

Fordham Law Review

Volume 80 | Issue 6

Article 19

June 2012

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Recommended Citation

Mariana Pargendler, *State Ownership and Corporate Governance*, 80 Fordham L. Rev. 2917 (2012).
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ARTICLE
STATE OWNERSHIP
AND CORPORATE GOVERNANCE

*Mariana Pargendler**

State ownership of publicly traded corporations remains pervasive around the world and has been increasing in recent years. Existing literature focuses on the implications of government ownership for corporate governance and performance at the firm level. This Article, by contrast, explores the different but equally important question of whether the presence of the state as a shareholder can impose negative externalities on the corporate law regime available to the private sector.

Drawing on historical experiments with government ownership in the United States, Brazil, China, and Europe, this study shows that the conflict of interest stemming from the state's dual role as a shareholder and regulator can influence the content of corporate laws to the detriment of outside investor protection and efficiency. It thus addresses a gap in the literature on the political economy of corporate governance by incorporating the political role of the state as shareholder as another mechanism to explain the relationship between corporate ownership structures and legal investor protection. Finally, this Article explores the promise of different institutional arrangements to constrain the impact of the state's interests as a shareholder on the corporate governance environment, and concludes by offering several policy recommendations.

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INTRODUCTION

After two decades of privatizations and the emergence of an increasing—though not quite conclusive—consensus on the comparative efficiency of private versus state ownership of business enterprise, the pendulum has swung in the opposite direction. Although atypical in the United States,¹ state ownership of listed companies is pervasive and growing elsewhere in the world. State-owned enterprises (SOEs) are now responsible for approximately one-fifth of global stock market value, which is more than two times the level observed just one decade ago.² According to a recent survey, government-controlled firms account for about 80 percent of the

1. LLOYD MUSOLF, UNCLE SAM'S PRIVATE, PROFITSEEKING CORPORATIONS: COMSAT, FANNIE MAE, AMTRAK, AND CONRAIL 2 (1983) ("Mixed enterprises occupy a political and economic no-man's-land in the United States, though they are regarded as unexceptional, even commonplace, in many parts of the world.")

2. *China Buys Up the World*, THE ECONOMIST, Nov. 13, 2010, at 11.

market capitalization in China, 60 percent in Russia, and 35 percent in Brazil.³

There is a large body of literature exploring the potential inefficiencies of state control of enterprise, and a growing body of literature on the ways in which the law, and in particular corporate law, might be structured to limit those inefficiencies. In this Article, I look at the other side of the problem: what is the effect of state ownership on the structure of corporate and capital markets law, not just as it applies to state-controlled firms but as it applies in general to firms that are entirely privately owned? The latter issue is arguably as important as, or even more important than, the problem of controlling the inefficiencies of state ownership. Nevertheless, it has been almost entirely neglected.

Drawing on historical and comparative experiments with state ownership, this Article shows that government control of business corporations can have unintended consequences well beyond potential firm mismanagement if the state pursues political goals inconsistent with shareholder wealth maximization—the concern that dominates the large literature on the relative merits of public and private ownership.⁴ An important, but so far overlooked, byproduct of government ownership stems from the conflict of interest inherent in the state's dual role as shareholder and corporate governance regulator.⁵ That is, where the state is a controlling shareholder of major business corporations, its interests as controller may come to dictate the content of general corporate laws to the detriment of both outside investor protection and efficiency.

There is now a vast body of empirical literature underscoring the importance of legal investor protection to the development of capital markets around the world. In particular, these works show a strong correlation among low levels of protection for minority shareholders, highly concentrated corporate control in the hands of the state and wealthy families, and underdeveloped capital markets.⁶ However, a series of studies

3. *The Company that Ruled the Waves*, ECONOMIST, Dec. 17, 2011, at 109.

4. For empirical studies discussing and evaluating these risks, see *infra* note 212. Following the 2008 bailouts, U.S. legal scholars warned that U.S. law does not adequately protect shareholders of government-controlled firms against such risks. See generally Marcel Kahan & Edward B. Rock, *When the Government Is the Controlling Shareholder*, 89 TEX. L. REV. 1293 (2011); see also J.W. Verret, *Treasury Inc.: How the Bailout Reshapes Corporate Theory and Practice*, 27 YALE J. ON REG. 283, 287, 326–44 (2010).

5. Although the focus here is on state shareholding and its implications for corporate governance regulation, other types of state investment (i.e., as a debtholder) may likewise raise conflicts with the state's regulatory function. For a recent example of the government's conflicting goals as investor and regulator, see Caroline Salas & Jody Shenn, *New York Fed Faces "Inherent Conflict" in Mortgage Buybacks*, BLOOMBERG (Oct. 21, 2010), <http://www.bloomberg.com/news/2010-10-21/new-york-fed-faces-inherent-conflict-in-seeking-to-recover-mortgage-loss.html> (stating that the New York Fed's attempt to recover taxpayer money employed in bailouts during the financial crisis may run counter to its mandate to promote the stability of the financial system).

6. For a few works representative of this extensive body of literature, see generally Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999); Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998). To be sure, the

on the political economy of corporate governance has demonstrated that the causal link between legal institutions, on the one hand, and corporate ownership structure and capital market development, on the other hand, is unlikely to be unidirectional. While poor investor protection can discourage ownership dispersion and capital market development, concentrated shareholdings in the hands of powerful families may also generate strong political opposition to legal reforms providing for stronger minority shareholder rights.⁷

Yet the existing literature on the political economy of corporate governance focuses exclusively on private owners, managers, and workers as the relevant political constituents.⁸ Perhaps due to the relative scarcity of listed state-owned firms in the Anglo-American world (the source of a major part of these studies), the potential role of the state as a shareholder in corporate governance is left entirely out of the equation. I argue that, by excluding this key political actor, conventional models have failed to adequately describe the political economy of the large, and recently growing, number of jurisdictions that boast a substantial number of mixed enterprises, here defined as corporations in which the government shares ownership with private investors.

The recognition of the role of the government as shareholder in corporate law reform unveils another dimension of the well-known correlation between family and state control of corporate enterprise.⁹ The conventional interpretation of why family and state control appear in tandem is that, in a system of poor investor protection and high private benefits of control, controlling shareholders do not give away control for fear of subsequent expropriation. Because robust capital markets fail to emerge in this context, only the state and wealthy families possess enough capital to invest in large-scale productive activity. In fact, the very existence of state-owned

“antidirector rights index” used in these initial works proved to be faulty. See Holger Spamann, *The “Antidirector Rights Index” Revisited*, 23 REV. FIN. STUD. 467, 470, 477–83 (2010) (finding numerous errors in the antidirector rights index that compromise the initial results obtained by the law-and-finance literature); see also Simeon Djankov et al., *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430 (2008) (representing a more recent work that relies on an improved index).

7. See, e.g., Lucian Arye Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127, 131 (1999) (arguing that “[a] country’s initial pattern of corporate structures influences the power that various interest groups have in the process producing corporate rules”); John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 80 (2001) (suggesting the existence of reverse causation between capital market development and legal investor protection, as “strong markets do create a demand for stronger legal rules”).

8. See, e.g., PETER ALEXIS GOUREVITCH & JAMES J. SHINN, *POLITICAL POWER AND CORPORATE CONTROL: THE NEW GLOBAL POLITICS OF CORPORATE GOVERNANCE* (2005) (modeling governance outcomes based on the preferences of owners, managers, and workers).

9. See, e.g., Kathy Fogel, *Oligarchic Family Control, Social Economic Outcomes, and the Quality of Government*, 37 J. INT’L BUS. STUD. 603, 612 (2006) (finding that “[m]ore family control is associated with more [state-owned enterprises]”); La Porta et al., *Corporate Ownership Around the World*, *supra* note 6, at 511–13.

enterprises is partially justified by the failure of capital markets to provide financing for large firms to carry out socially beneficial projects.¹⁰

Nevertheless, reverse causation remains equally plausible. For example, if state ownership serves as a substitute for capital markets, high levels of government ownership of enterprise may effectively “crowd out” the private sector.¹¹ The goal of this Article is to underscore an important but so far overlooked channel for reverse causation: the negative influence of the role of the government as a controlling shareholder on the levels of a country’s legal investor protection and, consequently, on its capital market development.

Although this study mostly refers to the interests of “the state” as a unitary actor for the sake of simplicity, its argument does not depend on an entirely monolithic, and hence unrealistic, view of the state. There are, to be sure, differing interests and powers within the state, often represented by competing government agencies, which might de facto diminish the state’s capacity to pursue its interests as a shareholder in a unitary manner and, in some cases, attenuate or even override the state’s conflicts of interest as shareholder and regulator.¹² Nevertheless, a number of such actors and interests that influence state action—such as popular pressure in democratic societies, or the self-interest of government officials—tend to consistently favor the interests of the state as shareholder over those of outside investors.

Various factors render the political economy of corporate law reforms particularly favorable to the interests of the government as controlling shareholder. Not only does the state have a natural and unmatched proximity to the lawmaking process—and is hence uniquely positioned to influence its outcomes—but legal rules that favor the interests of the state

10. See, e.g., STILPON NESTOR & LADAN MAHBOOBI, PRIVATISATION OF PUBLIC UTILITIES: THE OECD EXPERIENCE 6 (1999), available at <http://www.oecd.org/dataoecd/48/24/1929700.pdf> (noting that “[e]quity markets were narrow and illiquid in the great majority of OECD countries. . . . [I]t seemed natural to choose government financing as an effective way of backing expansion in these resource-hungry, capital-intensive industries”).

11. See, e.g., Alexander Aganin & Paolo Volpin, *The History of Corporate Ownership in Italy*, in A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD: FAMILY BUSINESS GROUPS TO PROFESSIONAL MANAGERS 325, 326 (Randall K. Morck ed., 2005) (stating that, in Italy, “[d]irect intervention by the state as an entrepreneur partially replaced and crowded out the role of the private sector in the accumulation of capital”). Still, the relationship between state ownership and capital market development is complex and resists oversimplification. Yet another source of complication relates to simultaneity problems due to omitted variable bias. Following Mark Roe’s work, another plausible hypothesis is that the adoption of a social-democratic regime (due to, say, war destruction) determines the level of both state ownership and capital market development. See, e.g., Mark J. Roe, *Legal Origins, Politics, and Modern Stock Markets*, 120 HARV. L. REV. 460 (2006).

12. See, e.g., John Armour et al., *A Comparative Analysis of Hostile Takeover Regimes in the US, UK and Japan (with Implications for Emerging Markets)* (Columbia Univ. Ctr. for Law & Econ. Studies, Working Paper No. 377, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1657953 (providing an analytic framework describing how regulatory responses to hostile takeovers are shaped by the interaction between interest groups and different subordinate lawmakers within a given jurisdiction). Part III.B *infra* discusses the implementation of different regulatory authorities as a potential solution to the state’s conflicts of interest.

as a shareholder over those of outside investors are often politically popular. For example, even the most financially developed jurisdictions have far more taxpayers than shareholders in publicly traded firms.¹³ As a result, many citizens may come to favor legal rules that privilege the interests of the state as a controlling shareholder over those of minority (and often foreign) investors. This risk is particularly acute since the same jurisdictions that exhibit higher levels of state-owned enterprise also tend to have less-developed capital markets and lower levels of stock ownership by households.

If ordinary citizens are often sympathetic to the state's interests as a shareholder, controlling families are even more so. In a system of concentrated corporate ownership, collective action problems allow controlling families to exercise disproportionate influence on legislative outcomes, stifling the enactment of investor protection laws.¹⁴ Moreover, the coexistence of state and family control significantly reinforces this pattern, as it creates a natural alignment of interests between the government and controlling families against minority shareholders. As a result, even if the political clout of such families is discounted, the state, as the controlling shareholder of some of the largest publicly traded firms, may have independent reasons to oppose reforms that redistribute wealth to minority shareholders and to sponsor legal changes that facilitate minority expropriation.

This symbiotic relationship between state and family control of business corporations has been overlooked due to a persistent focus on the distinctiveness of government control vis-à-vis private ownership of enterprise. In this sense, at least two differences stand out. First, managers of SOEs typically face lower performance incentives than private firms, since public enterprises are generally subject to a "soft" budget constraint, shielded from bankruptcy and hostile takeovers, and limited in their ability to enhance managerial performance through high-powered compensation contracts.¹⁵ Second, but more importantly, state-controlled firms tend to

13. This is due to a variety of factors, including income inequality, idiosyncratic preferences over risk and asset allocation, misinformation, and the participation of foreign investors in domestic markets. Even in the United States, only about one-half of the country's households own stocks. See INV. CO. INST. & SEC. INDUS. ASS'N, EQUITY OWNERSHIP IN AMERICA, 2005, at 7 (2005), available at http://www.ici.org/pdf/rpt_05_equity_owners.pdf, for a description of the rise of equity ownership among U.S. households, which jumped from 19 percent in 1983 to 50.3 percent in 2005. Of course, the large size of a given constituency is not synonymous with, and can indeed hinder, organized political influence. See MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS 53–57 (1971) (arguing that collective action in a group's interest is facilitated when the group is small). Nevertheless, if taxpayers face collective action problems, so do dispersed minority investors.

14. See Bebchuk & Roe, *supra* note 7, at 131.

15. See Albert Chong & Florencio López-de-Silanes, *The Truth About Privatization in Latin America*, in PRIVATIZATION IN LATIN AMERICA: MYTHS AND REALITY 1, 3 (Albert Chong & Florencio López-de-Silanes eds., 2005); OECD, CORPORATE GOVERNANCE OF STATE-OWNED ENTERPRISES: A SURVEY OF OECD COUNTRIES 14, 152–54 (2005).

pursue political or non-financial objectives other than shareholder wealth maximization.¹⁶

While differences between public and private ownership certainly exist (and are the subject of a large body of empirical literature¹⁷), it is easy to overstate the extent to which the interests of the government as a controlling shareholder differ from those of private controlling shareholders. Agency costs and the ensuing distortions in managerial incentives are a time-honored problem in widely held corporations, whereas the pursuit of non-pecuniary objectives beyond shareholder wealth maximization—widely acknowledged as the quintessential characteristic (or main evil) of government ownership—is hardly unique to SOEs.¹⁸

Indeed, too much emphasis on the differences between private and public control of enterprise has largely obscured their similarities. Conceding that the model of the firm as a profit maximizer may be a worse fit to state-owned firms does not mean that the government and managing bureaucrats are indifferent to the company's size, revenue, and profit distribution. A prominent strand of the literature on public choice models state and bureaucratic behavior based on the assumption that governments maximize fiscal revenues while bureaucracies maximize the size of their budgets.¹⁹ In disregarding the interests of the state and managing bureaucrats in the distribution of SOE profits, the corporate governance literature has, ironically, embraced too benign a view of the state as shareholder. The

16. The reasons for the underperformance of state-owned enterprises are summarized by Chong & López-de-Silanes, *supra* note 15, at 2–3.

17. The literature is too voluminous to be cited in full. For a few examples, see generally Hamdi Ben-Nasr et al., *The Political Determinants of the Cost of Equity: Evidence from Newly Privatized Firms*, 50 J. ACCT. RES. (forthcoming 2012) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1578785 (finding that the cost of equity increases with the degree of government control of enterprise); Anthony E. Boardman & Aidan R. Vining, *Ownership and Performance in Competitive Environments: A Comparison of the Performance of Private, Mixed and State-Owned Enterprises*, 32 J.L. & ECON. 1 (1989) (finding that mixed and state-owned enterprises perform significantly worse than comparable private companies); Ginka Borisova et al., *Government Ownership and Corporate Governance: Evidence from the E.U.*, 36 J. BANKING & FIN. (forthcoming 2012), available at <http://www.sciencedirect.com/science/article/pii/S0378426612000234> (concluding that government ownership is associated with lower governance quality); Mary M. Shirley & Patrick Walsh, *Public Versus Private Ownership: The Current State of the Debate* (World Bank Policy Research, Working Paper No. 2420, 2001), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=261854.

18. See generally Einer Elhauge, *Sacrificing Profits in the Public Interest*, 80 N.Y.U. L. REV. 733 (2005) (arguing that the claim that business corporations maximize profits is both descriptively and normatively wrong); Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1663–64 (2006) (stressing that private controlling shareholders pursue non-pecuniary as well as pecuniary private benefits of control).

19. On prominent theories of state behavior that focus on the government's fiscal interests, see generally DOUGLASS C. NORTH, *STRUCTURE AND CHANGE IN ECONOMIC HISTORY* (1981), and MANCUR OLSON, *POWER AND PROSPERITY: OUTGROWING COMMUNIST AND CAPITALIST DICTATORSHIPS* (2000). For a discussion of the merits and shortcomings of the widely employed assumption that bureaucrats are budget maximizers, see DENNIS C. MUELLER, *PUBLIC CHOICE III*, at 362–65 (2003).

same scholars who warn against the risk of political management of state-owned firms tend to assume that the government is otherwise unlikely to abuse minority investors.²⁰ The cases analyzed here challenge these assumptions, as the actions of the state as a controlling shareholder have too often mirrored the archetypal expropriation techniques employed by private controlling shareholders.²¹

This study thus addresses a gap in the literature on the political economy of corporate governance. Existing scholarship has failed to fully appreciate the influence of the state as shareholder in the development of corporate legal regimes, a force that has helped shape virtually every major corporate law issue—such as the degree of access to the corporate form, the legal regime of sale-of-control transactions, and the structure of shareholder voting rights—across different institutional settings. It also explores the extent to which the relative retreat of state ownership during the wave of privatizations of the 1980s and 1990s may have contributed to the greater degree of convergence toward stronger shareholder rights worldwide during the same period by transforming the political economy of corporate law reforms.

Part I of this Article analyzes how the interests of the government as shareholder have influenced corporate lawmaking in a variety of settings. It begins by describing the U.S. experience in the nineteenth century and then turns to the cases of Brazil, China, and Continental Europe in the twentieth century. Part II then speculates on the role that the wave of privatizations in the 1980s and 1990s, which reduced the importance of state ownership and therefore the state's stake in corporate laws, might have played in transforming the political economy of corporate governance and in fostering capital market development. Part III attempts to translate historical lessons into policy proposals by exploring the promise of different institutional arrangements to constrain the impact of the state's interests as a shareholder on the corporate governance environment, and by offering some recommendations that are both counterintuitive and contrary to influential Organisation for Economic Co-operation and Development (OECD) guidelines on SOEs. The Article concludes by reflecting on the continued significance of state ownership and its implications for corporate governance.

20. Kahan & Rock, *supra* note 4, at 1318 (dismissing concerns that “the government wants to enrich itself financially at the expense of the minority shareholders”).

21. Ronald J. Gilson and Jeffrey N. Gordon identify three principal methods for controlling shareholders to extract private benefits of control—namely, by taking for themselves a disproportionate amount of the firm's operating earnings, by minority freeze-outs, or by selling control at a premium. See Ronald J. Gilson & Jeffrey N. Gordon *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 786 (2003). All of these methods can also be used by government-controlled firms.

I. THE STATE AS SHAREHOLDER: A COMPARATIVE PERSPECTIVE

A. *The United States*

Compared to most other jurisdictions around the world, traditional SOEs were significantly less common in the United States throughout the twentieth century. Except for temporary takeovers of enemy property during wartime,²² the U.S. government largely refrained from nationalizing major industries and embracing a model of state capitalism in the post-World War II period. While mixed enterprises have dominated stock markets in many developed and developing countries, they were virtually non-existent in recent U.S. experience until the 2008 financial crisis.²³ In fact, the very idea of having the federal government acquire equity stakes in distressed financial institutions reluctantly emerged as a policy transplant from England, a country with far greater historical experience and familiarity with state-owned enterprise.²⁴ The partial nationalizations of distressed firms substituted the U.S. government's initial plan for its Troubled Assets Relief Program²⁵ (TARP), which consisted of less intrusive public purchases of "toxic" assets from the banks' balance sheets.²⁶

At least in the last century, the U.S. government has been largely immune from conflicts of interest in corporate governance regulation stemming from its interests as a corporate shareholder. As described in greater detail below, while federal and state governments in the United States have frequently (and increasingly) employed the corporate form since the beginning of the twentieth century, they have traditionally done so either as a sole proprietor or as a guarantor, not as co-shareholder or residual owner in partnership with private capital.

As the Supreme Court remarked in *Lebron v. National Railroad Passenger Corp.*, the passenger railroad company Amtrak, as a government-owned corporation, was "not a unique, or indeed even a particularly unusual, phenomenon."²⁷ Indeed, U.S. federal and state governments have made lavish use of the corporate form to perform public

22. See Stacey R. Kole & J. Harold Mulherin, *The Government as a Shareholder: A Case from the United States*, 40 J.L. & ECON. 1, 3–5 (1997); see also *Youngstown Sheet & Tube Co. v. Sawyer*, 343 U.S. 579 (1952) (holding that President Truman's seizure of the steel companies involved in a labor dispute during the Korean War was unconstitutional as a violation of the separation of powers).

23. MUSOLF, *supra* note 1, at 2.

24. See Paul Krugman, *Gordon Does Good*, N.Y. TIMES, Oct. 13, 2008, at A29 (stating that the initiative for government equity injections had to come from London rather than Washington due to the U.S. government's ideology).

25. See Economic Stabilization Act of 2008, Pub. L. No. 110-343, §§ 101–36, 122 Stat. 3765, 3767–3800 (codified as amended at 12 U.S.C. §§ 5211–5241 (Supp. IV 2010)).

26. Steven M. Davidoff & David Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. 463, 526 (2009).

27. *Lebron v. Nat'l R.R. Passenger Corp.*, 513 U.S. 374, 386 (1995). Amtrak's federal charter stated that it "shall be operated and managed as a for profit corporation." *Id.* at 385 (citing 45 U.S.C. § 541 (1988 and Supp. V)).

functions. As of 1990, the official count included as many as 6,397 government corporations in the United States, including 45 with federal charters—a number that seems to have been growing in recent years.²⁸

Still, the vast majority of these corporations have assumed one of two forms: (1) corporatized public instrumentalities, in which the corporate structure serves as an alternative organizational form to more traditional modes of public governance, or (2) privately owned but government-sponsored enterprise. As an example of the first type of organization, both state and federal governments have created corporations liberally in order to obtain greater operational flexibility over conventional public agencies or bureaucracies. President Franklin Delano Roosevelt pitched the creation of the Tennessee Valley Authority in 1933, for example, as “a corporation clothed with the power of government but possessed of the flexibility and initiative of a private enterprise.”²⁹ The government is typically the sole owner of these corporations, which are often no more than state agencies organized under a different, and more flexible, legal structure.³⁰

Additionally, the U.S. government has availed itself of a number of government-sponsored enterprises (GSEs), of which the Federal National Mortgage Association (Fannie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac), are the foremost examples.³¹ GSEs are chartered by the federal government to pursue public objectives or cure perceived market failures, but are organized in the form of profit-seeking corporations owned by private shareholders and listed on major exchanges. The government backing to GSEs does not come in the form of an equity stake but rather from its implicit guarantee to the corporation’s debt, which in turn helps advance the company’s public objectives by lowering its cost of capital. This hybrid structure mitigates the intra-shareholder conflicts associated with state ownership, albeit at the cost of creating even greater

28. JERRY MITCHELL, *THE AMERICAN EXPERIMENT WITH GOVERNMENT CORPORATIONS* 13, 15 (1999) (noting that the labels commonly used to refer to these corporations include “‘ad hoc government,’ ‘public authority,’ ‘public benefit corporation,’ ‘public corporation,’ ‘public enterprise,’ and ‘special-purpose government’”). A classic example of a federal government corporation performing commercial functions is the U.S. Postal Service; others performing regulatory functions include the Resolution Trust Corporation and the Federal Deposit Insurance Corporation.

29. *From the New Deal to a New Century*, TENN. VALLEY AUTH., <http://www.tva.gov/abouttva/history.htm> (last visited Apr. 21, 2012). In response to the proliferation of government corporations following the Great Depression, Congress enacted the Government Corporation Control Act of 1945, which was designed to restrain the formation of government corporations and enhance their accountability. For a detailed discussion of the Act, see C. Herman Pritchett, *The Government Corporation Control Act of 1945*, 40 AM. POL. SCI. REV. 495, 509 (1946).

30. See *Lebron*, 513 U.S. at 400 (holding that First Amendment protections apply to Amtrak); see also A. Michael Froomkin, *Reinventing the Government Corporation*, 1995 U. ILL. L. REV. 543, 548.

31. All of the six GSEs are financial institutions, a select group that also includes the Federal Home Loan Bank System (housing), the Farm Credit System and Farmer Mac (agriculture), and Sallie Mae (student loans). See THOMAS H. STANTON, *GOVERNMENT-SPONSORED ENTERPRISES: MERCANTILIST COMPANIES IN THE MODERN WORLD*, at xi (2002).

misalignment of interests between corporate shareholders and management, who benefit from the stock price appreciation due to risk-taking activities, and taxpayers, who are left to pick up the bill in case of failure.³²

Neither wholly owned government corporations nor GSEs pose the agency problems that are typical of multi-owner firms, since in the former case the government is the sole owner, and in the latter case it is not an owner at all. Until the 2008 financial crisis, simultaneous private and public ownership of business corporations in the United States was rare and of little practical significance.³³ Whereas a number of companies were formally chartered as “mixed enterprises,” most of them have converted to either entirely public or private ownership.³⁴

The Communications Satellite Corporation (Comsat), which was the object of the “most widely-publicized and hotly-contested battle involving mixed enterprise in the twentieth century,” turned out not to embrace a mixed-ownership model.³⁵ Comsat’s 1962 federal charter allowed the U.S. President to appoint three “public interest” directors out of its fifteen board members, but the firm was to be entirely owned by private sector shareholders.³⁶ Comsat’s governance structure ensured governmental influence and supervision without implicating the state’s financial interest in the enterprise.

Nevertheless, mixed-ownership corporations have a long historical pedigree in the United States. The establishment of the Bank of North America of 1781—a mixed-ownership corporation and the country’s first bank—preceded the adoption of the U.S. Constitution and was instrumental to the country’s continued independence.³⁷ Similarly, the First Bank of the United States of 1791 was also a mixed-ownership company in which the U.S. government held up to 20 percent of its stock.³⁸

The tension between the state’s interests as a shareholder and its role as a corporate regulator was clear from the outset. In the late eighteenth and early nineteenth centuries, the most salient corporate issues were not

32. The 2008 financial crisis made the serious character of these risks all too familiar. For an early description and analysis of the characteristics and conflicts inherent to GSEs, see generally JONATHAN G.S. KOPPELL, *THE POLITICS OF QUASI-GOVERNMENT: HYBRID ORGANIZATIONS AND THE DYNAMICS OF BUREAUCRATIC CONTROL* (2003).

33. See MUSOLF, *supra* note 1, at 2.

34. Froomkin, *supra* note 30, at 573 (concluding that the conceptual and practical difficulties associated with mixed enterprises are “largely theoretical at present”).

35. LLOYD D. MUSOLF, *MIXED ENTERPRISE: A DEVELOPMENTAL PERSPECTIVE* 56 (1972). “Paradoxically, none of the ‘mixed-ownership’ government corporations listed in the Government Corporations Control Act are that.” *Id.* at 51.

36. Comsat was created by the Communications Satellite Act of 1962. See Lebron v. Nat’l R.R. Passenger Corp., 513 U.S. 374, 391–92 (1995); Herman Schwartz, *Governmentally Appointed Directors in a Private Corporation—The Communications Satellite Act of 1962*, 79 HARV. L. REV. 350, 353 (1965).

37. ALEXANDER HAMILTON, TREASURY DEP’T, REPORT ON A NATIONAL BANK 92 (1790) (claiming that “American independence owes much to [the Bank of North America]”); see Froomkin, *supra* note 30, at 547 n.9 (noting that the Bank of North America was chartered by the Continental Congress and was 60 percent owned by the Superintendent of Finance).

38. *Lebron*, 513 U.S. at 386.

managerial agency costs and the resulting need for shareholder protection, as is the case today, but rather access to corporate charters, which at the time still required an individualized act of the legislature.³⁹ And, as it turns out, the financial interests of states as shareholders of incumbent firms influenced their willingness to charter potential competitors.

Take, for instance, the case of early banking in Philadelphia as described by Anna Schwartz.⁴⁰ Facing a budget surplus in 1792, the Commonwealth of Pennsylvania saw the highly lucrative Bank of North America, which was by then wholly owned by private merchants, as a promising investment opportunity.⁴¹ The state proposed to acquire a significant amount of the bank's stock, but negotiations with existing shareholders ultimately broke down.⁴² Local merchants who were dissatisfied with their accommodation in the Bank of North America saw this as an opportunity to obtain a corporate charter for a competing institution, the Bank of Pennsylvania.⁴³ In consideration for the grant of a charter to the Bank of Pennsylvania, the state was allowed to subscribe to one-third of the bank's capital stock, to be paid through a combination of specie, federal debt, and proceeds of a loan from the bank.⁴⁴

In 1803, still another group of credit-hungry merchants petitioned the legislature to incorporate the Philadelphia Bank.⁴⁵ The petition met with resistance from the Bank of Pennsylvania, which—itsself a direct product of the state's profit-making objectives—now appealed to the government's interests as a shareholder to oppose the incorporation of a new bank.⁴⁶ It argued that the chartering of another banking institution would reduce the Bank of Pennsylvania's profits and therefore jeopardize the state's investment.⁴⁷ Citizens argued before the legislature that, in light of “the extensive interest which the state holds in the Bank of Pennsylvania, they cannot too seriously consider the probable baneful effects of an additional chartered Bank at this period, on the fiscal concerns of the state and on the banking system.”⁴⁸

39. See Henry Hansmann & Mariana Pargendler, *The Evolution of Shareholder Voting Rights: Separation of Ownership from Consumption* 6 & n.10 (Jan. 2012) (unpublished manuscript) (on file with author) (arguing that “even if investor protection considerations have arguably become paramount in the end of history of corporate law, they were certainly not as important in the beginning of history”).

40. See generally Anna Jacobson Schwartz, *The Beginning of Competitive Banking in Philadelphia, 1782-1809*, 55 J. POL. ECON. 417 (1947).

41. See *id.* at 423–24.

42. See *id.*

43. *Id.* at 418–19. The primary motivation of bank shareholders in the late eighteenth and early nineteenth centuries was to obtain access to the bank's services (discounts and short-term loans) rather than a financial return on the stock. For a description of this argument, see Hansmann & Pargendler, *supra* note 39, at 11–12.

44. See Schwartz, *supra* note 40, at 423–24.

45. See *id.* at 426–27.

46. *Id.*

47. *Id.*

48. *Id.* at 429 (quoting S. JOURNAL, 249, 257, 269–70 (Pa. 1803–1804)).

The Commonwealth of Pennsylvania thus faced a familiar dilemma. In the words of Schwartz, “[A]s a stockholder in the Bank of Pennsylvania, its interests presumably coincided with those of the private investors in the bank, but as arbiter of the public welfare, it had to consider the views of the promoters of the Philadelphia Bank. These conflicted with the ambitions of Bank of Pennsylvania stockholders.”⁴⁹ The legislative committee in charge of evaluating the charter petition was initially determined to privilege the interests of the state as a shareholder.⁵⁰ It issued an unfavorable report on the charter application, deeming it against the “public interest” as possibly damaging to the state’s financial stake in the Bank of Pennsylvania.⁵¹

The state’s conflict of interest did not go unnoticed. One legislative proposal argued that elimination of the conflict required the state to divest its stock holdings in banks. It contended that

[i]t being the duty of the government to consult the general will and provide for the good of all, embarrassments must frequently be thrown in the way of the performance of this duty, when the government is coupled in interest with institutions whose rights are founded in monopoly, and whose prosperity depends on the exclusion and suppression of similar institutions.⁵²

This proposal for divestiture was defeated, but the Philadelphia Bank was able to engage successfully in Coasean bargaining and obtain a charter. In exchange for incorporation, the Bank of Philadelphia offered the state a \$135,000 cash payment, permitted the state to make a significant stock subscription, and loaned \$100,000 to the Commonwealth.⁵³ After winning a bidding war with the Bank of Pennsylvania—which offered the state significant boons for *denying* its competitor’s application for a charter—the Bank of Philadelphia was finally incorporated in 1804.⁵⁴

The state’s new holdings in the Philadelphia Bank had the potential to create the same conflicts of interest in future charter requests. Sure enough, Pennsylvania’s interests as a shareholder led it once again to oppose an incorporation petition from the Farmers’ and Mechanics’ Bank in 1807.⁵⁵ Side payments to the state government were repeatedly employed to satisfy the “public interest,” until the liquidation of the state’s shareholdings in banks in 1837 created the preconditions for a truly liberal chartering policy.⁵⁶

Pennsylvania was not unique in experiencing a tension between the state’s dual role as a shareholder and regulator. John Wallis, Richard Sylla, and John Legler have provided systematic evidence that individual states’

49. *Id.* at 426–27.

50. *Id.* at 426.

51. See Richard Sylla, *Early American Banking: The Significance of the Corporate Form*, 14 BUS. & ECON. HIST. 105, 111 (1985).

52. Schwartz, *supra* note 40, at 427 (quoting H. JOURNAL, 193 (Pa. 1812–13)).

53. *Id.* at 429.

54. *Id.*

55. *Id.* at 430–31.

56. Sylla, *supra* note 51, at 111.

financial interests had a substantial impact on their policies toward bank chartering. States whose main source of banking-related revenue came from taxes were significantly more likely to adopt a liberal chartering process than those in which the state was invested as a major bank shareholder.⁵⁷

Nor was the shareholder–regulator conflict limited to the incorporation of financial institutions. In the nineteenth century, U.S. state governments were also heavily invested in transportation improvement companies (notably turnpikes, canals, and railroads) and kept these interests in mind when reviewing charter applications from potential competitors. The State of New York’s interest in the economic success of the Erie Canal—which, in a historic example of public entrepreneurship, it built and financed on its own—illustrates the problem. Despite its pioneering role in the enactment of general incorporation statutes, New York refrained from passing a general incorporation law for canals to prevent competition from impairing the ratings of the Erie Canal’s state bonds.⁵⁸ Citizens were sympathetic to the state’s fiscal interests, leading to a “loud popular cry” against potential competition from railroads.⁵⁹ As a result, the New York legislature passed laws preventing railroads from carrying freight, hence guaranteeing the Erie Canal’s monopoly.⁶⁰

In New Jersey, this pattern was even more prevalent. The state’s infamous “monopoly bill” of 1832, which granted exclusive privileges to the Camden and Amboy railroad, was a bargained-for statute passed in exchange for a significant gift of company stock to the state.⁶¹ The state’s equity stake in the railroad turned out to be so profitable that it significantly reduced the taxes levied on its citizenry,⁶² thus making the monopoly politically popular. When a turnpike company applied for a competing charter a few years later, the committee in charge of the matter opined negatively on the petition so as to “preserve inviolate, sacred and unimpaired, the *faith*, the *integrity*, and the *revenues* of the state, by a strict adherence to the system of policy which has laid the foundation of our

57. See John Joseph Wallis, Richard E. Sylla & John B. Legler, *The Interaction of Taxation and Regulation in Nineteenth-Century U.S. Banking*, in *THE REGULATED ECONOMY: A HISTORICAL APPROACH TO POLITICAL ECONOMY* 121, 142 (Claudia Goldin & Gary D. Libecap eds., 1994).

58. RONALD E. SEAVOY, *THE ORIGINS OF THE AMERICAN BUSINESS CORPORATION, 1784-1855: BROADENING THE CONCEPT OF PUBLIC SERVICE DURING INDUSTRIALIZATION* 43 (1982).

59. ARTHUR T. HADLEY, *RAILROAD TRANSPORTATION: ITS HISTORY AND ITS LAWS* 11 (1886).

60. JANEY LEVY, *THE ERIE CANAL: A PRIMARY SOURCE HISTORY OF THE CANAL THAT CHANGED AMERICA* 38 (2003).

61. LAWRENCE M. FRIEDMAN, *A HISTORY OF AMERICAN LAW* 133 (3d ed. 2005).

62. *Id.*

Internal Improvements, *the principles of protection as a means of revenue.*"⁶³

Lawmakers also took into account the state's interests as a shareholder in defining appropriate rules for corporate governance. In 1846, the Revisors of the Civil Code of Virginia focused on the implications for "the finances of the state" to justify a proposed revision to relax the strict regressive voting scale prevalent at the time, which severely limited the voting rights of large shareholders.⁶⁴ They noted that "[t]he state has subscribed largely to works of internal improvement, and to her it is desirable that each work to which she subscribes should be so managed as not to sink the capital, but make it a source of some income."⁶⁵ The Revisors deemed that the state's financial interests would be best served by affording greater voting rights to large shareholders, who had an incentive to make decisions in order to maximize the values of their investment, rather than by giving comparatively greater voice to small holders, who could exercise their voting rights so as to privilege their interests as users by favoring low tolls to the detriment of profitability.⁶⁶

As capital and product markets developed throughout the nineteenth century, mixed enterprises became increasingly rare and remained so well into the twentieth century.⁶⁷ Yet, throughout the twentieth century, and especially in the post-war period, the state continued to share in the profits of business corporations. It did so no longer through equity ownership, but rather via taxation. In the years after World War II, while non-U.S. governments were rapidly increasing their equity holdings in important segments of the economy, the U.S. income tax rate applicable to business corporations was such as to, in the words of Adolph Berle, "virtually make[] the state an equal partner [in the corporate enterprise] as far as profits are concerned."⁶⁸ Meanwhile, the provisions of U.S. corporate law continued to be influenced by the states' financial interests—no longer as corporate shareholders but rather as collectors of corporate franchise taxes.⁶⁹

63. John Joseph Wallis, *Market-Augmenting Government? States and Corporations in Nineteenth-Century America*, in MARKET-AUGMENTING GOVERNMENT: THE INSTITUTIONAL FOUNDATIONS FOR PROSPERITY 223, 251 (Omar Azfar & Charles A. Cadwell eds., 2003).

64. REPORT OF THE REVISORS OF THE CIVIL CODE OF VIRGINIA MADE TO THE GENERAL ASSEMBLY AT DECEMBER SESSION 1846, at 335 (1847).

65. *Id.*

66. *Id.* For a detailed analysis of how regressive voting schemes in the nineteenth-century served to protect the interests of consumers rather than investors, see Hansmann & Pargendler, *supra* note 39.

67. Stephen Brooks, *The Mixed Ownership Corporation as an Instrument of Public Policy*, 19 COMP. POL. 173, 176 (1987).

68. Adolph A. Berle, *Property, Production and Revolution: A Preface to the Revised Edition* (Dec. 1967), reprinted in ADOLPH A. BERLE & GARDINER C. MEANS, MODERN CORPORATION AND PRIVATE PROPERTY, at xxviii (2d ed. 1991) ("Under the recent tax reduction, the federal government presently taxes corporate profits above \$25,000 at the rate of about 50 per cent.").

69. See, e.g., Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 255 (1977) (noting that both Delaware and its

Nevertheless, the government's financial interest in tax revenues creates different—and arguably more benign—regulatory incentives compared to outright ownership. The federal government's financial interest in income taxes favors the enactment of efficient corporate and securities regulations that maximize firm revenue. Although the states' interests in franchise taxes may lead them to enact corporate laws that are more managerialist than is socially desirable, their incentives to favor controlling over minority shareholders are still much weaker than when the state itself is the controlling shareholder.

B. Brazil

In contrast to the United States, but as in most other jurisdictions around the world, mixed corporations in Brazil became more common in the twentieth century, especially in the second half. While most nineteenth-century railroad corporations enjoyed publicly guaranteed dividends but were owned by private shareholders, by 1929 the government had taken over two-thirds of the country's railways, a fraction that would further increase in the following years.⁷⁰ However, it was not until the early 1940s, with the incorporation of the Companhia Siderúrgica Nacional (CSN) in 1941 (steel) and the Companhia Vale do Rio Doce in 1942 (mining), that Brazil witnessed the emergence of the first large-scale mixed enterprises having the government as a controlling shareholder from the outset.⁷¹

The impetus for the creation of these national giants came from a combination of national security considerations in view of the ongoing world war and a lack of private capital for financing industrialization.⁷² Brazil's National Development Bank (*Banco Nacional de Desenvolvimento Econômico* (BNDE), later *Banco Nacional de Desenvolvimento Econômico e Social* (BNDES)), established in 1952, became an important financing source of government corporations before switching roles to operate as a main financier of the private sector in subsequent decades.⁷³ In 1953, the federal government incorporated the oil company Petrobras as a mixed enterprise following a strong nationalistic campaign based on the slogan "*O Petróleo é Nosso* (The Oil is Ours)."⁷⁴ While the CSN and the BNDE initially benefited from U.S. government loans in connection with war cooperation efforts, most state-owned firms were primarily financed via

competitors "candidly admit that the purpose of corporate code revisions has been the attraction of charters to their state in order to produce significant tax revenues").

70. PETER EVANS, *DEPENDENT DEVELOPMENT: THE ALLIANCE OF MULTINATIONAL, STATE, AND LOCAL CAPITAL IN BRAZIL* 84 (1979).

71. *See id.* at 88–89.

72. *See generally* ALEXANDER GERSCHENKRON, *ECONOMIC BACKWARDNESS IN HISTORICAL PERSPECTIVE* (1962).

73. Werner Baer & Annibal V. Villela, *The Changing Nature of Development Banking in Brazil*, 22 *J. INTERAMERICAN STUD. & WORLD AFF.* 423, 425–34 (1980).

74. EVANS, *supra* note 70, at 91.

taxation.⁷⁵ Initially by practice, and later by law,⁷⁶ mixed enterprises in Brazil (*sociedades de economia mista*) had necessarily to be organized as a business corporation (*sociedade anônima*).

Starting in 1964, the ruling military government inaugurated an ambitious program to develop Brazil's capital markets, relying heavily on fiscal incentives in the form of favorable tax treatment for both investors and publicly traded companies.⁷⁷ The program was part of a series of then-recent anti-inflationary policies which, by restricting governmental loans to the private sector, triggered a severe working capital shortage in many firms.⁷⁸ This policy was strengthened with the enactment of Decree-Law 157 in 1967, which allowed taxpayers to allocate up to 10 percent of their federal income tax dues to make personal investments in publicly traded firms through certain mutual funds (157 funds)—thus making the purchase of shares in listed companies essentially free from a shareholder's perspective, since the price was paid by the government.⁷⁹ Moreover, the government further reinforced the creation of compulsory demand for domestic equities by imposing a legal requirement that pension funds and insurance companies invest a minimum percentage of their portfolio in local stock markets.⁸⁰

The upshot of these measures was a massive flow of funds into public companies, and a capital market boom.⁸¹ The governmental policies induced a number of family owned firms to undertake their first public issue of stock. And, perhaps more important, these policies led to a great expansion of state-owned firms with publicly traded shares, both because a large number of existing or newly created SOEs sold shares to the public for the first time, and because SOEs that were already listed sold additional shares. Indeed, state-controlled corporations turned out to be the foremost beneficiaries of the captive demand created by the government's program to foster capital market development through forced savings.⁸²

75. LUCIANO MARTINS, *ESTADO CAPITALISTA E BUROCRACIA NO BRASIL PÓS-64*, at 60 (1985).

76. Decreto-Lei No. 200, art. 5, de 25 de Fevereiro de 1967, DIÁRIO OFICIAL DA UNIÃO [D.O.U.] de 27.02.1967 (Braz.) (text given by Decreto Lei No. 900, de 29 de Setembro de 1969, DIÁRIO OFICIAL DA UNIÃO [D.O.U.] de 30.09.1969 (Braz.)).

77. For a detailed description of these policies, see generally David M. Trubek, *Law, Planning and the Development of the Brazilian Capital Market: A Study of Law in Economic Change*, BULLETIN (New York Univ. Graduate Sch. of Bus. Admin., Inst. of Fin.) nos. 72–73 (1971).

78. *Id.*

79. See Decreto-Lei No. 157, art. 3, de 10 de Fevereiro de 1967, DIÁRIO OFICIAL DA UNIÃO [D.O.U.] de 13.02.1967 (Braz.) (revoked by Decreto Lei No. 2.065, de 26 de Outubro de 1983, DIÁRIO OFICIAL DA UNIÃO [D.O.U.] de 28.10.1983 (Braz.)).

80. See, e.g., Flávio M. Rabelo & Flávio C. Vasconcelos, *Corporate Governance in Brazil*, 37 J. BUS. ETHICS 321, 329 (2002).

81. By the end of 1967, the trading volume on the Brazilian stock exchanges had risen by 91 percent. DAVID M. TRUBEK ET AL., *O MERCADO DE CAPITAIS E OS INCENTIVOS FISCAIS* 150 (1971).

82. José Roberto Mendonça de Barros & Douglas H. Graham, *The Brazilian Economic Miracle Revisited: Private and Public Sector Initiative in a Market Economy*, 13 LATIN AM.

As contemporary economists put it, “[W]hat began as an institutional reform to promote the low cost capitalization of private sector growth has in effect become a vehicle for public enterprise capital expansion.”⁸³ Government-controlled firms figured among the “blue chips” traded on Brazil’s stock exchanges, and were responsible for 75 percent of the market’s trading volume.⁸⁴ The magnitude of the expansion of state-owned enterprise is striking, with 231 public firms created between 1966 and 1976.⁸⁵ By 1974, twenty-two of the top twenty-five companies in the Brazilian economy were controlled by the government, with SOEs accounting for 49.7 percent of the total net book value of the top 1,000 Brazilian firms.⁸⁶

In the 1970s, academics and policymakers came to recognize the insufficiency of tax incentives and the importance of stronger legal protections for minority shareholders for increasing investor confidence and interest in corporate securities. Brazilian economist Mário Henrique Simonsen, then Treasury Secretary, resented Brazil’s dearth of large private enterprise, which he attributed to the absence of legal mechanisms to protect minority shareholders from expropriation, thus encouraging capital aggregation.⁸⁷ Nevertheless, having just used generous tax incentives to induce a large number of companies to go public—all of which had either wealthy families or the state itself as controlling shareholder—Brazil’s legal reform process faced an uphill political battle.⁸⁸ Both controlling families and the state had a vested interest in preventing the adoption of sweeping legal reforms that could redistribute corporate wealth and power away from controlling shareholders toward minority shareholders.

Given the prominence of SOEs in Brazil’s corporate landscape, some scholars advocated the adoption of a separate statute to suit the peculiar needs and characteristics of government-controlled firms, a proposal that was defeated.⁸⁹ In the absence of special legislation, the prevailing approach was instead to enact a single new Corporations Law in 1976, but to insert a new (and remarkably lean) chapter devoted to *sociedades de*

RES. REV. 5, 21 (1978) (“State enterprises rather than private firms were the major beneficiaries [of tax incentives].”).

83. *Id.* at 10.

84. MARTINS, *supra* note 75, at 71.

85. THOMAS J. TREBAT, BRAZIL’S STATE-OWNED ENTERPRISES: A CASE STUDY OF THE STATE AS ENTREPRENEUR 36 (1983) (noting that there was “not only the growth of public enterprises in the postwar period but also the proliferation of such entities under conservative military governments in the 1960s and 1970s”).

86. QUEM É QUEM NA ECONOMIA BRASILEIRA 45 (Visão ed., 1974); Mendonça de Barros & Graham, *supra* note 82, at 8.

87. MÁRIO HENRIQUE SIMONSEN, BRASIL 2002, at 124 (1973).

88. For a more thorough description, see Ronald J. Gilson, Henry Hansmann & Mariana Pargendler, *Regulatory Dualism as a Development Strategy: Corporate Reform in Brazil, the United States and the European Union*, 63 STAN. L. REV. 475 (2011).

89. See, e.g., José Cretella Júnior, *Sociedades de Economia Mista no Brasil*, 80 REVISTA DE DIREITO ADMINISTRATIVO 33, 37 (1965) (defending the adoption of a separate statute to govern state-owned firms).

economia mista.⁹⁰ The chapter made clear that, except as otherwise specified therein or in federal law, publicly traded mixed enterprises were subject to the same corporate law rules and regulations of the newly created Securities and Exchange Commission (*Comissão de Valores Mobiliários* (CVM)) as private issuers.⁹¹

Interestingly, this chapter expressly imposed on directors and controlling shareholders of mixed enterprises the same fiduciary duties applicable to privately owned corporations (thus incorporating the relevant provisions by reference), even though it specifically permitted the government to “steer the company’s activity toward the public interest that justified its creation.”⁹² However, what could look like an intractable tension between standard fiduciary duties and government control was more apparent than real. The general fiduciary duties created by the 1976 Corporations Law were exceedingly broad—indeed, probably too broad to effectively constrain abusive behavior. The pertinent provisions of the statute provide that controlling shareholders shall attend to the interests not only of shareholders, but also of employees, the community, and even the national economy.⁹³ All in all, Brazil’s Corporations Law proved to be quite accommodating to the needs of the government as a controlling shareholder.

In the years following passage of the 1976 statute, state-owned enterprises, which were until then perceived as highly successful and beneficial to the economy, entered a period of crisis.⁹⁴ In the general environment of international debt crisis and mounting inflationary pressures of the late 1970s and early 1980s, the Brazilian government increasingly

90. Lei No. 6.404, de 15 de Dezembro de 1976, DIÁRIO OFICIAL DA UNIÃO [D.O.U.] de 17.12.1976 (Braz.).

91. *Id.* art. 235.

92. *Id.* art. 238 (“[O]rientar as atividades da companhia de modo a atender ao interesse público que justificou a sua criação.”).

93. *Id.* art. 116 (“The controlling shareholder must use its influence so as to make the company fulfill its purpose and its social function, and has duties and responsibilities to the other shareholders, employees and the community in which it operates, whose rights and interests he must loyally abide by and respect.”) (“*O acionista controlador deve usar o poder com o fim de fazer a companhia realizar o seu objeto e cumprir sua função social, e tem deveres e responsabilidades para com os demais acionistas da empresa, os que nela trabalham e para com a comunidade em que atua, cujos direitos e interesses deve lealmente respeitar e atender.*”); art. 117, § 1(a) (listing as an instance of controlling shareholder abuse the act of “steering the company towards a purpose foreign to its corporate object or damaging of national interest, or leading it to favor another Brazilian or foreign company, to the detriment of the minority’s shareholder’s participation in the profits or assets of the company, or to the national economy”) (“*orientar a companhia para fim estranho ao objeto social ou lesivo ao interesse nacional, ou levá-la a favorecer outra sociedade, brasileira ou estrangeira, em prejuízo da participação dos acionistas minoritários nos lucros ou no acervo da companhia, ou da economia nacional*”).

94. Werner Baer, *The Privatization Experience of Brazil*, in INTERNATIONAL HANDBOOK ON PRIVATIZATION 220, 221 (David Parker & David Saal eds., 2003) (stressing the widespread “benign perception” enjoyed from the 1950s through the 1970s by Brazilian SOEs, which were the beneficiaries of a significant part of World Bank and USAID loans to Brazil).

came to employ state-owned firms as an instrument of macroeconomic policy. SOEs were ultimately forced to underprice their output in order to control rising inflation as well as to curb their investments and financing in foreign currency.⁹⁵ These policies resulted in a deterioration of the financial condition of state-owned firms that, combined with an international context favoring a smaller government, gave rise to pressures for the privatization of Brazilian companies. It was not until the 1990s, however, that a large-scale privatization movement finally took off.

While the influence of state interests in the development of the 1976 Corporations Law was subtle, subsequent legal reforms that were implemented in connection with Brazil's privatization process would provide a textbook example of the influence of the state as shareholder in corporate lawmaking. Although many features of the privatization process are unique to the state as a selling shareholder, the device used by the government to extract private benefits of control—insiders' appropriation of a large control premium not available to minority investors—is familiar in private sector transactions.⁹⁶

Brazil's National Denationalization Program (*Programa Nacional de Desestatização* (PND)), enacted into law in 1990, specified the procedures to be followed in privatization.⁹⁷ The objectives of the PND were numerous—and conflicting. The program's stated goals simultaneously included “reduction of public debt and the balancing of public finances” and “the strengthening of capital markets, through an increase in public offerings and the democratization of the capital of the companies taking part in the Program.”⁹⁸ However, in the Brazilian context of low investor protection and, consequently, low stock valuations, public offerings were unlikely to lead to revenue maximization absent major legal reforms.

Due to a combination of unfavorable macroeconomic conditions and insufficient investor protection, price-earnings ratios for Brazilian stocks were extremely low in the 1990s, with three-fourths of companies having a PE ratio below nine (against an average of twenty-one for the S&P 500 during the same period), and with more than half of these firms displaying share prices of less than 50 percent of book value.⁹⁹ Brazilian policymakers at the time reasoned that public share offerings would not only fail to maximize government revenue, but were also unlikely to

95. ROGÉRIO L.F. WERNECK, *EMPRESAS ESTATAIS E POLÍTICA MACROECONÔMICA* 13–14 (1987).

96. Gilson & Gordon, *supra* note 21, at 787.

97. Lei No. 8.031, de 12 de Abril de 1990, DIÁRIO OFICIAL DA UNIÃO [D.O.U.] de 13.04.1990 (Braz.).

98. *Id.* art. 1, I (“reordenar a posição estratégica do Estado na economia, transferindo à iniciativa privada atividades indevidamente exploradas pelo setor público”); II (“contribuir para a redução da dívida pública, concorrendo para o saneamento das finanças do setor público”); VI (“contribuir para o fortalecimento do mercado de capitais, através do acréscimo da oferta de valores mobiliários e da democratização da propriedade do capital das empresas que integrem o Programa”).

99. SOLUÇÕES PARA O DESENVOLVIMENTO DO MERCADO DE CAPITAIS BRASILEIRO 55–56 (Carlos Antonio Rocca ed., 2001).

generate sufficient levels of ownership dispersion and capital market development to justify the effort.¹⁰⁰

Empirical studies would later find that jurisdictions displaying low levels of legal protection of investors, and high levels of private benefits of control, were more likely to sell SOEs through private block sales rather than through share issue privatizations (SIPs), thus signaling privatizing governments' revenue-maximizing behavior.¹⁰¹ As a country that had, at an estimated 65 percent of firm value, the highest private benefits of control among thirty-nine sampled countries between 1990 and 2000 according to a study by Alexander Dyck and Luigi Zingales, this is precisely what Brazil did.¹⁰² According to William Megginson and colleagues' study on methods states have chosen to divest government equity stakes, Brazil was one of the countries with the lowest ratio of SIPs to privatizations worldwide.¹⁰³

Nevertheless, while existing studies on the choice of sales method in privatizations take the level of investor protection as given, the evidence from Brazil shows otherwise. Taking full advantage of its unique ability to reshape corporate law rules to further increase the already ample opportunities for extraction of private benefits of control, the Brazilian government in 1997 promoted a so-called "mini-reform" of the Corporations Law of 1976 with the acquiescence of controlling families. Although criticized by legal scholars and corporate governance experts, the reform was seen as "technocratic" and turned out not to be politically controversial.¹⁰⁴ The subject matter of the new law was not salient enough to attract the attention of broad segments of the Brazilian population, which, in any case, would likely be sympathetic to the government's attempt to maximize its privatization proceeds to cover the country's sizable external deficit.

100. Luciano Coutinho & Flavio Marcilio Rabelo, *Brazil: Keeping It in the Family*, in CORPORATE GOVERNANCE IN DEVELOPMENT: THE EXPERIENCES OF BRAZIL, CHILE, INDIA, AND SOUTH AFRICA 35, 47 (Charles P. Oman ed., 2003).

101. See William L. Megginson et al., *The Choice of Private Versus Public Capital Markets: Evidence from Privatizations*, 59 J. FIN. 2835 (2004) (finding a direct relationship between the share of SIPs over total privatizations and the level of legal investor protections in a given jurisdiction); see also Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537, 538-39 (2004) (finding that privatizations through block sales are more common among countries displaying high private benefits of control).

102. Dyck & Zingales, *supra* note 101, at 538. According to a different study, which used dual-class price differentials to estimate private benefits of control, an average Brazilian controlling shareholder could expect to extract up to 33.3 percent of the value of the company by holding as little as one-sixth of total cash flow rights. Tatiana Nenova, *The Value of Corporate Voting Rights and Control: A Cross-Country Analysis*, 68 J. FIN. ECON. 325, 327 (2003).

103. Megginson et al., *supra* note 101, at 2865.

104. Leslie Elliot Armijo & Walter Ness Jr., *Contested Meanings of "Corporate Governance Reform": The Case of Democratic Brazil, 1985-2003*, at 16-17 (prepared for the Annual Meeting of the Latin Am. Studies Ass'n, Oct. 7-9, 2004), available at http://lasa.international.pitt.edu/members/congress-papers/lasa2004/files/NessWalter_xCD.pdf.

Prior to the reform, Brazil's Corporations Law granted statutory appraisal rights (*direito de retirada*) to dissenting minority shareholders from spin-off transactions.¹⁰⁵ It also imposed a mandatory bid requirement (dubbed "tag-along" rights in Brazil) for common shares held by minority shareholders at the same share price paid to the controlling block upon a sale of control. The new statute, Law 9,457 of 1997, did away with both of these protections.¹⁰⁶ The removal of appraisal rights allowed the government to carry out cheaply its planned strategy of spinning off portfolio companies prior to their sale, thus avoiding out-of-pocket payments to dissenting shareholders and judicial disputes over the amounts due. The elimination of the mandatory bid requirement, in turn, permitted the state to appropriate the totality of the control premium to itself.¹⁰⁷

To be sure, the efficiency of premium-sharing, or "equal opportunity" rules (of which the mandatory bid rule is but one example), is the object of considerable controversy. There is a large body of literature suggesting that mechanisms that force controlling shareholders to share a control premium with minority investors are inefficient, as they do not differentiate between value-adding and value-decreasing acquisitions, and thus equally discourage both types of transactions.¹⁰⁸ However, in the Brazilian context of weak investor protection in going-private transactions, the elimination of the mandatory bid rule deprived minority shareholders of the opportunity to exit at a fair price upon a sale of control, and therefore exposed them to subsequent expropriation in abusive delisting transactions and freeze-out mergers.¹⁰⁹

Following the enactment of the statute, the Brazilian state went on to sell the cream of its holdings in return for a significant premium. There was a significant jump in privatization proceeds following the enactment of the

105. Lei No. 6.404, de 15 de Dezembro de 1976, art. 137, DIÁRIO OFICIAL DA UNIÃO [D.O.U.] de 17.12.1976 (Braz.).

106. Lei No. 9.457, de 05 de Maio de 1997, DIÁRIO OFICIAL DA UNIÃO [D.O.U.] de 06.05.1997 (Braz.).

107. See Armijo & Ness, *supra* note 104, at 16.

108. See generally Lucian A. Bebchuk, *Efficient and Inefficient Sales of Corporate Control*, 1994 Q.J. ECON. 957 (arguing that premium-sharing requirements may lead to an increase in concentrated corporate control in the hands of a controlling shareholder); Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 716, 737 (1982) (arguing that unequal sharing of gains in corporate control transactions maximizes shareholder wealth); Marcel Kahan, *Sales of Corporate Control*, 9 J.L. ECON. & ORG. 368, 378 (1993) (suggesting that premium-sharing requirements may be less efficient than private control transfers for sales of high fractions of corporate shares); see also John C. Coffee, Jr., *Transfers of Control and the Quest for Efficiency: Can Delaware Law Encourage Efficient Transactions While Chilling Inefficient Ones?*, 21 DEL. J. CORP. L. 359, 364-66 (1996) (stating that U.S. federal and state laws contain multiple legal mechanisms that discourage controlling shareholders from receiving a control premium, at least when the intent is to freeze out the minority).

109. Maria Helena Santana, *The Novo Mercado*, in FOCUS: NOVO MERCADO AND ITS FOLLOWERS: CASE STUDIES IN CORPORATE GOVERNANCE REFORM 1, 12-15 (2008).

amendments to the Corporations Law in May 1997, from US\$6.5 billion in 1996 to \$26.7 billion in 1997 and \$37.5 billion in 1998.¹¹⁰

The crown jewel of the privatization process was Telebras, a telecom company whose divestiture in one of the largest privatization transactions in history was a major driver behind the 1997 legal reform. Prior to its privatization in 1998, Telebras alone accounted for approximately 60 percent of all trades in the São Paulo Stock Exchange. The expected government gains from the legal reform abolishing premium-sharing requirements were substantial.

Through the ample use of preferred non-voting shares and, to a lesser extent, a pyramidal structure, the government was in a position to transfer uncontested control of Telebras by selling less than one-fifth of their total equity capital.¹¹¹ When the company was privatized, the federal government held 51.79 percent of Telebras common shares, amounting to 19.26 percent of the company's total capital, while foreign shareholders held roughly 40 percent of the company's total equity.¹¹² Telebras's ownership structure, which allowed the state to exercise uncontested control while holding only a minority of the company's cash-flow rights, distorted the government's incentives as the controlling shareholder by encouraging it to appropriate a disproportionate amount of the firm's value.¹¹³ As planned, the Brazilian government succeeded in obtaining a substantial control premium from the sale of Telebras. Economists estimate that the price of US\$19 billion received by the government represented a premium of roughly 160 percent over the price of Telebras non-voting preferred stock.¹¹⁴

The 1997 revisions to Brazil's Corporations Law provide a paradigmatic example of the risks that state ownership under a unitary corporate law regime poses to the overall corporate governance environment. Since the new statutory amendments were general in nature and by no means restricted to SOEs, they also benefited private firms' controlling shareholders to the detriment of outside investors. Consequently, control sales of government and privately owned firms alike were made at

110. BRAZILIAN DEV. BANK, *PRIVATIZATION IN BRAZIL: 1990-1994, 1995-2002*, at 3 (2002), available at http://www.bndes.gov.br/SiteBNDES/export/sites/default/bndes_en/Galerias/Download/studies/priv_brazil.pdf.

111. Telebras's pyramidal structure was a result of its historical self-financing model, in which the sale of telephone lines was financed by the consumers themselves in exchange for shares of stock in the local company. The telephone company would then install the line within twenty-four months of the purchase or subscription. See Ana Nôvaes, *Privatização do Setor de Telecomunicações no Brasil*, in *A PRIVATIZAÇÃO NO BRASIL: O CASO DOS SERVIÇOS DE UTILIDADE PÚBLICA* 145, 151 (2000).

112. *Id.* at 153.

113. For a model showing the exponential increase in agency costs in controlling-minority structures, see Lucian A. Bebchuk et al., *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Creation and Agency Costs of Separating Control from Cash Flow Rights*, in *CONCENTRATED CORPORATE OWNERSHIP* 295 (Randall Morck ed., 2000).

114. See Bruno Rocha & Iam Muniz, *Casos Brasileiros*, in *GOVERNANÇA CORPORATIVA NO BRASIL E NO MUNDO* 73, 82 (Ricardo P. C. Leal et al. eds., 2002).

substantial premiums to majority shareholders and at the expense of the minority. Examples of abusive sale-of-control transactions in the electric-power industry alone include Coelba (purchased for R\$165 per controlling share against R\$62 offered to the minority), CPFL (in which controlling shareholders received R\$432 per share compared to R\$126 offered for the public float) and Cesp Paranapanema (acquired for R\$34 per controlling share against R\$9 paid to the minority).¹¹⁵

Tatiana Nenova's empirical study on the impact of Law 9,457 on the level of private benefits finds that control value more than doubled following the enactment of the statute, reflecting greater opportunities for minority expropriation under the new regime.¹¹⁶ By encouraging abusive going-private transactions, the statute led to a sharp reduction in the number of listed firms in Brazilian capital markets and eroded investor confidence in new issues. The trading volume on the São Paulo Stock Exchange fell from more than US\$191 billion in 1997 to \$65 billion in 2001.¹¹⁷ Between 1995 and 2000, only eight companies went public on the São Paulo Stock Exchange.¹¹⁸

In December 2000, the São Paulo Stock Exchange launched the Novo Mercado (New Market), a voluntary premium exchange segment whose listing standards imposed much stricter corporate governance rules than those provided under Brazilian law, including the extension of tag-along rights to minority investors at the same price paid to controlling shareholders in the event of a sale of control.¹¹⁹ Understanding the political clout of controlling shareholders in blocking legal reforms, this approach to capital market development followed what Ronald Gilson, Henry Hansmann, and I term "regulatory dualism": it permitted established firms to continue to be governed by the existing legal regime, while creating a parallel system of stricter shareholder protection that is open to firms that voluntarily choose to adopt it.¹²⁰ By preserving the interests of established firms—which, despite the wave of privatizations, continued to include a number of giant SOEs, such as Banco do Brasil and Petrobras—regulatory dualism helped overcome the political economy constraints to investor protection reform and, ultimately, capital market development.¹²¹ Interestingly, SOEs were among the first to go public on the Novo

115. Mark Mobius, *Getting Brazil to Clean Up Its Act*, LATIN FIN., Dec. 2000, at 76.

116. Tatiana Nenova, Control Values and Changes in Corporate Law in Brazil 4 (Sept. 25, 2001) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=294064.

117. See *História do Mercado de Capitais*, PORTAL DO INVESTIDOR, <http://www.portaldoinvestidor.gov.br/InvestidorEstrangeiro/OMercadodeValoresMobili%C3%A1riosBrasileiro/Hist%C3%B3riadoMercadodeCapitais/tabid/134/Default.aspx> (last visited Apr. 21, 2012).

118. See Santana, *supra* note 109, at 7.

119. The role of the specific contributions of the Novo Mercado for the subsequent development of the Brazilian capital markets has been described in greater length elsewhere. See generally Gilson, Hansmann & Pargendler, *supra* note 88.

120. See *id.* at 478.

121. *Id.*

Mercado, arguably as part of a strategy pursued by incumbent politicians to insulate such firms from future political interference by their successors by binding them to a stronger investor protection regime.¹²²

The dramatic expansion of Brazil's capital market—which is now among the most active equity markets worldwide—has not entailed a decline in the SOE sector.¹²³ On the contrary, the recent discovery of new oilfields off the Brazilian coast is illustrative both of the continued vitality of mixed enterprises in emerging economies and of the distinctive behavior of the state as controlling shareholder of Petrobras, Brazil's giant oil corporation. While the federal government owned the oilfields in their entirety, Brazil's oil company Petrobras was state-controlled but 60 percent owned by private (including foreign) investors, which meant that the profits resulting from Petrobras's exploration of the new fields would need to be shared with outside stockholders.¹²⁴

The approach taken was for the government to assign to Petrobras its rights in the oil reserves in exchange for additional company shares. This stock issue, in turn, took place in connection with a public equity offering designed to raise additional outside capital to fund the necessary investments in drilling and exploration. In order to circumvent the provisions of the Corporations Law requiring minority shareholder approval of stock subscriptions that are payable in kind, Petrobras's lawyers structured both operations as separate transactions—even though they were described in the same legal document and openly referred to as a single transaction for the “capitalization” of Petrobras.¹²⁵

The result was a high-profile self-dealing transaction in which the interests of the Brazilian public as indirect beneficiaries of the government's oil and equity holdings were pitted against the economic interests of Petrobras's minority (and mostly foreign) investors. Commentators were concerned that the government would sell the oil, of which it was a 100 percent owner, at an inflated price to the company, of which the government owned only about 40 percent of the equity—hence transferring wealth from the company's noncontrolling public shareholders to the government.¹²⁶ In September 2010, the government finally set the price per barrel at US\$8.51—a median figure between the price of \$5 or \$6

122. See Thomas Kenyon, *Socializing Policy Risk: Capital Markets as Political Insurance* 3 (2006) (unpublished manuscript), available at <http://ssrn.com/abstract=896562> (arguing that governments opted to list state-owned firms on premium corporate governance standards “primarily to raise the political cost of potentially damaging actions by public shareholders”). See *infra* note 262 and accompanying text for a more detailed discussion.

123. Banco do Brasil's major equity offering in 2010 illustrates that, despite clear evidence of use of the bank to pursue social and political goals during the financial crisis, the state continues to use private investment to fund firms that it controls. See John Paul Rathbone & Andrew Downie, *Banco do Brasil Looks to Raise \$6bn*, FIN. TIMES, June 30, 2010, at 17.

124. See *Petrobras: Over a Barrel*, ECONOMIST, Sept. 4, 2010, at 70.

125. Mauro Rodrigues da Cunha, *A Capitalização da Petrobras é Prejudicial aos Acionistas Minoritários?*, 84 REVISTA CAPITAL ABERTO (2010).

126. *Petrobras: Over a Barrel*, *supra* note 124, at 70.

per barrel defended by minority investors and the price of \$10 or \$12 initially hinted at by the government.¹²⁷ The set price likely reflected a delicate balance between political and economic considerations. On the one hand, self-dealing by the government is politically popular, which in itself constitutes a strong reason for expropriating minority shareholders in a presidential election year.¹²⁸ On the other hand, Petrobras's need for capital to finance the exploration of the new reserves likely deterred the government from setting an overly inflated price, since the company's simultaneous stock offering could be jeopardized by such a serious abuse of minority investors. What is perhaps most worrisome is that a transaction structure designed to address national interests in a high-profile SOE transaction may well set a precedent for what constitutes permissible related-party transactions under Brazil's Corporations Law.

Petrobras's record share offering was completed in September 2010. By raising approximately US\$67 billion, it became the largest share offering in history.¹²⁹ Following the offering, the São Paulo Stock and Futures Exchange (BM&F Bovespa) became the world's second-largest stock exchange by market capitalization.¹³⁰ Buyers of Petrobras's stock included Brazilian and foreign investors, who considered that the risks of government abuse of outside shareholders were outweighed and mitigated by the sheer size of the company's oil reserves and its likely need to access capital markets again in the near future,¹³¹ although other investors deemed the offering overvalued and warned against a bubble.¹³² Interestingly, the government's ownership stake in Petrobras actually *increased* as a consequence of this offering (from about 40 percent to 48 percent of the company's total equity), showing that the state's role as a shareholder, and its interest in an inefficiently weak corporate governance regime, are not going away in the near future.¹³³

C. China

China is home to the most recent large-scale experiment with listed SOEs. In the 1990s, a large number of Chinese state-owned firms, which

127. *Id.*; Rodrigues da Cunha, *supra* note 125.

128. *Petrobras: Over a Barrel*, *supra* note 124, at 72 ("With elections due on October 3rd, Brazil's government was anxious to avoid the accusations of selling the country short that would have followed had it set an investor-pleasing price for the oil.").

129. See Jonathan Wheatley, *Petrobras Offering Raises \$67bn*, FIN. TIMES (Sept. 24, 2010), available at <http://www.ft.com/intl/cms/s/0/22437018-c778-11df-aeb1-00144feab49a.html>.

130. See Vincent Bevins, *Caution and Tough Regulation Are All-Weather Assets*, FIN. TIMES, Nov. 15, 2010, at 4.

131. See Herbert Lash, *Analysis: Petrobras Sale Draws Foreign Buyers Despite Risks*, REUTERS (Sept. 23, 2010), <http://www.reuters.com/article/2010/09/23/us-petrobras-investors-idUSTRE68M4SV20100923>.

132. Alexander Ragir, *Mobius Calls Petrobras Offering an "Abomination," May Represent a "Bubble,"* BLOOMBERG (Sept. 24, 2010), <http://www.bloomberg.com/news/2010-09-24/mobius-calls-petrobras-offering-an-abomination-may-represent-a-bubble.html>.

133. See Wheatley, *supra* note 129.

until then were operated by government agencies, were transformed into business corporations. At the same time that most of the Western world was undertaking standard privatization programs, the Chinese government embraced “corporatisation” as an integral part of its economic modernization strategy.¹³⁴ While some observers saw in the corporatization strategy a first step in the transition toward private control of enterprise, the goal of the Communist Party was arguably the reverse, that is, to increase state control of economic activity through leverage.¹³⁵

The Shanghai Stock Exchange opened in 1990 with IPOs of a number of SOEs.¹³⁶ Between 1991 and 1998, more than 600 firms that were previously wholly owned by the government went public in China.¹³⁷ As was the case in a number of capitalist economies in previous decades, minority interests in many of the newly corporatized SOEs were publicly traded and listed on national (and, increasingly, international) stock exchanges. By 1999, a typical listed SOE in China had just over 60 percent of its equity held by the government in the form of non-tradable shares, with the remainder of the firm’s stock being listed on the exchange and held by private investors.¹³⁸ A 2005 legal reform allowed for the conversion of non-tradable into tradable shares, a change that is expected to gradually eliminate China’s two-tier share structure.¹³⁹

While state-owned firms still dominate Chinese capital markets, the relative participation of entirely private issuers has been growing in recent years. The proportion of companies traded in Chinese exchanges having the state as a major or controlling shareholder has declined, from about 97 percent in 1997 to roughly 75 percent in 2003 and 60 percent in 2007, but

134. Cyril Lin, *Corporatisation and Corporate Governance in China’s Economic Transition*, 34 *ECON. PLAN.* 5, 6 (2001).

135. The goal of increasing state control over business through leverage is explicitly mentioned in a key Communist Party document issued in 1999. Donald Clarke, *Corporatisation, Not Privatisation*, 7 *CHINA ECON. Q.* 27, 28 (2003); see also Li-Wen Lin & Curtis J. Milhaupt, *We Are the (National) Champions: Understanding the Mechanisms of State Capitalism in China* 55–56 (Columbia Univ. Ctr. for Law & Econ. Studies, Working Paper No. 409, 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1952623 (examining the complex web of firms and relationships that characterizes China’s industrial organization, and suggesting that future reforms might “further enhance and legitimize state control over important corporate assets rather than impel a transition to dispersed ownership structures and diminished political involvement in corporate governance”).

136. See Zhiwu Chen, *Capital Markets and Legal Development: The China Case*, 14 *CHINA ECON. REV.* 451, 453 (2003).

137. See Jing Yu, *State-Owned Enterprise Reform in China: A Gradual Privatization Under an Uncertain Legal Regime* 6 (Mar. 28, 2002) (unpublished JSD Dissertation, Yale Law School) (on file with Lillian Goldman Library, Yale Law School).

138. See Katharina Pistor & Chenggang Xu, *Governing Stock Markets in Transition Economies: Lessons from China*, 7 *AM. L. & ECON. REV.* 184, 188 (2005) (citing CSRC data between 1999 and 2002).

139. See James Ahn & David Cogman, *A Quiet Revolution in China’s Capital Markets*, *MCKINSEY Q.*, Summer 2007, at 18, 20.

remains significant.¹⁴⁰ As of mid-2010, the top ten state-owned firms made up almost 40 percent of the Shanghai Stock Exchange market capitalization.¹⁴¹

As in other jurisdictions, the presence of the state as the dominant shareholder in the economy has had a profound impact on the nature and structure of China's corporate and securities laws. China's Company Law of 1994, enacted in response to the ongoing corporatization process, was designed with the needs and objectives of SOEs in mind. As in other jurisdictions, however, China's Company Law applied to government and privately controlled firms alike, with the result that the interests of the state as a shareholder imposed negative externalities on the legal regime available to private firms. In his overview of corporate governance practices in China, Donald Clarke encapsulates the problem by noting that

the need to provide for the special circumstances of state sector enterprises ends up hijacking the entire Company Law so that instead of state sector enterprises being made more efficient by being forced to follow the rules for private sector enterprises (the original ambition), potential private sector enterprises are hamstrung by having to follow rules that make sense only in a heavily state-invested economy.¹⁴²

State interests have molded China's original corporate laws—hence making them ill-adapted to private sector corporations—through numerous different channels. First, China's 1994 Company Law was largely mandatory, rather than enabling, in nature. Tailored to the needs of recently corporatized state firms, China's corporate laws—which included specific legal mandates about the reinvestment of profits and the minimum and maximum number of board members—offered a regime that was overly rigid and therefore dysfunctional when applied to privately owned companies.¹⁴³

The shortcomings of China's corporate laws were even more serious when it came to shareholder protection, a failure that earned Chinese capital markets the reputation for being “worse than a casino.”¹⁴⁴ According to an OECD report on corporate governance practices in China, Chinese stock markets were rife with cases of abuse by the state, as controlling shareholder, by means of related party transactions.¹⁴⁵ Although on paper, Chinese law allocated significant power to shareholders—such as the right

140. See Lin, *supra* note 134, at 24 (for 1997); OECD, CHINA IN THE GLOBAL ECONOMY: GOVERNANCE IN CHINA 314 (2005) (for 2003); Benjamin L. Liebman & Curtis J. Milhaupt, *Reputational Sanctions in China's Securities Markets*, 108 COLUM. L. REV. 929, 938 (2008) (for 2007).

141. William T. Allen & Han Shen, *Assessing China's Top-Down Securities Markets* 8 (N.Y. Univ. Sch. of Law, Pub. Law & Legal Theory Research Paper Series, Working Paper No. 10-70, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1648336.

142. Donald C. Clarke, *Corporate Governance in China: An Overview*, 14 CHINA ECON. REV. 494, 495 (2003).

143. See *id.* at 501.

144. OECD, *supra* note 140, at 314.

145. *Id.*

to monitor firm management and to make decisions about dividend distributions—in practice, these provisions served to protect the government as a controlling shareholder while denying meaningful legal rights to minority investors.¹⁴⁶ Prominent scholars argued that, despite the lack of legal protection for minority investors, extralegal substitutes existed in China to encourage the adoption of reasonable corporate governance practices.¹⁴⁷ Still, extralegal substitutes, while helpful, are often imperfect—and, given the prominence of the state’s interests as a controlling shareholder in a large number of listed firms, significant legal improvements are unlikely to be forthcoming.

Subsequent developments concerning the admissibility and requirements of securities actions in China provide a paradigmatic example of how the interests of the state as a shareholder can hinder the enforcement of investor rights. Confronting a then-recent rise in the number of private securities actions filed in Chinese courts, the Supreme People’s Court of China issued a notice in 2001 directing lower courts to temporarily suspend the filing of securities lawsuits.¹⁴⁸ A series of interviews conducted by Zhiwu Chen revealed that one of the main reasons behind the suspension of securities litigation in China was the Court’s concern that these lawsuits, if successful, could bring about major financial losses to the state as the controlling shareholder of most corporate defendants.¹⁴⁹

In 2002, the Supreme People’s Court lifted the general suspension and issued a new set of rules to govern private securities litigation in China. Although praised by the domestic media, foreign commentators viewed the new regulations as posing “several daunting obstacles” to plaintiffs in securities lawsuits against both state and private corporations.¹⁵⁰ In addition to other procedural and substantive requirements, the regulations made the filing of securities lawsuits conditional on the prior imposition of administrative or criminal penalties by the government, hence significantly weakening the prospects of successful initiation of securities fraud claims expressly contemplated by Chinese securities laws. The result is that conflicts of interest stemming from the state’s stockholdings—which were

146. See Yu, *supra* note 137, at 76.

147. See generally Franklin Allen et al., *Law, Finance, and Economic Growth in China*, 77 J. FIN. ECON. 57 (2005) (stating that China has low levels of investor protection, underdeveloped capital markets, and corporate control concentrated in the hands of the state or founders’ families). *But see* Liebman & Milhaupt, *supra* note 140, at 977 (asserting that Chinese stock exchanges’ application of shaming sanctions helps promote good corporate governance in the absence of a strong legal environment); Pistor & Xu, *supra* note 138, at 196–206 (arguing that China’s system of administrative governance through the quota system compensates for the deficiencies of legal governance protections).

148. For a detailed discussion of securities litigation developments in China, see Walter Hutchens, *Private Securities Litigation in China: Material Disclosure About China’s Legal System?*, 24 U. PA. J. INT’L ECON. L. 599 (2003).

149. See Chen, *supra* note 136, at 465. Other stated reasons for the suspension included concerns about a massive inflow of securities cases, a lack of expertise to address the suits, and the risk of conflicting decisions. *Id.* at 640.

150. Hutchens, *supra* note 148, at 599.

probably a key driving force behind the new rules—are likely to frustrate private enforcement efforts, since “the Chinese state will most likely not authorize massive litigation against itself or its assets on a routine basis.”¹⁵¹

In 2005, China’s corporations and securities statutes underwent a major overhaul, which, according to some commentators, changed the existing statute “almost beyond recognition.”¹⁵² In a few respects, the revisions eliminated previously existing shareholder protections, such as a mandatory bid rule at a “fair price” upon the acquisition of a 30 percent stake in a firm.¹⁵³ But in more fundamental respects, the revisions promised greatly improved protection for the rights of public shareholders. The new rules imposed fiduciary duties on managers and controlling shareholders, required listed firms to have independent directors, permitted derivative suits, and recommended (but did not mandate) cumulative voting.¹⁵⁴

Different factors help explain the recent improvements in minority shareholder rights in China in the face of massive government ownership and the attendant conflicts of interest. First, Chinese authorities and the branches of government that control business corporations are to a degree separated, either fortuitously or by design, from the authorities that make and enforce corporate and capital markets law. While local authorities have an interest in exploiting the minority shareholders of the firms they control, the central government and its agencies—including the increasingly active Chinese Securities Regulatory Commission (CSRC)—is often keen to rein in abusive behavior by powerful local actors and foster capital market development.¹⁵⁵

Second, even though private (and government) controlled corporations in China are largely subject to the same unitary legal regime, there is growing evidence of a differentiated approach in enforcement. China’s emerging takeover regulation permits the CSRC to exempt certain transactions from existing rules, hence selectively favoring the state’s interests in merging state-owned firms to create national champions.¹⁵⁶ Additionally, even though SOEs dominate China’s capital markets, they receive sanctions from the CSRC less frequently than do private firms.¹⁵⁷ A recent event study

151. *Id.* at 640.

152. See, e.g., Nicholas Calcina Howson, *The Doctrine that Dared Not Speak Its Name: Anglo-American Fiduciary Duties in China’s 2005 Company Law and Case Law Intimations of Prior Convergence*, in *TRANSFORMING CORPORATE GOVERNANCE IN EAST ASIA* 193, 193 (Hideki Kanda et al. eds., 2008).

153. Xin Tang, *Protecting Minority Shareholders in China: A Task for Both Legislation and Enforcement*, in *TRANSFORMING CORPORATE GOVERNANCE IN EAST ASIA*, *supra* note 152, at 145.

154. See *id.* at 143.

155. See Nicholas C. Howson, *Private Shareholders’ Suits in the People’s Republic of China: Making “Rule of Law” from the Bottom Up* 26–27 (2011) (unpublished manuscript) (on file with author) (describing the role of the CSRC in pushing for the increased availability of private shareholder suits in China).

156. Armour et al., *supra* note 12, at 80.

157. Allen & Shen, *supra* note 141, at 21 (warning that the possibility that SOEs are more law abiding cannot be discarded).

provides evidence of China's dual approach to enforcement. It found that only private firms experienced large abnormal returns around the announcement of regulatory changes designed to improve minority investor protection in China, thus suggesting that investors do not expect regulators to enforce these more stringent standards against SOEs.¹⁵⁸ Moreover, the 2008 Law on State-Owned Assets of Enterprises grants to the State-Owned Assets Supervision and Administration Commission (SASAC)—China's central holding company, and arguably the world's "largest controlling shareholder"¹⁵⁹—control rights that are superior to those available to private shareholders under the Company Law.¹⁶⁰ Although this dual standard is often the subject of criticism, it likely helps to mitigate the interests of the state as controlling shareholder in the development of the general corporate law regime.

Finally, despite these formal improvements to the "law on the books," the extent to which the new regime will effectively protect minority investors remains to be seen. Shortcomings in enforcement—which are certainly compounded when the state is the controlling shareholder—may undermine most protections formally conferred by the statute.¹⁶¹ For instance, Donald Clarke and Nicholas Howson have noted that, notwithstanding the new provisions in China's 2006 Company Law expressly permitting derivative action, derivative suits involving publicly traded corporations remain virtually non-existent, a phenomenon that they attribute to the courts' reluctance to accept politically charged cases.¹⁶²

While the overt influence of the interests of the state as a controlling shareholder on China's corporate governance environment have been sufficiently conspicuous to attract the attention of legal and economic scholars of Chinese capital markets,¹⁶³ this phenomenon is hardly unique to China; rather, it is widespread among jurisdictions where the state serves simultaneously as shareholder and corporate governance regulator. The state's pervasive presence in the Chinese economy has only made more severe a problem that is equally common, if more subtle, in Western economies where mixed enterprise plays a significant role.

158. See generally Henk Berkman, Rebel A. Cole & Lawrence J. Fu, *Political Connections and Minority-Shareholder Protection: Evidence from Securities-Market Regulation in China*, 45 J. FIN. & QUANTITATIVE ANALYSIS 1391 (2011).

159. Lin & Milhaupt, *supra* note 135, at 45.

160. See *id.* at 43 (noting that share transfers involving SOEs require the approval of SASAC even in situations in which controlling shareholders would not have veto rights under the Company Law).

161. Tang, *supra* note 153, at 147 ("Protections for the minority shareholders on the books do not seem bad, but legal enforcement remains a problem.")

162. See Donald C. Clarke & Nicholas H. Howson, *Pathway to Minority Shareholder Protection: Derivative Actions in the People's Republic of China* 40 (Sept. 30, 2010) (unpublished manuscript) (on file with author).

163. See, e.g., Clarke, *supra* note 135, at 30; Lin, *supra* note 134, at 26–27.

D. Continental Europe

State-owned enterprises, including mixed enterprises, figured prominently in twentieth-century Europe. By 1977, nineteen (38 percent) of the top fifty largest industrial companies in Europe were state-owned, and nine (18 percent) of them were mixed enterprises.¹⁶⁴ While the top fifty included a number of British companies (including wholly owned state corporations), eight of the nine largest mixed enterprises were Italian, German, or French.¹⁶⁵ The following vignettes of historical developments in Italy, Germany, and France illustrate the extent to which the interests of the state as a shareholder may have influenced the content of corporate laws in those jurisdictions.

1. Italy

Historically, controlling families and the state have dominated the corporate landscape in Italy. As capital markets declined after a 1907 liquidity crisis, the state gradually took over industries that had previously been run by private companies, such as railroads, banks, and insurance. In the 1930s, adverse economic conditions prompted an even greater incursion of the state into business activity. Established in 1933, the Istituto per la Ricostruzione Industriale (IRI) became the government-owned holding company of the state's equity interests in various banks and industrial corporations, including listed firms.¹⁶⁶ Although initially envisioned as a temporary response to economic emergency, both state and family control of corporations thereafter reached a stable equilibrium for most of the twentieth century. Mixed enterprise was quite significant in twentieth-century Italy, accounting for 18 percent of the number of listed firms and over 25 percent of total market capitalization by 1992.¹⁶⁷

As the Italian system of corporate governance consolidated into a model of state and family capitalism, attempts to increase investor protection and develop capital markets stalled. In their empirical study of the evolution of corporate ownership in Italy, Alexander Aganin and Paolo Volpin find that, after controlling for other relevant channels, the development of the Italian stock market has been positively correlated with investor protection and openness, and negatively correlated with government intervention.¹⁶⁸ They also note that the greatest improvements in investor protection in Italy

164. *Public Sector Enterprise: The State in the Market*, ECONOMIST, Dec. 30, 1978, at 51.

165. The other top mixed enterprise at that time was British Petroleum, previously a wholly owned corporation that had then recently begun to be privatized by the U.K. government.

166. For an excellent description of the evolution of corporate governance and ownership structures in Italy, see Guido Ferrarini, *Corporate Governance Changes in the 20th Century: A View from Italy* (European Corporate Governance Inst. Working Paper Series in Law, Working Paper No. 29, 2005).

167. Andrea Goldstein, *Privatization in Italy, 1993-2003: Goals, Institutions, Outcomes and Outstanding Issues*, in PRIVATIZATION EXPERIENCES IN THE EUROPEAN UNION 225, 256 (Marko Köthenbürger et al. eds., 2006).

168. Aganin & Volpin, *supra* note 11, at 342.

occurred at precisely the same time as the state was retreating from corporate ownership during the privatization process, since “[t]he government coupled the sale of assets with substantial improvement of the legal protection for minority shareholders.”¹⁶⁹ The authors interpret this finding as evidence that state ownership operates as a substitute for capital markets, arguing that “[d]irect intervention by the state as an entrepreneur partially replaced and crowded out the role of the private sector in the accumulation of capital.”¹⁷⁰

The potential of the state as controlling shareholder to influence corporate lawmaking provides another possible causal link between state presence and legal protection of investors, which, in turn, facilitates capital market development. The Italian case, however, raises the question of why the interests of the government as a selling shareholder in the privatization process contributed to greater investor protection and capital market development in Italy when it had precisely the opposite effect in Brazil. One possible explanation—namely, that the Italian government was more inclined to respect minority shareholder rights to begin with—does not find support in the evidence. In the late 1980s and the 1990s, Italian law permitted controlling shareholders, including the state, to extract extraordinary levels of private benefits to the detriment of minority investors.¹⁷¹

For example, Zingales provides strong anecdotal evidence suggesting that, like private controlling shareholders, the Italian government profited handsomely by engaging in abusive related party transactions to the detriment of minority investors. In 1992, the IRI, which is 100 percent owned by the Italian government, transferred its 83.3 percent equity stake in software company Finsiel to the telecommunications group STET, a mixed enterprise that is 47 percent owned by small investors but also controlled by the IRI.¹⁷² Despite the fact that, due to then-new EEC regulations, Finsiel was soon to lose its monopoly position and face increased competition, the company was priced at fifty times its earnings—a generous valuation compared to a standard multiple of twenty or thirty in similar international transactions.¹⁷³ STET’s stock price fell by 20 percent upon the announcement of the transaction.¹⁷⁴ Zingales estimates that this single transaction resulted in a wealth transfer from minority shareholders to the

169. *Id.* at 326.

170. *Id.*

171. Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537, 551 (2004) (finding that Italy had an estimated level of private benefits of control of 37 percent of firm value, compared to 65 percent in Brazil); Luigi Zingales, *The Value of the Voting Right: A Study of the Milan Stock Exchange Experience*, 7 REV. FIN. STUD. 125, 127 (1994) (finding that in Italy, private benefits of control were worth more than 60 percent of the value of the non-voting stock).

172. Zingales, *supra* note 171, at 146.

173. *Id.*

174. *See id.*

government in the amount of at least US\$110 million, or 7 percent of the equity value held by outside investors.¹⁷⁵

Another possible explanation for the divergent outcomes in Brazil and Italy is the difference in the number and scale of enterprise under whole versus partial state ownership in the two countries—the theory being that greater private capital participation in SOEs increases incentives for minority expropriation, while a sale of wholly owned subsidiaries makes it impossible for the state to maximize revenue by tinkering with the intra-shareholder distribution of sales proceeds, and therefore encourages the adoption of measures that maximize firm value. Since Brazil's largest and most profitable state-owned firms were publicly traded (such as telecom Telebras and mining firm Vale do Rio Doce), the government stood to profit by abusing minority investors when selling control of the firm. By contrast, a number of important SOEs to be privatized in Italy were still wholly owned subsidiaries of the state and organized under public law, thus allowing the government to internalize the benefits of an improved corporate governance environment in the form of higher sales proceeds.¹⁷⁶

The stated goals of the privatization process in Brazil and Italy are still another factor that may account for the different outcomes in the two jurisdictions. Brazil's privatization statute listed a number of competing objectives—such as the reduction of public debt through privatization proceeds and the development of capital markets—without establishing any order of priority.¹⁷⁷ Conversely, Italy's privatization program listed greater corporate efficiency, increases in market competition, and the development of financial markets as its three main goals.¹⁷⁸ Increased fiscal revenues and reduction of public debt were specifically ranked as “residual” objectives.¹⁷⁹ This suggests that, given the opportunity of expropriating minority shareholders, privatizations of mixed enterprises may be more conducive to the enactment of laws that improve investor protection and corporate governance standards precisely when revenue maximization is not the foremost objective.

Finally, there were more public share issue privatizations—as opposed to a private sale by the government of a controlling block of shares—in Italy than in Brazil, perhaps because Italy's policymakers placed a higher priority on capital market development as one of the goals of the privatization process. Although there were a number of block sales to strategic investors in the early 1990s, public share offerings became the dominant sales method in Italy after 1994.¹⁸⁰ Also, maximizing sales proceeds through public offerings requires increased investor confidence, which in turn

175. *Id.* at 147.

176. Goldstein, *supra* note 167, at 226–27.

177. *See supra* Part I.B.

178. Goldstein, *supra* note 167, at 228.

179. Bernardo Bortolotti, *Italy's Privatization Process and Its Implications for China* 10 (Fondazione Eni Enrico Mattei Note di Lavoro Series, Working Paper No. 118.05, 2005), available at <http://ssrn.com/abstract=833265>.

180. Goldstein, *supra* note 167, at 233.

encouraged the government to promote legal reforms that improved protections for minority investors.¹⁸¹

However, despite recent corporate governance improvements¹⁸² and the implementation of a large-scale and generally successful privatization program, the continued presence of the government as a shareholder in Italy provides reason for concern.¹⁸³ If, at €21.3 billion, the aggregate revenues of Italy's privatizations are significant by international standards, the share of proceeds resulting from control transfers (€50.4 billion) presents a different picture.¹⁸⁴ Although the state's overall equity interest in publicly traded companies has nearly halved since the 1990s (from 18 percent of market capitalization in 1990 to 9.5 percent in 2005), the Italian government's control of listed firms remains significant despite the wave of privatizations.¹⁸⁵ By 2001, listed firms controlled by the Italian government still accounted for 22.4 percent of total market capitalization (down from 45 percent in 1996),¹⁸⁶ which suggests that the conflict of interest stemming from the state's dual role as shareholder and regulator is likely to persist.

2. Germany

In the twentieth century, mixed enterprises (*gemischtwirtschaftliche Unternehmen*) were first popularized in Germany but later spread rapidly across Europe and beyond. Interestingly, Germany is widely recognized as the birthplace of modern institutional theories of the business corporation, according to which the purpose of the firm is not merely to maximize shareholder value, but rather to satisfy the public interest. While the relationship between theories of corporate purpose and ownership structure is certainly complex, it is at least suggestive that conceptions of the corporation as a state-like entity in charge of promoting the public good first gained ascendancy precisely in the jurisdiction that led the way in the use of mixed enterprises.

The interests of the government as a shareholder have played a visible role in Germany's corporate lawmaking process. A 1965 corporate law reform failed to outlaw the issuance of multi-voting stock due to strong

181. See Bortolotti, *supra* note 179, at 18.

182. See Luca Enriques, *Corporate Governance Reforms in Italy: What Has Been Done and What Is Left to Do*, 10 EUR. BUS. ORG. L. REV. 477, 481 (2009) (analyzing corporate governance reforms in Italy in recent decades).

183. For a positive assessment of Italy's privatization program, see William L. Megginson & Dario Scannapieco, *The Financial and Economic Lessons of Italy's Privatization Program*, 18 J. APPLIED CORP. FIN. 56 (2006).

184. Goldstein, *supra* note 167, at 235.

185. Marcello Bianchi & Magda Bianco, *Italian Corporate Governance in the Last 15 Years: From Pyramids to Coalitions?* 27 (European Corporate Governance Inst. Working Paper Series in Finance, Working Paper No. 144, 2006), available at <http://ssrn.com/abstract=952147>.

186. COMMISSIONE NAZIONALE PER LE SOCIETÀ E LA BORSA (CONSOB), *RELAZIONE PER L'ANNO 2001*, at 184 (2002).

opposition from local governmental authorities, who used special shares to exert a degree of control disproportionate to their capital contributions.¹⁸⁷ The self-interests of local governments prevented reform in the direction of one-share, one-vote until as late as 1998, and even then was overcome only by creating a special set of exceptions for governmental enterprise. The reform as enacted was the result of a political compromise.¹⁸⁸ While the Law on Transparency and Control in Corporations (*Gesetz zur Kontrolle und Transparenz im Unternehmensbereich* (KonTraG)) of 1998 prohibited voting caps and multi-voting rights, contrary provisions contained in special statutes on mixed enterprises—notably the Volkswagen law, which imposed voting caps and granted veto rights to the State of Lower Saxony—remained unaffected by the new legislation.¹⁸⁹

The interests of the German government as a shareholder also played an important part in the promotion of a “shareholder culture” in connection with its privatization process in the 1990s, of which the record-breaking IPO of Deutsche Telekom, in what was the largest public offering in European history, is a prominent example. A key government objective behind the sale of its stake in Deutsche Telekom was to maximize revenue in order to help Germany meet the budget requirements for the Economic and Monetary Union.¹⁹⁰ Nevertheless, as in Italy, but in sharp contrast to Brazil, the profit-maximizing ambitions of the German government led it to support, rather than suppress, outside investor rights.¹⁹¹

The more benign role of the German government in the corporate governance reform process was not the product of good intentions alone, but rather was facilitated by the ownership structure of the firms to be

187. Ulrich Seibert, *Control and Transparency in Business (KonTraG): Corporate Governance Reform in Germany*, 10 EUR. BUS. L. REV. 70, 72 (1999) (noting that the failure to eliminate super-voting stock “served to take account of the interests of local authorities, which wished to retain their influence on corporate policy by means of multiple-voting shares without needing to participate in necessary capital increases”).

188. See Sigurt Vitols, *From Banks to Markets: The Political Economy of Liberalization of the German and Japanese Financial Systems*, in THE END OF DIVERSITY? 240, 253 (Kozo Yamamura & Wolfgang Streeck eds., 2003) (“KonTraG was passed when these provisions were changed and thus opposition was dropped.”); Susanne Lütz, *From Managed to Market Capitalism? German Finance in Transition*, 9 GERMAN POL. 149, 164 (2000) (noting that “[a]gainst the initial plans of the Justice Ministry,” the Volkswagen law remained intact follow the adoption of the KonTraG).

189. Nevertheless, the European Court of Justice has more recently challenged the validity of the Volkswagen law. See Case C-112/05, *Commission v. Germany*, 2007 E.C.R. I-8995 (finding that the special shareholder rights of the State of Lower Saxony provided by the Volkswagen law violate the E.U. principle of free movement of capital). For a discussion of the case and its legal implications, see Wolf-Georg Ringe, *Company Law and Free Movement of Capital*, 69 CAMBRIDGE L.J. 378 (2010).

190. See Jeffrey N. Gordon, *The International Relations Wedge in the Corporate Convergence Debate*, in CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE 161, 171–72 (Jeffrey N. Gordon & Mark J. Roe eds., 2004).

191. For a description of the impact of the Deutsche Telekom privatization on the corporate governance environment in Germany, see *id.* at 164–65 (“The Telekom privatization in turn led the German government, eager to obtain a high price, to promote shareholder capitalism by cultural, market, and legal intervention.”).

privatized. In Brazil, the crown jewels among the SOEs were already listed on the exchange and had a substantial number (often a majority) of public shareholders, which permitted the government to profit financially by exploiting the minority and appropriating the control premium to itself. By contrast, Deutsche Telekom was previously a wholly owned subsidiary of Germany's national government, and it soon became clear that a flotation of the company in a good corporate governance environment would maximize the government's revenue from privatization. As explained by Jeffrey Gordon, "Public shareholder protection thus became both politically popular and fiscally prudent."¹⁹² This suggests that privatization can lead the way to corporate law reform in general, above and beyond any improvements in the management of companies that are privatized.

3. France

Famous for its *dirigiste* approach to economic policy, France boasted a large number of mixed enterprises (*sociétés d'économie mixte*) throughout the twentieth century. Mixed enterprises first appeared in France in the interwar period in imitation of foreign (notably German) experience.¹⁹³ Some mixed enterprises date back to the 1920s, while others, such as Renault and Francolor, were taken over by the government as enemy property following World War II.¹⁹⁴ The French government initially participated as a minority investor in the first mixed enterprises of the 1920s, although majority state control gradually became the norm in most *sociétés d'économie mixte* in the following years.¹⁹⁵

The interests of the French state as a shareholder have apparently impinged on the legal regime applicable to business corporations (*sociétés anonymes*).¹⁹⁶ The institutional orientation of France's corporate law toward the "interests of the corporation" (*intérêt social*)—as opposed to the interests of shareholders that arguably dominate U.S. law—is well suited to SOEs.¹⁹⁷ Furthermore, France's peculiar regime of "tenured" double

192. *Id.* at 187.

193. JEAN-DENIS BREDIN, L'ENTREPRISE SEMI-PUBLIQUE ET PUBLIQUE ET LE DROIT PRIVE 19 (1957); GEORGES RIPERT, ASPECTS JURIDIQUE DU CAPITALISME MODERNE 315 (1946) (describing the proliferation of mixed enterprises in France as a foreign import).

194. See, e.g., Raymond Vernon, *Enterprise and Government in Western Europe*, in *BIG BUSINESS AND THE STATE: CHANGING RELATIONS IN WESTERN EUROPE* 3, 7 (Raymond Vernon ed., 1974).

195. BREDIN, *supra* note 193, at 47–48.

196. See R. Houin, *La Gestion des Entreprises Publiques et les Methods de Droit Commercial*, in *ARCHIVES DE PHILOSOPHIE DU DROIT: LA DISTINCTION DU DROIT PRIVÉ ET DU DROIT PUBLIC ET L'ENTREPRISE PUBLIQUE* 79, 81 (1952) (arguing that the emergence of state-owned enterprises could have an impact on commercial laws by enhancing the public law character of its rules).

197. See, e.g., James A. Fanto, *The Role of Corporate Law in French Corporate Governance*, 31 *CORNELL INT'L L.J.* 31, 47 (1998) ("The concept of the *intérêt social*, which permeates the French corporate code, permits directors to consider the interests of all constituencies in deciding upon corporate strategy . . . [allowing] the State-owner to use controlled corporations for purposes other than profit-making.").

voting rights—according to which corporate charters may confer double voting rights to registered shareholders who have held their shares for a minimum period of two to four years—is particularly responsive to the state’s interests as a shareholder. Although the provision’s purpose is to give a loyalty premium to long-term shareholders, whose interests are supposedly better aligned with those of the company, a practical effect of this rule is to magnify the voting power of the state, which is invariably a long-term holder.¹⁹⁸

As elsewhere, the wave of privatizations starting in the 1980s significantly reduced, but did not by any means eliminate, the state’s equity holdings.¹⁹⁹ Charter provisions conferring double voting rights remain standard practice among French corporations, despite evidence that they facilitate expropriation of minority shareholders.²⁰⁰ This rule also benefits controlling shareholders of private firms, who have fiercely resisted proposals to adopt an unqualified regime of one-share, one-vote. The French government is said to have forcefully and successfully defended the exemption of double voting rights from the E.U. takeover directive, which otherwise prevents the use of multi-voting stock or capped voting as takeover defenses.²⁰¹

II. CORPORATE GOVERNANCE AFTER THE WAVE OF PRIVATIZATIONS

The foregoing case studies have illustrated how the interests of the state as a shareholder in different historical and legal contexts have played a key role in shaping the corporate law regimes applicable to both public and private firms. This part speculates on whether and to what extent the (relative) retreat of state ownership worldwide following the wave of privatizations in the 1980s and 1990s has impacted the political economy of corporate governance and, consequently, the observed levels of capital market development.

It is now well established that the implementation of privatization strategies and rising levels of capital market activity worldwide in the late 1980s and 1990s were roughly contemporaneous.²⁰² Just as the

198. See Henry Hansmann & Reinier Kraakman, *The Basic Governance Structure*, in *THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH* 33, 56 (Reinier R. Kraakman et al. eds., 2004) (maintaining that the award of double voting rights “serves to deter takeovers and enhances the power of the state as shareholder”).

199. See *ORG. DE COOPÉRATION & DE DEV. ÉCON., ÉTUDES ÉCONOMIQUES DE L’OCDE: FRANCE* 44 (2005) (noting that even after the privatizations, the presence of state-owned enterprises in France is comparatively greater than in other OECD countries).

200. See generally Chiraz Ben Ali, *Disclosure and Minority Expropriation: A Study of French Listed Firms* (2009) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1406165 (finding an association between double voting rights and minority expropriation).

201. See Ben Clift, *The Second Time as Farce? The EU Takeover Directive, the Clash of Capitalisms and the Hamstrung Harmonization of European (and French) Corporate Governance*, 41 *J. COMMON MKT. STUD.* 55 (2009).

202. See Bernardo Bortolotti et al., *Privatization and Stock Market Liquidity*, 31 *J. BANKING & FIN.* 297, 298 (2007) (“A remarkable wealth of evidence shows the correlation

international wave of privatizations reached its apex, equity markets around the globe experienced unprecedented growth. A study by Maria Boutchkova and William Megginson shows that the increase in market capitalization and liquidity levels in non-U.S. markets, where privatizations were most common, far exceeded the contemporaneous financial boom experienced in the United States.²⁰³ Non-U.S. markets saw a twelve-fold increase in market capitalization, and a twenty-fold increase in trading volumes, between 1983 and 1999.²⁰⁴ Increases in market capitalization and trading volumes in developing countries were even greater, at twenty-six times and ninety-two times, respectively, during the same period.²⁰⁵

While the privatization literature initially focused on the effects of ownership changes on firm-level performance, the temporal coincidence between the implementation of privatization strategies and the expansion of global equity markets has recently begun to attract scholarly attention. To be sure, the association between privatization and capital market growth is hardly surprising. The very withdrawal of the state as a source of equity and debt financing (through the privatization of government-owned banks) was reasonably expected to increase demand for private financing sources. Moreover, many, if not most, privatization programs were specifically devised to promote the development of local capital markets.²⁰⁶ A number of jurisdictions opted to privatize state-owned firms through public share offerings or SIPs, in which the very divestiture of government shareholdings directly contributed to increase liquidity and market capitalization of local exchanges. By mid-2000, all of the ten largest (and thirty out of the top thirty-four) stock offerings in history were the result of share issue privatizations.²⁰⁷

Nevertheless, the floating of SOEs on stock markets—which represents a direct contribution of privatizations to capital market development—accounts for only a minor fraction of the growth in capital markets worldwide during the period.²⁰⁸ A plausible but overlooked mechanism

between financial market development and privatization.”); Narjess Boubakri & Olfa Hamza, *The Dynamics of Privatization, the Legal Environment and Stock Market Development*, 16 INT’L REV. FIN. ANALYSIS 304, 326–29 (2007) (finding that while privatizations have no simultaneous effect on the development of equity markets, it has a lagged effect of one or two years depending on the quality of the legal regime, the privatization method, and the intensity or depth of the privatization strategy).

203. See Maria K. Boutchkova & William L. Megginson, *Privatization and the Rise of Global Capital Markets*, 29 FIN. MGMT. 31 (2000) (discussing the development of capital markets worldwide during the 1990s, and the role played by share issue privatizations).

204. *Id.* at 35–36.

205. *Id.* at 36–37.

206. *Id.* at 31.

207. *Id.* at 50. Bortolotti and colleagues find that share issue privatizations contribute to the development of capital markets by increasing market liquidity. See *supra* note 202.

208. Economists Enrico Perotti and Pieter van Oijen have provided some initial empirical evidence to suggest that privatizations have an indirect effect on capital market development by helping to lower “political risk.” See Enrico C. Perotti & Pieter van Oijen, *Privatization, Political Risk and Stock Market Development in Emerging Economies*, 20 J. INT’L MONEY & FIN. 43, 44 (2001).

through which privatizations might have indirectly contributed to capital market development is by facilitating the adoption of stronger investor protection laws. The 1990s were not only the golden age of privatizations, but also a period of significant global convergence in corporate governance practices and corresponding improvements in the observed level of shareholder rights. In a study of five large economies, John Armour and colleagues find that while the level of legal protection of minority shareholders was diverging until the late 1980s, there has been significant convergence toward greater investor protection since the mid-1990s—a trend that was not matched by similar levels of convergence in creditor rights and labor regulations.²⁰⁹

I want to raise the possibility that the privatization movement might have had the unintended consequence of improving the political economy of corporate law reforms in at least two ways. First, as was the case in Italy and, to a lesser extent, Germany, the interests of the state as a selling shareholder in SIPs induced the government to improve investor protections so as to maximize its sales proceeds. Second, even in cases like that of Brazil, where the state helped *decrease* investor protection to increase the control premium it was able to obtain in private sales of corporate control, privatizations might have had a lagged effect on the improvement of investor protection and the development of capital markets by reducing the magnitude of the state's financial interests as a controlling shareholder and, consequently, of its vested interest in opposing minority shareholder rights. Thus far, even the economists' laundry lists of the multiple benefits of privatization have overlooked the possible impact of the removal of the state as a major player in the political economy of corporate law reforms.

Nevertheless, the long-term effects of the privatization sales of the 1990s on the political economy of corporate law reforms are likely to be ambiguous at best. Many countries not only failed to eradicate state ownership in its entirety but even maintained or increased the existing number of publicly traded mixed enterprises by engaging in *partial* privatizations that floated minority equity interests in SOEs. A recent study by Bernardo Bortolotti and Maria Faccio shows that governments remain the largest ultimate shareholder of one-third of "privatized" firms.²¹⁰ While the state's interest in maximizing revenue from partial privatizations may have supported the adoption of minority investor protections in the 1990s, the government's continued financial stake in listed firms may lead it to disfavor further improvements in shareholder rights if no additional equity

209. See, e.g., John Armour et al., *How Do Legal Rules Evolve? Evidence from a Cross-Country Comparison of Shareholder, Creditor, and Worker Protection*, 57 AM. J. COMP. L. 579, 620–28 (2009); see also Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439 (2001) (proclaiming that "[t]here is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value," and that "[t]his emergent consensus has already profoundly affected corporate governance practices throughout the world").

210. See generally Bernardo Bortolotti & Mara Faccio, *Government Control of Privatized Firms*, 22 REV. FIN. STUD. 2907 (2009).

sales or issues are in sight. This is especially so because, in a number of cases, the government remains the controlling shareholder by resorting to leveraging devices such as dual-class stock, pyramids, and the like, without holding a proportionate equity interest in the company—hence further increasing the incentives and opportunities for minority expropriation.²¹¹

III. ADDRESSING CONFLICTS OF INTEREST

The previous parts showed how pervasive the conflicts of interest inherent in the government's dual role as shareholder and regulator can be in a variety of historical and legal contexts. This part will explore the potential of different institutional arrangements to mitigate the influence of the government as shareholder in corporate governance institutions. Unlike more conventional instances of conflicts of interest, disclosure in this case is unlikely to provide an adequate remedy. Changes to general corporate laws do not require a vote of the shareholders of the companies affected, while the citizenry is often sympathetic to laws that boost the state's financial interests as a shareholder, be it by maintaining monopolies, as in the nineteenth-century U.S. or by favoring minority expropriation upon control sales as in twentieth-century Brazil.

If disclosure is insufficient to eliminate the state's conflicts of interest, a structural approach becomes necessary to prevent the special interests of the government as a shareholder from frustrating the enactment of an efficient legal regime. Solutions to this problem invariably involve a tradeoff between the strength of the proposed remedy in eliminating the conflict and its political acceptability. I will examine the promise and challenges of two main categories of institutional arrangements to address the conflicts of interest arising out of the state's dual role as corporate governance player and referee: ownership strategies and legal strategies. Ownership strategies eliminate or mitigate the impact of the first role by improving the state's incentives as a shareholder through a conscious choice among different corporate ownership structures. Legal strategies take the existing ownership structure of state-owned enterprise as given, and instead seek to address the state's second role as a general corporate governance regulator either by differentiating the corporate legal regime applicable to private firms and SOEs or by assigning regulatory authority to a private organization or foreign jurisdiction.

A. Ownership Strategies

At least three ownership arrangements exist to mitigate the state's conflicts of interest as shareholder and corporate governance regulator. Listed in order of decreasing effectiveness and increasing political acceptability, these approaches are: (1) wholesale privatization, which

211. *Id.* at 2916 (noting that 52.38 percent of privatized firms in which the government remained the largest shareholder had leveraging devices, such as pyramids or dual-class shares) in place.

eradicates the conflict by eliminating in its entirety the state's role as a shareholder; (2) whole (as opposed to mixed) ownership of SOEs, which eliminates the state's interest in most governance rules typical of multi-owner firms; and (3) minority (as opposed to controlling) shareholdings by the state, which may serve to align the government's interests with those of outside investors in promoting corporate governance reforms.

1. Privatization

A simple—indeed simplistic—solution is to describe the shareholder–regulator conflict as yet another evil of state ownership of enterprise and join the numerous advocates in favor of privatization. Although complete privatization of government stock holdings would certainly eliminate the state's extra shareholder role, such a proposal is unlikely to be effective. While individual privatizations can have an almost immediate impact on firm-level performance, a transformation in the political economy of corporate lawmaking requires the state to relinquish ownership of a critical number of firms. Yet recent experience demonstrates that this is more easily said than done, since even governments that undertook large-scale privatization programs often retain significant shareholdings in major listed corporations.

State ownership has proven to be incredibly resilient in spite of the voluminous, if contentious, literature pointing to the comparative efficiency of private ownership.²¹² And, as the 2008 financial crisis made clear, pragmatic considerations in times of economic turmoil may lead to the emergence of state-owned enterprise even in inhospitable environments such as the United States. It is therefore unlikely that recognizing state ownership's indirect effects on the political economy of corporate lawmaking will tip the balance in favor of divestiture.

212. For reviews of the empirical literature supporting the superiority of private ownership, see, for example, Rafael La Porta et al., *Government Ownership of Banks*, 57 J. FIN. 265, 290 (2002) (finding that higher government ownership of banks in the 1970s is associated with lower subsequent levels of financial development and economic growth); William L. Megginson & Jeffrey M. Netter, *From State to Market: A Survey of Empirical Studies on Privatization*, 39 J. ECON. LIT. 321, 380 (2001) (concluding that “privately owned firms are more efficient and more profitable than otherwise-comparable state-owned firms”); Shirley & Walsh, *supra* note 17, at 51 (stating that out of fifty-two studies, thirty-two conclude that private and privatized firms significantly outperform public firms, fifteen do not find a significant link between ownership and performance, and five studies conclude that public firms perform better than private firms). Nevertheless, a number of works have cast doubts on the inherent superiority of private versus public ownership of enterprise. See, e.g., Kole & Mulherin, *supra* note 22, at 11 (finding no significant differences between the performance of government-controlled companies and private sector firms in the same industry); Stephen Martin & David Parker, *Privatization and Economic Performance Throughout the UK Business Cycle*, 16 MANAGERIAL & DECISION ECON. 225, 235–36 (1995) (finding no evidence that private ownership is inherently more efficient than state ownership); Clifford Zinnes et al., *The Gains from Privatization in Transition Economies: Is “Change of Ownership” Enough?*, 48 IMF STAFF PAPERS 146, 146–48 (2001) (finding that privatization fails to produce economic performance improvements in the absence of deep institutional reforms).

2. Whole Ownership of SOEs

Falling short of privatization, a more politically acceptable alternative to isolate the effects of state equity holdings on the corporate governance environment is through the choice of ownership structure. In order to mitigate the state's conflicts of interest in corporate lawmaking, whole government ownership may in fact be preferable to partial ownership. From the perspective of the political economy of corporate governance, the benefits of state ownership of 100 percent of a firm's equity holdings, as opposed to a lower threshold, are twofold. First, in eliminating the typical agency problems associated with multi-owner firms, whole ownership neutralizes the government's interest (and influence) in most legal provisions that govern the internal affairs rules of corporations. Second, as described in the analysis of the Italian and German cases, whole ownership creates superior incentives for the implementation of efficient corporate governance rules upon control sales. In the absence of expropriation opportunities against a non-existent minority, the government has an incentive to implement a legal regime that increases firm value in order to maximize its sales proceeds.

Even if unconsciously, the United States adopted precisely this approach when it created numerous government-owned corporations in the twentieth century while eschewing mixed enterprises.²¹³ Mixed enterprises were also less common in the United Kingdom compared to Germany, Italy, and France.²¹⁴ Indeed, in the twentieth century, mixed enterprises—as opposed to wholly owned state enterprise—came to be more prevalent in countries traditionally labeled as belonging to the civil law tradition compared to common law countries.

In his 1937 study on government ownership, John Thurston noted that “the practice of governmental participation with private investors has not proved popular in the English-speaking countries.”²¹⁵ He observed that “[c]ontrary to the Continental practice, the English countries appear to favor entire rather than partial government control.”²¹⁶ Although an analysis of the relationship between the ownership structure of SOEs and a country's legal tradition is outside the scope of this Article, the greater incidence of mixed enterprises in “civil law” jurisdictions seems to support the notion that the state's interests as a shareholder might be an important but so far

213. *See supra* Part I.A.

214. *See* Stefan Grundmann & Florian Möslin, *Golden Shares: State Control in Privatised Companies: Comparative Law, European Law and Policy Aspects* 6 (Working Paper, 2003), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=410580 (noting that Britain generally resorted to a system of total ownership by the state, while France, Italy, and Germany employed mixed enterprises to a greater extent).

215. JOHN THURSTON, *GOVERNMENT PROPRIETARY CORPORATIONS IN THE ENGLISH-SPEAKING COUNTRIES* 5 (1937).

216. *Id.* The reasons why mixed enterprises proved to be more popular in the civil law world were unknown to the author. *Id.* at 5–6 (“It is somewhat difficult to discover why the mixed corporation has not proved equally attractive in English-speaking countries.”).

neglected variable that can affect the level of a country's investor protection.

While the law-and-finance literature has argued that common law countries tend to boast greater capital market development and legal investor protection, Raghuram Rajan and Luigi Zingales's work on the "Great Reversals" suggested that civil law jurisdictions were actually no less financially developed than common law countries in the early twentieth century.²¹⁷ Subsequent work by economic historian Aldo Musacchio verified and corrected Rajan and Zingales's figures, finding a significant degree of legal convergence worldwide around 1913, but no significant correlation between the level of financial development and a country's legal tradition.²¹⁸ Interestingly, the incidence of mixed enterprises in civil law countries for the most part postdates World War I.²¹⁹

However, even if this development is relatively recent, it has since then proved to be enduring. Bortolotti and Faccio's survey of control structures prevailing after privatizations reveals that governments in civil law jurisdictions were far more likely to remain a controlling shareholder of "privatized" companies. Strikingly, governments remained the largest blockholder in 48.5 percent of privatized companies in civil law jurisdictions, compared to only 4.6 percent in common law countries.²²⁰ The governments of common law countries were more likely to divest most of their equity holdings, even as they retained control over corporate affairs through a greater utilization of golden shares.²²¹

In any event, a main lesson of this Article is that, from the perspective of the overall environment of corporate governance, it may be better if governments invest in industry as 100 percent owners rather than as partial owners together with private investors. This lesson runs contrary to conventional wisdom in general, and to OECD recommendations in particular. As put by a recent OECD report, "the listing of a minority stake in SOEs is considered a good practice both in establishing credibility and in

217. See generally Raghuram G. Rajan & Luigi Zingales, *The Great Reversals: The Politics of Financial Development in the Twentieth Century*, 69 J. FIN. ECON. 5 (2003). For representative works linking legal traditions to different levels of financial development, see *supra* note 6 and accompanying text.

218. See Aldo Musacchio, *Law and Finance c. 1900* (Nat'l Bureau of Econ. Research, Working Paper No. 16216, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1648016; see also Mariana Pargendler, *Politics in the Origins: The Making of Corporate Law in Nineteenth-Century Brazil*, 60 AM. J. COMP. L. (forthcoming 2012) (manuscript at 5–6) (showing that the distinction between common law and civil law jurisdictions was conspicuously absent from taxonomies of legal systems until well into the twentieth century).

219. See Pier Angelo Toninelli, *The Rise and Fall of Public Enterprise*, in THE RISE AND FALL OF STATE-OWNED ENTERPRISE IN THE WESTERN WORLD 3, 18 (Pier Angelo Toninelli ed., 2000) (stating that the "great age of public enterprise" did not begin until after World War II).

220. Bortolotti & Faccio, *supra* note 210, at 2924.

221. *Id.* (noting that "[i]n common law countries, 86.5% of firms have outstanding golden shares, compared to only 49.2% of companies in civil law countries").

dealing with a host of other corporate challenges.”²²² This point of view, however, pays insufficient attention to the political role of the state as a controlling shareholder and, therefore, its potential to undermine much-needed investor protection reforms.

Nevertheless, the benefits that whole over partial state ownership may bring to the political economy of corporate governance by eliminating the government’s conflict of interest will have to be balanced against the implications of different ownership structures for corporate performance. Intuitively, one may expect mixed enterprises to perform better than wholly owned government firms, as the former are subject to monitoring and pressures from private market participants from which the latter are immune. The available empirical evidence on the relative efficiency of mixed enterprises versus wholly owned SOEs is mixed, but overall seems to provide mild support for the performance advantages of mixed enterprises.²²³ Another advantage of mixed over whole ownership of SOEs is that the former permits the government to obtain information about enterprise value from the market price of the firm’s shares. These efficiency advantages may in part explain why, despite obvious conflicts from a corporate governance standpoint, and despite numerous predictions of their imminent demise throughout the twentieth century,²²⁴ mixed enterprises have proven to be remarkably durable.

3. The State as Minority Shareholder

Most cases described above illustrate how the presence of the state as controlling shareholder can distort the political economy of corporate lawmaking to prevent the enactment of legal rights for minority investors. This raises a question as to what role the government may play in corporate governance reforms when it is not the controlling shareholder, but rather a minority shareholder that does not enjoy special prerogatives. For the government to qualify as a minority shareholder, it must hold less (in fact, far less) than a majority of the firm’s shares, and not have special legal

222. OECD, *SOES OPERATING ABROAD* 12 (2009).

223. See Catherine C. Eckel & Aidan R. Vining, *Elements of a Theory of Mixed Enterprise*, 32 SCOT. J. POL. ECON. 82 (1985), for a theoretical model suggesting that mixed enterprises may perform better than SOEs, but worse than private firms. For empirical works, see Boardman & Vining, *supra* note 17, at 26 (finding that wholly owned SOEs and mixed enterprises are both significantly less efficient than private firms, and that mixed enterprises are equally or less profitable than wholly owned SOEs); Sumit K. Majumdar, *Assessing Comparative Efficiency of the State-Owned Mixed and Private Sectors in Indian Industry*, 96 PUB. CHOICE 1, 13 (1998) (finding that the performance of private firms is superior to that of SOEs, with mixed enterprises falling in between); Aidan R. Vining & Anthony E. Boardman, *Ownership Versus Competition: Efficiency in Public Enterprise*, 73 PUB. CHOICE 205, 222 (1992) (finding that SOEs and mixed enterprises are less profitable than private companies, and that wholly owned SOEs are less profitable than mixed enterprises).

224. See, e.g., RIPERT, *supra* note 193, at 318 (condemning mixed enterprises as an attempt to “reconcile the irreconcilable”). For a recent critique of hybrid firms, see *The Rise of the Hybrid Company*, *ECONOMIST*, Dec. 5, 2009, at 78.

rights (such as golden shares) or otherwise exercise de facto influence over the firm.

If the government is indeed a minority shareholder and is otherwise unable to exercise informal control over management and obtain private benefits of control—and this is a big “if”—the cases analyzed throughout this Article suggest that minority state ownership could be more conducive to the adoption of legal investor protections than a system in which the government is the controlling shareholder. In nineteenth-century Virginia, the financial interests of the state government as a minority shareholder were an important factor in the transition from highly regressive voting schemes to voting rules that bear greater proportion to equity ownership.²²⁵ State-owned pension funds—perhaps most notably the California Public Employees’ Retirement System (CalPERS)—have played an influential role in promoting higher corporate governance standards.²²⁶ Future research is needed to elucidate the precise dynamics and political implications of state minority holdings, a subject that will be particularly useful for guiding public policy on domestic and international sovereign wealth funds.

B. Legal Strategies

Even if it is impossible or undesirable to alter existing ownership structures of state-owned firms, other legal and institutional arrangements exist to mitigate the shareholder–regulator conflict. One approach is to adopt separate corporate laws applicable only to the state as shareholder; another is to give foreign or non-state regulatory authorities the power to design and enforce corporate and securities regulations.

1. Dual Regulatory Regimes

Compared to privatization, a less intrusive and politically more promising alternative is to address directly the negative externalities generated by state ownership on general corporate laws by creating a dual regulatory regime that supplies different rules for state and mixed corporations versus private enterprise. The suggestion that government-owned corporations should be governed by a different set of rules than those applicable to private sector companies is by no means novel.²²⁷ The traditional rationale behind this proposal is that private firms and SOEs

225. See *supra* notes 64–66 and accompanying text.

226. See, e.g., Diane Del Guercio & Jennifer Hawkins, *The Motivation and Impact of Pension Fund Activism*, 52 J. FIN. ECON. 293 (1999) (finding that activism by public pension funds is consistent with shareholder wealth maximization); Michael P. Smith, *Shareholder Activism by Institutional Investors: Evidence from CalPERS*, 51 J. FIN. 227 (1996) (examining various instances of shareholder activism by CalPERS, and finding that shareholder wealth increases in firms that adopt or settle the fund’s proposals).

227. For early instances of proposals for a separate statute for state-owned firms, see BREDIN, *supra* note 193, at 279 (France); Cretella, *supra* note 89, at 37 (Brazil).

have different functional characteristics and objectives and would therefore be best served by different legal regimes.²²⁸

A traditional economic rationale for state ownership is to exploit natural monopolies in a non-profit-maximizing fashion—so as to avoid the deadweight loss that would ensue if the monopoly were operated by a profit-maximizing private firm, which would presumably restrict output to allow for price and revenue increases. Additional justifications for state ownership of enterprise include the pursuit of distributive, developmental, or other public policy goals. It is therefore not difficult to see why a legal regime tailored to profit-maximizing firms may be inadequate to non-profit-maximizing firms, and vice versa. However, despite numerous recommendations to the contrary, separate corporate law statutes for state-owned firms remain the exception, not the rule.²²⁹

But there is another overlooked justification for establishing a distinct corporate regime for SOEs, which is to relieve state interests in corporate lawmaking. As argued elsewhere, the creation of a dual regime can be a second-best solution when powerful political actors effectively block the enactment of a single efficient legal regime.²³⁰ As a variation on regulatory dualism, the regime applicable to state-owned and private firms would be separate and different from the legal regime governing private sector corporations precisely to permit the private regime to develop along more efficient lines by exempting it from the interests and pressure of the government as shareholder.

This proposal for a strict differentiation between the legal regime applicable to public and private firms is a variation on, rather than an instance of, regulatory dualism. Under regulatory dualism, both old and new firms can freely choose between the old regime of low investor protection and the new regime of high investor protection.²³¹ The benefits of this feature in lessening incumbents' opposition to the new regime are at least twofold: old firms can either continue to be governed by the old regime without the stigma associated with grandfathering, or opt for the more stringent new regime (and therefore obtain a lower cost of capital) if they are so willing.²³² By contrast, the proposal for a dual and different regime for private and public firms in principle does not permit the

228. Gilson, Hansmann, and I term this rationale for a dual regulatory regime “regulatory diversification,” which we define as occurring when “[t]he actors being regulated are not homogeneous in their needs for regulation,” so that efficiency requires “two or more parallel regimes of regulation, with each regime designed to deal with the particular characteristics of a distinct set of actors.” See Gilson, Hansmann & Pargendler, *supra* note 88, at 480.

229. Among these exceptions are Israel and Argentina. See HÉCTOR CÁMARA, *SOCIEDADES DE ECONOMÍA MIXTA* (1954) (Argentina); Kahan & Rock, *supra* note 4, at 1358–60 (Israel).

230. Gilson, Hansmann & Pargendler, *supra* note 88, at 475 (“Regulatory dualism [is a strategy that] seeks to mitigate political opposition to reforms by permitting the existing business elite to be governed by the old regime, while allowing other firms to be regulated by a new parallel regime that is more efficient.”).

231. See *id.* at 480–81.

232. *Id.*

government to opt into the private regime or allow controlling families to opt into the government regime. As such, this proposal is less accommodating to the interests of the state and controlling families than a standard form of regulatory dualism and may therefore be less politically feasible. To be sure, regulatory dualism and regulatory differentiation of public and private regimes are not mutually exclusive. Jurisdictions facing severe political hurdles to corporate reforms can—and in many cases should—adopt a separate legal regime for state-owned firms, along with regulatory dualism for private companies.

This proposal for strict regulatory differentiation, although relatively modest in scope and practically attainable, stands in sharp contradiction with existing best practices recommendations for SOEs. Conventional wisdom suggests that the same set of laws and regulations should, to the greatest degree possible, govern private sector entities and government-owned firms alike. For example, the Guidelines on Corporate Governance of State-Owned Enterprises of the OECD prescribe that “[w]hen streamlining the legal form of SOEs, governments should base themselves as much as possible on corporate law and avoid creating a specific legal form when this is not absolutely necessary for the objectives of the enterprise.”²³³ Additionally, the Guidelines suggest that “SOEs should be subject to the same high quality accounting and auditing standards as listed companies” and “[l]arge or listed SOEs should disclose financial and non-financial information according to high quality internationally recognised standards.”²³⁴

Interestingly, the main rationale behind this traditional prescription for a unitary legal regime to govern public and private firms also lies in the state’s conflict of interest as a shareholder and market (rather than corporate governance) regulator. The concern—which is not merely conceptually possible, but also corroborated by experience—is that the government will try to impose more favorable regulatory standards (for example, in pricing, quality, environmental or competition rules) on the firms it owns versus those controlled by the private sector.²³⁵ The imposition of a single regime on public and private companies alike would prevent the government from disadvantaging private firms through special regulatory hurdles that do not apply to SOEs, thus assuring the creation of a “level playing field” when both types of companies compete in the marketplace.

With respect to corporate law rules in particular, another justification for a unitary legal regime is that the imposition of a private legal regime helps enhance efficiency of SOEs by constraining their bureaucrat-managers’

233. OECD, OECD GUIDELINES ON CORPORATE GOVERNANCE OF STATE-OWNED ENTERPRISES 20 (2005).

234. *Id.* at 43.

235. See, e.g., D. Daniel Sokol, *Competition Policy and Comparative Corporate Governance of State-Owned Enterprises*, 2009 BYU L. REV. 1713, 1718–20 (2009) (noting that SOEs in a variety of countries engage in a variety of anticompetitive behavior that is not adequately constrained by existing antitrust laws).

economic waste and overly politicized decision making. This line of reasoning was made explicit in Brazil in the 1960s, as well as in China in connection with its large-scale process of “corporatization” of SOEs in the 1990s. As described in greater detail below, the adoption of the same corporate laws applicable to private firms is but one technique adopted by state-owned enterprises in an attempt to credibly commit to higher corporate governance standards.²³⁶

But while a unitary corporate law regime may be in the interests of state-owned enterprises, it may in fact be detrimental to private firms. Despite the looming risk of state abuse, SOEs have a number of advantages over private firms in attracting investors. Mixed enterprises typically enjoy an implicit or explicit government guarantee, rendering them effectively bankruptcy-proof. Government-controlled firms are far more common in monopolistic industries, whereas private firms often face significant competition. And because they do not enjoy the same degree of government support and have fewer rents to distribute, private firms arguably have greater need than SOEs of an effective investor protection regime in order to attract investors. A unitary regime, however, is less likely to provide an efficient level of investor protection to private firms.²³⁷

As this Article illustrates, the government’s dual role as shareholder and regulator prevents it from credibly committing not to change its corporate law rules in an opportunistic manner in the future if opportunities for profit-making through expropriation are sufficiently attractive. Indeed, this risk of exploitative policy reversal is precisely the reason why most countries do not promulgate the most important limitations to state action via private laws, but rather inscribe them in public constitutions that are particularly difficult to amend. Moreover, the net effects of a unitary legal regime may actually be detrimental to private companies and their shareholders, since the unsuccessful attempts of the state to commit to a private law regime in fact undermines the ability of private firms to make a credible commitment to investor protection. As suggested throughout this Article, the state is not necessarily constrained by, but rather shapes and constrains, the development of corporate laws, with possible negative consequences for the corporate governance environment of private firms.

J.P. Morgan Chase’s acquisition of Bear Stearns in 2008 is illustrative of how little deference even a democratic and limited government such as that of the United States is willing to pay to corporate law rules in carrying out its objectives. In an attempt to ensure completion of the transaction, the

236. For a statement of the commitment rationale, see OECD, *supra* note 222, at 12 (“[I]t is generally held that the credibility of a commitment to ‘commercial commitment’ in an SOE is a function of the degree of which the SOE is made subject to generally applicable corporate law.”).

237. The proposal for a dual regime thus entails a tradeoff typical of regulatory dualism. See Gilson, Hansmann & Pargendler, *supra* note 88, at 480–81 (“[U]nder regulatory dualism, the introduction of the reformist regime may actually cause the established regime to become even *less* efficient than it would be if it were the sole regime, since the reformist regime draws off some of the constituency for reform of the established regime.”).

merger agreement contemplated a number of deal protection devices—including a share exchange agreement for 39.5 percent of Bear Stearns’s stock—that effectively disenfranchised the target’s shareholders, and, for this reason, were unlikely to pass muster under Delaware takeover law.²³⁸ To be sure, the U.S. government was not interested in the transaction as a shareholder, but rather as the architect and financier—or “investment banker”²³⁹—of a deal designed to avoid the macroeconomic crisis that was expected to result from the collapse of Bear Stearns. Moreover, the fact that the acquisition took place in the midst of a severe financial crisis, whose deleterious economic consequences the deal sought to attenuate, makes it difficult to draw reliable generalizations from the developments surrounding this specific transaction.

These caveats aside, Marcel Kahan and Edward Rock described the position of Delaware courts as “between a rock and a hard place” in facing the dilemma between maintaining the integrity of its case law and upsetting the interests of the federal government (on whose goodwill the very existence of Delaware’s corporate law depends).²⁴⁰ Delaware’s ingenious solution was to avoid making a decision altogether by taking advantage of a pending lawsuit in New York and deferring the case to its sister court.²⁴¹ This alternative, while available in the U.S. federalist system, is lacking in most other countries. Hence, the possibility remains that the courts’ sympathy to the interests of the government could jeopardize the integrity of corporate laws, as ad hoc (and public-interest-inspired) decisions favoring the interests of the government as controlling shareholder may set the tone for what type of behavior is permissible for controlling shareholders generally (both public and private) within a given jurisdiction.

A dual regime for state-owned and private enterprise is not without precedent. State-owned firms around the world are, to varying degrees, subject to distinctive rules set forth in special statutes or corporate charters, even if regular corporate laws still maintain residual application. The multiplicity of regulatory regimes stemming from different statutory charters that derogate general corporate laws has led French jurist George Ripert to disparage the existing system of “[u]ne loi par société!”²⁴²

Germany employed a dual approach to appease resistance to investor protection improvements. Local authorities ceased to oppose the enactment of a corporate governance law in 1998 when it became clear that their rights

238. See David A. Skeel, Jr., *Governance in the Ruins*, 122 HARV. L. REV. 696, 736 (2008) (reviewing CURTIS J. MILHAUPT & KATHARINA PISTOR, *LAW AND CAPITALISM* (2008)) (noting that the merger agreement “flouted ordinary Delaware corporate law” and “might well have been struck down if the merger did not have the government’s imprimatur”). See generally Marcel Kahan & Edward Rock, *How to Prevent Hard Cases from Making Bad Law: Bear Stearns, Delaware, and the Strategic Use of Comity*, 58 EMORY L.J. 713 (2009).

239. See Skeel, *supra* note 238, at 733.

240. Kahan & Rock, *supra* note 238, at 713.

241. *Id.* at 715.

242. RIPERT, *supra* note 193, at 317.

under a special statute would not be affected by the reform.²⁴³ China has not only embraced special rules for SASAC, the state holding company that serves as the controlling shareholder of SOEs, but there is also growing evidence that it may have embraced a dual approach in enforcement, with government-owned firms being de facto subject to more lax regulatory standards than their private counterparts.²⁴⁴ Even if these regulatory distinctions have earned a bad reputation, additional differentiation in the legal regimes applicable to private and government corporations may in fact facilitate legal reforms that strengthen the protection of minority investors in private sector corporations.

Adopted by most countries that have recently undertaken large-scale privatizations, golden shares provide a more prominent example of a special regime applicable only to privatized firms. Golden shares are essentially a special class of stock issued to the privatizing government that grants special voting and veto rights that are disproportionate to, or even independent of, its cash-flow rights in the company. In most countries, the issuance of golden shares requires the enactment of a special enabling statute (often in the form of a separate section of the privatization law), which typically specifies that only the state can be a holder of, and exercise the rights granted by, these securities.²⁴⁵ Despite golden shares' drawbacks for corporate decision making and the operation of the market for corporate control, a marked advantage of this mechanism is that it addresses the government's interests while keeping the legal regime applicable to private firms intact—and is therefore a more attractive alternative to a single regime molded by the state's interests.²⁴⁶

Moreover, the current legal system in the United States to some extent already provides such a dual regime, and has come under sharp criticism for precisely that reason. Legal scholars have recently condemned the failure of U.S. law to afford the same minority protections to shareholders of private and government-controlled companies, with the latter being comparatively disadvantaged.²⁴⁷ In testimony before Congress, J.W. Verret remarked that “[g]overnment shareholders don’t have to play by the same rules as the rest of us, a fact which will strain the governance mechanisms of the capital markets at a time when they are already in crisis.”²⁴⁸ For

243. See *supra* notes 187–89 and accompanying text.

244. See *supra* notes 156–62 and accompanying text. China's lesser deference to the rule of law may partly explain the particular success of a dual enforcement strategy in the country.

245. See Grundmann & Möslin, *supra* note 214, at 2–3.

246. Nevertheless, the European Court of Justice has closely scrutinized golden shares and special state voting rights and impermissible restrictions to its common market. See *supra* note 189.

247. See, e.g., Kahan & Rock, *supra* note 4, at 1317–19, 1363; Verret, *supra* note 4, at 286–89.

248. *The U.S. Government as Dominant Shareholder: How Should Taxpayers' Ownership Rights Be Exercised? Hearing Before the Subcomm. on Domestic Policy of the House Comm. on Oversight & Gov't Reform*, 111th Cong. (2009) (testimony of J. W. Verret, Assistant Professor, George Mason University School of Law).

instance, existing doctrines of sovereign immunity severely restrict suits against the government for breaches of fiduciary duties of controlling shareholders, and the U.S. government is expressly exempted from insider trading laws.²⁴⁹ Moreover, the securities of government-sponsored enterprises are generally exempt from federal securities laws and the jurisdiction of the U.S. Securities and Exchange Commission (SEC) more generally, despite official calls for a unitary regime.²⁵⁰

This Article suggests that such criticism of the existing duality of legal regimes is unwarranted once the political economy component of corporate lawmaking is taken into account. Perhaps counterintuitively, the award of a different treatment to outside shareholders of state-controlled corporations can in fact permit the provision of greater protection of minority investors in private firms. This line of reasoning strongly favors the adoption of a separate regulatory regime applicable only to state-owned firms.

2. Dual Regulatory Authorities

When the creation of a dual regime is driven by political considerations, the adoption of a dualist regulatory structure by a single regulatory authority faces practical hurdles.²⁵¹ Apart from possible difficulties associated with the implementation and administration of different standards within a single jurisdiction, the risk exists that the same political constituency that blocks the establishment of a single efficient legal regime will stymie the creation of a dual regime.²⁵² This section explores the potential of a split in regulatory authorities to address the conflicts of interest inherent in the state's dual role as shareholder and regulator.

a. Dual Regulatory Authorities Within the Same State

Unlike the proposal for a different legal regime for state-owned and private firms discussed above, which conflicts with conventional best practices recommendations, the proposal for a separation of regulatory authorities within a given jurisdiction is standard in the literature. The OECD Guidelines on Corporate Governance on State-Owned Enterprises defend a "strict separation of the state's ownership and regulatory functions" as a "fundamental prerequisite for creating a level playing field for SOEs and private companies and for avoiding distortion of competition."²⁵³ Consistent with these recommendations, France

249. *Id.*

250. See STANTON, *supra* note 31, at 23. For a report of three major government agencies calling for the elimination of such exemptions, see DEP'T OF THE TREASURY, SEC & BD. OF GOVERNORS OF FED. RESERVE SYS., JOINT REPORT ON THE GOVERNMENT SECURITIES MARKET, at xvi (1992) ("The Agencies support legislation removing the exemptions from the federal securities laws for equity and unsecured debt securities of Government-sponsored enterprises ('GSEs'), which would require GSEs to register such securities with the SEC.").

251. See generally Gilson, Hansmann & Pargendler, *supra* note 88.

252. *Id.*

253. OECD, *supra* note 233, at 3, 18.

established a Government Shareholding Agency in 2004 to represent the interests of the state as a corporate shareholder (*l'État actionnaire*) while leaving independent the government's regulatory function.²⁵⁴ Similarly, the U.S. Treasury's controlling stake in AIG is held by a trust (of which the Treasury is the sole beneficiary) in an attempt to avoid political interference in the trust's (and, therefore, the company's) management.²⁵⁵

The effectiveness of the separation of the public agencies responsible for managing the government's equity holdings and agencies responsible for regulating the industry remains an open question. This Article suggests that recommendations for institutional separation within the same jurisdiction as a solution to conflicts in corporate governance regulation should be taken with a grain of salt. In virtually all cases of conflicts of interest in corporate law reforms analyzed throughout this Article, an institutional separation between the public body in charge of elaborating corporate laws (usually Congress or courts) and those responsible for managing the enterprise (the executive branch) was already in place, but this institutional separation was insufficient to eliminate the state's conflicts of interest and influence over the legal regime.

b. Federalism

In addition to separate public agencies, federalism provides another way to quarantine a government's lawmaking from its ownership function. In Germany and Brazil, corporate law is generally federal (national) law even though at least some state enterprises belong to state (sub-national) governments. By contrast, in the early twentieth-century United States, federally owned corporations were habitually chartered under state laws.²⁵⁶

The federal solution may therefore be helpful in reducing conflicts of interest in corporate lawmaking. In addition to splitting the state's ownership and regulatory functions, decentralized power necessarily limits what politicians can sell in a corrupt or corruptible system.²⁵⁷ Nevertheless, this approach is not free from difficulties. State interests often play a prominent role in federal lawmaking. A case in point is the significant (and successful) opposition of German state governments to a 1998 federal corporate law reform mandating a one-share, one-vote rule, which would have impaired the states' prior influence in portfolio firms

254. For a detailed description, see *The Missions of the Government Shareholding Agency (APE)*, AGENCE DES PARTICIPATIONS DE L'ÉTAT, http://www.ape.minefi.gouv.fr/sections/qu_est_ce_que_l_ape/ (last visited Apr. 21, 2012).

255. See AIG, Annual Report (Form 10-K) 3 (Feb. 26, 2010), available at http://www.aigcorporate.com/investors/2654275_15501T04_CNB.pdf.

256. See Pritchett, *supra* note 29, at 508.

257. For a version of this argument, see Edward B. Rock, *Encountering the Scarlet Woman of Wall Street: Speculative Comments at the End of the Century*, 2 THEORETICAL INQUIRIES L. 237, 261–63 (2001) (describing how the existence of overlapping corrupt sovereigns undermined the stability of corrupt legal outcomes in the nineteenth-century United States).

through veto rights and voting caps.²⁵⁸ Moreover, this type of duality has been partially outlawed in the United States, as the Government Corporation Control Act of 1945 restricted what it saw as the “anomaly” of using state charters for the creation of federal corporations, requiring a specific act of Congress for their establishment.²⁵⁹

c. Private and Public Regulatory Authorities Within the Same State

Another possibility is to have a dual regulatory regime imposed by a private regulatory authority. As described in greater detail elsewhere, Brazil’s Novo Mercado, a voluntary listing standard of the São Paulo Stock Exchange providing for more stringent corporate governance standards than those required under Brazilian law, provides precisely such an example.²⁶⁰ However, as a paradigmatic example of regulatory dualism, the Novo Mercado does not differentiate between the regime applicable to private firms on the one hand, and state-owned enterprises on the other. On the contrary, the Novo Mercado explicitly welcomed listings of state-owned and recently privatized firms.

Brazilian SOEs began to take advantage of domestic bonding opportunities through the Novo Mercado soon after they became available. Sabesp, a sewage company that had been wholly owned by the São Paulo state government, was the second firm to pursue a listing on the Novo Mercado.²⁶¹ Sabesp’s IPO was coupled with the issuance of American Depositary Receipts (ADRs) in the United States, where most of the company’s public float is now traded. It is telling that the offerings were not driven by capital raising considerations, since all of its traded stock was the product of secondary offerings. Instead, the incumbent government’s motivation behind the listing was to achieve greater efficiency in the company’s management and to render it immune from future political interference.²⁶² Since Sabesp’s offering in 2002, other SOEs and recently privatized firms have embraced a Novo Mercado listing. In 2006, government-controlled banking giant Banco do Brasil restructured its capital structure to convert its preferred non-voting stock into voting common stock in order to become eligible for a Novo Mercado listing.

Nevertheless, the state’s attempts to make a credible commitment to higher corporate governance standards by subjecting its controlled firms to a private law regime are not bulletproof. The danger remains that the presence of the government as a shareholder may eventually undermine the Novo Mercado’s stricter investor protection standards. The recent attempt by the BM&F Bovespa to revise the Novo Mercado listing rules in order to

258. See *supra* notes 188–89 and accompanying text.

259. See Pritchett, *supra* note 29, at 508.

260. Gilson, Hansmann & Pargendler, *supra* note 88, at 482–501.

261. See *Corporate Governance Reform Activities in Brazil and IFC Support: Timeline of Events Through 2006*, in FOCUS: NOVO MERCADO AND ITS FOLLOWERS: CASE STUDIES IN CORPORATE GOVERNANCE REFORM, *supra* note 109, at 37, 38.

262. See generally Kenyon, *supra* note 122.

provide for even stricter corporate governance standards met with resistance by existing firms listed on the exchange, which vetoed the most ambitious proposals.²⁶³ The three state-controlled firms listed on the Novo Mercado were among the companies that voted against some of the proposed revisions, such as the creation of a mandatory audit committee, the imposition of a mandatory bid rule triggered upon the acquisition of 30 percent of the firm's stock, and an increase in the minimum proportion of independent directors from 20 to 30 percent of the company's board.²⁶⁴

Moreover, the exchange's private regulations do not eliminate the state's extra role as a regulator. Any private regulatory regime depends on the state's regulatory acquiescence and contractual enforcement. In Brazil, as in the United States, stock exchange regulations are not immune from legal and political interference. The issuance of Novo Mercado regulations requires the approval of Brazil's Securities and Exchange Commission, just as changes to the New York Stock Exchange rules require prior U.S. SEC approval. Consequently, the risk persists that the interests of the government as a shareholder may come to hamper the revision of Novo Mercado's listing standards over time.

d. Dualism Across Different Jurisdictions

More promising than the split of regulatory authorities within a single jurisdiction is the attempt of listed SOEs to subject themselves to regulatory and enforcement action by a different state or an international institution. Outsourcing of enforcement of state legal obligations is now a conventional mechanism by which national governments can tie their hands and therefore credibly commit not to expropriate foreign investors through abusive policy reversals. To encourage foreign direct investment, governments typically enter into such commitments by signing bilateral investment treaties providing for international arbitration to resolve disputes.²⁶⁵

State-owned enterprises, in turn, have resorted to a dual regulatory approach across different jurisdictions by cross-listing and issuing ADRs in foreign jurisdictions. Perhaps surprisingly, state-owned corporations are

263. See Gilson, Hansmann & Pargendler, *supra* note 88, at 482–501 (discussing the Novo Mercado revision process).

264. Banco do Brasil and Copasa vetoed all three of these proposed changes, while Sabesp only voted against the proposed increase in the minimum proportion of independent directors. See BANCO DO BRASIL, AUDIÊNCIA RESTRITA 2010, CÉDULA DE VOTAÇÃO PARA AS COMPANHIAS LISTADAS NO NOVO MERCADO, available at <http://www.bmfbovespa.com.br/empresas/download/BRASIL.pdf>; COPASA, AUDIÊNCIA RESTRITA 2010, CÉDULA DE VOTAÇÃO PARA AS COMPANHIAS LISTADAS NO NOVO MERCADO, available at <http://www.bmfbovespa.com.br/empresas/download/COPASA.pdf>; SABESP, AUDIÊNCIA RESTRITA 2010, CÉDULA DE VOTAÇÃO PARA AS COMPANHIAS LISTADAS NO NOVO MERCADO, available at <http://www.bmfbovespa.com.br/empresas/download/SABESP.pdf>.

265. For a discussion of the role of bilateral investment treaties as a commitment device, see Jennifer Tobin & Susan Rose-Ackerman, *Foreign Direct Investment and the Business Environment in Developing Countries: The Impact of Bilateral Investment Treaties* (Yale Law Sch., Ctr. for Law, Econ. & Pub. Policy, Research Paper No. 29, 2005), available at <http://ssrn.com/abstract=557121>.

more likely than family-controlled firms to cross-list or issue ADRs abroad²⁶⁶—a decision that a significant strand of the literature attributes to the desire to lower their cost of capital by “bonding” to higher corporate governance standards than those available in their home countries.²⁶⁷ According to the “bonding hypothesis,” a cross-listing helps firms from countries offering low investor protections to credibly commit to protecting investors by piggybacking onto more protective NYSE corporate governance standards. This Article suggests that the particular susceptibility of state-owned firms to governmental conflicts of interest in the enforcement of investor protections may help explain why SOEs are more likely than private firms to cross-list their shares in foreign markets, particularly in the United States.

Nevertheless, while cross-listing may be a promising approach to deal with states’ conflicts of interest in SOEs, it is not without challenges.²⁶⁸ First, securities regulations applicable to foreign issuers are significantly more lenient than those applicable to domestic firms.²⁶⁹ Second, there is evidence that the SEC tends to be more forgiving of, and therefore brings fewer claims against, foreign issuers, thus further undermining the effectiveness of a bonding strategy.²⁷⁰ It is also reasonable to suppose that,

266. GOUREVITCH & SHINN, *supra* note 8, at 114 (“[T]he percentage of U.S. cross-listers is weighted towards government-owned firms, to an extent far larger than the weight of state-controlled firms in their domestic stock markets: 50 percent of the Argentinean issues, 60 percent of those from Brazil, 35 percent from Chile, 60 percent from France, and 60 percent from Italy.”).

267. Legal and economic scholars have advanced the “bonding hypothesis” to explain a foreign firm’s choice to cross-list in the United States. For works supporting the bonding hypothesis, see generally John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229 (2007); Craig Doidge et al., *Why Are Foreign Firms Listed in the U.S. Worth More?*, 71 J. FIN. ECON. 205 (2004) (finding that foreign firms that cross-list in the United States have a significantly higher Tobin’s q compared to similar companies from the same country of origin); Craig Doidge et al., *Has New York Become Less Competitive than London in Global Markets? Evaluating Foreign Listing Choices over Time*, 91 J. FIN. ECON. 253 (2009) (finding that the U.S. cross-listing premium persists following the enactment of the Sarbanes-Oxley Act).

268. A recent event study has cast further doubt on the legal bonding hypothesis. It found that foreign firms cross-listed in the U.S. had positive abnormal returns following the announcement of the 2010 U.S. Supreme Court decision in *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869 (2010), which severely limited the scope of U.S. civil liability for securities fraud involving foreign private issuers. See Amir N. Licht et al., *What Makes the Bonding Stick? A Natural Experiment Involving the U.S. Supreme Court and Cross-Listed Firms*, (Harvard Bus. Sch., Working Paper No. 11-072, 2011), available at <http://ssrn.com/abstract=1744905>.

269. See Larry E. Ribstein, *Cross-Listing and Regulatory Competition*, 1 REV. L. & ECON. 97 (2005), available at <http://www.degruyter.com/view/j/rle.2005.1.1/rle.2005.1.1.1014/rle.2005.1.1.1014.xml?> (discussing the various factors leading cross-listing jurisdictions to exempt foreign firms from its internal governance rules).

270. See Natalya Shnitser, Note, *A Free Pass for Foreign Firms? An Assessment of SEC and Private Enforcement Against Foreign Issuers*, 119 YALE L.J. 1638, 1668–83, 1693 (2010) (finding that SEC enforcement action is far less frequent with respect to foreign issuers); Jordan Siegel, *Can Foreign Firms Bond Themselves Effectively by Renting U.S. Securities Laws?*, 75 J. FIN. ECON. 319, 321 (2005) (finding that Mexican firms cross-listed in the U.S. escaped regulatory action even as they abused minority investors).

all things being equal, the SEC may be more willing to file enforcement actions against private firms than government-controlled firms so as to avoid diplomatic tensions. Consequently, the risk of a reverse bonding strategy persists, in which “weak corporate governance practices of the home country are exported to the foreign listing environment.”²⁷¹

CONCLUSION

To the extent that the world’s largest firms have controlling shareholders, they are all too often states rather than individuals, families, or financial institutions. Despite several waves of privatization, state ownership remains pervasive around the globe. Corporations that are government controlled and publicly traded account for a sizable (and growing) fraction of the market capitalization in numerous jurisdictions, particularly in emerging markets.

But despite their economic significance and legal complexity, SOEs remain surprisingly understudied. The existing literature has all but neglected the political economy implications of state ownership for the content of a country’s corporate laws in general and for its level of investor protection in particular. Yet, as this Article demonstrates, the conflicts of interest inherent in the state’s dual role as a player and referee are both evident and enduring, and manifest themselves in a variety of historical and institutional contexts. I suggest that this mechanism may account for an overlooked channel for reverse causation in the relationship between legal investor protection and ownership structure: while a deficient legal regime and underdeveloped capital markets may prompt the state to assume an entrepreneurial function, the political role of the state as controlling shareholder may, in turn, hinder the development of an effective investor protection regime as a precondition for further financial development.

This Article represents an initial attempt to illustrate and address this problem. The conflicts of interest stemming from the state’s two roles, although serious, are hardly sufficient to condemn government ownership of enterprise. Alternative institutional arrangements, ranging from different ownership structures to dual regulatory systems, can be used to mitigate the state’s interest in the design and enforcement of corporate law rules applicable to private firms. State ownership is not going away and, absent institutional innovations, neither are the government’s conflicts of interest as a corporate governance regulator.

271. MILHAUPT & PISTOR, *supra* note 238, 134 (2008) (describing the case of China Aviation Oil, a Chinese company with tight links to the state that was cross-listed in Singapore).