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Corporate Control and Idiosyncratic Vision

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Zohar Goshen
Columbia Law School and ECGI
Assaf Hamdani
Hebrew University of Jerusalem and ECGI

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ABSTRACT. This Article offers a novel theory of corporate control. It does so by shedding new light on corporate-ownership structures and challenging the prevailing model of controlling shareholders as essentially opportunistic actors who seek to reap private benefits at the expense of minority shareholders. Our core claim is that entrepreneurs value corporate control because it allows them to pursue their vision (i.e., any business strategy that the entrepreneur genuinely believes will produce an above-market rate of return) in the manner they see fit. We call the subjective value an entrepreneur attaches to her vision the entrepreneur's idiosyncratic vision. Our framework identifies a fundamental tradeoff, stemming from asymmetric information and differences of opinion, between the entrepreneur's pursuit of her idiosyncratic vision and investors' need for protection against agency costs. Entrepreneurs and investors address this inevitable conflict through different ownership structures, each with different allocations of control and cash-flow rights.

Concentrated ownership, therefore, should not be viewed as an unalloyed evil. To the contrary, it creates value for controlling and minority shareholders alike. Our analysis shows that controlling shareholders hold a control block to increase the pie's size (pursue idiosyncratic vision) rather than to dictate the pie's distribution (consume private benefits). Importantly, when the entrepreneur's idiosyncratic vision is ultimately realized, the benefits will be distributed pro rata to all investors. Our framework provides important insights for investor protection and corporate law doctrine and policy. We argue that corporate law for publicly traded firms with controlling shareholders should balance the controller's need to secure her idiosyncratic vision against the minority's need for protection. While the existing corporate-law scholarship has focused solely on the protection of minority shareholders, we show that it is equally important to pay heed to the rights of the controlling shareholders.

AUTHORS. Zohar Goshen is the Alfred W. Bressler Professor of Law, Columbia Law School and Professor of Law at Ono Academic College. Assaf Hamdani is the Wachtell, Lipton, Rosen & Katz Professor of Corporate Law, Hebrew University of Jerusalem. For helpful comments we are grateful to John Coffee, Luca Enriques, Deng Feng, Merritt Fox, Jesse Fried, Ronald Gilson, Andrew Gold, Victor Goldberg, Jeff Gordon, Henry Hansmann, Robert Jackson, Curtis Milhaupt, Gideon Parchomovsky, Ariel Porat, Alex Raskolnikov, Ruth Ronen, Alan Schwartz, Robert Scott, Alex Stein, Yishay Yafeh, and the participants in the following events: the Columbia Law School Faculty Talk; the NYU/Penn Conference on Law & Finance; the 23rd Annual Meeting of the American Law and Economics Association; the Workshop on Responsibility and Accountability of Corporate Ownership 2013, Copenhagen Business School; the Law and Economics Workshops at ETH Zurich, Switzerland and Harvard Law School; and the Law and Finance Seminar, University of Oxford. We are grateful to Daniel Belke, Yosef Kalmanovich, Ray Koh, Jason Schnier, Brooke Sgambati, Anna Shifflet, and Alex Zbrozek for their superb research assistance and thoughtful editing work. We also thank the Milton Handler Faculty Research Gift, the Grace P. Tomei Endowment Fund, and the Hebrew University's Center for Empirical Legal Studies of Decision Making and the Law for their financial support.

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INTRODUCTION

Several prominent technology firms that went public in recent years, including Google[1] and Facebook,[2] adopted the controversial dual-class share structure in which the founders retain shares with superior voting rights. Alibaba, the Chinese company that set the record for the largest ever IPO, decided to list its shares in New York instead of Hong Kong so that it could use this dual-class share structure.[3] Essentially, the goal of this structure is to allow the entrepreneur-controlling shareholder to preserve her indefinite, uncontestable control over the corporation.[4] Commentators have criticized the dual-class structure for creating governance risks.[5] But why do entrepreneurs insist on holding control in the first place?

The answer has important implications for corporate law. Most public corporations around the world have controlling shareholders,[6] and concentrated ownership has a significant presence in the United States as well.[7]

1. *See* Simon C.Y. Wong, *Google's Stock-Split Plan Would Replace Stewardship with Dictatorship*, HARV. BUS. REV. (Apr. 18, 2012), https://hbr.org/2012/04/googles-stock-split-plan-would [https://perma.cc/B8T9-6YBU].

2. *See* Brad Stone, *Facebook Will Form 2 Classes of Stock*, N.Y. TIMES (Nov. 24, 2009), http://www.nytimes.com/2009/11/25/technology/internet/25facebook.html [http://perma.cc/AW79-7FRP]; James Surowiecki, *Unequal Shares*, NEW YORKER (May 28, 2012), http://www.newyorker.com/magazine/2012/05/28/unequal-shares [http://perma.cc/R3AS-FUS3].

3. *See* Neil Gough, *After Loss of Alibaba I.P.O., Hong Kong Weighs Changes to Its Listing Rules*, N.Y. TIMES: DEALBOOK (Aug. 29, 2014, 7:31 AM), http://dealbook.nytimes.com/2014/08/29/hong-kong-begins-thinking-aloud-about-issue-that-lost-it-alibabas-i-p-o [http://perma.cc/7VY3-LF6W].

4. With an ownership of a majority of the voting rights, the controlling shareholder's control is uncontestable, as a hostile takeover is impossible.

5. *See, e.g.*, Lucian Arye Bebchuk et al., *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, *in* CONCENTRATED CORPORATE OWNERSHIP 295, 301-05 (Randall K. Morck ed., 2000).

6. *See, e.g.*, Marco Becht & Colin Mayer, *Introduction* to THE CONTROL OF CORPORATE EUROPE 1, 19 (Fabrizio Barca & Marco Becht eds., 2002) (noting that in fifty percent of Dutch, French, and Spanish companies, more than 43.5%, twenty percent, and 34.5% of votes are controlled by controlling shareholders, respectively); Stijn Claessens et al., *The Separation of Ownership and Control in East Asian Corporations*, 58 J. FIN. ECON. 81, 82 (2000) ("[M]ore than two-thirds of [East Asian] firms are controlled by a single shareholder."); Mara Faccio & Larry H.P. Lang, *The Ultimate Ownership of Western European Corporations*, 65 J. FIN. ECON. 365, 378 (2002) (reporting that only around thirty-seven percent of Western European firms are widely held); Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471, 471 (1999) (finding that, after a review of large corporations in twenty-seven countries, "relatively few . . . firms are widely held").

7. Concentrated ownership is usually contrasted with the dispersed-ownership structure, the most prevalent structure in the United States and the United Kingdom, in which most of

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For example, Facebook, Google, and Viacom all have controlling shareholders.[8] In the concentrated-ownership structure, a person or an entity—the controlling shareholder—holds an effective majority of the firm's voting and equity rights.[9] The governance concerns raised by firms with controlling shareholders differ from the governance concerns associated with firms with dispersed ownership. Yet, legal scholars have largely overlooked the issues arising from firms with concentrated ownership.[10] Moreover, as we explain below, Delaware's doctrine concerning controlling shareholders has often been puzzling and inconsistent.[11]

Unlike diversified minority shareholders, a controlling shareholder bears the extra costs of being largely undiversified and illiquid.[12] Why, then, does she insist on holding a control block despite having to bear these costs?[13]

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

8. *See* Kobi Kastiel, *Executive Compensation in Controlled Companies*, 90 IND. L.J. 1131, 1133 (2015) (noting that Viacom has a controlling shareholder who holds eighty percent of the votes); Floyd Norris, *The Many Classes of Google Stock*, N.Y. TIMES: ECONOMIX (Apr. 2, 2014, 6:03 PM), http://economix.blogs.nytimes.com/2014/04/02/the-many-classes-of-google-stock [http://perma.cc/SR9C-XFRH]; Harriet Taylor, *What's Happening at Facebook's Shareholder Meeting*, CNBC (June 11, 2015, 10:39 AM), http://www.cnbc.com/2015/06/11/facebook-annual-shareholder-meeting-what-to-expect.html [http://perma.cc/2XHC-MHMT].

9. At this stage we address the case of a concentrated-ownership structure with a controlling shareholder holding an effective majority of the votes, i.e., a block of shares large enough to immunize the controller from the risk of a hostile takeover (usually more than fifty percent of the votes and equity). We do not, at this juncture, analyze ownership structures, such as dual-class shares, pyramids, and leveraged buyouts, which enable investors to hold uncontestable control without owning a majority of equity rights. *See infra* Section III.A.2 (discussing dual-class ownership structure). Nor do we discuss companies with a dominant blockholder that exerts considerable influence without having a lock on control.

10. For a notable exception, see Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1663-64 (2006).

11. *See infra* Part IV.

12. *But see* Mara Faccio et al., *Large Shareholder Diversification and Corporate Risk-Taking*, 24 REV. FIN. STUD. 3601, 3636 (2011) (finding heterogeneity in the degree of portfolio diversification across large shareholders).

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The prevailing answer focuses on private benefits of control.[14] According to conventional wisdom, entrepreneurs seek a controlling interest in order to exploit their dominant position and divert value from the company or its investor, thereby capturing private benefits of control. An alternative, and less pessimistic, theory proposes that allowing an entrepreneur to consume some level of private benefits is a necessary cost of incentivizing efficient monitoring and good performance.[15] The controller in this explanation still diverts value to herself at the expense of investors, but on balance, her actions benefit the investors and the corporation as a whole.

Both theories explain corporate control as a function of private benefits. However, the depiction of controlling shareholders as being either motivated or rewarded by private benefits of control is unconvincing from both positive and normative standpoints. On the one hand, there may be good reason to doubt that most controlling shareholders around the world are opportunists whose motivation for control is the prospect of exploiting loopholes in minority-investor protection. On the other hand, it is by no means clear that investors, courts, and lawmakers should actually tolerate some level of value diversion by controlling shareholders in order to incentivize them to monitor management.

This Article offers an alternative explanation for the value of control by entrepreneurs. Under our framework, control allows entrepreneurs to pursue business strategies that they believe will produce above-market returns by securing the ability to implement their vision in the manner they see fit. The entrepreneur values control because it protects her against the possibility of subsequent *midstream* investor doubt and objections regarding either the entrepreneur's vision or her abilities.

Control matters because business ideas take time to implement. This ongoing process requires numerous decisions, ranging from day-to-day management issues to major strategic choices. Perhaps the most important decision is whether to continue a business, change its course, or close it down. However, investors and entrepreneurs often need to make these decisions under conditions of asymmetric information or differences of opinion. Investors cannot always observe the entrepreneur's efforts, talents, and actions.

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

14. *See infra* notes 30-39 and accompanying text (describing the private benefits of the control theory of concentrated ownership).

15. *See infra* notes 40-49 and accompanying text (describing the monitoring theory of concentrated ownership).

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Therefore, it is hard for investors to determine the real cause of a corporation's poor performance: it could be the entrepreneur's incompetence or laziness, temporary business setbacks, or simply bad luck. Since the entrepreneur commonly knows more about the business and her own efforts and talent than investors, she has the ability to exploit investors by the way she manages the business. Investors will wish to contain this risk of agency costs by maintaining the right to close the business down or fire the entrepreneur. Even when investors and entrepreneurs have the same information, the complexity of the business and the uncertainty of the future might yield different beliefs as to the potential success or failure of the business. Consequently, under conditions of asymmetric information or differences of opinion, entrepreneurs and investors may disagree over whether a business should continue and in what fashion.

Thus, in our framework, both investors and entrepreneurs value control, but for different reasons. The entrepreneur wants to retain control over management decisions to pursue her idiosyncratic vision for producing above-market returns. That is, control enables entrepreneurs to capture the value that they attach to the execution of *their* idiosyncratic vision.[16] Investors, by contrast, value control because it allows them to minimize agency costs.[17]

Henry Ford's story illustrates our theory well. Ford did not invent the automobile, nor did he own any valuable intellectual property in the technology. He was competing with hundreds of other entrepreneurs attempting to create a "horseless carriage." Ford, however, had a unique vision regarding car production. The Detroit Automobile Company, the first firm that he founded, was controlled by investors.[18] While investors demanded that cars be immediately produced and sold, Ford insisted on perfecting the design prior

16. Unlike the pursuit of this type of vision that will benefit all shareholders equally, the pursuit of nonpecuniary benefits of control refers to the value (e.g., personal satisfaction, pride, fame, political power) that only the entrepreneur derives from the execution of her business idea. Alessio Pacces analyzes what he labels *idiosyncratic* private benefits of control. *See* ALESSIO M. PACCES, RETHINKING CORPORATE GOVERNANCE: THE LAW AND ECONOMICS OF CONTROL POWERS 93-94 (2012). Although his analysis is based on a specific form of nonpecuniary private benefits of control, his framework is similar to ours in that it features deferred compensation of entrepreneurship. *See also* Alessio M. Pacces, *Control Matters: Law and Economics of Private Benefits of Control* 12 (European Corp. Governance Inst., Working Paper No. 131/2009, 2009), http://ssrn.com/abstract=1448164 [http://perma.cc/T2MR-43RR] [hereinafter Pacces, *Control Matters*] (explaining how idiosyncratic private benefits such as personal satisfaction can be cashed in on the market for corporate control).

17. Agency costs arise when investors grant an agent the power to make decisions that affect the value of their investments. *See generally* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (developing a formal analysis of agency costs).

18. M. Todd Henderson, *The Story of* Dodge v. Ford Motor Company*: Everything Old Is New Again*, *in* CORPORATE LAW STORIES 37, 40 (J. Mark Ramseyer ed., 2009).

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to production, leading to delays and frustration on both sides. The tension eventually led investors to shut down the firm.[19]

Ford's second attempt, the Henry Ford Company, was also controlled by investors. Again, after designing a car, Ford resisted the investors' pressure to move directly into production.[20] Ultimately, Ford's obstinacy prompted investors to replace him with Henry Leland, who changed the company's name to the Cadillac Automobile Company and successfully produced the car that Ford had designed.[21] In Ford's third attempt—the Ford Motor Company—he insisted on retaining control. This time, with no outside-investor interference, Ford transformed his innovative ideas for car design and production into one of the greatest corporate success stories of all time.[22]

The entrepreneur's idiosyncratic vision has two distinctive features in our framework. First, it reflects the parts of the entrepreneur's business idea that outsiders may be unable to observe or verify. This could be because the entrepreneur cannot persuade investors that she is the best person to continue running the firm or that her business plan will produce superior returns. Second, it reflects the above-market pecuniary return expected by the entrepreneur, which, if the business succeeds, will be shared on a pro rata basis between the entrepreneur and investors. Importantly, idiosyncratic vision need not concern an innovation or new invention: as long as the entrepreneur has a plan that she subjectively believes will result in above-market returns, she has idiosyncratic vision.

While it may seem intuitive that entrepreneurs enter a business aiming to beat the market and that they fear that differences of opinion with their investors might frustrate their vision, this explanation is absent from the existing economic literature. Economists reject the idea of beating the market because, in equilibrium, investments yield only normal market returns. And economists have thus far rejected the idea of differences of opinion—as opposed to asymmetric information—because rational actors with rational expectations will not have differences of opinion when they share the same

19. *See id*.

20. *See id*. at 45.

21. *See id*.

22. *See id*. at 47. The Cadillac Automobile Company became a success, as did the Ford Motor Company. Put differently, this example does not aim at demonstrating that entrepreneurs are always right. Rather, we use this example to demonstrate the value that entrepreneurs attach to their ability to exercise control even against investors' objections. Finally, with yet another move along the spectrum of ownership structures, Ford's grandson, Henry II, took the corporation public in 1956 with a dual-class share structure, ensuring that control stayed with the Ford family to this day. *See id*. at 72.

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information.[23] Thus, economists have focused on private benefits as the principal motivation for holding control. This Article recognizes that controlling owners are often entrepreneurs who hope to increase the value of their firms by implementing their idiosyncratic visions. Building on this insight, we offer an explanation of controlling ownership that is more aligned with real-world experiences and therefore offers superior policy prescriptions. Indeed, only recently, and gradually, economists have started to acknowledge the pursuit of above-market returns[24] and the existence of differences of opinion.[25] Our Article thus makes an important contribution to the theory of corporate control.

Our argument unfolds as follows. In Part I, we describe the limits of the existing explanations of corporate control. The minority-expropriation theory views controlling shareholders around the world as opportunists aspiring to expropriate minority shareholders and extract private benefits of control at their expense. The optimal-reward theory views controlling shareholders as providing a valuable service of monitoring management and suggests that an optimal level of private-benefit extractions should be allowed to induce efficient monitoring. However, these accounts fail to explain the prevalence of firms with controlling shareholders in countries with robust regimes of investor protection, such as the United States. They also offer very limited

23. *See* Robert J. Aumann, *Agreeing to Disagree*, 4 ANNALS STAT. 1236, 1236 (1976) (showing that two people with common knowledge about past events must hold the same view concerning the likelihood of future events).

24. *See, e.g.*, Raghuram G. Rajan, *Presidential Address: The Corporation in Finance*, 67 J. FIN. 1173, 1177 (2012) ("To create [net present value (NPV)], the entrepreneur has to go out on a limb, distinguishing herself from the rest of the herd of potential competitors and thus potentially earning sustainable profits . . . . [T]he process of creating positive [NPV] invariably implies differentiation—whether in creating new products or product varieties that nobody else manufactures, in developing production methods that are more efficient than those of the competition, or in targeting customer populations or needs that have hitherto been overlooked.").

25. For recent and revealing testimony about the norm among contract-theory scholars, see Patrick Bolton, *Corporate Finance, Incomplete Contracts, and Corporate Control*, 30 J.L. ECON. & ORG. 64, 70-71 (2014) ("Our first approach to this second question was to assume that the entrepreneur and financier had *different beliefs* about which investments were preferable. Based on casual observation, we assumed that the entrepreneur was generally more *optimistic* about the success of risky investments than the financier. . . . As simple and plausible as this solution seemed to us, the contract-theory community at the time was not ready to accept two departures from orthodoxy in the same paper: [i]ncomplete contracts and differences of opinion. We received almost unanimous advice to change the model and do away with differences of opinion. So, instead of modeling differences in objectives arising from different beliefs, we modeled them as arising from the presence of *private benefits*: [w]e assumed that the entrepreneur derives both financial returns and private benefits from the venture, while the investor derives only financial returns.").

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guidance concerning the corporate legal rules that should govern firms with controlling shareholders.

In Part II, we develop our theory of corporate control and use it to analyze the building blocks of corporate-ownership structures. We identify a fundamental tension that arises whenever entrepreneurs raise funds from investors under the conditions of asymmetric information and differences of opinion: while entrepreneurs want the freedom to pursue their idiosyncratic vision, investors seek protection from agency costs. We then show that the entrepreneur and investors can use different combinations of control and cash-flow rights to balance the investors' concern regarding agency costs against the entrepreneur's interest in pursuing her idiosyncratic vision.

In Part III, we use our theory to uncover the essence of the bargain between outside investors and controlling shareholders. We first show that corporate ownership structures can be recast as combinations of cash-flow and control rights that entrepreneurs and investors adopt to balance the conflicting objectives of minimizing agency costs for the investors and maximizing the entrepreneurs' ability to pursue their idiosyncratic vision. We then explore the spectrum of public-company ownership structures: concentrated-ownership (the controlling shareholder holds a control block of shares having equal cash-flow and voting rights), dispersed-ownership (shares are widely held by investors), and dual-class firms (the controlling shareholder holds shares with superior voting rights that allow it to hold a majority of voting rights without holding a majority of cash-flow rights). Both dispersed-ownership and the dual-class structures represent variations on the *separation of cash flow and control*,[26] thereby exposing investors to management agency costs (i.e., mismanagement). Concentrated ownership, by contrast, bundles cash-flow rights and control together. While dispersed ownership, with its contestable control, constrains the ability of entrepreneurs to pursue their idiosyncratic vision, an entrepreneur in the concentrated-ownership structure enjoys permanent and uncontestable control,[27] much as she does in the dual-class structure. The controlling owner values permanent and uncontestable control because it allows her the freedom of action that is often necessary to realize her idiosyncratic vision. At the same time, the controller-entrepreneur's large equity stake limits investors' exposure to management agency costs.

26. Rather than adopting the famous Adolph Berle and Gardiner Means phrase "separation of ownership and control," our piece uses "cash flow" instead of "ownership," as we disregard the formal rights and focus on the actual rights. *See* ADOLPH A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1933).

27. With the controller owning a majority of the voting rights, control is uncontestable because a hostile takeover is impossible.

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Finally, in Part IV, we outline the corporate-law implications of our framework. The existing corporate-law literature focuses solely on protecting minority shareholders from agency costs.[28] Our new theory of corporate control, however, requires lawmakers and courts to balance minority protection against controllers' rights to secure their idiosyncratic vision. This tension between minority protection and controller rights underlies our blueprint of the policy considerations that should guide lawmakers crafting the legal regimes that govern firms with controlling shareholders.

As we demonstrate, a one-sided theory of corporate control, focusing only on minimizing agency costs, is blind to the cost of minority-protection regimes. Our theory, by contrast, uncovers the hidden cost of regulation—that is, interference with the entrepreneur's freedom to pursue her idiosyncratic vision—and presents the legal challenge of balancing these goals. We show that one-sided theories inexorably lead to self-defeating suggestions of increasing minority protection while neglecting the essence of the concentrated-ownership contract. We also demonstrate that the recognition of controllers' rights may justify legal outcomes that are contrary to the traditional notions of shareholder-value maximization. Specifically, we (1) offer a new rationale for applying the business-judgment rule to firms with controlling shareholders, (2) call for caution in adopting governance reforms aimed at enhancing director independence, and (3) argue for close scrutiny of controlling shareholders' attempts to unbundle the link between control and cash-flow rights.

I. EXISTING EXPLANATIONS AND THEIR LIMITS

The prevailing explanations of concentrated ownership focus primarily on the availability of private benefits of control.[29] As we explain in this Part, however, these accounts cannot explain the prevalence of concentrated

28. The conventional view is that one of corporate law's principal goals is regulating agency costs. *See* John Armour et al., *What Is Corporate Law?*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 1, 2 (Reinier Kraakman et al. eds., 2d ed. 2009) ("[M]uch of corporate law can usefully be understood as responding to three principal sources of opportunism: conflicts between managers and shareholders, conflicts among shareholders, and conflicts between shareholders and the corporation's other constituencies . . . ."). As we will show, corporate law should aim to balance idiosyncratic vision and agency costs.

29. *See* Luigi Zingales, *Insider Ownership and the Decision To Go Public*, 62 REV. ECON. STUD. 425 (1995); Lucian Arye Bebchuk, *A Rent-Protection Theory of Corporate Ownership and Control* (Nat'l Bureau of Econ. Research, Working Paper No. 7203, 1999), http://ssrn.com/abstract=168990 [http://perma.cc/T29K-XR2E].

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ownership around the world and fail to offer a coherent theory of corporate law for firms with controlling shareholders.

A. The Minority-Expropriation View

According to conventional wisdom, the controlling shareholder seeks a controlling interest in the corporation to exploit her dominant position and consume private benefits at the expense of minority shareholders.[30] She can pursue pecuniary benefits by entering into self-dealing transactions,[31] engaging in tunneling,[32] or employing family members. She can also pursue nonpecuniary benefits by boosting her ego and her social or political status through her influence on corporate decisions.[33] In short, it's good to be the king (or the queen).

With private benefits commonly perceived as a precondition *motivating* concentrated ownership, it is unsurprising that this ownership structure is often frowned upon.[34] Empirical studies have confirmed that concentrated ownership is more widespread in countries that provide minority shareholders with weak legal protection.[35] Control premiums—the difference between the price for shares in a control block and the market price of the minority shares—in countries with weak minority protection are also higher than in countries

30. *See* Bebchuk, *supra* note 29, at 8.

31. *See* Simeon Djankov et al., *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430 (2008). The analysis of the relative efficiency of rules regulating self-dealing was developed several years earlier. *See* Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality,* 91 CALIF. L. REV. 393 (2003) (introducing and applying a property rule-liability rule analysis to minority shareholders' protection).

32. The term tunneling refers to transactions, especially within a business group or a pyramidal ownership structure, on terms aimed at favoring the controlling shareholder. *See, e.g.*, Vladimir Atanasov et al., *Law and Tunneling,* 37 J. CORP. L. 1 (2011); Simon Johnson et al., *Tunneling,* 90 AM. ECON. REV. (PAPERS & PROC.) 22 (2000).

33. *See, e.g.*, Harold Demsetz & Kenneth Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 J. POL. ECON. 1155, 1161-62 (1985).

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

35. *See, e.g.*, Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1145-51 (1998) (finding that concentrated ownership is prevalent worldwide and attributing this ownership structure to weak legal regimes and underdeveloped markets).

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with strong minority protection.[36] Concentrated ownership appears to thrive where weak legal protections allow a controlling owner to line her own pockets by taking advantage of minority shareholders.

The premise underlying the standard account of concentrated-ownership states that holding a control block is costly because it involves management monitoring, loss of liquidity, and reduced diversification.[37] At the same time, the controlling position allows controllers to enjoy private benefits of control. It thus follows, according to the conventional view, that the more the controller can exploit the minority, the greater her interest in holding the block. The explanation concludes that low-quality investor protection encourages entrepreneurs to hold a controlling stake.

There are two problems with this explanation. First, it assumes that most controllers around the world are opportunists who take advantage of imperfect markets and weak protections for minority shareholders. Second, it cannot explain the significant presence of concentrated ownership in the United States and other countries with strong investor-protection laws.[38] Nor can it explain the practice of retaining control blocks in a portfolio of firms by holding companies such as Berkshire Hathaway or by private-equity funds.[39]

Our analysis, by contrast, identifies reasons other than private benefits that motivate entrepreneurs to hold a controlling position and explains why concentrated ownership exists even in countries with strong investor-protection laws. In our framework, entrepreneurs value control even when they

36. *See* Alexander Dyck & Louigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537, 590 (2004) (finding that better legal protection of minority shareholders is associated with lower private benefits of control). The premise underlying this study is that a control premium reflects the current value of all future private benefits. *See also* Tatiana Nenova, *The Value of Corporate Voting Rights and Control: A Cross-Country Analysis*, 68 J. FIN. ECON. 325, 344-45 (2003) (finding a negative correlation between a country's quality of investor protection and the value of control-block votes).

37. See Ronald J. Gilson & Jeffery N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785 (2003); Ronald J. Gilson & Alan Schwartz, *Constraints on Private Benefits of Control: Ex Ante Control Mechanisms Versus Ex Post Transaction Review*, 169 J. INSTITUTIONAL & THEORETICAL ECON. 160 (2013).

38. *See* MARK J. ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE: POLITICAL CONTEXT, CORPORATE IMPACT 5 (2003) (noting that controlling shareholders exist also in jurisdictions with good law); Gilson, *supra* note 10, at 1644 (same).

39. Private-equity funds normally buy all the shares of the corporations in their portfolios, but sometimes they buy a control position. When funds buy a control position they pay a control premium. Rather than engaging in self-dealing, the fund focuses on implementing its reorganization plan, increasing the value of the firm, and selling it for a profit before the term of the fund ends. Such behavior cannot be explained by the incentive to consume the private benefits of control. *See* Steve N. Kaplan & Per Stromberg, *Leveraged Buyouts and Private Equity*, 22 J. ECON. PERSP. 1, 5 (2008).

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genuinely intend to share all of the firm's cash flows and assets on a pro rata basis with minority shareholders.

B. The Optimal-Reward View

An alternative, less cynical view explains concentrated ownership by focusing on the value of monitoring. Instead of relying on imperfect markets to monitor management, investors rely on the controller to fulfill this role. Controllers play a constructive governance role because their substantial equity investment encourages them to monitor management more effectively than imperfect markets.[40] However, because holding a control block imposes costs (i.e., illiquidity, reduced diversification, and monitoring), an entrepreneur would not agree to hold a control block without the prospect of securing a disproportionate share of cash flows—or equally valuable nonpecuniary benefits.[41] Minority investors therefore should allow the controller to consume some degree of private benefits in exchange for her valuable monitoring service.[42] Under this view, corporate law should tolerate the optimal level of private-benefit consumption by controlling shareholders. Put differently, this

40. *See* Gilson, *supra* note 10, at 1651 ("[A] controlling shareholder may police the management of public corporations better than the standard panoply of market-oriented techniques employed when shareholdings are widely held.").

41. Ronald Gilson argues that nonpecuniary benefits of control can explain the prevalence of concentrated ownership even in countries with strong investor protection. As he explains, these benefits need not come at the expense of the minority shareholders. *See* Gilson, *supra* note 10, at 1663-64 (defining nonpecuniary private benefits of control as "forms of psychic and other benefits that, without more, involve no transfer of real company resources and do not disproportionately dilute the value of the company's stock to a diversified investor"). For a formal modeling of such unharmful nonpecuniary private benefits, see Pacces, *Control Matters*, *supra* note 16.

42. *See* Gilson & Gordon, *supra* note 37, at 785 ("Because there are costs associated with holding a concentrated position and with exercising the monitoring function, some private benefits of control may be necessary to induce a party to play that role."); Gilson & Schwartz, *supra* note 37, at 164 (promoting a regime where controlling shareholders can bargain with the minority for consuming optimal private benefits of control); Maria Gutierrez & Maria Isabel Saez, *A Contractual Approach To Discipline Self-Dealing by Controlling Shareholders* 5 (European Corp. Governance Inst., Law Working Paper No. 138/2010, 2010) http://ssrn.com/abstract=2440663 [http://perma.cc/CV42-Z8E9] ("A blockholder will only exert control if the sum of public and private benefits that he gets from doing so outweigh the private costs of control that he must incur in order to monitor management."); *see also* Albert H. Choi, *Public Benefits of Private Control: Controlling Shareholder's Long-Term Commitment* 5 (Va. Law & Econ., Research Paper No. 19, 2015), http://ssrn.com/abstract=2619462 [http://perma.cc/837W-3YHP] (arguing that "[t]he larger the private benefits of control, the more likely that the controlling shareholder will stay with the firm and care about the firm's long-term performance").

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approach perceives (optimal) private benefits as an appropriate *reward* for the costs of holding a control block, including the cost of monitoring management.

Monitoring indeed plays an important function in assuring efficient management and corporate law assigns the role of monitoring to the board of directors.[43] But why does monitoring require one to own a controlling block?

One possible answer is that the controller's substantial equity stake aligns her interests with those of the minority shareholders, thereby providing superior incentives to monitor.[44] But why rely on a controlling shareholder to monitor management rather than increase directors' incentives to monitor effectively by improving their compensation?[45] The answer could be that designing a compensation package replicating the incentives produced by a substantial equity block is too difficult or prohibitively costly.[46] This could be the case, for example, in countries where financial markets or legal institutions are underdeveloped. This answer, however, fails to explain the variance of ownership structures *within* the countries. In other words, why can investors rely on market mechanisms to provide adequate monitoring at some companies, but not others?

Moreover, the claim that corporate law should tolerate the controllers' optimal consumptions of private benefits is questionable even if controlling shareholders do provide effective monitoring that cannot be achieved through a compensation package.[47] This claim is based on the assumption that the duty

43. *See* Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1468 (2007) (noting that "directors are supposed to 'monitor' the managers in view of shareholder interests").

44. Monitoring is just a means to achieve the ultimate goal of efficient management. Why not simply improve management's own compensation package to incentivize it to manage efficiently? *See generally* Michael C. Jensen & Kevin J. Murphy, *CEO Incentives: It's Not How Much You Pay, but How*, 3 HARV. BUS. REV. 138 (1990) (viewing incentive compensation as a device to reduce agency costs).

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

46. Oliver Hart rejected a similar answer regarding the need for equity ownership to incentivize managers. *See* Oliver Hart, *Financial Contracting*, 39 J. ECON. LITERATURE 1079, 1082 (2001) ("[W]hy use financial structure rather than an incentive scheme to solve what is really just a standard agency problem?").

47. One such difficulty is that the control block exposes the controller both to upside and downside risk. However, finance theory suggests that diversified shareholders would prefer that risk-averse managers be provided with a share of the upside without the downside, so as not to increase the risk aversion of a manager who likely has a nondiversified financial

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of loyalty prevents the parties from rewarding controllers for their monitoring effort.[48] However, if the investors value the controller's monitoring, minority shareholders can contract with her for compensation *without* the controller resorting to stealth consumption of private benefits.[49]

Under our framework, entrepreneurs value control because it allows them to pursue their idiosyncratic vision, thereby possibly producing above-market returns. Since controllers do not rely on private benefits to reward them for monitoring management and other costs of holding a control block, investors need not provide controllers with some degree of private benefits. Thus, our framework is more consistent with corporate-law doctrine, which does not tolerate controllers' consumption of private benefits.

Having delineated two prevailing views on the incentives of controlling shareholders, we next present our competing explanation in which controlling shareholders value control because it allows them to pursue their idiosyncratic visions.

and human capital investment in the firm. Another presumed reason for the superiority of controlling shareholders refers to the ease by which a controlling shareholder can fire management, while removing the board of a widely held corporation is much more difficult. This description may be accurate. *Cf.* Assaf Hamdani & Ehud Kamar, *Hidden Government Influence over Privatized Banks*, 13 THEORETICAL INQUIRIES L. 567, 581-83 (2012) (explaining why displacing senior executives may be easier for controlling shareholders than for boards). Yet, a properly incentivized board could quite easily fire the CEO. True, replacing a board that fails to monitor management may be difficult, but not as difficult as replacing an incompetent controlling shareholder.

48. Indeed, the proposal is to make the duty of loyalty a default rule. *See* Gilson & Schwartz, *supra* note 37, at 170-72.

49. The controller can sign, for example, a performance-based consulting agreement while getting approval by either a committee of independent directors or by a majority of the minority shareholders. *See* Ben Amoako-Adu et al., *Executive Compensation in Firms with Concentrated Control: The Impact of Dual Class Structure and Family Management*, 17 J. CORP. FIN. 1580, 1580 (2011) (finding that executive compensation contracts in controlled corporations are consistent with the optimal contract theory of executive compensation); *see also* Assaf Hamdani & Yishay Yafeh, *Institutional Investors as Minority Shareholders*, 17 REV. FIN. 691, 704-05 (2013) (finding evidence that institutional investors play an active role in monitoring executive pay arrangements for controlling shareholders in Israel). Just as an illustration, the S-1 of ThermaWave corporation, a company that Bain Capital recapitalized in the 1990s, describes an "Advisory Agreement" that paid Bain for its monitoring. Therma-Wave, Inc., Pre-Effective Amendment No. 1 (Form S-1) (May 19, 1999), http://www.sec.gov/Archives/edgar/data/828119/0000929624-99-000994.txt [http://perma.cc/DMN4-47G4]. Moreover, at the IPO stage, the controller can agree with investors that she will keep an extra amount of shares as upfront compensation for monitoring. Assume that the value of the firm is $100 and that she is selling fifty percent for fifty dollars. If minority shareholders value her monitoring services, say, at two percent, they might agree to invest fifty dollars and receive just forty-eight percent of the shares.

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II. A THEORY OF CORPORATE CONTROL

Like the conventional explanations, we begin with the premise that holding a control block—the number of shares required to provide the controller with an effective majority of the votes—is costly. In our framework, however, controllers are willing to incur these costs because they expect the firm to produce an above-market rate of return. Despite this expectation, controllers cannot own the whole firm because they are wealth constrained and must raise funds from investors. The controller intends to share with investors on a pro rata basis the pecuniary benefits of her vision. But why would entrepreneurs insist on holding control and thus incurring costs if they genuinely intend to capture only their pro rata share of the firm's cash flows?

The answer, we argue, relates to the fact that differences of opinion threaten to prevent the entrepreneur from pursuing her idiosyncratic vision. In our framework, both investors and entrepreneurs would like to maximize the firm's expected return. Each party, however, may hold different beliefs concerning the best way to achieve this goal. Thus, control matters for an entrepreneur because it allows her to ensure that the firm will pursue *her* idiosyncratic vision even against the investors' objections.

We do not argue that control offers no private benefits—pecuniary or nonpecuniary. Nor do we rule out the possibility that—especially in countries with weak protection of investor rights—private benefits will motivate some controllers to hold a control block. Rather, our analysis shows that controllers-entrepreneurs may value control even if they have no intention to consume private benefits. Put differently, one novelty of our framework is that it offers a theory that can explain why even investors who genuinely intend to consume no private benefits may nevertheless insist on retaining control.

The prevailing theories of concentrated ownership are an outgrowth of the financial-contracting literature, which assumes that entrepreneurs value control because it enables them to enjoy *private benefits*.[50] Our analysis, however, is part of a growing body of literature that studies the implications of *differences of opinion* between entrepreneurs and investors.[51] Specifically, we

50. *See, e.g.*, Philippe Aghion & Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59 REV. ECON. STUD. 473, 473-74, 476 (1992).

51. For an analysis of the link between control and differences of opinion, see generally Eric Van den Steen, *Disagreement and the Allocation of Control*, 26 J.L. ECON. & ORG. 385 (2010). For recent examples of economic studies focusing on the implications of differences of opinion for firms' capital structures, see Sheng Huang & Anjan V. Thakor, *Investor Heterogeneity, Investor-Management Disagreement and Share Repurchases*, 26 REV. FIN. STUD. 2453 (2013); and Hae Won (Henny) Jung & Ajay Subramanian, *Capital Structure Under Heterogeneous Beliefs*, 18 REV. FIN. 1617 (2014).

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argue that a fundamental tradeoff between entrepreneurs' pursuit of their idiosyncratic vision and investors' desire for protection from agency costs underlies many corporate-ownership structures.

In Section II.A, we discuss the value of control for both entrepreneurs and investors under conditions of asymmetric information, differences of opinion, and agency costs. In Section II.B, we discuss the role of cash-flow rights.

A. Idiosyncratic Vision, Agency Costs, and Control

1. The Entrepreneur's Idiosyncratic Vision

Our analysis of the value of control starts with an entrepreneur who has a business idea. This idea can be an invention of a new product, but it does not have to be an invention or a discovery. It can be an innovative method of marketing an existing product, capitalizing on a new market niche, motivating employees, creating an optimal capital structure, or utilizing new sources of capital.[52] The entrepreneur might, of course, eventually be proven wrong about her idea. What matters for our analysis, however, is that the entrepreneur genuinely believes that successful implementation of the idea will produce an above-market rate of return on the total resources invested in the business (i.e., money, time, and effort).[53] Think of an entrepreneur opening a shoe store on a street where ten other shoe stores already exist because she believes she can do better than the competitors.

We refer to the entrepreneur's belief that a proper implementation of her strategy will produce above-market returns as her *idiosyncratic vision*.[54] The

52. *See* Rajan, *supra* note 24 and accompanying text. Raghuram Rajan refers to this value as the "entrepreneur's idea." *Id.* at 1179; *see also* JOSEPH A. SCHUMPETER, THE THEORY OF ECONOMIC DEVELOPMENT 95-127 (Redvers Opie trans., Harvard Univ. Press 1934) (1911) (explaining the entrepreneur's innovative role).

53. Financial economists call it a positive NPV project or positive alpha. *See* WILLIAM J. CARNEY, CORPORATE FINANCE: PRINCIPLES AND PRACTICE 84-87 (1st ed. 2005) (explaining NPV). Our story will hold true even if the entrepreneur believes the project has a zero NPV (i.e., will provide a normal market rate of return) as long as the normal rate of return takes account of all the resources invested in the project. However, we believe that the entrepreneur's pursuit of an above-market rate of return is a more accurate description of reality. Nonetheless, some studies have found empirical support for a positive NPV performance. *See* sources cited *infra* note 106.

54. We called this component of the idea the "idiosyncratic vision," but one could also call it the entrepreneurial vision or idea, the business plan, the subjective value, or the hidden value. *See, e.g.*, Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U. L. REV. 521, 521-22 (2002) (expressing the concept as "hidden value" to describe Delaware's deference to the incumbent board in hostile takeover cases). In other words, we assume that the project is not a fully standardized one. *See* Rajan, *supra*

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entrepreneur's idiosyncratic vision can relate to the business idea itself or the entrepreneur's belief in her unique ability to execute it.[55]

For expositional convenience, our analysis in this Part focuses on a simplified setting of an entrepreneur with a business idea. Our notion of idiosyncratic vision, however, is not limited to individuals who open a new business. Even investment funds or managers of well-established publicly traded companies may have idiosyncratic vision. Consider, for example, a private-equity fund that buys control of an industrial conglomerate with famous brands but poor financial results and intends to increase profits by implementing its own management methods.[56] Or the manager of a large, mature publicly traded corporation who genuinely believes that her business strategy will outperform the competition.[57]

If the entrepreneur has sufficient wealth, she can fund the entire business by herself, including the research required for development and the costs of implementation and marketing. As the sole owner, the entrepreneur holds all rights to the income from the business (cash-flow rights). She will assume all the risks and capture all the returns associated with the business. The entrepreneur will also make all the decisions, minor and major, associated with the business's execution. She can pursue her idea for as long as she wants and

note 24, at 1193 ("Standardization . . . reduces the idiosyncratic and personalized aspects of the entrepreneur's role, allowing her job to resemble that of a typical CEO, and making it easier for an employee or outsider to replace her as CEO.").

55. For the normative prescriptions that we present in the last Part, we do not need to know which entrepreneur has idiosyncratic vision that will produce above-market returns. Nor do we need to know the expected success rate for entrepreneurs having idiosyncratic vision. To justify the law's need to balance between facilitating the pursuit of idiosyncratic vision and curtailing the pursuit of private benefits, all we need to accept is that many entrepreneurs in many industries are motivated by the pursuit of idiosyncratic vision and some of them will be successful. Moreover, as we explain below, investors' skepticism over entrepreneurs' ability to implement their vision or willingness to work "hard" may partially explain their willingness to allow entrepreneurs to exercise control only as long as they own a majority of cash-flow rights.

56. The main strategy of private-equity funds is to buy complete ownership (or control) of existing firms and then improve their performance. *See, e.g.*, Joachim Heel & Conor Kehoe, *Why Some Private Equity Firms Do Better than Others*, MCKINSEY Q. (Feb. 2015), http://www.mckinsey.com/insights/corporate_finance/why_some_private_equity_firms_do_better_than_others [http://perma.cc/ZPJ8-6FJ9] ("The main source of value in nearly two-thirds of the deals in our sample was company outperformance.").

57. Idiosyncratic vision can be found in every type of industry, both in creating a firm and in preserving its success over the years. *See, e.g.*, *World's Most Admired Companies 2015*, FORTUNE, http://fortune.com/worlds-most-admired-companies [http://perma.cc/6TRE-LS8E]; Kristina Zucchi, *The Most Successful Corporations in the U.S.*, INVESTOPEDIA (July 9, 2015), http://www.investopedia.com/articles/investing/070915/most-successful-corporations-us.asp [http://perma.cc/HBG9-DZ94].

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in whatever manner she prefers, even if the business is losing money and every expert in the field believes that she is pursuing a surefire failure of an idea. No matter how much money she loses, no one can force her to sell the business, hire a professional manager, or close the business down. If in the end she fails, she might be called "stupid" or "smart but ahead of her time." If she succeeds, she might be called "a visionary" or "a genius."[58]

2. *Outside Investors and the Value of Control*

Assume, however, that the entrepreneur is short on funds and must rely on investors to provide funding. The parties must then decide on the allocation of control—will the entrepreneur or investors make decisions concerning the business? In our framework, the entrepreneur and investors share the objective of maximizing the firm's expected return. At first sight, this common objective should make the parties indifferent to the allocation of control. As we explain below, however, problems of asymmetric information, differences of opinion, and agency costs make control valuable for both the entrepreneur and the outside investors.

The entrepreneur's idiosyncratic vision will often include elements that outsiders, including the firm's minority shareholders, cannot observe or verify. This could be because sharing the information with outsiders would destroy its value (e.g., competitors could copy the idea) or simply because the entrepreneur can present outsiders with nothing more than her strong conviction concerning the value of her idea. The uncertainty regarding the feasibility of the idea and differences of opinion are also possible reasons. An entrepreneur's idiosyncratic vision can be shaped by her experience, management talent, knowledge, character, or intuition, all variables that are difficult to quantify.[59] In our framework, the entrepreneur's idiosyncratic vision thus becomes a source of asymmetric information and differences of opinion that cannot be overcome by increased monitoring, investigation, or disclosure.[60]

58. Indeed, the failures and successes of Ford, Steve Jobs, and other entrepreneurs over the course of their careers provide real illustrations of our point.

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

60. In other words, if there is an auction over the business idea and all facts are equally known to all participants, the entrepreneur will bid more than outside investors due to her idiosyncratic vision.

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Asymmetric information and differences of opinion can arise ex ante when the entrepreneur tries to persuade investors to make the initial investment. Assume that the entrepreneur presents her business idea to potential investors, and they consult with experts who all opine that the idea is impossible. Even if our entrepreneur is successful in convincing investors to make the initial investment, informational asymmetry and differences of opinion may inhibit her ability to implement her business idea.

Business ideas take time to implement. This ongoing process requires many decisions, ranging from day-to-day management issues to major strategic choices. Assume that the entrepreneur convinces investors to make the initial investment, but then fails to deliver the product on time or at the quality initially promised. Persuading investors to continue the business at this stage might prove more difficult than convincing them to make the initial investment because the setback may cause investors to doubt either the entrepreneur's ability to execute the business idea or her vision for the business.[61] Asymmetric information and differences of opinion may lead investors to discontinue the business even when the entrepreneur genuinely believes that, notwithstanding the initial setback, the business will surely produce above-market returns. This is essentially what we believe occurred when investors shut down Ford's first company.

Another famous example is Jobs's failure, in 1985, to convince Apple's board to pursue his proposed strategy for increasing the sales of the Macintosh Office, the suite of second-generation office software. The board sided with the company's CEO, and Jobs, one of Apple's founders, had to leave the Macintosh division and then the company.[62]

The risk of investors disrupting the entrepreneur's pursuit of her idiosyncratic vision exists even when the firm is publicly traded and investors are using stock prices as a proxy for the firm's performance. Markets do not necessarily overcome differences of opinion and asymmetric information. Moreover, markets might be myopic, preferring short-term over long-term

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

62. *See* WALTER ISAACSON, STEVE JOBS 186-206 (2011); Randal Lane, *John Sculley Just Gave His Most Detailed Account Ever of How Steve Jobs Got Fired from Apple*, FORBES (Sept. 9, 2013), http://www.forbes.com/sites/randalllane/2013/09/09/john-sculley-just-gave-his-most-detailed-account-ever-of-how-steve-jobs-got-fired-from-apple [http://perma.cc/T6SD-M9EU].

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investments, either because investors have different investment horizons or because it is too costly to correct inefficient pricing.[63]

Information asymmetry and differences of opinion are further exacerbated by the well-known phenomenon of agency costs, which arises whenever principals hire an agent to act on their behalf.[64] In our context, agency costs are commonly divided into two types.[65] Controllers can engage in *mismanagement*,

63. To be sure, as the debate over hedge fund activism illustrates, the myopic market claim is controversial. *See, e.g.*, Lucian A. Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism*, 114 COLUM. L. REV. 1085 (2015); Robin Greenwood & Michael Schor, *Investor Activism and Takeovers*, 92 J. FIN. ECON. 362 (2009); April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN. 187 (2009); Mark J. Roe, *Corporate Short-Termism—in the Boardroom and in the Courtroom*, 68 BUS. LAW. 977, 1005 (2013). Yet, theoretical models show that market myopia is possible and empirical studies provide support. *See* Adam Brandenburger & Ben Polak, *When Managers Cover Their Posteriors: Making the Decisions the Market Wants To See*, 27 RAND J. ECON. 523, 526-27 (1996) (explaining myopia as a function of information asymmetries between managers and shareholders); Brian J. Bushee, *Do Institutional Investors Prefer Near-Term Earnings over Long-Run Value?*, 18 CONTEMP. ACCT. RES. 207 (2001) (finding that high levels of transient ownership are associated with an overweighting of near-term expected earnings); Brian J. Bushee, *The Influence of Institutional Investors on Myopic Investment Behavior*, 73 ACCT. REV. 305 (1998) (arguing that a high level of institutional ownership by institutions exhibiting high portfolio turnover, diversification, and momentum trading significantly increases managerial incentives to pursue short-term projects); Simon Grant et al., *Information Externalities, Share-Price Based Incentives and Managerial Behavior*, 10 J. ECON. SURV. 1 (1996) (examining information asymmetries in incentive schemes that lead to inefficient managerial behavior); Natalie Mizik, *The Theory and Practice of Myopic Management*, 47 J. MARKETING RES. 594, 596 (2010) (describing how myopic outcomes can occur as a result of signaling, the lemons problem, or information neglect); Andrei Shleifer & Robert W. Vishny, *Equilibrium Short Horizons of Investors and Firms*, 80 AM. ECON. REV. 148 (1990) (explaining that it is less risky and less costly for asset managers to arbitrage a short-term asset for which mispricing will disappear in the short term than a long-term asset where there is more time for bad news or a wave of pessimism to hit); Jeffrey C. Stein, *Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior*, 104 Q.J. ECON. 655, 655-56 (1989) (proposing a game-theory model according to which, if markets infer positive values from certain observable managerial signals and manipulation of those signals is not easily detected, managers have an incentive to manipulate these signals to enhance stock prices); Tomislav Ladika & Zacharias Sautner, Managerial Short-Termism and Investment: Evidence from Accelerated Option Vesting (Nov. 4, 2015) (unpublished manuscript), http://ssrn.com/abstract=2286789 [http://perma.cc/XK5J-VNLC] (finding that management with shortened timeframes for performance-based compensation resulted in less real investment by corporations).

64. *See* Jensen & Meckling, *supra* note 17, at 308-10 (developing a formal analysis of agency costs).

65. *See* Zohar Goshen, *Controlling Corporate Agency Costs: A United States-Israeli Comparative View*, 6 CARDOZO J. INT'L & COMP. L. 99, 117 (1998) (distinguishing between the two types of agency problems); *see also* Bernard S. Black, *The Legal and Institutional Preconditions for*

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including reduced commitment, shirking, pursuit of acquisitions just to increase firm size or achieve diversification without creating shareholder value,[66] and investment of resources in entrenchment.[67] Controllers can also engage in *takings*, directly diverting pecuniary private benefits to themselves by, for example, consuming excessive pay and perks[68] or conducting favorable related-party transactions.[69] In the typical case of a widely held public company, mismanagement dominates takings and the problem is labeled "management agency costs," while in the typical controlling shareholder case, takings dominate mismanagement and the problem is labeled "control agency costs."[70]

Agency costs have two potential effects on investors. First, the risk of agency costs could make investors less willing to trust the entrepreneur's ongoing judgment about the business's fate. Assume the entrepreneur informs investors about a delay in the business's execution and asks for more time and money. Is the delay due only to temporary obstacles, with success still attainable? Or is the entrepreneur, who already knows that the business is doomed, attempting to exploit investors?[71] Second, the existence of agency costs may heighten the value investors place on control, because this provides a

Strong Securities Markets, 48 UCLA L. REV. 781, 842 (2001) (distinguishing between shirking and more illicit types of wrongdoing).

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

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

68. *See* Lucian Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002) (discussing the high level and composition of executive compensation as manifestations of the agency problem); Jensen & Meckling, *supra* note 17, at 312.

69. *See* Atanasov et al., *supra* note 32.

70. *See* Bebchuk & Hamdani, *supra* note 34, at 1283-85 (discussing the differences between the nature of agency costs at controlled and widely held firms); Luca Enriques & Paolo Volpin, *Corporate Governance Reforms in Continental Europe*, 21 J. ECON. PERSP. 117, 119-22 (2007) (same).

71. *See* OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING 47 (1985) (explaining that actors without full information are subject to counterparty "opportunism," which "refers to the incomplete or distorted disclosure of information, especially to calculated efforts to mislead, distort, disguise, obfuscate, or otherwise confuse"). In fact, agency costs arise whenever asymmetric information is coupled with conflicting or misaligned interests. *See* Jensen & Meckling, *supra* note 17, at 309-10 (explaining that agency costs arise whenever an agent is utilized).

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means to mitigate agency costs, such as by firing the entrepreneur or closing down the business.

The inevitable tension between idiosyncratic vision and asymmetric information, differences of opinion, and agency costs makes one thing clear: control matters for both investors and entrepreneurs. Since contracts between entrepreneurs and investors are incomplete,[72] the party with control over decision making will have more power in determining the business's fate.[73] On the one hand, control empowers the entrepreneur to make the decisions that she believes are necessary for the firm to produce above-market returns, even against investors' objections. On the other hand, while they expect to enjoy their pro rata shares if the entrepreneur is successful, investors know that granting control to the entrepreneur creates a risk of agency costs.

These conflicting interests make contracting between entrepreneurs and investors challenging. It is impossible to provide investors with *full protection* from agency costs and the entrepreneur with *unlimited freedom* to pursue idiosyncratic vision; therefore, the parties must agree on an acceptable compromise between these two goals.

B. Control and Cash-Flow Rights

We have thus far explained why control matters for both entrepreneurs and investors. We now explain the interplay between control and cash-flow rights in allowing entrepreneurs to pursue their idiosyncratic vision while protecting investors against agency costs.[74]

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72. In theory, the entrepreneur and investors could contract in advance regarding the decisions to be made under various circumstances. The contract might deal with questions such as: for how long can the execution continue? How many losses or expenses are acceptable? What level of performance should be considered a failure or a success? In practice, however, they will face two problems. First, not all contingencies can be anticipated in advance and specified in the contract. Second, the information required for the determination that a contingency has occurred and for making an appropriate decision could be nonverifiable. *See, e.g.*, Aghion & Bolton, *supra* note 50, at 473 (recognizing that "financial contracts are inherently incomplete").

73. *See* Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691, 695 (1986). The importance of control rights is clearly displayed in venture-capital financing. *See generally* William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 473 (1990) (analyzing the relationship between investors and venture capitalists).

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

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1. *The Role of Cash-Flow Rights*

The execution of the business idea will generate income that, after paying all fixed claims (e.g., to suppliers and employees), represents the return on the business idea and the parties' investments. The parties should allocate these cash flows between the entrepreneur and the investors.[75] This allocation of cash flows is traditionally understood to determine the parties' risk and expected return.[76]

Our framework, however, suggests that the allocation of cash flows can play two additional roles. First, the entrepreneur's cash-flow rights shape her incentives, thereby affecting agency costs. Stock options (a form of residual cash-flow rights), for example, can reduce agency costs by aligning the entrepreneur's interests with those of the investors. Second, the allocation of cash-flow rights can determine the boundaries of the entrepreneur's control. For instance, if all of the investment is made at the start of the business, the entrepreneur will have more autonomy than if the investment is made in several stages according to milestones.[77] Similarly, an investment based on a commitment to unconditionally pay fixed amounts on predetermined dates (i.e., debt) will provide the entrepreneur with more discretion than an investment with a commitment to pay residual cash flows on a discretionary basis but subject to termination at will (i.e., equity).

2. *Control and Cash-Flow Rights as Substitutes*

Control rights and cash-flow rights sometimes serve as substitutes for each other when balancing idiosyncratic vision and agency costs. Control and cash-

show next, ownership structures are, to a large degree, different contractual templates, which a simple contracting model can sufficiently explain.

75. *See, e.g.*, Jesse Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 971 (2006) ("[E]nhanced cash flow and control rights may reduce the moral hazard problems associated with financing entrepreneurs . . . [and the] use of preferred stock may provide founders with stronger incentives to generate value, and board control may enable [investors] to more easily monitor and replace poorly performing entrepreneur-managers.").

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

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

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flow rights may thus serve as building blocks that can be used in different combinations to balance idiosyncratic vision and agency costs.[78]

In some cases, cash-flow rights can provide their holders with de facto control. For instance, consider a case where the entrepreneur has full control over managerial decisions, but investors commit to make their investments in stages. In this case, investors' cash-flow rights—in the form of staged financing—provide them with de facto control over an important subset of management decisions, namely, the decision whether to continue the business. In other cases, cash-flow rights can compensate for the loss of control. For example, assume that investors can design a compensation package that provides the entrepreneur with the same (above-market) expected return that she would receive from implementing her idiosyncratic vision.[79] In this case, the entrepreneur might agree to assign control rights to investors.[80]

3. Bargaining Power and Competition

We have thus far shown that investors and entrepreneurs can adopt different combinations of cash-flow and control rights to balance entrepreneurs' interest in pursuing their idiosyncratic vision and investors'

78. Control rights can be divided along many dimensions to achieve a desirable balance between the entrepreneur and investors. For example, control can be divided by the parties' identities (e.g., granting complete control either to the entrepreneur or to the investors; splitting the control between the parties; or granting rights of consultation, monitoring, or veto), a decision's type or importance (e.g., one party retaining decisions over operations and the other retaining control over financing, or one party retaining control over day-to-day management and the other over strategic decisions), governance structures (e.g., the right to appoint directors and the CEO), or contingencies. These building blocks of control represent a spectrum of rights that take a precise shape according to the parties' contract.

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

79. An important assumption underlying our framework is that neither entrepreneurs nor investors value control for intrinsic reasons, because they derive some nonpecuniary benefits simply by virtue of exercising control. Rather, the premise underlying our analysis is that investors and entrepreneurs value control because of its impact on the return on their investment.

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

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desire for protection from agency costs. The specific combination that the parties adopt will reflect the outcome of the negotiations between investors and entrepreneurs. This outcome depends on each party's relative bargaining power. The same business could thus result in different allocations of control and cash-flow rights. When capital is generally scarce (e.g., when interest rates are high) or when capital for a specific area of business is scarce (e.g., a shortage of venture capital funding), investors can attain a better deal.[81] By contrast, when capital is chasing business ideas, or when the entrepreneur has a particularly appealing idea or track record, she can bargain for more favorable terms.[82] Furthermore, agency costs and idiosyncratic vision are not necessarily valued symmetrically. Thus, the entrepreneur might proportionally value control rights much more than the increase in price that the investors will demand due to their increased exposure to agency costs.[83] In other words, competition and relative bargaining power can result not just in different pricing, but also in variations in a contract's quality of terms (from the investors' or the entrepreneur's perspective) for the same basic deal.

III. CONCENTRATED OWNERSHIP REVISITED

Our analysis thus far can be summarized as follows: first, while investors value control because it offers them protection from agency costs, entrepreneurs value control because it allows them to pursue their idiosyncratic vision. Second, any contract between entrepreneurs and investors must balance the entrepreneurs' freedom to secure their idiosyncratic vision and the investors' protection against agency costs. Third, the investors and

81. *See* Albert Choi & George Triantis, *The Effect of Bargaining Power on Contract Design*, 98 VA. L. REV. 1665 (2012) (developing an analytical framework to assess the impact of bargaining power on nonprice contract terms); Albert Choi & George Triantis, *Market Conditions and Contract Design: Variations in Debt Collateral Contracting*, 88 N.Y.U. L. REV. 51 (2013); Blake D. Morant, *The Quest for Bargains in an Age of Contractual Formalism: Strategic Initiatives for Small Businesses*, 7 J. SMALL & EMERGING BUS. L. 233, 237 (2003) (explaining how the inequality of bargaining power of small business results in reduced contract protections).

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

83. For example, while entrepreneurs may be undiversified given their human capital investment, investors hold a diversified portfolio. Thus, the value that entrepreneurs attach to their ability to pursue idiosyncratic vision may be higher than the value that investors attach to the agency cost associated with leaving the entrepreneur with control.

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entrepreneurs will allocate cash-flow and control rights to achieve this balance.[84]

Our theory of corporate control offers two novel insights. First, corporate ownership structures can be recast as different combinations of cash-flow and control rights. Second, each combination of cash-flow and control rights represents a different balance between idiosyncratic vision and agency costs. As this Part will show, these insights offer a new understanding of the fundamental tradeoffs underlying concentrated-ownership, widely held, and dual-class firms.

A. Toward a New Theory of Corporate Ownership Structures

1. The Spectrum of Ownership Structures

To appreciate the fundamental tradeoffs underlying corporate ownership structures, it may be helpful to think about both control and cash-flow rights as a pie with a fixed size[85]: as more control (cash-flow) rights are provided to investors, less control (cash-flow) rights are available for entrepreneurs. Essentially, control rights are divided between entrepreneurs and investors along one dimension, as are cash-flow rights. The zero-sum nature of control and cash-flow rights enables us to recast all corporate ownership structures as alternative contracts lying along this two-dimensional spectrum.

Consider two examples located on opposite ends of the spectrum of ownership patterns. In the first example, investors hold full control rights and all residual cash flows, while the entrepreneur receives only a fixed salary. One can describe this arrangement as an employment contract in which the investors hire the entrepreneur. The entrepreneur, however, retains some degree of control even in this case. The investors can fire the entrepreneur at will, but as long as she is in office, the entrepreneur maintains control over the day-to-day decisions. This allocation of cash-flow rights therefore leaves investors exposed to agency costs (of the mismanagement type) caused by the misaligned interests of the entrepreneur who only receives a fixed salary. Investors' exposure to agency costs is limited, however, by their control

84. While market forces are efficient in allocating control and cash-flow rights through different ownership structures, our normative legal prescription, *infra* Part IV, is aimed at persuading courts and legislators not to frustrate that process. Mandatory regulations and court rulings based on the one-sided agency costs theory will reduce the contractual freedom available to entrepreneurs and investors to achieve efficient allocation of control and cash-flow rights.

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

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rights—they can terminate the entrepreneur at will. In turn, the uncertainty of her employment term limits the entrepreneur's freedom to pursue her idiosyncratic vision.[86]

At the other end of the spectrum, the entrepreneur holds all control and cash-flow rights, whereas the investors hold only a fixed claim on the business's cash flows. This setting is commonly described as a loan contract in which the entrepreneur borrows from creditors (investors). As financial economists have long recognized, however, even creditors with fixed claims retain contingent control rights.[87] As long as she pays creditors on time, the entrepreneur can make all the decisions, but in the event of a default, control may shift to the investor creditors.[88] By holding full control rights, the entrepreneur has nearly unlimited freedom to pursue her idiosyncratic vision. However, this same freedom exposes investors to the agency costs of debt (e.g., increasing the riskiness of the business).[89] This exposure is limited only by their contingent control rights, which, in turn, set a ceiling on the entrepreneur's freedom to pursue her idiosyncratic vision.[90]

2. *Dual-Class Firms and Dispersed Ownership*

As our focus here is on the concentrated-ownership structure, we apply our framework only to publicly traded firms. We start with the two ends of the

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

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

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

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

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

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spectrum: dispersed-ownership and dual-class firms. We then show that concentrated ownership represents an optimal solution between these extremes.

In the dispersed-ownership structure, shareholders hold nearly all residual cash flows, while management receives a salary and a small fraction of residual cash flows through options and bonuses included in its compensation package.[91] Leaving management with only a small fraction of residual cash flows exposes investors to management agency costs.[92] Those costs, however, are curbed by shareholders' control rights, which provide shareholders with the ability to terminate management.[93] At the same time, the threat of replacement curtails management's ability to implement its idiosyncratic vision.[94]

Control in a dispersed-ownership structure is contestable. The degree of contestability presents a tradeoff between agency costs and idiosyncratic vision: less-entrenched managers expose investors to lower agency costs, but at the expense of the managers having less ability to pursue their idiosyncratic visions.[95]

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91. Kevin J. Murphy, *Executive Compensation: Where We Are, and How We Got There*, *in* HANDBOOK OF THE ECONOMICS OF FINANCE 214, 217 (George M. Constantinides et al. eds., 2013) (reviewing the historical evolution of executive compensation).

92. *Id.* at 234 ("[A]gency costs arise when agents receive less than 100% of the value of output.").

93. To be sure, shareholders' formal power may not translate into real power, as they may encounter legal and other obstacles in voting management out of office. *See, e.g.*, Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 688-94 (2007). Moreover, companies may adopt antitakeover provisions in their charters, and management can employ other antitakeover tactics to entrench themselves and ward off shareholder activism. Delaware, for example, allows firms to have staggered boards and implement poison pills to effectively block takeovers, subject only to minimal judicial review. *See* Air Prods. & Chems., Inc. v. Airgas, Inc., 16 A.3d 48, 58 (Del. Ch. 2011) (sustaining the board's use of a poison pill in combination with a staggered board). While Delaware provides directors with a large degree of freedom to resist hostile bids, *see id.* at 55 ("[A]s Delaware law currently stands, the answer must be that the power to defeat an inadequate hostile tender offer ultimately lies with the board of directors."), the United Kingdom insists on a rule under which shareholders should have the right to decide whether to sell the firm, *see* PAUL L. DAVIES, GOWER AND DAVIES' PRINCIPLES OF MODERN CORPORATE LAW 374-76 (8th ed. 2008).

94. *See* Jean-Jacques Laffont & Jean Tirole, *Repeated Auctions of Incentive Contracts, Investments, and Bidding Parity with an Application to Takeovers*, 19 RAND J. ECON. 516, 523 (1988) (demonstrating that a greater ease of replacement corresponds with reduced incentives to make unobservable investments).

95. In this light, the debate over allowing or restricting takeover defenses should be seen as a debate over where to place the balance between agency costs and idiosyncratic vision. *See* Black & Kraakman, *supra* note 54, at 521-22 (explaining Delaware's approach to takeovers

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In the dual-class structure, the entrepreneur holds shares with superior voting rights, while investors' shares have voting rights that are inferior or nonexistent.[96] Notable examples of corporations with dual-class structures are Facebook[97] and Google.[98] By owning a majority of the voting rights, the entrepreneur retains full control over business decisions and can block any hostile-takeover bids. Uncontestable and indefinite control provides the entrepreneur with maximum ability to realize her idiosyncratic vision, which, under our framework, can ultimately benefit both the entrepreneur and investors (if the entrepreneur turns out to be right).[99] However, the entrepreneur's uncontestable and indefinite control, coupled with the entrepreneur's smaller fraction of residual cash flows, leaves investors with high exposure to both management agency costs[100] and control agency costs

with the notion of hidden value—under which the firm's true value is apparent to directors but not shareholders or acquirers). *But see* Philippe Aghion et al., *Innovation and Institutional Ownership* 3-4 (Nat'l Bureau of Econ. Research, Working Paper No. 14769, 2009), http://www.nber.org/papers/w14769 [http://perma.cc/GZD5-UTFD] (finding that the positive relationship between innovation and institutional ownership is stronger when CEOs are less entrenched due to protection from hostile takeovers, and that "the decision to fire the CEO is less affected by a decline in profitability when institutional investment is high").

96. For example, assume one share out of ten shares has fifty-one percent of the votes, while the remaining nine shares have together forty-nine percent of the votes. Each share has equal rights for residual cash flows. The entrepreneur owns the super share (fifty-one percent of the votes and ten percent of residual cash flows), and investors own the remaining shares (forty-nine percent of the votes and ninety percent of residual cash flows).

97. *See* Stone, *supra* note 2.

98. In fact, Google now has three classes of shares. Wong, *supra* note 1.

99. In 2012, Google issued additional common stock and could easily have diluted the dual-class protection by issuing both Class A and Class B stock. But it declined to do so, and the founders wrote a letter to shareholders explaining why. Interestingly, the letter said that the founders insisted on dual-class stock because they wanted to pursue long-term projects without the possibility of losing control over these projects. They specifically said, for example, that the structure was necessary because "[t]echnology products often require significant investment over many years to fulfill their potential. For example, it took over three years to ship our first Android handset, and then another three years on top of that before the operating system truly reached critical mass." Letter from Larry Page, CEO & Co-Founder, Google, & Sergey Brin, Co-Founder, Google, to Google S'holders (Dec. 31, 2011), http://investor.google.com/corporate/2011/founders-letter.html [http://perma.cc/B7TC-KB7G].

100. The exposure to agency costs is a negative function of an entrepreneur's share of cash-flow rights. *See* Stijn Claessens et al., *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, 57 J. FIN. 2741, 2755 (2002) (finding that controlled corporations' market-to-book ratio (a measure of firm value) increases with controllers' cash-flow rights but declines in the wedge between those rights and voting rights). The entrepreneur's share of cash-flow rights in a dual-class firm is normally higher than that of the CEO in a widely held firm. *See* Paul A. Gompers et al., *Extreme Governance: An Analysis of Dual-Class Firms in the United*

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(the *takings* type).[101] Indeed, although prominent technology firms such as Google, Facebook, LinkedIn, Groupon, Yelp, Zynga, and Alibaba adopted the dual-class structure, this ownership structure is used infrequently because of investors' substantial exposure to agency costs.[102]

B. Concentrated Ownership

Conventional wisdom links concentrated ownership to private benefits of control. In our framework, however, concentrated ownership, which is situated between the extremes of dispersed-ownership firms (low idiosyncratic vision and low agency costs) and dual-class firms (high idiosyncratic vision and high agency costs), represents yet another way to balance idiosyncratic vision and agency costs. Specifically, by tying the entrepreneur's freedom to pursue her idiosyncratic vision to her large equity stake, concentrated ownership significantly alleviates shareholders' agency costs associated with relinquishing control to the entrepreneur.

In both the concentrated-ownership and the dual-class structures, the entrepreneur controls the company by virtue of owning the largest share of the company's voting equity. In both structures, the entrepreneur's uncontestable control provides her with the freedom to pursue her idiosyncratic vision. But uncontestable control also provides controllers in both structures with similar *ability* to exploit minority shareholders and thus aggravate the control agency problem. However, the *incentive* to expropriate the minority is not similar under both structures. The higher the controller's share of cash-flow rights, the lower her incentive to expropriate the minority.[103] Unlike in the dual-class

States, 23 REV. FIN. STUD. 1051, 1053 (2010) (finding that insiders at U.S. dual-class firms hold on average forty percent of cash-flow rights).

101. On the distinction between control and management agency costs, see *supra* Section II.A.2.

102. *See* Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J.L. ECON. & ORG. 83, 95 (2001) (finding that only six percent of IPO firms have dual-class shares). As our analysis indicates, investors weigh agency costs against the likely benefits of providing entrepreneurs with the ability to pursue their idiosyncratic visions. Thus, if investors believe in the entrepreneur's unique abilities and vision, they might agree to buy shares in the dual-class structure notwithstanding agency costs. Similarly, when the entrepreneur has very high idiosyncratic vision but insufficient wealth to hold the majority of equity rights (e.g., when the corporation is too big), she might insist on holding uncontestable control without a large equity investment and thus will offer only the dual-class structure.

103. Assume a controller has uncontestable control. If she owns just twenty percent of the equity, she can divert value from the other eighty percent shareholders, but if she owns eighty percent of the equity, she can only divert value from the other twenty percent shareholders. The smaller her equity stake, the more she can divert from others – and thus the higher her incentive to divert.

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structure, equity in a concentrated-ownership structure is issued at a ratio of one share to one vote.[104] As control rights are distributed pro rata according to each shareholder's investment, the controller cannot preserve her control without holding a substantial fraction of cash-flow rights. Thus, while the exposure to the control-agency problem is high in a dual-class structure (high incentive due to small equity), it is only moderate in the concentrated-ownership structure (low incentive due to large equity).

In the dispersed-ownership and the dual-class structures, those with de facto control do not necessarily hold a majority of cash-flow rights.[105] Thus, these structures expose investors to management agency costs. The concentrated-ownership structure, however, provides a middle-ground solution: it bundles cash-flow rights and control. Under a "one share, one vote" regime, the entrepreneur can retain control only if she holds cash-flow rights sufficient to give her control. Indeed, holding a control block inflicts costs on the entrepreneur. She needs to put her equity at risk, reducing liquidity and diversification, and to work either directly by serving as a manager or indirectly by monitoring professional managers. Under the conventional view, the entrepreneur is willing to pay this price in order to enjoy the private benefits of control. Under our framework, however, the entrepreneur is willing to bear these costs in order to hold indefinite and uncontestable control, which enables her to pursue her idiosyncratic vision. After all, this is a comparatively small cost, as the entrepreneur herself is (subjectively) confident she will make above-market returns on her investment and costs.[106]

From the investors' perspective, the entrepreneur's bundling of control and cash-flow rights alleviates both asymmetric information and agency-cost concerns. First, asymmetric information and differences of opinion as to the

104. *See* Renee Adams & Daniel Ferreira, *One Share-One Vote: The Empirical Evidence*, 12 REV. FIN. 51, 52 (2008).

105. In other words, these structures represent variations of "separation of cash flow and control." *See supra* note 26 and accompanying text.

106. *See, e.g.*, Christian Andres, *Large Shareholders and Firm Performance—an Empirical Examination of Founding-Family Ownership*, 14 J. CORP. FIN. 431, 444 (2008) (finding that family firms are more profitable than widely held firms and companies with other types of blockholders when the founding family is still active either on the executive or the supervisory board); Danny Miller et al., *Are Family Firms Really Superior Performers?*, 13 J. CORP. FIN. 829, 856-57 (2007) (finding that family-controlled corporations with a lone founder outperform non-family-controlled corporations in market valuation); Belen Villalonga & Raphael Amit, *How Do Family Ownership, Control and Management Affect Firm Value?*, 80 J. FIN. ECON. 385, 388 (2006) ("Family ownership creates value for all of the firm's shareholders only when the founder is still active in the firm either as CEO or as chairman with a hired CEO.").

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entrepreneur's idiosyncratic vision are priced differently when the entrepreneur's own equity—for example, the equity investment required to secure a majority of voting rights—is placed at risk (thereby putting a lot of "skin in the game"). Second, substantial equity investment by the entrepreneur strongly aligns her interests with those of the investors, thereby reducing management agency costs. Third, since control blocks are relatively illiquid, bundling control and cash-flow rights restricts the ability of the entrepreneur to quickly walk away from the business. This type of lock-in effect increases the entrepreneur's commitment to the business and in turn reduces agency costs for the investors.

To be sure, even entrepreneurs with a lot of "skin in the game" might make costly mistakes, such as making the wrong predictions about the market's future direction. Yet, compared to entrepreneurs with relatively insignificant cash-flow rights—under both dispersed-ownership and dual-class structures—they have substantial incentives to avoid these mistakes.

Our analysis thus shows that concentrated ownership is not necessarily inferior to dispersed ownership. Each ownership structure presents a different balance between agency costs and idiosyncratic vision. The spectrum of ownership structures according to our framework can be summarized as follows:

Table 1.
SPECTRUM OF OWNERSHIP STRUCTURES

Ownership Structure	*Agency Costs (Management/Control)*	*Ability To Pursue Idiosyncratic Vision*
Dispersed Ownership	Low/Low	Low
Concentrated Ownership	Low/Medium	High
Dual-Class Ownership	High/High	High

In sum, while contestable control constrains the entrepreneur's ability to pursue her idiosyncratic vision under dispersed ownership, the concentrated-ownership structure allows her to enjoy indefinite and uncontestable control without subjecting investors to the high management agency costs associated with the dual-class structure. Control enables the entrepreneur to pursue her idiosyncratic vision for both herself and investors. However, the entrepreneur must pay for her position in the form of lost diversification and liquidity, and increased execution and monitoring costs. While the entrepreneur's large equity stake protects minority shareholders from management agency costs, investors are nevertheless exposed to control agency costs. But, by tying the entrepreneur's freedom to pursue her idiosyncratic vision to her large equity

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stake, concentrated ownership moderates the control agency cost by decreasing her incentive to exploit the minority shareholders.

IV. CORPORATE LAW: CONTROLLER RIGHTS AND MINORITY PROTECTION

In this final Part, we present the principal implications of our theory for corporate law. We offer a blueprint of the policy considerations that should guide lawmakers in the United States and around the world in crafting corporate legal regimes for firms with controlling shareholders. While recognizing the importance of minority protection, our theory also underscores the importance of allowing controllers to pursue their idiosyncratic vision. Thus, we argue that controlling shareholders' rights play, and should play, a critical role in corporate law. We further argue that the interplay of minority protection with controllers' rights sheds light on some of the most puzzling aspects of Delaware case law and jurisprudence concerning firms with controlling shareholders.

In Section IV.A, we argue that any legal regime governing firms with controlling shareholders encounters an inevitable tradeoff between the goals of protecting investors and allowing controllers to maximize idiosyncratic vision. As we explain in the subsequent Sections, this tradeoff should shape both governance arrangements and corporate doctrine moving forward.

In Section IV.B, we discuss the rights that controlling shareholders should have, demonstrating that recognition of the controllers' rights may justify legal outcomes that are contrary to the traditional notions of shareholder-value maximization.

Section IV.C analyzes the main elements of minority protection. We advance two specific points. First, the need to balance idiosyncratic vision and minority protection may undermine the protection against self-dealing. Some self-dealing should be tolerated not because we believe that controllers deserve to be rewarded with private benefits, but because regulation would result in excessive interference with the controller's pursuit of her idiosyncratic vision. Second, we argue that Delaware's approach to identifying self-dealing transactions should be modified to account for the need to protect the minority from midstream changes to the firm's governance structure.

Lastly, Section IV.D uses our framework to reevaluate several difficult corporate law cases and shed new light on their appropriate resolutions.

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A. The Tradeoff Between Minority Protection and Controller Rights

Under our framework, the nature of the bargain underlying concentrated ownership is as follows: controllers-entrepreneurs retain control because of their concern that asymmetric information or differences of opinion may lead investors to prevent them from pursuing their idiosyncratic visions. Investors relinquish control in exchange for the substantial equity investment made by the controller-entrepreneur and the right to a pro rata share of cash flows.[107]

This understanding of the nature of concentrated ownership offers three basic prescriptions for corporate law. First, the law should protect investors' right to a pro rata share of cash flows by containing agency costs and preventing controllers from capturing private benefits at the expense of minority investors.[108] Second, the law should also recognize controllers' rights to pursue their idiosyncratic vision. Finally, corporate law should preserve the link between controllers' freedom to pursue their vision and their significant equity investment.

Corporate-law scholarship generally focuses on the first prescription: the need to protect outside investors against agency costs, i.e., controlling shareholders' self-dealing and other forms of minority expropriation. Under our framework, however, the concentrated-ownership structure is based not only on the investors' need for protection from agency costs, but also on the controller's willingness to make a significant equity investment in exchange for the uncontestable right to implement her idiosyncratic vision. Our analysis, therefore, calls for corporate law to protect the controller's right to pursue her idiosyncratic vision while simultaneously protecting minority investors from expropriation through self-dealing and other methods of value diversion.

Moreover, we argue that finding the appropriate doctrinal balance between minority protection and controller rights is challenging because of the inevitable tension between these goals. Ideally, corporate law should be designed to achieve both of these goals. Corporate law should secure minority shareholders' rights to a pro rata share of the corporate pie, while preserving

107. Note that investors are not willing to make their investments based only on their belief in the value of the entrepreneur's vision. If that were the case, they would allow the entrepreneur to use the dual-class structure. Rather, investors insist that the entrepreneur has the right to pursue her vision only as long as she holds sufficient cash-flow rights to provide her with control.

108. As we mentioned above, our framework does not rule out the possibility that private benefits of control might motivate some entrepreneurs to hold control. However, a legal system that adopts an effective regime to contain controllers' diversion of value makes it less likely that controllers would be motivated by private benefits. *See supra* notes 103-104 and accompanying text.

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the controller's freedom to pursue her idiosyncratic vision to maximize the corporate pie. As we explain below, this ideal goal is an elusive one.

First, it is difficult to distinguish those corporate decisions or transactions that genuinely concern the controller's idiosyncratic vision from those designed to produce unequal distributions of gains between controlling and minority shareholders. Second, legal measures intended to protect investors from value diversion could also produce costly errors. Third, prohibiting non-pro-rata distributions might require interventionist measures that could undermine the controller's right to execute her idiosyncratic vision.

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

This illustration underscores the sometimes opaque line between the controller's unfair self-dealing and legitimate decisions that ultimately affect the controller's ability to implement her idiosyncratic vision. Protecting the minority against inappropriate value diversion requires some constraints on the entrepreneur's ability to exercise control. These constraints can take the form of ex post review by courts as to the fairness of related-party transactions, or an ex ante requirement to secure approval of such transactions by a majority of the minority shareholders.[109] Regardless of its form, minority protection against agency costs will necessarily require curtailing some of the freedom to pursue an idiosyncratic vision that the controller would have otherwise enjoyed as a single owner.[110]

One might argue that constraining self-dealing need not interfere with the controller's ability to pursue her idiosyncratic vision. After all, the argument goes, if the controller does not intend to expropriate value from the minority,

109. *See* Goshen, *supra* note 31, at 396-97.

110. The single-owner standard is useful not only as a benchmark for the protection of investors, *see, e.g.*, Lucian Arye Bebchuk, *The Sole Owner Standard for Takeover Policy*, 17 J. LEGAL STUD. 197, 210 (1988), but also as a benchmark for the controller's right to secure her idiosyncratic vision.

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why would she care about the extra scrutiny? If the transaction is executed on arm's-length terms, the court will find it to be fair ex post,[111] or minority shareholders will grant their approval ex ante. This argument would be correct under the conditions of symmetrical information and zero transaction costs. In the real world, however, asymmetric information or differences of opinion may cause minority shareholders to err in evaluating the proposed transaction. Moreover, it is costly to screen self-dealing; plaintiffs sometimes bring suits without merit,[112] courts make mistakes,[113] and minority shareholders might strategically attempt to hold out.[114] Other prophylactic measures aimed at creating an effective minority-protection regime also produce significant costs.[115] Accordingly, protecting minority shareholders against agency costs may interfere with the controller's right to pursue her idiosyncratic vision.

The tradeoff between minority protection and controller rights has obvious implications for the design of corporate law. Lawmakers and courts should seek an optimal balance between providing minority protection and preserving the freedom of controlling shareholders to make managerial decisions. More practically, the nature of minority protection should depend on the considerations of enforcement. Enforcing a given protection may be prohibitively costly not only because of the direct compliance costs incurred by corporations or courts but also because of constraints placed upon the entrepreneur's pursuit of her idiosyncratic vision.[116]

111. For a case in which the court approved as fair a series of self-dealing transactions after concluding that these transactions promoted the controlling shareholder's idiosyncratic vision (without using this term, of course), see *Cookies Food Prods., Inc. v. Lakes Warehouse Distrib., Inc.*, 430 N.W.2d 447 (Iowa 1988).

112. *See, e.g.*, Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 61 (1991).

113. *See* Goshen, *supra* note 31, at 403-04 (explaining the inefficiencies associated with a fairness test).

114. *See* Zohar Goshen, *Controlling Strategic Voting: Property Rule or Liability Rule?*, 70 S. CAL. L. REV. 741, 753 (1997).

115. Modern corporate governance relies on a variety of gatekeepers and enforcement measures to constrain agency costs. These include, for example, creating financial reporting and other disclosure duties, requiring outside auditors and setting standards for their work, and establishing requirements for outside independent directors. These measures could interfere with the controller's ability to manage the firm in a way that limits her ability to capture her idiosyncratic vision. *See, e.g.*, Filippo Belloc, *Law, Finance and Innovation: The Dark Side of Shareholder Protection*, 37 CAMBRIDGE J. ECON. 863, 864 (2013) (finding that countries with stronger shareholder protection tend to have larger market capitalization but also lower innovative activity).

116. Ex ante, investor protection is beneficial for entrepreneurs as well, as it is vital for capital-market development and reduced cost of capital. Entrepreneurs, however, also value the ability to pursue their visions.

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B. Controller Rights

We start by analyzing the scope of the rights of a controlling shareholder in a concentrated-ownership structure and the type of protection that should accompany these rights.

1. Management Rights: The Business-Judgment Rule and Board Composition

The entrepreneur is willing to make a significant equity investment in exchange for the right to implement her idiosyncratic vision. The allocation of control matters in light of the asymmetric information and differences of opinion between the entrepreneur and the market. Some of the greatest breakthroughs in business ideas came from "crazy" or "visionary" entrepreneurs (e.g., Ford's assembly line and production design).[117] These ideas might never have come to fruition in the absence of the entrepreneurs' control. What then should be the nature of a controller's right to pursue her idiosyncratic vision?

Corporate law should recognize the controlling shareholder's right to exercise control over any issue that could affect the firm's value. Controlling shareholders should be free to set the firm's future direction and make all management decisions. This includes the right to assume a managerial role as well as the right to appoint and fire managers.

These rights seem to follow directly from the prevailing regime under which shareholders with a majority of the votes appoint all members of the board. Our analysis, however, has two implications for corporate-law doctrine and policy.

First, courts should generally refrain from interfering with nonconflicted business decisions that controllers or their representatives make. In other words, our analysis suggests a new explanation for the application of the business-judgment rule, which generally insulates disinterested directors from liability for negligence,[118] to firms with controlling shareholders. Our analysis also questions some statements that Delaware courts made on the application

117. *See, e.g.*, THADDEUS WAWRO, RADICALS & VISIONARIES: ENTREPRENEURS WHO REVOLUTIONIZED THE 20TH CENTURY (2000).

118. *See* William T. Allen et al., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1298 (2001) (showing that the business-judgment rule creates a presumption that a decision was made by disinterested and independent directors who acted in subjective good faith and employed a reasonable decision-making process).

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of the duty of care to controlling shareholders.[119] The controller-entrepreneur opts to retain control because of her expectation that asymmetric information or differences of opinion would otherwise lead minority investors to make decisions that would prevent her from pursuing her idiosyncratic vision. The ownership structure reflects a contractual agreement in which minority investors do not get any say in the management of the firm in exchange for the substantial equity investment staked by the controller-entrepreneur. In other words, the business judgment was sold to the controller-entrepreneur. Thus, a suit brought to court by a minority investor asking for judicial intervention in the controller-entrepreneur's nonconflicted business decision runs contrary to the implicit contractual agreement embedded in the controlling ownership structure. Courts should apply the business-judgment rule to avoid intervention and ensure that the minority investors stick to their bargain.

Moreover, the existence of asymmetric information and differences of opinion should, independent of the contractual bargain claim, cause courts to pause before they attempt to intervene in business decisions. The asymmetric information and differences of opinion between the controller-entrepreneur and the court are more severe than between investors and controllers-entrepreneurs because courts require verifiable facts as the basis for their rulings. Thus, for the same reason that controllers are willing to bear additional costs in order to gain independence from investors, courts should not be empowered to make decisions that, from the entrepreneur's perspective, would destroy her idiosyncratic vision. Empowering courts to do otherwise will nullify the ability of controllers-entrepreneurs to contract with investors for uncontestable control.

This rationale differs from the conventional justifications for noninterference with controlling shareholders' business decisions.[120] The

119. *See, e.g.*, Cinerama, Inc. v. Technicolor, Inc., No. CIV-A-8358, 1991 WL 111134, at *19 (Del. Ch. June 24, 1991) ("[W]hen a shareholder, who achieves power through the ownership of stock, exercises that power by directing the actions of the corporation, he assumes the duties of care and loyalty of a director of the corporation."), *aff'd in part, rev'd on other grounds sub nom*. Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del. 1993); *see also* Jens Dammann, *The Controlling Shareholder's General Duty of Care: A Dogma That Should Be Abandoned*, 2015 U. ILL. L. REV. 479, 480-81 ("[G]iven that controlling shareholders have powerful financial incentives to make well informed decisions, it is not clear why a general duty of care is needed to protect minority shareholders.").

120. For the conventional rationale underlying the business-judgment rule, see *In re Walt Disney Co. Derivative Litigation*, 907 A.2d 693, 698 (Del. Ch. 2005), which states that "redress for [directors'] failures . . . must come . . . from the markets, through the action of shareholders . . . and the free flow of capital, and not from this Court"; and the Ohio Supreme Court case, *Gries Sports Enterprises v. Cleveland Browns Football Co.*, 496 N.E.2d 959, 963-64 (Ohio 1986), which states that "directors are better equipped than the courts to make business judgments."

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conventional corporate-law literature assumes that judicial review of nonconflicted transactions is simply unnecessary in a concentrated-ownership environment, as the controller's significant equity stake provides her with incentives to maximize value for all investors.[121] Given their reduced agency costs, controlling shareholders are thought to be better positioned than either the courts or minority shareholders to make business decisions. Our explanation, by contrast, focuses on the need to offer the controller the freedom to implement her business plan even when investors (and courts) believe that such a plan would not enhance share value. Indeed, courts should refrain from interfering even when all minority shareholders agree that the controller is hopelessly wrong and that her business plan is certain to reduce share value in the future.[122]

Second, our diagnosis of the importance of controllers' management rights sheds new light on corporate-governance reforms designed to enhance board independence at firms with controlling shareholders. Controllers' voting power enables them to appoint any candidate they wish to the board. Recent corporate-governance reforms, however, constrain the controller's power to appoint directors. Listing requirements, for example, require boards or board committees to maintain a certain percentage of directors who are independent, not only from the company, but also from the controller.[123] Some legal systems go further and empower minority shareholders to influence board composition by, for example, appointing the minority shareholders' representatives to the board.[124]

121. *See, e.g.*, Dammann, *supra* note 119, at 482.

122. Recall that we do not argue that controllers' idiosyncratic visions would necessarily produce above-market returns. Rather, we claim that entrepreneurs value control because it allows them to pursue their visions and that, in the concentrated-ownership structure, controlling shareholders are able to get control by having enough skin in the game.

123. *See* NASDAQ, INC., NASDAQ STOCK MARKET RULES § 5605(b)(1) (2015) ("A majority of the board of directors must be comprised of [i]ndependent [d]irectors . . . ."); N.Y. STOCK EXCH., INC., NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 303A.01 (2015) ("Listed companies must have a majority of independent directors.").

124. *See, e.g.*, Roger Barker & Iris H.-Y. Chiu, *Protecting Minority Shareholders in Blockholder-Controlled Companies: Evaluating the UK's Enhanced Listing Regime in Comparison with Investor Protection Regimes in New York and Hong Kong*, 10 CAP. MKT. L.J. 98, 107 (2015) (describing new listing rules in the United Kingdom that provide minority investors with additional influence, including the power to delay the majority's approval of candidates for the position of independent director); Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1947-48 (1996) (describing the virtues of cumulative voting as a mechanism for minority representation); Corrado Malberti & Emiliano Sironi, *The Mandatory Representation of Minority Shareholders on the Board of Directors of Italian Listed Corporations: An Empirical Analysis* 11-18 (Bocconi Legal Studies,

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These prophylactic measures may be necessary to enforce the rule against self-dealing.[125] Our analysis, however, explains why lawmakers should proceed cautiously when constraining controllers' power to appoint board or management positions. Board reforms aim to make the board more effective in monitoring those with power—the CEO or the controlling shareholder. But asymmetric information and differences of opinion could prevent the controller-entrepreneur from credibly communicating her idiosyncratic vision not only to investors, but also to skeptical independent board members. Therefore, the need to balance controller rights and minority protection should also shape board reforms at firms with controlling shareholders. At a minimum, the controller should have the power to appoint a majority of the board, which in turn should have the power to appoint the CEO and other members of management.[126]

2. *Property-Rule Protection: Preserving Control*

To preserve the entrepreneur's uncontestable control, her right to make management decisions should be afforded a property-rule protection.[127] In other words, the market (i.e., minority shareholders) or courts should not be able to unilaterally take control rights away from the controller-entrepreneur in exchange for objectively determined compensation; the controller should be able to prevent a nonconsensual change of control from ever taking place.[128]

Research Paper No. 18, 2007), http://ssrn.com/abstract=965398 [http://perma.cc/6C6Z-G9JA] (reviewing minority-representation reforms in Italy).

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

126. Indeed, under NASDAQ Rule § 5615(c)(2), a controlled company is exempt from the requirement of Rule § 5605(b) of the *NASDAQ Stock Market Rules* requiring a majority of independent directors on the board. NASDAQ, INC., *supra* note 123, § 5605(c)(2). A similar exemption exists under Section 303A.00 of the *New York Stock Exchange's Listed Company Manual*. NEW YORK STOCK EXCH., INC., *supra* note 123, § 303A.00 (2015).

127. *Cf.* Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1092 (1972) (noting that under a liability rule, an entitlement can be taken without the owner's consent, subject to a duty to pay an objectively fair price (a commitment supervised by courts ex post), but under a property rule, an entitlement may only be taken with the owner's consent (in exchange for a mutually agreed upon price ex ante)).

128. The need for property-rule protection arises from the fundamental justification for allocating control and management rights to the entrepreneur. The controller-entrepreneur

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The property-rule protection of controller rights has some straightforward implications that are consistent with existing doctrine and are no different from those associated with the standard protection of private property. As courts in Delaware have long recognized, controllers cannot be forced to sell their control blocks even when doing so would clearly benefit the corporation or its minority shareholders.[129] The controller is generally free to exit her investment by selling her control block whenever she wants and for whatever price she sees fit.[130]

Nonetheless, the controller's property-right protection extends to a broader—and less intuitive—range of corporate actions, where corporate-law doctrine is less clear. Controllers can lose control not only when they sell their shares, but also when the company takes action—like issuing shares—that dilutes the controllers' holdings. We claim that companies with controlling shareholders should not be required to take actions that would cause the controller to lose her control even when doing so would benefit the corporation or minority investors.

Consider the following hypothetical: a bank must increase its capital to meet new capital adequacy requirements. The bank has two options: issue new shares or sell one of its subsidiaries. The bank's controlling shareholder, who owns fifty-one percent of the shares, has her own liquidity problems that prevent her from buying additional shares of the bank. Issuing new shares would therefore dilute the controller and may cause her to lose her control position. How should the board decide between the two options? At first

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

129. *See* Bershad v. Curtiss-Wright Corp., 535 A.2d 840, 845 (Del. 1987). *But see* Jens Dammann, *Corporate Ostracism: Freezing Out Controlling Shareholders*, 33 J. CORP. L. 681, 694 (2008) (explaining an innovative proposal for a regime under which minority investors could force the controller out).

130. Some limits are imposed, however, on the identity of the buyer. *See* Harris v. Carter, 582 A.2d 222, 235 (Del. Ch. 1990) (prohibiting sale of control to a known looter and imposing limited duties of investigation on controlling shareholders). In *Hollinger International, Inc. v. Black*, Delaware's Chancery Court allowed the board to use a poison pill to prevent a controlling shareholder from selling his control block. We believe, however, that this holding applies only when the sale of the block is in clear violation of the controller's fiduciary duties. *See* Hollinger Int'l, Inc. v. Black, 844 A.2d 1022, 1085-86 (Del. Ch. 2004) (allowing the board to deploy a poison pill when the sale of control was the culmination of an improper course of conduct by the controller and in violation of his contractual obligations).

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glance, the directors' fiduciary duties would require them to choose the option that best serves the company's interests while disregarding the controller's interest in preserving control. Our analysis, however, calls for another approach. Under our framework, the controlling shareholder cannot and should not be forced to lose her control. The board, therefore, should be prohibited from taking steps that would force the controller to lose control even when doing so would enhance share value. The board should thus decide to sell a subsidiary simply because issuing new shares would force the controller to lose control.[131]

While it is consistent with at least two Delaware cases,[132] our approach leads to an outcome that contradicts the traditional notions of shareholder-value maximization, as the need to preserve control might drive firms with controlling shareholders to take value-reducing actions. Yet, a regime under which minority shareholders, the board, or courts could compel the controller to lose control—whether by a forced sale, dilution, or any other action—is inconsistent with the need to provide controllers with a property-rule protection for their right to make management decisions and to pursue their idiosyncratic vision. Importantly, this outcome is *not* justified by the need to provide controllers with private benefits to reward them for their willingness to monitor management. Rather, it is based on the parties' mutual ex ante consent to an arrangement that enables entrepreneurs to pursue their idiosyncratic vision.

131. This treatment of the controller differs from that of minority shareholders (or investors at widely held firms). We normally allow management to use rights offerings even when that might coerce investors into a choice between dilution and increasing their investment. For evidence that controllers' need to preserve their control affects firm decisions concerning capital structure, see, for example, Thomas Schmid, *Control Considerations, Creditor Monitoring, and the Capital Structure of Family Firms*, 37 J. BANKING & FIN. 257, 263-66 (2013) (finding evidence consistent with the hypothesis that family firms in Germany use the firms' capital structures to optimize control over the firms).

132. Our approach seems to be consistent with Delaware case law. *See* Adlerstein v. Wertheimer, No. CIV-A-19101, 2002 WL 205684, at *11 (Del. Ch. Jan. 25, 2002) (holding that directors who diluted the controller in order to save the company from insolvency breached their fiduciary duties); Mendel v. Carroll, 651 A.2d 297, 306 (Del. Ch. 1994) (holding that the board cannot take steps that would force the controller to lose its control block "in the absence of a threatened serious breach of fiduciary duty by the controlling stockholder"). For an analysis of these decisions, see John C. Coffee, Jr., *Transfers of Control and the Quest for Efficiency: Can Delaware Law Encourage Efficient Transactions While Chilling Inefficient Ones?*, 21 DEL. J. CORP. L. 359, 390-96 (1996), which discusses *Mendel*; and Andrew Gold, *The New Concept of Loyalty in Corporate Law*, 43 U.C. DAVIS L. REV. 457, 483 n.130 (2009), which discusses *Adlerstein*.

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3. *Right To Sell Control for a Premium*

Whether controlling shareholders can sell their shares for a premium is one of the most important and controversial questions for firms with controlling shareholders.[133] Delaware recognizes the right of controlling shareholders to sell at a premium, subject to the restriction on selling control to a looter.[134] As explained above, the controller's right to sell at any time is the essence of her property right.[135] But what about the right to sell for a premium not shared by minority shareholders?[136]

A key premise underlying the objection to controllers' right to sell for a premium is that a control premium is a proxy for private benefits and thus also a proxy for minority expropriation. Under this view, imposing constraints on controllers' ability to sell for a premium would decrease the risk of inefficient sales motivated by the prospect of consuming private benefits at the expense of minority shareholders.[137]

Under our framework, however, a control premium is not necessarily a proxy for private benefits of control or the magnitude of minority expropriation. Instead, it could reflect the value that either the buyer or the

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

134. *See, e.g.*, Abraham v. Emerson Radio Corp., 901 A.2d 751, 753, 758 (Del. Ch. 2006); *Harris*, 582 A.2d at 232-35.

135. Many countries follow the so-called equal-opportunity rule by requiring a buyer of more than a certain percentage of a firm's shares (usually around thirty percent) to make a tender offer that would take the shareholder to at least fifty-percent share ownership. *See, e.g.*, THE PANEL ON TAKEOVERS & MERGERS, THE CITY CODE ON TAKEOVERS AND MERGERS r. 36.4 (11th ed. 2013) (U.K.) (stating that a purchaser crossing thirty percent triggers a mandatory offer for over fifty percent of the company); Directive 2004/25, of the European Parliament and of the Council of 21 April 2004 on Takeover Bids, 2004 O.J. (L 142) 12, 17 ("Member States shall ensure that [a controller] is required to make a bid as a means of protecting the minority shareholders of that company. Such a bid shall be addressed at the earliest opportunity to all the holders of those securities for all their holdings at the equitable price.").

136. The controller receives a premium when the price per share at which she sells her shares is higher than the same shares' market price, which essentially represents the price at which other investors can sell their shares. The precise method for calculating this price difference is beyond the scope of this Article.

137. *See, e.g.*, Lucian Arye Bebchuk, *Efficient and Inefficient Sales of Corporate Control*, 109 Q.J. ECON. 957, 960 (1994).

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seller entrepreneur attaches to her idiosyncratic vision. A seller who believes that she could earn above-market returns on her shares would insist on a premium for selling her stake even if, had she stayed in control, she would have shared the realized returns on a pro rata basis with minority shareholders. For the seller, the premium merely reflects the pro rata share of what she expected to receive had she stayed in control. Likewise, a buyer who believes he could make an even greater above-market return on the new investment would be willing to pay such a premium even if he intends to share these returns pro rata with the minority shareholders.[138]

C. Minority Rights

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

1. Pro Rata Share: Identifying Self-Dealing

Minority shareholders' main concern is that the controller-entrepreneur will engage in self-dealing, tunneling, or other methods of capturing more than her pro rata share of cash-flow rights. The principal form of minority protection is the strong regulation of non-pro-rata distributions of the firm's assets. In exchange for the controller's freedom to pursue her idiosyncratic vision by executing her business idea as she sees fit, the controller commits to share proportionally with the minority any cash flows that the business will produce. If she seeks any preference over the minority, she should negotiate with investors and obtain their approval—either before entering the joint investment or before receiving the preference. Otherwise, any non-pro-rata distribution will be subject to strict judicial scrutiny.[139]

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

139. *See, e.g.*, Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) (discussing the elimination of minority shareholders via a cash-out merger between the corporation and its majority owner).

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

The distinction between self-dealing and other legitimate transactions is an important one. Under Delaware law, for example, this distinction determines whether a lawsuit challenging a transaction is carefully reviewed under the plaintiff-friendly entire-fairness standard or quickly dismissed under the defendant-friendly business-judgment rule.[140] However, drawing the line between cases that deserve close scrutiny and those that do not is often difficult. For example, when the controller sells her privately owned asset to the publicly traded firm that she controls, she engages in clear self-dealing. In many cases, however, it is unclear whether close scrutiny is justified solely because the controller's interests with respect to certain corporate actions are not fully aligned with those of the minority.[141] We have no intention of resolving this issue here. Rather, we would like to use one famous example to argue that the test for identifying self-dealing should take into account the need to balance minority protection and controller rights.

Consider the dividend distribution question underlying *Sinclair Oil Corp. v. Levien*.[142] In this seminal case, Delaware's Supreme Court held that pro rata

140. *See generally* Steven M. Haas, *Towards a Controlling Shareholder Safe Harbor*, 90 VA. L. REV. 2445 (2004) (examining the entire-fairness standard and business-judgment rule in the context of controlling-shareholder transactions). For the methods used by some European jurisdictions to contain self-dealing by controllers, see generally Pierre-Henri Conac et al., *Constraining Dominant Shareholders' Self-Dealing: The Legal Framework in France, Germany, and Italy*, 4 EUR. COMPANY & FIN. L. REV. 491 (2007), which discusses France's, Germany's, and Italy's approaches to regulating self-dealing by shareholders.

141. *See* Dammann, *supra* note 129, at 694 (noting that the Delaware test makes it difficult for plaintiffs to establish self-dealing because "[w]hile it may be possible to show that the course of action taken by the corporation benefited the controlling shareholder, it is extremely difficult to prove that this advantage came at the expense of the other shareholders"); Luca Enriques, *Related Party Transactions: Policy Options and Real-World Challenges (with a Critique of the European Commission Proposal)*, 16 EUR. BUS. ORG. L. REV. 1, 13-14 (2015) (discussing the practical difficulties associated with the need to decide on a case-by-case basis whether a director or a dominant shareholder may have an indirect interest on a given issue).

142. Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971) (denying a claim that a large dividend distribution that deprived the corporation of resources to pursue corporate opportunities while allowing the controlling corporation liquidity to finance its corporate opportunities should be subject to entire-fairness review instead of the business-judgment rule).

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dividend distributions do not require close judicial scrutiny even when the company decides to pay these dividends in order to satisfy the controller's liquidity needs.[143] Should courts protect the minority against the risk that a controlling shareholder will use a pro rata dividend distribution to advance its own liquidity needs or other interests? The *Sinclair* court provided a clear answer to this question: no. It held that pro rata dividend distributions do not amount to self-dealing and should thus be reviewed only under the business-judgment rule.[144] Is this truly the most desirable outcome?

Indeed, a pro rata distribution could be used to satisfy the controller's own liquidity needs while denying the corporation highly profitable growth opportunities. In other words, a pro rata dividend distribution could be harmful to minority shareholders. Nevertheless, as we explain next, a legal rule that attempts to supervise the controller and prevent such abusive distributions would not only be too costly, it would also violate the implied contract underlying concentrated ownership.

Any rule that would try to scrutinize pro rata dividend distributions would necessarily interfere with the controller's management rights and her ability to secure her idiosyncratic vision. First, control over the firm's capital structure—the amount of capital that is required and how to finance the firm's operations—might be an integral part of implementing an entrepreneur's strategy.[145] Outside intervention would therefore significantly interfere with the controller's ability to make managerial capital decisions. Second, efforts to distinguish legitimate dividend distributions from illegitimate ones are prone to error because of asymmetry of information and differences of opinion.[146]

143. *See id.* at 721-22.

144. *See id.* at 722.

145. In a world with no transaction costs, the firm's capital structure (i.e., its debt-to-equity ratio) can be determined by using any combination of dividends, leverage, and issuance of new shares, with the same effect on corporate value. Similarly, buying a risky investment with no leverage is the same as buying a solid investment with leverage. *See, e.g.*, Merton Miller, *The Modigliani-Miller Propositions After Thirty Years*, 2 J. ECON. PERSP. 99 (1988) (discussing Franco Modigliani and Merton Miller's theorems about the irrelevance of capital structure and dividend policy for corporate value). But in a world with transaction costs, idiosyncratic vision as to a business idea is no different than idiosyncratic vision as to capital structure. A controlling shareholder's decision to issue new shares and invest in a project should be treated in the same manner as her decision to avoid a project and distribute the money.

146. Any investment offers a combination of risk and expected returns that is calculated based on estimates of future events or consequences. An investment with an expected return that equals the market's normal expected return associated with the risk of the investment offers a zero NPV. In efficient markets, all investments offer a normal rate of return and thus are zero NPV. To make our point, it is sufficient to assume that most markets are efficient. If the expected return on the investment is lower (or higher) than the market pricing of the

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Third, even if courts were able to accurately determine that a certain dividend is illegal, effective enforcement would itself require excessive intervention in the firm's management. A disgruntled controller who is prohibited from paying a dividend to meet her liquidity needs may decide, for example, to avoid risky investments and instead deposit the dividend amount in the firm's bank account in order to distribute the same amount in the near future. Will courts, in such a case, allow minority shareholders a cause of action to force the controlling shareholder to invest the funds in a more profitable alternative? Clearly, courts will not create a cause of action that will require them to assume responsibility for management decisions in which the controller is forced to put the money to other, more profitable uses. In other words, effectively policing the pro rata distribution of dividends would ultimately require courts to abandon the business-judgment rule.

Our discussion of *Sinclair* thus shows that the inevitable tension between controller rights and minority protection should shape the legal distinction between self-dealing and other legitimate transactions. The interests of controlling shareholders, to be sure, are not always fully aligned with those of minority investors—even when it comes to pro rata dividend distributions. Yet not every conflict of interest justifies legal intervention to protect the minority.

2. Midstream Changes

The preceding analysis provides support for Delaware's approach to self-dealing transactions. In this Section, however, we explain that the same approach fails to protect minority shareholders against controlling shareholders making unilateral changes to the firm's governance midstream. Controlling shareholders could theoretically enjoy more than their pro rata share of the business by using their control to change the firm's governance arrangements midstream either directly through changes in the charter and/or bylaws or indirectly through some business combination, such as a merger. These changes could be inconsistent with the initial contract between the

risk that it carries, then it offers a negative (or positive) NPV and should be avoided (or is a bargain). A controller's decision to forego an investment in order to distribute dividends will harm minority shareholders only if the avoided investment had a positive NPV. Negative NPV investments should be avoided regardless of the dividend distribution, and zero NPV investments leave shareholders with many market alternatives for reinvesting the dividend. As the potential damage from dividends is tied to the decision about an investment's NPV, adjudicating the claim would require courts to decide whether the investment is good or bad. Courts cannot make such a decision. Indeed, avoiding such decisions is a major justification for the business-judgment rule.

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entrepreneur and investors underlying the concentrated-ownership structure.[147]

Consider, for example, the link between control and cash-flow rights. As we explained in the last Part, under the one share, one vote rule, bundling control with a significant equity investment mitigates management agency costs and asymmetric information concerns. Once the controller raises funds from investors, however, she might be tempted to unravel this arrangement and find ways to preserve uncontestable control without having to incur the costs associated with holding a large equity block. For example, a controller might attempt to amend the corporation's certificate of incorporation to provide for tenure voting, whereby the governance right of the minority would be diluted (a change similar in its effect to forcing the minority into a dual-class structure).[148] A necessary element in any minority-protection scheme is, therefore, a protection against unilateral, midstream changes to the firm's governance arrangement.

Indeed, on several occasions, minority shareholders unsuccessfully attempted to challenge such changes in Delaware courts. Courts refused to review these changes under the entire-fairness standard, holding that the disparate *economic* impact of such changes on the controller did not amount to self-dealing as long as the *legal* effect was equal.[149]

Under our theory, however, courts should protect minority shareholders against the controller's attempt to back away from her commitment to bundle control and cash-flow rights.[150] Part of the problem may be that Delaware

147. *See* Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1573-85 (1989) (explaining the risk of opportunistic charter amendments).

148. *See, e.g.*, Williams v. Geier, 671 A.2d 1368, 1370-74 (Del. 1996) (describing a tenure voting plan).

149. *See id.* at 1378 ("There was on this record . . . no non-pro rata or disproportionate benefit which accrued to the Family Group on the face of the Recapitalization, although the dynamics of how the Plan would work in practice had the effect of strengthening the Family Group's control . . . ."); eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 37 (Del. Ch. 2010) ("The cases eBay relies on do not support a rule of law that would invoke entire fairness review any time a corporate action affects directors or controlling stockholders differently than minority stockholders.").

150. This protection also would address an important dimension that we have not discussed thus far. The ownership structure of public companies may evolve over time, especially when companies with controlling shareholders go public. *See, e.g.*, Julian Franks et al., *The Life Cycle of Family Ownership: International Evidence*, 25 REV. FIN. STUD. 1675, 1687-1707 (2012). Under the one share, one vote capital structure, companies that need to raise more capital to fund their development may decide to issue more shares, thereby diluting the controllers' holdings. Under our framework, the entrepreneur in the concentrated-ownership structure (unlike in a dual-class one) cannot retain her control without holding a sufficient fraction of cash-flow rights.

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courts use a single test for two distinct tasks—identifying self-dealing and preventing midstream governance changes. The problem of midstream governance changes by controlling shareholders requires its own legal framework. Similar to self-dealing cases, this framework should consist of two elements: first, identifying cases of midstream changes that deserve some level of scrutiny, and second, making a decision as to the nature of protection that minority shareholders should enjoy.

3. Type of Protection

Minority rights, like controller rights, could be protected by a liability or property rule.[151] Under a liability rule, the controller can engage in self-dealing transactions without minority shareholders' consent, subject to her duty to pay an objectively fair price (a commitment supervised by courts ex post). Under a property rule, the controller cannot engage in self-dealing without securing the minority's consent (typically by a majority-of-the-minority vote ex ante).

The need to balance controller and minority rights affects the desirable form of minority protection. A property rule provides the minority with consent-based protection that is vulnerable to holdout, thereby creating a risk of the minority interfering with the controller's management right. By contrast, a liability rule provides the minority with fair, compensation-based protection vulnerable to judicial mistakes, but it is less likely to interfere with the controller's management rights.[152] That is, under a liability rule, the transaction takes place and only its price is litigated, while under a property rule the minority can terminally block the transaction. As a result, we believe that the tradeoff between minority protection and controller rights supports a liability-rule protection for minority shareholders to better balance minority protection against agency costs and preservation of idiosyncratic vision.[153] As

151. *See* Goshen, *supra* note 31, at 408 (expanding Guido Calabresi and Douglas Melamed's property-rule and liability-rule framework from the protection of *individuals* to the protection of *groups*).

152. To be sure, as Delaware's case law demonstrates, majority-of-the-minority votes may play an important role in scrutinizing self-dealing transactions even under a liability rule. Yet, it authorizes courts to approve self-dealing transactions notwithstanding the minority's objection, thereby reducing the risk of errors resulting from holdouts or differences of opinion between the controller and investors.

153. In theory, our framework considers a liability-rule protection more appropriate. Taking institutional differences across countries into account, however, our framework does not identify any form of protection—liability or property—as superior because the actual effect of each protection depends on the judicial system and institutional investors of a given jurisdiction. A liability rule may not work in certain markets or legal systems without an

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we explained earlier, Delaware's corporate law indeed relies on judicial review to scrutinize controllers' self-dealing. Given Delaware's ecosystem of specialized courts and vibrant private enforcement, we find this approach desirable.[154]

D. Difficult Cases

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

1. Freezeout Transactions

In a freezeout transaction, the controlling shareholder of a publicly traded company buys out minority shareholders in order to take the company private.[155] Although freezeouts have been the subject of extensive analysis by legal scholars,[156] courts continue to struggle with the proper approach to

effective regime of shareholder lawsuits or where courts lack the necessary expertise to adjudicate fairness disputes. *See* Goshen, *supra* note 31, at 409.

154. Note that specialized courts would not only enhance minority protection, but also reduce the risk of excessive interference with controlling shareholders' rights. Specialized courts are less likely to err. This in turn would decrease the cost—in terms of undermining controller rights—of rules designed to protect minority shareholders. *See, e.g.*, Luca Enriques, *Off the Books, but on the Record: Evidence from Italy on the Relevance of Judges to the Quality of Corporate Law*, *in* GLOBAL MARKETS, DOMESTIC INSTITUTIONS: CORPORATE LAW AND GOVERNANCE IN A NEW ERA OF CROSS-BORDER DEALS 257, 258 (Curtis J. Milhaupt ed., 2003) (demonstrating the "central role of judges in shaping the legal environment for corporate actors").

155. Guhan Subramanian, *Fixing Freezeouts*, 115 YALE L.J. 2, 6-7 (2005).

156. *See, e.g.*, Lucian Arye Bebchuk & Marcel Kahan, *Adverse Selection and Gains to Controllers in Corporate Freezeouts*, *in* CONCENTRATED CORPORATE OWNERSHIP, *supra* note 5, at 247; Gilson & Gordon, *supra* note 37, at 796-803; Subramanian, *supra* note 155; Zohar Goshen & Zvi Wiener, *The Value of the Freezeout Option* (Columbia Law Sch. Ctr. for Law & Econ. Studies,

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regulating these transactions.[157] Our analysis offers a new perspective on the difficulty of crafting an optimal freezeout regime.

Let us start with controller rights. In our view, the inevitable conflict between minority protection and controller rights calls for providing controllers with an option to discontinue their partnership with the minority by taking the firm private. Buying out the minority may be required when keeping the firm public interferes with the realization of the entrepreneur's idiosyncratic vision.[158] Additionally, bolstering minority protection increases the likelihood that such protections would interfere with the realization of idiosyncratic vision, thereby creating an increased need to make it possible for controllers to take the corporation private.[159] Finally, there is an obvious difficulty in forcing an entrepreneur to work for others—minority investors—for as long as minority investors wish.[160] As a matter of legal doctrine, the need to provide the controller with an option to buy out the minority explains why

Working Paper No. 260, 2003), http://ssrn.com/abstract=217511 [http://perma.cc/ZL94-ET9E].

157. *See, e.g.*, *In re* MFW S'holders Litig., 67 A.3d 496, 524-36 (Del. Ch. 2013) (holding that freezeout mergers could be subject to the business-judgment rule if the controller allows the firm to adopt certain procedural safeguards); *In re* CNX Gas Corp. S'holders Litig., 4 A.3d 397, 400 (Del. Ch. 2010) (developing the unified standard for reviewing controlling shareholder freezeout transactions).

158. For example, an entrepreneur may believe it is no longer possible to implement her idiosyncratic vision while complying with the extensive disclosure duties imposed on public companies. In this case, the only way for the controller-entrepreneur to implement her plan and capture the value she attaches to the project is by taking the firm private. *See* Harry DeAngelo et al., *Going Private: Minority Freezeouts and Shareholder Wealth*, 27 J.L. & ECON. 367, 371-79 (1984) (finding that the elimination of the costs attendant to the regulation of public ownership is a source of efficiency).

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

160. *Cf.* UNIF. P'SHIP ACT § 601 (NAT'L CONFERENCE OF COMM'RS ON UNIF. STATE LAWS 2013) (explaining that partnership is at will).

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Delaware courts have abandoned the requirement that freezeout transactions satisfy a business purpose test.[161]

For minority shareholders, however, freezeout transactions present a substantial risk of expropriation on a large scale. Controlling shareholders might opportunistically use the option to buy out the minority at unfair prices while taking advantage of their superior access to information regarding the firm's value.[162] The risk of expropriation calls for effective measures to protect minority shareholders in freezeout transactions.

But a property-rule protection — that is, making a freezeout conditional on a mandatory majority-of-the-minority vote — might undermine the controller's option to take the firm private in order to preserve her idiosyncratic vision in two respects.[163] First, asymmetric information or strategic voting considerations might lead minority shareholders to vote against proposals of going private that are actually fair to the minority, thereby preventing the controller from making an exit that could secure her idiosyncratic vision. Second, forcing the controller to stay has the same consequence as preventing dividend distribution.[164] The court will have to interfere with management's decisions, normally protected by the business-judgment rule, to make sure the controller continues to work efficiently for the minority. Therefore, despite the high risk of expropriation, minority shareholders' protection should tilt toward a liability-rule protection.[165]

Our analysis thus calls for a narrow reading of the Delaware Chancery Court's decision in *In re CNX Gas Shareholders Litigation*, which addressed the scope of judicial review for going-private transactions structured as tender offers. It is possible to read the decision as requiring controlling shareholders

161. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 715 (Del. 1983) (explaining that allowing controllers to buy out the minority only if they present convincing business reasons for taking the firm private would overly burden controllers, especially given the role played by asymmetric information).

162. *See, e.g.*, Coggins v. New England Patriots Football Club, Inc., 492 N.E.2d 1112, 1116 (Mass. 1986) (reviewing controller opportunism to the detriment of minority shareholders under Delaware's old "business purpose" test).

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

164. *See supra* text accompanying notes 142-146.

165. As we explained above, *see supra* notes 152-154 and accompanying text, an important consideration in this context is the extent to which courts can effectively protect the minority under a liability rule. To be sure, a legal regime could adopt a variety of measures to protect the minority, such as approval by special committees of the board and shifting the burden of proof to controllers. Yet some form of an exit option should be left open even when the minority objects.

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to allow the board to use a poison pill to prevent a freezeout.[166] Under this interpretation, a controlling shareholder would be significantly limited in her ability to complete a going-private transaction. However, in a subsequent decision, the court seemed to suggest that a poison pill is required only if the controller wishes to avoid judicial review of the transaction under the entire-fairness standard.[167] In other words, the court essentially allowed controllers to choose between a liability rule (judicial review) and a property rule (majority-of-the-minority vote and board veto). Allowing controllers to choose the regime that would apply to their going-private transaction seems consistent with the pursuit of idiosyncratic vision.[168] However, a regime that would compel controllers to subject their going-private transaction to the substantial delays associated with a board's deployment of a poison pill would unnecessarily delay the freezeout by forcing the controller to replace the directors before merging.

2. Sale to a Third Party

The last case we consider is a transaction in which a third party, unrelated to the controller, buys all of the company's shares from both the controller and the minority shareholders. In a transaction of this type, the controller—with a majority of the votes—can effectively force the minority to sell their shares (an implied drag-along option).[169] Delaware courts have reviewed such

166. *See In re* CNX Gas Corp. S'holders Litig., 4 A.3d 397, 415 (Del. Ch. 2010) ("A controller making a tender offer does not have an inalienable right to usurp or restrict the authority of the subsidiary board of directors. A subsidiary board, acting directly or through a special committee, can deploy a rights plan legitimately against a controller's tender offer . . . to provide the subsidiary with time to respond, negotiate, and develop alternatives."), *cert. granted*, C.A. No. 5377, 2010 WL 2705147 (Del. Ch. July 5, 2010). The poison pill—formally known as a "rights plan"—is a device used to prevent shareholders from buying shares without the board's consent. In the presence of a poison pill, buying shares beyond a certain limit set by the board would be prohibitively costly. *See* Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973, 985-86 (2002).

167. *In re CNX Gas Corp.*, 2010 WL 2705147, at *10 ("A controller that uses its influence over the target board to restrict the authority of the committee [to use a pill] affirmatively chooses to stand on both sides of the transaction, thereby triggering entire fairness review.").

168. For this reason, we generally support the recent decision in *In re MFW Shareholders Litigation*, 67 A.3d 496, 502 (Del. Ch. 2013), which held that a freezeout merger could be subject to the business-judgment standard of review if the controller both (i) allowed a special committee of independent directors to veto the transaction and (ii) conditioned the transaction on a majority-of-the-minority shareholder vote.

169. A drag-along option is a right that enables a majority shareholder to force a minority shareholder to join in the sale of a company. The majority owner doing the dragging must give the minority shareholder the same price, terms, and conditions as any other seller.

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transactions under different levels of scrutiny, depending on whether the controller and the minority received equal consideration. A sale to a third party raises genuine minority-protection concerns when the consideration for the controller differs from that payable to the minority. Cases of this type create a conflict between the controller and the minority over the allocation of the sale proceeds. The controller might abuse her control over the target to divert value from the minority by creating a transaction with the third-party buyer that would benefit the controller at the expense of the minority. Not surprisingly, courts have subjected these transactions to the searching entire-fairness test.[170]

By contrast, when a third-party buyer offers equal consideration to all shareholders, minority shareholders apparently need no protection. After all, with the largest equity stake and no apparent conflict, the controller could be relied upon to work hard to achieve the most feasible and fairest bargain. Yet, Delaware case law on this issue is in remarkable disarray. While some decisions hold that these transactions do not require close scrutiny,[171] others have allowed minority shareholders to proceed with claims that the controller's need for cash—liquidity—created a conflict that justified the court's closer review of the transaction.[172]

Delaware courts' willingness to treat the controller's liquidity needs as creating a conflict that justifies judicial review is especially puzzling given the courts' reluctance to treat the controller's liquidity needs as justifying judicial review in other contexts. As we explained in the last Section, the Delaware Supreme Court rejected minority shareholders' claims that the controller's unique liquidity needs create a disabling conflict that should subject even a pro

170. *See In re* John Q. Hammons Hotels Inc. S'holder Litig., No. CIV-A-758-CC, 2009 WL 3165613, at *12 (Del. Ch. Oct. 2, 2009) (requiring procedural protections in order to apply the business-judgment rule); Ryan v. Tad's Enters., 709 A.2d 682, 689 & n.9 (Del. Ch. 1996) (applying entire fairness when the controlling stockholder received a benefit that was not shared with the minority shareholders in an asset sale), *aff'd*, 693 A.2d 1082 (Del. 1997).

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

172. *See* McMullin v. Beran, 765 A.2d 910, 923 (Del. 2000) (stating that a duty of loyalty claim could be filed against the parent for negotiating an all-cash transaction to satisfy a liquidity need); N.J. Carpenters Pension Fund v. Infogroup, Inc., No. CIV-A-5334-VCN, 2011 WL 4825888, at *4, *9-10 (Del. Ch. Sept. 30, 2011) (denying a motion to dismiss when the director, who was also a large stockholder, was in desperate need of liquidity to satisfy personal judgments, repay loans, and fund a new venture); *see also In re* Synthes, Inc. S'holder Litig., 50 A.3d 1022, 1036 (Del. Ch. 2012) ("It may be that there are very narrow circumstances in which a controlling stockholder's immediate need for liquidity could constitute a disabling conflict of interest irrespective of pro rata treatment.").

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rata dividend to the strict entire-fairness review.[173] How can one explain this inconsistent treatment of controllers' liquidity needs?

From this perspective, our framework sheds new light on the Delaware approach: we believe that the answer lies not in the nature of the conflict, but rather in the absence of concerns about the controller's idiosyncratic vision.

To begin, the controller can sell her block at a premium, thereby taking her share of the expected value of idiosyncratic vision and enabling the minority to stay in and share the profits derived from the buyer's idiosyncratic vision. Alternatively, the controller can freeze the minority out to pursue her idiosyncratic vision in a wholly owned corporation, subject only to minority shareholders receiving an appraisal right and entire-fairness protection.[174] However, by contrast to these situations, the right to drag along the minority (by using the controller's voting power to force a sale) does not protect the controller's ability to pursue her idiosyncratic vision: the controller sells the corporation and ends her pursuit of her business strategy. Why, then, does the controller receive the right to force the minority to sell its shares together with her?

The answer is to allow the *buyer* to pursue his idiosyncratic vision in a wholly owned corporation. Instead of buying just the control block and then freezing out the minority, subject to appraisal rights and entire-fairness review, the buyer is willing to pay an equal premium to the minority to avoid the costs of a freezeout (i.e., time, effort, uncertainty, and litigation). In this scenario, the seller who forces the minority to sell together with her assumes the role of an auctioneer. However, while the controller has substantial holdings that normally induce her to maximize sale price, the same substantial holdings might also create a financial conflict over the type and structure of the consideration. Thus, while a board of directors of a widely held firm assumes the role of an auctioneer only subject to a heightened duty of care (i.e., *Revlon* duties)[175] because it does not have a substantial financial interest, the controller might be subject to a fairness test due to her substantial financial interest in the deal.[176]

173. *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 721-22 (Del. 1971) (explaining that pro rata dividend payments are subject to the business-judgment rule, even if they were paid for the clear benefit of the controlling shareholder parent).

174. *See, e.g.*, DEL. CODE ANN. tit. 8, § 262 (2013) (providing for appraisal rights); Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1115 (Del. 1994) (discussing the entire-fairness requirement).

175. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986).

176. Of course, the controller can avoid the role of an auctioneer by selling only her block. Obviously, she will do just that unless selling with the minority will result in a higher price. Put differently, in this case, the seller needs the minority to sell with her, not to allow her to

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Therefore, it is clear that the controller's liquidity needs should be treated differently. A regime that would impose scrutiny on dividend distributions would inevitably interfere with controllers' management rights and might undermine their ability to pursue their idiosyncratic visions. These concerns cease to apply when the controller decides to sell the whole corporation to a third party. By putting her management rights up for sale, and also forcing the minority to sell, the controller signals that she is no longer concerned with *her* idiosyncratic vision. Moreover, a sale to the highest bidder also means that asymmetric information is no longer an issue. It is much easier to compare differences in considerations between bidders. In other words, employing judicial review is less likely to have negative consequences. Thus, a risk of a conflict of interest may correctly call for judicial scrutiny.

CONCLUSION

In this Article, we demonstrated that corporate-ownership structures represent a spectrum of contracts allocating control and cash-flow rights between entrepreneurs and investors. Our theory identifies the inevitable tension between the entrepreneur's desire to pursue her idiosyncratic vision and the investors' need for protection against agency costs as the main explanation for the various forms of ownership structures. Concentrated ownership is one such structure on this spectrum. It bundles control and cash-flow rights to foster the controller's idiosyncratic vision and reduce the minority shareholders' exposure to agency costs.

From this framework, we questioned the views that private benefits of control are vital to controlling shareholders and that improvement in monitoring explains the controlling-shareholder structure. In so doing, our theory marks a significant departure from the existing scholarship on corporate control. Instead of assuming that controlling owners are expropriators who are motivated by a desire to consume private benefits at the expense of minority shareholders, we assert that many controlling owners are instead motivated primarily by a desire to pursue their idiosyncratic visions that they believe will increase the value of their firms to the benefit of all shareholders. In addition to challenging the existing theories of concentrated ownership, we further explained how the tension between idiosyncratic vision and agency costs informs, and should inform, the shape of corporate law doctrines concerning corporations with controlling shareholders.

get the right price for her idiosyncratic vision, but to allow her to extract a higher share of the buyer's idiosyncratic vision. Accordingly, a controller cannot, for example, decide to take a cash offer over a higher-valued bid when dragging along the minority, due to her liquidity needs, as this would be a breach of her duties as an auctioneer.

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