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Abstract

The "law matters" thesis implies countries will not develop a robust stock market or diffuse corporate ownership structures unless laws are in place that curtail the extraction of private benefits of control by large shareholders and address information asymmetries from which outside investors suffer. In Britain, however, the law did not provide extensive protection to shareholders when ownership separated from control, which suggests "investor friendly" corporate and securities law is not a necessary condition for a transition from family capitalism to a corporate economy characterized by widely held firms. If law did not provide the foundation for the unwinding of family ownership what did? This paper argues that the dividend policy of publicly quoted firms played a significant role. Essentially, dividends mimicked the role that the "law matters" thesis attributes to corporate and securities law, namely constraining corporate insiders and supplying information flow to investors. In so doing, dividends helped to provide the platform for ownership to separate from control when law did not provide substantial protection for outside shareholders.

Keywords: corporate law, securities law, corporate ownership, dividend policy, shareholder protection, ownership and control.

JEL Classifications: G32, G35, G38, K22, N24.

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1. Introduction

As the 20th century drew to a close, corporate law scholarship "found the market" as "contractarian" analysis became the dominant mode of analysis. A key underlying presumption of this economically oriented school of thought was that market dynamics define primarily how directors, shareholders and others associated with companies interact. Corporate law, the thinking went, had only a supplementary and supportive role to play, namely facilitating efficient contracting. No sooner had legal academics started to push law to the margins when economists began to assert that the extent to which law provides protection for investors is a key determinant of the configuration of corporate governance structures around the world. The claim made was that the "quality" of corporate and securities law does much to determine whether a country will have strong securities markets and a corporate economy dominated by firms with widely dispersed share ownership.

The "law matters" thesis economists have advanced has important normative implications, since it suggests countries will not develop a robust stock market or escape from potentially backward family capitalism unless laws are in place that provide suitable protection for investors. Not surprisingly, the thesis has attracted much attention from legal academics.[1] But is "investor friendly" corporate and securities law in fact a necessary condition for a country to develop strong securities markets and a corporate economy where large firms are generally widely held? The experience in the United Kingdom suggests not.

Currently, Britain has an "outsider/arm's-length" system of ownership and control, so called because most U.K. public companies lack a shareholder owning a large block of equity and those owning shares (typically institutional investors) generally refrain from taking a "hands-on" approach to the management of companies. This

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[1] To illustrate, a search carried out in May 2006 to find articles mentioning economist Rafael La Porta and "corporate law" on the Westlaw "JLR" database yielded 212 "hits". Rafael La Porta is one of a number of co-authors whose work provides the foundation of the "law matters" thesis: see infra note xx to xx and related discussion.

system took shape between the 1940s and the 1980s, as control blocks owned primarily by company founders and their heirs unwound and institutional investors rose to prominence. By the end of this period, the widely held company so often identified as the hallmark of corporate arrangements in the United States had moved to the forefront in the U.K. The "law matters" thesis implies that Britain should have had laws in place that were highly protective of shareholders as the transition occurred. In fact, from the perspective of investor protection, Britain had "mediocre" corporate and securities legislation during the relevant period.

If corporate and securities law did not provide the foundation for the separation of ownership and control in U.K. public companies, what did? A number of possibilities have been canvassed in the literature, including regulation by the privately run London Stock Exchange that supplemented the protection investors had under corporate and securities legislation and takeover activity that acted as a catalyst for the reconfiguration of existing ownership patterns.[2] This paper identifies a new candidate, the dividend policy of publicly quoted firms.

Essentially, dividends contributed to the unwinding of share ownership structures in U.K. public companies by mimicking the role that the "law matters" thesis attributes to corporate and securities law, namely constraining corporate insiders and providing investors with information flow about companies with publicly traded shares. Legal regulation of dividends was minimal in the U.K. Hence, while economists have been stressing the importance of law as a determinant of corporate governance systems, at least in Britain corporate behavior lightly constrained by legal rules played a significant role. The paper does not claim that the payment of dividends by U.K. public companies was a sufficient condition for a separation of ownership and control to occur since it was the norm for publicly traded firms to pay dividends before control blocks unwound.

[2] On the role of the regulation by the London Stock Exchange, see Brian R. Cheffins, "Does Law Matter?: The Separation of Ownership and Control in the United Kingdom", (2001), 30 Journal of Legal Studies 459, 473-76, 481-82. On takeovers, see Julian Franks, Colin Mayer and Stefano Rossi, "Spending Less Time With the Family: The Decline of Family Ownership in the U.K." (2004) ECGI Working Paper Series in Finance, 35/2004, 18-24; Brian R. Cheffins, "Mergers and the Evolution of Patterns of Ownership and Control: The British Experience" (2004) 46 Business History 256, 259-62.

Nevertheless, with other conditions being favorable, dividends were an important supplementary factor.

The paper proceeds as follows. Part 2 outlines the law matters thesis, using a simple hypothetical involving a family-dominated public company to illustrate the key dynamics. Part 3 assesses the extent to which the law matters story accounts for developments in the U.K., primarily by tracing back through history how Britain would have scored on corporate and securities law indices economists advancing the law matters thesis have constructed. Part 4 discusses in general terms how dividends might have helped to reconfigure ownership patterns in U.K. public companies despite financial economics precepts that imply dividends are a "mere detail". Part 5 outlines how the pattern of dividend payments by U.K. public companies imposed discipline on the use of corporate earnings by those in a controlling position. Part 6 explains how dividends, by performing a "signalling" function, helped to supply the informational foundation investors would have required to buy shares in sufficient volume for diffuse share ownership to evolve. Part 7 assesses a potential objection to the thesis that dividend policy helped to prompt the unwinding of ownership patterns in U.K. public companies, namely that, due to tax, dividends were too "expensive" to function as a shareholder-friendly substitute for corporate and securities law. Part 8 concludes with some general remarks on the need to take into account both law and the market to understand fully the evolution and operation of systems of corporate governance.

2. The "Law Matters" Thesis

A. The Theory

Assume, by way of a highly stylized example, ABC Co. has 100 shares and became a public company under the leadership of its founder.[3] The founder's son is now chief executive, the family continues to own 50 of the shares and the remainder are

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[3] The departure point for this example is a scenario set out by Lucian A. Bebchuk and Mark J. Roe, "A Theory of Path Dependence in Corporate Ownership and Governance", (1999) 52 Stanford Law Review 127, 143-45.

widely held. The total value of the company's shares is $100, but a key differential exists. The controllers' equity is worth $60, or $1.20 per share. The outsiders' shares – the ones traded publicly -- fetch a price of $0.80 per share, meaning their equity is worth $40 collectively. The $0.40 differential per share constitutes the "control premium", partly reflecting the private benefits of control the dominant faction can extract at the expense of outside investors.[4]

Assume further the chief executive of ABC Co. is a poor manager and the company's performance is suffering accordingly. Correspondingly, if the family's control block was completely unwound and he was replaced by a competent successor the company would be worth $1.10 per share, or $110 overall.[5] A move to diffuse share ownership would therefore increase firm value.[6] Will this happen?

To sharpen the analysis, assume the family has two choices, one being the status quo and the other being for the family to exit by selling its shares in a public offering to dispersed investors.[7] Assuming a sale price of $1.10 per share, the total proceeds the family would receive would be $55 (50 x $1.10). A sale would therefore yield the family $5 less than the value of its shares under current arrangements. The move to diffuse share ownership would increase the value of the equity that was already publicly held from $40 to $55. Still, this would not be a benefit the family would capture, so it would

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[4] On the contribution which extracting private value makes to the control premium, see Alexander Dyck and Luigi Zingales, "Private Benefits of Control: An International Comparison" (2004) 59 Journal of Finance 537, 540-41; Diane K. Denis and John J. McConnell, "International Corporate Governance", (2003) 38 Journal of Financial and Quantitative Analysis 1, 24-25.

[5] A pro rata valuation of $1 per share is appropriate because each would have one vote attached and would thus benefit equally from a control premium. On this, see Tatiana Nenova, "The Value of Corporate Voting Rights and Control: A Cross-Country Analysis", (2003) 68 Journal of Financial Economics 325, 330.

[6] It should not be taken for granted that diffuse ownership is in fact more efficient than concentrated ownership: Brian R. Cheffins, "Corporate Law and Ownership Structure: A Darwinian Link", (2002) 25 University of New South Wales Law Journal 346, 356-67.

[7] In practice, there may well be other options. One would be for the family to retain its stake, persuade the current chief executive to resign and hire a talented outsider to manage the company. Another would be for the family to try to sell its stake to a purchaser willing to pay a control premium.

refrain from unwinding its stake. A "controller's roadblock" would thus preclude a shift towards a more efficient ownership structure.[8]

The controller's roadblock would not be the only obstacle to a value-enhancing transition to diffuse share ownership. There could be problems on the investors' side too. The point can be illustrated by changing the facts slightly. Assume the market value of ABC Co. is as before ($100) but that the private benefits of control ABC Co. yields are no longer as lucrative. As a result, the family's shares are worth $55, or $1.10 per share. The publicly quoted shares trade at $0.90 per share, meaning the equity of the outside shareholders is worth $45 collectively. Under these facts, the controller's roadblock should not deter a transition to the more efficient diffuse ownership structure since the sale price the controlling faction would receive -- $1.10 per share -- would be equal to the value of its stake. Correspondingly, the family might well decide it was time to obtain the benefits of risk-spreading and unwind its holding.

The potential hitch would be on the other side of the equation -- convincing investors to buy the shares. The scenario we have been considering will be characterized by asymmetric information, in the sense that the family will know more about ABC Co.'s assets, risks and prospects than outside investors.[9] The family, or the investment bankers acting on the family's behalf, would assert that the additional profits generated by a change of ownership justified a sale price of $110, or $1.10 per share. Investor reaction likely would be sceptical. Buyers who realize that a seller knows more about the quality of an asset than they do and who cannot readily verify assertions offered can only safely assume that what is on offer is a sub-standard "lemon".[10] By analogy, with respect to ABC Co., investors might well interpret the family's decision to sell as a panicky bail-out on a failing business. A widespread reaction of this sort would drive down the price of

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8 On the terminology, see Bebchuk and Roe, supra note xx, 143.

9 On asymmetric information and the issuance of shares, see Richard A. Brealey and Stewart C. Myers, Principles of Corporate Finance, 7th ed. (Boston: McGraw Hill, 2003), 412, 511-13.

10 The intuition here is what drives the well-known "market for lemons", first described by George A. Akerlof, "The Market for 'Lemons': Quality, Uncertainty and the Market Mechanism", (1970) 84 Quarterly Journal of Economics 488.

ABC Co. shares already trading on the market well below the existing $0.90 level. The family's plan to sell out at $1.10 would then collapse and the status quo would be maintained even though net overall benefits would have been generated if a change in ownership structure had taken place.

Currently, a widely held belief is that corporate law – the rules governing the rights and duties of directors, senior executives and shareholders -- is a variable that does much to explain how strong securities markets and diffuse share ownership can emerge in the face of possible rent extraction, information asymmetries and the potential inefficiencies of family-oriented management.[11] The basic logic underlying the "law matters" thesis is that where corporate law is deficient, potential outside investors will be hesitant about buying shares because of fear corporate "insiders" (large shareholders and/or senior executives) will skim or squander firm profits.[12] Corporate insiders, being aware of such scepticism, will refrain from using the stock market to exit and will opt instead to retain the potentially ample private benefits of control available due to weak regulation. The widely held corporation will therefore not become dominant, regardless of whatever inherent economic virtues it might offer.

The "law matters" thesis implies that things might well unfold differently if a country has "quality" corporate law.[13] Outside investors, cognizant that the law constrains rent extraction by corporate insiders, will be reassured about the logic of owning tiny holdings in publicly traded companies. Concomitantly, controlling

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11 On the popularity of this line of thinking, see Mark J. Roe, "Corporate Law's Limits", (2002) 31 Journal of Legal Studies 233, 236-37; Luca Enriques, "Do Corporate Law Judges Matter? Some Evidence from Milan", (2002) 3 European Business Organization Law Review 756, 766-67.

12 For summaries of the thesis, see Roe, "Corporate", supra note xx, 236-39; Troy E. Paredes, "A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law is not the Answer", (2004) 45 William and Mary Law Review 1055, 1063-64. The "law matters" terminology was coined by John C. Coffee, "The Future as History: Prospects for Global Convergence in Corporate Governance and its Implications", (1999) 93 Northwestern University Law Review 641, 644.

13 The phrase is borrowed from Peter A. Gourevitch, "The Politics of Corporate Governance Regulation", (2003) 112 Yale Law Journal 1829, 1830.

shareholders, aware that the law largely precludes them from exploiting their position, will be favourably disposed towards unwinding their holdings.[14]

Securities law and, more precisely, disclosure regulation is also potentially important.[15] In an unregulated environment, by virtue of information asymmetries, potential investors may well shun corporate equity because they cannot distinguish "high-quality" companies from their less meritorious counterparts.[16] With compulsory disclosure rules in place, investors will find it easier to separate the good firms from the "lemons". As deserving companies begin to receive support from the market, so the thinking goes, they will begin to carry out public offerings with increasing regularity. As the process continues, a country's securities market will become stronger and a suitable economic platform will have been established to allow the widely held company to become dominant.

Disclosure regulation can also potentially help to foster ownership dispersion by encouraging dominant shareholders to exit.[17] If the law requires substantial transparency, the odds of detection of improper diversion of corporate assets grow. If corporate insiders are in fact discovered exploiting minority shareholders, adverse publicity, lawsuits and regulatory sanctions could all follow. Apprehension about such outcomes should in turn discourage dominant shareholders from extracting private benefits of control and thus lead them to contemplate unwinding their holdings.

The law matters thesis offers a message that policymakers potentially ignore at their peril: countries will struggle to reach their full economic potential unless laws that

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14 For a mathematically oriented version of this proposition, see Andrei Shleifer and Daniel Wolfenzon, "Investor Protection and Equity Markets", (2002) 66 Journal of Financial Economics 3.

15 Bernard Black, "The Core Institutions that Support Strong Securities Markets", (2000) 55 Business Lawyer 1565, 1567-68, 1570-73.

16 Peter Blair Henry and Peter Lombard Lorentzen, "Domestic Capital Market Reform and Access to Global Finance: Making Markets Work", (2003) NBER Working Paper No. 10064, 16.

17 Alan Ferrell, "The Case for Mandatory Disclosure in Securities Regulation Around the World", (2004), Harvard Center for Law, Economics and Business Working Paper No. 492, 13-14.

protect minority shareholders are in place.[18] America's rich and deep securities markets are frequently cited as a key source of innovation and economic dynamism.[19] The law matters thesis suggests that such benefits are only likely to be secured if the correct regulatory environment is in place. Leading proponents of the law matters thesis have acted as consultants for the International Monetary Fund and the World Bank, which in turn have promoted corporate law reform globally with a particular emphasis on protection of minority shareholders.[20] The message, in turn, has seemingly been heard by policymakers, since governments around the world over the past decade been strengthening regulations affecting outside investors.[21]

B. The Evidence

Economists Rafael La Porta, Florencio López-de-Silanes and Andrei Shleifer have, in various studies, tested whether corporate and securities law in fact constitutes a determinant of ownership structure. In a 1998 paper published together with Robert Vishny they constructed an index of "anti-director rights" designed to measure how strongly the corporate legislation of 49 countries favoured minority shareholders against managers.[22] Regressions they ran yielded statistically significant correlations between their index and various indicators of stock market development, including the percentage of companies with diffuse share ownership. A follow up 1999 study focusing on fewer countries and using a richer set of data on ownership patterns did the same.[23] According

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18 Paredes, "Systems", supra note xx 1067; Brian R. Cheffins, "Law as Bedrock: The Foundations of an Economy Dominated by Widely Held Public Companies", (2003) 23 Oxford Journal of Legal Studies 1, 6.

19 Mark J. Roe, "Political Preconditions to Separating Ownership from Corporate Control" (2000) 53 Stanford Law Review 539, 542.

20 See Rafael La Porta's cv, http://mba.tuck.dartmouth.edu/pages/faculty/rafael.laporta/cv.html , visited May 15, 2006) (identifying him as an International Monetary Fund consultant); "New Twist on Corporate Governance", *New York Times*, January 11, 2005 (identifying Florencio López-de-Silanes as a consultant to the World Bank). On the activities of the International Monetary Fund and the World Bank, see Roe, "Corporate", *supra* note xx, 237.

21 Henrik Cronqvist and Mattias Nilsson, "Agency Costs of Controlling Minority Shareholders", (2003) 38 Journal of Financial and Quantitative Analysis 695, 696.

22 Rafael La Porta et al., "Law and Finance" (1998) 106 Journal of Political Economy 1113.

23 Rafael La Porta et al., "Corporate Ownership Around the World" (1999) 54 Journal of Finance 471.

to La Porta, López-de-Silanes and Shleifer their "results suggest(ed) that dispersion of ownership goes together with good shareholder protection, which enables controlling shareholders to divest at attractive prices".[24]

La Porta, López-de-Silanes and Shleifer did not treat disclosure regulation as an aspect of shareholder protection when calculating the quality of corporate law.[25] In a follow-up study, however, they examined securities law in 49 countries to determine whether laws governing prospectuses – documentation circulated to prospective investors by those organizing public offerings of securities – were a determinant of the size of national stock markets and corporate ownership structures.[26] They found that private enforcement of prospectus regulation, as measured by the strictness of disclosure requirements and the burden of proof private investors had to meet to sue successfully in the event of misdisclosure, were strongly associated with the configuration of securities markets and the diffusion of share ownership.[27]

La Porta, López-de-Silanes and Shleifer's efforts have been criticized from various angles. One objection has been that law simply is too complex to be reduced to numbers.[28] Another is that La Porta, López-de-Silanes and Shleifer, due to relying on a few seemingly random proxies, may not have captured properly variations in the quality of corporate and securities law.[29] It has also been suggested various mistakes were made in the coding of countries, with the problem being compounded with their study of

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[24] Id. at 496.

[25] As they acknowledged: id., 512.

[26] Rafael La Porta et al., "What Works in Securities Laws?", (2006) 61 Journal of Finance 1.

[27] They also tested the impact of "public enforcement", as determined by the powers government regulators had to investigate and sanction misdisclosure, but found this variable had little explanatory power.

[28] Mathias M. Siems, "Numerical Comparative Law: Do We Need Statistical Evidence in Law in Order to Reduce Complexity?" (2005) 13 Cardozo Journal of International & Comparative Law 521, 529-30; Mathias M. Siems, "What Does Not Work in Comparing Securities Laws: A Critique of La Porta et al.'s Methodology", [2005] International Corporate & Commercial Law Rev. 300, 301-2.

[29] Roe, "Corporate Law's", supra note xx, 252; Detlev Vagts, "Comparative Company Law – The New Wave" in Rainer J. Schweizer et al. (eds.), Festschrift für Jean Nicolas Druey zum 65. Geburtstag (Zurich: Schulthess, 2002), 595, 601; José M. Garrido Garcia, "Company Law and Capital Markets Law", (2005) 69 Rabels Zeitschrift 761, 766-67.

corporate law because they did not explain in any detail how countries were scored on particular variables.[30]

La Porta, López-de-Silanes and Shleifer responded to their critics in a 2005 working paper co-written with Simeon Djankov. They conceded the original index of anti-director rights was "based on an ad-hoc collection of variables" and implicitly acknowledged it was not optimally coded, as they presented and tested a revised index constructed with greater precision.[31] The correlations found previously remained largely unchanged upon re-testing with the new index.[32] On the other hand, Holger Spamann found after recoding the anti-director rights index with the help of local lawyers and rerunning the relevant regressions that most of the statistically significant outcomes had disappeared.[33] It is too early to say whether efforts such as this will dislodge the "law matters" thesis, particularly because, as of yet, La Porta, López-de-Silanes and Shleifer's findings on securities law remain unchallenged. At the very least, their work constitutes

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30 Siems, "Numerical", supra note xx, 539. The study done on securities law is less vulnerable to criticism on transparency grounds than the work on corporate law since the authors made available extensive background information on the internet. See http://post.economics.harvard.edu/faculty/shleifer/papers/Securities_data.xls (for the raw data La Porta *et al.* used for their securities law index); http://econweb.fas.harvard.edu/faculty/shleifer/Data/securities_documentation.pdf (for expert reports, organized by country).

31 Simeon Djankov, Rafael La Porta, Florencio López-de-Silanes and Andrei Shleifer, "The Law and Economics of Self-Dealing", (2005), unpublished working paper, 4, 26.

32 Id. at 31. For the purposes of the paper, Djankov, La Porta, López-de-Silanes and Shleifer also constructed and ran regressions using a new index of corporate law that focused specifically on self-dealing. The self-dealing index, which was designed to measure on a cross-border basis how a hypothetical self-dealing contract was regulated, has three dimensions: public enforcement (fines and other criminal sanctions); private enforcement *ex ante* (regulation of the approval process by which the hypothetical transaction could be validated) and private enforcement *ex post* (the ease with which aggrieved minority shareholders could prove wrongdoing). The authors found with regressions they ran that there were statistically significant correlations between all three of their self-dealing measures and various indicators of the development of stock markets. However, only *ex post* private control of self-dealing "mattered" for the topic of concern here, namely ownership concentration: id. at 22-24. As a result, this paper does not subject the self-dealing index to the same scrutiny as the anti-director rights and securities law indices.

33 Holger Spamann, "On the Insignificance and/or Endogenity of La Porta *et al.*'s 'Anti-Director Rights Index'", (2006), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=894301 .

ground-breaking comparative research that has put corporate law in the spotlight in a manner that has not occurred before or is likely to be replicated soon.[34]

C. The Implications for Academic Corporate Lawyers

The law matters story, assuming the original findings remain undisturbed, offers a potentially reassuring message to corporate law scholars who might be wondering whether the rules they teach in class and write about are more than a side-show. The economically-oriented "contractarian" model of the corporation emerged as the dominant school of thought among academic corporate lawyers during the 1980s and 1990s, particularly in the U.S.[35] The contractarian model treats the corporation as a set of consensual transactions with relations being driven primarily by market dynamics, supported at various key junctures by norm-based governance.[36] From this perspective corporate law seemingly has only a modest supplementary role to play, this ideally being helping private parties to effectuate preferred business objectives.[37] Put more strongly, from an economic perspective, corporate law, at least in the U.S., might only be "an empty shell that has form but no content"; in a word "trivial".[38]

Corporate law academics understandably might be troubled that the subject matter of their research is "trivial".[39] For those worried on this count, the law matters thesis is welcome news. If La Porta, López-de-Silanes and Shleifer are correct, the quality of corporate law does not simply influence how those associated with individual companies

[34] On the innovative nature of the work done, see Roe, "Corporate Law's", supra note xx, 252. For examples of studies using the anti-director index as a departure point, see those cited by Siems, "Numerical", supra note xx, 525-26 as well as Marco Pagano and Paolo F. Volpin, "The Political Economy of Corporate Governance", (2005) 95 American Economic Review 1005.

[35] Brian R. Cheffins, The Trajectory of (Corporate Law) Scholarship (Cambridge: Cambridge University Press, 2004), 44-49.

[36] For various papers where authors use norms-driven analysis to supplement contractarian insights, see Symposium, Norms & Corporate Law, (2001) 149 University of Pennsylvania Law Review 1607.

[37] Thomas W. Joo, Corporations and the Role of the State: Putting the "Law" Back Into "Private Law", (2002) 35 University of California at Davis Law Review 523, 523.

[38] Bernard S. Black, "Is Corporate Law Trivial? A Political and Economic Analysis", (1990) 84 Northwestern University Law Review 542, 543.

[39] See, for example, Therese H. Maynard, "Law Matters. Lawyers Matter." (2002) 76 Tulane Law Review 1501.

conduct themselves but dictates the configuration of national corporate governance arrangements. Hence, at a more fundamental level than most corporate law academics would have likely envisaged, law seemingly does "matter".

3. The "Law Matters" Thesis in a British Context

A. Setting the Scene

The intuition underlying the law matters thesis is easy to grasp and there is empirical evidence that supports the claims made. Still, while the law matters thesis provides a good "story", at least with respect to Britain, history casts doubt on its persuasiveness. The United Kingdom, uniquely within Europe, has an "outsider/arm's-length" system of ownership and control akin to that in the U.S.[40] Ownership is diffuse in the sense that most large companies are publicly quoted and lack an "insider" shareholder who owns a large block of equity.[41] Share ownership is institutionally dominated, with domestic institutional investors (primarily pension funds, insurance companies and collective investment vehicles known as unit trusts and investment trusts) owning 49% of the shares in U.K. public companies as of 2004 and foreigners – again primarily institutional investors – owning 33%.[42] Though there are instances of activism,[43]

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40 Erik Berglöf, "A Note on the Typology of Financial Systems" in Klaus J. Hopt and Eddy Wymeersch (eds.), Comparative Corporate Governance: Essays and Materials (Berlin: Walter de Gruyter, 1997), 151, 157-64; John Armour, Brian R. Cheffins and David A. Skeel, "Corporate Ownership and the Evolution of Bankruptcy Law: Lessons from the United Kingdom" (2002) 55 Vanderbilt Law Review 1699, 1704, 1715, 1750-52 (conceding differences exist between the U.S. and the U.K. systems of corporate governance but concluding they share an outsider/arm's-length system of ownership and control).

41 Marc Goergen and Luc Renneboog, "Strong Managers and Passive Institutional Investors in the U.K." in Fabrizio Barca and Marco Becht (eds.), The Control of Corporate Europe (Oxford: Oxford University Press, 2001), 259, 280 (providing empirical evidence indicating "the ownership structure of British listed companies differs radically from that found on the Continent"). See also Mara Faccio and Larry H.P. Lang, "The Ultimate Ownership of Western European Corporations", (2002) 65 Journal of Financial Economics 395; Christoph van der Elst, "The Equity Markets, Ownership Structures and Control: Towards an International Harmonization?" in Klaus J. Hopt and Eddy Wymeersch (eds.), Capital Markets and Company Law (Oxford: Oxford University Press, 2003), 3.

42 National Statistics Online database, *supra* note xx: http://www.statistics.gov.uk/statbase/TSDTimezone.asp, "Share Ownership" release/Table A: Beneficial Ownership of Shares, 1963-2004. Among U.K.-based institutional investors, the breakdown as of 2004 was: insurance companies 17.2%, pension funds 15.7%, investment trusts 3.3%, unit trusts 1.9% and other institutional investors 10.7%. For additional background, see Tony Tassell and Lina Saigol, "International Investors in the UK are Buying the Keys to the Kingdom", Financial Times, June 22, 2005, 21 (attributing

institutional shareholders tend to be passive investors. As a 2001 review of institutional investment commissioned by the U.K. government said, "(i)t remains widely acknowledged that concerns about the management and strategy of major companies can persist among (company) analysts and fund managers for long periods of time before action is taken."[44] The "outsider/arm's-length" nomenclature thus is apt for the U.K.

How did this system of ownership and control take shape? The law matters thesis implies that the law would have offered a protective environment to potentially vulnerable outside investors as control structures unwound. Matters in fact developed differently.[45]

Larger British industrial and commercial firms first began to join the stock market in the late 19th century. Nevertheless, primarily due to continuing family involvement, public companies rarely lacked a dominant shareholder.[46] Between World War I and World War II ownership blocks unwound at least to some degree in numerous U.K. public companies.[47] Still, as of the mid-1930s, even among the largest companies in the U.K., a majority continued to have a "dominant ownership interest".[48]

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the growth in foreign investors to international fund management groups taking greater market share and identifying "other institutional investors" as hedge funds, venture capital companies and investment companies).

43 Paul Myners, *Institutional Investment in the UK: A Review* (London: HM Treasury, 2001), 89.

44 Id.

45 For a more detailed account of the chronology than is provided here, see Brian R. Cheffins, "History and the Global Corporate Governance Revolution: The UK Perspective", (2001) 43 Business History 87, 89-90.

46 Alfred D. Chandler, Scale and Scope: The Dynamics of Industrial Capitalism (Cambridge, MA: Belknap Press, 1990), 240-42; Lance E. Davis and Robert E. Gallman, Evolving Financial Markets and International Capital Flows: Britain, the Americas, and Australia, 1865-1914 (Cambridge: Cambridge University Press, 2001), 162-63.

47 Julian Franks, Colin Mayer and Stefano Rossi, "The Origination and Evolution of Ownership and Control", (2003) ECGI Finance Working Paper No. 09/2003, Table 4 (finding that with a sample of 25 companies incorporated around 1900, the percentage of shares owned by the directors collectively fell from 54% to 36% between 1920 and 1940).

48 P. Sargant Florence, Ownership, Control and Success of Large Companies: An Analysis of English Industrial Structure and Policy 1936-1951 (London: Sweet & Maxwell, 1961), 240-41. Florence was summarizing the results of his study of ownership patterns in 82 manufacturing and commercial (e.g. shipping and newspapers) companies as of 1936. He categorized these as "very large" on the basis they had issued share capital with a par value of £3 million or over.

By the beginning of the 1950s, family control of some form remained the norm in major U.K. companies.[49] Nevertheless, among the very largest firms, a trend towards a divorce between control and ownership was becoming clear.[50] The unwinding of voting control in U.K. public companies continued apace and by the end of the 1970s, family owners had been largely marginalized. A study of British business carried out in 1969 remarked upon the "steady decline of family power in British industry" and suggested that "the family empire" was "being steadily swept away by the forces of nature".[51] Business historian Geoffrey Jones, in a 1999 paper, concurred, saying of the decades following World War II:

> "Personal capitalism and family ownership was swept away in these decades. Britain became the classic Big Business economy, with an unusually unimportant small and medium-sized sector, and with ownership separated from control."[52]

The decline of family capitalism was accompanied by the rise of institutional investment. As of 1957, U.K.-based institutional investors owned between them 21% of all U.K. quoted equities. This figure rose to 30% in 1963, 48% in 1975 and 60% in 1991.[53] Over the same period, the percentage of shares owned directly by individuals dropped from 66% in 1957 to 54% in 1963, 38% in 1975 and 20% in 1991.[54]

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[49] Leslie Hannah, "Visible and Invisible Hands in Great Britain", in Alfred D. Chandler and Herman Daems (eds.), Managerial Hierarchies: Comparative Perspectives on the Rise of the Modern Industrial Enterprise (Cambridge, MA, 1980), 41, 53 (119 of the largest 200 British firms had family board members in 1948); Derek F. Channon, The Strategy and Structure of British Enterprise (London: Macmillan, 1973), 75, 161 (finding in a study of the largest 100 manufacturing companies in the U.K. as of 1970 that 92 were carrying on business as of 1950 and that 50 of the 92 were under family control at that point).

[50] Florence, Ownership, *supra* note xx, 186-87. Florence based his claim on his study of the share ownership structure in all 92 of the UK's manufacturing and commercial companies having over £3 million of issued share capital as of 1951.

[51] Graham Turner, *Business in Britain* (London: Eyre and Spottiswoode, 1969), 221, 239.

[52] Geoffrey G. Jones, "Corporate Governance and British Industry", (1998-99), University of Reading Department of Economics Discussion Paper in Economics and Management, No. 399, 14.

[53] For 1957, see John Moyle, "The Pattern of Ordinary Share Ownership", (1971), University of Cambridge Department of Applied Economics Occasional Paper #31, 18. Otherwise, see National Statistics Online database, *supra* note xx.

[54] National Statistics Online database, *supra* note xx.

If institutional shareholders had chosen to work together to dictate to managers how firms should be run, the institutions could have replaced family owners as "hands on" controllers of Britain's public companies. This potential for control was not turned into reality.[55] According to a 1978 report prepared for the Institute of Chartered Accountants of England and Wales,

> "(i)nstitutional participation in managerial decision-making has been favoured generally (but)…(f)inancial institutions have generally been unwilling to act collectively in the use of their voting strength, or to accept those responsibilities which others would assign to them".[56]

With institutional investors shying away from direct involvement in the management of U.K. public companies, Britain's version of "outsider/arm's-length" system of corporate governance was firmly in place by the end of the 1970s.[57]

B. Company Law

Given the chronology, in order for events occurring in Britain to fall into line with the "law matters" thesis the country should have had "quality" corporate and securities law in the decades following World War II. In fact, U.K. company law did not provide

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55 On the distinction between potential and reality in this instance, see Paul Davies, "Institutional Investors in the United Kingdom," in D.D. Prentice and P.R.J. Holland, (eds.) Contemporary Issues in Corporate Governance (Oxford: Clarendon Press, 1993), 69, 82.

56 Richard J. Briston, and Richard Dobbins, The Growth and Impact of Institutional Investors (London: Institute of Chartered Accountants in England and Wales, 1978), 54. Similarly, Jack Coffee and Bernard Black noted in a 1994 article on British institutional investors that "complete passivity" was absent but remarked upon "the reluctance of even large shareholders to intervene": Bernard S. Black and John C. Coffee, "Hail Britannia? Institutional Investor Behavior Under Limited Regulation", (1994) 92 Michigan Law Review 1997, 2086.

57 The evidence on this point is not entirely clear cut. See Steve Nyman and Aubrey Silberston, "The Ownership and Control of Industry", (1978) 30 *Oxford Economic Papers* (NS), 74, who examined ownership and control in the largest U.K. companies by either net assets or sales as of 1975 and found that 56.3% of the 224 they focused upon were "owner-controlled." Nyman and Silberston, however, relied on an expansive definition of "owner-controlled", bringing into this category not only any company with a shareholder having a stake of 5% or more of the equity but also any firm with a family chairman or managing director. According to their data, if "owner-controlled" was simply defined to include only those companies where a shareholder owned 10% of the equity only 42.4% would have qualified and only 30.8% would have done so with a 20% cut-off.

extensive protection for outside investors during this period.[58] Contemporaries generally echoed this view. Some did suggest that outside shareholders were in fact well protected. For instance, L.C.B. Gower observed in the 1969 edition of his well-known text on company law that a shareholder "now has an impressive array of remedies at his disposal, especially where fraud or unfairness is alleged".[59] On the other hand, Tom Hadden remarked in the 1972 edition of his company law text on the "relative impotence of shareholders, and especially minority shareholders" and suggested "the minority shareholder's effective powers of intervention are insufficient to allow him to protect his legitimate interests."[60] Economist J.F. Wright observed similarly in a 1962 chapter on the finance of industry that "(a)lthough shareholders have certain legal rights, these are little more than minimal requirements of good faith from directors".[61] R.R. Pennington concurred in his 1968 text on investors and the law, explaining the reluctance of shareholders to intervene in corporate affairs in the following terms:

> "(I)t is worth asking whether the history of company law over the last hundred years with its tolerance of voteless shares, the exclusion of minority shareholders from boards of directors, and the obstacles placed in the way of shareholders seeking legal remedies, is not largely responsible for the apathy."[62]

It is understandable why contemporaries generally asserted that U.K. company law was not highly protective of outside investors in the decades following World War II.

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[58] Cheffins, "Does Law", supra note xx, 468-72, 476-81.

[59] L.C.B. Gower, The Principles of Modern Company Law, 3rd ed. (London: Stevens & Sons, 1969), 614.

[60] Tom Hadden, Company Law and Capitalism (London: Weidenfeld and Nicolson, 1972), 278.

[61] J.F. Wright, "The Capital Market and the Finance of Industry" in G.D.N. Worswick and P.H. Ady (eds.), The British Economy in the Nineteen-Fifties (Oxford: Clarendon Press, 1962), 461, 463.

[62] R.R. Pennington, The Investor and the Law (London: MacGibbon & Kee, 1968), 502. See also at 477, where Pennington said about shareholder voting:

> "(T)he law should provide minimum guarantees for shareholders so that they may exercise their voting rights freely and not be overborne by controlling groups acting against the interests of the average shareholder, either out of self-interest or otherwise improperly. At present the laisser-faire attitude of the mid-nineteenth century still permeates the case law, and…controlling shareholders are permitted to vote without restraint in their own self-interest and to the detriment of the minority shareholders."

Minority shareholders in U.K. public companies, unlike their counterparts in the U.S., had little chance of gaining standing to sue directors for breaches of duty or relying on an "appraisal remedy" (the right of shareholders to demand a buy-out of their shares after dissenting on specified fundamental issues).[63] Moreover, insider dealing was not made illegal until 1980.[64]

Scoring U.K. company law over time on the anti-director index complied by La Porta, López-de-Silanes and Shleifer offers further confirmation that outside investors in Britain were not afforded extensive legal protection as ownership structures unwound. La Porta, López-de-Silanes and Shleifer's anti-director rights index was composed of six elements. These were: 1) the ability of a shareholder to cast votes at a shareholder meeting by mailing in a proxy form; 2) a possible requirement to deposit shares before a proxy vote; 3) the availability of cumulative voting, which permits minority shareholders to "bundle" their votes and thereby increases the likelihood they can elect their representatives to the board of directors; 4) mechanisms offering relief to oppressed minority shareholders; 5) rules obliging a company to give existing shareholders a right of first refusal when new shares are issued ("pre-emptive" rights) and 6) the ability of shareholders owning up to 10% of the shares to call, on their own initiative, a shareholders' meeting.[65] Currently, according to the index La Porta *et al.* compiled, Britain scores "5" out of "6", with the only "0" occurring because U.K. companies legislation does not provide for cumulative voting.[66] As Table 1 indicates, however, historically matters were much different.[67]

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[63] Cheffins, "Does", *supra* note xx, 469-70, 477.

[64] *Id.* at 470-71, 478.

[65] La Porta et al., "Law", supra note xx, 1127-28.

[66] Id., 1130. The U.K.'s score remains the same under the revised anti-director index compiled by Djankov et al.: "Law and Economics", supra note xx, Table XII.

[67] Some others have examined the evolution of U.K. corporate law by reference to La Porta *et al.*'s anti-director index. See Franks, Mayer and Rossi, "Origination", *supra* note xx, 28; Kathrina Pistor, Yoram Keinan, Jan Kleinheisterkamp and Mark D. West, "The Evolution of Corporate Law: A Cross-Country Comparison" (2002) 23 University of Pennsylvania Journal of International and Economic Law 791, 802-3.

Table I: Historical Evolution of U.K. Company Law, as Measured by La Porta, López-de-Silanes and Shleifer's Anti-Director Index

	Anti-Director Index Score	Explanation
Mid 19C-1900	1	British companies legislation has never required shareholders to deposit their shares with the company or a financial intermediary prior to a shareholder meeting and thus has always scored at least one out of six on the anti-director index.[68]
1900-1948	2	A 1900 amendment authorized shareholders owning 10% of the shares to call a shareholders meeting.[69]
1948-1980	3	The Companies Act 1948 created a statutory right for shareholders to vote by proxy.[70]
1980-present	5	Companies issuing new shares were required to make the equity available on a pro-rata basis to existing shareholders in accordance with the percentage of shares

[68] Deducing how a country's company law should be scored on this issue is not fully straightforward. La Porta et al. indicated a country would receive a "1" on the proxy deposit variable "if the company law…does not allow firms to require that shareholders deposit their shares prior to a general shareholders meeting": "Law", supra note xx, 1122. The authors also said, however, a "1" would be appropriate so long as the depositing of shares was not required: ibid., 1127. Presumably because U.K. companies legislation was silent on the issue, Britain was given a "1" on this count.

[69] Companies Act 1900, 63 & 64 Vict., ch. 48, s. 13. Others tracing the U.K.'s anti-director index score over time erroneously cite different dates for the introduction for the change to the law: Franks, Mayer and Rossi "Origination", supra note xx, 28 (1948); Pistor *et al.*, "Evolution", *supra* note xx, 803 (saying 1909, and saying also the % was dropped to 5% in 1948, which never occurred).

[70] Companies Act 1948, s. 136. Section 210 of the Companies Act 1948 was addressed specifically to the protection of oppressed shareholders, which is one of the criteria upon which the La Porta et al. anti-director index is based. Nevertheless, the protection afforded was so weak that a "0" score is more appropriate than "1". See Hadden, Company Law, supra note xx, 260 (saying that "it is clear that the restrictive interpretation of s. 210 adopted by the courts has largely destroyed its efficacy as a genuine protection for minority interests").

Pistor, Keinan and Kleinheisterkamp and West give U.K. company law a "1" on the protection of minority shareholder count all the way back to 1844, saying a "direct shareholder suit" was authorized by companies legislation enacted in that year: supra note xx, 803. It is not clear what shareholder rights the authors had in mind, since LLSV focused on "oppression" in their anti-director index rather than the possibility of bringing a "shareholder suit". Pistor, Keinan and Kleinheisterkamp and West state erroneously that the right of shareholders to bring a derivative suit was only recognized in 1975. The right to do so – which U.K. company law tightly circumscribed – had in fact been recognized since Foss v. Harbottle (1843) 2 Hare 461.

[71] Companies Act 1980, ch. 22, s. 17.

		already owned.[71] The judiciary was authorized to grant a remedy to a shareholder who had been unfairly prejudiced by a company's actions.[72]

For present purposes, the aspect of the table that deserves the closest attention is 1948-80, since it was during this period that Britain's outsider/arm's-length system of corporate governance took shape. During this period, one major piece of companies legislation was passed, the Companies Act 1967.[73] This legislation made various changes to the existing statutory scheme, including the introduction of more rigorous disclosure requirements for large blocks of shares, director shareholdings and contracts between directors and their companies.[74] Nevertheless, since the changes did not relate to any of the variables in La Porta, López-de-Silanes and Shleifer's anti-director index, the U.K.'s score would have remained unchanged.[75] Hence, during the decades when ownership separated from control in Britain, the country's company law simply equalled the average (3.00) for the 49 countries upon which La Porta *et al.* focused when constructing the 1990s version of their anti-director rights index.

Only in 1980 did Britain's score became "5". This pushed the U.K. ahead of the anti-director index average for common law countries (4.00) and into line with countries such as the United States and Canada.[76] Nevertheless, to the extent the index measures the extent to which law constrains insider misconduct and protects minority shareholders,

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72 Companies Act 1980, s. 75; now Companies Act 1985, s. 459. Franks, Mayer and Rossi concur that the U.K.'s score on oppression of minority shareholders changed from "0" to "1" in 1980: "Origination", supra note xx, 7.

73 Companies Act 1967, c. 81.

74 Companies Act 1967, s. 16 (requiring companies, via annual directors' reports, to disclose publicly directors' interests in contracts with the company and details of directors' holdings of shares), ss. 33, 34 (requiring companies to maintain a register of shareholders owning 10%+ or more of the outstanding shares that was to be open for inspection by the public).

75 The changes in 1967 would have improved the U.K.'s score on Djankov, La Porta, López-de-Silanes and Shleifer's private enforcement *ex post* self-dealing index (see *supra* note xx). This is because with this index a country's score is governed partly by whether its corporate legislation obliges companies to divulge publicly the existence of large share blocks and report material facts about transactions in which directors have a personal interest.

76 Under the revised anti-director index compiled by Djankov et al. the U.S. scored only a "3". See "Law and Economics", supra note xx, Table XII.

U.K. company law failed to offer the sort of protection to outside investors one would expect for a country where ownership was separating from control in public companies.

C. Securities Law

Given the correlations La Porta, López-de-Silanes and Shleifer found between private enforcement of prospectus regulation on the one hand and the size of national stock markets and the configuration of share ownership on the other, one would expect that the U.K. would have scored well on this count as control structures unravelled. As with company law, however, this was not the case. Again, La Porta *et al.* measured private enforcement with two components, the extent of disclosure required in prospectuses and the burden of proof an investor was required to meet when suing a company, its directors and its accountants for misdisclosure. With both, for the period when ownership separated from control, the U.K.'s scores were lower than would have been anticipated if law was the catalyst for the unwinding of control blocks.

La Porta, López-de-Silanes and Shleifer focused on six variables when calculating their private enforcement disclosure scores. One was the presence or absence of a legal requirement that a company deliver a copy of a prospectus to those contemplating buying shares in a public offering. The other five were matters to be discussed in prospectuses companies issued, namely executive compensation, equity ownership structure, share ownership by directors, "irregular" contracts and "related party" transactions.[77] La Porta *et al.* give Britain a 0.83 disclosure rating (five "1"s out of a possible six), with the gap being that companies are not required to deliver prospectuses to prospective investors.[78] This figure is only slightly above average for common law countries (0.78) but is well ahead of the norm for countries of French legal origin (0.45) and German legal origin (0.60).

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[77] La Porta et al. "What Works", supra note xx, 6.

[78] See http://post.economics.harvard.edu/faculty/shleifer/papers/Securities_data.xls (United Kingdom entry). For more background, see Alistair Alcock, "Securities Law of United Kingdom", in http://econweb.fas.harvard.edu/faculty/shleifer/Data/securities_documentation.pdf , 275. La Porta, López-de-Silanes and Shleifer, in compiling their securities law scores, relied on reports of local experts; Alcock's paper was the expert report on the U.K.

In a sense, the U.K.'s high disclosure regulation score should not be surprising since Britain was a pioneer with respect to the regulation of prospectuses.[79] Nevertheless, as Table II shows, in historical terms Britain's disclosure requirement rating was not very flattering. To put the U.K.'s disclosure score into proper context, it is essential to bear in mind the status of the London Stock Exchange's Listing Rules. Through its Listing Rules, the Exchange regulated corporate disclosure and obliged listed companies to provide more information than was required by U.K. companies legislation.[80] Particularly from the 1960s onwards, the London Stock Exchange imposed tough disclosure requirements on listed companies.[81] These reforms, however, would not have affected the U.K.'s disclosure regulation score.

In grading the quality of securities law, La Porta, López-de-Silanes and Shleifer focused on "actual laws, statutes…and any other rule with force of law."[82] Before the mid-1980s, the Listing Rules did not fall into this category, since the obligations they imposed on companies listed on the London Stock Exchange were at most contractual in orientation.[83] The Financial Services Act 1986 gave the London Stock Exchange's listing rules the status of subordinate legislation, which would have qualified the relevant provisions for inclusion in the U.K.'s disclosure regulation score and therefore accounts for the dramatic 1986 improvement from 0.33 to 0.75.[84]

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[79] Paul G. Mahoney, "Mandatory Disclosure as a Solution to Agency Problems", (1995) 62 University of Chicago Law Review 1047, 1063.

[80] Cheffins, "History", *supra* note xx, 98; Douglas M. Branson, Some Suggestions from a Comparison of British and American Tender Offer Regulation, (1971) 56 Cornell Law Review 685, 710, n. 122.

[81] The process began in earnest in 1964 when the London Stock Exchange issued a statement making a number of recommendations in the direction of more disclosure. See Charles Anderson, "The Stock Exchange and Disclosure", The Banker, October 1964, 619; Harold Rose, Disclosure in Company Accounts, 2nd ed. (London: IEA, 1965), 57-58.

[82] La Porta et al., "What Works", supra note xx, 5.

[83] L.C.B. Gower, J.B. Cronin, A.J. Easson and Lord Wedderburn of Charlton, Gower's Principles of Modern Company Law, 4th ed. (London: Stevens & Sons, 1979), 506, note 90 (speculating that the listing rules were not intended to create a legally enforceable contract, but discussing case law authority suggesting that they were contractual in orientation).

[84] Financial Services Act 1986, s. 142(6) (designating the Stock Exchange as the "competent authority" for the part of the Act dealing with the official listing of securities), s. 144(2) (authorizing "the

Table II – Historical Evolution of Disclosure Requirements for Prospectuses Under U.K. Law

	Prospectus Delivery	Director Share Ownership	Executive Compensation	Irregular Contracts	Ownership Disclosure	Related Party Transactions	**Disclosure Requirement Score**
1867-1986	0	0	0	1.00[85]	0	1.00[86]	0.33
1986-1995[87]	0	1.00	0.50	1.00	1.00	1.00	0.75
1995-present	0	1.00	1.00[88]	1.00	1.00	1.00	0.83

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competent authority" to require the submission of listing particulars – essentially equivalent to a prospectus -- as a condition of listing).

The chronology provided here glosses over a complex situation existing during 1985 and 1986. During these years, certain items in the London Stock Exchange Listing Rules would have qualified as a "rules of law" and other provisions would not have. For background, see Clive M. Schmitthoff (ed.), Palmer's Company Law, 24th ed. (London, 1987), 272, 276-77, 297-98.

85 Beginning in 1867, a company issuing a prospectus was required to disclose contracts that would influence whether an applicant would take up shares. Companies Act 1867, 30 & 31 Vict., ch. 131, s. 38.

86 From 1867 onwards, a company issuing a prospectus had to disclose corporate transactions to which its directors were parties: Companies Act 1867, s. 38. The contracts in question also had to be material to a potential purchaser of shares; this was a judicial gloss on the legislation. See A.F. Topham, Palmer's Company Law, 19th ed. (London: Stevens & Sons Ltd., 1949), 350-51.

87 With the version of the London Stock Exchange Listing Rules that was in effect when the Listing Rules were transformed into subordinate legislation, four of the five topics specified by La Porta, López-de-Silanes and Shleifer were dealt with in a manner where a score of "1" was appropriate. See Council of the Stock Exchange, Admission of Securities to Listing (London: International Stock Exchange of the United Kingdom and Ireland, 1984), Section 3, chapter 1, ¶¶ 3.9 (equity ownership structure), 4.8 (fundamental/irregular contracts), 6.5 (related party transactions), 6.6. (director share ownership). With the fifth topic, executive pay, the score would have been ".50" rather "1" because the Listing Rules only required that aggregate figures be divulged (id., Section 3, chapter 1, ¶ 6.3). La Porta et al. say a "1" is only appropriate when the executive pay arrangements of individual executives have to be disclosed: "What Works", supra note xx, 6.

88 La Porta, López-de-Silanes and Shleifer gave the U.K. a "1" on executive compensation disclosure. In so doing, they relied on s. 80 of the Financial Services and Markets Act 2000, which stipulates that listing particulars must include all information investors would reasonably require. The reasoning, according to the report on the U.K. prepared by Alistair Alcock, was that regulators in the U.K. would expect companies to provide detailed remuneration data for senior executives in listing particulars: *supra* note xx, 275-76. Accepting for the sake of argument that La Porta, López-de-Silanes and Shleifer's analysis is correct, it is unclear when companies carrying out public offerings would reasonably have been expected to divulge information on the remuneration arrangements of individual executives. The Financial Services Act 1986 contained a provision (s. 146) equivalent to s. 80 of the Financial Services Markets Act 2000, so in theory the U.K. could have been given a "1" back to 1986. 1995 has been selected, however, for present purposes, with the rationale being that the London Stock Exchange's Listing Rules were amended that year to require listed companies to disclose annually on an individualized basis the pay arrangements of their directors. See Brian R. Cheffins, Company Law: Theory, Structure and Operation (Oxford: Oxford University Press, 1997), 663.

The U.K.'s score with executive pay now has a firmer foundation. The Prospectus Regulation, a European Union measure that came into force in 2005 and is directly applicable as law in Member States

With the burden of proof investors are required to meet in civil suits involving allegations of misdisclosure, La Porta *et al.* award Britain a grade of 0.66. This is only slightly above average for common law countries (0.60) but again is well ahead of the norm for countries of French legal origin (0.39) and German legal origin (0.42). The 0.66 mark is based on an average of three components, these being identical 0.66 burden of proof grades for suits brought against a company, its directors and its accountants.[89] As Table III indicates, however, between 1948 and 1986, which again encompasses the period when the U.K.'s outsider/arm's-length system of ownership and control largely took shape, Britain's score was only 0.44. The Financial Services Act 1986 boosted the U.K.'s score to its current level. The relevant statutory provisions were revised as part of an overhaul of financial services regulation occurring in 2000, but the U.K.'s score did not change.[90]

Table III – Historical Evolution of the Burden of Proof for Prospectus Misdisclosure Under U.K. Law

	Suing the Company	Suing Directors	Suing Accountants	**Burden of Proof Score**
Mid19C-1890	0.66[91]	0[92]	0[93]	0.22

such as the U.K., stipulates that information on the service contracts of directors must be provided in a prospectus. See Commission Regulation (E.C.) 809/2004 O.J. 2004 L149/1, Annex 1, ¶ 16.2.

89 See http://post.economics.harvard.edu/faculty/shleifer/papers/Securities_data.xls (United Kingdom entry).

90 See Alcock, "Securities", *supra* note xx, 278-80, discussing the Financial Services and Markets Act 2000, c. 8.

91 Under the common law those allotted shares as part of a public offering could sue the company for recission of the purchase if there was misdisclosure in the prospectus: see Lynde v. Anglo-Italian Hemp Spinning Co. [1896] 1 Ch. 178; Collins v. Associated Greyhound Racecourses [1930] 1 Ch. 1. The plaintiff could do so without proving that the misrepresentations were made knowingly or recklessly: see Smith's Case (1867) 2 Ch. App. 604, 615, affd. sub. nom. Reese River Co. v. Smith (1869) L.R. 4 H.L. 79. The plaintiff, however, had to establish the materiality of the misrepresentation and reliance upon it: Alcock, "Securities", supra note xx, 280. According to La Porta, López-de-Silanes and Shleifer's methodology, this means a score of 0.66 is appropriate, not 1.00. On how they measure the liability standard for companies issuing shares, see La Porta et al., "What Works", supra note xx, 7.

92 At common law, investors could only sue directors on the basis of a misleading prospectus by showing the directors made the misstatement with knowledge of its falsity or did so recklessly: Derry v. Peek (1889) 14 App. Cas. 337 (H.L.). This meant the standard of proof score was "0", which La Porta et al. say is correct if a plaintiff can only sue successfully if misdisclosure in a prospectus is intentional or characterized by gross negligence. On how they measure the liability standard of directors, see La Porta et al., "What Works", supra note xx, 7.

1890-1948	0.66	0.33[94]	0	0.33
1948-1986	0.66	0.33	0.33[95]	0.44
1986-present	0.66[96]	0.66[97]	0.66[98]	0.66

A way of synthesizing the historical trends with the regulation of prospectuses is to use the disclosure and burden of proof figures to formulate an overall private

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93 Under the common law, an investor buying equity in a public offering could only succeed in a suit against a company's accountants if they were part of a conspiracy to defraud potential investors. See Committee on Company Law Amendment (Mr. Justice Cohen, chair), Report, Cmnd. Paper 6659, (London: HMSO, 1945), 24. This meant the standard of proof score was "0", which La Porta et al. again say is correct if a plaintiff can only win if misdisclosure in a prospectus is intentional or characterized by gross negligence. On how they measure the liability standard of accountants, see La Porta et al., "What Works", supra note xx, 7.

94 As a result of the Directors' Liability Act of 1890, ch. 64, 53 & 54 Vict., a person who subscribed to purchase shares in a public offering supported by a misleading prospectus had a statutory right to sue the directors of the company in question. Liability existed regardless of the absence of fraud or recklessness, but investor reliance on the misstatement was explicitly required. The relevant phrase was "on the faith of the prospectus": Directors' Liability Act 1890, s. 3(1). Moreover, directors could escape liability by establishing that they believed on reasonable grounds that what was said was true: Directors' Liability Act 1890, s. 3(1)(a). The U.K.'s burden of proof score for suing directors thus would have been 0.33, which La Porta et al. stipulate is appropriate if investors can only bring a successful suit if they prove that a director acted with negligence and that there was reliance on the prospectus.

95 The Companies Act 1948 stipulated that if experts (e.g. accountants) consented to a report being included as part of a prospectus they were liable to compensate for losses sustained by reason of an untrue statement in the report. See Companies Act 1948, s. 43 as well as s. 40 (stipulating that if an expert's report accompanied a prospectus, the prospectus could not be distributed unless the expert had consented) and s. 46 (deeming statements made in supporting reports to be treated as part of the prospectus). The legislative change would have moved the burden of proof score concerning accountants from 0.00 to 0.33, but no higher since a plaintiff still had to establish reliance on the misdisclosure and accountants were absolved of responsibility if they were not negligent (i.e. they reasonably believed the statements made were true).

96 Since the mid-1980s investors have had a statutory option for suing a company on the basis of misdisclosure in listing particulars. The statutory remedy does not qualify for a "1" score because the issuer can rely on a reasonable belief defense. On the logic involved, discussed in terms of current legislation, see Alcock, supra note xx, 280.

97 The Financial Services Act 1986 repealed the rules in U.K. companies legislation regulating civil liability for misleading prospectuses and introduced a regime authorizing suits against "persons responsible for any listing particulars": ss. 150-52. The 1986 legislation deemed company directors to be "persons responsible" for listing particulars: Financial Services Act 1986, s. 152(1)(b). A 0.66 score is appropriate for directors because ss. 150-52 stipulated an aggrieved investor could bring a successful claim against "persons responsible" without proving reliance but defendants had a defense if they had reasonable grounds for believing listing particulars were accurate.

98 "Persons responsible for listing particulars" was defined to include those accepted responsibility for any part of the particulars: Financial Services Act 1986, s. 152(1)(b). This would have encompassed an accountant whose report appeared in listing particulars with his consent: Schmitthoff (ed.), Palmer's, supra note xx, 312.

enforcement index score.[99] Extrapolating from La Porta *et al.*'s data, Britain would currently have a score of 0.75, calculated on the basis of an average of its disclosure requirement (0.83) and burden of proof (0.66) figures. Britain's score exceeds the common law average (0.69), if only modestly, but is considerably higher than the French legal origin average (0.42) and the German legal origin average (0.51). As Table IV indicates, however, historically matters were much different, with Britain's private enforcement score being much lower during the decades when ownership separated from control than it is currently. Of particular note is the 0.39 score for 1948-86, which covers the decades when the U.K.'s outsider/arm's-length system of ownership and control took shape.

Table IV – Historical Evolution of Prospectus Regulation, as Measured by a Cumulative Private Enforcement Index

	Disclosure Requirements	Burden of Proof	**Private Enforcement Score**[100]
1867-1890	0.33	0.22	0.28
1890-1948	0.33	0.33	0.33
1948-1986	0.33	0.44	0.39
1986-1995	0.75	0.66	0.71
1995-present	0.83	0.66	0.75
English legal origin (average)	0.78	0.60	0.69
French legal origin (average)	0.45	0.39	0.42
German legal origin (average)	0.60	0.42	0.51

As Table IV shows, in historical terms, the pattern with securities law is much the same as it is for company law. Currently, as is the case with company law, the U.K. scores highly with respect to private enforcement of securities law but the score can be

99 La Porta, López-de-Silanes and Shleifer took this step in the version of "What Works" they circulated as a National Bureau of Economics Research working paper but did not do so in the published version. See Rafael La Porta *et al.*, "What Works in Securities Laws?", (2003), NBER Working Paper 9982, Table II.

100 The "private enforcement scores" for the U.K. currently, English legal origin, French legal origin and German legal origin are taken from La Porta et al. "What Works" (NBER Working Paper), supra note xx, Table II.

attributed primarily to legislation enacted after the transition to outsider/arm's-length corporate governance was largely complete. Pivotally, during the decades when ownership structures of larger public companies decisively unwound, Britain's private enforcement rating was inferior to the current average score for common law countries, countries of German legal origin and even countries of French legal origin. Thus, as with company law, the legal protection afforded to investors was considerably below the standard that the law matters story would predict. To the extent La Porta *et al.*'s anti-director and prospectus disclosure indices constitute reliable proxies for the quality of protection afforded to outside investors, factors other than corporate and securities law must have accounted for the unwinding of control blocks in publicly quoted companies in the U.K.

4. The Relevance of Dividends

As the highly stylized example outlined in Part 2 illustrates, the widely held company might not become dominant in a country even if it enjoys inherent economic advantages. One obstacle is the "controller's roadblock": the dominant shareholders in companies might not capture a sufficient portion of the gains available from a transition to dispersed ownership to compensate them for the loss of private benefits of control. Investor scepticism is another: potential buyers of shares for sale would reason logically -- if incorrectly -- that optimistic claims made about future shareholder returns were implausible. Given that corporate law in the U.K. was not highly protective of minority shareholders, what eroded the private benefits of control sufficiently to motivate blockholders to exit? And how were the information asymmetries affecting potential investors addressed?

Various factors played a role. For instance, the profitability of U.K. companies began to decline in the 1960s and fell precipitously in the 1970s.[101] This should have

[101] Christine Oughton, "Profitability of U.K. Firms" in Kirsty Hughes (ed.), The Future of U.K. Competitiveness and the Role of Industrial Policy (London: Policy Studies Institute, 1993), 55, 59 (providing annual data on gross and net profit rates between 1954 and 1991 for companies in the manufacturing and services sectors); W.A. Thomas, The Finance of British Industry (London: Metheun,

diminished the private benefits of control eligible for extraction, which would have provided those owning large blocks of shares in U.K. companies with an incentive to exit. In addition, particularly beginning in the mid-1960s, the London Stock Exchange regulated with increasing strictness disclosure by listed companies and transactions potentially tainted by conflicts of interest.[102] This should have simultaneously reduced the scope for "skimming" by dominant shareholders and fostered confidence among investors contemplating buying shares. Additionally, the financial intermediaries who organized public offerings of shares had, due to concerns about building up and retaining highly valued reputations for competence and propriety, strong incentives to ensure that when companies sold equity to the public arrangements were attractive to potential investors. Such "quality control" would have deterred to some degree sharp practice by controlling shareholders and would have been reassuring to investors.[103]

Merger activity further hastened the unwinding of incumbent ownership structures, as numerous family owners sold out and many of the companies carrying out acquisitions issued shares publicly to finance the deals involved.[104] Also important was a demography and tax-driven "wall of money", namely a massive flow of funds to insurance companies and pension funds that had to be invested somewhere.[105] Shares in U.K. public companies stood out, if only by process of elimination, as a promising potential candidate. Due to inflation, government bonds ("gilts") were generally a bad

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1978), 218, 310 (providing data indicating that gross trading profits, as a percentage of total source of company funds, fell from 72% in 1952-55 to 69% in 1956-60, to 64% in 1961-65 and again to 59% in 1966-70); Committee to Review the Functioning of Financial Institutions (Chairman, Sir Harold Wilson), Evidence on the Financing of Trade and Industry, vol. 3 (London: HMSO, 1977), 230 (pre-tax inflation adjusted rate of returns for companies fell from 13% in 1960 to 9% in 1969 and again to 3.5% in 1976).

102 On disclosure, see Anderson, "Stock Exchange", supra note xx. On related party transactions, see Federation of Stock Exchanges in Great Britain and Ireland, Admission of Securities to Quotation, (London: E. Couchman & Co., 1966), sch. II, Part A, para. 29, Part B, para. 26; Memoranda of Guidance, Acquisitions and Realisations of Subsidiary Companies, Businesses or Fixed Assets by Quoted Companies, and Bids and Offers for Securities of a Company, para. 6.

103 Cheffins, "Does Law", supra note xx, 472-73.

104 Cheffins, "Mergers", supra note xx, 261.

105 Brian R. Cheffins, "Are Good Managers Required for a Separation of Ownership and Control?" (2004) 13 Industrial and Corporate Change 591, 604; John Plender, That's the Way the Money Goes: The Financial Institutions and the Nations Savings (London: Andre Deutsch, 1982), 26; John Littlewood, The Stock Market: 50 Years of Capitalism at Work (London: Financial Times/Pitman Publishing, 1998), 255.

investment.[106] Exchange controls tightly constrained investing abroad.[107] Thus, if only by default, shares of U.K.-based public companies deserved serious consideration by investors.

While these various factors no doubt contributed to the separation of ownership and control in Britain, the story remains incomplete. For instance, though declining profitability in the U.K. corporate sector would have eroded private benefits of control, the situation only became chronic in the 1970s. Similarly, prior to the reforms of the mid-1960s, the requirements the London Stock Exchange imposed on listed companies were not particularly onerous, meaning there was scant information available on public companies.[108] As for scrutiny by financial intermediaries, since this hinged on public offerings occurring, this was only an episodic constraint on those controlling U.K. public companies. Moreover, there was a bias against tapping equity markets. In Britain, as in all major economies, retained earnings have traditionally constituted the dominant source of corporate finance and the contribution of equity has been, in comparison, modest.[109] An abrupt decline in new issues during the mid-1960s even led the *Economist* to remark upon "how unimportant economically is the London equity market".[110]

With institutional investors, while constrained choices dictated that they consider seriously buying shares in public companies, they had good reason to pause. Throughout the 20th century, the real (i.e. inflation-adjusted) return investors obtained by way of

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106 Cheffins, "Are Good", supra note xx, 605.

107 Id., 607-9.

108 "U.S. Analysts' Views of British Industry", Times, April 13, 1959, 17; Clyde H. Farnsworth, "Corporate Data Scarce in Britain", New York Times, October 5, 1963, 28; "British Companies Urged to Disclose More", Times, February 11, 1964 (according to a Scottish investment trust, of the U.K. public companies in which the investment trust held shares, only 3% published quarterly figures and only 38% published annual turnover figures).

109 Colin Mayer, "Financial Systems, Corporate Finance, and Economic Development" in R. Glenn Hubbard (ed.), Asymmetric Information, Corporate Finance, and Investment (Chicago: University of Chicago Press, 1990), 307, 310-12; Jenny Corbett and Tim Jenkinson, How is Investment Financed? A Study of Germany, Japan, the United Kingdom and the United States, [1997] Manchester School, Supplement, 69, 74-75.

110 "New Issues – Less Important and Much Less Fun", Economist, March 16, 1968, 107.

capital gains on U.K. shares was, on average, only 1% annually.[111] Moreover, U.K. companies did not seem promising targets for investment during the decades following World War II. A 1956 report on management succession in British companies bemoaned "(t)he shortage of good managers, particularly at the top."[112] Critics in the early 1970s said there was "a certain claret-grouse-and-port induced somnolence in British boardrooms"[113] with "the unconscious ambition of most directors (being) to retire and become a country squire".[114] Indeed, as Britain lost ground relative to its major industrial rivals in the decades following World War II, inferior corporate leadership was identified by many as the single most important cause.[115] As Robin Marris, a noted economist, said in a 1979 essay, "(t)he principal source of British decline…is its managerial malaise".[116] To the extent such criticism of the executives running U.K. public companies was on the mark, institutional investors had a plausible justification for forsaking corporate equity in favour of other asset classes.

Since the explanations for the unwinding of ownership in U.K. public companies summarized thus far each suffer from notable limitations, there is scope for decisions companies made about distributing cash to shareholders by way of dividends – doing so by repurchasing shares was prohibited until the early 1980s and was irrelevant for tax reasons until the mid-1990s[117] -- to constitute an important supplementary variable. The

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111 Elroy Dimson, Paul Marsh and Mike Staunton, Triumph of the Optimists: 101 Years of Global Investment Returns (Princeton, N.J.: Princeton Univ. Press, 2002), 151.

112 Acton Society Trust, Management Succession (London: Action Society Trust, 1956), 1

113 Fortune Magazine, June 1973, quoted in Charles Raw, Slater Walker: An Investigation of a Financial Phenomenon (London: Andre Deutsch, 1977), 170.

114 George Norman, "The English Sickness", Bankers' Magazine, November, 1973, 192, 195.

115 Derek H. Aldcroft, "The Missing Dimension: Management Education and Training in Postwar Britain" in Derek Aldcroft and Anthony Slaven (eds.), Enterprise and Management (Scolar Press, 1995), 93, 93, 110-11; Geoffrey Owen, From Empire to Europe: The Decline and Revival of British Industry Since the Second World War (London: Harper Collins, 1999), 418.

116 Robin Marris, "Britain's Relative Decline: A Reply to Stephen Blank", in Isaac Kramnick (ed.), Is Britain Dying? Perspectives on the Current Crisis (Ithaca N.Y.: Cornell University Press, 1979), 89, 93.

117 Trevor v. Whitworth (1887) 12 App. Cas. 409 (establishing the common law rule prohibiting the repurchase of shares); Companies Act 1981, c. 62, ss. 45-62 (authorizing share buy-backs under prescribed circumstances); P. Ragahavendra Rau and Theo Vermaelen, Regulation, Taxes and Share Repurchases in

contribution dividends made to investment returns is one point that must be borne in mind. While purely from a capital gains perspective, U.K. shares delivered only a 1% average annual real return during the 20th century, with dividends taken into account the annualized real return on shares in British public companies improved to 5.8%.[118] Thus, dividends were a key "sweetener" that would have given investors an incentive to buy equity.

The dividend policy U.K. public companies adopted also operated in ways more directly relevant to the unwinding of control blocks. Dividends, as we will see, served as a check on the squandering of corporate assets by those running public companies and generated information that should have addressed at least partially apprehension among investors concerned about lack of knowledge of the companies involved. Dividends thus mimicked the role attributed to companies legislation by the law matters thesis and in so doing acted as at least a partial substitute in fostering the unwinding of control blocks.

Especially for those familiar with the basic tenets of modern corporate finance theory, the proposition that dividends "mattered" in the manner just described requires elaboration and justification. During the late 1950s and early 1960s economists Merton Miller and Franco Modigliani formulated a series of "irrelevance" propositions that effectively launched financial economics as a body of knowledge.[119] Their propositions were offered under a deliberately restrictive set of assumptions, such as tax neutrality between dividends and capital gains, full symmetry of information, the absence of

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the United Kingdom, (2002) 75 Journal of Business 245, 251-59 (describing the tax position from 1981 onwards).

118 Dimson, Marsh and Staunton, supra note xx, 151 (assuming dividends were fully reinvested in the stock market).

119 Franco Modigliani and Merton H. Miller, "The Cost of Capital, Corporation Finance and the Theory of Investment" (1958) 48 American Economic Review 261; Merton Miller & Franco Modigliani, "Dividend Policy, Growth and the Valuation of Shares" (1961) 34 Journal of Business 411. On the significance of Miller and Modigliani's contribution to the study of corporate finance, see Jonathan B. Baskin and Paul J. Miranti, A History of Corporate Finance, (Cambridge: Cambridge University Press 1997), 12, 18; Alan J. Auerbach, "Taxation and Corporate Financial Policy" in Alan J. Auerbach and Martin Feldstein (eds.), Handbook of Public Economics, vol. 3 (Amsterdam: Elsevier, 2002), 1250, 1252.

managerial agency costs, perfectly competitive capital markets and no transaction costs.[120] From this departure point, Miller and Modigliani characterized decisions about corporate finance as nothing more than ways of dividing up the cash flows produced by a business and repackaging them for distribution to investors.[121]

Of particular relevance in the present context, under the assumptions Miller and Modigliani made, a company's market value will be determined by "real" economic considerations such as its investment policy and the earning power of its assets rather than by any sort of balance between dividends and retained earnings.[122] Dividend policy will thus be nothing more than packaging of a company's real value; "a mere detail".[123] A corollary is that, assuming a company has settled upon its business strategy and its choice of ventures to pursue and exploit, dividends will not affect returns to investors.[124] This is because the higher (lower) the dividend, the less (more) an investor will receive in capital appreciation.[125] Moreover, since investors can always create a "homemade dividend" by selling some of their own shares, a company's decision to pay or withhold a dividend should be a matter of indifference to them.[126]

While as a matter of pure theory dividends might be a "mere detail", real-world conditions in the U.K. diverged substantially from Miller and Modigliani's assumptions during the period when ownership separated from control.[127] For instance, during the

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120 For a summary, see Ronald C. Lease, Kose John, Avner Kalay, Uri Loewenstein and Oded H. Sarig, Dividend Policy: Its Impact on Firm Value (Boston: Harvard Business School Press, 2000), 36-37.

121 Donald H. Chew, "Introduction: Financial Innovation in the 1980s" in Donald H. Chew (ed.), The New Corporate Finance: Where Theory Meets Practice (New York: McGraw Hill, 1993), ix, xii.

122 Miller & Modigliani, "Dividend", supra note xx.

123 Modigliani and Miller, "Cost" supra note xx, 266; see also Daniel R. Fischel, "The Law and Economics of Dividend Policy", (1981) 67 Virginia Law Review 699, 701.

124 On the importance of holding investment policy constant for the purpose of analysis, see Jeremy Edwards, "Does Dividend Policy Matter?", (1984) 5 Fiscal Studies 1, 1.

125 On this point, see Fischer Black, "The Dividend Puzzle", (1976) 2 Journal of Portfolio Management 5, 5; Zohar Goshen, "Shareholder Dividend Options", (1995) 104 Yale Law Journal 881, 885-86.

126 Fischel, "Law", supra note xx, 701-2.

127 Those who derive insights from Miller and Modligiani's work in fact generally acknowledge their assumptions were not realistic. Instead, the precepts in question are treated as a valuable intellectual

decades following World War II, transaction costs were hefty.[128] This meant that for investors seeking a regular cash flow receiving dividends from the companies in which they owned shares could well be preferable to creating a "homemade dividend" by selling equity. Tax was anything but neutral, with individual investors usually having a strong tax bias in favor of retained earnings, and institutional investors, and particularly pension funds, the converse.[129] Also, capital markets were not perfectly competitive. For instance, the system of dealing in corporate equity, involving "brokers" on the "buy" side and "jobbers" on the "sell" side, was subject to anti-competitive practices that attracted the attention of U.K. antitrust regulators in the 1980s.[130] Given the manner in which markets operated in practice, dividends potentially could function as a substitute for corporate law in a way that would have been impossible under Miller and Modigliani's restrictive assumptions.

5. Dividends and the Private Benefits of Control

A. The Agency Cost Theory of Dividends

The managing director of a leading U.K. fund manager said in a 1994 op-ed in the *Financial Times* newspaper that dividend policy imposes "vital discipline on company boards".[131] What is known as the "agency cost" theory of dividends formalizes the logic involved, ascribing to dividends an important role in curbing the potential excesses of

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departure point. Real-world frictions are then introduced and inferences drawn about the contributions of theoretically irrelevant financial practices. See Peter H. Huang and Michael S. Knoll, "Corporate Finance, Corporate Law and Finance Theory", (2000-01) 74 Southern California Law Review 175, 178-79.

[128] See P.J. Naish, The Complete Guide to Personal Investment (London: Evans Brothers, 1962), 25; Adrienne Gleeson, People and Their Money: 50 Years of Private Investment (Cambridge: M & G Group, 1981), 136 (saying an investor generally needed to make a profit of nearly 10% on the sale of shares to cover the attendant costs).

[129] See discussion infra Part 7.

[130] For background, see Ranald Michie, The London Stock Exchange: A History (Oxford: Oxford University Press, 2000), 483, 486, 544-55.

[131] Paddy Linaker, "City Must Defend its Capital Position", Financial Times, April 19, 1994, 17 (Linaker was the managing director of the Prudential, a major insurance company and fund manager).

insiders controlling public companies.[132] The theory in turn offers clues as to how ownership separated from control in U.K. public companies when the law did not offer substantial protection to outside investors.

The agency cost theory of dividends is conventionally discussed with the widely held company as the reference point, with the thinking being dividends impose constraints on managers otherwise liable to act contrary to the interests of arm's-length shareholders.[133] The theory is also relevant, however, for companies where a shareholder owns a sufficiently large block of shares to exercise *de facto* control.[134] In a company of this sort, the blockholder should be both able and willing to keep management in line. On the other hand, there is potential for blockholders to exercise their influence in a manner that is contrary to the interests of outside investors. Dividends can act as a potential check, since the regular distribution of earnings to investors reduces the scope a dominant shareholder has to skim or squander corporate profits.[135]

To elaborate, corporate insiders will generally have a bias against dividends because the retention of earnings increases the size of the assets under their control and reduces the need to turn to capital markets for additional finance. Companies, however, with leftover income (cash flow in excess of that required to fund economically worthwhile projects) may well fail to maximize shareholder value.[136] Self-serving behavior is one danger. For instance, "sweetheart" deals might be engineered to siphon off a disproportionate share of accumulated earnings to firms the large shareholder

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[132] The label, and the original statement of the theory, were provided by Frank Easterbrook, "Two Agency-Cost Explanations of Dividends", (1984) 74 American Economic Review 650.

[133] See, for example, Lease et al., Dividend, supra note xx, 80-81.

[134] Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert W. Vishny, "Agency Problems and Dividend Policies Around the World" (2000) 55 Journal of Finance 1, 4-5.

[135] La Porta et al., "Agency", supra note xx, 4; Mara Faccio, Larry H.P. Lang and Leslie Young, "Dividends and Expropriation", (2001) 91 American Economic Review 54, 55.

[136] Michael C. Jensen, "Agency Costs of Free Cash Flow, Corporate Finance and Takeovers", (1986) 76 American Economic Review (Papers and Proceedings) 323, 323; Randall Morck and Bernard Yeung, "Dividend Taxation and Corporate Governance", (2005) 19 Journal of Economic Perspectives 163, 170.

controls.[137] Also, since blockholders of public companies will generally have most of their wealth tied up in their own firms, they might well drive their companies to pursue value-destroying diversification strategies in the interests of spreading risk.[138] Another possibility, at least in companies dominated by families, is that amateurish family management will squander accumulated profits through a combination of bad business decisions and policy errors.[139] When companies make regular dividend payments corporate insiders have less discretionary cash to dissipate in these various ways.

An ongoing commitment to pay dividends also places inherent limits on the ability of a company to finance its business plans from retained earnings and thus can compel a return to the capital markets to obtain needed funds. Raising capital exposes those running a company to “screening” by investors and scrutiny by financial intermediaries (e.g. investment banks, often referred to in the U.K. as merchant banks). Hence, dividends can activate beneficial capital market discipline on companies with *de facto* controlling shareholders.[140] In sum, the payment of dividends potentially acts as a check on the skimming or squandering of corporate profits that should simultaneously give blockholders an incentive to exit and encourage outside investors to buy shares.

B. The Propensity of U.K. Public Companies to Pay Dividends

There is a substantial body of empirical evidence that is consistent with the agency cost characterization of dividends.[141] Nevertheless, the discipline dividends can impose is potentially illusory since corporate insiders might simply reverse field and stop

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137 Ronald J. Daniels and Jeffrey G. MacIntosh, “Toward a Distinctive Corporate Law Regime”, (1991) 29 Osgoode Hall Law Journal 863, 885.

138 See Easterbrook, “Two”, supra note xx, 653 (making the same point with widely held companies, focusing on the risk aversion of managers with their jobs and wealth tied up in their firms).

139 On advantages the widely held company has on this count (at least theoretically), see Cheffins, “Corporate Law”, supra note xx, 357.

140 Easterbrook, “Two”, supra note xx, 653.

141 For a summary, see Lease et al., “Dividend”, supra note xx, 89-91.

distributing cash to shareholders.[142] Dividends can therefore only play the role ascribed to them by agency cost theory if those controlling a company are bound in a credible way to continue to make regular, ongoing dividend payments.[143] The available evidence suggests U.K. public companies conducted themselves as if they were operating under such constraints.

The dividend pay-outs of public companies were not were not strikingly large when the U.K.'s outsider/arm's-length system of ownership and control took shape. The ratio of dividends to profits in such firms was approximately 40% in the 1950s, 45% in the 1960s and 30% in the 1970s.[144] Dividend/pay-out ratios in the United States were similar and indeed moderately higher over the same period (48% in the 1950s, 41% in the 1960s and 43% in the 1970s).[145] Moreover, U.K. companies paid out a considerably higher percentage of their reported net profits in the form of dividends during the 1920s and 1930s than was the case from the 1940s onwards.[146] This discrepancy, however, was not generally due to the adoption of a markedly more conservative dividend policy.[147]

142 Franklin Allen and Roni Michaely, "Payout Policy" in George M. Constandines, Milton Harris and Rene M. Stulz (eds.), Handbook of the Economics of Finance, volume 1A, Corporate Finance (Amsterdam: Elsevier, 2003), 337, 384.

143 Goshen, "Shareholder", supra note xx, 881, 889.

144 On the 1950s, the average for the decade was calculated on the basis of annual figures set out in Royal Commission on the Distribution of Income and Wealth, Report No. 2: Income from Companies and its Distribution, 161, Table P7 (1975). On the 1960s and 1970s, see Steve Toms and Mike Wright, "Corporate Governance, Strategy and Structure in British Business History", 1950-2000, (2002) 44 Business History 91, 105.

145 Mary O'Sullivan, Contests for Corporate Control: Corporate Governance and Economic Performance in the United States and Germany (Oxford: Oxford University Press, 2000), 192.

146 Baskin and Miranti, supra note xx, 192; Steven A. Bank, "The Dividend Divide in Anglo-American Corporate Taxation", (2004) 30 Journal of Corporation Law 1, 11-12. Figures on retained earnings complied by Thomas, Finance, supra note xx, 89 (Table 4.2) imply that during the 1920s and 1930s the dividend/profit ratio typically ranged between 70% and 85%, with companies apparently paying more in dividends than they generated in profits in 1921. Thomas' figures were derived from data set out in Hargreaves Parkinson, "British Industrial Profits: A Survey of Three Decades," Economist, December 17, 1938, 597.

147 See Thomas, Finance, supra note xx, 108 (identifying continuity between dividend policies adopted in the 1930s and the years after World War II).

Instead, the declining ratio of dividends to profits was primarily a result of changes in accounting practice that led companies to report earnings more fully.[148]

Though dividend payments were not inordinately generous, U.K. public companies did act as if they felt compelled to make regular cash distributions to shareholders as ownership separated from control. According to empirical evidence from the 1970s, only a tiny minority of companies listed on the London Stock Exchange refrained from paying dividends and, of the companies that paid dividends, only a small minority reduced the pay-out level from the previous year.[149] During the decades following World War II, most U.K. public companies set their dividend policies at least partially by reference to profits and, as mentioned, earnings declined markedly during the 1970s.[150] The percentage of companies failing to pay dividends therefore was probably smaller during the 1950s and 1960s than it was during the 1970s.

Why did U.K. public companies nearly universally pay dividends and generally refrain from cutting pay-out levels? A 1966 text on share valuations provides a hint. As the author acknowledged, some boards were tempted to settle dividend policy by asking

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148 See A.J. Arnold and D.R. Matthews, "Corporate Financial Disclosures in the U.K., 1920-50: The Effects of Legislative Change and Managerial Discretion", (2002) 32 Accounting and Business Research 3. According to this analysis of the accounts of 50 large U.K. public companies, sample companies reported much higher net profits in 1950 than in 1920 and 1935 while dividend payments remained largely constant. Arnold and Matthews acknowledge the increase in reported profits was partly due to inflation but argue accounting reforms introduced by the Companies Act 1948 were the primary agent of change.

149 See G. Chowdhury and D.K. Miles, "An Empirical Model of Companies' Debt and Dividend Decisions: Evidence from Company Accounts Data", (1987) Bank of England Discussion Paper, No. 28, Table 4. Based on a sample of 653 U.K. public companies for the years 1970 to 1979, they found the percentage of companies failing to pay a dividend ranged from 0.9% to 3.5% annually and the percentage of companies cutting their dividend payment ranged from 9% to 33.8%, with the exception of 1974 (47%). See also Andrew Benito and Garry Young, "Hard Times or Great Expectations?: Dividend Omissions and Dividend Cuts by U.K. Firms", (2001), Bank of England Working Paper, No. 147, 18-21 (finding, on the basis of a somewhat larger sample, the percentage of non-payers ranged between 5% and 7% annually between 1974 and 1979 and finding the proportion of companies cutting their dividends varied from 6% to 15%).

150 On the link between profits and dividends, see infra notes xx to xx and accompanying text (discussing how evidence on aggregate dividend pay-outs by U.K. public companies conformed with a "partial adjustment" model of dividends). On declining profits in the 1970s, see supra note xx to xx and related discussion.

"How little can we pay in order to keep the shareholders quiet?"[151] They did not follow through, however, since they were "aware of hardships that might be caused by reduction of dividend".[152]

C. Company Law

What "hardships" might have come into play for publicly quoted firms that reduced dividends or suspended dividend payments entirely? Company law is one possibility that needs to be taken into account. Dividends were lightly regulated in the U.K. and there was no common law or statutory rule directing those in control of a company to declare a dividend.[153] According, however, to a 2000 study by La Porta, Lopez-de-Silanes, Shleifer and Vishny, company law can induce firms to pay dividends even if there are no rules directly compelling companies to make dividend payments.[154] They argue that if corporate law provides strong investor protection, shareholders will be able to use their legal powers to force companies to disgorge cash and thereby preclude corporate insiders from using company earnings in a self-serving or misguided way.

La Porta *et al.* tested their dividend/company law hypothesis by conducting a study of dividend policies adopted by large firms in 33 countries, grouping those countries that scored between "0" and "3" on their anti-director index into a "low protection" category and grouping those with a score of "4" or above into a "high protection" category.[155] They found, consistent with their conjectures, that companies

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151 T.A. Hamilton Baynes, Share Valuations (London: Heinemann, 1966), 84, quoting a pamphlet entitled "Standard Boardroom Practice"; see also F.R. Jervis, The Economics of Mergers (London: Routledge & Kegan Paul, 1971) 74 (characterizing the philosophy of U.K. managers in very similar terms).

152 Hamilton Baynes, Share, supra note xx at 84.

153 The only legal constraints in place were common law rules, supplanted largely by statute in 1980, that restrained a company from prejudicing creditors by paying dividends when it lacked the financial wherewithal to distribute the cash. On the common law, see Re Exchange Banking Co., Flitcroft's Case (1882) 21 Ch.D. 519, 533-34. On statutory reform, see Companies Act 1980, c. 22, ss. 39-45. On the fact that there were no rules compelling companies to declare dividends, see Horace B. Samuel, Shareholders' Money: An Analysis of Certain Defects in Company Legislation with Proposals for Their Reform (London: Sir Isaac Pitman & Sons, 1933), 145; Alex Rubner, The Ensnared Shareholder: Directors and the Modern Corporation (London: Macmillan, 1965), 22.

154 La Porta et al., "Agency", supra note xx.

155 Id., 12.

from countries with good shareholder protection paid higher dividends, all else being equal, than companies from countries where investors were poorly protected. However, at least for the decades when ownership separated from control in the U.K., their analysis lacks explanatory power. Again, between 1948 and 1980 U.K. company law scored a "3" on La Porta *et al.*'s anti director index, thus relegating Britain to the "low protection" category. Following their logic, company law rules should not have been a source of "hardship" for corporate insiders contemplating cutting or passing on dividend payments.

While La Porta *et al.*'s analysis suggests companies legislation did little to compel U.K. public companies to pay dividends, the corporate constitutions of such firms conceivably could have played a role. It was standard practice for a public company's articles of association to provide shareholders with the right to veto the dividend policy proposed by the board of directors, though not to vary the size of the dividend.[156] Even this qualified right served to distinguish Britain from the United States, where shareholders did not have any sort of right to vote on dividend policy.[157] However, the prospect of a shareholder vote in fact likely had little impact on the setting of dividend policy.

Graham and Dodd did say of the U.K. in the 1940 edition of their well-known text on securities analysis:

> "…the mere fact that the dividend policy is submitted to the stockholders for their specific approval or criticism carries an exceedingly valuable reminder to the management of its responsibilities, and to the owners of their rights, on this important question."[158]

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[156] A schedule to companies legislation known as "Table A" that governed presumptively the content of the corporate constitution of companies operating under the legislation gave shareholders this right and companies rarely departed from this norm. See Pennington, Investor, supra note xx, 440; Gower, 3rd ed., supra note xx, 353.

[157] Bank, "Dividend", supra note xx 13.

[158] Benjamin Graham and David L. Dodd, Security Analysis: Principles and Technique (2d ed., 1940), 383, note 1 (quoted in Bank, "Dividend", supra note xx, 14).

On the other hand, a 1950 British text on investment acknowledged that the dividend decision was "not…at the unfettered discretion of the directors" but indicated "(shareholder) confirmation is normally a mere formality."[159] A study based on a 1984 survey of senior managers of 50 of the U.K.'s largest companies confirmed the irrelevance of shareholder voting on dividends.[160] Respondents said that even if a dividend cut was proposed, they were not concerned shareholders would veto what was proposed. Hence, U.K. company law apparently did not impose serious constraints on the dividend policy public companies adopted during the period when ownership was separating from control. Other "hardships" must therefore have come into play.

D. Retaining the Option to Issue New Shares

While company law did little to deter managers from reneging on a policy to make expected and continuing dividend payments, a desire to retain the option to raise capital by issuing new shares likely did do so. A 1933 book dealing with the position of the British private investor *vis-à-vis* the public company described the dynamics involved as follows:

> "Most companies hope to extend their business, and in fact do so from time to time. For this purpose, fresh money is necessary. Fresh money is usually raised by new issues. But the success and attractiveness of a new issue are to a large extent determined by the earnings and dividend record of the Company during previous years."[161]

Matters changed little over time. Typically when U.K. publicly quoted companies offered new shares for sale they did so by way of a rights issue, meaning that the company offered to current shareholders the right to subscribe for new shares in

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159 Lewis G. Whyte, Principles of Finance and Investment, vol. 2 (Cambridge: Cambridge University Press, 1950), 91. See also Gower et al., 4th ed. supra note xx, 408 (arguing that the control that shareholders had was merely "theoretical", citing the fact that shareholders had no say over interim dividends the directors might opt to declare).

160 Jeremy Edwards & Colin Mayer, "An Investigation into the Dividend and New Equity Issue Practices of Firms: Evidence from Survey Information", (1986), Institute for Fiscal Studies, Working paper No. 80, Table 2.

161 Samuel, Shareholders, supra note xx, 145-46.

proportion to their existing holdings.[162] With this practice in mind, the author of a 1979 text on U.K. business finance observed "(d)irectors should always try to keep shareholders satisfied because then they represent a very good source of new capital". This in turn made dividends important:

> "(Directors') dividend policy will be influenced by the knowledge that at some future time they may have to encourage the investing public to provide their company with more funds. This will only be possible if the profits earned and dividends paid by the company in past years have been adequate to reward the risk involved."[163]

The 1984 survey of senior managers on dividend policy just cited confirms those running public companies thought precisely along these lines, with executives saying they feared dividend cuts would make it more difficult to raise cash by selling new issued equity.[164]

Since, as previously discussed, there is a managerial bias in favour of financing companies by way of retained earnings, it may seem surprising that retaining the option to obtain external finance by issuing shares would have influenced the dividend policy of U.K. companies. Empirical studies are lacking on the relationship between dividends and the issuance of shares in British public companies during the decades following World War II.[165] Nevertheless, the available evidence suggests that keeping open the option of carrying out a public offering was sufficiently important to give public companies a meaningful incentive to refrain from reducing or eliminating dividends.

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162 David Blake, Pension Schemes and Pension Funds in the United Kingdom, 2nd ed., (Oxford: Oxford University Press, 2003), 580; Martin Dickson, "Last Rites are Premature for the British Rights Issue", Financial Times, August 5/6, 2000, 13 (both noting, though, that the methods companies used to issue shares became more varied throughout the 1990s).

163 Kenneth Midgley and Ronald G. Burns, Business Finance and the Capital Market, 3rd ed. (London: Macmillan, 1979), 253.

164 Edwards and Mayer, "Investigation", supra note xx, 8-10.

165 See Geoffrey Meeks and Geoffrey Whittington, The Financing of Quoted Companies in the United Kingdom, Royal Commission on the Distribution of Income and Wealth, Background Paper No. 1 (London: HMSO, 1976), 32-33 (remarking on how their empirical study of the financing of U.K. companies could not isolate changes to dividend pay-outs prior to the issuance of shares).

Consider the 1950s. Between 1949 and 1953 one in three companies quoted on the London Stock Exchange carried out a public offering, and this figure rose to nearly three out of five for larger firms.[166] The Radcliffe Committee, a committee struck by the U.K. government to examine the working of the monetary system, observed in its 1959 report that "the new issue market has been a far from marginal source of capital in the calculations of most of the larger British firms".[167] Reliance on public offerings in turn influenced dividend policy. Economist W.A. Thomas said of the late 1950s in his 1978 history of the finance of British industry in the 20th century that "with an increased volume of new issues companies wanting to come to the market frequently sought to maintain the status of their shares by dividend 'sweeteners'."[168] A press report from 1962 echoed the theme, saying: "shareholders' dividends are limited to rates which will enable the concern to raise fresh capital at reasonable rates."[169]

Primarily due to increased borrowing from banks, the percentage of funds U.K. public companies raised externally that was derived from the issuance of shares dropped markedly through much of the 1960s and the first half of the 1970s.[170] On the other hand, since external funds were growing steadily as a percentage of total sources of finance,[171] as a percentage of combined external and internal funds the proportion generated from the issuance of shares remained more or less constant over time.[172] Other evidence

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166 R.F. Henderson, "Capital Issues" in Brian Tew and R.F. Henderson (eds.), Studies in Company Finance: A Symposium on the Economic Analysis and Interpretation of British Company Accounts (Cambridge: Cambridge University Press, 1959), 64, 69-70.

167 Committee on the Working of the Monetary System (Lord Radcliffe, Chairman), Report, Cmnd. 827 (London: HMSO, 1959), 80. For additional evidence on share offerings by U.K. public companies during the 1950s, see Wright, "Capital", supra note xx, 478-79.

168 Thomas, Finance, supra note xx, 241.

169 Margot Naylor, "The Merger Crunch", The Statist, January 25, 1962, 289, 290. See also Rubner, Ensnared, supra note xx, 97, 151.

170 Thomas, Finance, supra note xx, 326; Mervyn King, Public Policy and the Corporation (London: Chapman and Hall, 1977), 209. On the surge in bank borrowing, see Thomas, Finance, supra note xx, 324-25, 327.

171 Thomas, Finance, supra note xx, 310, 315.

172 Meeks and Whittington, "Financing", supra note xx, 4-5 (providing data for U.K. public companies from 1948 to 1971).

confirms public offerings of shares retained practical significance after the 1950s.[173] In a number of individual years between 1956 and 1975 new issues surged markedly, with the purpose primarily being to finance acquisition activity.[174] Indeed, during the latter half of the 1960s, the U.K.'s largest companies (the top 100, calculated by net assets) financed more of their growth by public offerings than by retained earnings, with the driver again being the need to pay for mergers.[175] Also, when the market for corporate debentures collapsed in the latter half of the 1970s as a result of a dramatic rise in inflation, the percentage of external funds raised by way of the issuance of equity rose substantially.[176] In sum, during the period when dispersed share ownership became the norm in larger U.K. companies, a desire to retain the option to return to equity markets should have been sufficiently potent to deter to some degree corporate insiders from abandoning dividends.

E. Liquidity

Keeping open the option to raise capital was not the only factor that would have discouraged the reduction or elimination of dividend payments. A desire to create and preserve a liquid market for shares also would have come into play. Large shareholders will generally be badly diversified since most of their wealth will be tied up in the company in which they own the dominant stake.[177] One way for a blockholder to address this problem is to unwind their equity stake partially so as to spread some of the risk.[178] For shareholders who treat this as a priority, the stock market will be thought of primarily

[173] Meeks and Whittington, "Financing", supra note xx, 4 (referring to equity issuance as playing a "not trivial" but "subsidiary" role in the financing of growth).

[174] S.J. Prais, The Evolution of Giant Firms in Britain: A Study of the Growth of Concentration in Manufacturing Industry in Britain 1909-70 (Cambridge: Cambridge Univ. Press), 130.

[175] Geoff Meeks and Geoffrey Whittington, "Giant Companies in the United Kingdom", (1975) 85 Economic Journal 824, 831-32. Similarly, in 1970, a not untypical year, approximately half of the largest companies in the U.K. issued new shares for cash: Prais, Evolution, *supra* note xx, 129.

[176] "The U.K. Corporate Bond Market", Bank of England Quarterly Bulletin, March 1981, 54, 54, 56-57.

[177] Supra note xx and related discussion.

[178] For instance, after the family foundations that had been the dominant shareholders in the Rank Organisation entertainment group lost majority control due to a decision by the company to enfranchise the company's non-voting shares, they announced they would begin selling out. The explanation was that under the new circumstances "it made little sense for them to keep all of their eggs in one basket." See "Compensation for the Voters", Times, January 26, 1976, 19.

as a source of liquidity rather than capital.[179] Many companies going public in the U.K. following World War II apparently fell into this category. Only a minority of initial public offerings actually raised new money for the company concerned, meaning the objective of going public often was to allow the incumbent shareholders to cash out at least partially.[180]

When creating liquidity is a priority, a blockholder will be keen to ensure that there will be buyers for the company's equity at an acceptable price as and when a partial unwinding of the block occurs. Investors, in turn, will be looking for evidence the shares will deliver sufficiently good value over time to make a purchase worthwhile. Dividends can then come into play. Once a company has gone public, the blockholder's continuing interest in liquidity can serve as an implicit bond to investors that the company will be run so that dividends will continue to be paid at a rate sufficient to maintain an active market in the company's shares. A collateral benefit for investors will be that paying dividends will erode excess cash building up in the firm that a dominant shareholder might otherwise squander or expropriate.[181]

In the decades following World War II, dividends plausibly performed these functions in British public companies with a dominant shareholder. Due in large part to the financial intermediaries orchestrating public offerings of shares (generally merchant banks operating as "issuing houses")[182] companies that went public faced immediate pressure to pay dividends. For an issuing house organizing a "flotation" (an initial public offering), the company's prospective dividend yield, calculated by dividing the dividend per share by the share price, was an important factor in setting the price of the issue.

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179 For more detail on this characterization, see Armando Gomes, "Going Public Without Governance: Managerial Reputation Effects", (2000) 55 Journal of Finance 615, 634.

180 Jervis, Economics, *supra* note xx, 35, 73; A.J. Merrett, M. Howe and G.D. Newbould, Equity Issues and the London Capital Market (London: Longmans, 1967), 84-85; see also G.D. Newbould, "The Benefits and Costs of a Stock Exchange Quotation", Banker's Magazine, June 1967, 359, 359-60 (discussing mixed empirical evidence on whether companies went public to create liquidity or raise new funds).

181 La Porta et al, "Agency", supra note xx, 7.

182 Issuing houses captured the new issue market from stockbrokers in the decades following World War II. See Michie, London, supra note xx, 268, 354-55, 412-15.

Accordingly, the issuing house would advise the company on the proportion of earnings that the company should propose to distribute by way of dividends, with the target yield being determined by factors such as the history of the company, past financial results and conditions in the industry.[183] The issuing house would do its best to get this right because the dividend yield ascribed to shares when a company was seeking to go public did much to fix the price at which the shares would be accepted by the market.[184]

It was also understood that once a company had carried out a public offering, refraining from paying dividends could cause the market for its shares to decline and even wither away.[185] Correspondingly, so long as family owners and other blockholders were concerned about taking advantage of the liquidity the stock market provided, they were under an onus to ensure that their company continued to pay dividends to outside investors. This likely helps to explain why a 1962 text on personal investment offering guidance on how to choose shares for income recommended "medium-sized provincial (i.e. regional rather than national) companies with family management and a reasonably secure market for their products", reasoning that their dividend policy tended to be "unexciting but…gently progressive".[186]

While a desire to maintain liquidity can motivate those running a company to arrange for a meaningful annual dividend to be paid, retaining the option to exit will not necessarily remain important after a company has gone public. For those owning a substantial percentage of shares in a public company the opportunities that exist to extract private benefits of control will help to determine the priority they attach to liquidity. If such opportunities are meagre, diversification will look attractive and preservation of an exit option will be important. On the other hand, if there is much to gain from exploiting control, liquidity will not be a serious concern. A blockholder who has taken a company

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[183] Hamilton Baynes, supra note xx, at 31; Merrett, Howe and Newbould, supra note xx, 97.

[184] Hamilton Baynes, supra note xx, at 107-9.

[185] A.R. English, Financial Problems of the Family Company (London: Sweet & Maxwell, 1958), 62-63; see also Samuel, Shareholders, supra note xx, 145 (explaining that U.K. public companies paid dividends as a means of "retaining popularity with (shareholders)").

[186] Naish, Complete, supra note xx, at 128.

public will instead forsake unwinding their ownership stake and focus fully on skimming private benefits. As part of the strategy, with those running the company no longer under any compunction to maintain liquidity, the company might simply stop paying dividends.[187]

Though in theory a dominant shareholder might forsake liquidity to exploit potential private benefits of control, in the decades following World War II owning a large interest in a U.K. public company was not a particularly attractive proposition. Corporate profits, as mentioned, were collapsing.[188] Taxes on income and accumulated wealth were punishing.[189] Owning a large business offered little in the way of "psychic income", with businessmen generally being held in low esteem and not being major players on the national political scene.[190] Given all of this, preserving liquidity likely was a higher priority for owners of large blocks of shares than exploiting their position as major shareholders.

The tax system, as well as penalizing wealth and high incomes, provided those running U.K. public companies with an additional and more direct incentive to refrain from forsaking liquidity by eliminating dividends. In the decades following World War II, for individuals in higher income brackets, dividends were usually taxed much more severely than retained earnings.[191] This gave families with a large stake in a public company a tax incentive to prefer that no dividends be paid. U.K. tax legislation

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187 La Porta et al., "Agency", supra note xx, 7.

188 Supra note xx and related discussion.

189 Marginal tax rates on investment income were as high as 98%: Steven Bank, Brian Cheffins and Marc Goergen, "Dividends and Politics", (2004), ECGI working paper, No. 24/2004, Table 3. With accumulated wealth, from the 1940s to the 1980s, the rate of estate tax was 80% was for estates valued at more than £1 million: David J. Jeremy, A Business History of Britain, 1900-1990s (Oxford: Oxford University Press), 118.

190 On esteem, see John Fidler, The British Business Elite: Its Attitudes to Class, Status and Power (London: Routledge & Kegan Paul, 1981), 183-86 (discussing a survey of 130 directors in large U.K. companies conducted in the mid-1970s which included founding entrepreneurs and family businessmen). On politics, see Keith Robbins, "British Culture versus British Industry" in Bruce Collins and Keith Robbins (eds.), British Culture and Economic Decline (London: Weidenfeld and Nicolson, 1990), 1, 12-13 (pointing out that achieving high office in Britain was a full-time occupation incompatible with the pursuit of a successful business career).

191 See discussion infra Part VII.

provided, however, that if a company controlled by not more than five persons failed to distribute a reasonable amount of its profits, tax officials could allocate the company's earnings to the shareholders personally and thereby deem the profits to be taxable at the punishing personal rates standard following World War II.[192]

The definition of companies potentially subject to this sort of direction – referred to as a "close company" from 1965 onwards[193] -- was ultimately cast very broadly. As a practical matter most every family-owned company qualified.[194] Almost the only way out was to take advantage of an exemption created for companies that obtained a stock market quotation and ensured at least 25% (later 35%) of the ordinary shares were publicly held.[195] L.C.B. Gower observed in the 1969 edition of his company law text that "this is undoubtedly a very strong factor in impelling substantial private companies to convert themselves into public companies".[196]

Continued protection from being designated as a "close company" hinged not merely on maintaining a stock market listing and a "free float" of 25% but on dealings in the shares occurring during the year for which tax officials were seeking to impose additional income tax.[197] The problem was not merely an academic one because thinness of trading was quite common for U.K. public companies of the time, even among those listed on the London Stock Exchange rather than provincial stock markets.[198] It was in

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192 See, for example, H.G.S. Plunkett, The Income Tax Act 1952 (London: Sweet & Maxwell, 1952), § 245, discussing Income Tax Act 1952, 15 & 16 Geo. 6/1 Eliz. 2, ch. 10, ss. 245, 256. See also Finance Act 1965, ch. 25, s. 78.

193 Finance Act 1965, sched. 18, s. 1(1).

194 Gower, 3rd ed., supra note xx, 177. The position was similar before the introduction of the close company concept in 1965. See David R. Stanford, Tax Planning and the Family Company, 2nd ed. (London: Sweet & Maxwell, 1964), 106.

195 Gower, 3rd ed., supra note xx, 177, discussing Finance Act 1965, sched. 18, s. 1(3), which imposed a 35% requirement; Income Tax Act 1952, s. 256(5) imposed a 25% requirement.

196 Gower, 3rd ed., supra note xx, 177; see also Wright; "Capital", supra note xx, 467.

197 Income Tax Act 1952, s. 256(5) (surtax); Finance Act 1965, sched. 18, s. 1(3).

198 "Is New Issue Procedure in Keeping with 1966?", Times, January 10, 1966, 14 (saying of smaller companies listed on the London Stock Exchange, "(f)requently, after the initial opening flurry, dealing in these stocks slow down to an extent that barely justifies a listing"); J.R. Franks, J.E. Broyles and M.J. Hercht, "An Industry Study of the Profitability of Mergers in the United Kingdom", (1977) 32 Journal of Finance 1513, 1519 (finding in a study of mergers in the Breweries and Distilleries sector of the Official

this context that dividends came into play. The maintenance of a reasonable dividend policy was an important step companies could take to ensure trading activity would occur.[199] If a company refrained entirely from paying dividends, the market for the shares might well wither away completely and the tax advantages of being publicly quoted would disappear. Hence, while generally for individuals U.K. tax law was biased strongly against dividends, once a company with a family owner had gone public, tax-driven concerns about share liquidity provided an incentive for the company to continue making dividend payments to shareholders.

F. Takeover Bids

In circumstances where a public company has a family blockholder that has unwound its holding to the point where the percentage of shares the family owns is insufficient to block an unsolicited offer to obtain control through the purchase of shares held by outside investors, fear of an unwelcome bid can motivate those running the company not only to make regular dividend payments but to increase pay out levels. It is well known that takeovers have a disciplinary aspect: if a company's share price is depressed because a company is failing to maximize shareholder return, prospective bidders may begin to contemplate unlocking shareholder value by acquiring the company and replacing the incumbent managers.[200] This, however, is contingent upon the ownership structure of potential targets.

So long as a family owns a majority of the shares in a public company or close to it, a bidder who cannot persuade the family to sell will be not be able to force the issue.[201]

List of the London Stock Exchange that with 14% of the month-end stock prices recorded for the purpose of the study the number of days since the last reported trade exceeded 30).

199 English, Financial, supra note xx, 62-63.

200 Frank H. Easterbrook and Daniel R. Fischel, The Economic Structure of Corporate Law (Cambridge MA: Harvard University Press, 1991), 172-73.

201 Leslie Hannah, The Rise of the Corporate Economy, 2nd ed. (London: Methuen, 1983), 130-31. For instance, in 1969, the managing trustees of three trusts which together controlled 56% of publicly quoted chocolate manufacturer Rowntree rejected a takeover offer from General Foods of the U.S. in favor of a bid by another British company even though the General Foods bid was approximately 50 per cent higher. See Warwick Brophy, "Trustees Reject New General Foods Bid for Rowntree", Times, April 21, 1969, 17. Using voting control to deny minority shareholders a large premium was controversial. See, for

On the other hand, as and when a family's stake becomes too small, (perhaps at 20% to 25% of the shares) to provide a *de facto* veto, a "hostile" takeover bid emerges as a realistic and worrying possibility.[202] Bidders, aware of the family's weak position, will be able to structure their offers to acquire the company so that little, if any, control premium is made available. Also, if family members have been exercising managerial prerogatives, the chances of this continuing will be nil if the hostile takeover succeeds since the bidder will put in a new executive team.

In a milieu where dividends are popular with investors, blockholders fearing takeover bids have an incentive to adopt dividend policies that are sufficiently generous to keep share prices high enough to discourage prospective bidders.[203] Corporate Britain first experienced hostile takeovers in the early 1950s and contemporaries quickly surmised the trend might prompt U.K. companies to pay more generous dividends than had been the norm previously.[204] For instance, in 1954 Labour politician Roy Jenkins proposed a motion in the House of Commons that "this House deplores recent manifestations of the technique of takeover bids in so far as they have…seriously undermined the policy of dividend restraint" (Britain had a "voluntary" system of

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example, John Gilmore, "Gloves Off in the Bids Game", Times, June 21, 1967, 25; "Guarding the Rights of the Minority", Times, April 23, 1969, 29.

[202] In 1953, House of Fraser carried out a successful hostile takeover of Binns, a retailer, even though the directors of Binns and their families owned 29% of Binns ordinary shares and opposed the bid. See George Bull and Anthony Vice, Bid for Power, 3rd ed. (London: Elek Books, 1961) at 158, 160. A 1965 bid by British Shoe, part of a conglomerate controlled by Charles Clore, for Lewis Investment Trust, owner of a number of department stores, also illustrates. The situation was described in the Times newspaper in the following terms:

> "The key to the success of the Clore bid will rest largely with the Cohen family, who control at least 20 per cent and possibly 30 or 40 per cent of the Lewis's shares….British Shoe are geared to go ahead and try to wrest control of the company, even if the Cohen family are unwilling to sell out." See "Take-over Fever Mounting to High Pitch", Times, October 12, 1965, 16.

Clore's bid succeeded: Jervis, Economics, *supra* note xx, 84-85.

[203] See Fischel, Law, supra note xx, 713-14; Mervyn A. King, Corporate Taxation and Dividend Behaviour: A Comment, 38 Review of Economic Studies 377, 379 (1971).

[204] Sam Aaaronovitch and Malcolm C. Sawyer, Big Business: Theoretical and Empirical Aspects of Concentration and Mergers in the United Kingdom (London: Macmillan, 1975), 244.

dividend controls in place between 1949 and 1951).[205] Subsequently, there was much speculation that fears of an unwelcome bid were indeed inducing U.K. public companies to adopt increasingly liberal dividend policies.[206] The 1961 edition of a book on takeovers concurred with the logic, saying of the mid-1950s that it was "clear that take-over bids in general…roused boards of directors to the risks of a conservative dividend policy. They were impressed by how easily companies which had been following a conservative dividend policy fell to the take-over bidder….".[207]

Though the evidence on point is not entirely clear cut, from the 1940s through to the 1970s U.K. public companies that paid high dividends, given levels of profits and investment, apparently did face a reduced risk of a takeover.[208] It is less clear whether takeover activity in fact prompted the adoption of more liberal dividend policies. Empirical studies, based on tests for a correlation between the level of acquisition activity and aggregate dividend pay-outs by U.K. public companies, have yielded mixed results.[209] Nevertheless, it is plausible that at least in companies where blockholders failed to own a sufficiently large percentage of shares to veto a takeover offer, the threat of a hostile takeover bid provided companies with an incentive to continue to pay, and perhaps increase, dividend payments.[210]

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205 Quoted in Littlewood, Stock Market, *supra* note xx, 86. See also Anthony Crosland, "The Case Against Take-over Bids", The Listener, September 2, 1954, 347.

206 William Mennell, Takeover: The Growth of Monopoly in Britain, 1951-61 (London: 1962), 34, 131; Midgley and Burns, Business, supra note xx, 255, 314-15; H.B. Rose, The Economic Background to Investment (Cambridge: Cambridge University Press, 1960), 231.

207 Bull and Vice, Bid, supra note xx, 35; see also at 11.

208 Andrew P. Dickerson, Heather D. Gibson and Euclid Tsakalotos, Takeover Risk and Dividend Strategy: A Study of U.K. Firms, 46 Journal of Industrial Economics 281 (1998) (finding that between 1948 and 1970 higher dividend payments were associated with a significantly lower probability of a takeover); Douglas Kuehn, Takeovers and the Theory of the Firm (London: Macmillan, 1975), 103-4, 122, 127 (failing to find between 1959 and 1967 a strong correlation between dividend policy and the likelihood of takeover).

209 *Compare* King, Corporate, supra note xx, 380 (finding, using data from 1950-71, a statistically significant link) with Bank, Cheffins and Goergen, supra note xx (finding, using data from 1949-2002, takeover activity was inversely correlated with distributions to shareholders).

210 If only a small sub-set of such U.K. companies in fact felt under direct pressure to raise dividends in response to takeover fears, studies based on aggregate data may well fail to capture the effect because figures for other companies would wash out the effect.

G. Drawing Matters Together

To sum up, U.K. companies were not obliged by law to pay dividends so in theory they could renege and stop distributing cash to shareholders. Despite this, for reasons largely if not entirely unrelated to company law, the vast majority of public companies in fact did pay dividends and most shied away from cutting the pay-out level from the previous year. The cash distributions being made would, all else being equal, have reduced the scope for blockholders to skim or squander profits their companies were generating. This, in turn, would have given large shareholders an incentive to exit and should have fostered in some measure investor confidence in shares. As we will see next, the dividend policy of U.K. public companies would have helped to underpin demand for shares in another way, namely by playing a "signalling" function.

6. Dividends and "Signalling"

A. The Theory

The work done by La Porta, López-de-Silanes and Shleifer on securities law suggests that strong disclosure rules are associated with robust stock markets and diffuse share ownership.[211] Between the 1940s and the 1980s, though, the law in the U.K. was not particularly rigorous in comparison with modern legal standards.[212] How, then, did investors acquire sufficient knowledge about companies to feel confident enough to buy shares in the volume required to provide a platform for the dispersion of share ownership? Dividends likely played a key role.

Corporate insiders are apt to know much more about a company's future prospects than do investors.[213] Dividend payout policy constitutes a potential means for

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[211] See supra notes xx to xx and accompanying text.

[212] See supra notes xx to xx and related discussion.

[213] This is borne out by the fact corporate insiders can earn abnormal returns from dealing in shares in their own companies even when they trade without infringing laws governing insider trading. See Andrei Shleifer, Inefficient Markets: An Introduction to Behavioral Finance (Oxford: Oxford University Press, 2000), 6-7.

those controlling a company to "signal" such private information.[214] The process will not operate under all circumstances. In order for dividends to perform a signalling function, dividend payments ultimately must impose costs on firms that perform poorly in a way they do not for successful firms.[215] Otherwise, all companies lacking a promising future could adopt a generous dividend policy and deceive investors with impunity, thereby devaluing the dividend signal completely.

In contrast, if those responsible for setting dividend policy know a penalty is associated with sending a false signal they will refrain from doing so, at least when the anticipated costs exceed the likely benefit.[216] Decisions to raise, cut or maintain dividend payments can then potentially communicate information about a company's prospects over and above that provided by publicly filed accounting data and other corporate announcements. In other words, dividends can function as a peacock's tail, as a signal of value only truly profitable companies can afford to display.[217]

It can in fact be "dangerous to lie with dividends".[218] A company that chooses and adheres to a generous dividend policy without the cash flow to back it up will over time have to resort to the capital markets to raise the cash required to continue to pay dividends to shareholders and finance day-to-day operations. Investment bankers and investors, aware of the company's disappointing track record, will be difficult to win over. If the efforts to raise fresh capital fail and the company continues to pay dividends at the same rate, the company could end up in serious financial difficulty in short order. Assuming lying with dividends is likely to result in this sort of fate, investors can infer

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[214] As Miller and Modigliani themselves recognized in their pioneering work on dividends and corporate finance: "Dividend", supra note xx, 430. For summaries of formal models of dividend "signalling", see Lease et al., Dividend, supra note xx, 102-6.

[215] Edwards, "Does", supra note xx, 12-13; Lease et al., Dividend, supra note xx, 97; Luis Correia da Silva, Marc Goergen and Luc Renneboog, Dividend Policy and Corporate Governance (Oxford: Oxford University Press, 2003), 38-39.

[216] Avner Kalay, "Signaling, Information Content, and the Reluctance to Cut Dividends", (1980) 15 Journal of Financial and Quantitative Analysis 855.

[217] "Dividend's End", Economist, January 12, 2002.

[218] David Davies, "Upending Some Sacred Cows", Financial Times, June 3, 1985, 21; on the theory involved, see Brealey and Myers, supra note xx, 438.

sensibly from a company's decision to maintain or increase gradually its dividend pay-out that those setting dividend policy believe the company's prospects are good enough to support current pay-out levels for some time to come.

By the same token, a sizeable dividend increase will plausibly constitute good news. Companies lacking a promising future can fairly readily mimic public announcements offering optimistic forecasts.[219] In contrast, given the downside associated with the adoption of an untenably generous dividend policy, companies are unlikely to opt to boost their dividend pay-out substantially unless those in charge are confident that the company's future is sufficiently bright to sustain matters over time.[220] Conversely, a dividend cut can reasonably be taken to represent bad news, since the decision implies that those running a company are apprehensive about the future and thus are conserving cash to avoid a problematic effort to rely on capital markets to raise fresh capital.[221] In sum, dividends can, as signalling theory implies, offer a valuable profit forecast.

There is little empirical U.K. data on the signalling theory of dividends, and that which is available only covers from the late 1980s onwards.[222] Nevertheless, as we will see now, there is ample circumstantial evidence indicating that during the decades immediately following World War II dividends were conveying information valued by shareholders. Thus, for investors who could not count on corporate and securities legislation to induce companies to divulge a sufficient volume of reliable information to provide a foundation for investing, the dividend policy companies adopted likely served as a viable substitute.

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219 Lease et al., Dividend, supra note xx, 98.

220 Black, "Dividend", supra note xx, 6.

221 See Harry DeAngelo, Linda DeAngelo and Douglas J. Skinner, "Dividends and Losses", (1992) 47 Journal of Finance 1837 (arguing that if a company suffers a loss in a particular year it will generally not cut its dividend if the poor results were merely due to unusual occurrences during that year but will cut its dividend if there is a long-term trend involved).

222 The first study, which tested dividend announcements made between 1989 to 1992, was carried out by economist Paul Marsh. The findings are discussed in "Revisiting the Dividend Controversy", Economist, August 15, 1992, 69; Paul Marsh, "Why Dividend Cuts are a Last Resort", Financial Times, August 12, 1992, 16.

B. The Pervasiveness of Dividends

Again, during the decades following World War II the vast majority of U.K. public companies paid annual dividends and only a small number reduced their pay-outs from the previous year.[223] This pattern would have helped to ensure dividend policy could perform a signalling function. Decisions companies take concerning dividends are only apt to convey useful information when a change in policy is likely to cause a company to stand out from the crowd.[224] Hence, when the proportion of U.S. publicly quoted companies that paid dividends fell from 67% in 1978 to 21% in 1999,[225] cutting or suspending dividend payments became much less likely to be seen as a confession of failure.[226] The available evidence suggests that signals conveyed by dividend announcements of U.S. public companies indeed were considerably weaker in the 1990s than they had been in previous decades.[227] The declining percentage of dividend payers is a plausible explanation why.

The situation was considerably different in Britain during the decades following World War II. In contrast with the United States in the 1990s, there was nowhere to hide. Given the dividend policies adopted almost universally by U.K. public companies, a firm that omitted to pay dividends or reduced its dividend payment from the previous year would have stood out as an exception from the norm. This would have served to reinforce the message its dividend policy communicated to investors.

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[223] Supra note xx and related discussion.

[224] Chowdhury and Miles, supra note xx, 8.

[225] Eugene F. Fama and Kenneth R. French, "Disappearing Dividends: Changing Firm Characteristics or Lower Propensity to Pay?", (2001) 60 Journal of Financial Economics 3.

[226] "Shares Without the Other Bit, Economist", November 20, 1999, 135.

[227] See Yakov Amihud and Kefei Li, The Declining Information Content of Dividend Announcements and the Effect of Institutional Holdings (2006), forthcoming Journal of Financial and Quantitative Analysis; Raj Chetty, Joe Rosenberg and Emmanuel Saez, Market Responses to Dividend Announcements and Payments: Evidence from the 2003 Dividend Tax Cut and the Time Series, (2005), unpublished working paper, at 12-13, forthcoming in Alan Auerbach and Joel Slemrod (eds.), *Taxing Corporate Income in the 21st Century*, Cambridge: Cambridge University Press (both finding a decline in the reaction of stock prices of U.S. public companies to announcements of dividend changes as the 20th century drew to a close).

C. Companies Feared Adverse Consequences if They Failed to Pay Dividends in Accordance with Investor Expectations

Signalling theory again presupposes that for dividends to convey meaningful information to shareholders, companies need to fear being penalized if they adopt dividend policies inconsistent with their long-term prospects. During the period when ownership separated from control in the U.K. dividend policy in fact was set as if there was apprehension about creating a misleading impression when distributing cash to shareholders. More precisely, there was a marked tendency among companies to treat stability as a high priority and to refrain from adjusting pay-out levels significantly absent exceptional circumstances.

A study of aggregate dividend pay-outs by U.K. public companies by Steven Bank, Brian Cheffins and Marc Goergen illustrates that caution was indeed the watchword with decisions about dividend policy.[228] Work done by economist John Lintner in the 1950s puts the findings of this study into context.[229] Lintner gleaned from interviews with managers of U.S. public companies that such firms had long-term target dividend pay-out/earnings ratios in mind but avoided altering the pay-out rate if the change might need to be reversed in the short term. Managers instead engaged in "dividend smoothing", meaning they only adjusted dividend policy in response to substantial and persistent changes in earnings. Lintner in turn used his findings to formulate an empirically testable "partial adjustment" model of dividends, with the foundations being the notion of a target dividend/profit ratio, changes in current earnings and the dividend level in the previous year.

Subsequent empirical tests of the Lintner model and variations upon it designed to incorporate explicitly past financial performance and future earnings potential verified

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[228] Bank, Cheffins and Goergen, supra note xx.

[229] John Lintner, "Distribution of Incomes of Corporations Among Dividends, Retained Earnings, and Taxes", (1956) 46 American Economic Review 97.

that the model had considerable explanatory power.[230] Thus, the evidence suggests public companies have generally aimed to provide shareholders with a dependable flow of cash payments and so have resisted cutting dividends in response to a temporary decline in earnings and have only increased distributions to shareholders when management was confident the higher payments could be maintained. The Bank/Cheffins/Goergen study of dividend pay-outs by U.K. public companies between 1949 and 2002 falls into line with this pattern, as a partial adjustment model based on Lintner's work performed well in explaining the data.[231] Those setting dividend policy for U.K. public companies thus were apparently using earnings as a key reference point in determining dividend policy but also smoothed dividends rather than adjusting cash distributions purely in response to annual financial results.

U.K. public companies likely smoothed their dividends because of concerns about a negative investor reaction if they set dividend policy differently. In the decades immediately following World War II, it was widely known the stock market implied a very bleak future from dividend cuts and companies therefore strongly resisted them.[232] The authors of the 1979 edition of a text on U.K. business finance described the implications as follows:

> "shareholders value steadily increasing dividends very highly because they think such a rise would not be implemented unless directors had confidence in being able to maintain it. Hence…(d)irectors try hard not to reduce dividends, resorting if necessary to past undistributed profits to maintain them".[233]

[230] da Silva, Goergen and Renneboog, Dividend, supra note xx, 41; Lease et al., Dividend, supra note xx, 128-29; Terry A. Marsh and Robert C. Merton, "Dividend Behavior for the Aggregate Stock Market," (1987) 60 Journal of Business 1, 3.

[231] Bank, Cheffins and Goergen, supra note xx; the Lintner model was redefined so as take into consideration earnings fluctuations going back over time as well as current earnings. On the rationale for this, see Eugene F. Fama and Harvey Babiak, "Dividend Policy: An Empirical Analysis", (1968) 63 Journal of the American Statistical Association 1132.

[232] Thomas, Finance, supra note xx, 219; Andrew Glyn and Bob Sutcliffe, British Capitalism, Workers and the Profits Squeeze (Harmondsworth, U.K.: Penguin, 1972), 118.

[233] Midgley and Burns, Business, supra note xx, 253.

The 1984 survey of senior managers cited earlier also illustrates those running U.K. public companies feared a share price “hit” if they failed to smooth dividends. Respondents said a dividend cut would be perceived as an indicator that current earnings were suffering and as a signal that longer-term profitability was in jeopardy.[234] They acknowledged moreover that the manner in which they were setting dividend policy constituted an important method of conveying information to investors.[235]

A study of the financial performance of quoted and unquoted companies during the 1980s confirms that among British publicly quoted companies concerns about investor reactions prompted dividend smoothing.[236] Drawing upon a list of the 1000 largest U.K. firms as of 1980, the study matched private companies with publicly quoted firms on the basis of size and industry and compared the financial results over the next seven years. One finding was that private companies were more likely to cut dividends in the face of deteriorating financial conditions than their stock market counterparts. This result can be explained on the basis the privately held companies, lacking an investor base equivalent to those of the publicly quoted firms, failed to attribute to dividends a signalling function and thus felt free to adjust pay-outs in accordance with changes in earnings.[237] The evidence suggests in sum that U.K. companies in fact were sufficiently apprehensive of investor reactions for dividends to perform a signalling function.

While investors generally would have reacted negatively to a reduction in dividend pay-outs, a key category of investor – pension funds -- had a particular reason to discourage dividend cuts during the period when the U.K.’s outsider/arm’s-length system of ownership and control took shape. Statistics illustrate just how important pension funds were becoming. The percentage of shares of U.K. public companies they owned

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[234] Edwards and Mayer, “Investigation”, supra note xx, 8-10. See also Peter Martin, “A Corporate Conundrum”, Financial Times, January 26, 1991, 8 (quoting a U.K. investment as saying “(m)ost major companies that cut their dividend for short-term reasons live to regret it”).

[235] Edwards and Mayer, “Investigation”, supra note xx, 10-11.

[236] Colin P. Mayer and Ian Alexander, “Stock Markets and Corporate Performance: A Comparison of Quoted and Unquoted Companies,” (1991) Centre for Economic Policy and Research Discussion Paper No. 571.

[237] Id., 45.

rose from 3% in 1957 to 9% in 1969, to 17% in 1975 and to 31% in 1991, by which point pension funds owned a higher percentage of shares than any other category of investor.[238] Until the mid-1960s, it was conventional for pension funds to value assets in which they invested at book value.[239] Since book value is an accounting measure focusing on the position at the date of purchase, this produced the odd result that identical investments were attributed different values depending on when they were bought. To improve matters, pension fund actuaries began valuing assets on the basis of the expected future income stream, which with equities involved using a "dividend discount model" based on dividend pay-outs.[240]

Pension fund managers, being aware of how shares were valued under the dividend discount model, took a dim view of dividend cuts.[241] The pension contributions a corporate employer was obliged to make were determined in part by the match of assets and liabilities, meaning that if the value ascribed to shares held by company pension plans fell significantly the companies would be under pressure to correct matters by making additional contributions. Pension funds therefore generally discouraged companies in which they owned shares from cutting dividends and welcomed sustainable increases in dividend payments.[242] With pension funds moving to the forefront as investors in U.K. shares from the 1950s through to the 1980s, those deciding dividend policy on behalf of public companies had to be mindful of this bias since they could lose crucial institutional support if they failed to do so. This would have reinforced any signalling-driven bias against cutting dividends.

D. Dividends and Share Prices

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[238] On sources, see supra note xx (Moyle and National Statistics website).

[239] S.J. Head et al., "Pension Fund Valuations and Market Values", (2000) 6 British Actuarial Journal 55, 60.

[240] Id.

[241] Barry Riley, "Survey of Pension Fund Investment", Financial Times, May 6, 1993, Survey of Pension Fund Investment, I.

[242] Id.

While the pervasiveness of dividends and the prevalence of dividend smoothing both suggest dividends were performing a signalling function in the decades following World War II, a strong link between dividend payouts and share prices is perhaps the strongest evidence dividends were conveying information valued by investors. In purely theoretical terms, dividend policy should not be a determinant of share prices. According to corporate finance theory, the return shares offer to investors over time is a risk-adjusted function of what a company will pay out to shareholders throughout its existence, whether as cash distributions or a final payment upon liquidation. Correspondingly, ascertaining the value of a company's shares at any one time should involve estimating what the company's net cash flow will be throughout the remaining life of the business.[243]

Assuming, as did Miller and Modligiani, full symmetry of information between managers and investors, no transaction costs and so on, market participants should immediately digest any new data on future profitability that becomes available and a company's share price will reflect fully the information "in the market". If the stock market in fact prices information in this manner, then, as Miller and Modligiani hypothesized, there will be no scope for a company's dividend policy to convey anything meaningful to investors. With dividends failing to play any sort of signalling role, the size and pattern of annual cash distributions will be irrelevant to a company's stock market valuation.[244]

Matters generally worked much differently in practice in the U.K. during the decades following World War II, with dividends in fact constituting a key determinant of share prices. According to a 1955 report issued by a Royal Commission on the taxation of profits and income, "(i)t is the distributed profits that tend most directly to influence the market value of a share".[245] A study based on 1949-57 data derived from a sample of 165 companies quoted on the London Stock Exchange confirmed that the value of shares

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243 Cheffins, Company Law, supra note xx, at 55.

244 See Lease et al., Dividend, supra note xx, 25-27.

245 Royal Commission on the Taxation of Profits and Income, Final Report, Cmd. 9474 (London: HMSO, 1955), 17 (majority report); see also 386-87 (minority report, exploring the point in more detail).

of U.K. public companies depended far more on dividend payments than reported earnings.[246] According to this study, variations in the last declared dividend per share and the most recent published data on retained earnings combined to explain much about share price fluctuations. Dividends and undistributed profits were not treated equally, however. Instead, cash distributions were capitalized in the share price at a much higher rate.[247]

In this milieu, dividend announcements made by public companies not surprisingly captured considerable attention. For investors and stockbrokers, private knowledge of the dividend a company would declare was prized information that could induce heavy buying and selling of shares.[248] Hence, as early as 1939 the London Stock Exchange had set up "Trans Lux", which used a large screen to convey dividend announcements and other news simultaneously to all members of the London Stock Exchange.[249] By the mid-1960s, the London Stock Exchange's Listing Rules required that a company not only notify the Stock Exchange immediately of a decision by the board concerning the declaration or omitting of a dividend payment but also provide advance notice of board meetings where such matters would be considered.[250] Press coverage also reflected the interest in dividends. Newspapers that dealt with business issues in detail routinely reported on dividend announcements of public companies and offered a comparative figure for the previous year, perhaps supplemented by supporting analysis.[251]

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[246] G.R. Fisher, "Some Factors Influencing Share Prices", (1961) 71 Economic Journal 121.

[247] For additional empirical evidence supporting the same conclusion, see Rose, Economic, supra note xx, 459-60; P. Sargent Florence, "New Measures of the Growth of Firms", (1957) 67 Economic Journal 244, 246.

[248] Richard Spiegelberg, The City: Power Without Accountability (London: Blond & Briggs, 1973), 48. Insider dealing was not illegal in the U.K. until 1981: *supra* note xx and accompanying text.

[249] F.E. Armstrong, The Book of the Stock Exchange, 5th ed. (London: Sir Isaac Pitman & Sons Ltd., 1957), 123-24.

[250] Federation of Stock Exchanges in Great Britain and Ireland, Admission of Securities to Quotation, supra note xx, 42 (Communication of Announcements).

[251] Naish, Complete, supra note xx, 141-42.

Contemporaries were well aware of the attention investors paid to dividends and the impact dividend policy had on share prices. A 1957 edition of a book on the London Stock Exchange characterized dividend announcements as being of "great importance", saying

> "Frequently they mean a reconstruction of yield shown on a share, based on a distribution which it is deemed by directors unwise to continue, on which it is decided to improve. This alteration of yield frequently leads to realisations or further buying, which quickly brings in its train a price adjustment as a natural consequence."[252]

A 1960 text on investment characterized the price readjustment process as follows:

> "If a change in dividend has been fully anticipated, the news of the change will leave the price of the share concerned more or less unaltered….If an increase in dividends proves to have disappointed a sufficient number of investors, its announcement will be accompanied by a fall in share prices; and the failure of dividends declared to be reduced as much as had been feared will be accompanied by a rise."[253]

Dividends admittedly are a coarse method of conveying of information to investors. One source of potential misapprehension is that a dividend cut conceivably could be good rather than bad news, since the reduction could signify that a company is conserving capital to exploit valuable growth opportunities. Similarly, a dividend increase could be bad rather than good news, as the decision might be an implicit concession by management that their company is struggling and thus is disinvesting by returning money to shareholders.[254]

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[252] Armstrong, Book, supra note xx, 123-24.

[253] Rose, Economic, supra note xx, 456; see also Naish, Complete supra note xx, at 41-43 (offering a description of the process based on hypothetical facts).

[254] Easterbrook, "Two", supra note xx, 651-52; Victor Brudney, "Dividends, Discretion, and Disclosure", (1980) 66 Va. L. Rev. 85, 109-12.

Despite the potential ambiguities or contradictions of dividend action, the language may in fact be clear to those to whom it matters.[255] Certainly, in the U.K., the fact that dividends were strongly correlated with share prices in the decades following World War II suggests decisions companies made on the distribution of profits were conveying information investors relied upon. This does not mean the signalling effect remained equally strong as time progressed. Instead, it likely diminished as investors relied increasingly on additional sources of information to assess the prospects of companies.[256] The rise of investment analysts, who specialize in the researching of companies and the offering of recommendations on the buying and selling of shares, illustrates how additional information was becoming available to investors.

Investment analysts, a U.S. export, first arrived in Britain during the mid-1950s, and by the 1960s the detailed study of companies and industries had become a widely adopted practice in the London financial community.[257] Nevertheless, the efforts undertaken were rudimentary by present-day standards, in part because investment analysts generally lacked direct access to the executives managing companies.[258] Over time, matters improved considerably. A 1998 history of the stock market makes the point, remarking on how things had changed since the 1960s:

> "(The 1960s) were exciting, pioneering days for investment analysts. With no apparent limit to their horizons, they enjoyed the satisfaction of pure research and discovery in a competitive search for basic information. It was very different

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255 Brudney, "Dividends", supra note xx, 113.

256 On the fact that the dividend signal will weaken as the quality of other forms of disclosure improves, see Nils H. Hakansson, "To Pay or Not to Pay Dividend", (1982) 37 Journal of Finance 415 (making the point that dividends cannot play a productive signaling role when full information is already available); see also Amihud and Li, "Declining", supra note xx (arguing that as institutional ownership of U.S. public companies increased dividends became a less meaningful signal since the institutional investors had better access to other sources of information on companies than did individuals).

257 Walter A. Eberstadt, "Investment Ties Across the Atlantic", Times, July 17, 1967, Wall Street (special section), VIII. See also "Investment Analysts' Society", Times, May 2, 1955, 19 (announcing the establishment of the U.K.'s Society of Investment Analysts).

258 Eberstadt, "Investment", supra note xx.

> from the prospect today for the trainee analyst entering a mature business with a high level of shared information".[259]

As better sources of information became available, U.K. investors placed increasing emphasis on annual and interim earnings figures and company profit forecasts when valuing shares.[260] This in turn meant less attention was paid to dividends. For instance, during 1968, the share price of retailer and market favourite Tesco Ltd. doubled despite a dividend yield of 0.9%, which was considerably lower than the yield on government bonds.[261] Still, while the signalling effect of dividends did diminish over time, investors nevertheless continued to treat dividend policy as an important barometer of corporate performance. Economist Mervyn King (later governor of the Bank of England) said in his 1977 book *Public Policy and the Corporation* that "the payment of the dividend is the principal direct line of communication from management to shareholder".[262]

Others concurred. A 1975 text on analysis of the British stock market said:

> "Dividend forecasts are needed as they are an important factor in share price determination; indeed they form the basis used (for an investment analysis technique known as) the intrinsic value approach and in many computer-based stock evaluation models."[263]

Similarly, the *Economist* observed in 1979 that the "preoccupation with (dividend) yields can reduce investment analysis to a simple question of whether a dividend is likely to be

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[259] Littlewood, Stock, supra note xx, 126.

[260] Littlewood, id., 159; William G. Nursaw, The Art and Practice of Investment (London: Hutchinson, 1963), 38; Robert Heller, The Naked Investor (London: Weidenfeld and Nicolson, 1976), 223-34. The price/earnings ratio in particular became a popular way of measuring how highly investors valued earnings companies were producing. See Janette Rutterford, "From Dividend Yield to Discounted Cash Flow: A History of U.K. and US Equity Valuation Techniques", (2004) 14 Accounting, Business & Financial History 115, 138.

[261] R.J. Briston, The Stock Exchange and Investment Analysis, 3rd ed. (London: George Allen & Unwin, 1975), 372.

[262] King, Public, supra note xx, 175.

[263] Michael Firth, Investment Analysis: Techniques of Appraising the British Stock Market (London: Harper & Row, 1975), 117.

held or not."[264] Moreover, an empirical study covering 1962 to 1986 found that dividend pay-outs of the U.K.'s 500 largest publicly quoted companies correlated in a statistically significant manner with fluctuations in the aggregate market capitalization of those firms.[265] Thus, even if the attention investors paid to dividend announcements waned somewhat over time, dividends continued to be a significant determinant of share prices through to the 1980s.

E. Summary

In the U.K. the signalling effect of dividends continued to diminish after outsider/arm's-length corporate governance was well-established. For instance, in 1992 the *Economist* acknowledged that while a dividend cut was taken far more seriously by the markets than "glossy hand-outs and analysts' briefings", "investors are increasingly clear-eyed…looking less to the dividend and more to the profits covering it".[266] Nevertheless, during the period when ownership separated from control, there was an informational feedback loop between investors and companies operating via dividend policy. In the decades immediately following World War II, U.K. legislation did not impose extensive disclosure requirements on publicly quoted firms, with the only periodic disclosure obligation imposed by statute being a requirement to file annually audited financial statements.[267] In this milieu, the dividend policy adopted by U.K. companies would have acted as at least a partial substitute for investors seeking information on which shares to buy and sell. Thus, to the extent that standards of corporate disclosure influence demand for shares among outside investors, the pay-out

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264 "To Cut or Not to Cut", Economist, June 9, 1979, 118.

265 Stephen Leithner and Heinz Zimmerman, "Market Value and Aggregate Dividends: A Reappraisal of Recent Tests, and Evidence from European Markets", (1993) 129 Swiss Journal of Economics and Statistics 99, 111-12. This finding was not replicated for the other countries studied (France, Germany, Switzerland and the United States).

266 "Dividend Dilemmas", Economist, August 15, 1992, 12. See also "A Modest Sort of Problem, Made Powerful by Myth", Economist (U.K. edition), January 25, 1992, 93 (saying "the value of dividends as signals may be fading….(C)omputers and sharper competition have raised standards among stock analysts, providing investors with more reliable information about companies' operations").

267 The key statutory provisions governing the preparation and filing of annual financial statements were Companies Act 1948, ss. 38, 126(1), 127, 149, 156, sch. 4, sch. 8.

policy adopted by U.K. companies would have helped to provide the foundation for the post-World War II reconfiguration of Britain's system of ownership and control.

7. A Potential Caveat: Dividends Could Be Costly to Shareholders

The signalling and agency cost characterizations of dividends both imply those owning equity benefit from dividend payments, either from the transmission of information or the disciplining of management.[268] For shareholders, however, the virtues of dividends can be illusory.[269] More particularly, even if dividends do convey information to shareholders and serve to constrain to some degree those in control of companies, if there are substantial costs involved with the paying and receipt of dividends shareholders may fail to benefit overall.[270] Applying this reasoning to circumstances in Britain, if dividends were subject to tax penalties as compared with retained earnings, the dividend policies U.K. public companies adopted may have been a net deterrent to investment in shares. If this was the case, dividends logically would not have contributed in a meaningful way to the unwinding of ownership structures.

U.K. tax rules in fact did penalize certain recipients of dividends, these being individuals with high incomes who owned shares directly rather than via an investment intermediary. The point can be illustrated by calculations taking into account the relevant tax variables where a score of 1 implies indifference between dividends and retained earnings, a score of less than 1 represents a tax bias in favor of retained earnings and a score of greater than 1 signals the converse.[271] The "tax preference ratio" for individuals paying the top marginal rate of tax ranged between 0.03 and 0.18 between 1949 and

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[268] See Francisco Pérez-González, "Large Shareholders and Dividends: Evidence from U.S. Tax Reforms", (2003), working paper, Columbia Univ. Business School, 4-5.

[269] Benito and Young, "Hard Times", supra note xx, 10.

[270] Jean Crockett and Irwin Friend, "Dividend Policy in Perspective: Can Theory Explain Behavior?", (1988) 70 Review of Economics and Statistics 603 (outlining circumstances where investors will buy shares in companies paying dividends despite being suffering a tax penalty).

[271] On the methodology, see James Poterba and Lawrence Summers, "The Economics Effect of Dividend Taxation" in Edward Altman & Marti Subrahmanyam, (eds.), Recent Advances in Corporate Finance (Homewood, Ill.: R.D. Irwin, 1985), 227. Their model, in turn, was based upon parameters developed in King, Public, supra note xx, 75-77.

1979.[272] Hence, when U.K. public companies in this era paid a dividend rather than retaining earnings they were essentially imposing a substantial tax penalty on a major group of investors.[273]

While for individuals owning shares the tax system was biased against dividends, U.K. companies that were paying dividends were not imposing a meaningful tax penalty on institutional investors, the constituency that was moving to the forefront as the U.K.'s outsider/arm's-length system of ownership and control took shape. From the end of World War II onwards, ownership of shares by individuals dropped quickly. As the Economist noted in 1953:

> "In the last five years there has been no net personal investment on the Stock Exchange. Sales of securities from private portfolios seem to have clearly exceeded the purchases that individuals have made."[274]

A 1980 survey of U.K. financial markets, relying on data from a study of the flow of funds prepared by the Bank of England, confirmed individuals were net sellers of corporate equity. Each year between 1963 and 1977 individuals sold more shares than they bought, with the amounts involved varying from a low of £1.22 billion in 1969 to a high of £3.79 billion in 1973.[275] The proportion of shares of U.K. public companies owned by individuals correspondingly declined dramatically.[276]

As private investors exited, the "buy" side of the market for shares in U.K. public companies became thoroughly dominated by institutional investors, with pension funds

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[272] Bank, Cheffins and Goergen, supra note xx, Table 3. The tax preference ratio rose to 0.51 in 1980 due to a cut in the top rate of income tax.

[273] Managers indeed sometimes sought to resist pressure to pay out more dividends with the argument that "if we increase your dividends, we increase your taxes": Clive Wolman, "Why it Pays Dividends to Pass on Profits", Financial Times, May 14, 1985, 24.

[274] "Corpse in the Capital Market", Economist, February 7, 1953, 375, 375.

[275] Marshall E. Blume, "The Financial Markets" in Richard E. Caves and Lawrence B. Krause (eds.), Britain's Economic Performance (Washington D.C.: Brookings Institution, 1980), 276-77, 294 (only citing precise amounts for 1966 to 1977).

[276] See supra note xx and accompanying text.

and insurance companies taking the lead role.[277] As the London Stock Exchange said in written evidence submitted in 1977 to a committee struck by the U.K. government to review the functioning of financial institutions, "(t)he personal sector has been for over twenty years a consistent net seller of securities at a fairly steady rate in constant price terms" and "(t)he institutions…have been absorbing the sales by the private individuals".[278] Data compiled for a 1978 study of the growth of institutional investors confirmed the point, indicating that collectively key British institutional investors were net purchasers of shares in each and every year through the 1960s and 1970s.[279]

Insurance companies paid tax on income received – including dividends paid out by companies in which they owned shares -- at a rate much lower than imposed on individuals paying the top rate of tax.[280] This meant that the tax penalty associated with dividends – if any – was much less substantial than it was for highly paid individuals. Pension funds, which were essentially exempt from both income tax and capital gains tax, typically had up to the late 1990s a tax preference in favor of dividends.[281] The upshot is that for those in fact buying shares in any volume during the period when ownership separated from control, the tax "downside" of dividend payments should not have detracted substantially from whatever disciplinary and signaling benefits there in fact

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277 The percentage of shares of U.K. public companies owned by unit trusts consistently trailed far behind those for insurance companies and pension funds. For instance, as of 1975, unit trusts owned 4.1%, insurance companies owned 15.9% and pension funds owned 16.8%: National Statistics Online database, supra note xx. Investment trusts generally owned more shares than unit trusts in the decades following World War II but they struggled to raise new funds and thus were the weakest of the four legs of the institutional market. See Littlewood, Stock, supra note xx, 262; Briston and Dobbins, Growth, supra note xx, 17.

278 Committee to Review the Functioning of Financial Institutions (Sir Harold Wilson, chairman), Report (London: HMSO, 1980), 208, 214.

279 Briston and Dobbins, Growth, supra note xx 189; see also Blume, "Financial", supra note xx, 286.

280 Briston, Stock, supra note xx, 199-200. According to King, Public, supra note xx at 266, the effective dividend income tax rate for insurance companies ranged between 22.8% and 27.8% between 1947 and 1975, which was far below the tax rates individuals paid on investment income.

281 Between 1965 and 1973 pension funds' tax preference ratio was 1 (i.e. indifference between capital gains and dividends). Otherwise, until 1997 the score was always above 1, ranging from a low of 1.18 (April 1956 to April 1958) to a high of 1.70 (April 1964 to April 1965). From 1997 onwards, the tax preference ratio again was 1. See Bank, Cheffins and Goergen, supra note xx, Table 4.

were. Tax therefore should not have disrupted the momentum dividends created in favor of diffuse share ownership.

8. Conclusion

As we have seen, via a highly stylized example involving a single publicly quoted firm, the widely held company might not become dominant in a country even if it enjoys inherent economic advantages. One obstacle is the "controller's roadblock": dominant shareholders might not exit because they will fail to capture a sufficient portion of the gains available from a transition to diffuse share ownership to compensate them for the loss of private benefits of control. Investor scepticism is another: potential buyers of shares for sale might well reason logically but incorrectly that optimistic claims made about future shareholder returns are implausible. The law matters thesis hypothesizes corporate and securities law can address both obstacles to diffuse share ownership. In the U.K., however, law was not highly protective of outside shareholders as ownership separated from control. What constraints, then, induced blockholders to exit? And what motivated outside investors to buy shares?

This paper has argued that dividend policy played a significant role. The payment of dividends was not a sufficient condition for the separation of ownership and control. The fact the reconfiguration of ownership and control in U.K. public companies was essentially a post-World War II phenomenon while companies had a penchant for paying dividends in prior decades illustrates the point.[282] Nevertheless, as other factors contributed to the reconfiguration of the corporate economy in the U.K, dividend policy played an important supplementary role.

For instance, while declining profitability in the U.K. corporate sector likely would have only motivated blockholders to exit as the 1970s began, the implicit commitment to pay dividends would have imposed discipline on public companies throughout the entire period when ownership separated from control. Similarly, while

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282 Supra note xx and related discussion.

stock exchange rules imposed various new disclosure requirements on listed companies during the 1960s, the manner in which share prices were determined indicates that prior to this point investors could and did rely heavily on dividend pay-outs to gauge how to proceed. Hence, while other factors no doubt contributed to the separation of ownership and control in the U.K., dividend policy constituted an important variable that helped to substitute for the lack of protection offered to minority shareholders under Britain's corporate and securities laws.

Does this mean, as contractarian analysis might be taken to imply, that law is trivial? That would be reading too much into what occurred in the U.K. The analysis presented here does illustrate that the market can contribute significantly to the rise of a system of corporate governance oriented around the widely held company. Nevertheless, law's role should not be ignored. Jack Coffee has made this point with respect to the U.S.[283] Share ownership unwound sufficiently before the enactment of federal securities legislation in the early 1930s for Berle and Means to make their well-known claim that ownership had separated from control in many large U.S. companies.[284] Coffee acknowledges accordingly that robust securities markets can arise when statutory protection offered to outside investors is minimal but argues regulation might be required subsequently to sustain matters, particularly since market shocks can batter investor confidence.

This insight could be pertinent for the U.K. A case could be made that a shift in favour of formalized regulation occurring during the 1980s made the stock market orientation of U.K. corporate governance more durable than otherwise might have been the case. As we have seen, statutory reforms carried out in the 1980s -- after diffuse share ownership had gained a firm foothold -- served to increase significantly the

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283 John C. Coffee, "The Rise of Dispersed Ownership: The Roles of Law and State in the Separation of Ownership and Control", (2001) 111 Yale Law Journal 1, 64-71.

284 Cheffins, "Law", *supra* note xx, 8, discussing Adolf Berle and Gardiner Means, The Modern Corporation and Private Property (New York: Harcourt & Brace, 1932); Securities Act 1933, 15 U.S.C. 77; Securities Exchange Act 1934, 15 U.S.C. 78.

protection of outside investors.[285] A key reason why the U.K.'s score on La Porta, López-de-Silanes and Shleifer's securities law index improved substantially was that the London Stock Exchange's listing rules were vested with the status of subordinate legislation.[286] The change was part of a broader trend in favour of greater regulation of U.K. capital markets during the mid-1980s.

Prior to this point, Britain's equity markets and important components of the country's financial services sector were governed by a system where self-regulation was integral. A series of privately operated organizations, with the London Stock Exchange being among the most prominent, supervised the relevant activities without drawing upon statutory powers and without being directly accountable or answerable to government officials.[287] Serious doubts arose about the viability of self-regulation in the early 1980s in the wake of increasing globalization of financial markets, a series of scandals affecting the London financial community and an investigation of the London Stock Exchange's share dealing system by antitrust regulators.[288] The government responded with legislative reform oriented primarily around Financial Services Act 1986 that was designed to create "self-regulation within a statutory framework".[289] The U.K.'s outsider/arm's-length system of ownership and control retained its vitality despite a stock market crash in 1987 and a series of corporate governance scandals in the early 1990s and the shift in favour of formal legal regulation might be part of the reason why.[290] To the extent this is correct, and to the extent dividends contributed to the separation of ownership and control in Britain that occurred from the 1940s through to the end of the

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285 Supra notes xx to xx and related discussion.

286 Supra notes xx to xx and accompanying text.

287 See Michael Moran, The Politics of the Financial Services Revolution (London: MacMillan, 1991), 61-68.

288 On the antitrust investigation, see *supra* note xx and related discussion. See more generally J.J. Fishman, *The Transformation of Threadneedle Street: The Deregulation and Reregulation of Britain's Financial Services* (Durham, N.C.: Carolina Academic Press, 1993), 31-40.

289 Financial Services in the United Kingdom, Cmnd. 9432, (London: HMSO, 1985) at 13.

290 There in fact was a prompt and effective self-regulatory response to the corporate governance scandals of the early 1990s: Cheffins, Company, *supra* note xx, 373-74, 611-13. However, the remaining self-regulatory aspects of financial services regulation in the U.K. were largely swept away in the wake of the enactment of the Financial Services and Markets Act 2000, c. 8.

1970s, developments in the U.K. illustrate that it is necessary to take into account both the market and law to understand fully how systems of corporate governance evolve and operate.

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