

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 a variety of 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, while consuming private benefits is the pathology of holding control. 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 or management 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 the 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.

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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.¹

Concentrated ownership is the predominant ownership structure of public companies around the world,² with a substantial presence in the United States.³ In this structure, a person or entity—the controlling shareholder—holds an effective majority of the firm’s voting and equity rights.⁴ Unlike diversified minority shareholders, a controlling shareholder

¹ 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).

² 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).

³ 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 & 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).

⁴ At this stage we do not analyze ownership structures, such as dual-class shares, pyramids, and LBOs, 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.

typically shoulders the costs of being largely undiversified and illiquid.⁵ Why, then, does she hold the block?⁶

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

With private benefits commonly perceived as a precondition *inducing* concentrated ownership, it is not surprising that this ownership structure is

⁵ *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).

⁶ 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.

⁷ *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; Luigi Zingales, *Insider Ownership and the Decision to Go Public*, 62 REV. ECON. STUD. 425 (1998).

⁸ *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>.

⁹ *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 Goshen, *Controlling Self-Dealing*].

¹⁰ *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).

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

often frowned upon.¹² Empirical studies have reinforced further the negative view associating concentrated ownership with unsavory business practices. Economists have shown that concentrated ownership is more widespread in countries that provide minority shareholders with weak legal protection,¹³ 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.¹⁴

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.¹⁵ 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.¹⁶ Put differently, this approach

¹² 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 & 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).

¹³ 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).

¹⁴ 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).

¹⁵ 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.”).

¹⁶ See Ronald J. Gilson & 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*

perceives (optimal) private benefits as an appropriate *reward* for holding a control block.

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 opportunists 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* execution of *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 utilize the financial-contracting literature which studies the manner in which entrepreneurs and those who provide financing (investors) allocate control and cash-flow rights.¹⁷ 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. 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 ownership structures lie on a spectrum representing different allocations of those rights to address the tension

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 (forwarding a regime where controlling shareholders can bargain with the minority for consuming optimal private benefits of control).

¹⁷ 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.”).

between the entrepreneur's pursuit of idiosyncratic value and investors' need for protection against 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 uncontested control allows her to pursue idiosyncratic value without necessarily holding substantial cash-flow rights. Concentrated ownership—where the entrepreneur must hold a substantial fraction of cash-flow rights to secure her ability to pursue idiosyncratic value—is located in between these poles. Accordingly, concentrated ownership is a contracting device that allows the controller to pursue idiosyncratic value while reducing minority shareholders' exposure to agency costs (due to the controller's 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.¹⁸ 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.¹⁹ 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.²⁰ 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,

¹⁸ 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).

¹⁹ *Id.* at 45.

²⁰ *Id.* at 47.

ensuring that control stayed with the Ford family, which continues to this day.²¹

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.

In Part II, we analyze a range of corporate ownership structures: dispersed ownership, private equity funds, dual-class shares, and lastly, 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.²²

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.²³

I. THE FINANCIAL CONTRACTING FRAMEWORK

The financial contracting literature studies the basic contract underlying the relationship between entrepreneurs (providing business ideas) and investors (providing financing).²⁴ Economists and legal scholars have used this framework to explore the allocation of cash-flow and control

²¹ *Id.* at 72.

²² 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).

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

²⁴ For a review of this literature, see Hart, *supra* note 17.

rights across a variety of specific financing arrangements.²⁵ Our approach is novel in several respects. First, it identifies the entrepreneur's idiosyncratic value as a source of asymmetric information between business ideas and financing both when the entrepreneur raises funds and during the idea's ongoing development.²⁶ Importantly, unlike pecuniary or non-pecuniary private benefits, idiosyncratic value is a pecuniary payoff that will be shared pro-rata when realized.²⁷ Second, it explores the inherent tension between entrepreneurs and investors when responding to asymmetric information associated with idiosyncratic value. Third, it shows that entrepreneurs and investors can use different combinations of cash-flow and control rights to curb agency costs and preserve idiosyncratic value.²⁸

A. *Idiosyncratic Value.*

An entrepreneur has a business idea. This idea could be an invention of a new product, an innovative method of producing or marketing an existing product, identifying a new market or a niche in an existing market, a new method of motivating employees, or even a better execution of a known method for motivating employees.²⁹ The idea could also relate to the

²⁵ See Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 407 (reviewing venture capital backed firms); Steven N. Kaplan & Peter Stromberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281 (2003) (same); Philippe Aghione & Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59 REV. ECON. STUD. 473 (1992) (explaining the choice between debt and equity at closely-held firms).

²⁶ Our framework also differs from the incomplete-contracts literature. While we share the starting point under which control matters because contracts are inevitably incomplete, we do not assume that entrepreneurs should be in control because they make asset-specific investments. See generally Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119 (1990); Raghuram G. Rajan & Luigi Zingales, *Power in a Theory of the Firm*, 118 Q. J. ECON. 387 (1998).

²⁷ The financial-contracting literature normally assumes that entrepreneurs care not only about the project's expected cash flows, but also about non-pecuniary benefits of control. See Aghione & Bolton, *supra* note 25, at 476; Hart, *supra* note 17, at 1085.

²⁸ Our work follows the seminal transaction cost economics theory of Oliver Williamson, see generally Oliver Williamson, *Transaction Cost Economics*, 1 HANDBOOK INDUST'L ORG. 135 (1989).

²⁹ See Raghuram G. Rajan, *The Corporation in Finance*, 67 J. FIN. 1173, 1177 (2012) ("[T]o create net present value, the entrepreneur has to go out on a limb, distinguishing herself from the rest of the herd of potential competitors, and thus potentially earning sustainable profits... the process of creating positive net present value invariably implies differentiation – whether in creating new products or product varieties that nobody else manufactures, in developing production methods

financial aspects of the business, such as its capital structure (e.g., leverage levels and dividend policy), or its sources of capital.³⁰ To be clear, it does not have to be an invention or a discovery. Think of an entrepreneur opening a shoe store in a street where ten other shoe stores already exist because she believes she can do better than the competition. Or a newly-appointed CEO of an established and successful firm who believes her business plan will make the firm even more successful. Or a private equity fund that buys control of a corporation with financial difficulties and intends to appoint new management that will improve performance. It could be anything, although the entrepreneur might eventually be wrong. To be considered a business idea in our framework, however, what matters is that the entrepreneur genuinely believes that successfully implementing the idea will produce an above-market rate of return on the total resources invested in the project (money, time, effort, etc.).³¹

If the entrepreneur has sufficient wealth he can fund the entire project—the research required for development, the costs of implementation, and the effort required for marketing. As the sole owner, the entrepreneur will both assume all the risks and capture all the returns associated with the project. With complete control, the entrepreneur will make all the decisions, minor and major, associated with the project’s execution. The only challenge that the entrepreneur faces is executing the business idea and capturing its value. The entrepreneur can pursue his idea for as long as he wants in whatever manner he prefers, even if the business is losing money and every expert in the field expresses the opinion that he is pursuing a surefire failure of an idea. No matter how much money he is losing and for how long, no one can force him to sell the business, hire a professional manager, or close the business down. If at the end he fails he might be called “stupid” or “smart but ahead of his time,” and if he succeeds he might be called “a visionary” or “a genius.”³²

that are more efficient than that of the competition, or in targeting customer populations or needs that have hitherto been overlooked.”) Rajan refers to this value as the “entrepreneur’s idea.” *See id.* at 1179. *See also* Joseph Schumpeter, *THEORY OF ECONOMIC DEVELOPMENT* (1911) (explaining entrepreneur’s innovative role).

³⁰ Such as publicly-traded or private debt, local investors or foreigners, trade or bank credit, venture capital or strategic investors.

³¹ Financial economists call it a positive net present value project (NPV). *See* William Carney, *CORPORATE FINANCE: PRINCIPLES AND PRACTICE* 104 (2010) (explaining NPV). Our story will hold true even if the entrepreneur believes the project has a zero NPV (*i.e.*, will provide normal market rate of return) as long as the normal rate of return applies to all the resources invested in the project. However, we believe that the entrepreneur’s pursuit after above market rate of return is a more intuitive understanding of reality.

³² Indeed, the failures and successes of Henry Ford, Steve Jobs, and other entrepreneurs over their careers provide a real illustration of our point.

We call the subjective value the entrepreneur assigns to his business idea the “idiosyncratic value.”³³ Idiosyncratic value should not be confused with non-pecuniary benefits of control. Non-pecuniary benefits of control refer to the value (e.g., pride, fame, political power) that only the entrepreneur derives from the mere execution of his business idea. What we label as idiosyncratic value, in contrast, is the expected *pecuniary* return if the project succeeds. These returns, if achieved, are shared on a pro-rata basis between the entrepreneur and investors. But, the distinctive feature of idiosyncratic value is the fact that the entrepreneur cannot credibly convey it to outsiders, thereby (as we explain below) making control vital for the entrepreneur.

Some business ideas will have low idiosyncratic value and thus can be implemented by others. Other business ideas will have high idiosyncratic value, thereby making the entrepreneur uniquely vital to their execution. An entrepreneur’s high idiosyncratic value can be due to special vision, experience, un-quantified management talent,³⁴ knowledge, character, or intuition. As we explain below, the entrepreneur’s right to execute her business idea protects her idiosyncratic value.

B. Asymmetric Information.

The idiosyncratic value reflects the parts of the business idea or the entrepreneur’s unique position to execute the idea that cannot credibly be conveyed or verified. Idiosyncratic value thereby creates asymmetric information that cannot be overcome by more monitoring, investigation, or disclosure. This could either be because sharing the information with outsiders would destroy its value (e.g., competitors could copy the idea), due to the uncertainty concerning the feasibility of the innovation, or

³³ We called this component of the idea the idiosyncratic value but one could also call it the entrepreneur vision/idea, the business plan, the subjective value, or hidden value. *Cf.* Bernard Black & Reinier Kraakman, *Delaware’s Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U. L. REV. 521 (2002). In other words, we assume that the project is not a fully standardized one. *See also* Rajan, *supra* note 29, at 1200 (“[S]tandardization . . . reduces the idiosyncratic and personalized aspects of the entrepreneur’s role, allowing her job to resemble that of a typical CEO, and making it easier for an employee or outsider to replace her as CEO.”).

³⁴ Stand-alone managerial talent, however, should not be confused with idiosyncratic value. An entrepreneur’s unique managerial talent can be a source of idiosyncratic value when outsiders cannot fully appreciate the returns that this talent is expected to produce. But when both the entrepreneur and outsiders agree on the expected value of the entrepreneur’s managerial talent, it no longer qualifies as idiosyncratic value in our framework

simply because the entrepreneur can present outsiders with nothing more than her strong conviction concerning the value of the idea.³⁵

When the entrepreneur is the sole owner of the firm, the informational asymmetries inherently associated with idiosyncratic value are of little concern. However, asymmetric information does create difficulties when the entrepreneur must raise funds from outsiders to develop the project. For simplicity, we shall refer to those who provide the entrepreneur with financing as “investors.”

Assume the entrepreneur presents his business idea to potential investors. The investors consult with experts in the field and they all opine that the idea is impossible. This is the *ex-ante* information asymmetry that the entrepreneur faces when persuading investors to make the initial investment.

Asymmetric information creates hurdles even if the entrepreneur persuades investors to make the initial investment. If the entrepreneur eventually does not deliver the product on time or at the quality initially promised, persuading investors to continue the project at this stage might prove more difficult because investors might believe the setback casts doubt on either the entrepreneur’s unique ability to execute the project or her conviction in the project’s future success.³⁶ This is the *ongoing* information asymmetry that the entrepreneur faces when persuading investors to continue the execution of the project. Different business ideas and entrepreneurs present different idiosyncratic values according to the complexity and nature of the asymmetric information involved. However, asymmetric information disappears once idiosyncratic value is realized.

To be sure, problems of asymmetric information characterize many cases in which entrepreneurs seek capital.³⁷ Our focus here is on the problem of asymmetric information that arises from the idiosyncratic value’s subjective nature, that is, the fact that the entrepreneur’s belief concerning the project’s value is non-verifiable not only *ex ante*—at the

³⁵ The common definition of asymmetric information refers to different degrees of knowledge of objective facts. Here, we define asymmetric information as also including different estimates of the economic or business implications of similar facts. In other words, if there is an auction over the business idea and all facts are equally known to all participants the entrepreneur will bid the most due to her idiosyncratic value.

³⁶ The reasons for a delay in executing a business idea could vary: Unanticipated technological obstacles, unexpected delay in implementing organizational changes or inability to recruit high quality employees, or a delay in anticipated market developments such as future changes in demand.

³⁷ See generally, Richard A. Lambert et al., *Information Asymmetry, Information Precision, and the Cost of Capital*, 16 REV. FIN. 1 (2012); Stewart C. Myers & Nicholas S. Majluf, *Corporate Financing and Investment Decisions When Firms Have Information That Investors Do Not Have*, 13 J. FIN. ECON. 187 (1984).

time of making the investment—but also when the idea is being developed or implemented.³⁸

C. *Agency Costs.*

The information asymmetry stemming from the inability to verify idiosyncratic value is exacerbated by the presence of opportunistic players, presenting the well-known phenomenon of agency costs.³⁹ Assume the entrepreneur pitches his business idea to investors. Does the entrepreneur genuinely believe in the project? Or is he simply lying to exploit investors? Or assume the entrepreneur informs investors about a delay in the project's execution and asks for more time and money. Is the delay due to some temporary obstacles, with the project's success still attainable? Or is it an attempt by the entrepreneur, who at this stage already knows the project is doomed, to exploit investors?⁴⁰

Agency costs can take many forms besides conveying inaccurate information as opportunities for unscrupulous behavior are limitless. Commonly, agency costs are divided into two types.⁴¹ The first type is *mismanagement*, including reduced commitment, shirking, pursuing acquisitions just to increase firm size or achieve diversification,⁴² and

³⁸ Furthermore, while, as we will show next, investors are concerned with asymmetric information as a source of agency costs, in our contracting story the entrepreneur is also concerned with asymmetric information as an impediment to her ability to persuade investors to allow her to pursue idiosyncratic value.

³⁹ See Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (developing a formal analysis of agency costs).

⁴⁰ See Oliver Williamson, *THE ECONOMIC INSTITUTION OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING* 47 (1985) (explaining actors without full information are subject to counterparty “opportunism” which “refers to the incomplete or distorted disclosure of information, especially calculate efforts to mislead, distort, disguise, obfuscate, or otherwise confuse”). In fact, agency costs arise whenever asymmetric information is coupled with conflicting or misaligned interests. See Jensen & Meckling, *supra* note 39, at 310 (explaining that agency costs arise whenever an agent is utilized).

⁴¹ See Zohar Goshen, *Controlling Corporate Agency Costs: A United States-Israeli Comparative View*, 6 CARDOZO J. INT'L & COMP. L. 99, 117 (1998) (distinguishing between the two agency problems) [hereinafter Goshen, *Controlling Corporate Agency Costs*]; Bernard S. Black, *The Legal and Institutional Preconditions for Strong Capital Markets*, 48 UCLA L. REV. 781, 842 (2001) (distinguishing between shirking and more illicit types of wrongdoing).

⁴² See, e.g., Michael C. Jensen, *Agency Cost of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AMER. ECON. REV. 323 (1986) (size); Yakov Amihud & Baruch Lev, *Risk Reduction as a Managerial Motive for Conglomerate Mergers*, 12 BELL J. OF ECON. 605 (1981).

investing resources in entrenchment.⁴³ The second type is *takings*, in which the agent directly diverts to himself pecuniary private benefits by, for example, consuming excessive pay and perks,⁴⁴ or conducting related-party transactions.⁴⁵

It is the inevitable tension between agency costs and idiosyncratic value that makes contracting between entrepreneurs and investors challenging. The entrepreneur wants freedom to pursue idiosyncratic value. Although they would enjoy their pro-rata share if idiosyncratic value were realized, investors need to restrict the entrepreneur's freedom in order to minimize agency costs. In a world with transaction costs, simultaneously providing investors full protection from agency costs and the entrepreneur with unlimited freedom to pursue idiosyncratic value is impossible. Therefore, the parties must agree on an acceptable balance between these two goals.⁴⁶

To reach an acceptable idiosyncratic-value/agency-cost balance, the contract between investors and the entrepreneur will typically allocate two key elements: control and cash-flow rights.⁴⁷ As in any negotiation, the intensity of competition and each side's relative bargaining power will determine the ultimate balance.⁴⁸ We now turn to explain this contracting process.

⁴³ Andrei Shleifer & Robert W. Vishny, *Management Entrenchment: The Case of Manager Specific Investments*, 25 J. FIN. ECON. 123 (1989).

⁴⁴ See Jensen & Meckling, *supra* note 39, at 32; Lucian A. Bebchuk, Jesse A. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002) (discussing high levels and composition of executive compensation as manifestation of agency problem).

⁴⁵ See Black et al., *Law and Tunneling*, 37 J. CORP. L. 1 (2011). In the typical case of a widely-held public company, mismanagement is dominating over takings and the problem is labeled "management agency costs," while in the typical controlling shareholder case, takings is dominating over mismanagement and the problem is labeled "control agency costs." See Bebchuk & Hamdani, *supra* note 12, at 1283--1285 (discussing differences between nature of agency costs at controlled and widely-held firms); Luca Enriques & Paolo Volpin, *Corporate Governance Reforms in Continental Europe*, 21 J. ECON. PERSP. 117, 120 (2007) (same).

⁴⁶ The conventional view is that corporate law's principal goal is regulating agency costs. See John Armour et al., *What is Corporate Law*, in THE ANATOMY OF CORPORATE LAW 1, 2 (Reinier Kraakman et al., eds., 2d ed. 2009) ("[M]uch of corporate law can usefully be understood as responding to three principal sources of opportunism: conflicts between managers and shareholders, conflicts among shareholders, and conflicts between shareholders and the corporation's other constituencies. . . .") As we will show, corporate law aims at balancing between idiosyncratic value and agency costs.

⁴⁷ See Oliver Hart, *Financial Contracting*, 39 J. ECON. LIT. 1079, 1079 (2001).

⁴⁸ See, for example, George G. Triantis & Albert H. Choi, *Market Conditions and Contract Design: Variations in Debt Covenants and Collateral*, N.Y.U. L. REV. (forthcoming 2012).

D. *Financial Contracting: Control and Cash-flow Rights.*⁴⁹

1. *The Role of Control.* – Business ideas take time to implement. This ongoing process requires many decisions, ranging from day-to-day management issues to major strategic choices. Given that idiosyncratic value is non-verifiable, control is a crucial element in the entrepreneur's ability to secure idiosyncratic value. Perhaps the most important decision is whether to continue the project. Under conditions of asymmetric information, there may be a divergence of opinion over whether the project should be continued and in what fashion. Accordingly, how will the parties decide on the project's fate?

In theory, they can contract in advance regarding the decisions to be made under various circumstances.⁵⁰ In practice, however, they will face two problems. First, not all contingencies can be predicted in advance and specified in the contract.⁵¹ Second, the information required for the determination that a contingency has occurred and for making an appropriate decision could be non-verifiable.⁵² Since contracts are incomplete, the party with control over decision-making will have more power in determining the project's fate.⁵³ In the presence of asymmetric information and agency costs, the entrepreneur will want to retain control over a wide range of management decisions to pursue idiosyncratic value,⁵⁴ while investors will wish to do exactly the same in order to minimize agency costs.

⁴⁹ An advanced contractual theory refers to the parties' effort to strike an efficient balance between the front-end cost (the contracting process) and the back-end cost (the enforcement process). See Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 YALE L.J. 814 (2006). Here, however, we present a simple contracting model as we aim to analyze ownership structures and not contracts in general. As we will show next, ownership structures are, to a large degree, different contractual templates, which a simple contracting model can sufficiently explain.

⁵⁰ The contract will deal with questions such as: for how long can the execution continue? How much losses/expenses are acceptable? What level of performance should be considered failure/success? Which milestones should be reached?

⁵¹ See, for example, Aghione & Bolton, *supra* note 25, at 473 (recognizing that "financial contracts are inherently incomplete").

⁵² *Id.* at 479-80.

⁵³ See Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691 (1986). The importance of control rights is clearly displayed in venture capital financing. See generally William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 473 (1990) (analyzing relationship between investors and VCs).

⁵⁴ There is, of course, a relationship between the management rights and the right to keep managing. The shorter the right to keep managing, or if it can be stopped at will, affects indirectly the scope of management's rights regardless of their breadth.

Assume that investors insisted on having all control rights. Assume further that the entrepreneur genuinely believes, despite some initial setbacks, that the firm should continue with the project. With control in their hands, however, investors may cut their losses by discontinuing the project, thereby preventing the entrepreneur from realizing idiosyncratic value.⁵⁵ Or investors might lose faith in the entrepreneur, questioning the quality of her performance (due to either insufficient talent or agency costs), and decide to terminate her employment and hire someone else to execute the project.⁵⁶ These decisions could be the outcome of asymmetric information or a difference of opinion between investors and the entrepreneur concerning the project's expected value. In short, granting investors complete control would minimize both their exposure to agency costs and the entrepreneur's ability to secure idiosyncratic value.⁵⁷

Now assume that the entrepreneur raised funds while retaining full control. In this scenario the entrepreneur can continue the project against investors' objections. In other words, her control position would allow the entrepreneur to pursue the idiosyncratic value she attaches to the project regardless of any setbacks. However, leaving full control in the hands of an opportunistic entrepreneur would subject investors to high degree of agency costs, such as keeping the project afloat when it should be abandoned.⁵⁸ In short, granting the entrepreneur complete control will maximize both her ability to secure idiosyncratic value and investors' exposure to agency costs.

⁵⁵ A very notable example is the story of Henry Ford mentioned in the introduction. Similar stories are Jack Bogle who was fired from managing the Wellington Management Company and returned to transform Vanguard into the largest mutual fund company in America, and Jon Luther whose investors closed a food chain he managed, Benchmark, only for him to become the turn-around CEO of Popeye's and Dunkin Donuts. See Rick Newman, *REBOUNDERS: HOW WINNERS PIVOT FROM SETBACK TO SUCCESS*, Chpts. 3 & 4 (2012). Cf. Andrei Shleifer & Robert Vishny, *The Limits of Arbitrage*, 52 J. FIN. 35 (1997).

⁵⁶ Apple firing Steve Jobs is the story that immediately comes to mind, but a more notable example is again Henry Ford and his replacement by investors for Henry Leland, discussed *supra*.

⁵⁷ It will also subject the entrepreneur to the risk of opportunism on the part of investors. See generally Jesse Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. Rev. 967 (2006).

⁵⁸ Indeed, agency costs are the reason why we treat the entrepreneur as the one caring for idiosyncratic value and not both parties although, if materialized, investors will benefit pro-rata. Due to asymmetric information investors cannot verify the amount of control (freedom to manage) the entrepreneur truly needs to secure the idiosyncratic value. Investors might fear that the entrepreneur is asking for more control than she actually needs to create room for agency costs.

Control rights can be divided along many dimensions to achieve a desirable balance between the entrepreneur and investors.⁵⁹ For example, control can be divided by the parties' identity,⁶⁰ a decision's type or importance,⁶¹ governance structures,⁶² or contingencies.⁶³ These building blocks of control represent a spectrum of rights that take a precise shape according to the parties' contract.

2. The Role of Cash-flow Rights. – The execution of the business idea is expected to generate income, which after paying all fixed claims (suppliers, employees, etc.) represents the return on the business idea and the parties' investment. The contract should allocate the project's cash flows between the entrepreneur (to compensate for the business idea and any other investment on his part) and investors.⁶⁴

Cash flows are important in two respects. First, they determine the parties' risk and expected return.⁶⁵ The value of the expected cash flows (discounted for time and risk) relative to the value of the investment made will determine the project's profitability. Investors will agree to fund the project only if their expected share of the project's income provides them with an adequate return on their investment. Whatever left for the entrepreneur will determine her risk and expected return, thereby affecting her incentives and efforts.

⁵⁹ See Jean Tirole, *Corporate Governance*, 69 *ECONOMETRICA* 1 (2001) (explaining that financial economists have failed to study the various dimensions along which control could be allocated between entrepreneurs and investors).

⁶⁰ E.g., granting complete control either to the entrepreneur or to the investors, or splitting the control equally between the parties (joint decisions) or unequally (70%-30%), or granting rights of consultation, or monitoring, or veto.

⁶¹ E.g., one party retaining decisions over operations (e.g., hiring employees, selecting suppliers) and the other retaining control over financing (e.g., taking loans, raising more equity), or one party retaining control over "small" decisions (e.g., day to day management) and the other over "big" decisions (e.g., strategic decisions).

⁶² E.g., the right to appoint directors, the CEO, etc. and dividing the parts among the parties.

⁶³ E.g., defaulting on interest payment, breaching a covenant, missing dividend payments, missing a milestone, such that one side begins with control but if a predetermined event occurs control flips to the other side either permanently, or for a fixed time.

⁶⁴ For example, "enhanced cash flow and control rights may reduce the moral hazard problems associated with financing entrepreneurs . . . [and the] use of preferred stock may provide founders with stronger incentives to generate value, and board control may enable [investors] to more easily monitor and replace poorly performing entrepreneur-managers." See Fried & Ganor, *supra* note 57, at 971.

⁶⁵ For example, investors will consider receiving residual cash-flow rights to be riskier than receiving fixed cash-flow rights and far future cash flows will have lower value than near future cash flows.

Second, by affecting the scope of the entrepreneur's control and the nature of her incentives, the allocation of cash-flow rights can affect both the entrepreneur's ability to pursue idiosyncratic value and investors' exposure to agency costs. For instance, if all the investment is made at the start of the project the entrepreneur will have more control than if the investment is made in stages according to milestones.⁶⁶ Similarly, an investment against a commitment to unconditionally pay fixed amounts on pre-determined dates will provide the entrepreneur with less discretion than an investment against a commitment to pay discretionally residual cash flows. While more control increases the ability to secure idiosyncratic value, it also increases the exposure to agency costs.

Like control rights, cash-flow rights can be divided along many dimensions. Investment can be made at once, or staged according to milestones, for a fixed duration (debt) or indefinite duration (equity). Similarly, cash-flow rights can be fixed (a salary, interest), residual (dividends), hybrid (preferred dividends), or contingent (convertibles). These building blocks of cash-flow rights represent a spectrum of rights that take a precise shape according to the parties' agreement.

3. The Interplay of Control and Cash-flow Rights. – The parties allocate control and cash-flow rights with the aim of finding an optimal balance between the entrepreneur's need to secure idiosyncratic value and investors' need to guard against agency costs. For any given project, both control and cash-flow rights are a pie with a fixed size.⁶⁷ The more control rights (or cash-flow rights) provided to investors, the less control rights (or cash-flow rights) provided to the entrepreneur, and vice versa. Moreover, as control and cash flows affect both the ability to secure idiosyncratic value and the exposure to agency costs, the two rights can act not just as complements but also as substitutes.

a. The Spectrum of the Rights. – To understand the interplay of control and cash-flow rights, assume a contract located on one end of the spectrum where investors receive full control rights and all residual cash flows, and the entrepreneur receives only a fixed salary for executing the project. Such a contract is commonly described as the investors "hiring" the entrepreneur. But the entrepreneur has some degree of control even in this case. True, investors can fire the entrepreneur at will, but as long as she

⁶⁶ See generally Kate Litvak, *Governance through Exit: Default Penalties and Walkaway Options in Venture Capital Partnership Agreements*, 40 WILLAMETTE L. REV. 771 (2004) (analyzing stage financing in VC partnership agreements); Paul A. Gompers, *Optimal Investment, Monitoring, and the Staging of Venture Capital*, 50 J. FIN. 1461 (1995) (analyzing staged financing in VC portfolio investments).

⁶⁷ The *rights* are a fixed size pie although their content might vary. For instance, cash flow rights are a fixed size, but the actual cash flows might increase or decrease when different allocations of these rights affect incentive and effort.

is employed the entrepreneur maintains control over the day-to-day decisions. Due to the misaligned interests of the entrepreneur who receives a fixed salary only, investors are exposed to agency costs (of the mismanagement type). Investors' exposure to agency costs is limited, however, as they have control rights—they can terminate the entrepreneur at will. The uncertainty of her employment term, in turn, limits the entrepreneur's ability to secure idiosyncratic value.⁶⁸

Let us now turn to the other end of the spectrum in which the entrepreneur has all control and cash-flow rights, whereas investors hold only a fixed claim. Such a contract is commonly described as the entrepreneur "borrowing" from creditors (investors). But as financial economists have long recognized, even creditors with fixed claims retain contingent control rights.⁶⁹ As long as the entrepreneur is paying the creditors on time she can make all decisions, but in the event of default control may shift to investors-creditors.⁷⁰ By holding full control rights, the entrepreneur has freedom to pursue idiosyncratic value. But, this same freedom exposes investors to the agency costs of debt (e.g., increasing the riskiness of the project).⁷¹ Investors receive contingent control rights to limit their exposure to agency costs. The latter rights, in turn, set a ceiling on the entrepreneur's freedom to pursue idiosyncratic value.⁷²

b. Cash-Flow and Control Rights as Substitutes. – Both control and cash-flow rights can serve as substitutes when attempting to balance

⁶⁸ However, just to illustrate a slight move to the other end of the spectrum, investors could limit their right to fire the entrepreneur only for cause and add to his salary some stock options, representing a slice of the expected residual cash flows. This would incentivize effort and create a commitment to stay with the project.

⁶⁹ See Jaime Zender, *Optimal Financial Instruments*, 46 J. FIN. 1645 (1991); Sung C. Bae et al., *Event Risk Bond Covenants, Agency Costs of Debt and Equity, and Stockholder Wealth*, 23 FIN. MGMT. 28, 28-29 (1994).

⁷⁰ Patrick Bolton & David S. Scharfstein, *Corporate Finance, the Theory of the Firm*, 12 J. ECON. PERSP. 95, 100 (1998) (explaining creditors take control in cases of default).

⁷¹ See Robert A. Haugen & Lemma W. Senbet, *Bankruptcy and Agency Costs: Their Significance to the Theory of Optimal Capital Structure*, 23 J. Fin. & Quant. Anal. 27 (1988); Roberta Romano, FOUNDATIONS OF CORPORATE LAW 183 (2d ed., 2010) ("By altering the risk of a firm's investments after credit is obtained, manager-shareholders can transfer wealth from bondholders to themselves.").

⁷² See generally Oliver Hart & John Moore, *Debt and Seniority: An Analysis of the Role of Hard Claims in Constraining Management*, 85 AM. ECON. REV. 567 (1995). Just to illustrate moving along the spectrum to the other end, assume investors-creditors can contract for covenants limiting the scope of decisions the entrepreneur can make (e.g., limiting dividends or leverage) or asset use by the entrepreneur (e.g., restricting a sale). See Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117 (1979) (detailing bond covenants used to reduce debt agency costs).

idiosyncratic value and agency costs. For instance, staged financing provides existing or future investors with de-facto control over the decision whether to continue the project.⁷³ Similarly, stock options (a form of residual cash-flow rights) can reduce agency costs by aligning the entrepreneur's interests with those of investors. The building blocks of control and cash-flow rights can thus be used to create different mixtures that balance idiosyncratic value and agency costs. If the parties can design a compensation package (salary, options, and bonuses) that provides the entrepreneur with an adequate return for his business idea (and any other investment on her part) control rights could possibly be assigned to investors. And vice versa, if investors can receive cash flows that adequately compensate for risk, control rights could be assigned to the entrepreneur.⁷⁴

E. Bargaining Power and Competition.

The specific contract between investors and entrepreneurs—the outcome of the negotiations between the parties—will also depend on each party's relative bargaining power. When capital in general is scarce (such as when interest rates are high) or when capital for a specific area of business is scarce (such as a shortage of venture capital funding), investors can get a better deal.⁷⁵ In contrast, when capital is chasing business ideas (too much “dry powder”), or when the entrepreneur has a very appealing idea or track record, she can bargain for more beneficial terms.⁷⁶ Due to differences in bargaining power, the same project could result in different allocations of control rights and cash-flow rights.

⁷³ See *supra* note 66 and accompanying text (describing control from staged financing).

⁷⁴ In fact, different securities represent different mixtures of these two elements. For example, a common share represents an indefinite investment entitled to residual cash flows (high exposure to agency costs) with control rights (high degree of protection), while a bond represents a fixed-duration investment with fixed cash flows (low exposure to agency costs) and only contingent control rights (low degree of protection).

⁷⁵ See Blake D. Morant, *The Quest for Bargains in an Age of Contractual Formalism: Strategic Initiatives for Small Businesses*, 7 J. SMALL & EMERGING BUS. L. 233, 237 (2003) (explaining inequality of bargaining power of small business results in reduced contract protections); Cf. Mark C. Suchman et al., *The Legal Environment of Entrepreneurship: Observation on the Legitimation of Venture Finance in Silicon Valley*, in THE ENTREPRENEURS: ORIGINS OF ENTREPRENEURSHIP AND THE EVOLUTION OF INDUSTRIES 349 (Claudia Bird Schoonhoven & Elaine Romanelli eds., 2001) (suggesting that without bargaining power entrepreneurs may take investment on a take-it-or-leave-it basis).

⁷⁶ See, e.g., Paul Gompers & Josh Lerner, *The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements*, 39 J.L. & ECON. 463, 493, 496 (1996) (finding that VC use of covenants is related to supply and demand in the venture capital industry).

Furthermore, agency costs and idiosyncratic value are not necessarily symmetrically valued.⁷⁷ Thus, the entrepreneur might value control rights much more than the price that investors attach to their increased exposure to agency costs.⁷⁸ In other words, competition and relative bargaining power can result not just in different pricing, but also in variations in a contract's quality (from the investors' or entrepreneur's perspective) for the same basic deal.

II. SPECTRUM OF OWNERSHIP PATTERNS

This Part uses our framework to show that different ownership structures lie on a spectrum of possible financial contracts between the entrepreneur and investors. Specifically, we will review dispersed ownership, private equity funds, dual-class firms, and concentrated ownership. As we will explain, each ownership structure presents a different balance between idiosyncratic value and agency costs.

A. *Dispersed Ownership.*

On one end of the spectrum lies the dispersed ownership structure. This structure is similar to our earlier illustration of the entrepreneur as an employee: investors hold all control and residual cash-flow rights, and the entrepreneur receives a salary.⁷⁹

We analyze the dispersed ownership case as the entrepreneur being the board of directors and the CEO jointly (we will call them "Management"). An entrepreneur can be in a dispersed ownership structure either because she sold her control block to the market (or was diluted) due to risk diversification or wealth-constraints, or because she was appointed to manage an established widely-held firm. The analysis in both scenarios is similar and we will continue with the latter case. Assume that Management competes over the right to manage an existing firm. In a typical case, it may appear that Management's idiosyncratic value is small,⁸⁰ as it basically amounts to an offer to "manage better than others," while investors are asked to hand over ("invest") their already operational firm. To be sure, managerial talent could be an important element in the success or collapse

⁷⁷ While entrepreneurs may be undiversified given their human-capital investment, investors hold a diversified portfolio.

⁷⁸ For example, Facebook recently went public with a dual class structure in place, leaving investors without control, *see Unequal Shares*, The New Yorker, at http://www.newyorker.com/talk/financial/2012/05/28/120528ta_talk_surowiecki.

⁷⁹ See *supra* text accompanying note 68.

⁸⁰ For indirect evidence supporting this proposition, *see* Steven Kaplan et al., *Should Investors Bet on the Jockey or the Horse? Evidence From the Evolution of Firms from Early Business Plans to Public Companies*, 64 J. FIN. 75 (2008) (finding that post-IPO firms' core line of business or business idea was remarkably stable while the management turned over quite frequently).

of many well-established, publicly-traded corporations.⁸¹ Yet, investors at existing publicly-traded firms operating in an environment characterized by an active market for managers are more likely to accurately price the expected value of managers' talent, thereby leaving less room for asymmetric information and idiosyncratic value. Also, note that if management's idiosyncratic value is large, management can move to the other end of the spectrum by initiating a management buyout (MBO), with management owning control and residual cash-flow rights and investors providing debt.⁸²

We start with the allocation of cash flows. Shareholders receive all residual cash flows, while Management receives a salary and a small fraction of residual cash flows through options and bonuses included in the compensation package.⁸³ Leaving management with a small fraction of residual cash flows exposes investors to management agency costs.

Moving to control rights, Management controls the day-to-day management decisions (CEO's authority), and many substantial business and governance decisions (board's authority),⁸⁴ while shareholders retain control over a few significant decisions (e.g., a merger or sale of substantially all of the firm's assets).⁸⁵ More importantly, shareholders can, in theory, displace Management or sell their shares to a bidder seeking control of the corporation.⁸⁶

In widely-held firms, shareholders' ability to terminate Management curtails Management's ability to secure idiosyncratic value,⁸⁷ and limits shareholders' exposure to management agency costs. If shareholders—the investors—are convinced that Management is wrong in pursuing a business

⁸¹ For example, Ford Motor and Henry Ford, Lee Iacocca and Chrysler; Kodak; Eastern Air Lines; Lehman Brothers; Apple; Nokia; and Blackberry. Yet, despite their pursuit of idiosyncratic value, managers may lack the resources to buy a control block.

⁸² See, for example, Steven Kaplan, *The Effect of Management Buyouts on Operating Performance and Value*, 24 J. FIN. ECON. 217 (1989) (presenting evidence on changes in operating results of firms that went through a management buyout).

⁸³ Kevin J. Murphy, *Executive Compensation: Where We Are, and How We Got There*, in HANDBOOK OF THE ECONOMICS OF FINANCE (Milton Harris & Rene Stulz, eds.) (Forthcoming) (generally reviewing executive compensation).

⁸⁴ Del. Gen. Corp. L. § 141(a) (granting expansive board authority).

⁸⁵ See Del. Gen. Corp. L. § 271 (requiring a shareholder vote for sale of substantially all the firm's assets); Del. Gen. Corp. L. § 251 (requiring majority shareholder vote for statutory mergers).

⁸⁶ Charles R.T. O'Kelley & Robert B. Thompson, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS: CASES AND MATERIALS 157 (6th ed., 2010) (explaining that shareholders can effectively only "vote, sell, and sue").

⁸⁷ See also Jean-Jacques Laffont & Jean Tirole, *Repeated Auctions of Incentive Contracts, Investments, and Bidding Parity with an Application to Takeovers*, 19 RAND. J. ECON. 516 (1988) (demonstrating that ease of replacement undermines management incentives to make unobservable investments).

strategy, or if they believe Management is incompetent or unmotivated, they can elect new leadership or tender their shares to a bidder for control.⁸⁸

To be sure, there is a difference between formal and real power. Shareholders may encounter legal and other obstacles in voting Management out of office.⁸⁹ Moreover, companies may adopt antitakeover provisions in their charter and Management can employ other antitakeover tactics. Some legal systems provide directors with a large degree of freedom to resist hostile bids,⁹⁰ while others, like the United Kingdom, insist on a rule under which shareholders should have the right to decide whether to sell the firm.⁹¹ Yet, some argue that even where the law allows it to resist hostile bids, Management cannot practically decline a tender offer when the price offered is sufficiently high.⁹²

For our framework, however, it is sufficient to point out that in a dispersed ownership structure control is contestable: The stronger the market for corporate control and the more effective the proxy mechanism, the greater the risk of Management removal. Making it more difficult for investors to displace Management enhances Management's ability to pursue idiosyncratic value while increasing investors' exposure to agency costs.⁹³

⁸⁸ See also Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465 (2005).

⁸⁹ See, for example, Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675 (2007).

⁹⁰ Delaware, for example, allows firms to have staggered boards and implement a poison pill to effectively block takeovers, subject only to minimal judicial review. See *Airgas, Inc. v. Air Products and Chemicals, Inc.*, 16 A.3d 48 (Del. Ch. 2010).

⁹¹ See Paul L. Davies, GOWER AND DAVIES' PRINCIPLES OF MODERN CORPORATE LAW 374-76 (8th ed., 2008). Regardless of the formal rules of takeover defenses, hostile takeovers are rare in the United Kingdom, see Charlie Weir & David Laing, *Ownership Structure, Board Composition and the Market for Corporate Control in the UK: An Empirical Analysis*, 35 APPLIED ECON. 1747 (2003); John Armour & David A. Skeel, *Who Writes the Rules for Hostile Takeovers, and Why? The Peculiar Divergence of US and UK Takeover Regulation*, 95 GEO. L.J. 1727 (2007).

⁹² See also Steven N. Kaplan & Bernadette A. Minton, *How Has CEO Turnover Changed? Increasingly Performance Sensitive Boards and Increasingly Uneasy CEOs*, NBER Working Paper No. 12465 (2006), at <http://www.nber.org/papers/w12465> (the average tenure for CEOs of large US corporations is slightly over six years); Marcel Kahan & Edward B. Rock, *Embattled CEOs*, 88 TEX. L. REV. 987 (2010) (arguing that, since 2000, CEOs have been losing power to boards and shareholders).

⁹³ In this light, the debate over allowing or restricting takeover defenses should be seen as debate over where to place the balance between agency costs and idiosyncratic value. See also Black & Kraakman, *supra* note 33 (explaining Delaware's approach to takeovers by the notion of hidden value—under which the firm's true value is apparent to directors but not shareholders or acquirers). *But see*

B. Private Equity Funds.

Private equity funds present a different tradeoff between idiosyncratic value and agency costs. Private equity funds normally obtain control of corporations, private or public, and take them through some form of reorganization according to the fund's strategy.⁹⁴ These funds are organized as partnerships, with the entrepreneur being the general partner and the investors being limited partners.⁹⁵

Beginning with control, the fund's investors have virtually no say on its affairs,⁹⁶ nor can they terminate the employment of the general partner who manages the fund. The fund, however, is for a limited duration (normally ten years).⁹⁷ Indeed, the limited duration is essentially an exit right for investors, which allows them to end the general partner's control over their investment.

In terms of cash flows, the general partner receives a compensation package that includes fixed management fees for managing the fund (normally about 2%) and sizeable residual cash flows (normally 20% of profits), while investors receive the remainder of the residual cash flows.⁹⁸

Compared to a CEO in a widely-held corporation, the general partner of a private equity fund enjoys both full control over all decisions affecting the value of the fund's investment and a much more generous compensation package.⁹⁹ While the CEO has an uncertain term, as he can be fired at will (subject to the costs of a proxy fight and a hostile takeover)

Philippe Aghion et al., *Innovation and Institutional Ownership*, at <http://www.nber.org/papers/w14769> (finding a positive relationship between innovation and institutional ownership is stronger when CEOs are less entrenched due to protection from hostile takeovers, and that the decision to fire the CEO is less affected by a decline in profitability when institutional investment is high).

⁹⁴ See Steven N. Kaplan & Per Stromberg, *Leveraged Buyouts and Private Equity*, 23 J. ECON. PERSP. 121, 121 (2009) (generally reviewing private equity firms) [hereinafter Kaplan & Stromberg, *Leveraged Buyouts*].

⁹⁵ *Id.*

⁹⁶ See *id.* at 126 (“[A]fter committing their capital, the limited partners have little say in how the general partner deploys the investment funds, as long as the basic covenants of the fund agreement are followed.”).

⁹⁷ See Andrew Metrick & Ayako Yasuda, *The Economics of Private Equity Funds*, 23 REV. FIN. STUD. 2303, 2309 (2010) (“[T]he typical fund has a lifetime of ten years, with GPs allowed to make investments in new companies only during the first five years.”).

⁹⁸ *Id.* at 2311.

⁹⁹ Why would an entrepreneur manage a widely-held corporation and not a private equity fund? It could be the type of idiosyncratic value (a business idea that has economies of scale that can be replicated in the many corporations owned by the private equity fund), the market power of the entrepreneur (reputation, experience), or taste (non-pecuniary benefits, asset specific investment in human capital).

the general partner has a fixed term to manage the fund.¹⁰⁰ Additionally, shareholders' investment in a widely-held firm is for an indefinite term with management normally able to raise more money by issuing debt or equity and preserve retained earnings. In contrast, investors' contribution to the private equity fund is for a fixed duration, and the general partner cannot raise additional funds once the fund is "closed," nor can she keep proceeds from realized investments.¹⁰¹ Indeed, the general partner will have to open a new fund in order to raise more money.¹⁰²

The general partner is granted full discretion to pursue idiosyncratic value, with the restriction that the time frame for the realization of such value (*i.e.*, the reorganization strategy) fits the duration of the fund. While the general partner's complete control and an assured fixed term increase her ability to secure idiosyncratic value, they also increase investors' exposure to agency costs. However, agency costs are contained by the fund's 2/20 fee structure, which operates to align the interests of the general partner with those of the fund's investors. The presence of sophisticated investors,¹⁰³ and the fund's fixed term and inability to raise more financing, further limit the exposure to agency costs: An entrepreneur that subjects fund investors to agency costs (mismanagement or takings) will suffer reputational losses leading investors to shun her future funds.¹⁰⁴

¹⁰⁰ True, the CEO might serve much longer than the term of a fund, and many CEOs do serve long periods. The point is that they cannot count on it. *See* Kaplan & Minton, *supra* note 86, at 2 (explaining the average tenure for CEOs of large US corporations is slightly over six years).

¹⁰¹ *See* Metrick & Yasuda, *supra* note 97, at 2304.

¹⁰² *Id.*

¹⁰³ Investors in a private equity fund are commonly several well-informed sophisticated individuals and institutional investors with investment's horizon and goals aligned with the fund strategy.

¹⁰⁴ *See* Ji-Woong Chung et al., *Pay for Performance from Future Fund Flows: The Case of Private Equity*, 25 REV. FIN. STUD. 3259 (2012) (estimating the incentives generated by general partners' need to raise future funds). Activist hedge funds could also be analyzed within our framework. Unlike private-equity funds, they do not seek control. Rather, they buy a position that would enable them to exert some influence in their role as shareholders. They then try to pressure the firm to take one or two steps—such as putting itself up for sale, paying a large dividend, or pursuing a structural change. *See* Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729 (2008). This difference in strategy between private equity and activist hedge funds could be explained by the fact that control is less valuable for an investor that would like the firm to take a single, relatively-defined task. In other words, the fund can openly communicate the course of action that it would like the firm to implement. There is no need for the fund to implement its plan itself.

C. *Dual-class Firms.*

A dual-class share structure lies on the other end of the spectrum. In this structure, the entrepreneur holds shares with superior voting rights while investors' shares have inferior or no voting rights.¹⁰⁵ By owning a majority of voting rights, the entrepreneur has full control over business decisions, and he can block any hostile takeover without even the minimal judicial review that might restrict management in a widely-held company. Despite holding a small share of residual cash flows, the entrepreneur has fully uncontestable control for an unlimited time.¹⁰⁶

The entrepreneur's small fraction of residual cash flows increases investors' exposure to management agency costs.¹⁰⁷ Investors' exposure to these costs is exacerbated by the entrepreneur's uncontestable and indefinite control, which also subject investors to control agency costs (the *takings* type). Accordingly, it might appear that investors are getting the worst of all worlds in this structure by bearing both management and control agency costs.

Yet, uncontestable and indefinite control provides the entrepreneur with maximum ability to secure idiosyncratic value. If investors believe in the entrepreneur's unique professional abilities and vision,¹⁰⁸ they might agree to buy shares in the dual-class structure.¹⁰⁹ Similarly, when the

¹⁰⁵ For example, assume 1 share out of 10 shares has 51% of the votes, while the remaining 9 shares have together 49% of the votes. Each share has equal rights for residual cash flows. The entrepreneur owns the super-share (51% of the votes and 10% of residual cash flows), and investors own the remaining shares (49% of the votes and 90% of residual cash flows).

¹⁰⁶ The dual-class structure can be viewed as a spectrum of contracts depending on the level of equity ownership by the controller.

¹⁰⁷ The exposure to agency costs is a negative function of entrepreneur's share of cash-flow rights. See Stijn Claessens et al., *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, 57 J. Fin. 2741 (2002) (finding that controlled corporations' market to book ratio increases in controllers' cash-flow rights but declines in the wedge between those rights and voting rights). The entrepreneur's share of cash-flow rights in a dual-class firm is normally higher than that of the CEO in a widely-held firm. See Paul A. Gompers et al., *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, 23 REV. FIN. STUD. 1051, 1053 (2010) (insiders at U.S. dual-class firms hold on average 40% of cash-flow rights).

¹⁰⁸ And her responsiveness to non-legal forces such as reputation. See Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980) (pointing to reputation as a management restricting device); Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997) (illustrating the role of reputation in trusting corporate managers).

¹⁰⁹ In 2012, Google issued additional common stock, and could easily have diluted the dual-class protection by issuing both Class A and Class B stock. But it declined to do so, and the founders of Google wrote a letter to shareholders explaining why.

entrepreneur has very high idiosyncratic value but insufficient wealth to hold the majority of equity rights (e.g., when the corporation is too big), she might insist on holding uncontested control without a large equity investment and thus could offer only the dual-class structure. Indeed, at least in the United States, firms going public with a dual-class structure are the exception, not the rule.¹¹⁰ Additionally, as the recent examples of Facebook and Google demonstrate, firms that go public with such a structure are often those with a relatively high demand for their shares.¹¹¹ In other words, as explained above, an entrepreneur's unique bargaining power or the strong demand for a specific firm (justified or not) can cause investors to agree to a dual-class structure.

D. *Controlling Shareholders.*

In a concentrated ownership structure, the entrepreneur controls the company by virtue of owning a large block of *voting* equity, which, unlike dual-class shares, is issued at one-share-one-vote. Accordingly, control and cash flows rights are distributed pro-rata between the entrepreneur and investors (minority shareholders) according to each side's investment. Although the controlling shareholder structure could be formed in different ways—an entrepreneur who wholly-owned a corporation could sell a minority stake to the market, or buy control of a widely-held corporation through a tender offer or from another controller—the analysis in each case is similar.

The concentrated ownership structure is just another contract on the idiosyncratic-value/agency-cost spectrum, falling between dispersed ownership (low idiosyncratic value and low agency costs) and dual-class firms (high idiosyncratic value and high agency costs).¹¹² Concentrated

The letter, <http://investor.google.com/corporate/2012/founders-letter.html>, says, among other things, that the entrepreneurs that founded Google insisted on dual-class stock because they wanted to pursue long term projects without the possibility of losing control over these projects. They specifically say, for example, that the structure was necessary because “[t]echnology products often require significant investment over many years to fulfill their potential. For example, it took us over three years to ship our first Android handset, and then another three years on top of that before the operating system truly reached critical mass.”

¹¹⁰ See Robert M. Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J. L. ECON. & ORG. 83 (2001) (finding only 6% of the firms in IPOs have dual class shares).

¹¹¹ See Simon C.Y. Wong, *Google's Stock-Split Would Replace Stewardship with Dictatorship*, HARV. BUS. REV. ONLINE (Apr. 18, 2012), at http://blogs.hbr.org/cs/2012/04/googles_stock-split_plan_would.html.

¹¹² Viewing the spectrum through the entrepreneur's share of cash-flow rights the order would be: dispersed ownership (a salary + 1-3% residual), private equity (2% + 20% residual), dual class (less than 50%), and controlling shareholders (sufficient to get a lock on control). Viewing the spectrum through control rights

ownership—bundling control with cash-flow rights—allows the entrepreneur to secure idiosyncratic value while alleviating investors' exposure to management agency costs.

To illustrate the point, assume that the investors—like in a dispersed ownership structure—control the firm by holding a majority of the shares, and they hire the entrepreneur to manage the business on their behalf. The entrepreneur will hold actual control over day-to-day management. Yet, investors can unilaterally decide whether to continue the business or terminate the entrepreneur's employment. The entrepreneur might agree to manage the firm and implement his business idea even without control, if investors offered him a compensation package that provided him with appropriate compensation for his business idea and any other investment on his part.¹¹³ Indeed, this is the typical case in a dispersed ownership structure.

Now, assume that the entrepreneur—like in a dual class firm—retains control over the business. From his standpoint, control secures idiosyncratic value. The entrepreneur holds the power to make all decisions, including the execution of the business idea and whether to continue the business. Even if the business fails to produce the expected returns, investors cannot close the business or displace the entrepreneur.¹¹⁴ Neither can they demand their investment back. The most that investors can do is sell their shares on the market.¹¹⁵ Though this structure maximizes

the order would be: dispersed ownership (at will or contestable), private equity (10 years), dual class (indefinite), and controlling shareholders (indefinite). In the idiosyncratic value view, the controlling shareholder structure lies between the dual class share and MBO structure. However, viewing the spectrum through agency cost exposure, the dual class share structure provides for much higher agency costs than the controlling shareholder structure.

¹¹³ However, such an arrangement might present several challenges. First, designing a compensation package that would provide the entrepreneur (manager) with an appropriate return on his idea could be prohibitively costly and complex. Depending on the business idea, and the idiosyncratic value associated with it, investors might need to offer the entrepreneur very high-powered incentives, which in turn, given asymmetric information, could distort the entrepreneur's incentives and produce a range of agency costs. Second, when the entrepreneur has no control, relying exclusively on compensation to capture her return on her business idea would expose her to agency costs. Investors could opportunistically terminate her employment before idiosyncratic value is realized or fail to take value-enhancing actions that would positively affect her compensation. Given asymmetric information, investors might simply lose faith in the project and prematurely close it down.

¹¹⁴ The power to displace the CEO is one of the important features of equity. See Zsuzsanna Flack, *Optimal Financial Contracting: Debt versus Outside Equity*, 11 REV. FIN. STUD. 383, 389 (1998) (explaining outside equity has the right to dismiss and replace management independently of their realization of cash flow).

¹¹⁵ It is commonly assumed that en-masse exit by investors could discipline managers at widely-held firms. See, e.g., Alex Edmans & Gustavo Manso,

the entrepreneur's ability to capture idiosyncratic value, it also exacerbates agency cost concerns for investors. After all, when investors provide the entrepreneur with uncontested control for unlimited time, they give up important market-based mechanisms—such as the market for corporate control—that serve to discipline managers at widely-held firms. Indeed, this is the typical investors' exposure in the dual-class share structure.

While dispersed ownership and dual-class structures represent variations on “separation of cash-flow and control,”¹¹⁶ the controlling shareholder structure provides a middle ground solution: It bundles cash-flow rights and control. Under a one-share-one-vote regime, the entrepreneur retains control only if she holds an equity position sufficient to give her control. However, holding a control block inflicts costs on the entrepreneur. She needs to put her equity at risk, reducing liquidity and diversification, and to “work” either directly or by monitoring professional managers. While investors do not necessarily bear equal share in this expense, the entrepreneur must share with them pro-rata the expected return of the business. This is the “price” the entrepreneur pays to hold uncontested control for unlimited time in order to protect her pursuit of idiosyncratic value. After all, this is a small cost, as the entrepreneur is (subjectively) certain to make above market returns on her investment and costs.

From investors' perspective, the entrepreneur's bundling of control and cash-flow rights alleviates asymmetric information and agency cost concerns. First, asymmetric information as to the idiosyncratic value is reduced when the entrepreneur has a lot of “skin in the game.” Second, substantial equity investment by the entrepreneur greatly aligns the interests of the entrepreneur with those of investors, thereby reducing management agency costs. Moreover, aligning interests through the substantial equity holding replaces the complexity of designing a compensation package for the entrepreneur with much simpler equity-based returns. Third, as control blocks are less liquid, bundling control and cash-flow rights restricts the ability of the entrepreneur to quickly walk away from the business. This type of lock-in effect increases the entrepreneur's commitment.

Governance through Trading and Intervention: A Theory of Multiple Blockholders, 24 REV. FIN. STUD. 2395 (2011). The impact of investor exit—and the resulting decline in market price—on controlling shareholders is less clear. See, for example, Antoine Faure-Grimaud & Denis Gromb, “Public Trading and Private Incentives”, 17 REV. FIN. STUD. 985 (2004)

¹¹⁶ As compared with the famous Berle and Means term “separation of ownership and control,” our term uses “cash flow” instead of “ownership,” as we disregard the formal rights and focus on the actual rights. See Adolph A. Berle & Gardiner C. Means, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

Is this, therefore, the ideal ownership structure? The answer is no.¹¹⁷ As we noted earlier, in the perfect structure the entrepreneur is not wealth-constrained and can fully finance the business, thereby maximizing idiosyncratic value with no agency costs.¹¹⁸ Once investors enter the picture, financial contracting between entrepreneurs and investors will result in different mixtures of balancing contracts (*i.e.*, ownership structures), none of which can both fully secure idiosyncratic value and fully eliminate agency costs.¹¹⁹ The controlling shareholder structure is no different.¹²⁰

Compared to dispersed ownership, the controlling-shareholder structure curtails management agency costs by forcing the controller to own a significant equity stake. This structure, however, does create exposure to the control agency costs present in dual-class structures. Investors face the risk that although the entrepreneur will efficiently manage the firm and realize the idiosyncratic value she will evade the commitment to share residual cash flows pro-rata and consume private benefits of control.

In sum, the controlling shareholder structure is a contract in which the entrepreneur enjoys uncontested control for an unlimited time, allowing him to secure idiosyncratic value. However, the entrepreneur must pay for his position in lost diversification, liquidity, and additional execution and monitoring costs. Investors (minority shareholders) receive protection from management agency costs due to the entrepreneur's large equity holding and the corresponding incentive alignment, but are exposed to control agency costs that might circumvent their right to a pro-rata share of residual cash flows.

III. REFLECTIONS ON THE THEORY AND EMPIRICS OF CONCENTRATED OWNERSHIP

Before we proceed to evaluate corporate law in light of our financial-contracting analysis, we would like to highlight several theoretical insights

¹¹⁷ Although an empirical study has found that controlled firms do better than widely-held firms, which in turn do better than dual-class firms. *See Controlled Companies in the S&P 1500: A Ten Year performance and Risk Review*, <http://irrcinstitute.org/pdf/FINAL-Controlled-Company-ISS-Report.pdf>

¹¹⁸ See Henry Hansmann, *Ownership of the Firm*, 4 J. L. ECON. & ORG. 267 (1988) (explaining such firms are rare).

¹¹⁹ Much like variety of cars: medium-safety/medium-speed/medium-price, low-safety/high-speed/medium-price, high-safety/low-speed/medium-price, high-safety/high-speed/high-price etc.

¹²⁰ Why would a controlling shareholder not take the firm private? It could be for many reasons: he is spreading his risk of failure, there is insufficient liquidity in the market, the company is too large, he has no track record that will allow him to raise a large investment, etc.

and empirical predictions that follow from our framework. These insights both question and supplement prior scholarship on concentrated ownership.

The assumption underlying the existing literature is that controllers are motivated to hold a control block in order to extract private benefits of control. This assumption leads to several contentions that we challenge. Section A will consider the claim that private benefits of control and poor investor protection are the cause for concentrated ownership. Section B assesses the possibility that improved monitoring explains the controlling-shareholder structure. Section C concludes by considering the conventional premise that the size of the control premium is indicative of the quality of investor protection and by offering several directions for empirical research.

A. *Private Benefits Inducing Concentrated Ownership.*

The premise underlying the standard account of concentrated ownership is that holding a control block is costly—as it involves monitoring management, loss of liquidity, and reduced-diversification. At the same time, the control position allows controllers to enjoy private benefits of control. It thus follows that the more the controller can exploit the minority the greater his interest in holding the block. According to this view, a concentrated ownership structure is a consequence of low-quality investor protection (“bad law”) allowing controllers to exploit minority shareholders. In short, private benefits *induce* the concentrated ownership structure.¹²¹

There are several difficulties with this explanation. First, it assumes that most controllers around the world are opportunists, taking advantage of the imperfect legal and market protections for minority shareholders. Second, it cannot explain the presence of concentrated ownership in the United States and other countries with “good law,”¹²² the investment practice of private equity funds,¹²³ or the pricing of carve outs.¹²⁴ Third, it explains a

¹²¹ See *supra* notes 12-14 and accompanying text.

¹²² See Gilson *supra* note 8.

¹²³ Private Equity funds normally buy all the shares of the corporations in their portfolio, but sometimes they buy a control position. When funds buy a control position they pay a control premium. Rather than engaging in self-dealing, the fund focuses on implementing its reorganization plan increasing the value of the firm and selling it for a profit before the term of the fund ends. Such behavior cannot be explained by incentive to consume private benefits of control. See Kaplan & Stromberg, *Leveraged Buyouts*, *supra* note 94.

¹²⁴ A carve-out occurs when a parent firm sells partial ownership interest in a subsidiary to the public while retaining at least half of the common stock, thus controlling the carved-out subsidiary. A carved-out subsidiary is thus a firm that went public as a majority-owned firm. Schipper and Smith found that the initial percentage returns on the stock of the new subsidiaries was much lower than those observed in studies of public offerings generally. That is, in newly issued stocks of

phenomenon only through its pathology without offering a functional explanation.

Our analysis, in contrast, identifies reasons other than private benefits to hold a controlling position: Entrepreneurs may insist on retaining control because it secures their ability to realize idiosyncratic value. In other words, entrepreneurs may value control even when they genuinely intend to share all the firm's cash flows and assets on a pro-rata basis with the minority shareholders. Our analysis thus explains why concentrated ownership exists even in "good-law" countries, and, for "bad-law" countries, our analysis suggests that focusing exclusively on minority protection offers an incomplete account. While the quality of investor protection affects agency costs, the quality of markets impacts the ability of entrepreneurs and investors to overcome asymmetric information, thereby affecting idiosyncratic value. Thus, one should look to the quality of both, law *and* markets, to explain the prevalence of concentrated ownership in certain jurisdictions.¹²⁵

C. *Monitoring as Insufficient Explanation.*

An alternative, more positive view explains minority investors' willingness to tolerate the controller's consumption of private benefits by focusing on the value of monitoring. Instead of relying on imperfect markets to monitor management, investors rely on the controller to take on this role. As holding a control block imposes costs (illiquidity, reduced diversification, and monitoring), an entrepreneur would not agree to hold a control block without the prospect of securing some non-pro-rata share of residual cash flows—or equally valuable non-pecuniary benefits—to offset

a majority-owned firm the issuer offered a lower discount on its stocks relative to public offerings generally. See Katherine Schipper & Abbie Smith, *A Comparison of Equity Carved-Outs and Equity Offerings: Share Price Effects and Corporate Restructuring*, 15 J. FIN. ECON. 153 (1986). Moreover, parent firms' announcements of reacquisition of their carved-out subsidiaries are associated with positive abnormal returns for public shareholders that approximate those earned by target firms in arms-length mergers and acquisitions. And, after a parent firm sells off its interest in the carved-out subsidiary, in most cases minority shareholders are bought out for the same price. See April Klein, James Rosenfeld & William Beranek, *The Two Stages of An Equity Carve-Out and the Price Response of Parent and Subsidiary Stock*, 12 MANAGERIAL & DECISION ECON. 449 (1991).

¹²⁵ The basic claim is that idiosyncratic value depends on financial development. Developed market institutions facilitate outside investors' ability to reduce the information gap regarding entrepreneurs' idiosyncratic value, thereby making control less valuable. See also Aghion et al., *supra* note 93 (finding that the decision to fire the CEO is less affected by a decline in profitability when institutional investment is high). Additionally, it may be difficult to structure an optimal compensation package for management of a widely-held firm when markets are underdeveloped (enforcement is weak, etc.).

the additional costs only she shoulders. In exchange for her valuable monitoring service, minority investors must therefore allow the controller to consume some degree of private benefits.¹²⁶ While in the earlier explanation private benefits of control *induced* entrepreneurs to hold control, here (optimal) private benefits of control *reward* entrepreneurs in a concentrated ownership structure. But both explanations are similarly incomplete.

This view consists of two related premises. First, investors rely on investors with a substantial ownership stake to monitor management. Second, to the extent that controllers do provide valuable monitoring services, they need to be rewarded with private benefits of control.

Let us start with the first premise. Monitoring indeed plays an important function in assuring efficient management. Nonetheless, “monitoring” is a service, much like “management,” that can be delegated. Indeed, corporate law assigns the role of monitoring to the board of directors. Why does monitoring require one to own a controlling block? One possible answer is that the controller’s substantial equity stake aligns her interests with those of minority shareholders, thereby providing superior incentives to monitor. This answer presents the issue as a question of how to design optimal monitoring incentives *i.e.*, by using a control block or a compensation package.¹²⁷ But why not improve the compensation of directors who are already assigned the role of monitoring management?¹²⁸ The answer could be that designing a compensation package that will replicate the incentives produced by a substantial equity block is difficult and prohibitively expensive.¹²⁹ This could be the case, for example, in countries where financial markets or legal institutions are

¹²⁶ See, e.g., Gilson & Gordon, *supra* note 16, at 785; Gilson & Schwartz, *supra* note 16, at 4 (arguing that private benefits of control “compensate controlling shareholders for the monitoring they provide and the diversification they yield to maintain control”).

¹²⁷ Monitoring is just a means to achieve the ultimate goal of efficient management. Why not simply improve management’s own compensation package to incentivize it to manage efficiently? See generally, Michael C. Jensen & Kevin J. Murphy, *CEO Incentives: It’s Not How Much You Pay, But How*, 33 J. APP. CORP. FIN. 36 (1990) (viewing incentive compensation as device to reduce agency costs).

¹²⁸ See, e.g., Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 864 (1993) (arguing that encouraging directors to hold substantial equity interests would provide better oversight incentives). But see Assaf Hamdani & Reinier Kraakman, *Rewarding Outside Directors*, 105 MICH. L. REV. 1677, 1682-83 (2007) (arguing that equity pay for directors “cannot substitute for direct monitoring incentives”).

¹²⁹ A similar answer regarding the need for equity ownership to incentivize managers was rejected by Oliver Hart. See Hart, *supra* note 17, at 1082 (“[W]hy use financial structure rather than an incentive scheme to solve what is really just a standard agency problem”).

underdeveloped. This answer, however, fails to explain the variance of ownership structures within countries: In other words, why is it the case that investors can rely on market mechanisms to provide adequate monitoring at some companies but not others?

These questions notwithstanding, we assume *en arguendo* that controlling shareholders do provide effective monitoring that cannot be replicated—or would be costlier to replicate—through a compensation package.¹³⁰ Yet, we question the claims that private benefits are a necessary reward for monitoring and that corporate law should facilitate the consumption of an optimal level of private benefits.

The claim that optimal private benefits are a desirable reward for monitoring relies on several implicit assumptions. First, without some private benefits the controlling shareholder essentially receives less than her pro-rata share, as only she bears the costs associated with a control block. Second, the controller's (reduced) share of the pie is insufficient to compensate her for her total investment (business idea, costs of holding the block, monitoring, etc.). Third, controlling shareholders cannot contract with minority shareholders to receive compensation in a transparent manner. Fourth, allowing controlling shareholders to consume an optimal level of private benefits is not more costly to enforce than a complete ban on unfair dealing. We will now discuss each assumption.

Consider first the assumption regarding the controlling shareholder's disadvantaged position. This assumption is based on comparing costs and benefits for the controller and the minority. While the controller and the minority share equally in the residual cash flows, only the controller bears

¹³⁰ One such difficulty is that the control block exposes the controller both to upside and down-side risk. However, finance theory suggests that diversified shareholders would prefer that risk-averse managers be provided with a share of the upside without the downside, as not to increase their risk aversion of a manager who likely has a non-diversified financial and human capital investment in the firm. This is why options are a predominate form of compensation for management.

Even assuming that the monitor should be provided with a share of downside risk, directors can receive restricted or phantom stocks to replicate the control block incentives. Even so, the argument goes, mimicking the incentive effects of a substantial control block will be prohibitively expensive. This might be true, but we note that the private equity compensation package suggests it is possible.

Another presumed reason for the superiority of controlling shareholders refers to the ease by which a controlling shareholder can fire management, while removing the board of a widely-held corporation is much more difficult. This description may be accurate. *See, e.g.,* Assaf Hamdani & Ehud Kamar, *Hidden Government Influence over Privatized Banks*, 13 TH. INQ. L. 567, 582 (2012) (explaining why displacing senior executives may be easier for controlling shareholders than for boards). Yet, it confuses the picture. A properly-incentivized board could quite easily fire the CEO. True, replacing a board that fails to monitor management may be difficult, but not as difficult as replacing an incompetent controlling shareholder.

the costs of illiquidity, non-diversification, and monitoring, and thus needs extra compensation to make her whole. This argument, however, is based on an incomplete calculation. Even under a regime of pro-rata distribution of cash flows, only the controller enjoys some valuable benefits. First, only she enjoys the value of the option to freeze the minority out.¹³¹ Second, as we explain below,¹³² only the controller enjoys the option to drag-along the minority, allowing her to force the minority to sell their shares to a third party along with the controller. Third, only the controller enjoys the value embedded in her ability to time dividends according to her tax planning and liquidity needs. Are these benefits sufficient to offset the cost of holding a control block? One cannot answer this question without quantifying the full costs and benefits.

Consider next the assumption that, without private benefits, the return on the controller's investment would be insufficient. This assumption is based on an *ex post* view. Assume a wealth-constrained entrepreneur has a business idea with an expected normal return on investors' investment and the entrepreneur's costs. An entrepreneur who offers investors say 50% of the shares would calculate whether the cash flows on her 50% stake, representing an effective lower return than that of investors, are still sufficient to compensate her for the costs. If not, the entrepreneur will offer investors less shares for the same amount of investment (*i.e.*, demand higher valuation) up to the point investors receive insufficient return and refuse to invest.¹³³ Under this scenario, the problem of allocating appropriate returns between the controller and the minority shareholders is solved *ex ante* at the IPO stage through pricing. Clearly, a project that cannot offer sufficient value to both the entrepreneur and the investors will be avoided, but in all undertaken projects the entrepreneur would never be undercompensated.

We now turn to the assumption that controllers cannot contract with minority shareholders to receive compensation. This assumption is based on the claim that the parties cannot contract out of the fiduciary duty of loyalty.¹³⁴ Indeed, the duty of loyalty is mandatory, but it does not prevent the parties from compensating the controller for her monitoring in a transparent fashion. All that the duty of loyalty asks for is an objective

¹³¹ See Zohar Goshen & Zvi Weiner, *The Value of the Freezeout Option* Colum. Working Paper No. 260, available at http://www.law.columbia.edu/null/WP260?exclusive=filemgr.download&file_id=95197&showthumb=0 (calculating the value of the option); see also *Mendel v. Carroll* (Del. Ch. 1994) (promoting strong controller protections of freeze out options and sale of control on controller's own terms).

¹³² See *infra* Part IV.C.2.

¹³³ This is exactly the same point that, according to the monitoring explanation, determines the "optimal" amount of private benefits. If a controller consumes more than the optimal private benefits, investors are left with an insufficient return and thus will not invest.

¹³⁴ Indeed, the proposal is to make the duty of loyalty a default rule.

approval process.¹³⁵ The controller can sign, as many do, a performance-based consulting agreement while getting approval by either a committee of independent directors or by a majority of the minority vote.¹³⁶ Moreover, at the IPO stage the controller can agree with investors that she will keep an extra amount of shares as upfront compensation for monitoring.¹³⁷ The bottom line is that if minority shareholders value the controller's monitoring they can contract with her for compensation without the controller resorting to private benefits of control.

Lastly, we find questionable the assumption that allowing controllers to consume optimal amount of private benefits would not be more complex to enforce than a complete ban on unfair dealings. What is the "optimal" level of private benefits? Can it be specified? Who will make sure the controller takes just the optimal level? Even the current regime that restricts private benefits presents many enforcement difficulties. The controller enjoys a dominant position and clear informational advantage over both outside investors and courts.¹³⁸ The transactions and other channels by which controllers consume private benefits are commonly complex thereby making the "benefit" taken hard to spot and quantify. Indeed, most self-dealing transactions require costly litigation involving professional valuations to determine whether the transaction is fair leading to a lengthy battle of experts. Sometimes even the decision whether an activity or a transaction indeed constitutes self-dealing is a complex one.¹³⁹ Clearly, these issues will not be easily resolved by attempting to judge whether the controller consumed just the optimal amount of private benefits.

To the contrary, the current regime subjecting self-dealing to the fairness test assigns courts with a complex but clear task: determine whether the transaction is one that could have taken place between willing

¹³⁵ See, e.g., *In re CNX Gas Corp.*, 4. A.3d 397 (Del. Ch. 2010).

¹³⁶ See Ben Amoako-Adu et al., *Executive Compensation in Firms with Concentrated Control: The Impact of Dual Class Structure and Family Management*, 17 J. CORP. FIN. 1580 (2011). See also Assaf Hamdani & Yishay Yafeh, *Institutional Investors as Minority Shareholders*, REV. FIN. (forthcoming 2012) (finding evidence that institutional investors play an active role in monitoring executive pay arrangements for controlling shareholders in Israel). Just as an illustration, the S-1 of ThermaWave corporation, a company that Bain Capital recapitalized in the 1990s, describes an "Advisory Agreement" that paid Bain for its monitoring of the firm. <http://www.sec.gov/Archives/edgar/data/828119/0000929624-99-000994.txt>.

¹³⁷ Assume the value of the firm is \$100 and she is selling 50% for \$50. If minority shareholders value her monitoring services, say at 2%, they might agree to invest \$50 and receive just 48% of the shares.

¹³⁸ See Leo E. Strine, Jr., *The Inescapably Empirical Foundation of the Common Law of Corporations*, 27 DEL. J. CORP. L. 499, 509 (2002) (commenting on the controller as the "800-pound gorilla" and independent directors as "chimpanzees").

¹³⁹ A split Delaware Supreme Court and 10 years litigation in *Williams v. Geier*, 671 A.2d 1368 (Del. 1996) are illustrative.

buyers and sellers. Normally, between the buyer's and the seller's reservation prices there is surplus (a range between the two reservation prices) which can be divided in many ways. As long as the transaction is within that range it is a fair deal. Thus, the court judging self-dealing is not concerned with the division of the surplus but rather whether the price is within the fair deal range. Given that under the entire fairness test the controller is already taking most of the surplus,¹⁴⁰ adding optimal private benefits will require approving transactions that outstrip minority shareholders' reservation price, making the court's role uncertain and more complex.

In our framework, control allows entrepreneurs to protect idiosyncratic value. The controller expects to receive an above-market return if successful and does not need to consume additional private benefits. The controller's costs—liquidity, diversification, and monitoring—are the price she is paying for buying indefinite uncontested control, enabling her to pursue idiosyncratic value. This goal, and not private benefits of control, is the essence of the contract underlying concentrated ownership.

C. *Control Premium and Investor Protection.*

The conventional wisdom among financial economists is that the size of a control premium—as measured, for example, by the difference between the market value of the minority shares and the price at which control is sold—reflects the private benefits the controller can consume.¹⁴¹ This understanding has made the size of the control premium one of the standard proxies for the quality of investor protection.¹⁴²

Our analysis, in contrast, shows that the link between control premium and investor protection is far more complicated. On the one hand, even entrepreneurs who share all cash flows with the minority on a pro-rata basis may attach significant value to control, as it enables them to ensure that idiosyncratic value would ultimately be realized. The control premium could therefore be a proxy for the idiosyncratic value that either the existing or the new controller expects the firm to produce. This in turn suggests that the existence of a control premium does not necessarily imply poor investor protection.

On the other hand, as we explain in the next Part, minority-protection rules can constrain the controller's freedom to pursue idiosyncratic value. In a regime with weak minority protection we should therefore expect a high control premium. However, this could either be because controllers enjoy great freedom to pursue idiosyncratic value or because they can enjoy large

¹⁴⁰ Goshen, *Controlling Self-Dealing*, *supra* note 9.

¹⁴¹ See Craig Doidge, *U.S. Cross-Listings and the Private Benefits of Control: Evidence from Dual-Class Firms*, 72 J. FIN. ECON. 519, 520 (2004) (explaining that private benefits can be measured when control is sold).

¹⁴² See Dyck & Zingales, *supra* note 14, and Nenova, *supra* note 14.

private benefits of control, or both. And vice versa, in a regime with strong minority protection we should expect a low control premium. But again, it could either be because controllers receive little freedom to pursue idiosyncratic value or because their consumptions of private benefits of control is constrained, or both. In short, the tension between protecting minority shareholders and idiosyncratic value implies that control premiums are a mixed signal as to the efficiency of investor protection in a given country.¹⁴³

To be sure, we do not argue that the standard account is wrong. Rather, we claim that it is incomplete. Private benefits *may* be important for controlling shareholders and a control premium *may* reflect the value of private benefits of control. Yet, as our analysis shows, private benefits may not be *the only* explanation for concentrated ownership. Indeed, our model sheds a new light on a question that has long occupied legal scholars as well as economists—what is the explanation for the presence of concentrated ownership in countries like the United States that have high quality minority shareholders’ protections (“good law”)?¹⁴⁴

In fact, our framework informs some existing empirical findings. First, as mentioned earlier, firms with controlling shareholders exist even in countries with strong investor protection, such as Sweden and the United States.¹⁴⁵ Second, control premia significantly vary across firms within countries, although the quality of investor protection is generally the same

¹⁴³ The actual split between these two competing effects depends on the specifics of a given country. To illustrate the point, assume that two countries with similar minimal minority-shareholders’ protections display high control premiums. In country A, the business norm is averse to exploiting minority shareholders, such that reputation is a substitute to legal protections. In this case, the premium will mostly reflect idiosyncratic value. In country B, there is no business norm averse to exploiting the minority. In this case, if there are no other substitutes to legal protections (markets, securities regulators, etc.) the premium will mostly reflect private benefits of control.

Since the studies of control premium do not give any measure of pricing it is further hard to determine the value of the signal. It could be that minority shareholders in different countries receive different discounts for their shares reflecting concessions in quality of protections in exchange for freedom to the controller to pursue idiosyncratic value.

¹⁴⁴ The explanation for the prevalence of concentrated ownership in certain countries and not others should thus focus not just on legal measures of minority protection but also on markets and their ability to overcome asymmetric information associated with idiosyncratic value. Additionally, it could also support theories such as path-dependency. See Lucian A. Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 *STAN. L. REV.* 127 (1999).

¹⁴⁵ See Mark J. Roe, *POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE: POLITICAL CONTEXT, CORPORATE IMPACT* 5 (2003) (noting that controlling shareholders exist also in jurisdiction with good laws); Gilson, *supra* note 8, at 1644 (same).

for all public companies governed by a single legal regime. Idiosyncratic value, in contrast, varies across firms and entrepreneurs within a single legal regime.¹⁴⁶ Third, family controlled firms tend to be more valuable when the founder is actively engaged in management or monitoring,¹⁴⁷ suggesting that controllers who exhausted their idiosyncratic value will be more likely to consume private benefits. We believe that, going forward, empirical studies should be designed to account for the mixed signals associated with control premia and seek to separate the effects of agency costs and idiosyncratic value.

IV. CORPORATE LAW: CONTROLLER RIGHTS AND MINORITY PROTECTION

In this Part, we present the principal implications of our analysis for corporate law. We first offer a tentative blueprint of the policy considerations that should guide lawmakers and courts in crafting the legal regime governing firms with controlling shareholders. The existing corporate law literature solely focuses on minority protection from agency costs. Our framework, however, shows that *controlling shareholders' rights* also play, and should play, a critical role in corporate law.

In section A we argue that any legal regime governing firms with controlling shareholders encounters an inevitable tradeoff between the goals of minority protection and allowing controllers to pursue idiosyncratic value. We then turn to evaluate legal doctrine in light of our framework. We focus mostly on Delaware law, as it is the jurisdiction with the most developed case law. In Delaware, two fundamental principles underlie the law governing firms with controlling shareholders. Directors' fiduciary duties require them to act in the corporation's best interests—that is, maximize share value; but, controlling shareholders are also not required to sacrifice their interests to serve the interests of shareholders as a group.¹⁴⁸ The conflict between these two principles often leads to confusing

¹⁴⁶ See Dyck & Zingales, *supra* note 14, at 554-556, Table III (reporting significant variance—measured by standard deviation—within countries in the magnitude of control premium across firms). Note that the authors did not find any statistically significant link between a firm's industry and the magnitude of the control premium.

¹⁴⁷ See Belen Villalonga & Raphael Amit, *How Do Family Ownership, Control and Management Affect Firm Value?*, 80 J. FIN. ECON. 385, 388 (2006) (finding that family ownership creates value for all of the firm's shareholders only when the founder is still active in the firm either as CEO or as chairman with a hired CEO); Christian Andres, *Large Shareholders and Firm Performance—An Empirical Examination of Founding-family Ownership*, 14 J. CORP. FIN. 431 (2008) (finding that family firms are more profitable than widely-held and companies with other types of blockholders, but only when the founding-family is still active either on the executive or the supervisory board).

¹⁴⁸ See *Bershad v. Curtiss-Wright*, 535 A.2d 840 (Del. 1987).

and indeterminate doctrine. We do not aim at providing a comprehensive account of legal doctrine. Rather, we illustrate the power of our framework in explaining how corporate law doctrines are shaped by the interaction of minority protection against agency costs with controllers' rights to secure idiosyncratic value. Section B discusses the rights that controlling shareholders should have. We demonstrate that controllers' rights may produce legal outcomes that run against traditional notions of shareholder value maximization. Section C analyzes the main elements for minority protections. Here, we explain why Delaware's approach to identifying self-dealing transactions should be modified to take into account the need to protect the minority against mid-stream changes to the firm's governance structure. Lastly, section D uses our framework to reevaluate several difficult corporate law cases.

A. *The Tradeoff between Minority Protection and Controller Rights.*

Our analysis thus far can be summarized as follows. Corporate law should recognize the controller's right to pursue the idiosyncratic value that she attaches to the business while protecting investors from expropriation through self-dealing and other methods of value diversion. Ideally, corporate law doctrine would be designed in a manner to achieve both of these goals. For several reasons, however, there is an inevitable conflict between minority protection and controller rights. First, drawing a line between decisions that concern idiosyncratic value and those that could lead to unequal distributions may be difficult. Second, measures to protect the minority from value diversion could produce costly errors. Third, enforcing the prohibition against non-pro-rata distributions might require interventionist measures that could undermine the controller's right to execute the business idea.

To see the interplay between minority protection and controller rights assume the entrepreneur owns 60% of a firm. The entrepreneur genuinely believes that a specific component produced only by one company is necessary for the development of a new product. It so happens, however, that the company producing the component is 100% owned by the entrepreneur. Accordingly, the entrepreneur wishes for her 60%-owned firm to buy the components from her wholly-owned company. If the entrepreneur were the sole owner of both firms, she could simply buy the component under whatever terms she desired. But, with investors owning 40% of the firm's shares, there is an understandable suspicion that the entrepreneur is abusing this transaction to divert value from minority shareholders to his wholly-owned corporation.

This illustration underscores the at-times opaque line between unfair self-dealing and decisions that affect idiosyncratic value. As a result, protecting the minority against inappropriate value diversion requires some constraints on the entrepreneur's ability to exercise control. These

constraints can take the form of *ex post* review by courts as to the fairness of the transaction, or a requirement to get an *ex ante* approval by a majority of minority shareholders.¹⁴⁹ The need to provide the minority with protection against agency costs will necessarily require inhibiting some of the freedom to pursue idiosyncratic value that the entrepreneur enjoyed as a single owner.¹⁵⁰

One might argue that constraining self-dealing need not necessarily interfere with the controller's ability to pursue idiosyncratic value. After all, the argument goes, if the controller does not intend to expropriate the minority why would she care about the extra supervision? If the transaction is on arm's-length terms, the court will find it to be fair,¹⁵¹ or minority shareholders will grant their approval. This argument would be correct in a world without transaction costs. In the real world, however, plaintiffs sometime bring suits without merit,¹⁵² and courts make mistakes.¹⁵³ Likewise, under a rule that requires a majority-of-minority vote, minority shareholders might strategically attempt to hold-out or simply err in evaluating the proposed transactions.¹⁵⁴ This conclusion applies to other, prophylactic measures required for creating an effective minority-protection regime.¹⁵⁵ Accordingly, protecting minority shareholders against agency costs inevitably interferes with the controller's right to pursue idiosyncratic value.

The inevitable tradeoff between minority protection and controller rights has obvious implications for the design of corporate law. Lawmakers and courts should seek an optimal balance between minority protection and

¹⁴⁹ Goshen, *Controlling Self-Dealing*, *supra* note 9.

¹⁵⁰ The single-owner standard is useful not only as a benchmark for the protection of investors, but also as a benchmark for the controller's right to secure idiosyncratic value. *See, for example*, Lucian A. Bebchuk, *The Sole Owner Standard for Takeover Policy*, 17 J. LEGAL STUD. 197 (1988).

¹⁵¹ For a case in which the court concluded that a controlling shareholders had a high idiosyncratic value (without using this term, of course) and therefore approved a series of long term self-dealing transactions as fair, *see Cookies Food v. Lakes Warehouse*, 430 N.W. 2d 447 (Sup. Iowa 1988).

¹⁵² Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. Econ. & Org. 55 (1991); Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497 (1991).

¹⁵³ *See* Goshen, *Controlling Self-Dealing*, *supra* note 9 (explaining the inefficiencies associated with a fairness test).

¹⁵⁴ *See Id.* (reviewing opportunism and inefficiencies associated with majority-of-minority voting).

¹⁵⁵ Modern corporate governance relies on a variety of gatekeepers and enforcement measures to constrain agency costs. These include, for example, financial reporting and other disclosure duties, requiring outside auditors and setting standards for their work, and requirements for outside independent directors. These measures could interfere with the controller's ability to manage the firm in a way that limits her ability to capture idiosyncratic value.

providing controlling shareholders with the freedom to make managerial decisions. More practically, the nature of minority protection should depend on enforcement considerations. Enforcing a given protection may be too costly not only because of the direct compliance costs incurred by corporations or courts, but also due to the expected cost of detracting from idiosyncratic value.

B. Controller Rights.

Our analysis of the controlling shareholder's side of the contract focuses on the scope of the controller's rights and the type of protection that should accompany these rights.

1. Management Rights: Business Judgment Rule and Board Composition. – The entrepreneur-controller is willing to make a significant equity investment in exchange for the right to secure the idiosyncratic value that he attaches to the business idea. The allocation of control matters in light of the asymmetric information between the entrepreneur and the investors/market. Some of the “crazy” or “visionary” entrepreneurs are responsible for some of the greatest breakthroughs in business ideas, ideas that would have never come to pass in the absence of control. What then should be the nature of idiosyncratic value protection?

Corporate law should recognize the entrepreneur's right to exercise control over any issue that could affect the project's value. Controlling shareholders should be free to set the firm's direction and make all management decisions. This includes the right to assume a managerial role (if the controller is an individual) as well as the right to appoint and fire managers. This has two implications for corporate law. First, courts should not interfere with business decisions that controllers or their representatives make. In other words, our analysis explains why courts should follow the business judgment rule.¹⁵⁶ The controller-entrepreneur retains control because of her concern that asymmetric information would induce investors to make decisions that would destroy the project's idiosyncratic value. Asymmetric information, however, also cautions against allowing courts to exercise control over business decisions. Like investors, courts could make decisions that, from the entrepreneur's perspective, would destroy idiosyncratic value.

This rationale differs from the conventional justification for not interfering with controlling shareholders' business decisions. The legal literature assumes that judicial review of non-conflicted-transactions is

¹⁵⁶ For the rationale underlying the business judgment rule, see *In re Walt Disney Co. Derivative Litigation*, 907 A.2d 693, 698 (Del. Ch. 2005) (“[R]edress for [directors'] failures . . . must come . . . through the actions of shareholders . . . and not from this Court”); *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984) (“[D]irectors are better equipped than the courts to make business judgments . . .”).

simply unnecessary in a concentrated ownership environment, as the controller's significant equity stake provides her with incentives to maximize value for all investors.¹⁵⁷ Our explanation, in contrast, focuses on the need to allow the controller the freedom to implement its business plan even when investors (and courts) believe that such a plan would not enhance share value.

Second, controllers' management rights shed a new light on corporate-governance reforms designed to enhance board independence at firms with controlling shareholders. Controllers' voting power enables them to appoint any candidate they wish to the board. Recent corporate-governance reforms, however, constrain the controller's power to appoint directors. Listing requirements, for example, require boards or board committees to have a certain percentage directors who are independent not only from the company but also from the controller.¹⁵⁸ Some legal systems go further and empower minority shareholders to influence board composition by, for example, appointing their representatives to the board.¹⁵⁹

These measures may be necessary to enforce the rule against self-dealing.¹⁶⁰ Our analysis, however, explains why lawmakers should proceed cautiously when constraining controllers' power to fill board or management positions. Board reforms aim at making the board more effective in monitoring those with power—the CEO or the controlling shareholder. But asymmetric information could prevent the controller-entrepreneur from credibly communicating her beliefs concerning idiosyncratic value not only to investors but also to skeptical, independent board members. Thus, the need to balance controller rights and minority protection should also shape board reforms at firms with controlling shareholders. It should be acknowledged that the presence of such representatives could interfere with the controller ability to manage. At a

¹⁵⁷ See, for example, Bebchuk & Hamdani, *supra* note **שגיאה! הסימניה אינה מוגדרת.**, at 1310.

¹⁵⁸ See the stock exchange rules Nasdaq Rule 4350(c)(1) and Section 303(a) of the NYSE's Listing Company Manual.

¹⁵⁹ See, e.g., Carrado Malberti & Emiliano Sironi, *The Mandatory Representation of Minority Shareholders on the Board of Directors of Italian Listed Corporations: An Empirical Analysis*, Bocconi Legal Studies Research Paper No. 18, available at <http://ssrn.com/abstract=965398> (reviewing minority representation reforms in Italy); Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1947-49 (1996) (describing virtues of cumulative voting as mechanism for minority representation).

¹⁶⁰ See Bernard S. Black & Woochan Kim., *The Effect of Board Structure on Firm Value: A Multiple Identification Strategies Approach Using Korean Data*, 104 J. FIN. ECON. 203 (2012) (reporting evidence that reforms enhancing director independence positively affected Korean firms); Jay Dahya & John J. McConnell, *Does Board Independence Matter in Companies with Controlling Shareholders?*, 21 J. APPLIED CORP. FIN. 67 (2009) (finding corporate value is consistently higher in controlled firms with independent directors).

minimum, the controller should have the power to appoint a majority of the board (which in turn should have the power to appoint the CEO and other members of management).

2. Property Rule Protection: Preserving Control. To preserve the entrepreneur's uncontested control, his right to make management decisions should be afforded a property-rule protection.¹⁶¹ In other words, the market (minority shareholders) or courts cannot unilaterally take control rights away from the controller in exchange for objectively-determined compensation; the controller should be able to prevent a non-consensual change of control from ever taking place.¹⁶²

The property-rule protection of controller rights has some straightforward implications that are no different than the standard protection of private property. Controllers cannot be forced to sell their control block even when doing so would clearly benefit the corporation or its minority shareholders.¹⁶³ The controller is generally free to exit her investment by selling her control block whenever she wants and for whatever price she sees fit.¹⁶⁴

Nonetheless, the controller's property-right protection extends to a broader range of corporate actions. Controllers can lose control not only when they sell their shares, but also when the company takes action—like

¹⁶¹ See generally Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972).

¹⁶² The need for a property-rule protection arises from the fundamental justification for allocating control and management rights to the entrepreneur. The controller-entrepreneur is the one who has the unique vision or subjective assessment concerning the project's value (idiosyncratic value). Any objectively determined compensation for a nonconsensual taking will rarely be fair to the entrepreneur. The extensive academic literature on property and liability rules suggests that a property-rule protection is appropriate when idiosyncratic value is present. See Henry E. Smith, *Property and Property Rules*, 79 N.Y.U. L. REV. 1719, 1722–31, 1755–56 (2004).

¹⁶³ See *Bershad v. Curtiss-Wright*, 535 A.2d 840 (Del. 1987). But see generally Jens Dammann, *Corporate Ostracism: Freezing Out Controlling Shareholders*, 33 J. CORP. L. 681, 694 (2007) (explaining an innovative proposal for a regime under which minority investors could force the controller out).

¹⁶⁴ Some limits are imposed, however, on the identity of the buyer. See *Harris v. Carter*, 582 A.2d 222 (Del. Ch. 1990) (prohibiting sale of control to a known looter and imposing limited duties of investigation on controlling shareholders). In the *Hollinger* case, Delaware's chancery court allowed the board to use a poison pill to prevent a controlling shareholder from selling his control block. We believe, however, that this holding applies only when the sale of the block is in clear violation of the controller's fiduciary duties. See *Hollinger International, Inc., v. Black*, 844 A.2d 1022, 1085-1086 (Del. Ch. 2004) (allowing the board to deploy a poison pill when the sale of control was the culmination of an improper course of conduct by the controller and in violation of his contractual obligations).

issuing shares—that dilutes their holdings. Under our framework, companies with controlling shareholders need not take actions that would make the controller lose its control even when doing so would benefit the corporation or minority investors.

Consider the following hypothetical. A bank must increase its capital to meet new capital adequacy requirements. The bank has two options: issuing new shares or selling one of its subsidiaries. The bank’s controlling shareholder, who owns 51% of the shares, has her own liquidity problems that prevent her from buying additional shares of the bank. Issuing new shares would therefore dilute the controller and may cause her to lose her control position. How should the board decide between the two options? At first sight, directors’ fiduciary duties require them to choose the option that best serves the company interests while disregarding the controller’s interest in preserving control. Under Delaware case law, however, the board might be prohibited from taking steps that would force the controller to lose control “in the absence of a threatened serious breach of fiduciary duty by the controlling stockholder.”¹⁶⁵ The board could thus decide to sell a subsidiary only because issuing new shares would force the controller to lose its control.¹⁶⁶

This outcome runs against traditional notions of shareholder value maximization, as the need to preserve control might drive firms with controlling shareholders to take value-reducing actions. Yet, a regime under which minority shareholders, the board, or courts, could compel the controller to lose control—whether by a forced sale, dilution, or any other action—is inconsistent with the need to provide controllers with a property-rule protection for their right to make management decisions and preserve idiosyncratic value. Moreover, this outcome is not justified by the need to provide controllers with private benefits to reward them for their willingness to monitor management. Rather, it is based on the parties’ mutual consent *ex ante* on an arrangement that would enable entrepreneurs to pursue idiosyncratic value to the benefit of both investors and the entrepreneur.

¹⁶⁵ See *Mendel v. Carroll*, 651 A.2d 297,306 (Del. Ch. 1994). For an analysis of this decision and its implications, see John C. Coffee, Jr., *Transfers of Control and the Quest for Efficiency: Can Delaware Law Encourage Efficient Transactions While Chilling Inefficient Ones?*, 21 DEL. J. CORP. L. 359, 390-396 (1996).

¹⁶⁶ Note that this treatment of the controller differs from that of minority shareholders (or investors at widely-held firms). We normally allow management to use rights offerings even when that might coerce investors into a choice between dilution and increasing their investment. For evidence that controllers’ need to preserve their control affect firm decisions concerning capital structure, see, e.g., Thomas S. Schmid, *Control Considerations, Creditor Monitoring, and the Capital Structure of Family Firms*, 37 J. BANKING & FIN. 257 (2013) (finding evidence consistent with the hypothesis that family firms in Germany use firms’ capital structure to optimize control over the firm).

3. *Right to Sell Control for a Premium.* – Whether controlling shareholders can sell their shares for a premium is one of the most important and controversial questions for firms with controlling shareholders.¹⁶⁷ Delaware recognizes the right of controlling shareholders to sell at a premium, subject to the restriction on selling control to a looter (the “market rule”).¹⁶⁸ As we explained earlier, the controller’s right to sell at any time is the essence of her property right.¹⁶⁹ But what about the right to sell for a premium not shared by minority shareholders?

Our framework offers several justifications for allowing controllers to sell their stake for a premium without sharing it with the minority. A key premise underlying the objection to controllers’ right to sell for a premium is that a control premium is a proxy for private benefits and thus for minority expropriation. Under this view, imposing constraints on controllers’ ability to sell for a premium would decrease the risk of

¹⁶⁷ The common law norm to sell control for a premium is explained clearly in *Zeitlin v. Hanson Holdings, Inc.*, 397 N.E.2d 387, 388-89 (N.Y. 1979) (“It has long been settled law that, absent looting of corporate assets, conversion of a corporate opportunity, fraud or other acts of bad faith, a controlling stockholder is free to sell, and a purchaser is free to buy, that controlling interest at a premium price.”) *But see* William D. Andrews, *The Stockholder’s Right to Equal Opportunity in the Sale of Shares*, 78 HARV. L. REV 505 (1965) (arguing for a sharing of control premium with minority shareholders).

¹⁶⁸ See *Abraham v. Emerson Radio Corp.*, 901 A.2d 751, 758 (Del. Ch. 2006); *Harris v. Carter*, 582 A.2d 222, 234 (Del. Ch. 1990).

¹⁶⁹ Many countries follow the so-called equal-opportunity rule by requiring a buyer of more than a certain percentage of a firm’s shares (usually around 30%) to make a tender offer that would take the shareholder to at least over 50% share ownership. See, e.g. U.K. City Code on Takeovers and Mergers, Rule 36 (stating a purchaser crossing 30% triggers a mandatory offer for over 50% of the company); EU Takeover Directive (Directive 2004/25/EC [adoption: codecision COD/2002/0240]) (mandating that “Member States must ensure that [a controller] is required to make a bid as a means of protecting the minority shareholders of that company. Such a bid must be addressed at the earliest opportunity to all the holders of those securities for all their holdings at the equitable price”). To be sure, the equal-opportunity rule could protect the minority against a sale to a looter (after all, we do not rule out the possibility that a control premium would reflect private benefits of control). Moreover, it does not prevent the controller from selling her shares for a premium. Rather, it requires the buyer to offer the same premium to all shareholders. Yet, forcing the buyer to pay a premium to all shareholders raises the acquisition’s total costs, thereby effectively barring a range of control transactions in which the buyer’s expected increase in corporate value is insufficient to justify paying the premium demanded by the current controller to all shareholders. Thus, to the extent that a control premium is a proxy for idiosyncratic value (and not private benefits), the cost of the equal opportunity rule—in terms of discouraging efficient transactions—are expected to be higher. See Lucian A. Bebchuk, *Efficient and Inefficient Sales of Corporate Control*, 1994 Q. J. ECON. 957.

inefficient sales motivated by the prospect of consuming private benefits at the expense of minority shareholders.¹⁷⁰

As the previous Part has explained, however, a control premium is not necessarily a proxy for private benefits of control or the magnitude of minority expropriation. It could also reflect the idiosyncratic value from either the buyer's or the seller's perspective. A seller who believes that she could earn above-market return on her shares would insist on a premium for selling her stake even if, had she stayed in control, she would have shared the idiosyncratic value, when realized, on a pro-rata basis with minority shareholders. In this sense, the seller is only taking a premium reflecting her pro-rata share of what she expected to receive. Consequently, a buyer that believes he could make an even greater above-market return on the new investment would be willing to pay such a premium. In this respect, the buyer is allowed to substitute for the seller as the counterparty to the contract with the minority, under the assumption that the buyer envisions a higher idiosyncratic value regarding the firm which will be shared pro-rata with the minority shareholders.¹⁷¹

C. *Minority Rights.*

Our analysis of the minority shareholder's side of the contract focuses on the threats facing minority shareholders in a controlling-shareholder structure, and the type of protection that should be provided to enforce minority rights.

1. Pro-Rata Share: Identifying Self-Dealing. – Minority shareholders' main concern is that the entrepreneur-controller will engage in self-dealing, tunneling, or other ways to capture more than his pro-rata share of cash-flow rights. The principal form of minority protection is the strong regulation of non-pro-rata distributions of the firm's assets. In exchange for her freedom to execute the business idea in the manner she wishes, the controller commits to share equally with the minority any cash flows that the project will produce. If she seeks any preference over the minority, she should negotiate with investors and obtain their approval—either before

¹⁷⁰ See Bebchuk, *id.*

¹⁷¹ At the same time, our framework could lend support to the equal-opportunity rule. After all, investors in our framework allow the controller to preserve control in order to enable the controller to pursue idiosyncratic value that would then be shared with investors. When the controller exits the joint investment she takes her pro-rata part of her idiosyncratic value from the buyer leaving minority shareholders to wait until the new buyer will realize his idiosyncratic value. The claim could thus be that the seller must first perform her contractual commitment to the minority (pay the promised share of idiosyncratic value) before she can ask the minority to enter a new contract with the buyer.

entering the joint investment or before getting the preference. Otherwise, any non-pro-rata distribution will be subject to strict judicial scrutiny.¹⁷²

A legal regime governing companies with controlling shareholders thus should accomplish two important tasks: first, create a workable distinction between business decisions and self-dealing; and second, implement adequate mechanisms to govern self-dealing transactions. We discuss below the choice between different mechanisms to govern self-dealing. In this section, we shall focus on the first element—the test for identifying transactions that deserve closer scrutiny.

The distinction between self-dealing and other transactions has considerable consequences. Under Delaware law, for example, this distinction determines whether a lawsuit challenging a transaction would be carefully reviewed under the plaintiff-friendly entire fairness standard or quickly dismissed under the business judgment rule.¹⁷³ But, drawing the line between cases that deserve close scrutiny and those that do not is often difficult. Some cases are straightforward, for example, when the controller sells her privately-owned asset to the publicly-traded firm that she controls. In other cases, however, it is unclear whether the fact that the controller's interests with respect to certain corporate actions are not fully aligned with those of the minority justifies close scrutiny.¹⁷⁴ We have no intention of resolving this issue here. Rather, we would like to use one famous example to argue that the test for identifying self-dealing should take into account the need to balance minority protection and controller rights.

Consider the *dividend distribution* question underlying the *Sinclair* case.¹⁷⁵ Should courts protect the minority against the risk that a controlling shareholder would use a pro-rata dividend distribution to advance its own interests? The *Sinclair* court answered this question with a clear: “No.” It held that pro-rata dividend distributions do not amount to self-dealing and should thus be reviewed under the business judgment rule.¹⁷⁶ But, is this outcome the desirable one?

For purposes of our discussion, assume that a pro-rata distribution could be used to satisfy the controller's own liquidity needs while denying the corporation highly profitable growth opportunities. In other words,

¹⁷² *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) (discussing elimination of minority shareholders via merger between corporation and its majority owner); *Jones v. H. F. Ahmanson & Co.*, 460 P.2d 464, 469 (Cal. 1969).

¹⁷³ See generally Steven M. Haas, *Towards a Controlling Shareholder Safe Harbor*, 90 VA. L. REV. 2445 (2004).

¹⁷⁴ See Jens Dammann, *Corporate Ostracism: Freezing Out Controlling Shareholders*, 33 J. CORP. L. 681, 694 (2007) (noting that the Delaware test makes it difficult for plaintiffs to establish self-dealing because “while it may be possible to show that the course of action taken by the corporation benefited the controlling shareholder, it is extremely difficult to prove that this advantage came at the expense of other shareholders.”).

¹⁷⁵ See *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971).

¹⁷⁶ *Id.*

assume that a pro-rata dividend distribution could be harmful to minority shareholders. Nevertheless, a legal rule that would aspire to supervise the controller and prevent such “abusive” distributions would be too costly.

Any rule that would try to scrutinize pro-rata dividend distributions would necessarily interfere with the controller’s management rights. First, control over the firm’s capital structure—the amount of capital that is required and how to finance the firm’s operations—might be an integral part of implementing an entrepreneur’s vision. Outside intervention would therefore significantly interfere with the controllers’ ability to make management decisions concerning idiosyncratic value. Second, distinguishing “legitimate” dividend distributions from non-legitimate ones is prone to errors given asymmetric information. Third, even if courts were to accurately determine that a certain dividend is illegal, effective enforcement would itself require excessive intervention. A disgruntled controller prohibited from paying a dividend may decide, for example, to deposit the dividend amount in the firm’s bank account in order to distribute the same amount in the near future. Clearly, courts would not assume responsibility for management decisions by forcing the controller to put the money to other, more profitable uses. In other words, effectively enforcing the non-distribution of dividends will ultimately require courts to abandon the business judgment rule.

Our discussion of *Sinclair* thus shows that the omnipresent tension between controller management rights and minority protection should shape the legal distinction between self-dealing and other transactions. The interests of controlling shareholders are not always fully aligned with those of minority investors. Yet, not every conflict of interest justifies legal intervention to protect the minority.

2. *Mid-stream Changes.* – The preceding analysis provides support for Delaware’s approach to identifying self-dealing transactions. In this section, however, we explain that the same approach fails to protect minority shareholders against unilateral changes to the firm’s governance mid-stream. Controlling shareholders can enjoy more than their pro-rata share of the project by using their control to change the firm’s governance arrangements mid-stream either directly—through changes in the charter/bylaws—or indirectly through some business combination, such as a merger. These changes could be inconsistent with the initial contract between the entrepreneur and investors.¹⁷⁷

Consider, for example, the link between control and cash-flow rights. Under one-share-one-vote, the controller’s willingness to make a significant equity investment in order to secure his control position alleviates management agency costs and asymmetric information concerns. Once he raises funds from investors, however, the controller might be

¹⁷⁷ Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549 (1989) (explaining risk of opportunistic charter amendment).

tempted to unravel this arrangement and find ways to preserve uncontested control without having to incur the costs associated with holding a large equity block.¹⁷⁸ A necessary element in any minority-protection scheme is, therefore, a protection against unilateral, mid-stream changes to the firm's governance arrangement.

Indeed, on several occasions minority shareholders did attempt to challenge such changes in Delaware courts, but without success. Courts refused to review these changes under the entire fairness standard, holding that the disparate *economic* impact of such changes on the controller did not amount to self-dealing as long as the *legal* effect was equal.¹⁷⁹

In our opinion, this approach is inconsistent with the need to protect the minority against agency costs. Part of the problem may be that Delaware courts use a single test for two distinct tasks—identifying self-dealing and coping with mid-stream changes. The problem of mid-stream governance changes by controlling shareholders requires its own legal framework. Like self-dealing cases, this framework should consist of two elements: first, identifying cases of mid-stream changes that deserve some level of scrutiny; and second, making a decision on the nature of protection that minority shareholders should enjoy.

3. Type of Protection. – Minority rights, like controller rights, could be protected by a liability or property-rule.¹⁸⁰ Under a liability-rule, the controller can engage in self-dealing transactions without minority shareholders' consent, subject to her duty to pay an objectively fair price (a commitment supervised by courts). Under a property-rule, the controller cannot engage in self-dealing without securing the minority's consent (typically by a majority-of-the-minority vote).

The need to balance controller and minority rights affects the desirable form of minority protection. A property-rule provides the minority with consent-based protection that is vulnerable to hold out, thereby creating a risk of interfering with the controller's management right. In contrast, a liability-rule provides the minority with fair-compensation-based protection vulnerable to judicial mistakes, while being less likely to interfere with the controller's management rights.¹⁸¹ As a result, other things equal,¹⁸² the

¹⁷⁸ See, for example, Black et al., *Law and Tunneling*, 37 J. CORP. L. 1 (2011).

¹⁷⁹ See *Williams v. Geier* 671 A.2d 1368, 1378 (Del. 1996) (“[T]here was on this record: ... no non-pro-rata or disproportionate benefit which accrued to the Family Group on the face of the Recapitalization, although the dynamics of how the Plan would work in practice had the effect of strengthening the Family Group's control.”); See also *eBay Domestic Holdings v. Newmark*, 16 A.3d 1 (Del. Ch. 2010).

¹⁸⁰ See Goshen, *Controlling Self-Dealing*, *supra* note 9, at 408.

¹⁸¹ To be sure, as Delaware's case law demonstrates, majority-of-the-minority votes may play an important role in scrutinizing self-dealing transactions even under a liability rule. Yet, it authorizes courts to approve self-dealing transactions notwithstanding the minority objection, thereby reducing the risk of errors

tradeoff between minority protection and controller rights supports a liability-rule protection for minority shareholders to better balance between protecting minority against agency costs and preserve idiosyncratic value.¹⁸³

D. “Difficult Cases.”

In this section, we consider two examples of transactions that have occupied courts and scholars alike, and are not easily classified as dealing with either minority protection or controller rights. We first address freezeout transactions. As we explain, transactions of this type raise an inevitable and difficult tension between minority protection and controller rights. We then address Delaware’s indeterminate approach concerning transactions in which both the controller and the minority sell, for equal consideration, 100% of the firm to a third party. In this case, the need for minority protection is substantially weaker than in a freezeout transaction. At the same time, however, subjecting these transactions to closer scrutiny is unlikely to interfere with the controller’s right to secure idiosyncratic value.

1. Freezeout Transactions. – In a freezeout transaction the controlling shareholder of a publicly-traded company buys out minority shareholders in order to take the company private. Although freezeouts have been the subject of extensive analysis by legal scholars,¹⁸⁴ courts continue to

resulting from holdouts or differences of opinion between the controller and investors.

¹⁸² Although, in theory, our framework would consider a liability-rule protection more appropriate, once reality is introduced, our framework does not identify any form of protection—liability or property—as superior because the actual effect of each protection depends on the judicial system and institutional investors of a given jurisdiction. A liability-rule may not work in certain markets or legal systems without an effective regime of shareholder lawsuits or where courts lack the necessary expertise to adjudicate fairness disputes. See Goshen, *Controlling Self-Dealing*, *supra* note 9, at 409.

¹⁸³ Note that specialized courts would not only enhance minority protection, but also reduce the risk of excessive interference with controlling shareholders’ rights. Specialized courts are less likely to err either in favor of the controller or in favor of investors. This in turn would decrease the cost—in terms of undermining controller rights—of rules designed to protect minority shareholders. See, e.g., Luca Enriques, *Off the Books, But on the Record: Evidence from Italy on the Relevance of Judges to the Quality of Corporate Law*, in *GLOBAL MARKETS AND DOMESTIC INSTITUTIONS: CORPORATE LAW IN A NEW ERA OF CROSS BORDER DEALS* (Curtis Milhaupt ed., 2003).

¹⁸⁴ See, for example, Guhan Subramaman, *Fixing Freezeouts*, 115 *YALE L.J.* 2 (2005); Gilson & Gordon, *supra* note 16, at 796-803; Lucian A. Bebchuk & Marcel Kahan, *Adverse Selection and Gains to Controllers on Corporate Freezeouts*, in *CONCENTRATED CORPORATE OWNERSHIP* 247 (Randall Morck, ed.)

struggle with the proper approach for regulating these transactions.¹⁸⁵ Our analysis offers a new perspective on the difficulty of crafting an optimal freezeout regime.

Let us start with controller rights. In our view, the inevitable conflict between minority protection and controller rights calls for providing controllers with an option to discontinue their partnership with the minority by taking the firm private. Buying out the minority may be required when keeping the firm public interferes with the realization of idiosyncratic value,¹⁸⁶ or when an imprecise minority-protection regime proves too costly. Additionally, bolstering minority protection increases the likelihood that such protections would interfere with the realization of idiosyncratic value, thereby creating an increased need to make it possible for controllers to take the corporation private.¹⁸⁷ Furthermore, there is an obvious difficulty in forcing an entrepreneur to “work” for others—minority investors—for as long as the minority shareholders wish.¹⁸⁸ As a matter of legal doctrine, the need to provide the controller with an option to buy out the minority, explains why Delaware courts have abandoned the requirement that freezeout transactions satisfy a business purpose test.¹⁸⁹

(2000); Zohar Goshen & Zvi Wiener, *The Value of the Freezeout Option*, Berkeley Program in Law & Economics, Working Paper Series (Mar. 1, 2000).

¹⁸⁵ See, for example, *In re CNX Gas Corp.*, 4. A.3d 397 (Del. Ch. 2010) (developing the unified standard for reviewing controlling shareholder freezeout transactions).

¹⁸⁶ For example, consider a case when it is no longer possible to implement the entrepreneur’s vision while complying with the extensive disclosure duties imposed on public companies. In this case, the only way for the entrepreneur-controller to implement his plan and capture the value he attaches to the project is by taking the firm private. See Harry DeAngelo, Linda DeAngelo & Edward M. Rice, *Going Private: Minority Freezeouts and Shareholder Wealth*, 27 J. LAW & ECON 367 (1984) (finding the source of efficiency to be the elimination of the costs attendant to the regulation of public ownership).

¹⁸⁷ Assume a liability-rule protection against self-dealing. Further assume the court makes errors in 20% of the cases: half of them it approves unfair transactions and the other half it blocks fair transactions. When the court approves an unfair transaction, the direct damage is the given transfer of wealth from the minority to the controller (*i.e.*, zero sum transfer), while the indirect damage of underdeterrence is limited due to the small percentage of such mistakes. However, when the court erroneously blocks a fair transaction the damage is not limited to overdeterrence and zero sum transfer, as it also includes the frustration of idiosyncratic value. The last damage might in some cases be too high to tolerate. Thus, due to the potential incidence of such cases the legal system should contain a safety valve when minority shareholder protections are involved—the ability to take the company private.

¹⁸⁸ See Uniform Partnership Act (1997) § 601 (explaining partnership is at will).

¹⁸⁹ See *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) (explaining that allowing controllers to buy out the minority only if they present convincing business reasons for taking the firm private would overly burden controllers,

For minority shareholders, however, freezeout transactions present a substantial risk of expropriation on a large-scale. Controlling shareholders might opportunistically use the option to buy out the minority at unfair prices while taking advantage of their superior access to information concerning the firm's value.¹⁹⁰ The risk of expropriation calls for effective measures to protect minority shareholders in freezeout transactions.

But a property-rule protection—that is, making a freezeout conditional on a majority-of-minority vote—might undermine the controller's option to take the firm private in order to preserve idiosyncratic value, especially under conditions of asymmetric information.¹⁹¹ Minority shareholders with a property-rule protection have a veto over the controller decision to force the minority to exit. Such a result is contrary to the goal of preserving idiosyncratic value in two respects: For one, it does not allow the controller to exit and secure the idiosyncratic value, as she believes needs to be done. Secondly, forcing the controller to stay has the same consequence as preventing dividend distribution. The court will have to interfere with management decisions, normally protected by the business judgment rule, to make sure the controller continues to work efficiently for the minority. Therefore, despite the high risk of expropriation minority shareholders' protection should tilt towards a liability-rule protection.¹⁹²

Our analysis thus calls for a narrow reading of the Delaware chancery court's decisions in *CNX Gas*. One could read the decision as requiring controlling shareholders to allow the board to use a poison pill to prevent a freezeout.¹⁹³ But in a subsequent decision, the court seems to suggest that a poison pill is required only if the controller would like to avoid judicial review of the transaction under the entire fairness standard.¹⁹⁴ In other

especially given the role played by asymmetric information). *See also Jones v. H. F. Ahmanson & Co.*, 460 P.2d 464, 469 (Cal. 1969).

¹⁹⁰ *See Coggins v. New England Patriots Football Club, Inc.*, 492 N.E.2d 1112 (Mass. 1986) (reviewing controller opportunism to detriment of minority under the old "business purpose" test).

¹⁹¹ *See also Benjamin Hermalin & Alan Schwartz, Buyouts in Large Companies*, 25 J. LEG. STUD. 351 (1996) (calling for protecting the minority with a liability-rule to provide the controller with optimal incentives to encourage her entrepreneurial effort).

¹⁹² To be sure, a legal regime could adopt of variety of measures to protect the minority, such as approval by special committees of the board and shifting the burden of proof to controllers. Yet, some form of an exit option should be left open even when the minority objects.

¹⁹³ *See In re CNX Gas Corp.*, 4. A.3d 397, 415 (Del. Ch. 2010) ("[A] controller making a tender offer does not have an inalienable right to usurp or restrict the authority of the subsidiary board of directors. A subsidiary board, acting directly or through a special committee, can deploy a rights plan legitimately against a controller's tender offer...to provide the subsidiary with time to respond, negotiate, and develop alternatives.")

¹⁹⁴ *See id.*

words, the court allowed controllers to choose between a liability rule (judicial review) and a property rule (majority of minority vote and board veto). Allowing controllers to choose the regime that would apply to their going-private transaction seems consistent with the pursuit of idiosyncratic value. However, a regime that would compel controllers to subject their going-private transaction to the substantial delays associated with a board's deployment of a poison pill would unnecessarily delay the freezeout by forcing the controller to replace the directors and only then merge.

2. *Sale to Third Party*. – The last example that we would like to consider is a transaction in which a third party, who is not related to the controller buys all the company's shares from both the controller and minority shareholders. In a transaction of this type, the controller—with a majority of the votes—can effectively force the minority to sell their shares (an implied drag-along option). Delaware courts have reviewed such transactions under different forms of scrutiny, depending on whether the controller and the minority received equal consideration. A sale to a third party raises genuine minority protection concerns when the consideration for the controller differs from that payable to the minority. Cases of this type create a conflict between the controller and the minority over the allocation of the sale proceeds. The controller might abuse her control over the target to divert value from the minority by bargaining with the third-party buyer for a transaction that would benefit the controller at the expense of the minority. Not surprisingly, courts have subjected these transactions to the entire fairness test.¹⁹⁵

In contrast, when a third-party buyer offers equal consideration to all shareholders, minority shareholders apparently need no protection. After all, with the largest equity stake and no apparent conflict, the controller could be relied upon to work hard to achieve the best feasible bargain. Yet, Delaware case law on this issue is in remarkable disarray. While some decisions hold that these transactions do not require close scrutiny,¹⁹⁶ others have allowed minority shareholders to proceed with claims that the controller's need for cash—liquidity—created a conflict that justified the

¹⁹⁵ See *In re John Q. Hammons Hotels Inc. S'holder Litig.*, Civil Action No. 758-CC, 2009 WL 3165613 (Del. Ch. 2009) (requiring procedural protections in order to apply the business judgment rule); *Ryan v. Tad's Enters., Inc.*, 709 A.2d 682, 689 & n. 9 (Del. Ch. 1996), *aff'd*, 693 A.2d 1082 (Del. 1997) (applying entire fairness when the controlling stockholder received a benefit that was not shared with the minority shareholders in an asset sale).

¹⁹⁶ See *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 202 n. 95 (Del. Ch. 2006) (“[T]ransactions where the minority receive the same consideration as the majority, particularly a majority entitled to sell its own position for a premium, had long been thought to fall within the ambit of non-conflict transactions subject to business judgment rule protection.”).

court's review of the transaction.¹⁹⁷ Delaware courts' willingness to treat the controller's liquidity needs as creating a conflict that justifies judicial review is especially puzzling given their reluctance to treat the controller's liquidity needs as justifying judicial review in other contexts, such as pro-rata dividends.¹⁹⁸ Our financial contracting framework sheds a new light on this inconsistent approach. We believe that the answer lies not in the nature of the conflict, but, rather, in the absence of idiosyncratic value concerns.

To begin, the controller can sell his block at a premium, thereby taking his share of the idiosyncratic value, while enabling the minority to stay and share in the buyer's idiosyncratic value. Alternatively, the controller can freeze the minority out to pursue his idiosyncratic value in a wholly-owned corporation, subject to minority shareholders receiving an appraisal right and entire fairness protection.¹⁹⁹ But, contrary to these situations, the right to drag-along the minority does not protect the controller's idiosyncratic value: The controller sells the corporation and ends his pursuit of idiosyncratic value. Why, then, does the controller receive the right to force the minority to sell their shares together with him?

The answer is to allow the *buyer* to pursue her idiosyncratic value in a wholly-owned corporation. Instead of buying just the control block and then freezing out the minority, subject to appraisal rights and entire fairness review, the buyer is willing to pay an equal premium to the minority to avoid the cost of a freezeout (time, effort, uncertainty, and litigation). In this scenario the seller who forces the minority to sell together with him assumes the role of an auctioneer. However, the controller has substantial holdings that normally induce him to maximize sale price. Thus, unlike the board of directors of a widely-held firm who assumes the role of an auctioneer subject to a heightened duty of care (*i.e.*, Revlon duties)²⁰⁰ the controller is only subject to the duty of loyalty.

¹⁹⁷ See *N.J. Carpenters Pension Fund v. Infogroup, Inc.*, 2011 WL 4825888, at *4, *9–10 (Del. Ch. 2011) (denying motion to dismiss when the director, who was also a large stockholder, was in desperate need of liquidity to satisfy personal judgments, repay loans, and fund a new venture"); *McMullin v. Beran*, 765 A.2d 910 (Del. 2000) (stating duty-of-loyalty claim could be filed against the parent for negotiating an all-cash transaction to satisfy a liquidity need). See also *In re Synthes, Inc. Shareholder Litigation*, 2012 WL 3594293, at *10 (Del. Ch. 2012) (NO. CIV.A. 6452) (“[I]t may be that there are very narrow circumstances in which a controlling stockholder's immediate need for liquidity could constitute a disabling conflict of interest irrespective of pro rata treatment.”).

¹⁹⁸ See *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971) (explaining pro-rata dividend payments are subject to business judgment rule, even if paid for clear benefit of controlling shareholder/parent).

¹⁹⁹ See, e.g., Del. Gen. Corp. L. § 262 (providing for appraisal rights); *Kahn v. Lynch Commc'ns Sys., Inc.*, 638 A.2d 1110, 1115 (Del. 1994) (entire fairness).

²⁰⁰ *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

Of course, the controller can avoid the role of an auctioneer by selling only his block. Obviously, he will do just that unless selling with the minority will result in a higher price. Put differently, in this case the seller needs the minority to sell with him not to allow him to get the right price for his idiosyncratic value, but to allow him to extract a higher share of the *buyer's* idiosyncratic value. Accordingly, a controller cannot, for example, decide, due to his liquidity needs, to take a cash offer over a higher valued bid when dragging along the minority, as this would be a breach of his duties as an auctioneer.

Therefore, the different treatment of the controller's liquidity needs is apparent. A regime that would impose scrutiny on dividend distributions would inevitably interfere with controllers' management rights and might undermine their ability to preserve their idiosyncratic value. These concerns cease to apply when the controller decides to sell the whole corporation to a third party. By putting her management rights for sale, and also forcing the minority to sell, the controller signals that she is no longer concerned with *her* idiosyncratic value. Moreover, a sale to the highest bidder also means that asymmetric information is no longer an issue. In other words, employing judicial review is less likely to be costly here. Thus, even a relatively small risk of a conflict of interest might call for judicial review.

CONCLUSION

In this Article, we have demonstrated that ownership structures are multiple solutions placed along a spectrum of contracts dividing control and cash-flow rights between entrepreneurs and investors. Concentrated ownership is one such structure on this spectrum bundling control and cash-flow. Our theory identifies the tension between the entrepreneur's need to pursue idiosyncratic value and investors' quest for protection against agency costs as the main explanation for the variety of ownership patterns.

From this framework, we have questioned the views 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 protections. In addition to challenging existing theories regarding concentrated ownership, we further explained how the tension between idiosyncratic value and agency costs is informing, and should inform, the shape of corporate law doctrines concerning corporations with controlling shareholders.

Accordingly, the Article establishes that the controlling shareholder structure provides a legitimate contracting device to maximize shareholder wealth by fostering the controller's idiosyncratic value and reducing minority shareholders' exposure to agency costs.