extent that this is correct, countries which ignore the interests of minority shareholders are unlikely to have strong equity markets or more than a tiny handful of companies with diffuse share ownership. The result, according to at least some advocates of the law matters thesis, is that these countries will suffer financial underdevelopment. This is because, under optimal conditions, the best arrangement for corporate enterprise is a widely held professionally managed firm. What follows is a strong message for policy-makers: recognise the Darwinian implications of minority shareholder protection (or lack thereof). To be more precise, a country must provide a hospitable environment for outside investors so the Berle-Means corporation can exploit its natural advantages or adverse economic consequences will follow.

216 Ibid 192. Legislation dealing with insider dealing in the UK includes *Criminal Justice Act 1993* (UK) c 36, ss 52–64; *Financial Services and Markets Act 2000* (UK) c 8, s 118 (regulating 'market abuse', of which insider dealing is a classic example).

217 Mayer, 'Stock-Markets', above n 169, 192–3. The role which regulation plays in deterring the establishment of blockholder governance should not, however, be overestimated. Instead, when a liquid market exists for a company's shares various practical obstacles serve to create a bias against large share blocks. See John C Coffee, 'Liquidity Versus Control: The Institutional Investor as Corporate Monitor' (1991) 91 *Columbia Law Review* 1277, 1318–21; Bernard S Black and John C Coffee, 'Hail Britannia?: Institutional Investor Behavior Under Limited Regulation' (1994) 92 *Michigan Law Review* 1997, 2056, 2063–4.

218 Roe, 'The Quality of Corporate Law Argument', above n 31, 11.

219 Porter, above n 110, 76, 82; Bhide, above n 119, 138–9; Mayer, 'Stock-Markets', above n 169, 193.

This paper has subjected to critical scrutiny the inferences that can and should be drawn from the law matters thesis. We have seen that while a separation of ownership and control does have positive features, the agency cost problem constitutes a serious potential drawback. Moreover, companies which have a dominant blockholder are perhaps better able to develop a valuable corporate architecture than their widely held counterparts. Given such dynamics, it should probably not be surprising that empirical research which has been conducted does not offer a definitive verdict on the extent to which ownership structure affects corporate performance.

Once it is recognised that the trade-offs between diffuse and concentrated ownership mean it cannot be taken for granted that the Berle-Means corporation is inherently superior, the Darwinian inferences that can be drawn from the law matters thesis need to be recast. If, as some have argued, ownership structure is irrelevant to corporate performance, strengthening minority shareholder protection could foster more diffuse share ownership without yielding a beneficial economic outcome. On the other hand, the manner in which share ownership is configured may influence the results companies deliver under a range of circumstances, including where control is on the verge of being transferred to heirs or where innovative capacity is pivotal. If this is right, countries which offer a suitable platform for dispersed share ownership may reap dividends because the Berle-Means corporation will move to the forefront in certain sectors of the economy. Increasing the legal protection available to outside investors will therefore constitute a potentially useful addition to the 'organizational toolkit'. Even here, however, there are dangers, since laws that protect outside investors could deter potentially beneficial blockholding. In sum, while the law matters thesis seems to offer a clear and urgent message for policy-makers, the practical realities of corporate ownership structure mean that the true situation is considerably more complex.