european corporate governance institute

ecgi

Agency Problems, Legal Strategies and Enforcement

Law Working Paper N° 135/2009
November 2009

John Armour
Oxford University and ECGI
Henry Hansmann
Yale Law School and ECGI
Reinier Kraakman
Harvard Law School and ECGI

© John Armour, Henry Hansmann and Reinier Kraakman 2009. All rights reserved. Short sections of text, not to exceed two paragraphs, may be quoted without explicit permission provided that full credit, including © notice, is given to the source.

This paper can be downloaded without charge from:
https://doi.org/10.67929/ecgi-law-135-2009

european corporate governance institute

ECGI Working Paper Series in Law

Agency Problems, Legal Strategies and Enforcement

Working Paper N°.135/2009

November 2009

John Armour
Henry Hansmann
Reinier Kraakman

© John Armour, Henry Hansmann and Reinier Kraakman 2009. All rights reserved. Short sections of text, not to exceed two paragraphs, may be quoted without explicit permission provided that full credit, including © notice, is given to the source.

Abstract

This article is the second chapter of the second edition of The Anatomy of Corporate Law: A Comparative and Functional Approach," by Reinier Kraakman, John Armour, Paul Davies, Luca Enriques, Henry Hansmann, Gerard Hertig, Klaus Hopt, Hideki Kanda and Edward Rock (Oxford University Press 2009). The book as a whole provides a functional analysis of corporate (or company) law in Europe, the U.S., and Japan. Its organization reflects the structure of corporate law across all jurisdictions, while individual chapters explore the diversity of jurisdictional approaches to the common problems of corporate law. In its second edition, the book has been significantly revised and expanded.

"Agency Problems and Legal Strategies" establishes the analytical framework for the book as a whole. After further elaborating the agency problems that motivate corporate law, this chapter identifies five legal strategies that the law employs to address these problems. Describing these strategies allows us to more accurately map legal similarities and differences across jurisdictions. Some legal strategies are "regulatory" insofar as they directly constrain the actions of corporate actors: for example, a standard of behavior such as a director's duty of loyalty and care. Other legal strategies are "governance-based" insofar as they channel the distribution of power and payoffs within companies to reduce opportunism. For example, the law may accord direct decision rights to a vulnerable corporate constituency, as when it requires shareholder approval of mergers. Alternatively, the law may assign appointment rights over top managers to a vulnerable constituency, as when it accords shareholders - or in some jurisdictions, employees - the power to select corporate directors. We then consider the relationship between different enforcement mechanisms - public agencies, private actors, and gatekeeper control - and the basic legal strategies outlined. We conclude that regulatory strategies require more extensive enforcement mechanisms - in the form of courts and procedural rules - to secure compliance than do governance strategies. However, governance strategies, for efficacy, require shareholders to be relatively concentrated so as to be able to exercise their decisional rights effectively.

In addition to Chapter 2, Chapter 1, "What is Corporate Law?," is available in full text on the SSRN at http://ssrn.com/abstract=1436551.

Keywords: Agency, agency cost, agency problem, appointment rights, decision rights, control rights, regulation, corporate governance, equal treatment, trustee, mandatory disclosure, enforcement, private enforcement, public enforcement, gatekeeper control

JEL Classifications: D23, G32, G34, G38, K22, M14

John Armour
University of Oxford - Faculty of Law
Oriel College
Oxford OX1 4EW, United Kingdom
phone: +44 1865 286544
e-mail: john.armour@law.ox.ac.uk

Henry Hansmann
Yale Law School
P.O. Box 208215, New Haven,
CT 06520-8215 United States
phone: 203-432-4966
e-mail: henry.hansmann@yale.edu

Reinier Kraakman
Harvard Law School
1575 Massachusetts
Hauser 406
Cambridge, MA 02138
United States
phone: 617-496-3586, fax: 617-496-6118
e-mail: kraakman@law.harvard.edu

Oxford University Faculty of Law
Research Paper No. 21/2009

Yale Law School
Law, Economics & Public Policy Research Paper No. 388

Harvard Law School
Law & Economics Working Paper No. 644

European Corporate Governance Institute
Law Working Paper No. 135/2009

Agency Problems, Legal Strategies and Enforcement

John Armour
University of Oxford – Faculty of Law
Oxford-Man Institute of Quantitative Finance
European Corporate Governance Institute (ECGI)

Henry Hansmann
Yale Law School; European Corporate Governance Institute (ECGI)

Reinier Kraakman
Harvard Law School; European Corporate Governance Institute (ECGI)

This paper can be downloaded without charge from the Social Science Research Network electronic library at: http://ssrn.com/abstract=1436555.

Electronic copy available at: http://ssrn.com/abstract=1436555

2 Agency Problems and Legal Strategies

JOHN ARMOUR, HENRY HANSMANN, AND REINIER KRAAKMAN

2.1 THREE AGENCY PROBLEMS

As we explained in the preceding Chapter,[1] corporate law performs two general functions: first, it establishes the structure of the corporate form as well as ancillary housekeeping rules necessary to support this structure; second, it attempts to control conflicts of interest among corporate constituencies, including those between corporate 'insiders,' such as controlling shareholders and top managers, and 'outsiders,' such as minority shareholders or creditors. These conflicts all have the character of what economists refer to as 'agency problems' or 'principal-agent' problems. For readers unfamiliar with the jargon of economists, an 'agency problem'—in the most general sense of the term—arises whenever the welfare of one party, termed the 'principal', depends upon actions taken by another party, termed the 'agent.' The problem lies in motivating the agent to act in the principal's interest rather than simply in the agent's own interest. Viewed in these broad terms, agency problems arise in a broad range of contexts that go well beyond those that would formally be classified as agency relationships by lawyers.

In particular, almost any contractual relationship, in which one party (the 'agent') promises performance to another (the 'principal'), is potentially subject to an agency problem. The core of the difficulty is that, because the agent commonly has better information than does the principal about the relevant facts, the principal cannot easily assure himself that the agent's performance is precisely what was promised. As a consequence, the agent has an incentive to act opportunistically,[2] skimping on the quality of his performance, or even diverting to himself some of what was promised to the principal. This means, in turn, that the value of the agent's performance to the principal will be reduced, either directly or because, to assure the quality of the agent's performance, the principal must engage in costly monitoring of the agent. The greater the complexity of the tasks undertaken by the agent, and the greater the discretion the agent must be given, the larger these 'agency costs' are likely to be.[3]

As we noted in Chapter 1, three generic agency problems arise in business firms. The first involves the conflict between the firm's owners and its hired managers. Here the owners are the principals and the managers are the agents. The problem lies in assuring that the managers are responsive to the owners' interests rather than pursuing their own personal interests. The second agency problem involves the conflict between, on one hand, owners who possess the majority or controlling interest in the firm and, on the other hand, the minority or noncontrolling

[1] See *supra* 1.1.

[2] We use the term 'opportunism' here, following the usage of Oliver Williamson, to refer to self-interested behavior that involves some element of guile, deception, misrepresentation, or bad faith. See Oliver Williamson, THE ECONOMIC INSTITUTIONS OF CAPITALISM 47–9 (1985).

[3] See, e.g., Steven Ross, *The Economic Theory of Agency: The Principal's Problem*, 63 AMERICAN ECONOMIC REVIEW 134 (1973); PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS (John W. Pratt and Richard J. Zeckhauser (eds., 1984); Paul Milgrom and John Roberts, ECONOMICS, ORGANIZATION AND MANAGEMENT (1992).

Electronic copy available at: http://ssrn.com/abstract=1436555

owners. Here the noncontrolling owners can be thought of as the principals and the controlling owners as the agents, and the difficulty lies in assuring that the former are not expropriated by the latter. While this problem is most conspicuous in tensions between majority and minority shareholders,[4] it appears whenever some subset of a firm's owners can control decisions affecting the class of owners as a whole. Thus if minority shareholders enjoy veto rights in relation to particular decisions, it can give rise to a species of this second agency problem. Similar problems can arise between ordinary and preference shareholders, and between senior and junior creditors in bankruptcy (when creditors are the effective owners of the firm). The third agency problem involves the conflict between the firm itself—including, particularly, its owners—and the other parties with whom the firm contracts, such as creditors, employees, and customers. Here the difficulty lies in assuring that the firm, as agent, does not behave opportunistically toward these various other principals—such as by expropriating creditors, exploiting workers, or misleading consumers.

In each of the foregoing problems, the challenge of assuring agents' responsiveness is greater where there are multiple principals—and especially so where they have different interests, or 'heterogeneous preferences' as economists say. Multiple principals will face *coordination costs*, which will inhibit their ability to engage in collective action.[5] These in turn will interact with agency problems in two ways. First, difficulties of coordinating between principals will lead them to delegate more of their decision-making to agents.[6] Second, the more difficult it is for principals to coordinate on a single set of goals for the agent, the more obviously difficult it is to ensure that the agent does the 'right' thing.[7] Coordination costs as between principals thereby exacerbate agency problems.

Law can play an important role in reducing agency costs. Obvious examples are rules and procedures that enhance disclosure by agents or facilitate enforcement actions brought by principals against dishonest or negligent agents. Paradoxically, mechanisms that impose constraints on agents' ability to exploit their principals tend to benefit agents as much as—or even more than—they benefit the principals. The reason is that a principal will be willing to offer greater compensation to an agent when the principal is assured of performance that is honest and of high quality. To take a conspicuous example in the corporate context, rules of law that protect creditors from opportunistic behavior on the part of corporations should reduce the interest rate that corporations must pay for credit, thus benefiting corporations as well as creditors. Likewise, legal constraints on the ability of controlling shareholders to expropriate minority shareholders should increase the price at which shares can be sold to noncontrolling shareholders, hence reducing the cost of outside equity capital for corporations. And rules of law that inhibit insider trading by corporate managers should increase the compensation that shareholders are willing

[4] These problems become more severe the smaller the degree of ownership of the firm that is enjoyed by the controlling shareholder. See Luca Enriques and Paolo Volpin, *Corporate Governance Reforms in Continental Europe*, 21 JOURNAL OF ECONOMIC PERSPECTIVES 117, 122–5 (2007).

[5] Classic statements of this problem are found in James M. Buchanan and Gordon Tullock, THE CALCULUS OF CONSENT, 63–116 (1962) and Mancur Olsen, THE LOGIC OF COLLECTIVE ACTION (1965).

[6] Frank H. Easterbrook and Daniel R. Fischel, THE ECONOMIC STRUCTURE OF CORPORATE LAW, 66–7 (1991).

[7] See Hideki Kanda, *Debtholders and Equityholders*, 21 JOURNAL OF LEGAL STUDIES 431, 440–1, 444–5 (1992); Henry Hansmann, THE OWNERSHIP OF ENTERPRISE, 39–44 (1996).

to offer the managers. In general, reducing agency costs is in the interests of all parties to a transaction, principals and agents alike.

It follows that the normative goal of advancing aggregate social welfare, as discussed in Chapter 1,[8] is generally equivalent to searching for optimal solutions to the corporation's agency problems, in the sense of finding solutions that maximize the aggregate welfare of the parties involved—that is, of both principals and agents taken together.

2.2 LEGAL STRATEGIES FOR REDUCING AGENCY COSTS

In addressing agency problems, the law turns repeatedly to a basic set of strategies. We use the term '*legal* strategy' to mean a generic method of deploying substantive law to mitigate the vulnerability of principals to the opportunism of their agents. The strategy involved need not necessarily require legal norms for its implementation. We observed in Chapter 1 that, of the five defining characteristics of the corporate form, only one—legal personality—clearly requires special rules of law.[9] The other characteristics could, in principle, be adopted by contract—for example, through appropriate provisions in the articles of association agreed to by the firm's owners.[10] The same is true of the various strategies we set out in this section.[11] Moreover, the rule of law implementing a legal strategy may be, as discussed in Chapter 1, either a mandatory or a default rule, or one among a menu of alternative rules.[12]

Legal strategies for controlling agency costs can be divided into two subsets, which we term, respectively, 'regulatory strategies' and 'governance strategies'. Regulatory strategies are prescriptive: they dictate substantive terms that govern the content of the principal-agent relationship, tending to constrain the agent's behavior directly. By contrast, governance strategies seek to facilitate the principals' control over their agent's behavior.[13]

The efficacy of governance strategies depends crucially on the ability of the principals to exercise the control rights accorded to them. Coordination costs between principals will make it more difficult for them either to *monitor* the agent so as to determine the appropriateness of her actions, or to *decide* whether, and how, to take action to sanction nonperformance. High coordination costs thus render governance strategies less successful in controlling agents, and regulatory strategies will tend to seem more attractive. Regulatory strategies have different preconditions for success. Most obviously, they depend for efficacy on the ability of an external authority—a court or regulatory body—to determine whether or not the agent complied with particular prescriptions. This requires not only good-quality regulatory institutions—

---

[8] See *supra* 1.5.
[9] See *supra* 1.2.1.
[10] Law can, however, provide useful assistance to parties in relation to these other characteristics through the provision of 'standard forms'. See *supra* 1.4.1.
[11] For evidence on the role of contractual solutions to agency problems adopted by individual firms, see Paul Gompers, Joy Ishii and Andrew Metrick, *Corporate Governance and Equity Prices*, 118 QUARTERLY JOURNAL OF ECONOMICS 107 (2003); Leora Klapper and Inessa Love, *Corporate Governance, Investor Protection, and Performance in Emerging Markets*, 10 JOURNAL OF CORPORATE FINANCE 703 (2004).
[12] See Chapter 1's discussion of the various forms that rules can take, including even the promulgation of an explicitly non-binding code as a guide to best practice.
[13] An alternative labelling would therefore be a distinction between 'agent-constraining' and 'principal-empowering' strategies.

the hallmarks of which are expertise and integrity—but effective disclosure mechanisms to ensure that information about the actions of agents can be 'verified' by the regulator. In contrast, governance strategies—where the principals are able to exercise them effectively—require only that the principals themselves are able to observe the actions taken by the agent, for which purpose 'softer' information may suffice.

Table 2-1 sets out ten legal strategies—four regulatory strategies and six governance strategies—which, taken together, span the law's principal methods of dealing with agency problems. These strategies are not limited to the corporate context; they can be deployed to protect nearly *any* vulnerable principal-agent relationship. Our focus here, however, will naturally be on the ways that these strategies are deployed in corporate law. At the outset, we should emphasize that the aim of this exercise is not to provide an authoritative taxonomy, but simply to offer a heuristic device for thinking about the functional role of law in corporate affairs. As a result, the various strategies are not entirely discrete but sometimes overlap, and our categorization of these strategies does not quadrate perfectly with corporate law doctrine.

Table 2-1: Strategies for Protecting Principals

	Regulatory Strategies		**Governance Strategies**		
	Agent Constraints	Affiliation Terms	Appointment Rights	Decision Rights	Agent Incentives
EX ANTE	RULES	ENTRY	SELECTION	INITIATION	TRUSTEESHIP
EX POST	STANDARDS	EXIT	REMOVAL	VETO	REWARD

2.2.1 Regulatory strategies

Consider first the regulatory strategies on the left hand side of Table 2-1.

2.2.1.1 Rules and standards

The most familiar pair of regulatory strategies constrains agents by commanding them not to make decisions, or undertake transactions, that would harm the interests of their principals. Lawmakers can frame such constraints as *rules,* which require or prohibit specific behaviors, or as general *standards,* which leave the precise determination of compliance to adjudicators after the fact.

Both rules and standards attempt to regulate the substance of agency relationships directly. Rules, which prescribe specific behaviors *ex ante,*[14] are commonly used in the corporate context to protect a corporation's creditors and public investors. Thus corporation statutes universally include creditor protection rules such as dividend restrictions, minimum capitalization requirements, or rules requiring action to be taken following serious loss of capital.[15] Similarly, capital

[14] For the canonical comparison of the merits of rules and standards as regulatory techniques, see Louis Kaplow, *Rules Versus Standards: An Economic Analysis,* 42 DUKE LAW REVIEW 557 (1992).
[15] See *infra* 5.2.2.

market authorities frequently promulgate detailed rules to govern tender offers and proxy voting.[16]

By contrast, few jurisdictions rely solely on the rules strategy for regulating complex, intra-corporate relations, such as, for example, self-dealing transactions initiated by controlling shareholders. Such matters are, presumably, too complex to regulate with no more than a matrix of prohibitions and exemptions, which would threaten to codify loopholes and create pointless rigidities. Rather than rule-based regulation, then, intra-corporate topics such as insider self-dealing tend to be governed by open standards that leave discretion for adjudicators to determine *ex post* whether violations have occurred.[17] Standards are also used to protect creditors and public investors, but the paradigmatic examples of standards-based regulation relate to the company's internal affairs, as when the law requires directors to act in 'good faith' or mandates that self-dealing transactions must be 'entirely fair'.[18]

The importance of both rules and standards depends in large measure on the vigor with which they are enforced. In principle, well-drafted rules can be mechanically enforced. Standards, however, inevitably require courts (or other adjudicators) to become more deeply involved in evaluating and sometimes moulding corporate decisions *ex post.* In this sense, standards lie between rules (which simply require a decision-maker to determine compliance) and another strategy that we will address below—the trusteeship strategy, which requires a neutral decision-maker to exercise his or her own unconstrained best judgment in making a corporate decision.

2.2.1.2 Setting the terms of entry and exit

A second set of regulatory strategies open to the law involve regulating the terms on which principals *affiliate* with agents rather than—as with rules and standards—regulating the actions of agents after the principal/agent relationship is established. The law can dictate *terms of entry* by, for example, requiring agents to disclose information about the likely quality of their performance before contracting with principals.[19] Alternatively, the law can prescribe *exit opportunities* for principals, such as awarding to a shareholder the right to sell her stock, or awarding to a creditor the right to call a loan.

The entry strategy is particularly important in screening out opportunistic agents in the public capital markets.[20] Outside investors know little about public companies unless they are told. Thus it is widely accepted that public investors require some form of systematic disclosure to obtain an adequate supply of information. Legal rules mandating such disclosure provide an example of an entry strategy because stocks cannot be sold unless the requisite information is supplied, generally by the corporation itself.[21] A similar but more extreme form of the entry

[16] See, e.g., *infra* 8.2.5.4 (mandatory bid) and 9.2.2 (listing requirements).
[17] See *infra* 6.2.5. This is not to say that rules are wholly absent from such situations: some jurisdictions regulate forms of self-dealing judged to merit particular suspicion through rules *in combination with* a more general standards strategy.
[18] See, e.g., *infra* 5.3.1.1 (managerial liability vis-à-vis creditors).
[19] See *infra* 5.2.1 and 9.2.1.
[20] See *infra* 9.2.1.
[21] The role of disclosure rules in facilitating entry is most intuitive in relation to prospectus disclosure for initial public offerings, and new issues of seasoned equity. Ongoing disclosure rules may to some extent also facilitate entry, by new shareholders in the secondary market, while at the same time

strategy is a requirement that the purchasers of certain securities meet a threshold of net worth or financial sophistication.[22]

The exit strategy, which is also pervasive in corporate law, allows principals to escape opportunistic agents. Broadly speaking, there are two kinds of exit rights. The first is *the right to withdraw* the value of one's investment. The best example of such a right in corporate law is the technique, employed in some jurisdictions, of awarding an appraisal right to shareholders who dissent from certain major transactions such as mergers.[23] As we discuss in Chapter 7,[24] appraisal permits shareholders who object to a significant transaction to claim the value that their shares had *prior to* the disputed transaction—thus avoiding a prospective loss if, in their view, the firm has made a value-reducing decision.

The second type of exit right is *the right of transfer*—the right to sell shares in the market—which is of obvious importance to public shareholders. (Recall that transferability is a core characteristic of the corporate form.) Standing alone, a transfer right provides less protection than a withdrawal right, since an informed transferee steps into the shoes of the transferor, and will therefore offer a price that impounds the expected future loss of value from insider mismanagement or opportunism. But the transfer right permits the replacement of the current shareholder/principal(s) by a new one that may be more effective in controlling the firm's management. Thus, unimpeded transfer rights allow hostile takeovers in which the disaggregated shareholders of a mismanaged company can sell their shares to a single active shareholder with a strong financial interest in efficient management.[25] Such a transfer of control rights, or even the threat of it, can be a highly effective device for disciplining management.[26] Moreover, transfer rights are a prerequisite for stock markets, which also empower disaggregated shareholders by providing a continuous assessment of managerial performance (among other things) in the form of share prices.

---

facilitating exit by existing shareholders—an example of a single set of rules implementing more than one strategy. However, the function of ongoing disclosure rules is more general: see *infra*, text accompanying notes 49-51 and 9.2.1.4.2.

[22] For example, SEC registration requirements in the U.S. are waived for an issuer whose offers are restricted to 'accredited investors', defined as individuals with net worth in excess of $1m or annual income in excess of $200,000 for each of the last two years (17 C.F.R. §230.501(a), 505, 506 (SEC, Regulation D)). Similarly, in the EU, prospectus disclosure requirements are waived for issues restricted to 'qualified investors', with a securities portfolio of more than €500,000 and knowledge of securities investment (Art. 1(e)(iv), 2, 3(2) Directive 2003/25/EC, 2003 O.J. (L 345) 64 (Prospectus Directive)).

[23] The withdrawal right is a dominant governance device for the regulation of some non-corporate forms of enterprise such as the common law partnership at will, which can be dissolved at any time by any partner. Business corporations sometimes grant similar withdrawal rights to their shareholders through special charter provisions. The most conspicuous example is provided by open-ended investment companies, such as mutual funds in the U.S., which are frequently formed as business corporations under the general corporation statutes. The universal default regime in corporate law, however, provides for a much more limited set of withdrawal rights for shareholders, and in some jurisdictions none at all.

[24] See *infra* 7.2.2, 7.4.1.2.

[25] Some jurisdictions impose limits on the extent to which transfer rights may be impeded. An example is the EU's 'breakthrough rule' for takeovers, implemented in a few European countries. See *infra* 8.3.2.

[26] Viewed this way, of course, legal rules that enhance transferability serve not just as an instance of the exit strategy but, simultaneously, as an instance of the entry strategy and incentive strategy as well. The same legal device can serve multiple protective functions. See also *infra* 8.1.2.4.

2.2.2 Governance strategies

Thus far we have addressed the set of regulatory strategies that might be extended for the protection of vulnerable parties in any class of contractual relationships. We now turn to the six strategies that depend on the hierarchical elements of the principal-agent relationship.

2.2.2.1 Selection and removal

Given the central role of delegated management in the corporate form, it is no surprise that *appointment rights*—the power to *select* or *remove* directors (or other managers)—are key strategies for controlling the enterprise. Indeed, these strategies are at the very core of corporate governance. As we will discuss in Chapters 3 and 4, moreover, the power to appoint directors is a core strategy not only for addressing the agency problems of shareholders in relation to managers, but also, in some jurisdictions, for addressing agency problems of minority shareholders in relation to controlling shareholders, and of employees in relationship to the shareholder class as a whole.

2.2.2.2 Initiation and ratification

A second pair of governance strategies expands the power of principals to intervene in the firm's management. These are *decision rights,* which grant principals the power to *initiate* or *ratify* management decisions. Again, it is no surprise that this set of decision rights strategies is much less prominent in corporate law than are appointment rights strategies. This disparity is a logical consequence of the fact that the corporate form is designed as a vehicle for the delegation of managerial power and authority to the board of directors. Only the largest and most fundamental corporate decisions (such as mergers and charter amendments) require the ratification of shareholders under existing corporation statutes, and no jurisdiction to our knowledge requires shareholders to initiate managerial decisions.[27]

2.2.2.3 Trusteeship and reward

Finally, a last pair of governance strategies alters the incentives of agents rather than expanding the powers of principals. These are *incentive strategies.* The first incentive strategy is the *reward strategy,* which—as the name implies—rewards agents for successfully advancing the interests of their principals. Broadly speaking, there are two principal reward mechanisms in corporate law. The more common form of reward is a *sharing rule* that motivates loyalty by tying the agent's monetary returns directly to those of the principal. A conspicuous example is the protection that minority shareholders enjoy from the equal treatment norm, which requires a strictly pro rata distribution of dividends.[28] As a consequence of this rule, controlling shareholders—here the 'agents'—have an incentive to maximize the returns of the firm's minority shareholders—here the 'principals'— at least to the extent that corporate returns are paid out as dividends. The reward mechanism that is less commonly the focus of corporate law is the *pay-for-performance regime,* in which an agent, although not sharing in his principal's returns, is nonetheless paid for successfully advancing her

[27] See *infra* 3.4. The utility, for reducing agency costs, of separating the initiation of decisions from their ratification was first emphasized by Eugene Fama and Michael Jensen, *Separation of Ownership and Control*, 26 JOURNAL OF LAW AND ECONOMICS 301 (1983).
[28] See *infra* 4.1.3.2.

interests. Even though no jurisdiction *imposes* such a scheme on shareholders, legal rules often facilitate or discourage high-powered incentives of this sort.[29] American law, for example, has long embraced incentive compensation devices such as stock option plans, while more skeptical jurisdictions continue to limit them.

The second incentive strategy—the *trusteeship strategy*—works on a quite different principle. It seeks to remove conflicts of interest *ex ante* to ensure that an agent will not obtain personal gain from disserving her principal. This strategy assumes that, in the absence of strongly focused—or 'high-powered'—monetary incentives to behave opportunistically, agents will respond to the 'low-powered' incentives of conscience, pride, and reputation,[30] and are thus more likely to manage in the interests of their principals. One well-known example of the trusteeship strategy is the 'independent director', now relied upon in many jurisdictions to approve self-dealing transactions. Such directors will not personally profit from actions that disproportionately benefit the firm's managers or controlling shareholders, and hence are expected to be guided more strongly by conscience and reputation in making decisions.[31] Similarly, reliance on auditors to approve financial statements and certain corporate transactions is also an example of trusteeship, provided the auditors are motivated principally by reputational concerns.[32] In certain circumstances other agents external to the corporation may be called upon to serve as trustees, as when the law requires an investment banker, a state official, or a court to approve corporate action.

2.2.3 *Ex post* and *ex ante* strategies

The bottom row in Table 2-1 arranges our ten legal strategies into five pairs, each with an '*ex ante*' and an '*ex post*' strategy. This presentation merely highlights the fact that half of the strategies take full effect *before* an agent acts, while the other half respond—at least potentially—to the quality of the agent's action *ex post.* In the case of the regulatory strategies, for example, rules specify what the agent may or may not do *ex ante,* while standards specify the general norm against which an agent's actions will be judged *ex post.* Thus, a rule might prohibit a class of self-dealing transactions outright, while a standard might mandate that these

---

[29] See *infra* 6.1. and 6.2.

[30] We use the terms 'high-powered incentives' and 'low-powered incentives' as they are conventionally used in the economics literature, to refer to the distinction between economic incentives on the one hand and ethical or moral incentives on the other. Economic incentives are high-powered in the sense that they are concrete and sharply focused. See, e.g., Williamson, *supra* note 2, 137–41; Bengt Hölmstrom and Paul Milgrom, *The Firm as an Incentive System,* 84 AMERICAN ECONOMIC REVIEW 972 (1994). By referring to moral norms as 'low-powered' incentives we do not mean to imply that they are generally less important in governing human behavior than are monetary incentives. Surely, for most individuals in most circumstances, the opposite is true, and civilization would not have gotten very far if this were not the case.

[31] On the reputational consequences for independent directors of poor performance, see David Yermack, *Remuneration, Retention, and Reputation Incentives for Outside Directors*, 54 JOURNAL OF FINANCE 2281 (2004); Eliezer M. Fich and Anil Shivdasani, *Financial Fraud, Director Reputation, and Shareholder Wealth*, 86 JOURNAL OF FINANCIAL ECONOMICS 306 (2007).

[32] While auditors face reputational sanctions for failure (see, e.g., Jan Barton, *Who Cares About Auditor Reputation?*, 22 CONTEMPORARY ACCOUNTING RESEARCH 549 (2005)), their independence and hence trustee status may be compromised by financial incentives in the form of consulting contracts: see John C. Coffee, *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL LAW REVIEW 269, 291–3 (2004).

transactions will be judged against a norm of fairness *ex post.*[33] Similarly, in the case of setting the terms of entry and exit, an entry strategy, such as mandatory disclosure, specifies what must be done *before* an agent can deal with a principal, while an exit device such as appraisal rights permits the principal to respond after the quality of the agent's action is revealed.[34]

The six governance strategies also fall into *ex ante* and *ex post* pairs. If principals can appoint their agents *ex ante,* they can screen for loyalty; if principals can remove their agents *ex post,* they can punish disloyalty. Similarly, shareholders might have the power to initiate a major corporate transaction such as a merger, or—as is ordinarily the case—they might be restricted to ratifying a motion to merge offered by the board of directors.[35] Finally, trusteeship is an *ex ante* strategy in the sense that it neutralizes an agent's adverse interests prior to her appointment by the principal, while most reward strategies are *ex post* in the sense that their payouts are contingent on uncertain future outcomes, and thus remain less than fully specified until after the agent acts.

We do not wish, however, to overemphasize the clarity or analytic power of this categorization of legal strategies into *ex ante* and *ex post* types. One could well argue, for example, that the reward strategy should not be considered an *ex post* strategy but rather an *ex ante* strategy because, like the trusteeship strategy, it establishes in advance the terms on which the agent will be compensated. Likewise, one could argue that appointment rights cannot easily be broken into *ex ante* and *ex post* types, since an election of directors might involve, simultaneously, the selection of new directors and the removal of old ones. We offer the *ex post/ex ante* distinction only as a classification heuristic that is helpful for purposes of exposition.

Indeed, as we have already noted, it is in the same heuristic spirit that we offer our categorization of legal strategies in general. The ten strategies arrayed in Table 2-1 clearly overlap, and any given legal rule might well be classified as an instance of two or more of those strategies. Again, our purpose here is simply to emphasize the various ways in which law can be used as an instrument, not to provide a new formalistic schema that displaces rather than aids functional understanding.

2.3 COMPLIANCE AND ENFORCEMENT

Legal strategies are relevant only to the extent that they induce compliance. In this regard, each strategy depends on the existence of other legal institutions—such as courts, regulators, and procedural rules—to secure *enforcement* of the legal norms. In this section, we consider the relationship between enforcement and compliance. We then discuss three modalities by which enforcement may be effected.

2.3.1 Enforcement and intervention

Enforcement is most directly relevant as regards regulatory strategies such as rules and standards. These operate to constrain the agent's behavior; they cannot do this

[33] Compare *infra* 6.2.4 (*ex ante* prohibitions) and 6.2.5 (*ex post* standards).
[34] Compare, e.g., *infra* 5.2.1, 6.2.1.1, 9.2.1 (mandatory disclosure), and 7.2.2 (appraisal).
[35] See *infra* 7.4.

credibly unless they are in fact enforced.[36] This necessitates well-functioning enforcement institutions, such as courts and regulators, along with appropriately-structured incentives to initiate cases.

In contrast, governance strategies rely largely upon intervention by principals to generate agent compliance.[37] Whether this intervention takes the form of appropriate selection of agents and structure of rewards, credible threats of removal, or effective decision-making on key issues, its success in securing agent compliance depends primarily upon the ability of principals to coordinate and act at low cost. To be sure, governance strategies rely upon background legal rules to support their operation; in particular, they rely on rules defining the decision-making authority of the various corporate actors.[38] They therefore also require legal enforcement institutions to make such delineations of authority effective. However, governance strategies require less sophistication and information on the part of courts and regulators than is required to enforce agents' compliance more directly through regulatory strategies.[39] Enforcement institutions, therefore, are of first-order importance for regulatory strategies, but only of second-order importance for governance strategies.

2.3.2 Modes of enforcement

Turning now to the nature of these 'enforcement institutions', we distinguish three *modalities* of enforcement, according to the character of the actors responsible for taking the initiative: (1) public officials, (2) private parties acting in their own interests, and (3) strategically placed private parties ('gatekeepers') conscripted to act in the public interest. Modalities of enforcement might of course be classified across a number of other dimensions. Our goal here is not to categorize for its own sake, but to provoke thought about how the impact of substantive legal strategies is mediated by different modalities of enforcement. We therefore simply sketch out a heuristic classification based on one dimension—the character of enforcers—and encourage readers to think about how matters might be affected by other dimensions along which enforcement may vary. The categorization we have chosen, we believe, has the advantage that it likely reflects the way in which agents involved in running a firm perceive enforcement—that is, as affecting them through the actions of public officials, interested private parties, and gatekeepers.

2.3.2.1 Public enforcement

By 'public enforcement', we refer to all legal and regulatory actions brought by organs of the state. This mode includes criminal and civil suits brought by public officials and agencies, as well as various *ex ante* rights of approval—such as for

[36] This point is not new. For early recognition, see Roscoe Pound, *Law in Books and Law in Action*, 44 AMERICAN LAW REVIEW 12 (1910); Gary Becker, *Crime and Punishment: An Economic Approach*, 76 JOURNAL OF POLITICAL ECONOMY 169 (1968).

[37] It is possible to talk of such interventions as a form of 'enforcement', in the sense that they make the impact of the governance strategies credible to the agent. However, to avoid confusion with the more specific sense of enforcement understood by lawyers, we eschew this looser sense.

[38] For example, decision rights strategies require courts to deny validity to a purported decision made by a process that does not reflect the principals' decision rights.

[39] See Alan Schwartz, Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies, 21 JOURNAL OF LEGAL STUDIES 271 (1992); Edward B. Rock and Michael L. Wachter, Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation, 149 UNIVERSITY OF PENNSYLVANIA LAW REVIEW 1619 (2001).

securities offering statements—exercised by public actors. In addition to formal measures, public enforcement also encompasses reputational sanctions that may accompany the disclosure that a firm is under investigation.[40]

Public enforcement action can be initiated by a wide variety of state organs, ranging from local prosecutors' offices to national regulatory authorities that monitor corporate actions in real time—such as the U.S. Securities and Exchange Commission (SEC) monitoring corporate disclosures—and have the power to intervene to prevent breaches.[41] We also describe some self-regulatory and quasi-regulatory authorities, such as national stock exchanges and the UK's Financial Reporting Council, as 'public enforcers'. Such bodies are *enforcers* to the extent that they are able in practice to compel compliance with their rules *ex ante* or to impose sanctions for rule violations *ex post*, whether these sanctions are reputational, contractual, or civil. Moreover, they are meaningfully described as *public* enforcers where their regulatory efficacy is spurred by a credible threat of state intervention, and they can be seen as public franchisees.[42] Where no such credible threat exists, then such organizations are better viewed as purely private.

2.3.2.2 Private enforcement

'Private enforcement' most obviously encompasses civil lawsuits brought by private parties, such as shareholder derivative suits and class actions. Importantly, however, we wish to emphasize that it also should be understood as including informal, or reputational, sanctions imposed by private parties, which might take the form of lower share prices, a decline in social standing, or a personal sense of shame.[43] All of these may be inflicted by private parties on misbehaving corporate actors as private responses to wrongdoing.[44]

As with public enforcement, private enforcement embraces a wide range of institutions. At the formal end of the spectrum, these include class actions and derivative suits, which require considerable legal and institutional infrastructure in the form of a plaintiffs' bar, cooperative judges, and favorable procedural law that facilitates actions through matters as diverse as discovery rights and legal fees. Similarly, at the informal end of the spectrum, market reputation can only 'penalize' misconduct by corporate wrongdoers to the extent that there is a mechanism for dissemination of information about (possible) malfeasance and reasonably well-

---

[40] See Jonathan Karpoff and John Lott, Jr., *The Reputational Penalty Firms Face from Committing Criminal Fraud*, 36 JOURNAL OF LAW AND ECONOMICS 757 (1993); Cindy Alexander, *On the Nature of the Reputational Penalty for Corporate Crime: Evidence*, 42 JOURNAL OF LAW AND ECONOMICS 489 (1999); Jonathan Karpoff, D. Scott Lee and Gerald Martin, *The Costs to Firms of Cooking the Books*, 43 JOURNAL OF FINANCIAL AND QUANTITATIVE ANALYSIS 581.

[41] On the efficacy of public enforcement of securities laws in promoting deep and liquid markets, contrast Rafael La Porta, Florencio Lopes-de-Silanes and Andrei Shleifer, *What Works in Securities Laws?*, 61 JOURNAL OF FINANCE 1 (2006) with Howell Jackson and Mark Roe, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence*, Working Paper (2008), at http://www.ssrn.com.

[42] The concept of 'coerced self-regulation' is developed in Ian Ayres and John Braithwaite, RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE 101–32 (1992).

[43] Reputational losses may also be suffered by firms consequent on the announcement of a private lawsuit, in addition to the formal sanction it implies. See, e.g., Amar Gande and Craig Lewis, *Shareholder Initiated Class Action Lawsuits: Shareholder Wealth Effects and Industry Spillovers*, JOURNAL OF FINANCIAL AND QUANTITATIVE ANALYSIS (forthcoming).

[44] Indeed, the source of the sanction may be the actor himself, to the extent that very private internal feelings of guilt are involved.

functioning factor and product markets in which the terms on which the firm contracts become less favorable in response to that information.[45]

Unlike public enforcement, the modality we term private enforcement depends chiefly on the mechanism of deterrence—that is, the imposition of penalties *ex post* upon the discovery of misconduct. There are few direct analogs in private enforcement to the *ex ante* regulatory approval we have included within the mode of public enforcement. One example of such enforcement may be the UK's 'scheme of arrangement' procedure, whereby a company wishing to undertake a major restructuring transaction and having obtained requisite votes from shareholders (and creditors, if they are parties) may seek court approval of the arrangement.[46] The court will scrutinize the procedural steps taken at this point, and if its sanction is given to the scheme, it cannot be challenged *ex post*. However, if the focus is widened to include not only enforcement in the strict sense, but means of securing agent compliance more generally, there is an important counterpart: private actors are of course very much involved in *ex ante* governance interventions to secure compliance by agents. Indeed, while the discussion in this section has focused on public and private actors as initiators of the enforcement of legal norms, the same conceptual distinction can also be made in relation to governance interventions. Public actors may also be involved in governance interventions, for instance where the state is a significant stockholder. This position is not observed in most of the jurisdictions we survey, but in some countries—most notably China—state ownership of controlling shares in publicly-traded companies is common.[47] Under such circumstances, public actors—namely government agencies—take decisions regarding governance intervention.

2.3.2.3 Gatekeeper control

Gatekeeper control involves the conscription of noncorporate actors, such as accountants and lawyers, in policing the conduct of corporate actors. This conscription generally involves exposing the gatekeepers to the threat of sanction for participation in corporate misbehavior, or for failure to prevent or disclose misbehavior.[48] The actors so conscripted are 'gatekeepers' in the sense that their participation is generally necessary, whether as a matter of practice or of law, to accomplish the corporate transactions that are the ultimate focus of the enforcement efforts. We call the mode 'gatekeeper *control*' to emphasize that it works by harnessing the control that gatekeepers have over corporate transactions, and giving them a strong incentive to use that control to prevent unwanted conduct.

Gatekeeper control is probably best viewed as a form of delegated intervention: principals do not themselves engage in scrutiny of the agent, but leave this to the gatekeeper. Compliance is generally secured through the *ex ante*

---

[45] On the role of reputational penalties in contracting, see Simon Johnson, John McMillan and Christopher Woodruff, *Courts and Relational Contracts*, 18 JOURNAL OF LAW ECONOMICS AND ORGANIZATION 221 (2002); Franklin Allen, Jun Qian and Meijun Qian, *Law, Finance, and Economic Growth in China*, 77 JOURNAL OF FINANCIAL ECONOMICS 57 (2005).

[46] Part 26 Companies Act 2006 (UK).

[47] See Lee Branstetter, *China's Financial Markets: An Overview*, in CHINA'S FINANCIAL TRANSITION AT A CROSSROADS 23, 43–57 (Charles W. Calomiris ed., 2007).

[48] See Reinier Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 JOURNAL OF LAW ECONOMICS AND ORGANIZATION 53 (1986); John C. Coffee, Jr, GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE (2006).

mechanism of constraint (e.g., auditors refuse to issue an unqualified report) rather than through the *ex post* mechanism of penalizing wrongdoers. Such delegation of course creates a new agency problem between the gatekeeper and the principals. This is dealt with through the application of the basic legal strategies to the gatekeepers themselves, with chief reliance on the standards and trusteeship strategies.

2.4 DISCLOSURE

Disclosure plays a fundamental role in controlling corporate agency costs. As we have already noted,[49] it is an important part of the affiliation rights strategies. Most obviously, prospectus disclosure forces agents to provide prospective principals with information that helps them to decide upon which terms, if any, they wish to *enter* the firm as owners. To a lesser extent, periodic financial disclosure and *ad hoc* disclosure—for example, of information relevant to share prices, and of the terms of related party transactions—also permits principals to determine the extent to which they wish to remain owners, or rather *exit* the firm. However, continuing disclosure also has more general auxiliary effects in relation to each of the other strategies; hence we treat it separately at this point in our discussion.

In relation to regulatory strategies that require enforcement, disclosure of related party transactions helps to reveal the existence of transactions that may be subject to potential challenge, and provides potential litigants with information to bring before a court. In relation to governance strategies, disclosure can be used in several different, but complementary, ways. First, and most generally, mandating disclosure of the terms of the governance arrangements that are in place allows principals to assess appropriate intervention tactics. Second, and specifically in relation to decision rights, mandatory disclosure of the details of a proposed transaction for which the principals' approval is sought can improve the principals' decision. Third, disclosure of those serving in trustee roles serves to bond their reputations publicly to the effective monitoring of agents.

There is of course a need to ensure compliance with disclosure obligations themselves. This is a microcosm of the more general problem of securing agent compliance. For periodic disclosures, where the type of information is expected but the content is not yet known (so-called 'known unknowns'), no additional compliance mechanism may be required beyond a public statement that the disclosure is expected. If the principals are made aware that a particular piece of information (for example, annual financial statements, the structure and composition of the board, or executive compensation arrangements) is expected to be disclosed in a particular format, then non-disclosure itself can send a negative signal to principals, stimulating them to act.[50] The compliance issue with periodic disclosure is not so much whether it happens, but its quality, and hence a trusteeship strategy—in the form of auditors—is typically used to assist in assuring this. For *ad hoc* disclosure, the compliance issues are different, because by definition, principals do not expect particular disclosures in advance (that is, these are so-called 'unknown unknowns'). Here vigorous legal enforcement alone seems to be able to ensure compliance.[51]

---

[49] See *supra* 2.2.1.2; see also *infra* 9.2.1.

[50] This mechanism is used to enforce disclosure of governance arrangements in the UK and elsewhere under so-called 'comply or explain' provisions.

[51] See Utpal Bhattacharya and Hazem Daouk, *The World Price of Insider Trading*, 57 JOURNAL OF FINANCE 75 (2002).

2.5 LEGAL STRATEGIES IN CORPORATE CONTEXT

The law does not apply legal strategies in the abstract but only in specific regulatory contexts. For purposes of exposition and analysis, we have grouped those contexts into six basic categories of corporate decisions and transactions. Each of the seven chapters that follow focuses on one of those categories. Necessarily, the boundaries of these categories are to some degree arbitrary and overlapping. Nevertheless, each category has a degree of functional unity, and the typical deployment of legal strategies in each is at least moderately distinct.

Chapters 3 and 4 examine the legal strategies at play in the regulation of ordinary business transactions and decisions. Not surprisingly, governance strategies predominate in this context. Chapter 5 turns to corporate debt relationships and the problem of creditor protection—a context in which regulatory strategies are common, except when the firm is insolvent, when the emphasis shifts to governance strategies. Chapter 6 examines the legal regulation of related party (or self-dealing) transactions; Chapter 7 investigates the corporate law treatment of 'significant' transactions, such as mergers and major sales of assets, and Chapter 8 assesses the legal treatment of control transactions such as sales of control blocks and hostile takeovers. As the discussion below will demonstrate, jurisdictions adopt a fluid mix of regulatory and governance strategies in all of the last three transactional contexts. Finally, Chapter 9 turns to investor protection and the regulation of issuers on the public market, where regulatory strategies predominate.

While we do not claim that these transactional and decisional categories exhaust all of corporate law, they cover most of what is conventionally understood to be corporate law, and nearly all of the interesting and controversial issues that the subject presents today.

Within each of our seven substantive chapters, our analysis proceeds functionally. In most chapters, our analytic discussion is organized by agency problems and legal strategies: for a given category of corporate decisions, we review the legal strategies that are actively deployed by the key corporate law jurisdictions. In two chapters, however, the analytic discussion is organized somewhat differently—by categories of transactions in Chapter 7 (which concerns significant transactions), and by agency problems in Chapter 8 (which concerns control transactions). This variation in structure responds to the greater heterogeneity of the transactions dealt with in those chapters. Finally, to the extent that there are significant differences across jurisdictions in the legal strategies employed to regulate a given class of corporate decisions, we attempt to assess the origins of these differences. In particular, we ask to what extent these differences can be understood as functional adaptations to differences in institutions, such as trading markets and financial intermediaries (that is 'efficiency effects' of such complementary institutions), and how far they appear to be historical, cultural, or political artifacts driven by distributional rather than functional concerns.[52]

[52] On the distinction between 'efficiency effects' and 'distributional effects' of complementary institutions, see *supra* 1.6.1.

2.6 SYSTEMATIC DIFFERENCES

We might expect the use of the various legal strategies for controlling agency costs, and of the associated modes of enforcement, to differ systematically across jurisdictions. In particular, we would expect to see strong complementarities between the structure of share ownership and the types of legal strategies relied upon most heavily to control agency costs. Since the efficacy of governance mechanisms is closely linked to the extent to which principals are able to coordinate, it would be surprising if the structure of share ownership did not affect the extent to which these strategies are employed to control managers. In most jurisdictions around the world, the ownership of shares in publicly-traded firms is concentrated in the hands of relatively few shareholders—whether families or institutional investors. With such ownership patterns, owners face relatively low coordination costs as between themselves, and are able to rely on governance strategies to control managers. Where ownership of shares is more diffuse, however, governance mechanisms are less effective, and there is more need for regulatory mechanisms to take the fore.

Just as the choice of legal strategies for controlling agency problems is likely to complement the pattern of ownership, it will in turn be complemented by the nature and sophistication of the enforcement institutions. In systems relying heavily on regulatory strategies, enforcement institutions will likely have a greater role to play in securing compliance by agents, as opposed to intervention by principals themselves.[53] At a more micro level, particular regulatory strategies complement and are supported by different enforcement institutions. Rules require a sophisticated and quickly responding regulator, if they are not to end up imposing greater hindrance than benefit on parties. Standards, on the other hand, require independent and sophisticated courts and lawyers, if they are to be deployed effectively.

In addition, the appropriate *scope* of continuing disclosure obligations may vary depending on the extent to which particular legal strategies are employed. Thus in the U.S., where regulatory strategies are extensively used, continuing disclosure focuses on self-dealing transactions, and so assists in formal enforcement activities. In the EU, by contrast, where greater reliance is placed on governance mechanisms, disclosure obligations emphasize details of board structure.[54] The necessary *extent* of disclosure will also vary depending on the ownership structure. Where owners are highly coordinated, frequent disclosure may be less important for controlling managers:[55] owners are better able to discover information for themselves, and governance strategies can be used to stimulate disclosure of greater information. This is not to say, however, that effective and adequately enforced disclosure obligations do not matter in systems with coordinated owners. Rather, the problem with

---

[53] The existence of a demand for regulatory, as opposed to governance, strategies may be expected to spur the development of regulatory expertise. Thus in jurisdictions with widely dispersed retail shareholdings, such as the U.S., specialist courts tend to be more active because they are more in demand. See Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 CALIFORNIA LAW REVIEW 393 (2003).

[54] See e.g., The High Level Group of Company Law Experts, REPORT OF THE HIGH LEVEL GROUP OF COMPANY LAW EXPERTS ON A MODERN REGULATORY FRAMEWORK FOR COMPANY LAW IN EUROPE 45-46 (2002), at http://ec.europa.eu; Recommendation 2005/162/EC on the role of non-executive or supervisory directors of listed companies and on committees of the (supervisory) board (2005 O.J. (L 52)51), para. 9.

[55] See John Armour and Jeffrey N. Gordon, *The Berle-Means Corporation in the 21st Century*, Working Paper (2008), at http://www.law.upenn.edu.

coordinated owners is not the first of our three agency problems but the second: ensuring that the information management transmits to powerful owners, and information about how those owners exercise their control rights, makes its way to all owners equally—that is, preventing so-called 'selective disclosure'.

Many such institutional differences may make little overall difference to the success of firms' control of their agency costs, as various combinations of strategies and associated institutions may be functionally equivalent. However, there are some institutions whose presence or absence is likely to be important in any jurisdiction. In particular, given the fundamental role played by disclosure in supporting both the enforcement of regulatory strategies and the exercise of governance, institutions supporting disclosure—a strong and effective securities regulator and a sophisticated accounting profession, for example—are always likely to make an overall difference to the success of firms in controlling agency costs.[56]

[56] See Bernard Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA LAW REVIEW 781 (2001).

european corporate governance institute

about ECGI

The European Corporate Governance Institute has been established to improve *corporate governance through fostering independent scientific research and related activities.*

The ECGI will produce and disseminate high quality research while remaining close to the concerns and interests of corporate, financial and public policy makers. It will draw on the expertise of scholars from numerous countries and bring together a critical mass of expertise and interest to bear on this important subject.

The views expressed in this working paper are those of the authors, not those of the ECGI or its members.

www.ecgi.org

european corporate governance institute

ECGI Working Paper Series in Law

Editorial Board

Editor	Guido Ferrarini, Professor of Law, University of Genova & ECGI
Consulting Editors	Theodor Baums, Director of the Institute for Banking Law, Johann Wolfgang Goethe University, Frankfurt & ECGI Paul Davies, Cassel Professor of Commercial Law, London School of Economics and Political Science & ECGI Henry B Hansmann, Augustus E. Lines Professor of Law, Yale Law School & ECGI Klaus J. Hopt, Director, Max Planck Institute for Foreign Private and Private International Law & ECGI Roberta Romano, Allen Duffy/Class of 1960 Professor of Law, Yale Law School & ECGI Eddy Wymeersch, Professor of Commercial Law, University of Ghent & ECGI
Editorial Assistant :	Paolo Casini, "G.d'Annunzio" University, Chieti & ECARES, Lidia Tsyganok, ECARES, Université Libre De Bruxelles