"THE GOOD, THE BAD, AND THE UGLY" PRIVATE BENEFITS OF CONTROL AND THEIR REGULATORY IMPLICATOINS

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Abstract

This paper attempts to shed a new light on the economics and the law of corporate governance. It so does by taking stock of the weaknesses of the standard account of how law 'matters' for separation of ownership and control. This account fails to explain comparative corporate governance. Both the ownership structure and the functioning of the market for corporate control do not seem to depend entirely on the strength with which non-controlling shareholders are protected by corporate law. Without claiming that legal protection of minority shareholders does not matter in corporate governance, this paper shows that protection and exchange of corporate control is at least as important and so are the legal institutions that support them. This result is derived by introducing a third category of private benefits of control (idiosyncratic PBC), which supplements the more traditional specifications as inefficient consumption of control perquisites (distortionary PBC) or outright expropriation of shareholder value (diversionary PBC).

The implications for corporate law are broader than those of the 'law matters' framework. Even though legal institutions effectively constrain expropriation of non-controlling shareholders, they may still make corporate governance inefficient when they fail to provide entitlements to uncontested control independently of how much ownership is retained by corporate controllers. Likewise, regulation may undermine the takeover process when it restricts side payments that ultimately support efficient bargaining upon the value of corporate control.

Keywords: entrepreneurship, private benefits of control, entrenchment, comparative corporate governance, ownership structure, takeovers, Coase Theorem, agency costs, incomplete contracts, distribution of powers, self-dealing, control premium.

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Introduction

Comparative corporate governance shows that the frequency of publicly held companies, their ownership structure, and the way in which they are controlled, differ considerably across countries (e.g., Morck *et al.* 2005). This holds despite of a common theoretical framework for analyzing separation of ownership and control – the principal-agent paradigm. Within that framework, the most popular explanation of transnational differences is the so-called 'law matters' approach (La Porta *et al*. 1998). Quality of corporate law, which varies significantly across countries, is regarded as the most important institutional determinant of separation of ownership and control. However, all that corporate law is supposed to do is to make sure that investors are effectively protected from expropriation. This is considered as both a necessary and a sufficient legal condition for efficient separation of ownership and control.

This perspective tends to overlook that the decision to separate ownership from control is taken by *two* categories of players. One is the firm manager; the other is outside investors. While the latter obviously care about security and profitability of their investment, the former is apparently unwilling to hand control over to the market when the stock is placed with the investing public. Publicly held companies are governed by either controlling shareholders or the top corporate management. Both categories of corporate controllers seem to hold on their controlling position in the real world. Whatever the ownership structure is, corporate control is hardly ever exposed to interference by outside investors (Hellwig 2000).

This paper investigates why corporate controllers care so much about tenure, and how this affects corporate governance both positively and normatively. One obvious reason why managers and controlling shareholders entrench themselves is taking advantage of outside investors once they have their money, by extracting so-called private benefits of control (PBC). This is the most popular explanation of conflicts of interest in corporate governance, but it is not the only possible one. By departing from the standard principal-agent approach, I will show how

private benefits of control can also play a virtuous role in corporate governance. To this purpose, I am going to present a richer taxonomy of private benefits of control than that usually considered in the literature. They include not only control perquisites and siphoning-off of corporate assets, but also a reward for the controller's specific investments that shareholders could not be committed to pay upfront when they buy outside equity. When these three components are disentangled, investor protection is not all that matters in corporate governance. Allowing corporate controllers to extract further compensation in the form of PBC is at least as important. This may explain why, regardless of the ownership structure, corporate control turns out to be entrenched anyway. This perspective also sheds a new light on the legal underpinnings of separation of ownership and control and the efficiency of corporate laws.

The paper is structured as follows. Section 1 summarizes the current debate about private benefits of control, and highlights its shortcomings. Section 2 introduces a more articulated welfare analysis of PBC, based on a qualitative distinction between three categories of them. Section 3 discusses a stylized bargaining between an entrepreneur/manager and outside shareholders, under a number of simplifying assumptions. Section 4 elaborates on this outcome with special regard to the ownership structure and the market for corporate control. The regulatory implications of this framework are discussed in Section 5. It will be shown that corporate law needs not only to support credible commitments against expropriation of outside shareholders; it also needs to provide managers with uncontestable control rights and with the opportunity to cash in the value of their specific investments when they accept to hand control over to a better manager. Section 6 concludes.

1. Private Benefits and Corporate Control

The very notion of PBC is neutral as to the implications for shareholder wealth. By definition, the *private benefits* of a corporate controller include anything that is not shared with non-controlling shareholders (Coates 2003). Extraction of private benefits harms shareholder only inasmuch as it reduces the actual or potential returns on their investment, which are named conventionally as *security benefits*. This needs not necessarily be the case.[29] Nevertheless, mainstream economic theory only focuses on PBC that *reduce* the wealth of outside shareholders (Becht *et al*. 2002).[30] PBC have thus became synonymous of weak shareholder protection by legal institutions, which, in turn, are responsible of suboptimal separation of ownership and control (La Porta *et al*. 1998), stock market underdevelopment (La Porta *et al*. 1997), and lower rates of economic growth (Levine 1999).

In this perspective, the impact of PBC on ownership structure has been investigated both theoretically (Bebchuk 1999) and empirically (Nenova 2003; Dyck & Zingales 2004). These studies have demonstrated that little, if any, separation of ownership and control can be expected when private benefits are high enough. Very few commentators have wondered why the prevailing ownership structure still differs across countries when PBC are relatively low. Within developed countries, Sweden is a case in point (Holmén & Högfeldt 2004), but a similar argument applies to the Netherlands (Högfeldt 2005). The average size of PBC is quite low in both countries, and this parallels the documented strength of legal and extralegal institutions. However, corporate ownership is significantly more concentrated than in Britain and in the US.

One recent explanation is that empirical studies can only measure *pecuniary* PBC, whereas ownership structure is also affected by *non-pecuniary* PBC (Gilson 2006). Some businesses endogenously involve higher levels of non-pecuniary benefits (Demsetz & Lehn 1985), and ownership concentration is just the way to have them consumed efficiently. A problem with this approach is that it still does not explain the systematic cross-country variation in ownership structure that we observe around the world. Moreover, the empirical evidence on pecuniary PBC is just based on estimates of the so-called control premium – the difference in market price between controlling and non-controlling stock. This evidence tells us neither whether non-controlling stock is actually worth less because of PBC extraction nor whether other PBC are included in the reservation price for controlling stock.

This parallels another limitation of the theory. While sizeable PBC always result in ownership concentration, ownership concentration is inefficient only when they are extracted at the expenses of non-controlling shareholders. Only in this situation further separation of ownership and control would be in the interest of both controlling and non-controlling shareholders, but gains from trade are foregone due to inability of the latter to take a credible commitment that the former will not be expropriated (Bebchuk 1999). Conversely, when extraction of private benefits has no impact on *existing* security benefits, the ownership structure that supports their extraction has no efficiency consequence, but only distributional ones (Zingales 1995).

Whether private benefits of control can actually be so 'innocuous' to outside shareholders is

[29] Some PBC have no opportunity costs to outside shareholders, because either the controller is in the unique position to appropriate their value or, similarly, they would not have yet any value to non-controlling shareholders (Hart 2001; Holderness 2003).

[30] Over time, the attention of commentators has moved from extraction of non-pecuniary benefits, in the form of managerial perquisites (Jensen & Meclking 1976), to more tangible diversion of corporate assets and cash flow (Shleifer & Vishny 1997).

controversial (Ehrhardt & Nowak 2003). Skepticism depends on reliance of both economic and legal commentators on the principal-agent model of corporate governance. According to this model, an agent can only extract pecuniary and non-pecuniary benefits inasmuch as she fails to maximize the principal's profits. This view often neglects that agency costs are just a part of the economics of corporate governance, whereas contractual incompleteness is the ultimate reason why both control powers and their regulation matter (Hart 1995a; Zingales 1998). A prominent consequence of contractual incompleteness is that ex post division of surplus does not entirely depend on mechanism design, but also on the institutional setup. This setup determines the entitlement to decide in those contingencies not being previously contracted upon, via allocation of so-called *residual rights of control*. Control rights are thus allocated in such a way as to promote investments whose reward cannot be predetermined contractually – typically, those of the owners of key assets (Grossman & Hart 1986; Hart & Moore 1990). However, when ownership is separated from control, both managers and shareholders may have to make such investments. This has an impact on the balance between private benefits and security benefits in corporate governance.

The standard view is that promoting managerial investments is relatively 'unimportant' in large public companies as opposed to entrepreneurial firms (Hart 1995b). As a result, residual rights of control are still allocated to the owners, they are just delegated to a controlling agent, and delegation can be withdrawn anytime by means of a takeover. PBC can only be extracted efficiently under the opposite assumption, namely that non-contractible investments are also important on the management's side. Then residual rights of control are still delegated from the owners to the managers, but shareholders are committed to withdraw delegation only in certain states of the world (Burkart *et al.* 1997; Tirole 2001). Unfortunately, this framework allows no way out of a tradeoff between the shareholders' security benefits and the managers' private benefits of control – depending on the conditions under which shareholders can oust the incumbent management. This tradeoff is the current focus of economic theory of separation of ownership and control (Bratton & McCahery 2001).

A further, neglected dimension of private benefits of control, which stand not in a tradeoff relationship with security benefits, could offer an alternative perspective. A few economists have already suggested this. Zingales (2000) nicely characterizes PBC as evidence of an *appropriability* problem concerning the value of corporate control, which has not yet been completely understood by the theory. Other commentators likewise depart from the standard principal-agent paradigm in order to investigate the determinants of entrenchment of corporate control, which seems to prevail around the world independently of the ownership structure (Hellwig 2000). This parallels the intuition, by some Law and Economics commentators, that corporate law may affect the ownership structure not only by protecting investors from expropriation, but also by supporting control tenure (Cools 2005). This should provide managers with the incentive to make investments that cannot be secured contractually (Rock & Wachter 2001).

A broader question is why corporate control is so important across the board. One possible explanation is that a *third* category of PBC exists, which is not featured by the agency theory, but is necessary to support entrepreneurial activities that financial markets are unable to reward (Mayer 1999). Still missing in the literature is an account of how extraction of PBC can be reconciled with the more traditional problem of maximization of shareholder value by a controlling agent. A broader taxonomy of PBC is required to perform such an assessment.

2. 'The Good, the Bad, and the Ugly'

The distinction between rents and quasi-rents (Marshall 1893) is particularly useful for welfare analysis of PBC. Quasi-rents are the prospective reward to inventiveness; rents are the ongoing reward to incumbency. Two important sides of contemporary economics (Ricketts 2002) rely on this distinction: one is the theory of entrepreneurship; the other is the theory of the firm. Since Coase (1937), these two theories have hardly communicated with each other.

Incomplete contract theories of the firm characterize quasi-rents as non-contractible rewards to investments in relationship-specific assets. Asset specificity gives rise to the hold-up problem (Klein *et al.* 1978). The party whose assets cannot be redeployed outside the relationship risks being expropriated of her investments, to the extent that their cost is sunk and unforeseen contingencies may result in ex post redistribution of the quasi-rents generated. According to transaction costs economics, asset specificity determines a unique ('idiosyncratic') relationship between the investing party and the firm (Williamson 1979). Firm *organization* promotes idiosyncratic investments in both physical and human capital in that it protects them from hold-up (Williamson 1991). According to the property rights theory, however, only the *owners* of the physical assets being specialized can appropriate rewards on idiosyncrasy (Grossman & Hart 1986). Both approaches try to explain why firms exist as a response to contractual incompleteness. Yet they do not entirely explain entrepreneurship, which involves the highly peculiar idiosyncrasy of inventiveness in management, but "for which ownership is never a condition" (Kirzner 1979:94).

Corporate governance may indeed feature entrepreneurship in that framework. However, this requires that quasi-rents be allocated as a reward of managerial talent, independently of ownership of the underlying assets and of how they are combined

within an organization. I define these quasi-rents as *idiosyncratic* private benefits of control. They depend on the identity of who controls the corporate enterprise and are supposed to reward the specialization of managerial talent to a combination of assets financed by separating ownership from control.

What idiosyncratic PBC exactly are is another question. Commentators name them variously, in order to distinguish them from outside shareholder expropriation. They mostly characterize them as the physic satisfaction of bringing a firm to success (Mayer 1999; Holderness 2003; Gilson 2006). This fits the definition of idiosyncrasy, although it is a rather weak account of rewards to entrepreneurship in a market economy. Idiosyncratic PBC have no market value so long as they account for pure entrepreneurship, which – in the jargon of contract theory – is neither 'observable' nor 'verifiable'. They suddenly become more tangible when somebody is willing to take over. In that circumstance, idiosyncratic PBC become the value of corporate control. Therefore, idiosyncratic PBC are better characterized as a *deferred compensation* (Schnitzer 1995) for the investment of entrepreneurial talent in corporate governance, which will eventually materialize in the form of a control premium. This characterization has important consequences on welfare analysis.

Originally, idiosyncratic PBC are harmless to non-controlling shareholders. They are quasi-rents to be generated. They are only visible to the entrepreneur, who is considering going public, but foresees profit opportunities that markets are unable to price. At this stage, the value of corporate control to the entrepreneur is higher than to anybody else. Her controlling position is allocatively efficient. Things may change over time. Eventually, another entrepreneur may turn out to be a better manager. However, protection of idiosyncratic PBC will be a sufficient reason for the incumbent to stop the insurgent from taking over. This outcome is only apparently inefficient. Laffont and Tirole (1988) have demonstrated that allowing any better manager to take over firm control undermines the incentives of the previous management to make unobservable investments. Therefore, the question is whether insurgents can *induce* incumbents to part with control, by paying compensation for their idiosyncratic PBC, and still improve corporate performance on the stock market. In this perspective, protection of idiosyncratic control rents is certainly efficient ex ante, for it promotes the investment of unobservable talent, and may turn out to be just a distributional issue ex post, when the value of corporate control has become observable to potential acquirers. Idiosyncratic PBC are thus the 'good' ones.

Other kinds of PBC have no quasi-rent feature: they are just rents. Control rents may be extracted from non-controlling shareholders in two different fashions. One is outright diversion of firm's assets and profits. The other is distortion of management decisions aimed at maximizing consumption of control perquisites rather than the firm's profits. Following Mayer (1999), I define the rents arising from the first kind of behavior as *diversionary* private benefits of control, and those arising from the second kind as *distortionary* private benefits of control.

Diversionary private benefits account for 'stealing' in its broadest characterization (Roe 2003). Welfare assessment of stealing is not a novel subject in Law and Economics. Being an ex post redistribution of existing resources, stealing may seem neutral to overall social welfare. It is not. On the one hand, any effort taken to implement or to prevent stealing is a waste of resources (Cooter & Ulen 2004). On the other hand, the risk that stealing is operated ex post reduces investors' willingness to pay for non-controlling stock ex ante (Shleifer & Vishny 1997). A rational corporate controller would be willing to commit to a no-stealing policy at the outset, in order to maximize the proceeds from the sale of non-controlling stock. However, to the extent that this commitment is not credibly supported by the legal system, diversion is always implemented ex post and less separation of ownership and control than would be optimal occurs ex ante (Bebchuk 1999). In this perspective, diversionary private benefits are certainly the 'bad' ones.

Distortionary private benefits of control crudely account for bad management of the firm's resources. This is intuitively illustrated by a broad notion of 'shirking' (Roe 2003). A non-owner manager will always put a lower effort than he could in the management of the resources under control, and consume some of them in the form of perquisites. Under separation of ownership and control, extraction of perquisites will continue until it is worth far less to the controller than it costs to the owners as a whole. Therefore, distortionary private benefits are always extracted in an inefficient amount, whether they are considered in an ex ante or in an ex post perspective. Unfortunately, there is not much one can do about it. Perhaps the most important result of the agency theory of corporate governance is that separation of ownership and control can only generate second best outcomes (Jensen & Meckling 1976). Distortionary private benefits of control are nothing but an illustration of agency costs. In spite of their adverse effects on efficiency, they can only be characterized as 'ugly.'

A number of market and non-market institutions are there to make sure that distortionary PBC are extracted in a limited amount, so that separation of ownership and control still allows capturing gains from trade (Roe 2005). Traditional models of asymmetric information rely on monitoring, financial commitments, and incentive alignment. Incomplete contracts models do not share the same reliance on mechanism design (Zingales 1998). At the end of the day, minimization of distortionary PBC will be a matter of (re)allocation of corporate control (Hart 1995b). No matter of how they were selected and used

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to perform in the past, managers are to be replaced as soon as they prove less competent, or just more prone to shirking, than the best management alternative available on the market. This is how takeovers provide the ultimate solution to adverse selection and moral hazard problems in spite of changed circumstances.

This perspective overlaps with how idiosyncratic PBC enter the framework. The market for corporate control is not only the place where the management is replaced when it is no longer efficient, but also the final source of reward for its previous firm-specific investments. While the first is still apparently an agency problem, the second is certainly not. In order to understand the interaction between distortionary and idiosyncratic PBC in corporate governance, the mechanism of rewarding the investment of managerial talent in the form of private benefits requires a supplement of investigation.

2. Who Should be in Charge of Corporate Governance?

The role of idiosyncratic PBC in separation of ownership and control is best understood under a few simplifying assumptions. First, I assume that outside stock is sold to a single, professional representative of the investing public, who takes care of contracting with an entrepreneur on behalf of dispersed shareholders. In other words, both shareholder collective action problems (Grossman & Hart 1980) and agency costs in financial intermediation (Pacces 2000) are assumed away from this setting.

The second assumption is that institutions (most importantly, the law) allow corporate controllers to take a credible commitment that non-controlling shareholders will not be expropriated. This rules out diversionary PBC, which do not only have very peculiar effects on both separation of ownership and control and takeovers, but also short-circuit any virtue of idiosyncratic PBC. These effects will be highlighted at a later stage, suggesting that corporate law should have curbing diversionary PBC as a first priority, but not also as an exclusive goal.

The third assumption is also about the law. I initially assume that corporate law features absolute freedom of contract in the allocation of residual rights of control. This implies a full range of control entitlements that can be variously combined with ownership, including the possibility that a corporate controller is in charge with no ownership at all. I shall start by analyzing the theoretical determinants of separation of ownership and control under this assumption. How corporate law may effectively distort the outcome when this assumption is removed will be shown in section 5.

Let us consider the situation of an entrepreneur seeking outside finance. The entrepreneur is wealth-constrained and has a limited capacity to borrow (Aghion & Bolton 1992), so she has to raise some funds in the form of equity. No matter of how far this goes, clearly the entrepreneur will be no longer the sole owner of the firm's assets. The question is whether she can still control how the assets are operated under these circumstances, and to what extent she should in her capacity as manager of a corporation owned by outside shareholders.

This is a problem of allocation of residual right of control. On both the economic and the legal side, students of corporate governance are reluctant to allow control rights to be allocated any separately from ownership (Hart 1995b; Easterbrook & Fischel 1991). The economic rationale of this solution is that owners have the best incentives to maximize the value of their investment. When they have control rights, the argument runs, firm value will be maximized as a result.

The very notion of idiosyncratic PBC as a *further* value to be uncovered through the entrepreneurial process makes this assumption unwarranted. Firm-specific entrepreneurial talent will only be invested at the outset when idiosyncratic PBC can be appropriated at a later stage. Under separation of ownership and control, this requires that control rights be allocated to the managers who 'run' the firm, not to the shareholders that merely own it. The opposite solution would expose the entrepreneur/manager to shareholders' opportunism.[31] Being vested with residual rights of control, shareholders are committed to sell the company to the highest bidder, who will then replace the management without paying a compensation for previous firm-specific investments. This is a typical hold-up situation. A non-owner manager will refrain from specializing her talent to a given combination of assets, when she knows that the owners are in the position to appropriate all of the quasi-rents by means of a change in control. So long as residual control rights are bundled with ownership, a takeover will always prevent the manager from claiming compensation of her entrepreneurial contribution in the form of private benefits of control.

It is questionable whether PBC are needed at all to reward managerial investment. Apparently, the owners may preserve the manager's incentives to invest by making her compensation fully contingent on the future realization of profits (Hart 1995b). This solution can be implemented as a pay-per-performance scheme, or more simply result in shared ownership between controlling and non-controlling shareholders. Both alternatives are costly, in that either investors have to give up a share of their expected profits or a wealth-constrained entrepreneur

[31] Rajan and Zingales (1998; 2001) discuss a similar problem with the general provision of specialized human capital in the corporate enterprise. They develop a very interesting stakeholder theory of the firm, where, however, it is still efficient to have residual rights of control allocated to shareholders. I have critically reviewed this theory in Pacces (2007), where I explain why its conclusions are not applicable to the investment of entrepreneurial talent by a non-owner manager situated on top of the firm hierarchy.

can raise a limited amount of external funds in the form of equity. The advantage is that optimal profit sharing should induce *both* the manager and outside shareholders to invest their assets. Shareholders will be still in the position to auction control to the highest bidder for corporate ownership. However, they are committed not to replace the manager without paying her the stipulated share of the firm value realized so far.

Pay-per-performance is no way out of the hold-up problem. It can only induce the manager to make investments whose reward is contingent on the future realization of profits. However, firm performance is a *noisy* proxy of investment of managerial skill and effort (Laffont & Tirole 1988). No matter of how valuable these investments are they will bring no reward to the manager until they have produced some verifiable surplus. Yet this value may become appropriable *before* it is reflected in stock price.[32] Since no enforceable contract can be written about the division of this value before it is realized on the stock market, the manager can be expropriated of her firm-specific investments when a control transaction occur in the meantime, and its surplus is just divided between the existing owners and a takeover bidder (Schnitzer 1995).[33]

Takeover surplus is the ultimate source of entrepreneurs' reward in corporate governance. It includes the quasi-rents already generated by previous entrepreneurship. It also includes the prospective reward that the bidder expects to realize, eventually, in the next control sale. Idiosyncratic PBC account exactly for these quasi-rents. In the absence of alternative property rights protection (e.g., through the patent system), rewards to entrepreneurial innovation cannot be secured via profit sharing. These are 'profits in the entrepreneur's head,' which shareholders cannot be committed to compensate ex ante.[34] Shareholders are only committed to realize them ex post in their capacity as owners, as soon as anybody is willing to bid for taking a chance on those profits. So why should any entrepreneur bother uncovering profit opportunities for others, if she can reap no benefits from this activity? Entrepreneurship can only be reconciled with separation of ownership and control when the entrepreneur/manager can secure idiosyncratic PBC *on top* of the compensation being contracted upon with shareholders. This requires residual control rights. When there is a takeover bid, only a manager featured with control rights will have the opportunity to cash in the value of idiosyncratic PBC as a deferred compensation for previous firm-specific investments.

One such allocation of control rights should not be allowed to generate inefficient outcomes. Efficiency requires that, whenever control is transferred, reward to previous entrepreneurship be ultimately paid out of prospective enhancement of firm value, not out of redistribution of existing shareholder value. In this simplified setting, redistribution cannot occur via extraction of diversionary PBC for they are disallowed by assumption. To the same purpose, a further constraint must be imposed that control can only be 'sold' to the insurgent manager when she successfully bids for the company's stock (Pacces 2007). This constraint parallels the takeover practice and uncovers the rationale of the widespread prohibition of managers from selling just their office (Easterbrook and Fischel 1991).

The reader may still question whether such a solution is acceptable to outside shareholders. Apparently, it would expose powerless shareholders to hold-up in any potential control transaction. Controllers featured with incontestable control rights may frustrate any takeover attempt, in spite of its efficiency.[35] This outcome would be indeed unacceptable to the owners, but it holds only in a purely theoretical scenario where the manager has no interest whatsoever in the security benefits. It no longer holds when, as it normally happens, control rights are combined with an interest in the security benefits, namely stock ownership, stock options, and the like. When this is the case, both security benefits and private benefits are liquidated in a control transaction. Then the manager bears the negative effects of a hold-up strategy on her share of the security benefits. The current value of these benefits is all that she gets when she stays. However, the incumbent's interest in security benefits can be sold at a premium on condition that control is efficiently transferred to a successful bidder (Almazan & Suarez 2003).

When idiosyncratic PBC are compensated upfront, any takeover premium offered for the company's stock would suffice to induce the

[32] Entrepreneurs are especially alerted to exploiting profit opportunities, which are available in nature, but are still unknown to others (Kirzner 1979). The value of successful entrepreneurship is bound to become 'observable' eventually, but it will only become 'verifiable' at a later stage.

[33] This effect is highly specific to separation of ownership and control. Not differently from sole proprietorships, entrepreneurship in management generates quasi-rents. However, in corporate governance, these quasi-rents are appropriated only by who is entitled to decide upon a change in control and has, therefore, the power to bargain for a control premium.

[34] This depends on the value of entrepreneurship being intrinsically *uncertain* at the outset. For the distinction between risk and uncertainty in this perspective, see Knight (1921).

[35] A non-owner manager featured with residual control rights will be unwilling to part with control unless she gets from the owners not only compensation for idiosyncratic PBC, but also the remainder of the transaction surplus (Zingales 1995). Given the prohibition of sale of office, a prospective bidder cannot avoid being stuck in the owner's bargaining position, and this is sufficient to frustrate any takeover attempt.

incumbent manager to part with control, so long as she knows that expected profits (including her share of them) cannot increase any further under the current management. This outcome depends on two very reasonable assumptions. The first is that the incumbent manager believes that she cannot enrich her by any larger amount than the idiosyncratic PBC, which originally motivated the undertaking. The second is that the bidder believes that, even when the incumbent's PBC are compensated upfront, a new management can further increase firm value. Under these assumptions, the parties will bargain for the division of the extra surplus, but ultimately the transfer will take place (Zingales 1995). The only transfers that do not take place in this setting are those whose surplus does not exceed the idiosyncratic PBC claimed by the incumbent manager (Schnitzer 1995). To the extent that these are due to incorrect beliefs of the entrepreneur about her own managerial capabilities, some efficient control transfers would be indeed foregone. This is, however, the price to pay for fostering entrepreneurial innovation in corporate governance.

4. Coasian Bargaining and Efficient Sale of Control

Foregoing discussion shows that idiosyncratic PBC matter in two stages temporally distant, but conceptually related. The first is when ownership is separated from control. The second is when control changes hands. Let us briefly elaborate upon the relationship between the two stages. Entrepreneurs who make firm-specific investments that stock markets are unable to price at the outset will only go public when they can reasonably expect to cash in idiosyncratic PBC in the event of a takeover. Rational outside shareholders will only accept this arrangement when they still expect the returns on their investment to be maximized – i.e., that distortionary PBC are minimized. It should be recalled that diversionary PBC are still disallowed by assumption.

Expected extraction of distortionary PBC depends on the distribution of security benefits between the controller and non-controlling shareholders and on the likelihood that a change in control will occur when stock returns are not being maximized. Investors' willingness to pay for outside stock also depends on these two circumstances, which stand normally in a tradeoff relation. However, since consumption of distortionary PBC is inefficient, at the going public stage corporate controllers should choose to be committed not to extract any of them. As Grossman and Hart (1988) have shown, this result is achieved by selling *all of the firm ownership* to dispersed shareholders in such a way as to make corporate control perfectly contestable on the stock market. Under a number of reasonable assumptions, this maximizes the entrepreneur's proceeds from going public and makes separation of ownership and control efficient.

Very few firms in the real world go public in this fashion, and this only makes sense when idiosyncratic PBC matter enough to make control tenure preferable to contestability (Hart 1995b). Entrepreneurs are unwilling to give up control together with ownership when they believe that the value of their firm-specific investments is not included in the price they can get for outside stock. Unfortunately, this also implies that no commitment can be taken that control changes hands as soon as incumbents fail to maximize shareholder value. It is exactly under these circumstances that outside shareholders will apply a *discount* on the price of non-controlling stock, which is increasing in ownership dispersion: the lower the management's ownership stake, the higher the expected extraction distortionary PBC (Jensen & Meckling 1976).

How far would separation of ownership and control go when both idiosyncratic and distortionary PBC are present? This depends on how much the entrepreneur values his firm-specific investments and outside shareholders fear extraction of control perquisites. Equilibrium in the sale of non-controlling stock will be reached at the point in which expectations about the future, observable stream of profits converge. Stock prices, however, differ in one important respect from the firm value: the profits that are not yet observable or verifiable, the 'profits in the entrepreneur's head'. At the going public stage, these 'profits' must be equal to the discount on non-controlling stock. That is to say, the idiosyncratic PBC claimed by the corporate controller must be equal to the distortionary PBC anticipated by outside shareholders. Determining ownership structure based on this very simple model captures the intuition that ownership concentration efficiently arises when uncertainty of profits is high. The effect of uncertainty on idiosyncratic and (anticipated) distortionary PBC goes in the same direction.

The difference in value between controlling and non-controlling stock may become more tangible at a later stage. As soon as a third player is willing to pay for corporate control, this will be the control premium. The effects of the corporate controller's (unobservable) decision on whether to extract control perquisites or to make firm-specific investments only materialize at this point. She might have shirked much and invested little, and then the value of shirking to her will be easily compensated by the efficiency gains brought about by a more diligent manager (Almazan & Suarez 2003). She might have shirked little and invested a lot, and then her effort will be compensated as soon as a brainy manager realizes the potential she has uncovered, but the stock market has not yet priced (Schnitzer 1995). In both scenarios, a takeover would be most welcome for all the parties involved.

The market for corporate control is therefore the place where entrepreneurs both earn a reward for their firm-specific investments and they are replaced by a more efficient management. To be sure, this is not how the market for corporate control is normally

understood. Received wisdom is that takeovers promote efficiency in corporate governance not only by selecting the best available option for firm management, but also by *disciplining* extraction of control perquisites (Becht *et al.* 2002). Performance of the disciplinary function requires takeovers to be hostile. Under the threat of hostile takeover, the potential for extraction of *any* kind of PBC is disallowed by contestability in the market for corporate control. Both economists and legal scholars recognize that real-world corporate governance features much less contestability than the theory would predict.[36] However, the fact that corporate controllers are normally entrenched says nothing about the efficiency of this outcome. According to the mainstream interpretation (Morck *et al.* 1988), shareholders lose twice when control is entrenched: their shares are worth less because of excessive distortionary PBC being enjoyed; and they forego the opportunity of profitable tender offers by a more efficient management.

This interpretation is not the only possible, and the introduction of idiosyncratic PBC shows why it is wrong. The market for corporate control provides a natural solution to the problem of distortionary PBC. However, this has little to do with hostility in takeovers. When the incumbent controller is underperforming relative to the next best management alternative available on the market, reallocation of corporate control need not make any player worse off. This includes the incumbent management whose idiosyncratic PBC are due to be compensated. What is crucial is the definition of gains from trade. They include the surplus that the insurgent is expecting to generate on the stock market (i.e., the opportunity cost of current mismanagement – distortionary PBC), but exclude the value of the incumbent's firm-specific investments (idiosyncratic PBC). Gains from trade are positive only when distortionary PBC exceed idiosyncratic PBC; that is, when the insurgent attaches a higher value to corporate control than the incumbent. Any different specification of gains from trade would violate the incumbent's preferences ex post, which would be inconsistent with the assumption that these preferences matter ex ante for the application of entrepreneurship to the corporate firm.

Gains from trade are defined in such a way that the insurgent can only generate a takeover surplus by enhancing stock returns when she acquires sufficient ownership from both the incumbent and non-controlling shareholders. This fundamental insight dates back to Manne (1965), who introduced the notion of market for corporate control in the study of corporate governance. Appropriation of enhanced security benefits through coalescence of ownership provides both the private incentives for a takeover and the guarantee that changes in control are efficiency enhancing. Ownership, however, is just the instrument of this mechanism, whereas control is the very asset to be exchanged. Corporate control is allocated efficiently when the owners as a whole can profitably take over, but this does not imply that the value of corporate control already belongs to the owners. Indeed, *purchasing* corporate control in combination with undervalued ownership is what takeovers are all about.

That being said, the market for corporate control need not feature any contestability and is more fruitfully interpreted as an application of the Coase Theorem (Coase 1960; Stigler 1966). In the absence of transaction costs, allocation of control rights would have only distributional consequences. When shareholders have residual rights of control, managers have to buy the entitlement to tenure. This transaction will be concluded efficiently when the *expected* contribution of managerial firm-specific investments to firm value is higher than the private benefits to be compensated in a future takeover. When managers have residual rights of control, shareholders have to buy the entitlement to replace management. This transaction will be concluded efficiently when the security benefits of a takeover are *effectively* higher than the private benefits necessary to compensate the contribution of managerial firm-specific investments to firm value that far.

Non-observability of managerial contribution to the quasi-rents is the very source of transaction costs, which makes allocation of control rights relevant for realization of the efficient outcome. While the first contract would only be feasible in a world of perfect foresight, the second one is also possible in spite of high transaction costs. The difference is that side payments accounting for idiosyncratic PBC, which are clearly impossible ex ante, can more easily occur ex post. The launch of a takeover bid implies that the value of corporate control has become observable. When the bidder is committed to the acquisition of the company's ownership, compensation of the incumbent's idiosyncratic PBC would suffice for control to change hands efficiently. When confronted with such a bid, the corporate controller would not claim a control premium any higher than the security benefits that she expects to appropriate by taking the company private. Takeovers can succeed if and only if the bidder expects to generate higher security benefits.

This demonstrates that the market for corporate control is efficiently operated by 'friendly' takeovers. More precisely, this arrangement guarantees a constrained-efficient outcome. Distortionary PBC are minimized by friendly takeovers subject to the constraint of compensation of idiosyncratic PBC. The

[36] Control of the vast majority of publicly held corporations around the world is not contestable (Becht & Mayer (2001); Morck *et al.* 2005). And also when ownership structure is sufficiently dispersed to allow for contestability, takeovers originally initiated as hostile are concluded as a deal with the incumbent management (Schwert 2000).

market for corporate control maximizes shareholder value subject to the constraint of rewarding entrepreneurship through the award of a control premium.[37]

Constrained efficiency depends on the assumptions of the simplified framework developed in this paper, which are worth briefly recalling before discussing the legal implications. The efficient outcome obtains on condition that outside shareholders are not allowed to free ride on the takeover gains (Grossman & Hart 1980). Formally, this depends on collective action problems being ruled out.[38] This assumption is not particularly restrictive. Holdout by dispersed shareholders is just a nuisance when control transactions are bargained for between the bidder and the incumbent management. Friendly takeover bids cannot make outside shareholders worse off when sale of office and extraction of diversionary PBC are effectively prohibited – as I have assumed they are. Holdout by non-controlling shareholders is therefore unnecessary for efficiency, and there are a number of legal techniques to prevent this from occurring. Of these, squeeze-out of non-tendering shareholders is "a simple and elegant solution of the free-rider problem" (Yarrow 1985:4). Discussion of this solution and of its implications for takeover regulation is a matter for a separate inquiry (Amihud *et al*. 2004; Pacces 2007).

The absence of diversionary PBC is also crucial for idiosyncratic PBC to be cashed in efficiently through the takeover process. Following Grossman & Hart (1980), it is often assumed that dilution of minority shareholders is necessary for changes in control to be operated efficiently. Since controllers can only extract PBC by consuming perquisites or diverting resources from outside shareholders, the basic tradeoff in the market for corporate control is between the incumbent's failure to maximize shareholder value and the insurgent's ability to subsidize takeovers by diverting the efficiency gains to her own pockets (Bolton & von Thadden 1998). This is how corporate governance is understood as a tradeoff between diversionary and distortionary PBC (Bratton & McCahery 2001). This paper shows that this tradeoff is unwarranted when the legal system can curb diversionary PBC without interfering with how the market allocates corporate control. When this is the case, the real tradeoff is between protection of idiosyncratic PBC ex ante and minimization of distortionary PBC ex post.

This does not contradict the major contention of the 'law matters' thesis, only refines its implications. Outright diversion of shareholders' money dominates the extraction of any other kind of PBC, and thus it compromises the original selection of ownership structure and its efficient evolution through a (friendly) takeover process. When controllers cannot take a credible commitment that diversionary PBC will not be extracted if not in a limited amount, cost of equity capital will be higher and gains from trading both controlling and non-controlling stock will be foregone.[39] Control will still be entrenched. However, short of promoting entrepreneurship, entrenchment will be aimed at protecting ongoing stealing or at preventing further looting from occurring by means of takeovers (Bebchuk 1999). Corporate law's ability to counter stealing remains thus a precondition for efficient corporate governance. This also provides a necessary condition for the market for corporate control to be operated efficiently by friendly takeovers. Conditions become sufficient when policing diversionary PBC does not also prevent controllers from extracting compensation for their idiosyncratic PBC. An appropriate fine-tuning of fiduciary duties imposed on the board members of management-controlled corporations, or directly on controlling shareholders, can realistically hit the target.[40] However, a thorough investigation of this problem is outside of the scope of the present inquiry.[41]

5. Regulatory Implications

I have illustrated how separation of ownership and control depends on three different categories of PBC.

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[37] This result is very much in the spirit of Manne (1965). Manne's pioneering work on takeovers was also based on a Coasian approach. While it acknowledges the importance of the control premium, it contains no advocacy of hostile takeovers. Subsequent literature has often overlooked his warning that non-controlling shareholders' entitlement to share in the control premium undermines the very functioning of the market of corporate control. Side payments most often underlie the takeover mechanism, and they go from shareholders to corporate controllers. Manne did not provide an explanation of why managers and controlling shareholders must be entitled to a control premium. Idiosyncratic PBC are one such explanation.

[38] Shareholders who are able to coordinate costlessly will let the bidder appropriate a sufficient share of the takeover gains, so that she can offer a side payment to the incumbent controllers and still be better off.

[39] Being unable to distinguish honest managers from thieves and looters, shareholders will just offer lower prices for non-controlling stock. Being unable to cash in idiosyncratic PBC in markets for corporate control that auction stealing instead of profit opportunities, most talented entrepreneurs will exit from the stock market just refrain from entering it in the first place. These are typical 'lemons' equilibria first illustrated by Akerlof (1970).

[40] Striking an efficient balance between false positives and false negatives in the enforcement of fiduciary duties (Enriques 2000) actually implies that only an upper bound on extraction of diversionary PBC can be established. As I document in Pacces (2007), this does not undermine the ability of the market for corporate control to progressively transform idiosyncratic private benefits in security benefits, so long as takeovers do not allow for *incremental* expropriation of non-controlling shareholders.

[41] The basic terms of the problem are sketched out in the next section. I investigate the matter in more detail in Pacces (2007).

Law plays a crucial role in dealing with each category. Idiosyncratic PBC can only be appropriated when control rights are made *available* to the management of shareholder-owned firms. Diversionary PBC are only curbed when control entitlements are *regulated* in such a way as to prevent expropriation of non-controlling shareholders. Distortionary PBC are only minimized when Coasian bargaining on both private and security benefits is *enabled* in the market for corporate control. Besides the second statement, this analysis departs from the mainstream approach to Corporate Law and Economics. The advantage of this interpretation is that it provides an efficiency-based explanation of a number of real-world circumstances, which are considered as puzzling or suboptimal by the standard principal-agent approach. These are: (i) entrenchment of corporate control regardless of ownership concentration; (ii) ownership concentration also in the absence of expropriation of minority shareholders; (iii) side payments in takeovers operated under both dispersed and concentrated ownership. Ownership structure does not affect these circumstances, only the presence of private benefits does. However, the levels of each kind of PBC set the constraints of efficient selection of ownerships structure. Actual efficiency of the outcome depends on how corporate law regulates the extraction of each category of PBC.

Corporate law must make sure that entrepreneurs keep their entitlement to idiosyncratic PBC when they go public before returns on their firm-specific investments have become verifiable (Coates 2003). The empirical evidence (Brennan & Franks 1997; Pagano *et al.* 1998; Daines & Klausner 2001) suggests that going public is a step towards appropriation of these returns, which will be eventually accomplished through cashing in of a control premium. Corporate laws anyway support this outcome by allowing companies to be controlled with 50% of the ownership rights. Intuitively, this solution places a heavy financial burden on entrepreneurs who wish to grow relying on outside equity. Gains from trade are foregone when the marginal discount on non-controlling stock is lower than the per-share control premium accounting for idiosyncratic PBC. Still, the corporate controller could no longer protect this control premium when the ownership stake becomes insufficient to grant uncontested control rights. Under these circumstances, entrepreneurs must refrain from profitably placing further stock with the investing public. This is how the shortage of legal entitlements to corporate control determines suboptimal separation of ownership and control.

Corporate law needs not be so rigid. With a few exceptions (Becht & Mayer 2001; Cools 2005), Corporate Law and Economics tends to overlook one key feature of corporate law, which is *distribution of powers*. Because of the majority principle governing the corporate structure, a shareholder needs a half of the voting rights to be safely in control. This does not imply that a controlling shareholder owns 50% of the company. Corporate law may provide further entitlements to corporate control by allowing derogations from the one share–one vote principle. These derogations are often viewed with skepticism by both economic and legal commentators. However, they ease the constraint of protection of idiosyncratic PBC on separation of ownership and control. This is efficient to the extent that further separation occur via voluntary exchange of non-controlling stock (Ferrarini 2006).

Disproportionality between ownership and voting rights is quite popular in continental Europe, in spite of the significant variety with which derogations from one share–one vote are allowed (Bennedsen & Nielsen 2005). Deviations from one share–one vote do not seem to undermine stock market performance. Quite to the contrary, two countries where these deviations are the most frequent – Sweden and the Netherlands – have both a very high stock market capitalization to GDP and extensive separation of ownership and control (ISS, ECGI, Shearman & Sterling 2007). There is hardly any evidence that shareholders of Dutch or Swedish companies are being expropriated by this arrangement. Both disproportionality of voting rights and separation of ownership and control are significantly lower in Italy, where shareholder expropriation is perceived as a more serious problem (Bianchi *et al.* 2005). Therefore, derogations from the one share–one vote principle do not increase extraction of diversionary PBC, but only allow protection of idiosyncratic PBC when substantial expropriation of minority shareholders is not an option.

This is but one aspect of legal distribution of corporate powers. Besides providing controlling shareholders with a higher proportion of voting rights than stock ownership would grant, corporate law can provide entitlements to control rights independent of voting rights. This is necessary for management to be in charge of corporate decision-making without supporting share ownership. Management-controlled companies are economically efficient when idiosyncratic PBC are low enough to allow ownership to be largely placed with non-controlling shareholders. They are legally feasible under two major conditions (Cools 2005). On the one hand, management needs to be in control of how dispersed shareholders appoint board members and, more in general, of how they cast their votes. On the other hand, management must be in the position to prevent an unwanted takeover.

In continental Europe, these conditions are fulfilled in the Netherlands, but not in Sweden. As a result, the former exhibits a significant proportion of management-controlled listed companies (de Jong *et al.* 2001), whereas there is virtually none of them in the latter (Agnblad *et al.* 2001). Dutch corporate law provides a broader range of entitlements to control rights (Schuit *et al.* 2002). The 'structured regime' of appointment of two-tier board members can easily empower the management. This is supplemented by

other 'oligarchic' devices (like the stripping of shareholders' voting rights and shares having priority in voting), which are equally suitable for managerial and shareholder control. Plain availability of takeover defenses in both statutory and case law makes sure that incumbent management cannot be ousted against their will, at least not without compensation. On the contrary, Swedish corporate law falls short of entitlements that empower corporate management (Skog 1994). It only allows controlling shareholders to be in charge, thereby forcing separation of voting rights from ownership beyond what would be efficient (Holmén & Högfeldt 2005).

Asymmetry between entitlements for managerial and shareholder control can explain other apparently puzzling circumstances. American law is no more demanding on the one share–one vote principle than Swedish law. Only pyramidal group structures are legally disfavored in the US (Morck & Yeung 2005). This does not explain why also dual class security-voting structures are far less popular on American stock exchanges. Differently from Swedish law, corporate law in the US also allows the management to be in charge. It so does by placing in the board of directors, instead of in the shareholder meeting, the center of authority over corporate decision-making. This gives corporate controllers two options. Either they retain sufficient voting rights to act as controlling shareholders or they simply control the board. Management-controlled boards may disenfranchise non-controlling shareholders by determining when and how votes are cast through the proxy machinery, and whether an insurgent shareholder is allowed to take over. Delaware law supports 'director primacy' both in ongoing management and in changes in control (Bainbridge 2002).

Authoritative commentators in Law and Economics have questioned the merits of this outcome (Bebchuk 2005; Bebchuk & Cohen 2005), especially by contrasting it with the British model that promotes dispersion of ownership without supporting any of these features. This paper contends, instead, that managerial empowerment in the corporation is a necessary legal condition for highly dispersed ownership structures when idiosyncratic PBC matter. Unavailability of entitlements to managerial control is at least one reason why these structures have not emerged in most countries of continental Europe. The UK – where corporate ownership is at least as dispersed as in the US, but managers are apparently not as powerful – is no exception to this argument.

Managers are also powerful in the UK, although the source of their control rights is more articulated than under American law. When British managers are in control of the board, they are not in the position to disenfranchise outside shareholders (Davies 2002). However, shareholders must have a reason to challenge the management. Shareholders would not have one unless they feel that they are being expropriated, through extraction of diversionary PBC, or that a better management alternative is available, because of inefficient consumption of distortionary PBC. Shareholder power to replace board members is quite effective in preventing expropriation, but not as much in determining a change in control (Stapledon 1996). The reason is that British shareholders can hardly be or become large enough for that. Regulation of listed firms prevents large shareholders from appointing or replacing the majority of board members, so that takeovers need be operated via a going private transaction. Board members jointly hold sufficient ownership to veto one such transaction anytime a takeover has not been previously arranged with them (Franks *et al*. 2001).

British managers are therefore no less entrenched than their colleagues in the US (Weir & Laing 2003). The difference is that, in the UK, controlling shareholding is hardly an option for governing a publicly held company. On the one hand, this protects incumbent managers from hostile takeovers in spite of the formal prohibition of takeover resistance. On the other hand, this regulatory bias places an important constraint on the ownership structure of British companies. As a result, only businesses that feature relatively low levels of idiosyncratic PBC can be financed on the stock market. Highly innovative firms, and their entrepreneurs, should better stay private. This parallels the conclusion of a British commentator that the regulatory stance against PBC in the UK may undermine the financing of "activities that markets are unable to sustain" (Mayer 1999: 19).

The British example offers the opportunity to highlight a potential conflict between protection of idiosyncratic PBC – through *allocation* of control entitlements – and the legal policing of diversionary PBC – by means of *regulation* of the same entitlements. Corporate law should pursue these two equally important goals independently. According to the 'law matters' approach to corporate governance, the more minority shareholders are empowered relative to corporate management, the more efficiently they are protected against expropriation (La Porta *et al*. 1998; Djankov *et al*. 2006). This is both unnecessary and counterproductive. It is unnecessary because non-controlling shareholders need not interfere with the exercise of control powers, in order to shield themselves from expropriation. Corporate law can efficiently counter stealing when most dangerous transactions, falling under the broadest possible definition of self-dealing, are scrutinized for diversionary purposes. This scrutiny is actually very difficult, and the need to have it performed accurately explains why confusion between protection and empowerment of non-controlling shareholders is also counterproductive.

Powerful non-controlling shareholders may threaten the very exercise of entrepreneurial discretion in management (Rock & Wachter 2001). Not differently from the clients of lawyers or doctors, investors only challenge discretionary decision-making in hindsight, when they turn out badly. The difference with a standard principal-agent setting is

that this may result in opportunistic behavior undermining the protection of idiosyncratic PBC. This is the reason why, differently from any other profession subject to fiduciary duties, courts abstain from second-guessing business judgment. They only impose liability on corporate controllers when non-controlling shareholders are expropriated of their investment because of a conflict of interest, not also when the value of that investment is not being maximized. This principle, known in the US as Business Judgment Rule, is functionally upheld by other corporate jurisdictions (Kraakman *et al*. 2004). Empowering outside shareholders in corporate governance is clearly at odds with this reasoning.

The rationale of the Business Judgment Rule is that failure to maximize shareholder value cannot be 'regulated' (Roe 2003). Inefficient extraction of distortionary PBC is ultimately policed by the market for corporate control, and this is where regulation matters. The Coasian approach to takeovers advocated in this paper has important implications in this respect. An efficient market for corporate control requires that idiosyncratic PBC be cashed in through *side payments*. Those payments exist in the real world. They take the form of control premiums or 'golden parachutes' depending on whether control is transferred from controlling shareholders or from the management. Conventional wisdom looks at them with suspicion. Lawyers often consider them as 'bribes,' while economists tend to regard them as evidence of shareholder expropriation.

The prevailing approach to takeover regulation parallels this skepticism (Kraakman *et al*. 2004). On the one hand, regulators try to protect shareholders from extraction of distortionary PBC by promoting contestability also when companies have chosen to have none. On the other hand, regulation tends to allocate to minority shareholders the lion's share of the takeover gains for fear that diversionary PBC are unwittingly extracted via control transactions. Economic theory has demonstrated that these two goals are jointly unattainable. As a result, takeover regulation should optimize a tradeoff between diversionary and distortionary PBC (Burkart & Panunzi 2006). I have shown that this tradeoff is unwarranted when idiosyncratic PBC enter the picture. On this basis, protection of minority shareholders in takeover regulation turns out to be most unfortunate. When this approach seeks to promote contestability, by exposing idiosyncratic PBC to ex post expropriation, its effects ex ante are higher ownership concentration or just fewer entrepreneurs going public. When it prevents takeover gains from being divided between the incumbent and the insurgent management, by disallowing side payments, it forces corporate controllers to extract higher and higher distortionary PBC instead of profitably 'selling' control to a better manager.

The EC Takeover Directive is an exemplary illustration of both regulatory strategies. The principle of board neutrality and the so-called breakthrough rule attempt to restrict the ability of managers and controlling shareholders to entrench themselves. These rules only managed to be passed as an option for firms and member states. The regulatory stance against control premiums was more successful. A very severe mandatory bid rule, requesting equal treatment of controlling and non-controlling shareholders, is now compulsory all over Europe. Both aspects of the European takeover regulation are misguided. Entrenchment, as I showed, obtains anyway in corporate governance whenever entrepreneurship needs be rewarded. Denying that corporate control has a value, which is legitimately appropriated by who has invested in its production, does not make minority shareholders better off. It only undermines production and finance in a market economy.

6. Conclusion

This paper reinterprets corporate governance by introducing a third category of private benefits of control (idiosyncratic PBC), which supplements the more traditional specifications as inefficient consumption of control perquisites (distortionary PBC) or outright expropriation of shareholder value (diversionary PBC). Idiosyncratic PBC account for a further value to be appropriated as a reward for investment of entrepreneurship in the corporate structure. The quasi-rent nature of this value makes appropriation by the corporate controller a necessary condition for efficiency, which implies that residual control rights be allocated separately from ownership. This is required in order to overcome the non-contractibility problem in the takeover stage, where the value of control quasi-rents becomes observable by a bidder and then is subject to expropriation. Under the assumption that the non-controlling shareholders are unable to free ride on the takeover gains, the efficient outcome is derived as Coasian bargain between the incumbent and the insurgent over the value of corporate control. The bidder is allowed to reap the gains of a superior management subject to the constraint that the incumbent is rewarded for previous firm-specific investments via a control premium. Outside shareholders are at least as well off when the bidder can only gain from enhancing security benefits more than she has to pay as a control premium.

The implications of this framework for corporate law are more far-reaching than those of the standard 'law matters' approach. This paper does not only show why widespread entrenchment of corporate control makes economic sense. It also shows how corporate law undermines separation of ownership and control when it does not support control tenure by the right entitlements. When this is the case, ownership structures may be either more concentrated or more dispersed than it would be efficient. Likewise, regulation may undermine the efficiency of the takeover process when it restricts side payments

that ultimately support bargaining upon the value of corporate control.

One major consequence of the richer taxonomy of private benefits of control is that efficient corporate governance does not require that institutions be as protective as possible of non-controlling shareholders. Failure of corporate law to protect investors from extraction of diversionary PBC does undermine separation of ownership and control. However, further protection of non-controlling shareholders would be more than they bargained for. When shareholder empowerment makes the corporate controller unable to secure idiosyncratic PBC, this restricts the choice of ownership structure and makes it potentially suboptimal. Similarly, seeking shareholder protection by disallowing the payment of a control premium makes efficient changes in control more unlikely to succeed, thereby exposing investors to higher extraction of distortionary PBC.

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