Say-on-Dividend

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Abstract

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Keywords: Corporate Governance, Ownership Structure, Ownership Concentration, Corporation Law, Payout Policy, Dividends, Institutional Investors, Hedge Funds, Activists, Independent Directors

JEL Classifications: G32, G34, G35, K22

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Most listed firms have concentrated ownership structures. However this ownership type is problematic. A clinical analysis reveals that the corporate governance in these firms in terms of liability, voice and exit faces important design problems. Our analysis shows that the corporate governance of these firms is mainly aimed at checking the shareholders-manager agency problem leaving the controlling shareholder-minority agency problem unresolved. Therefore it is crucial to provide growing companies with commitment tools that allow them to access capital markets and to raise funds from outside investors in better terms without having to give up the benefits of control. This leads us to a proposal that could improve the protection of outside investors while maintaining the informational benefits of concentrated ownership structures: a "Say-on-Dividend" policy. This proposal is centered in empowering independent directors and activist and institutional investors in the design of dividend policy as informed intermediaries that can represent the voice of the outside investors in the control of the funds that they invest in the firm.

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1 Introduction, Motivation and Contribution

Corporate governance deals with commitment and credibility. It studies how corporate insiders can credibly commit to offer a fair rate of return to the suppliers of funds from outside the firm[1]. In this paper we argue that listed firms with controlling shareholders lack good commitment mechanisms (both of the market and non-market type) and introduce a proposal for a "Say-on-Dividend" policy to give independent directors and activist and institutional investors control over the dividend policy as an effective discipline that can limit minority expropriation, reduce the cost of financing for these firms and increase their growth opportunities and value.

The ultimate purpose of corporate governance is to reduce conflicts of interests and allow outside investors to control the insiders who have the information and make the decisions on their behalf. Though there are many different protection mechanisms encompassed under the label "corporate governance", all of them fall into three categories: voice, exit and liability[2]. There has been a long and unresolved debate on whether these mechanisms are complements or substitutes[3]. But an important overlooked fact is that the effectiveness of liability, voice

[1]This definition was introduced by Shleifer and Vishny (1997). But, the importance of the allocation of control rights between insiders and outsiders for financial contracting at firm level was first noted by Hart and Moore (1989) and by Aghion and Bolton (1992).

[2]Hirschman (1970) in his book entitled "Exit, Voice and Loyalty" was the first to make the distinction among these cathegories that have become the keystone to the understanding of corporate governance both from a legal and an economic perspective. Though he does not really introduce liability. His focus is on the trade off between exit and voice and views loyalty as a form of commitment device that induces the use of voice rather than exit. In this paper however we follow the more recent interpretation of Hansman and Kraakman that substitute "loyalty" for "liability" and argue for different degrees of complementarity among these three control mechanisms.

[3]Kahn and Winton (1998) and Maug (1998) present models where exit and voice are substitutes because, if the market is liquid enough, so that exit is possible, the large investors' knowledge can be used to earn trading profits at the expense of liquidity traders and this reduces the incentives to use voice to intervene actively. This view is held by many US legal scholars that argue that the high liquidity of the US secondary market for shares prevents the appearance of large shareholders with incentives to monitor (see Black (1990), Coffee (1991), Bhide (1993) and Roe (1994)). However there are also arguments in favour of complementarity. Holmström and Tirole (1993) show that in liquid markets, prices are more accurate and the information they convey can be useful to large shareholders or members of the board to make compensation or removal decisions. Moreover, the benefits of active monitoring are larger if they are reflected in the market prices, as shown by Aghion, Bolton and Tirole (2004).

and exit depends on the particular organizational type and especially on the nature of the outside investors and the controlling insiders[4].

In this paper we will focus on listed companies with concentrated ownership, where the insiders are controlling shareholders that raise additional equity in the capital markets[5]. Although most corporate governance literature focuses on listed firms with dispersed ownership, listed firms with concentrated ownership prevail in Europe, Asia and developing countries and seem to be growing in the US (as an example consider the case of Google or Facebook). The pros and the cons of this type of firm, as opposed to listed firms with dispersed ownership, are well understood. On the one hand, there is a very large literature both legal and financial explaining the benefits that the monitoring and long-term commitment that controlling shareholders bring to the firm[6]. In fact, jurisdictions where this form of control is common are friendlier in their regulation towards controlling shareholders[7]. But, on the

[4]The nature of the parties in conflict changes both across firms and across time, as new types of investors enter or exit the market. For example, the insider who holds power may be a hired executive or a family or the government (whose role as a shareholder had decreased in developed economies but is very large in developing economies). Outside investors may be small investors, large block-holders or a group of controlling shareholders, but now-a-days a large fraction of total ownership is in the hands of institutional investors and hedge funds.

[5]Gilson and Gordon (2013) argue that the canonical distinction between corporations of dispersed or concentrated ownership structure in terms of governance is obsolete because the concentration of ownership in the U. S. in the hands of investment funds proves that the Berle and Means account is no longer accurate. But, even though investment funds are becoming large shareholders, they do not usually become controlling shareholders, since most of them do not intervene actively in management.

[6]Concentrated ownership has been considered an efficient governance mechanism that increases firm value through monitoring and through alignment of interests. Among the first theory papers to consider the monitoring benefits of having a large shareholder we find Pfleiderer and Zechner (1994). They show that because of the tradeoff between optimal risk diversification and monitoring in equilibrium the optimal stake of the large shareholder is too small and there is too little monitoring and it may be necessary to provide incentives to the block-holder. The benefits of entrenchment and the long term view that block-holders can bring have also been stated in the legal literature, starting with Roe (1996). Some of these papers stress the monitoring benefit, e.g. Gilson and Schwartz (2003); while others focus on the "idiosyncratic" benefits that founders can bring to the firm because of their deep knowledge of the firm, e.g. Goshen, Zohar and Hamdani (2013).

[7]This effect has been reported by Bebchuck and Roe (1999) in terms of path-dependence. La Porta et al. (2000) provided ample evidence of the poor protection of minority shareholders in countries with concentrated ownership structures. On the other hand, Goshen and Hamdani (2013) argue that it is necessary to strengthen controlling shareholders' rights and move away from what they consider excessive minority protection in the US.

other hand, there are many theoretical and empirical studies explaining how the ability of the controlling shareholders to extract private benefits and expropriate the minority limits the investment and growth opportunity of these firms[8].

The paper first explains why liability, voice and exit are not working properly in these firms. Liability, referred to the enforcement of fiduciary duties among shareholders faces deep conceptual limitations. Voice gives ample control rights to the controlling shareholder to monitor the managers. But outside shareholders, whose interests may clash with those of the controlling shareholder, can only hope to be represented by independent directors or activist shareholders, and even these information intermediaries do not have many tools to oppose the controlling shareholders. The threat of exit exercised by small investors who may sell their shares and depress market prices can work for firms with important financial needs. But a controlling shareholder in a firm which generates free cash-flows can choose to retain them and expropriate the outside shareholders. And there is a lack of effective tools that can force him to distribute these free cash-flows as dividends.

This analysis lead us to investigate alternative control tools inspired in the ones observed in private firms that are very effective in dealing with expropriation problems. Thus we propose a "Say-on-Dividend" policy as a tool that can empower independent directors and activist investors vis a vis the controlling shareholders. This in turn protects outside shareholders ex-post. Moreover it can also be implemented ex-ante, as a commitment tool, which will be especially useful for firms that need to raise funds in the capital markets: commitment to a low level of minority expropriation allows private firms to go public and raise the funds they need to grow while preserving the benefits of having a concentrated ownership.

In the final part of the paper we present a simple theoretical model that makes explicit

[8]On the theory side Burkart et al. (1997) and Volpin and Enriques (2007) show how block-holders convert security benefits into private benefits but in the process dissipate some of the value. On the empirical side Dyck and Zingales (2004) and Nenova (2003) find that control premiums vary across countries and that they are negatively related to the quality of accounting disclosure rules, the level of protection of minority investors, the quality of law enforcement and the level of product market competition.

our assumptions about the conflict over dividend policy between the controlling shareholder and the outside investors and explains how it can be resolved through the introduction of a "Say-on-Dividend" policy that allows independent directors and/or activists investors to raise their voice to oppose the dividend policy of the firm. By making these assumptions explicit we can disentangle the implementation problems that will appear and determine under what circumstances the policy will work better.

Our paper contributes to different strands of the literature on corporate governance.

First, we contribute to the legal analysis of companies with concentrated ownership structures. Interestingly, in spite of abundant empirical evidence on minority expropriation, the most extended view among European legal scholars is that the law in jurisdictions with concentrated ownership is well designed to curtail the power of controlling shareholders, and the few critical papers have come from American scholars[9]. We argue that although law on books seems well designed, the minority will face huge obstacles in practice to exert liability, voice or exit in the presence of a controlling shareholder. Interestingly, this inability of the minority to effectively oppose in practice the policies of the controlling shareholder means that it is very unusual to observe conflicts in these companies, and this may reinforce erroneously the positive view of most legal scholars.

Second, we contribute to the critical legal analysis of corporate governance in firms with concentrated ownership structures that make proposals on how to reduce conflicts of interests among the shareholders of these firms. In particular, Bebchuck and Hamdani (1999) argue that the corporate governance recipes that can work in firms with dispersed ownership are unlike to work, and may even be counterproductive, in firms with controlling

[9] Concentrated ownership structures are linked to weak legal regimes and underdeveloped markets. Moreover La Porta et al. (1998) show empirically that the quality of investor protection favors the appearance of widely-held firms. Bebchuck (1999) and Zingales (1998) discuss theoretically the efficiency problems of corporations with a controlling shareholder. Nevertheless, European legal scholars tend to consider the protection of outside investors as one of the strengths of corporate law in continental jurisdictions. The embedded character of the legal institutions that deal with the specific challenges caused by majority-minority agency problems is disregarded by common law scholars, see for instance, Conac, Enriques and Gelter (2007) and Tröger (2014).

shareholders[10]. Moreover, Gilson and Schwartz (2014) claim that controlling shareholders that want to raise funds and to attract outside investors routinely use some commitment devices that constrain their ability to expropriate the minority. But they also show that these commitment mechanisms are very imperfect, and that the lack of better commitment mechanisms is a drag on the efficiency of these ownership arrangements. Our paper proposes a new control tool, which can be used as a commitment mechanism of the block-holder or as a disciplinary mechanism in hands of outside investors, and is specifically tailored to the expropriation problems of firms with concentrated ownership. Moreover this mechanism is designed to improve the effectiveness of independent directors and institutional investors as protectors of the interests of outside investors. We posit than rather than introducing new corporate governance institutions we can make better use of the mechanisms already in place empowering these information intermediaries with interests aligned with those of outside investors.

Third, our mechanism is based on giving outside investors greater powers to determine the dividend policy of these firms independently from the wishes of the controlling shareholders. Therefore our paper is also related to the literature on dividends[11]. Although there are many factors that influence the optimal dividend policy, there is agreement in the finance literature that dividend payments reduce free cash-flows and alleviate agency problems. The empirical literature shows that firms pay higher dividends when they have more independent boards, more pay for performance sensitivity and the threat of takeovers is higher. But interestingly, it also shows that firms with controlling shareholders and high levels of minority expropriation are the ones that pay lower dividends. Our contribution to this literature is to explain how the dividend policy of these firms could be changed taking into account that existing voice, exit and liability measures are unlikely to induce the controlling shareholders

[10]Nevertheless, Gerner-Beuerle (2014) finds clear evidence that code issuers emulate internationally accepted standards of good governance.

[11]See the references in Section 3.3.

to distribute free cash-flows.

Fourth, we contribute to the literature on institutional investors. Most of the literature on institutional investors has focused on their role in monitoring managers but there are very few studies explaining how these investors can have an impact in companies with controlling shareholders[12]. Our model analyzes the necessary interaction between the (passive) institutional investors and the activists in companies with controlling shareholders. We show that these two types of investors need each other to bring about changes in corporate governance when there are large shareholders. In our model the institutional investors need the activist to generate information about alternative policies and to publicly oppose the controlling shareholder, but the activist needs the voting power of the institutional investors to force a change of policy. We show that this complementarity of efforts can be good in limiting the threat of activist investors implementing short-sighted policies. The controlling shareholder will only have its decisions reversed when this is in the interest of a large enough percentage of outside investors.

The rest of the paper proceeds as follows. In Section 2 we start by reviewing how liability, voice and exit are different "partner type" and "corporate type" organizations. Then in Section 3 we argue that firms with controlling shareholders present the typical problems of both the partner type and corporate type organizations but lack liability, exit and voice mechanisms effective for checking the power of controlling shareholders. In Section 4 we focus on the challenge of how to improve at firm level exit and voice without the recourse to regulatory changes. In particular we propose a "Say-on-Dividend" policy as an adaptation of the strong distribution rights for the partners as way to improve exit and voice in corporations with controlling shareholders. Section 5 presents a model where the details of the implementation of this "Say-on-Dividend" policy are made explicit. Section 6 briefly concludes.

[12]See references in Section 3.2.1.

2 Understanding the Corporate Governance System in Different Organizations

Most firms start up as owner-manager firms where the manager is also the sole shareholder or has a very large fraction of ownership. In these firms the manager internalizes the full effect of his decisions on equity value. But when more funds are needed the insider that makes the decisions can only own part of the shares. When this happens there is a corporate governance problem. Outside investors want to make sure that the insider cannot use company resources to his own advantage, i.e. they want to prevent the insiders form expropriating the value his decisions create. But outside investors also want to make sure that the insider has enough incentives to exert effort and make decisions that create value in the first place. In this sense there is a tension in the design of corporate governance mechanisms that has been extensively discussed in the literature[13]. On the one hand we would like to monitor the insider very closely to prevent expropriation. But on the other hand we want to preserve the insiders' incentives and initiative to ensure the efficiency of the decision making process in generating value. This is the reason why designing good corporate governance mechanism is a difficult problem and also the reason why we observe different types of organization with different corporate governance rules.

In fact organizational types are chosen by the parties setting up a business venture depending on the contribution that each party is expected to make to the venture[14]. And the governance system, the liability, voice and exit that these parties will have at their disposal, is determined by the structure of the organization. The tools that conform the governance system are directed at either making the insiders accountable for decisions that may harm the outside investors (such as fiduciary duties or power to dismiss) or giving

[13]See Parigi, Pelizzon and von Thadden (2013), Bebchuk and Weisbach (2010), Harris and Raviv (2010) and Zingales (2009) for excellent discussions of this problem.

[14]Any firm, whether a corporation, a partnership, or other standard legal form, is to some extent a distinct "entity", in the sense that it provides a mechanism for segregating piles of assets and dedicating them to the firm as distinguished from the firm's owners. See Hansmam and Kraakman (2000).

bargaining power to the outsiders to oppose the decisions of the insiders (voting at the general meeting, approval for raising new funding). As the different allocation of control and nature of the funding differ in each case, the concrete mechanisms of governance find different weight, different characteristics, and different implications. In each particular case liability should be targeted to the party that effectively makes the key decisions -the party in control-. And voice and exit should be easy to exercise for the party that provides the bulk of the funding. But these mechanisms should also allow the insiders to exercise some discretion in making business decisions to preserve their incentives. Bearing this in mind, we review the governance systems of the organizational forms and consider how robust and effective they are to tackle the prevailing conflicts of interest. In this regard, the optimal governance system depends on the structure of the organization, but also on the nature of the outside investors and the controlling insiders.

From an analytical perspective it is helpful to relate all the different types of for profit organizations into two universal and abstract archetypes: partner type organization and corporate type organizations[15]. As we will see, these two archetypes present distinct governance features, because the nature of the relationship among the parties involved and the different allocation of control rights generates very different kinds of conflicts among the parties that the governance arrangements seek to ameliorate. Organizations confront two main governance problems: agency costs between the managers and the owners, and agency costs among the owners. Additionally, they are both faced with a trade-off between the severity of these agency costs and the increased efficiency and profitability generated by centralizing and specializing management. We will see that in different organizations this tension is resolved in different ways.

The first ideal archetype is the "partner type" organization. Its main characteristic is

[15]The differences between corporations and partnerships have been largely analyzed. Nevertheless, traditionally it has focused on the benefits of centralized managements and limited liability. Less attention has been devoted to the issue of governance.

the personal link among parties, which is driven by the individuality of the members (the so called “intuitus personae”). Among other, organization types like the limited partnership or the civil partnership, are included in this archetype, but the basic example is the partnership. In these organizations shareholders supply ”personal” and idiosyncratic contributions to the venture, which they commit to share, and pool resources in order to profit from the joint pursue of the venture[16]. But they also need to be protected from the non-compliance of the other participants, who may try to free ride on the efforts of the copartners or be tempted to pursue their own benefit engaging in competing behavior at the expense of the joint interest. The governance system in partner type organizations is aimed at avoiding the conflicts and misgivings among shareholders, and providing them with individual tools to defend their own interest in the venture, because otherwise the parties would not agree to enter in a long-term contract of this kind, where they are locked into an investment. As a result voice rights, exit rights and liability rights interlace to create a strong anti-expropriation net.

Starting first with voice, control is tightly shared by all shareholders through property rules[17]. The major risk that the owners or the partners want to avoid is mutual exploitation among them: they are locked-in in the same boat, and they fear that some of them benefit disproportionately from the others’ effort. This is in fact the most elemental form of opportunism or expropriation.

Second, regarding exit, the contract grants individual cash-out rights, forcing dissolution of the organization (at least if the partners have no means to buy the stake of the leaving partner, other than their investment in the partnership). The idea behind this is that perpetual relationships are undesirable (even repulsive) to the Law (slavery is the paradigmatic

[16] As noted by Williamson (1985) and Klein, Crawford and Alchian (1978) firms bring together bundles of assets that are worth more together than apart.

[17] In words of Lamoreaux and Rosenthal (2006) in page 130, ”Each partner possessed full ownership rights and, without consulting the other partners, could enter into contracts that were binding on the firm so long as those contracts were within the scope of the firm’s normal business activities. Not only was this right to act unilaterally in and of itself a potential source of conflict within the firm, but it also meant that partners (all of whom were unlimitedly liable for the firm’s debts) faced obligations that were beyond their control or perhaps even beyond their knowledge”.

case). So, exit rights guarantee a way out, liquidity, but also a hammer to discipline the copartners' opportunism[18].

Third, the members commit to a loyal behavior towards each other, mostly conceived through strict and inflexible forbidding rules (a flat prohibition on self-dealing transactions, like the prohibition of competition to the firm) rather than by fiduciary duties enforced through open standards. The rationale for this is that the partners can only profit commonly and not individually (private benefits) from the corporation. Moreover, it ensures the idea that insiders' loyalty is paramount. Ergo, any type of self-dealing is banned.

This type of organization functions well in small markets with reduced financial needs. But the drawbacks of this type of organization are well known. The main problem is, again, the tension between agency conflicts among owners and efficiency in the running of the business.

This loss in efficiency has several dimensions. In exchange for a perfect anti-expropriation plan, which is the main concern of the co-owners as they agree to set up a common business project, hold-up problems arise. The costs of this structure are high[19]. They are not stable in the long term, because conflicts among shareholders can destroy the firm any time, and "future" shareholders are not part of the deal. Moreover, transaction costs are very high since decisions must be taken only by the unanimous consent of all the partners. Additionally, they forgo the gains from specialization and expertise given that there is no separation between ownership and control. As markets grow, financial needs also grow and these draw-backs become prohibitively costly. Other concerns, like the long-term stability of the organization, become more important to be able to compete and gain credibility when bargaining in asym-

[18]Lamoreaux (2004) in page 29 states that "Partnerships offer greater protection against hold-up than ordinary contracts, because if one partner tries to extort income from another, the aggrieved party can threaten to dissolve the enterprise and force the exploiter either to buy him out or to bear proportionately the costs of liquidating firm-specific assets. The ability to exit thus provides an incentive for partners to resolve their differences in a mutually satisfactory way".

[19]Blair (2003) argues that the power of each partner to dissolve a partnership shows the fragility of the firm and the risk of breaking up firm-specific assets.

metric information settings. Transaction or decision making costs increase exponentially as the number of shareholders increases and specialization is necessary to gain efficiency.

The second ideal archetype is the “corporate type” organization. It is characterized by the autonomy of the organization as such vis-a-vis the personal characteristics and the vicissitudes of its members. These organizations are designed to serve long lasting purposes, independently from the idiosyncrasies or the interest of their shareholders. Therefore, the scope of individual rights is strongly reduced, if not directly eliminated. Owners only count as a class. The organization becomes more standardized, rigid and institutionalized. Among other, organization types like cooperatives or mutual guarantee companies are included in this archetype, but the basic legal form is the publicly traded corporation.

This institutionalization of the organization enforces stability and specialization. In this respect, voice, exit and liability are designed to have efficient centralized management and to help raise equity in the amount necessary for large-scale-capital intensive enterprises, these is, they interlace to create a for-profitability net. In fact, with the aim of maximizing efficiency, and since information for making decisions is in the hands of the specialized managers, they are given ample decisions rights. But to ensure that the managers interest are in line with maximizing firm value all the legal rights that give the investors voice, exit and liability are directed towards managers, and no longer against other shareholders. Managerial powers are delegated to hired and professional parties. Nevertheless, the shareholders can check the powers of the managers in control through the exercise of voting rights and their power to nominate and dismiss. Exit is provided by large financial markets for the shares that guarantee transferability of shares and this renders withdrawal rights unnecessary. Liability makes managers accountable to shareholders through ex-post litigation on the duties of care and loyalty of the managers as delegated agents, while fiduciary duties among shareholders are minimized. In this setting the main challenge for all corporate governance mechanisms to operate effectively is to overcome the collective action problems that limit the use of voice and liability and the dangers of exit based on market prices with asymmetric information.

It is important to notice that the corporation type is the organizational form used by both closely held and publicly held firms. In essence, the major governance achievement is that management powers are centralized, nevertheless at the expense of higher opportunity cost for the shareholders without controlling rights. The accepted wisdom is that the opportunism among shareholders in this organizational form is reduced in two different ways. First, regarding the close corporation, the protection of minority shareholders is achieved by contractual arrangements -even through granting strong individual rights to shareholders in some circumstances- and by jurisprudence -like in the case of oppression-. Second, regarding the public corporations, financial markets introduce a new investment technology that alters substantially the ownership structure of the traditional firm. When financial needs are very large all shareholders become atomistic and control is in the hands of the managers. This is the well known Berle and Means American corporate model with maximum separation of ownership and control. The big break away that these public corporations introduce in the corporate governance problem is the large and liquid market for shares which facilitates exit. In the public corporation, when control is effectively separated from ownership, the conflicts among shareholders tend to disappear, because they all have the same status as a class vis a vis the managers. But we will see in the next section that in some public corporations severe conflicts among shareholders are present and neither market nor legal mechanisms seem to offer a good solution.

3 The Case of Corporate Governance in Concentrated Ownership Structures

Our study case is the listed corporation with controlling shareholders. We ask whether its governance system is fit for solving the typical conflicts of interest that appear in these firms, given that governance of the corporation is set up irrespectively its ownership structure[20]. When private corporations grow and need small investors to provide the bulk of financing they go public, but in most cases the incumbent shareholders retain a significant equity stake.

The traditional approach has enlightened the benefits of having a controlling shareholder. In this sense, a corporation where the block-holder shares powers with the managers seems to capture the best from two worlds: it benefits from centralized and specialized management through hired executives, but it does not suffer from agency costs. It is true that, on the one hand, the governance configuration of a corporation can be useful and adequate to deal with the managerial powers of the hired executives. But, on the other hand, there are no clear means to combat conflicts among shareholders. In other words, what happens when there are co-owners who seek to take advantage of others that do not have control power?

In this section we will argue that in public corporations with large shareholders the governance arrangements are unbalanced, with liability, voice, and exit mainly targeted at helping the large shareholders control the managers, but leaving the small shareholders unprotected vis a vis the large shareholders. The power that controlling shareholders posses to make decisions unilaterally allows them to capture more than their fair share of the enterprise's returns[21].

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[20] Corporate governance is rigidly centralized and not readily adaptable to firms' varying circumstances. Sowards and Mofsky (1969) argue that the corporate law standards developed in the early nineteenth century were appropriate for the publicly held corporations, and, in many respects, inappropriate for the close corporation. Ribstein (2004) at p. 206 say that: "the corporate structure is problematic not simply because it tends to facilitate managerial rent-seeking, but also because it is excessively rigid. Firms need to be able to customize shareholders' and directors' powers to deal with firm-specific features such as ownership concentration or the nature of the firm's business. This might include not only variations on management forms, but also on the extent to which assets are locked-in under central management control or subject to partner-like cash-out".

[21] The expropriation problem has been empirically investigated using two different methods to measure the ratio of private benefits. One uses the market value of double class shares. DeAngelo and DeAngelo (1985) and Zingales (1995) apply this technique for US data for the United States and Nenova (2003) extends the study using data from 18 countries. The second method values the premium price of block holder transfers. See, in this respect, the seminal study by Barclay and Holderness (1989) and Dyck and Zingales (2004) with data for 39 countries.

3.1 Liability

The idea underneath the liability mechanism is that the agents who exert control over the corporation should be accountable for the decisions they make affecting outside shareholders. In this sense, liability is a very powerful tool to put a limit on the extraction of private benefits of control. Fiduciary law applies smoothly to the case of managers and finds no difficulties to be enforced if the judicial system works well[22]. But one aspect of the matter that has not deserved enough attention is that the effectiveness of the liability mechanism changes dramatically in the presence of a controlling shareholder.

The common perception among European legal scholars is that the Law in these jurisdictions counts with specific remedies and doctrines to constrain the controlling shareholders' power, particularly through unique litigation devices[23]. But the effectiveness of these "traditional" legal mechanisms of minority protection to discipline controlling shareholders and limit the extraction of private benefits, particularly in the case of listed corporations, is very questionable[24].

Moreover, there is ample evidence that liability does not work well in jurisdictions characterized by high ownership concentration[25]. In jurisdictions where dispersed ownership is common we find a widespread perception that judicial control is the best response to refrain controllers opportunism, irrespectively of whoever the controllers might be -managers or shareholders-[26]. Nevertheless, the rate of derivative suits against managers and controlling

[22] Thompson and Thomas (2004) report that, in 1998 and 1999, 824 class actions, 87 individual direct actions, and 137 derivative actions were brought in Delaware based on alleged violations of fiduciary duty.

[23] As an example of this view see Conac, Enriques and Gelter (2007).

[24] See the discussion in Section 4.

[25] This problem is discussed by Johnson et al. (2000), Enriques (2002) and Gelter (2012). Moreover, economic history research by Lamoreaux and Rosenthal (2006) shows that the difficult problem that the courts faced in the XIX century was to protect minority shareholders without promoting rent seeking behavior by minority shareholders that would undermine the power of controlling shareholder. For this reason, the courts were very conservative in defining what constituted an abuse of trust by those in control and they tended to give the controlling group the benefit of the doubt on the grounds that its members were unlikely to take actions that eroded the value of their own stock.

[26] Gilson and Gordon (2003) at page 793 say that "what's important is that judicial doctrine effectively puts a ceiling on the private benefits of control associated on operating the corporation". This view is further

shareholders is close to zero in all the jurisdictions where concentrated ownership structures are the norm. Many scholars point out to problems in enforcement[27]. The use of liability may also be reduced because of technical problems related to the not up-to-date procedural law and deficiencies in the litigation system (standing, the allocation of litigation risk, access to information, etc)[28]. Other problems regarding draft deficiencies, lack of expertise, or formalistic approaches to the law might also hinder the use of litigation to control large shareholders in these jurisdictions[29]. These shortcomings are also true for derivative actions against managers, but there is much less at stake because they are closely monitored by the controlling shareholder.

But, on a more conceptual level, our claim is that liability does not work well in these jurisdictions because the unequal voting power of the controlling shareholder makes it difficult to hold him liable for the behavior that would be punishable in a manager. Fiduciary duties of controlling shareholders towards non-controlling shareholders are not recognized in the statutes and in most countries they are not even developed by case law. It seems that disciplining controlling shareholders through litigation is not part of the agreement of the participants in these organizations[30]. This happens because there three important problems

discussed in Gilson and Schwartz (2013).

[27]Gilson and Schwartz (2013) focus on judicial enforcement as the key in reducing private benefits, and suggest the introduction of a specialized European court for corporate governance and dispute resolution that could play a similar role to the Delaware Court of Chancery in the US. However, we believe that enforcement problems exist mainly due to the deficiencies of an outdated litigation system, and specialized courts encounter other risks, particularly in small countries, like capture.

[28]Sáez and Riaño (2013).

[29]Ferrarini and Guidici (2006).

[30]Europen law makers natural inclination is to minimize the impact of enforcement discretion of courts through fiduciary duties. A clear example is German group law, which builds a very complicated system to organize transfers to group subsidiaries due to intra-group transactions on a yearly basis (notice that this system has low deterrence effect on abusive behavior by the dominant shareholders of groups). Another example is the new Directive on related party transactions, whose strategy to tackle private benefits relies on introducing ex ante rules as a substitute for ex post accountability mechanisms. Nevertheless, some jurisdictions, and in particular Germany, have developed by case law a doctrine of duties of loyalty between shareholders. This is applied to majority shareholders, thus working as a tool for minority protection. That said, its usefulness should not be overrated. In this sense, we consider the loyalty duties doctrine to be a substitute to the minority oppression doctrine in the U.S for closely held corporations. Otherwise, it has shown some merit limiting the abuse of the majority voting power in key "structural or organizational"

that make it difficult to determine specific duties for the block-holder towards the minority.

First, it is difficult to clarify whose interest should prevail. On the one hand, to the extent that they can control business decisions, controlling shareholders act as agents of the outside shareholders. But, on the other hand, controlling shareholders can defend as shareholders their own interest in the corporation. Consequently, legislators and judges find it hard to make controlling shareholders liable when they cause damages to the minority, but not to the "interest of the company", usually interpreted as the interest of the majority, which necessarily includes the controlling shareholder[31]. It seems doubtless that managers as fiduciaries should subordinate their own interests and act in the interest of the firm (that is, in the interest of the shareholders as a group). But it is far from clear where to set the limits if someone holds a controlling stake among the owners. Therefore, unless controlling shareholders act as officers, they are rarely exposed to liability.

Second, controlling shareholders can usually extract private benefits in the course of business transactions where the business judgment rule applies and these transactions are difficult to identify and regulate. Liability rules are easier to apply to transactions where the block-holder enters into a direct contract with the corporation and stands on both sides of the transaction. Examples of these cases include salaries, pensions, personal loans, etc. In these cases the treatment of the controlling shareholder should be similar to the treatment of a manager. But, more frequently, controlling shareholders' can extract private benefits by

decisions potentially harmful for the minority shareholders, like liquidation of the company, capital increases, and the like. But it has not proved to be a working mechanism to limit expropriation (for instance, through self-dealing or related parties transactions) or to make the controlling shareholder accountable in listed corporations.

[31] It has become a common place in Continental European jurisdictions to define the interest of the corporation as an open standard that needs to be put into more concrete terms through the legal procedure established to adopt corporate decisions. In practice the interest of the corporation is hard to pin down for the courts, so they are inclined to accept the definition of the corporate interest suiting controlling shareholders. Notice also that because the standard should not be understood substantively, judges are likely to confront it to procedurally terms. In other words, the majority rule determines each time which is the interest of the company. But then, the standard is not longer useful and allows too much discretion to the majority group (Spindler 2008). Because of this Schmidt (2004) criticizes the prevailing interpretation of "the interest of the company" as being too friendly with controlling shareholders.

altering business or strategic decisions[32]. This is especially true if the controlling shareholder is a firm, a parent company or the government, but also in the case of families that hold shares in many different firms. It can involve different business decisions, like acquisitions, or other investments that can benefit somehow the insiders, but might not be the best decision according to minority interests. It may be too difficult to distinguish legitimate corporate policy decisions from others aimed at looting from the firm. In other words, courts -as probably could not be otherwise- usually treat business and strategic decisions as business judgments. This problem is most acute in the case of groups of corporations and the treatment of transactions inside the group[33].

Third, it is difficult to determine the optimal level of private benefits which courts should allow. Forcing the conflicting transactions to be made at "market prices" is not a good solution. This happens for two reasons. Gilson and Schwartz (2013) argue that some ratio of private benefits is the necessary compensation that controlling shareholders demand for the monitoring costs that they incur, which include the illiquidity of their stake and the forgone diversification gains that they suffer in order to maintain a high enough stake that allows them to monitor managers. Gutiérrez and Sáez (2013) argue that controlling shareholders also bring business opportunities to the company and that a restrictive self-dealing practice might hinder efficient transactions from taking place. Opportunities for self-dealing arise in the course of business decisions, and the controlling shareholders, that stand to benefit from the self-dealing transactions, also have more information about the value that can be generated by these business decisions. Therefore the minority may be better off by allowing the controlling shareholder to engage in some degree of "informed" self-dealing, rather than forcing an uninformed decision. Thus, it is far from clear that a legal strategy

[32] See Atanasov, Black and Ciccotello (2011), Damman (2008) and Bertrand, Mehta and Mullainathan (2002).

[33] Groups are in fact the most extreme form of block-holder control. Not surprisingly, German Law has addressed this problem through complex and "wishful thinking" regulation, which has proved rather ineffective. In order to avoid litigation based on loyalty duties, they have enacted codified law on corporate groups based on special report and audit duties of the activity of the group. See Zöllner (2007).

aimed at achieving zero level of private benefit extraction is efficient. In this respect, the best regulation should enforce some optimal level of private benefits that is unlike to be zero[34]. But the problem then is how to fix this level. In other words, the optimal regulation of private benefit extraction and its impact on managerial decision making by the controlling shareholders find many limitations and depends crucially on every controller-firm pair[35]. This trade-off cannot be resolved efficiently by corporate law or doctrinal jurisprudence. Moreover, in practice regulation has only one choice: to pursue a low rate of private benefits (pointing towards zero) or to allow a high rate of private benefits (through no regulation or low enforcement). The current answer to this dilemma in jurisdictions where controlling shareholders are prevalent is to allow a high rate of private benefits. But the observation also stands in the symmetric case, that is, in those jurisdictions where the judicial pressure is higher, the number of controlling shareholders decreases.

In sum, the liability mechanism faces deep limitations for disciplining the key insiders in corporations with a controlling shareholder[36]. As a consequence, in jurisdictions where

[34]Gilson and Gordon (2003) argue that Delaware doctrine restricts the extent to which controlling shareholders can extract private benefits of control to a level at which it is plausible that the benefits to minority shareholders from the reduction of managerial agency costs as a result of concentrated monitoring by a controlling shareholder exceed the cost of the controlling shareholder's private benefits of control.

[35]Gutiérrez and Sáez (2014) present a model where private benefits appear as the result of choices on potential courses of action in a long term relationship. These choices are made with limited and asymmetric information and they affect both the public and the private benefits that accrue to each party. Regulation affects these choices and therefore it has a large impact on efficiency.

[36]In this sense, it is worth notice that in the absence of liability to discipline controlling shareholders, jurisdictions with dominant shareholders have developed substitutive exit mechanisms. One of these is the mandatory bid system for takeovers in the European Union, which in fact works as a substitute for liability in disciplining controlling shareholders. Protection of minority shareholders towards the extraction of private benefits comes as a mechanism to provide the exit of minority shareholders upon an acquisition of control. Moreover, the traditional legal strategy in these jurisdictions to curtail any kind of agency costs has been to force the controller to own a significant equity stake and battle against minority controlling positions. Under these assumptions, the system seeks to discard "bad" controlling shareholders or looters. To address this risk, minority shareholders could have "tag along" rights. If a shareholder holding more than, for example, thirty percent of the company's shares agrees to sell its stake in a negotiated transaction, the minority shareholders could have the right to "tag along"-that is, to sell their shares to the buyer on the same terms and conditions as the controlling shareholder is selling its interest. If private benefits from operating the corporation are not capped by the regulation until control is sold, the entrance of purchasers who pretend to extract private benefits in order of profit from its investment is curtailed. Nevertheless, the system is aimed

dominant shareholders are the prevalent case, a legal rate of private benefits is allowed. How big this rate is depends upon the health of alternative corporate governance mechanisms, such as the size of the markets, the reliance on external funding, the institutional structure, etc. But liability and anti self-dealing provisions have little bite for regular cases, and can only play a role, at best, in cases of blatant looting (sometimes through criminal enforcement).

3.2 Voice

Shareholders exert voice when they exercise their formal control rights over the firm's decisions[37]. Shareholders can exert direct voice and make corporate decisions that bind the firm. They can also exert delegated voice by choosing the board members as agents that will make those decisions on their behalf.

In jurisdictions where disperse ownership dominates direct voice is limited to a few decisions. The shareholders' voice is basically restricted to the choice of the directors through proxy voting and to decisions related to changes in the capital structure and to corporate control contests[38]. However in jurisdictions where concentrated ownership is the norm, direct management by the shareholders plays a more important role, with many key decisions reserved for the Shareholders General Meeting, and the selection of board members is simply one more of these decisions. In this model most decisions are directly taken by the controlling shareholders who dominate the Shareholders General Meeting and hold board seats[39].

Interestingly, a central debate on how to improve corporate governance in the last decade has focused on reducing the costs of the decision making in terms of facilitating shareholders

-at best - at discarding looters, but not at selecting good controllers or disciplining them. For a discussion of this system see Sáez and Bermejo (2010).

[37]Cools (2014) provides many interesting insights about the division of power between the shareholders and directors taking into account transaction costs and conflicts generated in both cases.

[38]The clear example is the United States, where, as discussed by Eisenberg (1976) public corporations are run and controlled by corporate management. This system is usually justified by efficiency reasons, i.e., basically, motives related to information asymmetries and managers' authority (hence it is usually referred to as "managerialism"). For a discussion of this clearly dominating orientation see Bainbridge (2006).

[39]Nevertheless, Hopt (1998) notes that some jurisdictions like Germany and the Netherlands, introduce the two tier boards to reduce the board's dependence on controlling shareholders.

participation in the decisions that are reserved to them and on extending those decisions to make insiders more accountable. Regarding participation, there have been reforms aimed at strengthening shareholders' rights in procedural terms (electronic voting, opportunity to ask questions, table resolution, etc.)[40]. Regarding the reach of the decisions that shareholders can take to make managers more accountable, the reforms have been aimed at making it possible for shareholders to fire managers, appoint new directors, and change the compensation structure, through "Say-on-Pay" policies[41]. Placing these corporate decisions in the hands of the shareholders should increase managers' accountability towards them: the so-called "Shareholders' Franchise"[42]. However these reforms face three obstacles that reduce their

[40]Surprisingly, the most widely shared concern in European jurisdictions is the need to promote initiatives that reactivate shareholders' meetings and favour shareholder activism. Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies can be interpreted in this line. Despite their widespread support, it would be naive to expect that legal rules facilitating voting -for instance, through electronic media- can increase the presence of retail investors at the General Meeting. Nevertheless, Continental jurisdictions have embraced this kind of reforms in order to promote "activism". The collective action and asymmetric information problems are not easy to overcome by these means, but they can be useful and valuable for institutional investors. However, there still remain problems related to cross-border voting, as noted by Strenger and Zetzsche (2013).

[41]Regarding director's election, in 2010, the SEC passed a rule which allowed certain shareholders to place candidates on the proxy statement; however, the rule was struck down by the United States Court of Appeals for the District of Columbia Circuit in 2011 and currently, only the nominating board can place candidates on the proxy statement. With regard to compensation, in 2010 the Dodd–Frank Act introduced a new rule that requires all public companies subject to the proxy rules to provide their shareholders with an advisory vote on the compensation of the most highly compensated executives. Say-on-Pay votes must be held at least once every three years. In 2012, only 2.6% of companies which voted on say on pay measures failed to pass them, as reported by Thomas and Van der Elst (2013). The European Union has also proposed new EU rules on providing shareholders with a 'say on pay' rule, which already exists in the UK, Belgium, the Netherlands, and Sweden, but other jurisdictions like France, Germany or Spain are moving in the same direction. The proposed directive would only affect EU listed firms that will have to produce both forward and backward-looking remuneration policy reports that will have to be put to a shareholder vote every year. If shareholders vote against it, the company has to explain in the next report how the vote against has been taken into account. It is worth noting that in these jurisdictions with concentrated ownership, there are already incentives not to overpay executives, so the enactment of Say on Pay has different motivations, like social pressures against increasing income inequality, or strong support of this measure by foreign institutional investors.

[42]This is the empowerment strategy promoted by Bebchuk to mitigate agency conflicts in a series of papers in 2007, 2006, 2005 and 2003, which has become a key idea in the reforms initiated in the US to improve corporate governance. However, this approach has also been critizised, especially in the aftermath of the financial crisis, as promoting short-termism, suggesting that the managers have been too focused on share price maximization. In this respect see Bratton and Wachter (2010) and a reply to the criticism in Bebchuck (2013).

effectiveness as protection for outside investors.

First, to the extent that outside investors are dispersed they do not have the incentives or the ability to get the information necessary to vote. Second, if small outsiders are passive, extending voice rights only empowers organized minorities, which may have their own agenda and generate a hold-up problem. Third, and most important in our case study, if insiders have significant voting power, none of these reforms will change the existing situation since they do not alter the bargaining power of the minority vis a vis the block-holders[43]. This is of particular concern in companies with concentrated ownership. In fact, the Shareholders General Meeting is usually much more empowered vis a vis the managers in jurisdictions with concentrated ownership. In fact they usually allow for appointment by majority, removal at will, limited number of years of board service, approval of compensation packages by the general meeting, etc.[44] In these jurisdictions voice is extensively developed because there is only partial -but not complete- separation of ownership and control. The voting power of the controlling shareholder is used to effectively discipline managers in all these matters[45]. As a result this ample spectrum of voting rights granted to the Shareholders General Meeting increases the power of the block-holders over the managers and promotes informed decision making, but it reinforces the conflict between the insiders and the outsiders, leaving the minority unprotected vis a vis the controlling shareholder. It will be almost impossible for the minority to use voice directly at the Shareholders General Meeting to fight the preferred decisions of the controller, no matter how harmful they are to the minority.

The solution to these problems with voice for outside investors has come from the interposition of informed parties with interests aligned with those of the outsiders and power

[43]It is undeniable that this line of reforms makes the shareholders' participation at the general meeting easier, but in the presence of a controlling shareholder, to promote shareholder engagement and influential participation by these means faces strong and insuperable limitations, as argued by Sáez and Riaño (2013).

[44]Kraakman et al. (2009) in page 61.

[45]It is frequently assumed by European scholars that the active role of shareholders in decision making in jurisdictions with concentrated ownership is perceived by many European law scholars as a corporate governance strength that reduces the agency problems of these firms. See for an example of this view Cools (2009).

to affect decisions[46]. This is the role that has been taken up by institutional investors and independent directors, which have been the real force behind changes in voice during the last decades. However the evidence on the effectiveness of their intervention in corporate governance has been mixed, in special for companies with concentrated ownership.

3.2.1 Institutional investors and voice

The activism of institutional investors is right now the most hotly debated topic in corporate governance, with academics dividend on the wealth effects that it generates for shareholders and for other stakeholders[47]. Activism refers to the actions taken by outside institutional investors to exert their voice so as to make insiders accountable and to override insiders' decisions that may not be in the best interest of shareholders.

The rise of investment and pension funds during the last quarter of the XX century created great expectations about their potential to solve agency conflicts, since they hold large stakes on behalf of small shareholders, so that they would seem to naturally solve the collective action problems of outside investors[48]. However the evidence shows that they have been reluctant to take an active role and, when they are forced to vote, they tend to side with the managers[49]. The main explanation for this behavior lies in the regulation and the

[46]To some extent, this is the diagnosis of the EU, proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement, COM(2014)213 final. The Commission entrust institutional investors the role of activist shareholders in the sense of voting and engaging in the long-term value of the corporation since they respond to "end beneficiaries", namely future pensioners, who have entrusted their money to these investors and expect to reap the benefits of a long-term investment.

[47]Macey (2008) argued that hedge funds and private equity activism were the newest big thing in corporate governance, and predicted that it was going to be controversial. Paradigmatic in this regard is the open discussion between Profs. Bebchuk and Lipton, (available in different posts and papers at http://www.law.harvard.edu/faculty/bebchuk/).

[48]Black (1990) and Coffee (1991).

[49]Gillan and Starks (2007) review this literature and conclude that there is little evidence of improvement in the long-term operating or stock-market performance of the targeted companies. But this literature is mainly focused on US firms with dispersed ownership. For countries where concentrated ownership is prevalent there are few studies but they also fail to find a significant impact of institutional investors. In particular Hamdani and Yafeh (2013) find that in Israel institutions rarely vote against insider-sponsored proposals. Norden and

nature of competition in the mutual fund industry. These funds are highly diversified and investment managers' remuneration is determined by fund size and performance relative to other funds, rather than by absolute returns. In this setting, investment in activism amounts to producing a costly public good form which all institutional investors can equally benefit[50]. This is consistent with the evidence that the little activism that institutional investors have produced has been aimed at changing corporate governance rules[51] and introducing "look good" measures that do not necessarily have a real bite[52].

Effective activism has been a much more recent phenomenon and has come from hedge funds[53]. These are funds that do not have liquidity restrictions, can invest in fewer companies and have management fees tied to total returns and thus have incentives to gather information and act on this information[54]. Interestingly they invest in targets that have unresolved agency problems[55]. There is by now consistent evidence of high returns to hedge fund activism[56]. The shares of the activists' targets experience positive and significant ab-

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Strand (2011) find that in Sweden institutional voting is more correlated with the target firms' size than with its performance. De Jong et al. (2005) study shareholder meetings in the Netherlands and find that less than 1% of management sponsored proposals are rejected by the Shareholders' General Meeting.

[50] An argument that was first put forward by Black (1990).

[51] Aggarwal at al. (2011) find that firm-level governance is positively associated with international institutional investment. In particular they find that foreign institutions and institutions from countries with strong shareholder protection play a crucial role in promoting governance improvements outside of the U.S.

[52] Part of the legal literature defines the activism of mutual funds and pension funds as "defensive" activism, trying to protect their reputation or to reduce legal risks, meaning that they only engage in actions to protect the value of existing investments when the firms are underperforming or their governance regime is deficient. See in particular Kahan and Rock (2007) and Cheffins and Armour (2012).

[53] Cheffins and Armour (2012) explain the rise of hedge funds activists starting in the 2000s as practitioners of offensive shareholder activism in comparison to the defensive interventions of pension and mutual fund since the 1980s.

[54] Damodaran (2012) explains why these characteristics put hedge funds in a better position to practice active value investment and achieve higher returns than other institutional investors.

[55] Brav, Jiang and Kim (2010) find that hedge funds typically target firms that have sound operating cash flows, but low (sales) growth rates, low leverage, and low dividend payout ratios.

[56] Among the most recent and wide evidence we find Becht at al. (2014). They examine 1800 cases of shareholder activism around the world and find large abnormal returns to shareholder activism at the block disclosure announcement of between 4.5 and 7.5 percent and also large additional abnormal returns to the disclosure of outcomes achieved by the activists (particularly of takeovers). Other papers that find similar results for the US are Klein and Zur (2009), Boyson and Mooradian (2011). Brav et. al. (2008) and Clifford (2008).

normal returns, both when the hedge funds announce that they have bought a stake and also later upon the announcement of observable outcomes that reduce the power of the insiders, such as board changes, payout policy changes, and restructurings including divestitures and takeovers. Although there is an open debate on whether these actions really increase long term value there is no evidence that the initial positive returns are subsequently reversed[57].

But activists face very high costs[58] and these costs are higher in listed firms with controlling shareholders[59]. When they face large shareholders, activists are more likely to use a cooperative and private engagement strategy rather than hostile and public campaign. There are few papers studying empirically the role of activists in firms with concentrated ownership structures. But the existing papers show that activists are reluctant to enter into these firms and that they usually enter in particular circumstances when these firms have an important need for the funds they provide. Moreover their activism in these firms is mostly directed towards improving business decisions. They also seem to be effective in implementing cosmetic reforms, but find huge resistance on key decisions[60].

[57]On the long-term effects Brav et al. (2013) and Bebchuck, Brav and Jiang (2014) examine long term windows of three to five years following activist interventions. They find that activist interventions are followed by improved operating performance of the target company due to higher production efficiency, an increase in the efficiency of capital redeployment and an increase in labor productivity. Nevertheless, Greenwood and Schor (2009) argue that these benefits accrue only to firms that are taken over during the period of engagement.

[58]Gantchev (2010) estimates that the average US public activist campaign that reaches the confrontational level of a proxy fight costs $10.5 millions. In addition, he estimates the costs of such confrontations to be about two thirds of the gross abnormal returns of hedge funds. Damoradan (2012) shows that once we take into account these huge costs the after fees returns of hedge funds are not higher than market returns.

[59]Cheffins and Armour (2012) argue that the only avenues that activists can exploit in companies with concentrated ownership are disagreements between significant block-holders, especially in family firms, and the use of rights available to minority shareholders, such as the right to select a director in a company that provides for "cumulative" voting for directors.

[60]Becht et al. (2008) examine 362 European activist interventions both in public and private firms from 2000 to 2008 and find that in family firms the returns to activism were driven by the fund's ability to engage the controlling family on a cooperative basis and persuade them to undertake its recommendations and to exploit divisions between family shareholders. Erede (2009) studies the presence of hedge funds in Italian firms and finds that most of the funds were using a cooperative low profile strategy, renouncing the exercise of their minority rights to appoint directors and to submit a list of candidates and thus to get one of them elected.

3.2.2 Independent directors and voice

Delegated voice works by allowing shareholders to nominate the directors that will make decisions on their behalf.

Interestingly, in spite of all the attention that has been devoted to the functioning of boards of directors in the last decades, the procedures for the nomination of directors have not seen important changes neither in jurisdictions with dispersed ownership nor in jurisdictions with concentrated ownership, and insiders still have the power to appoint the members of the board of directors. The only exceptions to this rule are cumulative voting and minority directors as attempts to empowering outside shareholders in the selection and nomination of directors to represent their voice on the board[61].

Almost all of the attempts to improve the functioning of boards have been focused on the introduction of independent directors with incentives aligned with those of outside shareholders and the mission of monitoring the insiders to make sure they maximize firm value[62]. For companies with dispersed ownership the logic of this is that, even if the proxy system does not work well, and insiders have the power to nominate board members, they will have to nominate boards with a majority of independents and the outsiders will be protected[63].

[61] In 2010, the SEC passed a rule which allowed certain shareholders to place candidates on the proxy statement; however, the rule was struck down by the United States Court of Appeals for the District of Columbia Circuit in 2011 and currently, only the nominating board can place candidates on the proxy statement. In Europe Corporate Governance Codes of Best Practice recommend that independent directors be nominated by an independent nomination committee, but the members of these committees are nominated by the shareholders general meeting, where the major shareholders can exert their power through their voting rights. In Italy Art 47-ter of Law No 262 of 2005 minority shareholders can propose an alternative list of candidates and at least one director should be appointed by the list that receives the second largest number of votes at the Shareholders' General Meeting.

[62] Since the Cadbury Report in 1992 many different norms and regulations try to make boards better monitors. In the US these requirements for board composition have been imposed by the Dodd-Frank Act of 2011, the Sarbanes-Oxley Act of 2002 and exchange listing requirements at the NYSE. Most other countries have enacted Corporate Governance Codes of Best Practice (under the "comply or disclose" rule). Bianchi et al. 2011 report compliance levels above 70% for most European countries.

[63] Nevertheless there are still many serious problems that hinder the effectiveness of independents because of unresolved information, nomination and incentive issues that could explain why the empirical evidence on the effectiveness of boards in mixed. The interested reader will find an in-depth review of these issues and of the finance literature on boards in Adams, Hermalin and Weisbach (2010).

But in jurisdictions with concentrated ownership structures, codes of best practice recommend that voting power at the board level should reflect the voting power of the different shareholders[64]. In publicly traded firms in Continental Europe so called ”constituency boards” are the norm, and the power of the controlling shareholders is checked by allowing particular classes of shareholders and other stakeholders to appoint their own “nominee” or constituency directors as well. Therefore independents are not likely to hold a powerful position on the boards of these companies[65].

But, even if there is a significant number of independent directors, in a company with concentrated ownership these directors do not have the right tools to be effective. Interestingly, most codes of best practice state that the function of independents is to monitor the management team. But in jurisdictions with concentrated ownership structures, independent directors are not really needed to monitor the managers (since they are already being monitored by the controlling shareholders), but to check the power of the large shareholders. However this is a difficult task for them because the tools of independents against controlling shareholders are not as powerful as the tools they can use against managers. Unlike managers, block-holders cannot be hired, fired or remunerated by the board, so independents have little ex ante deterrence power when there is a controlling stake. Moreover, controlling shareholders hold voting power at the Shareholders General Meeting, and can overrule board decisions and nominate their preferred independents[66].

[64] As an example see the Spanish Corporate Governance Code which under the “comply or explain” principle recommends that in all Spanish listed firms “the percentage of independent directors corresponds to the percentage that free-float represents in the capital of the company”.

[65] Gelter and Helleringer (2014) describe the rules allowing for constituency directors across Europe and explain why these boards are unlikely to represent the interest of outside investors.

[66] Gutiérrez and Sáez (2013) analyze in detail all these the problems that render independents an inefficient monitoring device for companies with concentrated ownership structures and conclude boards of directors lack the mandate, the incentives and the ability to control large shareholders.

3.3 Exit

Exit has two different dimensions. The first dimension refers to individual investors selling their shares in the secondary capital markets, while the second dimension refers to outside shareholders acting as a group to induce the insiders to give them back part of the funds invested in the company in the form of dividends. In this section we will discuss how each of these dimensions can work to discipline the insiders both in companies controlled by the managers and in companies with a controlling shareholder.

Regarding the first dimension of exit, even small, uncoordinated investors have the power to check managers and large investors by "voting with their feet", i.e. by refusing to provide their funds to the firm. If many outside investors wish to sell the price of the shares will go down and this can help discipline the insiders that control the funds[67].

In the case of managers the negative consequences of low market prices are stronger because their salaries and reputation, and the probability of being fired, or losing their job because of a takeover are all linked to stock market values. Of course, the recent crisis has shown that, if market prices are biased because of short-term bubbles, relying too much on them to discipline managers may be a bad idea[68]. But notice that none of this applies in the case of a controlling shareholder, since he cannot be fired or suffer a hostile takeover[69].

[67] The idea that stock prices can play a role in monitoring managers' actions was first formalized by Holmstrom and Tirole (1993), who present a model where secondary stock market traders learn about managers' actions and trade accordingly and the manager is disciplined via the stock holdings on his remuneration contract. They argue that this effect is higher when ownership is more dispersed and market liquidity is higher, because liquidity increases the profits that speculators can realize in trading on information. Because of this some authors (e.g., Bhide 1993; Coffee 1993) argue that exit is an alternative to activism by large shareholders. But Admati and Pfleiderer (2009) present a model where the threat of exit (also known as the "Wall Street Walk") by an informed large shareholder can also discipline a stock incentivized manager for particular decisions, although it may have a negative effect in managerial initiative.

[68] When market imperfections make prices in the short-term deviate from the long term value (market myopia) the value of long term investments that may be crucial for long term competitiveness (such as R&D capabilities) is not reflected in (and may even depress) short term prices. When faced with this situation, stock incentivized managers (and managers with career concerns) will underinvest. In an interesting survey Graham, Harvey and Rajgopalís (2005) find that 78% of executives would be willing to sacrifice long-term value to meet earnings targets. See the Kay Review (2012) for a complete discussion of the issue.

[69] However, there could still be some incentives for long-term shareholders to keep prices up for reputational

Nevertheless, both for companies with dispersed and concentrated ownership, lower market prices make access to new financing more difficult and expensive and reduce the investment opportunities of the firm. This financial market's pressure will be effective for firms with large investment needs, whose retained earnings are low compared to their investment opportunities. Therefore, for companies that do not have free cash flows, the threat of having many dissatisfied outside investors selling their shares in the stock market will be a strong exit mechanism that will keep the insiders in check and prevent minority expropriation.

But what happens in the case of firms that can satisfy their investment needs using the proceeds from previous equity issues and retained earnings as their sole sources of funds? Does exit have a role to play in the corporate governance of these firms that do not need to raise funds in the capital markets?

This bring us to the second dimension of exit, which relates to outside investors forcing or inducing a generous dividend policy that allows them to get back the money they have invested in the firm and reduce free cash-flows. Insiders have incentives to retain free cash-flows inside the firm, where they can make use of them to generate private benefits for themselves at the expense of outside investors. The financial literature makes a strong case of the usefulness of a generous dividend policy as a means to reduce this agency conflict[70]. Frank H. Easterbrook (1984) and Michael C. Jensen (1986) argue that in this context high dividend payouts can reduce the ratio of retained earnings to investment and subject these firms again to the discipline of having to raise funds in the capital markets, so that exit becomes a powerful threat again. With high dividends insiders will be unable to fund their suboptimal investment projects with free cash-flows and will be forced to issue either debt or equity if they want to raise money for investment. Therefore, although issuing securities is a

reasons but also in cases where controlling shareholders pledge their shares as a security for getting loans, with margin calls if the price of the security drops below a minimum defined in the loan contracts define a minimum price of stock and if the price drops below this, margin calls work and the borrower has to provide either more security or return the loan. This encourages controlling shareholders to take measures to keep the price of stock at least above the level fixed in the loan agreement.

[70]For a review of the large literature on dividend policy see Allen and Michaely (2003).

costly process that could be avoided by retaining earnings, it has the advantage of allowing outside investors to monitor investment policy and reduce agency conflicts.

The recent empirical research on dividend policy is consistent with the idea that dividends are used as a corporate governance mechanism that allows outside investors to reduce their investment in the firm when free cash-flows appear[71]. This suggests that dividends are the perfect exit mechanism to keep insiders in check, but the important question that remains is who will bell the cat? It is unclear why, in a firm where the dividend policy is controlled by the insiders, these insiders voluntarily select a dividend policy that reduces their discretion and prevents them from pursuing their preferred investment strategy.

We would expect that when insiders control dividend policy, they will use the dividend policy to reduce free cash-flows only if there is an incentive to do so. Thus dividend policy will be complementary to other corporate governance mechanisms, such as the fear of a takeover, stock options in the remuneration packages of the executives, the pressure of independent board members, the activism of institutional investors, etc.[72]

But, our previous analysis has shown the low effectiveness of alternative liability and voice mechanisms to check the power of controlling shareholders. Therefore we cannot expect controlling shareholders to have incentives to use dividend policy as the means of reducing free cash-flows and minority expropriation. Quite to the contrary, La Porta at al. (2000) show that in countries with concentrated ownership weak minority protection dividend payout

[71] Linda DeAngelo, DeAngelo and Stulz (2006) show that propensity to pay dividends is positively related to the ratio of retained earnings to total equity, which proxies for free cash-flows. Denis and Osobov (2008) find that that the likelihood of paying dividends is strongly associated with the ratio of retained earnings to total equity, and that the fraction of firms that pay dividends is high when firms' equity consists primarily of retained earnings and is low when retained earnings are negative.

[72] Gutiérrez and Sáez (2015) address this question in detail. They analyze the legal rules governing cash distributions and show that the law grants the control of dividend policy to the powerful insiders with weak protection for the interests of outside shareholders in this regard. Because of this they argue that dividend policy will be closely related to the overall quality of other corporate governance mechanisms. When insiders are in control of the dividend policy and overall corporate governance is weak, dividend policy will fail to reduce agency conflicts. But when insiders are in control of the dividend policy, but other corporate governance mechanisms are functioning well, and they give the insiders the right incentives, dividend policy will be designed so as to reduce free cash-flows.

tends to be lower. This is consistent with the findings of the more recent empirical evidence that analyzes the differences in dividend policy depending on ownership structure and shows that companies with controlling shareholders have lower payout ratios[73].

Therefore, exit in the financial markets will be a useful corporate governance mechanism in growing firms that need external funding to invest and for firms where complementary corporate governance mechanisms discipline managers. But for firms with concentrated ownership that generate free cash-flows exit will not be an efficient corporate governance mechanism. The law grants control over the dividend decision to the powerful insiders and there are no complementary liability or voice mechanisms that can be used to induce the controlling shareholder to offer a generous dividend policy that would make the firm more dependent on the funding provided by the outside investors.

4 How to improve corporate governance in firms with controlling shareholders through a "Say-on-Dividend" policy

In the previous section we have discussed the limits for the use of liability, exit and voice to discipline controlling shareholders. These mechanisms are designed to deal with a fiduciary agent that is hired and remunerated by the principals but there are conceptual problems that reduce their effectiveness to discipline one of the owners. Liability does not work well because it is difficult to determine and regulate specific duties for the block-holder towards the minority. Voice helps controlling shareholders to keep the managers in check but increases

[73]Denis and Osobov (2005) also find important differences between the dividend policies of firms in Germany, France and Japan, characterized by significant ownership concentration. In particular they find that in the U.S., Canada and the UK the firms with poor growth opportunities are more likely to pay dividends, while in Germany, France and Japan the result is the opposite. In order to identify the causality link Gugler and Yurtoglu (2003) study market reactions to announcements of dividend decreases in Germany and find that the negative effects are larger for companies where corporate insiders have more power. Zhang (2005) finds the same result for a large sample of firms from over 20 countries. Also investigating causality Thomsen (2005) finds that increases in block ownership are correlated with posterior decreases in dividend payouts.

their power vis a vis the minority. Moreover the minority has to rely on informed institutional investors and independent directors to exert voice on their behalf, but these parties face their own incentive and cost problems. Finally market exit grants escape and liquidity to each individual minority shareholder, but not to minority shareholders as a group, and will not discipline the controlling shareholder if the company generates free-cash flows.

This analysis highlights the need to find corporate governance mechanisms that can protect the investments of outside investors from the power of controlling shareholders without compromising the benefits that the presence of controlling shareholders brings to the firm, and in particular the informational advantage that reduces managerial power. Moreover, these solutions can also be useful ex-ante for block-holders willing to commit contractually to increase the value of the firm. The question then is whether it is still possible to improve the current situation in ways that allow individual firms to offer a better deal to outside investors. This is crucial to improve the growth opportunities of these firms.

A natural way out of this problem is to take as a reference the legal type that has been specifically designed to deal with expropriation problems: the "partner type" organization. Governance mechanisms from the tool kit of the partner type organizations could be beneficial to solve the conflicts among owners. For instance, loyalty duties among the copartners help avoid expropriation, unanimity rules for some key decisions give bargaining power to the shareholders with smaller stakes, and even though the transferability of shares is limited in different ways, strong distribution rights force insiders to give back the funds.

These protections are usually implemented by means of contracts among the shareholders (shareholders' agreements) in private corporations where ownership is concentrated. In fact, private corporations are highly contractual and their members have incentives to choose a governance structure that best fits their needs[74]. Shareholder agreements contain contractual

[74]In Europe, shareholder agreements might face many enforceability problems. It is a widespread perception that the attributes of the corporation are inalienable. Because of this individual cash out rights or appraisal rights are not available as a variant of the statutory rules of the corporate form since they disfigure its main and distinguishing basic structural elements (McCahery and Vermeulen, 2008) Taken to

mechanisms that enhance managerial control, like tag-along clauses to avoid the entrance of a looter in cases of changes of control, put options for the shareholders in some situations or events, etc.[75] Following this analysis, one may be tempted to propose the introduction of these arrangements into listed corporations through mandatory regulation. This is unlikely to work because, as we explain bellow, the main problem when moving from a private to a listed corporation is the asymmetric information gap that appears between insiders and outsiders, along with other coordination and decision making costs, and therefore a very careful design is needed to make this type of measures effective in this new environment.

Here we ask ourselves if it is possible to adapt the strong distribution rights and veto rights of the partners as a way to improve exit and voice in listed corporations with controlling shareholders in an informal unregulated way that deals with the informational specificities of listed firms.

4.1 Adapting distribution rights to facilitate exit for outside investors

In our previous analysis we have seen that exit can ameliorate conflicts between insiders and outsiders if there is in place a dividend policy that distributes all free cash-flows. But we also noticed that in corporations with controlling shareholders there aren't mechanisms to induce the controlling shareholder to follow this policy.

This happens because in the corporate type family, there is not an individual right for the dividend -that is, the payment cannot be claimed by any shareholder-, but rather a collective right -in the sense that the shareholders as a group must decide whether the business surplus is being distributed or not, and in which amount. Because of this the party that controls the company will also control its distribution policy. In practice, this decision is taken by the

the limit this argument would make those elements -like the majority rule or the collective withdrawal rights- mandatory, and rules altering them would be unacceptable or even unlawful. As noticed by Damman (2014) corporate law in the United States is largely enabling, whereas most other countries around the globe rely heavily on mandatory corporate law.

[75] Sáez and Bermejo (2010).

managers -in those corporations with dispersed ownership structure- or by the controlling shareholders -in the case of corporations with a concentrated ownership structure-. Moreover, dividend policy is considered a business decision, and as such it is subject to the business judgment rule, so the controlling party is free to make the decision[76].

On the other hand, in the partner type family, each individual partner has complete control over the funds he commits to the venture. The most extreme form of control comes from cash-out rights. But granting cash-out rights to corporate shareholders would threaten the long term commitment that is necessary for efficient specialized management of the funds. Moreover, in corporations individual shareholders can cash-out via exit in the financial markets. But we know that this form of exit is not enough to discipline insiders when there are free cash-flows. Interestingly, the partnership also offers protection over the reinvestment of the profits. And this is an additional form of control for the partners that could be better adapted to the case of listed corporations. In partnerships owners hold an individual and concrete right to a periodic distribution of the business profits. This right is considered an essential right of the co-owners. In this sense, it is a credit claim, enforceable against the partnership. It is a transferable right and can be seized by the private creditors of the shareholder. It is a default rule but it can be contractually overridden by the unanimous vote of the owners.

In sum, the requirement for partnerships to pass through their money blocks the accumulation of earnings and protects partners from expropriation. But how could this enhanced right to receive dividends be introduced in corporations?

Goshen (1995) makes a bold proposal on how to accomplish the distribution of net earnings. Goshen studies the conflict between the managers and shareholders in a listed

[76]Notice that in jurisdictions with controlling shareholders the involvement of the general meeting in taking the dividends decision is bigger than in jurisdictions where the controllers are the managers. In particular the approval of the balance sheet, which is in most Continental European countries voted on by the shareholder meeting (only Germany and Austria are the exception, as they permit an approval by the supervisory board), and the approval of the dividend distribution. But the problem in these jurisdictions is how to discipline controlling shareholders, not managers.

firm with dispersed ownership. He argues that forcing the managers to pay a high dividend would reduce free-cash flows and agency problems for these firms. However under US law directors have sole discretion over dividend policy. Therefore he proposes the introduction of shareholders' dividend options as a kind of individual cash-out rights that effectively give shareholders control over the dividend decision. This requires fixing ex-ante a high payout ratio but allowing the shareholders to choose between receiving a cash dividend or a stock dividend. The effective payout ratio and retention ratio would be the result of the aggregated individual decisions of all shareholders[77].

This rationale also seems to be behind the recent rise in the US of publicly traded limited liability companies (LLC), a new layer of public companies that use new corporate structures that are characterized by their limited liability nature and a requirement to pass-through all their earnings to the investors. According to The Economist LLCs represent 9% of the number of listed companies and in 2012 they paid out 10% of the dividends; but they took in 28% of the equity raised[78]. These kind of listed firms do not have to comply with mandatory governance requirements and have contractual freedom to shape the governance structure as they wish. Nevertheless, they still offer strong protection to their shareholders because they pay high dividends, so that investment capital must be raised in the capital markets[79].

[77] Interestingly, script dividends, which are frequently used by many companies with controlling shareholders, accomplish exactly the opposite result. The maximum dividend is fixed by the insiders. But the individual decisions of the outsiders on whether to have this dividend paid out in cash or in new shares will make the actual transfer of funds lower than the one implied by the stated dividend. In this respect it is important to notice that the critical point in Goshen's proposal is the ex-ante decision on the minimum payout ratio.

[78] These numbers include LLCs, LPs, and REITs.

[79] These firms distribute a significant part of their earnings and free cash flows among the members. In fact their average annual dividend yield is approximately 6%, while in corporations it is about 2%. There exists a tax incentive for these firms to pay dividends, since they are taxed as partnerships. In particular, according to Section 7704(d)(1) of the Internal Revenue Code, the LPs and LLCs which derive 90% percent or more of their gross income from certain sources of income (such as exploration and transportation of oil and gas, income from holding real estate, and income from some financial operations) are taxed as partnerships even if they are publicly traded firms. Income in these firms is passed through for taxation purposes to partners and partners pay taxes instead of the partnership. Thus there is an extra incentive to pay dividends to the extent necessary to cover the tax obligations of the partners. But the rest of profits can be retained. Gomtsyan (2014) argues that the fact that listed LPs and LLCs pay more dividends that required for tax

In other words, the high level of cash payments, and hence, the strong market discipline compensate the outside investors for the low level of legal protection.

However, it is worth noticing that most of these new companies are investment vehicles that hold financial and real estate assets, i.e. assets without growth options. This gives us a clue of why it is difficult to apply these solutions to the typical corporation. The problem is asymmetric information about the growth opportunities of the firm when the assets are specialized. Goshen leaves the decision on how much to reinvest in the hands of the shareholders and he explains that the shareholders can either follow the managers suggestion on how much should be reinvested or, if they think that there are free cash-flows they can opt for a higher distribution ratio. This makes sense if we assume that outside investors have good information about the investment opportunities of the firm. But notice that if the shareholders are not informed about the investment opportunities of the firm, they will make the decision based only on their individual liquidity needs. This would not be such a big problem if the cost of accessing the capital markets were low. But the problem of asymmetric information appears again when a company tries to raise funds from potential investors in these markets and makes access to new funding very expensive[80].

Therefore these solutions would be too costly for the typical corporation, because they involve losing the informational advantage that the expertise and monitoring of insiders bring to the company, both in the case of managers or controlling shareholders[81]. The informed

reasons is related to their governance structure and market expectation, i.e. dividend distributions limit the discretion of the insiders, which is dangerous in these firms since they are usually value firms and they have weaker investor protection rights.

[80] The problem of a firm that must issue securities to invest and whose managers know more about the firm's value than potential investors was first formalized by Myers and Majluf (1984) who use it to explain why firms underinvest and also why firms prefer to use internal versus external financing and debt versus equity issues. For a survey of the theoretical and empirical literature on financing with asymmetric information see Frank and Goyal (2005).

[81] There are additional reasons why Goshen's proposal has not been adopted by traditional corporations. One is the mandatory nature of the proposal. This implies that it would apply both to companies with or without free cash flows. Moreover Goshen focuses in the conflict between managers and shareholders in companies with dispersed ownership, and as we have discussed, for these companies there are easier to implement alternative market and monitoring mechanisms that can be used to discipline managers and to

insiders are the ones that can make the best decision on how much to retain, but at the same time they are the ones that have the incentives to retain too much and generate free cash-flows. In the partnership strong distribution rights are feasible because all the partners are insiders and share the same information. But for the corporation the introduction of any sort of distribution rights for the outside investors requires giving decision power to a party that should be free from conflicts of interest and have enough information about investment opportunities inside the firm.

4.2 Adapting veto power to give voice to outside investors

In terms of voice rights, the perfect anti-expropriation rule is to give veto power to each and every investor, treating them as partners. But in public corporations this would be totally inefficient and generate a breakdown of the decision making mechanisms. Again, this is not only because of the high transaction costs and the potential conflicts generated by the large number of investors, but mainly because of the asymmetric information problems that arise from specialized management by the insiders.

Because of these information problems, in jurisdictions with concentrated ownership it is challenging to come up with solutions that award some kind of veto power to the minority that can, simultaneously, be effective in reducing expropriation and preserve the advantages of having a controlling shareholder.

Traditionally, jurisdictions characterized by the presence of controlling shareholders have used three different types of legal rules aiming to limit excessive shareholder power and to protect external investors. In origin, many of these rules arise to help reduce intra-shareholder conflicts concerning unlisted corporations, and some of them are the result of the contracting activity among the parties. Similar formulas for minority protection are also applied to public stock corporations (despite the larger number of investors, the wider asymmetries of information and the increase of implementation costs). Our claim, as we explain

induce them to distribute free cash-flows.

bellow, is that none of the three types of legal rules does effectively prevent expropriation in public corporations with controlling shareholders[82].

The first set of legal rules used to give a kind of veto power to outsiders restricts the voting power of the controlling shareholder for some salient decisions, by altering the majority rule requiring supermajority rules[83] (sometimes in conjunction with high quorum requirements) or norms that force the bock-holder to refrain from voting[84].

The second set of rules establishes mandatory rights for the minority as a class. Some examples of these rules are rules granting to minority shareholders the power to call a Shareholders' General Meeting through court order following management inaction; rules allocating power between the board and the shareholders, extensive rights of information, appraisal rights, cumulative voting, etc. These governance strategies are commonly used in jurisdictions with controlling shareholders[85], although they often face implementation issues due to their dependence on high procedural provisions. And, interestingly, these rules are conspicuously absent in US Corporate Law.

[82] A general description of these tools to protect minorities, see Kraakman et al. (2009).

[83] For an overview of the use of this method for diluting the decisions rights of controlling shareholders in different jurisdictions Kraakman et al. (2009).

[84] It is worth noting that the development of these rules in Continental Europe is linked to the law of non-listed corporations. They are designed to protect minority shareholders in situations of conflict of interest, like the transfer of shares or a waiver of the non-competition obligation and the like. Another alternative is the majority of the minority rule. But this option has no tradition in European jurisdictions because deviations from the majority rule, which gives all control rights to "some" shareholders, appear to be contrary to the principle of "shareholders equal treatment" granted by the law. So, the introduction of rules that impose a majority of the minority approval in listed corporations regarding conflicted transactions and self-dealing operations, though increasing, is still rare (see Kraakman et al. 2009 at page 167). Both Italy and Spain have already enacted rules in this direction and this is also the direction taken by EU legislation (Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholders engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statements.

[85] The received wisdom among European legal scholars is that minority shareholders already receive extensive protection against majority shareholders by force of mandatory rules in Corporate Law, especially regarding the participation and information rights of the minorities (see for example Cahn and Donald, 2010). Moreover, the low rankings of investor protection originally awarded to Continental Europe countries in the pioneering work of La Porta el al. (1998) have been challenged and revised by several European scholars. In particular Berndt (2002), Braendle (2006), Lele and Siems (2007) and Armour et al. (2009) have produced new rankings where Continental European countries rank much higher.

The third set gives power to minorities to challenge the decisions taken by the Shareholders' General Meeting. In this case, outside shareholders are not protected ex-ante (since the voting power of the block-holder is not altered) but they are protected ex-post, through litigation if the decision made is unlawful or harmful for their interests. A resolution of the Shareholders General Meeting can be challenged by a part of the minority (or even an individual shareholder) and nullified by the judge under certain circumstances[86]. Although this litigation mechanism is widely used in Continental Europe, where controlling shareholders are common, it is not clear whether it has significant deterrence power, because the consequences for the block-holder are minimal[87].

Can these different types of rules effectively function as a kind of veto right for the outside investors? In Section 3 we discussed the two generic limitations of the typical voice mechanisms available for outside investors: the information and collective action problems of dispersed shareholders and the large bargaining power of the minority vis a vis the block-holders. All the rules that we have presented in this section are aimed at reducing the bargaining power of the block-holders but they leave unresolved the asymmetric information and collective action problems of the minority. Because of this, on the one hand, these "veto like" measures will not prevent minority expropriation if we have to rely on small dispersed shareholders to implement them[88] and, on the other hand, they may be used by

[86]European scholars argue that the traditional instruments to enhance minority protection in jurisdictions with dominant shareholders suffice to control expropriation problems. As an example of this view see Conac, Enriques and Gelter (2007).

[87]Challenges to shareholder resolutions constitute an imperfect device to enforce controlling shareholders' fiduciary duties. Sáez and Riaño (2013), provide an empirical study of rulings applying the section of the Spanish Public Companies Act governing challenges to shareholder resolutions. They show that this litigation mechanism faces both under and over-enforcement problems, and it is therefore in need of reform. It is not effective at restraining the quasi dictatorial powers of controlling shareholders in the general meeting and it leads to hold-up problems, which have also been reported with special severity in Germany by Cahn and Donald (2010) and Baums, Keinath and Gajek (2007). The common solution to these hold up problems caused by "predatory shareholders" is to increase standing requirements, and Spain will soon join the jurisdictions that have followed this path.

[88]Let's consider, for instance, the case of supermajority rules. It is clear that supermajority rules can be problematic because a vote is hard to come by, and it contributes to legitimize even more the control rights of the block-holder.

organized minorities whose interest may differ from the interests of small shareholders to hold up important decisions[89]. Therefore, there is the risk of generating a new agency costs by giving disproportional power to some minorities that will pursue their own agenda.

The conclusion from this analysis is that veto like measures, like supermajority rules, should only be introduced for relevant decisions where the interests of the block-holder and the minority clearly diverge[90], so as to make the most efficient use of the informational advantage of the block-holder in all other decisions. Moreover, expecting the minority to exhibit rational inaction, it is necessary to find some informed party that can determine the direction of the votes. And, to prevent hold up problems, this informed party should have interests that are aligned with those of the minority.

4.3 Introducing "Say-on-Dividend" to allow outside investors exercise their voice and exit rights

We have discussed the possibility of introducing contractually some type of distribution and veto rights for outside investors of listed firms with controlling shareholders. Our conclusions so far indicate that the introduction of any sort of distribution rights for the outside investors requires giving decision power to a party that should be free from conflicts of interest and have

[89]In fact, for part of the Continental legal literature, the risk of minority abuse -rather than the majority abuse- emerges as the real danger that needs to be fought. As it seems, European legal scholars and legislators fear more the minority hold-up risk than the majority disposition to expropriation. Two examples can illustrate this view. First, In Germany shareholders' fiduciary duties leading case, the so called Girmes, is aimed at reducing minorities hold-up, see Cahn and Donald (2010). The second example refers to the rescission of shareholder resolution (see note 88). This tool faces many restrictions to protect minority interest, but the spotlight on this matter has been put on the problem of abusive suits launched by professional litigants, as argued by Zetzsche and Vermeulen (2010).

[90]Corporate voting may enhance decision-making beyond monitoring, as it serves to aggregate heterogeneous preferences when the decision affects the different shareholders in different ways and there is a conflict over the best choice. The Jury Theorem says that, assuming that each shareholder votes for the decision that maximizes his utility, as the number of shareholders increases, the probability that a majority vote taken at the shareholders' meeting will select the alternative that maximizes aggregate value tends towards certainty. However notice that, as explained by Schouten (2010) this rule is useful for widely held firms, but the presence of a controlling shareholder introduced a kind of veto power that can distort this procedure. But Schouten's analysis in not complete either, because separating the controlling shareholder from the voting procedure through majority of the minority rules does not produce either an efficient outcome as a general rule.

enough information about investment opportunities inside the firm and that the introduction of veto rights should be limited to relevant decisions where the minority fears expropriation and should be done through an informed party with interests that are aligned with those of the minority. This leads us to propose a "Say-on-Dividend" policy as the best mechanism to improve the corporate governance of firms with controlling shareholders.

Over time corporations that rise funds in the capital markets come to finance themselves through retained earnings and have little need for their outside shareholders. This puts them in a difficult bargaining situation. Therefore we propose to give the outside investors partnership type distribution rights that allow them to force large dividend payouts and create an artificial need for the funds. But as we have seen dividend policy is currently controlled by the block-holders who have information on investment opportunities. In order not to lose this informational advantage, and to prevent hold up problems, partnership type veto power over the dividend decision has to be given to an informed party that understands the financial and investment needs of the corporation and whose incentives are aligned with the incentives of the minority shareholders. The solution is to engage activist and institutional investors and independent directors in the determination of the optimal dividend policy, i.e. a dividend policy that guarantees efficient investment while limiting expropriation. Thus we propose a "Say-on-Dividend" rule that allows informed representatives of the minority investors to veto the dividend proposal of the insiders.

The implementation of this "Say-on-Dividend" policy would redirect corporate governance mechanisms that are already in place, but are directed towards the supervision of the managers, to the reduction of the agency conflict between the minority and the controlling shareholder, in such a way as to preserve the monitoring and informational benefits that controlling shareholders provide in the management of the firm. "Say-on-Dividend" uses the voting power of the independent directors and institutional investors to force distribution of free cash-flows. Once we reduce free cash-flows and the potential for minority expropriation, the incentives of the minority and the controlling shareholder will be closely aligned, and therefore the ability of the controlling shareholder to supervise other key strategic and managerial decisions is not compromised.

The implementation of this idea can be done in two alternative ways.

The first is to take advantage of the Shareholders General Meeting vote on dividend policy, which is the norm in most jurisdictions with concentrated ownership. Under the current situation the Shareholders' General Meeting has to vote to approve the dividend proposal of the board. The "Say-on-Dividend" policy would only require a modification of the voting rules on the dividend proposal. This modification would recognize that the controlling shareholder faces a conflict of interests and would require either excluding him from the vote, or, alternatively, asking for a supermajority for the policy to be approved. In either case, the vote will only make a difference if some significant shareholders are willing to incur the costs of becoming informed about the investment opportunities and fund generating capacity of the firm, so that they can argue in favor of a more generous dividend policy. Considering the discussion of the problems faced by institutional investors in Section 3.2., this role is most likely to fall upon activist investors. But if the threshold for overruling the dividend proposal is high enough activists are unlikely to be able to overrule the insiders unless their voice is backed with the votes of other passive institutional investors. Interestingly, the presence of a "Say-on-Dividend" policy is therefore likely to encourage the participation of investment funds and activist investors in the capital of the firm. And, moreover, if the policy is well designed and the activists need the acquiescence of other institutional investors to change the dividend policy we can prevent hold up problems and potential short-termism policies that could harm the firm prospects.

Additionally, there is a second possibility to implement the "Say-on-Dividend" policy. This is to set up a fully independent board committee in charge of the dividend policy decision. This would mirror other independent board committees that are used to fix managerial remuneration or to control internal audits. In fact, if we want independents to be an effective voice for outside investors in companies with concentrated ownership we need to make sure that independents can control the decisions that generate conflicts between the block-holders and the minority, and only these decisions. In order to make the best use of the monitoring provided by the block-holders, we should allow block-holders to continue controlling most decisions and we are unlikely to want to have boards with a majority of independents. Current best practice recommends independent nomination, remuneration and audit committees. But these are not decisions where the interests of inside and outside investors are likely to differ. An independent dividend committee would be much more logical for firms with controlling shareholders.

The introduction of a "Say-on-Dividend" policy might raise some legal issues, especially regarding the enforceability of the mechanism. Here we discuss the pros and cons of the different avenues for introducing this mechanism.

The most straight forward approach is a mandatory one. Law scholars often show their preference for the enactment of mandatory legislation to permit shareholders vote, as the case of Say-on-Pay illustrates[91]. It is a common view that if the effectiveness is fully depending on the good will of the controlling shareholders, it won't work, since the insiders do not have the incentives to put in place a voting mechanism which is against their own interests. In the background emerges a more general distrust of self-regulation and self-enforcement. Even accepting this perspective, other considerations need to be taken into account in our particular case. To implement "Say-on-Dividend" through mandatory rules presents serious drawbacks.

First, as we will show through extension of the model, firms are different and this mechanism does not fit in all cases. Flexibility is therefore important. In particular, different types of firms can benefit more or less from activists, so not always facilitating activism can keep block-holders in check and increase firm value. We further consider the case of

[91] Thomas and Van der Elst (2013).

vulture funds, this is the idea that hedge funds do not add value and they force all firms to follow the same short-term policies irrespectively of their characteristics. If this is the case a "Say-on-Dividend" policy could be dangerous and it could induce underinvestment. The alternative in these cases that still protects the outsiders form expropriation would be the setting up of an independent dividend committee at the board to check the dividend policy of the block-holder, just as there exist remuneration and audit committees that keep in check the managers.

Second, compulsory rules entail the risk of diluting the effectiveness of a "Say-on-Dividend" policy for protecting outside shareholders in firms where it can be useful. Since not all firms will benefit from it, one can argue that the proposal would increase costs for many firms without a clear benefit. Therefore, if the measure is projected to be applied to all firms, the pressures of the insiders can be successful in two different ways: they may be able to lobby against it effectively or they may try to reduce its impact introducing some changes in the dividend decision, like additional report obligations, so the expected outcome will be limited to a poor procedural compliance. Both responses will likely lead to further watering down of outside shareholders protection.

Taking this into account we rule out a mandatory approach and concentrate on two other alternatives: introduction as a best practice policy in the existing corporate governance codes to force firms to comply or explain their choice, and introduction through an optionality approach.

The best practice approach would work as a commitment mechanism that allows controlling shareholders to offer a higher degree of protection for the outsiders. In this sense, it would work as an ex ante device, suitable for firms that need funding and are willing to try new solutions that allow them to be seen as trustworthy to new fund suppliers, like institutional investors. "Say-on-Dividend" could be included as best practice in corporate governance codes, especially in the codes of jurisdictions where most listed firms have controlling shareholders, recognizing that corporate governance recommendations for large corporations should be tailored in function of the existence or not of controlling shareholders. Once this measure is recognized as best practice activists and institutional investors can demand the introduction of the "Say-on-Dividend" policy as an improvement of corporate governance in firms with controlling shareholders, in very much the same way as with Say-on-Pay policies. In this sense, it can facilitate and reduce the costs to entry of these investors in firms with high concentration. Nevertheless, the problem with this approach is that it would require a long term view on the part of the players, implying both the controlling shareholders and the institutional and outside shareholders. Insiders only have incentives to introduce a "Say-on-Dividend" policy ex-ante, when they are raising funds, but this is the time when we have argued that there are no free cash flows and there are less expropriation problems. Thus myopic views would mean that the value of this commitment would be heavily discounted, especially because it would be easy to change ex-post.

Finally, we are left with the optionality approach, which we believe would work best in our case. This would imply approving legal provisions to give firms the option of introducing a "Say-on-Dividend" mechanism in their charters. Of course, there is the risk that insiders can abuse their power to maintain the status quo through the majority rule, but this could be prevented with a clever use of repeal rules[92]. Therefore it is very important to tailor rules and procedures for the adoption and repeal of the regime that the firm chooses. We propose a menu of three options to be chosen by the Shareholders General Meeting: (i) opt-in into a "Say-on-Dividend" vote for the majority of the minority as the most stringent possibility, (ii) opt-in into the creation of an independent dividend committee and (iii) maintaining

[92]In fact there is evidence that charters tend to be used by insiders to create discretion for firms to retain profits when the law mandates a generous distribution. For example, the Austrian GmbH by default has a requirement to distribute all profits, but in practice, every company has a provision to the contrary. The same was the case in Germany until the implementation of the accounting directives in 1985: firms were required to distribute all profits but they were allowed to create "discretionary hidden reserves" in the financial statements, which would allow them to choose their payout ratio. Moreover, Section 58(2) of the German AktG says that by default only half of the profits can be withheld from distribution, but charters permit the supervisory board to withhold the full amount.

the status quo by staying out of any of the two previous options. The reason for this approach is as follows: there is a controversy on the role of activists, but it is difficult to argue against an independent dividend committee. Therefore if a company opts into the independent committee this would be a protection against future repeal to opt in into a "Say-on-Dividend" vote, which would require a supermajority at the Shareholders General Meeting to be effective, serving as a protection against activists focused on the short-term. Finally the company can choose to maintain the status quo, but under the condition of a qualified majority over and above the controlling stake. Therefore the status quo can be maintained only when outside shareholders are willing to back the controlling shareholder, indicating that this may be the optimal policy for some companies. The introduction of the menu together with the introduction of these simple rules for approval and repeal would preserve the freedom of companies to select the regime most suited to their needs, but would ensure an improvement of outside investors' protection using the mechanisms that are already in place.

In the next section we present a simple model that explains how the "Say-on-Dividend" policy would work and discusses how each of these two alternatives has advantages and problems that make them more suitable to different types of firms.

5 Modeling the "Say-on-Dividend" Policy

In this section we develop a simple model that makes explicit our assumptions about the conflict over dividend policy between the controlling shareholder and the minority and how it can be resolved through the introduction of a "Say-on-Dividend" policy. By making these assumptions explicit we can disentangle the implementation problems that will appear and determine under what circumstances the policy will work better. Overall we will show that a "Say-on-Dividend" policy can work in practice as a mechanism that limits opportunities for minority expropriation and increases total firm value.

5.1 Agents and payoffs

Consider a one period economy where all agents are risk neutral and have access to an investment that offers a constant return $\underline{R}$ for every monetary unit invested. At time $t = 0$ the owner of a private firm takes the firm public in order to raise funds for investment A. The owner will sell a fraction of the shares $(1 - \alpha)$ worth A to outside shareholders and he will retain a fraction α. The owner will be able to retain a higher stake when the expected firm value for outside investors is higher. Investment in the firm offers decreasing returns to scale, so if all the funds raised are invested in the firm at time $t = 0$, the firm generates a total return at time $t = 1$ of $(1 + \pi\alpha)RA^{1/2}$. The return inside the firm is therefore determined by π and R.

R is a random variable which follows a uniform distribution, in the interval $(\underline{R}, \overline{R})$. At time $t = 0$, when the company goes public, the realization of R is not known. The value of R only becomes know at an interim period after the funds are raised and before investment is made[93]. We assume that the value of R is publicly observable but can only be verified by the outside shareholders at a cost C.

π captures the contribution of the blockholder to the firm's return. The blockholder' ability and incentives to contribute to the firm's return will depend on the founders's stake α. Therefore there is an advantage of having a controlling shareholder with a significant stake. In the case of a founder this advantage may come form his knowledge of the business. In the case of other blockholders it may come from their ability to control managers or from their ability to coordinate different firms in their ownership group. Firm value increases with the blockholders' stake α but there is a limit to the stake that the blockholder can retain because of the need to raise funds A. Because of this the firm will be more valuable if the expected returns for the outside shareholders increase, so that $(1 - \alpha)$ can be reduced.

[93]The implicit assumption here is that raising funds in the capital markets is costly and therefore when a firm goes public it raises a large amount of funds that will be invested over several periods. It is not possible to raise funds in each period after the realization of R becomes known.

There are N outside investors, each of them holding a percentage h_i of the shares for $i = 1, 2, ..., N$, so that $\sum_{i=1}^{i=N} h_i = 1 - \alpha$. These investors may be small individual investors or significant investors, including families, firms, public entities or institutional investors. We characterize each investor with two parameters. The first parameter is the fraction of the returns that they appropriate, $\gamma_i \in [0, 1]$. This number is expected to be lower than one for institutional investors since the managers of funds only receive the fraction of the returns of the fund that is paid as variable fee. The second parameter reflects any private benefits that shareholders could receive from business dealings with the firm in which they own shares, $B_i \geq 0$. We will assume that there are some total fixed costs of running the firm B and that some of the institutional investors can benefit receiving part of that money if they are loyal to the blockholder. In the case of institutional investors these benefits could arise in the form of fees for providing investment services to the firm. In the case of firms owning stakes in other firms and business groups they could arise from intra group operations and transfer prices. Thus different combinations of γ_i and B_i allow us to capture the different nature of the relationship between the firm and each of its shareholders. We will assume that the first I investors (with $I < N$) are significant investors, each with a different value of γ_i and B_i and the rest $(N - I)$ are small individual investors for whom $\gamma_i = 1$ and $B_i = 0$.

5.2 Dividend decision

Since $E(R) > \underline{R}$ it is always optimal to invest money in the firm. However, once the value of R is known, a dividend decision will be made about the dividend payout ratio, $d \in [0, 1]$, to determine how much of the money raised will be effectively invested in the firm. For a total amount of funds raised A, and fixed costs of running the firm B, the total amount to be invested $F = A - B$ will be dividend between funds invested in the firm, $(1 - d)F$, and funds that will be paid back to the shareholders as dividends on a pro-rata basis, dF, so that they can pursue the outside investment opportunity. Since the value of R is non-verifiable, dividend policy cannot be contracted ex-ante when the firm goes public.

The blockholder obtains private benefits from the money invested in the firm. He can appropriate a fraction $\alpha+\beta g$ of the funds reinvested, but only a fraction α of the dividends. Here β represents firm's characteristics that make minority expropriation more likely but are outside the firm's control, such as the legal environment, the liquidity of the capital market and the level of competition in the product market. On the other hand g represents the laxity of corporate governance inside the firm. This laxity can be reduced if the blockholder has commitment mechanisms that allow him to ensure a low level of expropriation, such as board independence and also by the intervention of activists investors. Therefore together β and g represent the (inverse of) the quality of corporate governance. If the quality of corporate governance is poor the blockholder will be able to divert more funds to himself. As we discussed in Section 3 the current situation is characterized by a lack of good commitment mechanisms for companies with controlling shareholders, which implies a high initial g that can however be reduced by successful activists.

In the absence of a "Say-on-Dividend" policy the blockholder chooses the dividend payout ratio d. At time $t=1$ both the inside and outside investments yield their returns, the firm is liquidated and all cash-flows are distributed among the investors.

If a "Say-on-Dividend" policy is implemented the proposal of the blockholder can be challenged by the outsiders. We will assume that in order to challenge the proposal it is necessary first to verify R. Each outside investor can choose wether to verify at a cost $C(h_i)$, which may be decreasing in the stake of the investor ($C'(h_i)\leq 0$). Verification is a public good so it is only necessary for one of the outside investors to verify.

If R has been verified the outside shareholders can cast votes against the dividend policy proposed by the block-holder on the basis of a one-share-one-vote rule. Voting has a cost $V(h_i)$ which may be decreasing in the stake of the investor ($V'(h_i)\leq 0$). The "Say-on-Dividend" policy will establish a minimum percentage of votes K needed to overrule the dividend proposal, with $\sum_{i=1}^{i=N} h_i > K$.

If the proposal is not overruled d is implemented. But if activists are successful and the proposal is overruled activists will have more say in the firm and corporate governance will become more strict (i.e. g will decrease to g_a), so that the blockholder will have more difficulties for appropriating private benefits. Given g_a the blockholder will prefer an alternative dividend payout ratio d_a that will be more aligned with the interests of the outside investors. In any case, at time $t = 1$ both the inside and outside investments yield their returns, the firm is liquidated with all cash-flows being distributed among the investors and the institutional investors who voted against the dividend policy lose the fees from providing investment services to the firm, B_i.

5.3 Timing

The timing of the game is the following:

- At time $t = 0$ the firm raises investment funds A by selling stakes $h_1, h_2, ..h_I, h_{I+1}, ..h_N$. The founder retains the highest possible stake α.
- In *stage 1* the blockholder chooses the laxity of corporate governance g.
- In *stage 2* investors observe R and the blockholder proposes the dividend payout ratio d. If there is no "Say-on-Dividend" policy in place d is implemented and we go to time $t = 1$.
- In *stage 3* the outside investors decide wether to verify R at a cost $C(h_i)$. If none of them verifies, d is implemented and we go to time $t = 1$.
- In *stage 4*, after verification, each outside investor decides whether to oppose the proposal. If the total percentage opposing is lower than K, d is implemented and we go to time $t = 1$.

- In *stage 5,* if the total percentage opposing is higher than K, so that activists are successful, they reduce the laxity of corporate governance to $g_a$and the blockholder implements his new preferred payout ratio d_a.

- At time $t = 1$ both the inside and outside investments yield their returns, the firm pays fees for investment services and it is liquidated with all cash-flows being distributed among the investors.

We will solve the game by backwards induction starting form the last stage of the game.

5.4 The impact of the dividend decision on investors' returns

The final overall investment return and its distribution across investors will depend on the dividend policy finally implemented, which in turn depends on the laxity of corporate governance inside the firm, g.

When activism fails, either because no investor verifies R or because the fraction of investors voting against is lower than K the blockholder will be able to extract private benefits inside the firm at the rate βg and he will choose d to maximize his expected return.

$$\underset{d\in[0,1]}{Max}\ \alpha\underline{R}dF + (\alpha + \beta g)(1 + \pi\alpha)R(1 - d)^{1/2}F^{1/2}. \tag{1}$$

The solution to this maximization problem is

$$d = 1 - \frac{(\alpha + \beta g)^2 (1 + \pi\alpha)^2 R^2}{\alpha^2 4\underline{R}^2 F} \tag{2}$$

The dividend payout ratio will be low when investment return inside the firm, R, is high relative to the return of outside investment opportunities. But the dividend payout will also be low when βg is high, i.e. when the blockholder enjoys substantial opportunities for extracting private benefits inside the firm.

For a given dividend payout ratio d the returns from investment that will be distributed among the outside investors will be given by:

$$(1 - \alpha)\underline{R}dF + (1 - \alpha - \beta g)(1 + \pi\alpha)R(1 - d)^{1/2}F^{1/2} \tag{3}$$

When the activism is successful the blockholder will have to implement an alternative dividend policy d_a that will reflect the stricter corporate governance standard $g_a < g$. For easiness of exposition we will assume, without loss of generality, that $g_a = 0$, so that now the blockholders preferred dividend payout ratio becomes.

$$d_a = 1 - \frac{(1+\pi\alpha)^2 R^2}{4\underline{R}^2 F} \tag{4}$$

Substituting in turn d and g and d_a and g_a in the payoff function of the outside investors we can compute the increase in the total returns from investment that an investor with holdings h_i will obtain from successful activism that increases the dividend payout ratio from d to d_a to be

$$\Pi_i(d, d_a) = h_i \frac{(1+\pi\alpha)^2 R^2}{4\underline{R}} \frac{2\alpha^2\beta g + (1+\alpha)\beta^2 g^2}{\alpha^2(1-\alpha)} \tag{5}$$

5.5 The voting decision

In this section, we discuss the outcome of the voting game assuming that R has already been verified. At these stage each outside investor has to choose whether to vote against $v_i = 1$ or not to vote $v_i = 0$. To make the decision each investor will take into account the gains that he can obtain form successful activism, Π_i, but also his voting cots $V(h_i)$, and, the significant investors will also consider the fraction of the returns that they appropriate γ_i, and the private benefits that may be lost if they vote against the blockholder's proposal B_i. Clearly a necessary condition for an investor to be willing to vote against the proposal is that his potential benefit is higher than the cost of voting, i.e.

$$\gamma_i \Pi_i(d, d_a) - V(h_i) - B_i \geq 0. \tag{6}$$

Here we start to see which are the problems for the practical implementation of a "Say-on-Dividend" policy. For small shareholders we have $\gamma_i = 1$ and $B_i = 0$, but the cost of casting the vote $V(h_i)$ may be large relative to their individual stakes, so they are unlikely to vote against the blockholder's proposals. If this is the case activism can only be successful if the significant shareholders are large enough relative to the minimum vote required to overrule the blockholder's decision, i.e. $\sum_{i=1}^{i=I} h_i > K$. For the significant investors we may assume that $V(h_i)$ is low, however in this case we have to consider γ_i and B_i.

The impact of B_i is clear, these large shareholders face a conflict of interest because they can "collude" with the blockholder to obtain some "private benefits". Colluding may be easier for families, firms and the state that may develop employment, business and political ties with the firms in which they own shares. Overall the average value of B_i will depend to a large extend on the regulation of self-dealing transactions. In the particular case of institutional investors B_i is likely to be higher when firms manage their employees pension funds, but also if the institutional investor is managed by a financial institution that can also provide banking services to the firm.

For most significant investors γ_i will be equal to one unless there are significant deviations from the one-share-one-vote rule, for example in the case of conglomerates. But for institutional investors γ_i will be lower than one. Index traking funds are an extreme case because they only charge their investors a fraction of the funds invested and do not get any gain from superior performance, i.e. they have $\gamma_i = 0$. Pension and investment funds will also have low values of γ_i. Among institutional investors hedge funds are most likely to satisfy this condition since a large part of their compensation depends on the fund's returns (γ_i is higher). Moreover hedge funds do not have to comply with regulation on diversification, so they can hold larger stakes in a smaller number of companies (higher h_i and higher Π_i) and they cannot engage in side businesses with the firms they invest in, therefore $B_i = 0$.

But even if this necessary condition is satisfied, the investor may not vote if he does not internalize the impact that his decision has on the probability of winning the vote. This is the same problem that Grossman and Hart (1980) analyzed for the atomistic shareholders of a firm that have to vote on wether to accept a takeover bid. If a shareholder is small enough to consider that his decision will not alter the outcome of the voting he will prefer not to vote because, provided all the others vote against, he can get all the benefits without suffering the voting costs. Just like Bagnoli and Lipman (1988) demonstrated in the case of takeovers, in our case this coordination problem can be overcame if there are pivotal shareholders that internalize the impact that their decision has on the probability of success of the activists.

Assuming that all significant shareholders behave as pivotal and that there are M significant investors for which condition (6) holds, with $\sum_{i=1}^{i=M} h_i > K$, we can see that the only pure equilibria of this voting game are those in which the activists are successful and there are exactly K votes against the blockholder's proposal, i.e. $\sum_{i=1}^{i=M} v_i h_i = K$[94].

5.6 The verification decision

Assuming that there are M institutional investors for which condition (6) holds, if one investor is willing to spend $C(h_i)$ in verifying R, his activism will be successful. Therefore a necessary condition for an investor to be willing to verify is that his expected payoff form doing it is positive, i.e.

$$\gamma_i \Pi_i(d, d_a) - V(h_i) - B_i - C(h_i) \geq 0. \tag{7}$$

This condition is even more restrictive than the necessary condition for voting against the proposal (6). This condition may be satisfied for different significant investors and there

[94] The proof is similar to Bagnoli and Lipman (1988) for target shareholders decision on whether to tender in hostile takeovers, though they also discuss possible mixed strategy equilibria. Here the pure stratey equilibriun with exactly K votes against the proposal is an equilibrium because there are no profitable deviations. The investors that did not vote benefit from the increase in value of their shares because the activists are successful, but they are better off for not having voted and incurred the costs of voting. The investors that voted against will have a possitive net gain from their successful activism and each of them knows that if he would deviate and not vote the proposal would fail.

Moreover there cannot be pure equilibria with $\sum_{i=1}^{i=M} v_i h_i \neq K$ because there would be profitable deviations. If $\sum_{i=1}^{i=M} v_i h_i > K$ some of the investors that voted against could have abstained and the activitst would still have been successful. If $\sum_{i=1}^{i=M} v_i h_i < K$ the investors that voted against would have prefered not to have voted.

have been several cases where founders, for whom verification costs $C(h_i)$ are small, have tried to start an activist campaign after having divested their initial stake. But a careful analysis of this condition indicates that hedge funds are the most likely to satisfy it. As we discussed before hedge funds are more likely to satisfy condition (6) and they are also more likely to have low verification costs. This is because, like other institutional investors, they are experts in valuing companies but unlike other institutional investors they can gain access to inside information, for example by having regular meetings with managers and other outside investors or by holding board seats. This is not possible in the case of pension and investment funds, that are not interested in accessing privileged information that would reduce the liquidity of their shares.

Finally notice that verification is a public good. Therefore only the investor with the highest expected payoff from verification will do so[95]. Thus, consistent with empirical evidence, among institutional investors, only hedge funds can be expected to launch a successful activist campaign.

5.7 The dividend proposal and the choice of internal corporate governance arrangements

Once the blockholder observes R he will make a dividend proposal that maximizes his expected return according to (2). But before he observes R he has to set up the internal corporate governance arrangements inside the firm, i.e. he has to chose g. This choice will depends on whether he expects or not be overruled. If no "Say-on-Dividend" policy is in place or condition (7) is not satisfied, so that even with a "Say-on-Pay" policy in place, there will be no activism, the blockholder will chose the highest possible g, since this maximizes his ex post returns. But if there is a "Say-on-Dividend" policy and condition (7) is satisfied

[95] If there are several investors for which the payoff from investigating is possitive the only pure strategy equilibrum is one where only the investor with the highest value will verify. There are no profitable deviations from these equilibrium, because the rest of the investors prefer not to verify provided he does verify, and he prefers to verify given that the other will not do it. For the same reasons there are no pure strategy equilibria where there is no verification or more than one investor verifies.

the blockholder will act strategically.

If activists are successful they will implement strict corporate governance ($g_a = 0$) and the blockholder will loose all his private benefits. To avoid this, the blockholder's best strategy is to improve the quality of internal corporate governance, reducing g down to the point where it does not pay for the activists to investigate. Therefore the laxity of corporate governance when the blockholder expects opposition from the activists will be the maximum g that satisfies

$$\max(\gamma_i \Pi_i(d, d_a) - V(h_i) - B_i - C(h_i)) \leq 0, \tag{8}$$

Since Π_i is continuous and decreasing in g there is only one value $\overline{g}$ that satisfies equation (8). Substituting for the value of $\Pi_i(d, d_a)$ from (5) into (8), we can solve for the value of $\overline{g}$. Then it is easy to check that $\overline{g}$ is decreasing in $\pi, R/\underline{R}$,β and γ_i but increasing in B_i and $C(h_i)$. Therefore the companies where a "Say-on-Dividend" policy will be more effective at reducing expropriation will be companies where the blockholder can make an important contribution to firm value (high π and $R/\underline{R}$) but there are legal and firm characteristics outside the blockholders' control that make expropriation likely (high β). Additionally, policies aimed at reducing asymmetric information (low $C(h_i)$), increasing the variable compensation of fund managers (high γ_i) and reducing the opportunities for side businesses between the firm and institutional investors (low B_i) will make activism more attractive and threatening and will force the blockholder to implement a lower $\overline{g}$.

As g decreases the interests of the blockholder and the outside investors become more aligned and the dividend proposal increases to

$$\overline{d} = 1 - \frac{(\alpha + \beta\overline{g})^2 (1 + \pi\alpha)^2 R^2}{\alpha^2 4 \underline{R}^2 F}. \tag{9}$$

This dividend will be lower than d_a but higher than d. Therefore, the threat of activism will by itself give incentives to the blockholder to improve corporate governance and increase dividends, increasing outside shareholders returns. However the effectiveness of the threat will critically depend on the regulation that determines investment fund fees and affects γ_i, the regulation on shareholders voting and information rights and affects $V(h_i)$ and $C(h_i)$, and the regulation that alters the potential private benefits for the investors and affects B_i.

It is also important to notice that in equilibrium the threat of activism is enough to keep the blockholder in check and therefore no verification or voting cost will be incurred.

An interesting case arises if firms lack good control mechanisms, so that it is difficult for the blockholder to reduce the value of g. This is in fact the picture that arises from our previous analysis of the litigation, voice and exit tools that companies with controlling shareholders can use to reduce the conflict of interest between the blockholder and the outside shareholders. In that case activism cannot work as an out of equilibrium threat. Expropriation can only be curtailed if the blockholders' dividend proposal is effectively overruled by the vote of the activists and institutional investors. In the model this will effectively bring g down to zero and eliminate all expropriation. However this favorable outcome requires incurring verification and voting costs, which may be substantial.

Overall, if activism does actually occur, the gain from reduced private benefits and increased dividends will be larger than the total costs of verification and voting. This is because when activism occurs it is rational for the individual investors to investigate and/or vote against the blockholder, so that the benefits of activism necessarily outweigth the total costs. But, as we discussed before, the empirical evidence shows that activist campaigns can be very costly. Therefore it is very likely that total firm value increases more when activism works merely as a (credible) threat than when we observe actual activist battles taking place.

5.8 Firm value and blockholder's stake

With an effective "Say-on-Dividend" policy the total investment payoff increases as g decreases and d increases

$$\underline{R}dF + (1+\pi\alpha)R(1-d)^{1/2}F^{1/2} \tag{10}$$

Substituting for the values of g and $\overline{g}$,the total increase in firm value is is equal to

$$\Pi(d, \overline{d}) = \frac{(1+\pi\alpha)R^2}{\alpha^2 4\underline{R}}\beta^2\left(g^2 - \overline{g}^2\right). \tag{11}$$

This simple equation shows that the total benefit from the "Say-on-Dividend" policy, $\Pi(d, \overline{d})$, will be high specially for firms that have large opportunities for extracting significant private benefits (high β) that have profitable investment opportunities (a high ratio $R/\underline{R}$), this is firms going public in jurisdictions with poor investors' protection.

This also illustrates how and when the "Say-on-Dividend" policy can work as a commitment device that will voluntarily be adopted by some firms as a best practice and when it will be necessary to implement an optionality approach, forcing the Shareholders General Meeting to vote the option of introducing a "Say-on-Dividend" mechanism in their charters.

Notice that from an ex-ante perspective, i.e. before the shares are issued, all this increase in firm value will be appropriated by the owner of the firm when he sells shares to outside shareholders to raise the funds needed for investment. He needs to sell an stake that is worth A. If total firm value is higher he can obtain that amount of money by selling a smaller stake and he will be able to retain a higher α. This has a direct positive impact on his total wealth but it also has an extra indirect positive effect on total wealth because the contribution of the blockholder to the firms returns increases with his stake (total return inside the firm is $(1+\pi\alpha)R$. So clearly, ex-ante, it is in the interest of the owner to introduce the "Say-on-Dividend" policy as best practice.

However, from an ex-post perspective, i.e. once the shares have been issued and α is given, the "Say-on-Dividend" policy only benefits the outside investors. They paid A for a $(1-\alpha)$ stake that now will be worth more than A. But the controlling shareholder will suffer because ex-post the value of the controlling stake is decreases as g decreases. Therefore firms with controlling shareholders that do not have a need for outside funding will be reluctant to adopt this measure voluntarily. If this is the case this measure is more likely to be adopted through the optionality approach.

5.9 Uninformed activism

We have assumed that activism can only happen with informed investors that are willing to pay for the cost of verification and a large enough number of significant shareholders are willing to incur the costs of voting. Most of the problems that we have identified so far can therefore be ameliorated by reducing the cost of verification and reducing the threshold for activism, K. However there is a negative view of activist investors which regards hedge funds as short-term investors that are using their hold up power to extract concessions from the insiders. To illustrate this view it is interesting to see what happens if the activist starts a vote against the proposed dividend policy without previous investigation, i.e. the activist does not add value but he may be willing to oppose the blockholder to get some type of concession (which could be introduced in the model as a negative value for B_i). Here we will assume that without verification the outsiders can only ask for a dividend policy that is optimal ex-ante, i.e. that only depends on the expected return and does not use the information of the blockholder. The idea is that these activists impose the same set of policies on all firms without taking into account their particular characteristics. In this case there are two countervailing effects. On the one hand the activists can reduce the private benefits of the blockholder ($g_a = 0$) but, on the other hand, they also impose a policy that is not necessarily optimal given the firm's characteristics. If this is the case the dividend policy that will be implemented if activism is successful, will be the one that solves the following maximization problem

$$\underset{d_{ua}\in[0,1]}{Max}\ \underline{R}dF + (1+\pi\alpha)E(R)(1-d)^{1/2}F^{1/2}.$$

Where $E(R)$ is the expected value of R and for the uniform distribution is equal to $(\underline{R}+\overline{R})/2$. The payout ratio imposed by the uninformed activists d_{ua} will therefore be equal to

$$d_{ua} = 1 - \frac{(1+\pi\alpha)(\underline{R}+\overline{R})^2}{16\underline{R}^2F}.$$

It is no longer clear that this policy benefits outsiders since $\Pi(d, d_{ua})$ may be negative. It can be expected that if the loss in information does not compensate the gain from the reduced private benefit ($\Pi_i(d, d_{ua}) < 0$) the outside investors will not overrule the dividend policy of the insider. The only danger in this case arises if K is so low that the veto can be imposed by an activist with his own agenda.

5.10 An independent dividend committee as an alternative

We have identified a number of problems that could hinder the effectiveness of a "Say-on-Dividend" policy as an effective commitment device. First, it may be too costly for activists and institutional investors to oppose the blockholder, either because there are large verification costs (high values of $C(h_i)$), important side businesses (high values of B_i) or because the variable compensation of fund managers is low (low values of γ_i). If this is the case, there will be no opposition to the blockholders' desired dividend policy. Second, even if activism is a real threat, when alternative corporate governance measures are lacking, the blockholder may be unable to commit to a reduced level of expropriation (i.e. the blcokholder will be unable to reduce g down to $\overline{g}$). If this is the case, activism will be successful and expropriation will be reduced but this will happen at the expense of costly battles. Third, if we assume that activists are uninformed, then total value may be destroyed if activists can take control of the dividend decision. Because of these problems we propose an independent dividend committee as an alternative to the "Say-on-Dividend" policy.

In this case after selling the shares the blockholder would chose the laxity of corporate governance g but, according to our optionality approach, he would have to set up an independent dividend committee if he wants to avoid the threat of a "Say-on-Dividend" policy. The independent dividend committee cannot alter other aspects of the firm's corporate governance, i.e. they cannot reduce g. But they can choose the dividend policy that will maximize outside shareholders value, i.e. they will choose d to so as to maximize

$$(1-\alpha)\underline{R}dF + (1-\alpha-\beta g)\,(1+\pi\alpha)R(1-d)^{1/2}F^{1/2}. \tag{12}$$

So that with an independent dividend committee the dividend payout ratio will increase up to

$$d_{ic} = 1 - \frac{(1-\alpha-\beta g)^2(1+\pi\alpha)^2R^2}{(1-\alpha)^2 4\underline{R}^2F}.$$

And the increase in firm value from the introduction of an independent dividend committee is given by

$$\Pi(d, d_{ic}) = h_i\frac{(1+\pi\alpha)^2R^2}{4\underline{R}}\frac{\beta^2g^2(1-2\alpha)}{\alpha^2(1-\alpha)^2}. \tag{13}$$

If we compare this equation with equation (11) we notice that the relative advantage of each of these policies will depend on the reduction in the value of g that can be achieved with a "Say-on-Dividend" policy. As we discussed above the value of $\overline{g}$ depends on general parameters that affect all firms in a jurisdiction. In particular $\overline{g}$ will be lower, and "Say-on-Pay" more attractive relative to an independent dividend committee, when legal protection is poor (high β) and when the quality of accounting is high (so that the investigation costs $C(h_i)$ will be low) and also when institutional investors receive substantial variable compensation (high γ_i) and are barred from offering side business to the firms where they invest (low B_i). But $\overline{g}$ also depends on particular firm characteristics. It will be lower for firms where the blockholder's contribution is high (high value of π), for more profitable firms (high ratio $R/\underline{R}$) and for firms subject to less asymmetric information (since $C(h_i)$ may also depend on firm's characteristics). Therefore the optimal policy will be different for different firms, which makes an optionality approach well suited to promote the introduction of a "Say-on-Dividend" policy.

6 Conclusions

In this paper we argue that liability, voice and exit can only be effective corporate governance mechanisms if they are suited to be used by the particular type of investor that provides the funding, and are aimed at curtailing the power of the specific type of party that holds control over those funds. This problem is particularly interesting when we consider the corporate governance of listed companies with concentrated ownership, where the insiders are controlling shareholders that raise additional equity in the capital markets. When free cash-flows appear these firms lack effective voice, exit and liability mechanisms to protect the minority. This is an important problem that limits the investment opportunities and value creation of these firms and we believe that it is crucial to provide growing companies with commitment tools that allow them to access the capital markets and get funding from outside investors in better terms without having to give up the benefits of control.

We argue that this could be done through a "Say-on-Dividend" policy that gives veto power over the dividend policy to institutional investors and/or independent directors, i.e. to informed parties with interest aligned with those of outside investors. This would ensure the distribution of free cash-flows to outside shareholders. Once we reduce free cash-flows and the potential for minority expropriation, the incentives of the minority and the controlling shareholder will be closely aligned, and therefore the ability of the controlling shareholder to supervise other key strategic and managerial decisions is not compromised. We develop a simple model that shows how this policy increases firm value acting as a commitment mechanism that restricts the controlling shareholder's opportunities to expropriate free cash-flows in the future. The "Say-on Dividend" policy can redirect corporate governance mechanisms that are already in place, but are directed towards the supervision of the managers, to the reduction of the agency conflict between the minority and the controlling shareholder, in such a way as to preserve the monitoring and informational benefits that controlling shareholders provide in the management of the firm.

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