

# **CONCENTRATED OWNERSHIP REVISITED: IDIOSYNCRATIC VALUE AND AGENCY COSTS**

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*This Article offers a new understanding of concentrated ownership—the prevalent form of corporate ownership around the world—by developing a framework for evaluating many corporate ownership patterns and exploring its legal and economic implications. The predominant view within legal and economic scholarship contends that controlling shareholders’ incentive for holding a control block is their desire to extract private benefits of control. Our analysis, however, shows that corporate control is valuable for entrepreneurs wishing to secure the idiosyncratic value that they ascribe to their business idea. Specifically, we demonstrate that the controlling-shareholder ownership structure can be explained as an allocation of control and cash-flow rights balancing the controller’s freedom to pursue idiosyncratic value against minority shareholders’ need for protection from agency costs.*

*The idiosyncratic-value/agency-cost framework provides new insights for both theory and doctrine. As a matter of theory, we question the view that private benefits of control are vital for controlling shareholders, that improved monitoring explains the controlling-shareholder structure, and that the size of control premiums is a good proxy for the quality of investor protection. As a matter of doctrine, we explore some key features of corporate law for publicly-traded firms with controlling shareholders, and illustrate how corporate law doctrines are shaped, and should be shaped, by the inevitable tension between the controller’s need to secure idiosyncratic value and minority protection from agency costs. While the corporate law literature has focused solely on minority shareholders’ protection we show that an equally important focus should be given to controllers’ rights.*

## INTRODUCTION

Suppose you ask someone “What is a bicycle?” And he answers: “A vehicle. And if you use one you can fall down and injure your head. You better wear a helmet.” Clearly, this answer is incomplete as it describes an object through its pathology while largely neglecting its key features and functionality. In this Article, we argue that the academic literature on concentrated ownership presents a similar shortcoming.<sup>1</sup>

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<sup>1</sup> See, e.g., Rafael La Porta et al., *Law and Finance*, 6 J. POL. ECON. 1113 (1998) (noting concentrated ownership’s prevalence, and attributing the structure to weak legal regimes and underdeveloped markets).

Concentrated ownership is the predominant ownership structure of public companies around the world,<sup>2</sup> with a substantial presence in the United States.<sup>3</sup> In this structure, a person or entity—the controlling shareholder—holds an effective majority of the firm’s voting and equity rights.<sup>4</sup> Unlike diversified minority shareholders, a controlling shareholder typically shoulders the costs of being largely undiversified and illiquid.<sup>5</sup> Why then does she hold the block?<sup>6</sup>

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<sup>2</sup> See, e.g., Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999) [hereinafter LLSV, *Corporate Ownership*] (finding that, after a review of large corporations in 27 countries, “relatively few...firms are widely held”); Claessens et al., *The Separation of Ownership and Control in East Asian Corporations*, 58 J. FIN. ECON. 81, 82 (2000) (“[M]ore than two-thirds of [East Asian] firms are controlled by a single shareholder.”); Marco Becht & Colin Mayer, *Introduction to THE CONTROL OF CORPORATE EUROPE* (Fabrizio Barca & Marco Becht eds., 2001) (noting that in 50% of Dutch, French, and Spanish companies, more than 43.5%, 20%, and 34.5% of votes are controlled by controlling shareholders, respectively); Mara Faccio & Larry H.P. Lang, *The Ultimate Ownership of Western European Corporations*, 65 J. FIN. ECON. 365 (2002) (reporting that only around thirty-seven percent of Western European firms are widely held).

<sup>3</sup> Concentrated ownership is usually compared to the dispersed ownership structure, the prevalent structure in the U.S. and the U.K., in which most of the firm’s shares are widely-held. See R.C. Anderson and D.M. Reeb, *Founding-Family Ownership and Firm Performance: Evidence from the S&P 500*, 58 J. FIN. 1301 (2003) (roughly 30% of S&P-500 companies have families as controlling shareholders); Marco Becht & J. Bradford DeLong, *Why Has There Been So Little Block Holding in America?* 613, in *HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD: FAMILY BUSINESS GROUPS TO PROFESSIONAL MANAGERS* (Randall K. Morck ed., 2005). *But see* Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 REV. FIN. STUD. 1377 (2009) (presenting evidence that raises doubts as to whether the ownership of U.S. public firms is actually dispersed).

<sup>4</sup> At this stage we do not analyze ownership structures, such as dual-class shares and pyramids, which enable investors to hold uncontested control without owning a majority of equity rights. See *infra* notes 99-104 and accompanying text (discussing dual-class ownership structure). Likewise, we do not discuss companies with a dominant block-holder that exerts considerable influence without having a lock on control.

<sup>5</sup> *But see* Mara Faccio et al., *Large Shareholder Diversification and Corporate Risk-Taking*, 24 REV. FIN. STUD. 3601 (2011) (finding heterogeneity in the degree of portfolio diversification across large shareholders).

<sup>6</sup> In other words, why not separate management from investment? As a wealthy investor, the entrepreneur can hold a diversified portfolio of securities and enjoy a market rate of return. At the same time, the firm could hire her as a CEO and compensate her for her effort and talent.

The prevailing answer to this fundamental question alludes to agency costs, *i.e.*, the availability of “private benefits of control.”<sup>7</sup> The controlling shareholder can use her dominant position to consume private benefits at the expense of minority shareholders.<sup>8</sup> She can, for example, enter into self-dealing transactions,<sup>9</sup> engage in tunneling,<sup>10</sup> employ family members, and boost her ego and social status through her influence on corporate decisions.<sup>11</sup>

With private benefits commonly perceived as a precondition *inducing* concentrated ownership, it is not surprising that this ownership structure is often frowned upon.<sup>12</sup> Empirical studies have reinforced further the negative view associating concentrated ownership with unsavory business practices. Economists have shown that concentrated ownership is more

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<sup>7</sup> See Lucian A. Bebchuk, *A Rent Protection Theory of Corporate Ownership and Control*, Nat'l Bureau of Econ. Research, Working Paper No. 7203 (1999), at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=168990](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=168990); Luigi Zingales, *Insider Ownership and the Decision to Go Public*, 62 REV. ECON. STUD. 425 (1998).

<sup>8</sup> *But see* Ronald Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1663-1664 (2006) (suggesting that there are non-pecuniary private benefits of control which do not come at the expense of the minority: “[F]orms of psychic and other benefits that, without more, involve no transfer of real company resources and do not disproportionately dilute the value of the company’s stock to a diversified investor”). For a formal modeling of such non-harmful non-pecuniary private benefits see Alessio M. Paces, *Control Matters: Law and Economics of Private Benefits of Control*, ECGI-Law Working Paper Series No. 131/2009 (2009), at <http://ssrn.com/abstract=1448164>.

<sup>9</sup> See, Simeon Djankov, Rafael La Porta, Florencia Lopez-de-Silanas, Andre Shleifer, *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430 (2008). Based on their study of 72 countries, the authors suggest that regulation of self-dealing transactions is best done by disclosure and ratification by disinterested shareholders. The analysis of the relative efficiency of rules regulating self-dealing was developed several years earlier by one of us, see Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 CAL. L. REV. 393 (2003) (introducing and applying the property-rule/liability-rule analysis to minority-shareholders’ protection) [hereinafter *Controlling Self-Dealing*].

<sup>10</sup> See, *e.g.*, Simon Johnson et al., *Tunneling*, 90 AM. ECON. REV. 22 (2000); Bernard Black et al., *Law and Tunneling*, 37 J. Corp. L. 1 (2011).

<sup>11</sup> See *e.g.*, Harold Demsetz & Kenneth Lehn, *The Structure of Corporate Ownership: Casus and Consequences*, 93 J. POL. ECON. 1155 (1985).

<sup>12</sup> See, for example, Rene M. Stulz, *The Limits of Financial Globalization*, 60 J. FIN. 1595, 1597 (2005) (contending that ownership concentration “limits economic growth, risk-sharing, financial development, and the impact of financial globalization”). *But see* Lucian A. Bebchuk and Assaf Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. PA. L. REV. 1263, 1281 (2009) (advocating for varying governance standards between companies with and without a controlling shareholder, and explaining that controlling shareholders provide the beneficial means and incentive to monitor management).

widespread in countries that provide minority shareholders with weak legal protection,<sup>13</sup> and that the size of control premiums—the difference between the price for shares in a control block and the market price of the minority shares—correlates inversely with the quality of corporate law, i.e., control premiums in so-called bad-law countries are higher than in good-law countries.<sup>14</sup>

Others have avoided this dark view and offered a positive, more balanced view of concentrated ownership: Controllers play a constructive governance role, as their substantial equity investment encourages them to monitor management more effectively than imperfect markets.<sup>15</sup> This positive view suggests that, in addition to illiquidity and reduced diversification, controllers incur the cost of monitoring managers. Consequently, this view arrives at the conclusion that some optimal level of private benefits of control should be permitted to incentivize controlling shareholders to hold a control block.<sup>16</sup> Put differently, this approach perceives (optimal) private benefits as an appropriate *reward* for holding a control block.

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<sup>13</sup> See, for example, LLSV, *Corporate Ownership*, *supra* note 2, at 511 (finding that the quality of investor protection is a robust determinant of widely-held firms).

<sup>14</sup> See Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537, 590 (2004) (explaining better accounting standards and legal protection of minority shareholders is associated with lower private benefits of control). The premise underlying this study is that a control premium reflects the current value of all future private benefits. See *id.* at 539. See also Tatiana Nenova, *The Value of Corporate Votes and Control Benefits: A Cross Country Analysis* 68 J. FIN. ECON. 325, 344-345 (2003) (finding a negative correlation between a country's quality of investor protection and the value of control-block votes).

<sup>15</sup> See Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1651 (2006) (“[A] controlling shareholder may police the management of public corporations better than the standard panoply of market-oriented techniques employed when shareholdings are widely held.”).

<sup>16</sup> See Ronald J. Gilson and Jeffery N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 785 (2003) (“[B]ecause there are costs associated with holding a concentrated position and with exercising the monitoring function, some private benefits of control may be necessary to induce a party to play that role.”); Maria Gutierrez & Maria Isabel Saez, *A Carrot and Stick Approach to Discipline Self-dealing by Controlling Shareholders*, 5 ECGI Law Working Paper No. 138/2010, available at <http://ssrn.com/abstract=1549403> (“[A] blockholder will only exert control if his benefits from doing so outweigh the private costs of control that he must incur in order to monitor management.”); Ronald Gilson & Alan Schwartz, *Constraints on Private Benefits of Control: Ex Ante Control Mechanisms Versus Ex Post Transaction Review*, SSRN Working Paper, (2012), at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2129502](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2129502) (forwarding a regime where controlling shareholders can bargain with the minority for consuming optimal private benefits of control).

The characterization of controlling shareholders as either induced or rewarded by private benefits of control is troubling. On the one hand, is it really the case that most controlling shareholders around the world are dishonest and therefore incentivized to hold control by the prospect of exploiting loopholes in minority protection? On the other hand, should investors, courts, and lawmakers indeed tolerate some level of minority expropriation in order to incentivize controlling shareholders to monitor management?

This Article offers a new understanding of concentrated ownership. Control matters for entrepreneurs because it allows *them* to pursue *their* business idea in whatever manner they see fit, thereby securing their ability to capture the *idiosyncratic value* that they attach to their unique ability to execute their business idea. Importantly, when the entrepreneur's idiosyncratic value is ultimately realized, it will be distributed pro-rata to all investors. Under our theory, controllers are motivated to hold control by their desire to *increase the pie's size* (pursue idiosyncratic value) rather than dictate the *pie's distribution* (consume private benefits). The controller's consumption of private benefits is merely the pathology of holding control. The controller in our framework does not rely on self-dealing, or other forms of inequitable distributions, to capture an appropriate return on her investment and effort.

As a starting point we use the financial-contracting literature which studies the manner in which entrepreneurs and those who provide financing (investors) allocate control and cash-flow rights.<sup>17</sup> We show that when allocating these rights the parties must address an inherent tension between the entrepreneur's pursuit of idiosyncratic value and investors' need for protection against agency costs. Both control and cash-flow rights affect entrepreneur's ability to pursue idiosyncratic value and exploit agency costs. For instance, granting more control rights to the entrepreneur will increase her ability to pursue idiosyncratic value but will also increase investors' exposure to agency costs. Against this background, we show that specific ownership structures represent different allocations of those rights to address the tension between idiosyncratic value and agency costs.

We further show that ownership structures are located on a spectrum. On one end lies dispersed ownership where the contestability of control curtails the entrepreneur's ability to secure idiosyncratic value. On the other end of the spectrum lies the dual-class share structure where the entrepreneur's uncontestable control allows her to pursue idiosyncratic value without necessarily holding substantial cash-flow rights. Concentrated ownership—where the entrepreneur must hold substantial fraction of cash-flow rights to secure her ability to pursue idiosyncratic value—is located in between these poles. Concentrated ownership is a

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<sup>17</sup> See Oliver Hart, *Financial Contracting*, 39 J. ECON. LIT. 1079, 1079 (2001) (“[F]inancial contracting can be described as the theory of what kind of deals are made between financiers and those who need financing.”).

contracting device that allows the controller to pursue idiosyncratic value while reducing minority shareholders' exposure to agency costs (due to the considerable share of cash-flow rights). The controlling shareholder is willing to bear the costs of holding a large block of shares in exchange for gaining uncontested control, which allows her, through the pursuit of idiosyncratic value, to generate an appropriate return on her investment and effort while complying with the pro-rata distribution rule.

The best illustration of our framework is the story of Henry Ford. Ford did not invent the automobile nor did he own any valuable intellectual property in the technology. He was competing with hundreds of other entrepreneurs attempting to create a "horseless carriage." Ford, however, had a unique vision regarding car production. The first firm that he founded, the Detroit Automobile Company, was controlled by investors. While Ford's investors demanded that cars be immediately produced and sold, Ford insisted on perfecting car design prior to production, leading to delays, frustration on both sides, and the eventual shutdown of the firm by the investors.<sup>18</sup> Ford's second attempt, the Henry Ford Company, was also controlled by investors. After designing a car, Ford did not move the design directly into production, resisting the investors' pressure and interference. Eventually, his obstinacy led to the investors replacing Ford with Henry Leland, changing the company name to the Cadillac Automobile Company, and producing the car designed by Ford with great success.<sup>19</sup>

In his third attempt, the Ford Motor Company, Ford insisted on retaining control. This time, with no outside investor interference, Ford transformed his ideas for car design and production (his idiosyncratic value) into one of the great corporate success stories of all time.<sup>20</sup> Finally, with yet another move along the spectrum of ownership structures, Ford's grandson, Henry II, took the corporation public in 1956 with a dual-class share structure, making sure that control stayed with the Ford family to this day.<sup>21</sup>

Our argument unfolds as follows. In Part I, we set up the financial-contracting framework for corporate investments and use it to analyze the building blocks of the paradigmatic contract between entrepreneurs and investors. We identify the entrepreneurs' idiosyncratic value as an important source of asymmetric information that exacerbates agency costs between the parties. We then show that investors and entrepreneurs can use different allocations of cash-flow and control rights to contain those agency costs while preserving idiosyncratic value.

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<sup>18</sup> M. Todd Henderson, *The Story of Dodge v. Ford Motor Company: Everything Old is New Again*, in CORPORATE LAW STORIES 40 (Mark Ramseyer, ed.)(2009).

<sup>19</sup> *Id.* at 45.

<sup>20</sup> *Id.* at 47.

<sup>21</sup> *Id.* at 72.

In Part II, we analyze a range of corporate ownership structures: dispersed ownership, dual-class shares, and concentrated ownership. We explain how each of these governance structures balances idiosyncratic value against agency costs. We also explain how the controlling shareholder structure fits within this framework.

In part III, we present the implications of our financial contracting framework for corporate theory. We challenge both the contention that it is private benefits that induce controlling shareholder to make the requisite equity investment, and the competing view that improved-monitoring explains the controlling-shareholder structure. In this Part we also question the common view that the size of the control premium is indicative of the quality of investor protection.<sup>22</sup>

In Part IV, we outline the corporate law implications of our financial-contracting framework. Unlike the existing corporate law literature that focuses solely on protecting the minority from agency costs, our framework requires lawmakers and courts to balance minority protection against controllers' rights to secure idiosyncratic value. We also show that corporate law should assign a property-rule protection to controlling shareholders' rights and a liability-rule protection to minority shareholders.<sup>23</sup>

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<sup>22</sup> See also Michael J. Barclay & Clifford G. Holderness, *The Law and Large-Block Trades*, 35 J.L. & ECON. 265, 268-69 (1992) (questioning the view that control premiums necessarily represent private benefits of control).

<sup>23</sup> See Goshen, *Controlling Self-Dealing*, *supra* note 9 (introducing and applying the property-rule/liability-rule analysis to minority-shareholders' protection).