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Strong shareholders, weak outside investors[*]

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Abstract

In this paper, we consider the corporate governance challenge of protecting outside investors in listed, controlled firms. European jurisdictions are supposed to be more veteran and skilled in dealing with these firms in comparison to the U.S. But we argue that outside investors in European listed firms with controlling shareholders are poorly protected compared to U.S. investors because the distinct European approach to the protection of investors, based on empowering active shareholders rather than shielding passive investors, is not well suited for controlled, listed firms. This approach translates into a lack of definition and development of specific fiduciary duties of the controlling shareholders towards market investors. Moreover, European jurisdictions have developed strong voice rights for active shareholders, which tend to play in favour of the controlling shareholders and organized minorities but are not effective for the protection of passive outside investors and limit their exit options. This explains why shareholder protection in European jurisdictions can be considered high, while outside investors' protection can be considered low at the same time, i.e., it represents a "strong shareholders, weak outside investors" problem that increases the cost of financing for listed European firms and reduces their growth opportunities and value.

JEL classification: G32, G34, G35, K22.

Keywords: Corporate Governance, Ownership Structure, Ownership Concentration, Corporation Law, Controlled Companies, Controlling Shareholders, Outside Investor Protection, Minority Expropriation

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1. Introduction and literature review

Corporate governance deals with commitment and credibility. It studies how corporate insiders can credibly commit to offer a fair rate of return to the suppliers of funds from outside the firm.[1] The ultimate purpose of corporate governance is to reduce conflicts of interest and allow outside investors to control the insiders who have the information and make the decisions on investors' behalf. Though there are many different protection mechanisms under the label "corporate governance", all of them fall into three categories: exit, voice, and liability.[2] There is a long and unresolved debate on whether these mechanisms are complements or substitutes.[3] But an important overlooked fact is that the effectiveness of exit, voice, and liability depends on the nature of the outside investors and the controlling insiders.[4]

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[1] This definition is used in A Shleifer and RW Vishny, "A Survey of Corporate Governance" (1997) 52 Journal of Finance 737. But the importance of the allocation of control rights between insiders and outsiders for financial contracting at firm level was first noted in O Hart and J Moore, "Default and Renegotiation: A Dynamic Model of Debt" (1989) 113 Quarterly Journal of Economics 1 and P Aghion and P Bolton, "An Incomplete Contracts Approach to Financial Contracting" (1992) 59 Review of Economic Studies 473.

[2] AO Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States* (Harvard University Press 1970) was the first to make the distinction among these categories that have become the keystone to the understanding of corporate governance both from a legal and an economic perspective. He does not introduce liability because his focus is on the trade-off between exit and voice and views loyalty as a form of commitment device that induces the use of voice rather than exit. In this paper, we follow the more recent interpretation of H Hansmann and R Kraakman, "Exit, Voice and Liability" (2015) mimeo, who substitute "loyalty" for "liability" and argue for different degrees of complementarity among these three control mechanisms.

[3] In some models, exit and voice are substitutes because, if the market is liquid enough so that exit is possible, the large investors' knowledge can be used to earn trading profits at the expense of liquidity traders and this reduces the incentives to use voice to intervene actively. This is the case in both C Kahn and A Winton, "Ownership Structure, Speculation, and Shareholder Intervention" (1998) 53 Journal of Finance 99 and E Maug, "Large Shareholders as Monitors: Is There a Trade-off between Liquidity and Control?" (1998) 53 Journal of Finance 65. This view is held by many U.S. legal scholars, who argue that the high liquidity of the U.S. secondary market for shares prevents the appearance of large shareholders with incentives to monitor, such as B Black, "Shareholder Passivity Reexamined" (1990) 89 Michigan Law Review 520; JC Coffee, "Liquidity versus Control: The Institutional Investor as Corporate Monitor" (1991) 91 Columbia Law Review 1277; A Bhide, "The Hidden Costs of Stock Market Liquidity" (1993) 34 Journal of Financial Economics 31; and M Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (Princeton University Press 1994). But there are also arguments in favour of complementarity. B Holmstrom and J Tirole, "Market Liquidity and Performance Monitoring" (1993) 101 Journal of Political Economy 678 show that in liquid markets, prices are more accurate and the information they convey can be useful to large shareholders or members of the board to make compensation or removal decisions. Moreover, the benefits of active monitoring are larger if they are reflected in the market prices, as shown by P Aghion, P Bolton, and J Tirole, "Exit Options in Corporate Finance: Liquidity versus Incentives" (2004) 8 Review of Finance 327.

[4] The nature of the parties in conflict changes both across firms and across time, as new types of investors enter or exit the market. For example, the insider who holds power may be a hired executive or a family or the government (whose role as a shareholder has decreased in developed economies but is very large in developing economies).

In this paper, we analyse the corporate governance problems of controlled, listed companies both in the U.S. and in Europe. In particular, we analyse the shortcomings of exit, voice, and liability measures to curtail the power of controlling shareholders across jurisdictions. Additionally, we argue that the differences in European corporate law, and particularly the absence of ex post liability for controlling shareholders and the development of strong voice rights that play in favour of active shareholders, give rise to a "strong shareholders, weak outside investors" situation. This situation facilitates outside investor expropriation in European controlled firms and perpetuates stock market under development in Europe relative to the U.S.

Listed, controlled corporations are firms with concentrated ownership, where the insiders are controlling shareholders who raise additional equity in the capital markets from outside investors, retaining a controlling stake.[5] Although traditionally the corporate governance literature focuses on listed firms with dispersed ownership, the importance of controlled, listed firms is apparent both in the U.S. and in Europe. In fact, as shown in Table 1, the ownership structure remains highly concentrated in continental Europe, where the percentage of controlled, listed firms (defined as firms in which a shareholder owns more than 25% of the shares) is above 50% for all countries except Sweden and Finland. In the U.S., listed, controlled firms represent a smaller, but still very high, 44% of the total. Even when we look at the biggest 50 firms in each country, a majority of firms in continental Europe and 12% of U.S. firms are controlled. Moreover, applying a much more stringent definition of control (requiring that a shareholder owns more than 50% of the shares either directly or indirectly), we still find percentages well above 30% for the firms in most continental European countries and 16% in the U.S.[6]

Outside investors may be small investors, large block-holders, or a group of controlling shareholders, but nowadays a large fraction of total ownership is in the hands of institutional investors and hedge funds.

[5] For RJ Gilson and JN Gordon, "The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights" (2013) 113 Columbia Law Review 863 the canonical distinction between corporations of dispersed or concentrated ownership structure in terms of governance is obsolete because the concentration of ownership in the U.S. in the hands of investment funds proves that the Berle and Means account is no longer accurate. But although investment funds have become large shareholders, they do not usually become controlling shareholders, because most of them do not intervene actively in management (P Rose, "The Corporate Governance Industry" (2007) 32 Journal of Corporate Law 887).

[6] Our data are in line with previous studies such as Ed Kamonjoh, "Controlled Companies in the Standard & Poor's 1500" (2016) IRRCI (Investor Responsibility Research Center Institute) available at https://irrcinstitute.org/reports/controlled-companies-in-the-standard-poors-1500/ and J Grant and T Kirchmaier, "Corporate ownership structure and performance in Europe", (2005) 2 European Management Review 231.

[Insert Table 1 about here]

In the U.S., many technology firms that have gone public with their founders retaining a controlling stake, such as Google, Facebook, and the like, have produced renewed interest in understanding the impact that controlling shareholders have on firm value and the problems of protecting outside investors.[7] On one side of the debate, some American scholars extol the emergence of controlled firms, claiming that the U.S. has gone too far in reducing the incentives for controlling shareholders, giving rise to a "strong managers, weak owners" situation as explained by Roe.[8] From this perspective, controlling shareholders are valuable because the illiquidity of their stake gives them incentives to focus on the long-term value of the company, solving the underinvestment problem caused by strong short-term managerial incentives.[9] On the other side, there is evidence of expropriation of outside investors in U.S. firms with high ownership concentration.[10] As controlled firms grow in importance, tunnelling, self-dealing, and other types of investor expropriation could become significant concerns in the U.S.

In continental Europe, where the data show controlled companies to be predominant, mechanisms that allow for a separation of ownership and control rights are widely used,[11] and

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[7] Interesting contributions to this debate are RJ Gilson and JN Gordon, "Controlling Controlling Shareholders" (2003) 152 University of Pennsylvania Law Review 785; RJ Gilson and A Schwartz, "Constraints on Private Benefits of Control: Ex Ante Control Mechanisms versus Ex Post Transaction Review" (2013) 169 Journal of Institutional and Theoretical Economics 160-183; and Z Goshen and A Hamdani, "Corporate Control and Idiosyncratic Vision" (2016) 125 Yale Law Journal 560. See also L Bebchuk and K Kastiel, "The Untenable Case for Perpetual Dual-Class Stock" 103 Virginia Law Review (2017) 585-630.

[8] Roe (n 3).

[9] Edmans (2011) explains a model where block-holders ameliorate this problem by producing information about the firm's fundamental value, so as to sell their stakes upon negative information, causing prices to reflect fundamental value and encouraging managers to invest for long-run growth as shown in A Edmans, "Blockholder Trading, Market Efficiency, and Managerial Myopia" (2011) 64 (6) Journal of Finance 2481. Consistent with this model, there is empirical evidence showing that block-holders increase firm investment (H Cronqvist and R Fahlenbrach, "Large Shareholders and Corporate Policies" (2009) 22 Review of Financial Studies 3941), and deter earnings manipulation (N Burns, S Kedia and M Lipson, "Institutional Ownership and Monitoring: Evidence from Financial Reporting Practices" (2008) 32 Journal of Banking and Finance 845).

[10] V Atanasov, A Boone, and D Haushalter, "Is There Shareholder Expropriation in the United States? An Analysis of Publicly Traded Subsidiaries" (2010) 45 Journal of Financial and Quantitative Analyses 1 find that subsidiaries of parents that own a substantial minority stake exhibit negative peer-adjusted operating performance and are valued at a 23% median discount relative to peers. V Atanasov, B Black, and CS Ciccotello, "Law and Tunneling" (2011) 37 Journal of Corporation Law 1 conclude that there are loopholes in the U.S. corporate, securities, accounting, and tax rules that allow managers and controlling shareholders to expropriate minority shareholders.

[11] We refer the interested reader to M Burkart and S Lee, "The One Share-One Vote Debate: A Theoretical Perspective" (2008) 12 Review of Finance 1; R Adams and D Ferreira, "One Share, One vote: The Empirical Evidence" (2008) 12 Review of Finance 51; H Almeida and D Wolfenzon, "A Theory of Pyramidal Ownership and

there is ample evidence of higher levels of minority expropriation relative to the U.S.[12] Moreover, there is a significant and persistent gap in stock market development with respect to Anglo-Saxon markets.[13] During the last 25 years, since the Cadbury Report, there have been many corporate governance reforms—from board composition to lowering barriers for participation in shareholders' general meetings (SGMs)—but Europe still lags behind in the number of listed firms, with relatively few firms accessing stock market financing.

We explain these higher levels of minority expropriation as the result of the distinct European approach to the protection of outside investors, based on empowering active shareholders rather than shielding passive investors, and we are able to clarify why in these jurisdictions shareholder protection can be considered high, while outside investors' protection can be considered low at the same time, i.e., the "strong shareholders, weak outside investors" problem.

We argue that the European approach based on empowering active shareholders leads to the consideration of equal fiduciary duties for all shareholders, with the aim of solving conflicts of interest among active shareholders, but fails to develop specific fiduciary duties for the

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Family Business Groups" (2006) 61 Journal of Finance 2637; L Bebchuk, R Kraakman, and G Triantis, "Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights" in RK Morck (ed), *Concentrated Corporate Ownership* (Chapter 10, University of Chicago Press 2000); M Ventoruzzo, "The Disappearing Taboo of Multiple Voting Shares: Regulatory Responses to the Migration of Chrysler-Fiat" (2015) mimeo, available at SSRN:http://ssrn.com/abstract=2574236.

[12] The expropriation problem has been empirically investigated using two different methods to measure the ratio of private benefits. One uses the market value of double class shares. H DeAngelo and L DeAngelo, "Managerial Ownership of Voting Rights: A Study of Public Corporations with Dual Classes of Common Stock" (1985) 14 Journal of Financial Economics 33 and L Zingales, "What Determines the Value of Corporate Votes?" (1995) 110 Quarterly Journal of Economics 1047 apply this technique for U.S. data for the United States and T Nenova, "The Value of Corporate Voting Rights and Control: A Cross-Country Analysis" (2003) 68 Journal of Financial Economics 325 extends the study using data from 18 countries. She finds the median value of control-block votes is highest in French civil law countries (22.6%), followed by German civil law countries (11.0%), with common law and Scandinavian civil law countries scoring the lowest, with 1.6% and 0.5%, respectively. The second method values the premium price of block-holder transfers, and it is used for U.S. firms in the seminal study by MJ Barclay and CG Holderness, "Private Benefits from Control of Public Corporations" (1989) 25 Journal of Financial Economics 371. A Dyck and L Zingales, "Private Benefits of Control: An International Comparison" (2004) 59 Journal of Finance 537-600 extend this with data for 39 countries and find that the U.S. has the lowest level of private benefits compared to countries with French legal origins (21% higher) and German legal origins (10% higher). Italy, Austria, Portugal, Germany, Denmark, Sweden, and Switzerland all have mean block premium values above 5% compared to 1% in the U.S. Nevertheless, levels of expropriation in Europe are still below those found in developing economies such as India, as shown by M Bertrand, P Mehta, and S Mullainathan, "Ferreting Out Tunneling: An Application to Indian Business Groups" (2002) 117 Quarterly Journal of Economics 121.

[13] The World Bank reports an increase in stock market capitalization as a percentage of GDP in the U.S. from 129.8% in 2005 to 151.2% in 2014, while for the Euro zone the percentage was 59.4% in 2005 and 59% in 2014.

controlling shareholders when they are making business decisions on behalf of market investors. This leads to a lack of accountability that cannot be overcome by other corporate governance mechanisms such as voice and exit, which tend to reinforce the power of the controlling shareholders. Our conclusion is that when dealing with listed, controlled firms, European jurisdictions need to reconsider the protection of outside investors. The U.S. regulations, albeit imperfect, are aimed at protecting passive market investors from the people who manage their money, be it managers or controlling shareholders. But Europe treats investors as shareholders who will get protection by active management of their control rights. While this approach can work very efficiently in private firms or even in listed firms with dispersed ownership, it is clearly not well suited to the problems of controlled, listed firms and generates the paradox of "strong shareholders, weak outside investors". We believe that this is a valuable contribution to the literature on the regulation of controlling shareholders**.**

In fact, there is a very large literature studying controlling shareholders and the pros and cons of this type of firm, as opposed to listed firms with dispersed ownership.

On the one hand, there are both legal and financial contributions explaining the benefits brought to the firm by the monitoring and long-term commitment of controlling shareholders. In particular, concentrated ownership has been considered an efficient governance mechanism that increases firm value through monitoring and alignment of interests. Pfleiderer and Zechner present the first theory paper that considers the monitoring benefits of having a large shareholder.[14] They show that because of the trade-off between optimal risk diversification and monitoring in equilibrium, the optimal stake of the large shareholder is too small and there is too little monitoring, and it may be necessary to provide incentives to the block-holder. The benefits of entrenchment and the long-term view that block-holders can bring have also been stated in the legal literature. Some papers stress the monitoring benefit,[15] while others focus on the "idiosyncratic" benefits that founders can bring because of their deep knowledge of the firm.[16] Additionally, Gilson and Schwartz and Choi argue that because private benefits are illiquid and nontransferable, they can

[14] Pfleiderer and J Zechner, "Large Shareholder Activism, Risk Sharing, and Financial Market Equilibrium" (1994) 102 Journal of Political Economy 1097.
[15] Gilson and Schwartz (n 7).
[16] Goshen and Hamdani (n 7).

promote long-term commitment by the controlling shareholder, and therefore controlled firms are expected to maximize the firm's long-term value.[17]

On the other hand, there are many theoretical and empirical studies explaining how the ability of the controlling shareholders to extract private benefits and expropriate the minority limits the investment and growth opportunity of these firms. On the theory side, Burkart, Gromb, and Panunzi and Enriques and Volpin show how block-holders convert security benefits into private benefits but in the process dissipate some of the value.[18] On the empirical side, Dyck and Zingales and Nenova find that the control premium varies across countries and that it is negatively related to the quality of accounting disclosure rules, the level of product market competition, the level of protection of minority investors, and the quality of law enforcement.[19]

Therefore, the level of protection of outside investors seems to be crucial in determining whether controlling shareholders increase or decrease the value of the firms where they operate. And interestingly, European jurisdictions, where this form of control is common, are friendlier in their regulation towards controlling shareholders than the U.S., and this seems to lead to higher levels of expropriation.[20] This difference in the treatment that controlling shareholders receive across jurisdictions has been explained by Bebchuk and Roe in terms of inefficient path-dependence in European jurisdictions with poor outside investor protection.[21] On the other hand, Goshen and Hamdani argue that it is necessary to strengthen controlling shareholders' rights and move away from what they consider excessive minority protection in the U.S.[22] Moreover, European legal scholars tend to consider the protection of stockholders as one of the strengths of corporate law in continental jurisdictions.[23]

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[17] RJ Gilson and A Schwartz, "Corporate Control and Credible Commitment" (2015) 43(C) International Review of Law and Economics 119; AH Choi, "Concentrated Ownership and Long-Term Shareholder Value" (2017) Harvard Business Law Review (forthcoming).
[18] M Burkart, D Gromb, and F Panunzi, "Large Shareholders, Monitoring, and the Value of the Firm" (1997) 112 Quarterly Journal of Economics 693; L Enriques and P Volpin, "Corporate Governance Reforms in Continental Europe" (2007) 21 Journal of Economic Perspectives 117.
[19] Dyck and Zingales (n 12) and Nenova (n 12).
[20] See references on n 12.
[21] L Bebchuk and MJ Roe, "A Theory of Path Dependence in Corporate Ownership and Governance" (1999) 52 Stanford Law Review 127.
[22] Goshen and Hamdani (n 7).
[23] In fact, this is often claimed in comparison to U.S. corporate law. The characterization of European jurisdictions as "shareholder friendly" can be tracked down as the natural response to the initial bias of taking the U.S. jurisdiction as the best benchmark, and to assess the quality of other corporate law systems depending on how much they replicate some prominent features of the U.S. law. As an example, see WG Ringe, "Changing Law and Ownership Patterns in

Our paper is able to explain this contradiction. The "strong shareholders, weak outside investors" paradox means that although there are strong rights for active shareholders in European jurisdictions and the law on the books seems well designed, outside investors face obstacles in practice to exert effective voice or exit measures in the presence of a controlling shareholder. Interestingly, the inability of the outside investors to effectively oppose in practice the policies of the controlling shareholder means that it is very unusual to observe conflicts in these companies, and this may erroneously reinforce the positive view of most European legal scholars.

The rest of the paper proceeds as follows. In Section 2, we start by analysing the distinct European approach to the protection of outside investors, based on empowering active shareholders, and the problems that this approach generates in the case of controlled, listed firms. In Sections 3 and 4, we discuss in detail the functioning of current liability, exit, and voice mechanisms to check the power of controlling shareholders both in the U.S. and in continental Europe. In Section 5, we address the challenge of how to improve outside investor protection within this system. Finally, Section 6 offers a brief conclusion.

Germany: Corporate Governance and the Erosion of Deutschland AG" (2015) 63 American Journal of Comparative Law 493, 508 stating that 'Minority protection is the natural response to strong controlling shareholders, and the German legal system subscribes to a number of such protective tools'. This idea can also be found in P Conac, L Enriques, and M Gelter, "Constraining Dominant Shareholders' Self-Dealing: The Legal Framework in France, Germany, and Italy" (2007) 4 European Company and Financial Law Review 491; J Armour, L Enriques, H Hansmann, and R Kraakman, "The Basic Governance Structure: The Interests of Shareholders as a Class" in R Kraakman (ed), *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn p.49ff, Oxford University Press 2017), 50ff; and S. Cools, "The Real Difference in Corporate Law Between the United States and Continental Europe: Distribution of Powers" (2005) 30 Delaware Journal of Corporate Law 697.

2. The paradox of "strong owners, weak outside investors" in controlled corporations

European regulation deals with the protection of equity investors from a different point of view than U.S. regulation. And these two diverse perspectives have crucial implications for the corporate governance of controlled, listed firms.

The U.S. approach to regulating listed firms attempts to protect atomistic shareholders.[24] Financial markets introduce a new investment technology that alters substantially the ownership structure of the traditional firm. When investors are risk averse and financial needs are very large, all shareholders become atomistic and control is in the hands of the managers.[25] This is the famous "Berle and Means" American corporate model with maximum separation of ownership and control.[26]

Most U.S. rules for the protection of atomistic shareholders can be equally applied to listed firms with or without controlling shareholders. Bebchuk and Hamdani argue that some standard corporate governance arrangements in the U.S. may no longer be optimal when applied to controlled firms.[27] For instance, the demand of an independent board might not be well suited for these corporations. And in a board dominated by the patrons or the principals, where seats are allocated according to the power of the controlling shareholder, the option that other (active) significant investors could have access to a seat should be taken into account.[28] But in spite of the

[24] For a general view of the legal strategies used in the U.S. to tackle this problem, see J Armour, H Hansmann, and R Kraakman, "Agency Problems and Legal Strategies" in R Kraakman (ed), *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn p. 29ff, Oxford University Press 2017), 29ff.

[25] MC Jensen and WH Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3 Journal of Financial Economics 305 and EF Fama and MC Jensen, "Separation of Ownership and Control" (1983) 26 Journal of Law and Economics 301 analyse how the separation of ownership and control occurs when investors are risk averse and there are substantial benefits from the separation of decision and risk bearing that occurs when the initial sole proprietor raises capital in the stock market by selling claims on the firm's cash flows to many small investors.

[26] AD Jr Chandler, *The Visible Hand: The Managerial Revolution in American Business* (Harvard University Press 1977) argues that the corporation had a key role in the development and modernization of American industry, and was born as a response to advances in technology and the expansion of markets that increased the volume of economic activity.

[27] L Bebchuk and A Hamdani, "Independent Directors and Controlling Shareholders" (2017) 165(6) University of Pennsylvania Law Review 1271; L Bebchuk and A Hamdani, "The Elusive Quest for Global Governance Standards" (2009) 157 University of Pennsylvania Law Review 1263.

[28] This proposal has been made by M Gutiérrez and MI Sáez, "Deconstructing Independent Directors" (2013) 13 Journal of Corporate Law Studies 63 and specifically for U.S. controlled firms by K Kastiel, "Against All Odds: Hedge Fund Activism in Controlled Companies" (2016) 96 Columbia Business Law Review 59.

concessions made for controlled firms in terms of board representation, it is worth noting that the U.S. system follows a clear reasoning: passive outside investors need to be protected from managing insiders, whether they are hired managers or controlling shareholders.

However, the European approach attempts to protect shareholders from the managers without taking into account the atomistic nature of the shareholders of listed firms. Corporate law in continental Europe gives the owners ample control rights inside the firm to keep the managers in check.[29] There is no special consideration for the specificities of passive outside investors, since their protection, just like the protection of active insiders, is expected to come from the exercise of their voting rights, i.e., there is no consideration for the problem of rational inaction when financial markets lead the creation of listed firms. In Europe, listed firms are therefore regulated as a particular type of corporation.[30] To exemplify this, notice that the overriding articulation of stock company laws in European jurisdictions refers mainly to the model of a non-listed company, with only a few provisions contemplating the disparities and particularities of the legal regime of listed companies in order to adjust to the stock market requirements and to the influence of EU law, which is more heavily focused on listed firms. In fact, the model seems to have served very well the development and growth of big businesses and groups, including many European champions, many of which were not only born as private firms but still remain private today.[31] In these non-listed firms, separation of ownership and control is not a major problem, and all shareholders are expected to take an active part in management. Their main problem is the intra-shareholders' agency costs: the conflicts among shareholders with

[29] See references on n 23.

[30] Company law handbooks in continental Europe explain that the traditional knowledge of company law includes many different business organizations, but listed corporations are not part of it. The special legal regimen of the listed firms is a new trend, and normally it is limited to a few provisions. Therefore, the background model of the regulation of the corporation in Europe is a non-listed firm, where active, committed owners take the key decisions. This is exemplified by L Stanghellini, "Corporate Governance in Italy: Strong Owners, Faithful Managers. An Assessment and a Proposal for Reform" (1999) 6 Indiana International and Comparative Law Review 91, 168 writing 'Closely held, unlisted companies are managed by 100% owners, or under their active supervision. Widely held, listed companies are managed by majority shareholders, acting alone or in stable associations, or under their active supervision. Italian capitalism is thus based on direct control of strong owners.

[31] H Fleischer, "A Guide to German Company Law for International Lawyers—Distinctive Features, Particularities, Idiosyncrasies" in H Fleischer, JL Hansen, WG Ringe (eds), *German and Nordic Perspectives on Company Law and Capital Markets Law* (Mohr Siebeck 2015) 3, states that 'The small number of 16,000 stock corporations in Germany, of which 850 are listed on the stock exchange, indicates that it is employed primarily by "big business": Of the 100 biggest enterprises in Germany, 64 are organized as stock corporations and 5 as European Companies'. See also Stanghellini (n 30) on page 167: 'Most Italian firms, even very large ones, are unlisted and privately held. Their ownership structure is extremely closed'.

different stakes (majority and minority shareholders) who have to share control and management powers. And the corporate rules of continental Europe are perceived as being especially well suited to deal with this conflict.[32]

But applying the European model of company law, based on the power of strong and active shareholders to listed firms, is problematic for two reasons.

First, the European approach does not offer protection from managers to rationally inactive, diversified fund providers who do not exercise their control rights. And therefore it creates powerful incentives for ownership concentration, because only large shareholders find it rational to make active use of their control rights to keep the managers in check.[33] Second, once we have a controlling shareholder who makes active use of his or her control rights, the lack of accountability in continental European jurisdictions gives this individual unchecked power vis-à-vis the pure fund providers. This happens not only because of this person's higher stake and the passive attitude of small shareholders, but also because he or she still is considered as a shareholder and not as an insider. In the U.S. case, whoever has control, be it a manager or shareholder, is treated as an insider from which the outsiders need to be protected. But corporate law in continental Europe does not consider controlling shareholders as insiders and throws them together with the outside investors on whose behalf they are making decisions. As a result, controlling shareholders become especially powerful in these jurisdictions and keep managers in check, but at the expense of leaving outside shareholders unprotected from the controlling shareholder. In fact, as we will discuss in detail in Section 3, in European jurisdictions there is a lack of specific rules protecting outside shareholders from inside shareholders who exert control.

This is the "strong shareholders, weak outside investors" paradox of European corporate law. In European jurisdictions, shareholder protection is high, while outside investors' protection is low, and if we want to talk about investor protection in general it is very important

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[32] Ringe (n 23) on page 502 states that 'The main objective of German legal rules is to help reduce intra-shareholder agency costs'. GH Roth and P Kindler, *The Spirit of Corporate Law: Core Principles of Corporate Law in Continental Europe* (Hart Publishing 2013) argue that throughout Europe only a small number of corporations are listed and therefore the reality of corporate law is dominated by small and medium-size enterprises, and, therefore, legal standards pertaining to control transactions or investor protection and other topics of capital market law are not part of the core principles of corporate law.

[33] Bebchuk and Roe (n 21) consider corporate law a determinant of ownership structure. R La Porta, F López-de-Silanes and A Schleifer, "Corporate Ownership Around the World" (1999) 54 Journal of Finance 471 provide evidence to support this argument.

to specify whom we have in mind. This “strong shareholders, weak outside investors” paradox explains two ongoing controversies in the literature on investor protection.

The first controversy refers to empirical findings showing that continental Europe scores low in many of the indexes that try to measure the quality of investor protection, while many law scholars are convinced that the quality of European corporate law is high. The low rankings of investor protection originally awarded to continental European countries in the pioneering work of La Porta and coauthors[34] have been challenged and revised by several European scholars, who have produced new rankings where continental European countries rank much higher.[35] Spamann claims convincingly that the differences are caused by measurement problems.[36] Despite this, we believe that the major problem lies in the loose definition of the investor who needs to be protected (and from whom). As we have seen, corporate law in continental Europe protects investors who are willing to actively exercise control rights; therefore, if one understands an investor as a shareholder who is willing to take an active part in corporate life, investor protection is indeed high in Europe (i.e., we have strong shareholders). But if one understands an investor as a passive market participant who simply trades in shares, investor protection in continental Europe is relatively low (i.e., we have weak outside investors). Therefore, adding up general measures of “investor” protection in these jurisdictions can yield either a positive or a negative result.[37]

The second controversy refers to the obsession that we have witnessed with corporate governance during the last 20 years, with unclear effects on the protection of outside investors.

Most of the new corporate governance measures that have been introduced into codes of best practice, and even into formal regulation, are aimed at reducing agency costs that arise when managers pursue personal interests that are in conflict with the investors’ interests. The wave of

[34] R La Porta, F López-de-Silanes, A Schleifer, and R Vishny, “Law and Finance” (1998) 106 Journal of Political Economy 1113.
[35] Comparative scholars have demonstrated that Germany is indeed one of the countries where minority protection is most pronounced: they find that Germany is top among a number of jurisdictions regarding the quality of shareholder protection, and that it even has increased this protection between 1970 and 2005. See Armour, Hansmann, and Kraakman (n 24); P Lele and M Siems, “Shareholder Protection: A Leximetric Approach” (2007) 7 Journal of Corporate Law Studies 17; UC Braendle, “Shareholder Protection in the USA and Germany: On the Fallacy of LLSV” (2006) 7 German Law Journal 257; and M Berndt, *Global Differences in Corporate Governance Systems. Theory and Implications for Reforms* (Wiesbaden, Deutscher Universitäts-Verlag 2002).
[36] H Spamann, “The 'Antidirector Rights Index' Revisited” (2010) 23 Review of Financial Studies 467.
[37] A similar point is made by Bebchuk and Hamdani, “Quest” (n 27), who argue that the impact of governance arrangements depends considerably on companies’ ownership structure, and separate methodologies should be developed for assessing governance in companies with and without a controlling shareholder.

privatizations in Europe during the 1980s and 1990s introduced for the first time in the European stock markets firms that had truly diversified ownership. This changed the focus of attention in continental Europe, which shifted from addressing the problems of the big corporations controlled by one or several large shareholders to those of widely held big corporations controlled by managers.

The most obvious example of this problem, as pointed out by Enriques, was a shocking underdevelopment of fiduciary duties for hired managers, which is the basic legal tool to make managers accountable in a situation of asymmetric information.[38] But now the need for new rules dealing with the managers of firms with diversified ownership was felt both by the regulators and by the growing numbers of institutional investors that held significant positions in these firms. Additionally, the public debate about the quality of corporate governance that had emerged in Anglo-American countries finally reached continental Europe. It is along these lines that we can interpret virtually all of the new corporate governance regulations that have been introduced during the last decades, such as codes of best practice, independent remuneration and audit committees, say-on-pay, and so on. All these measures restrict the power of the hired managers (in terms of their remuneration, ability to manage accounts, power relative to the SGM, etc.).

The pack of policy recommendations developed on the other side of the Atlantic to foster efficiency and protect outside market investors from managers is what we commonly refer to as "corporate governance". But in most European listed firms, controlled by families and their corporations, these recommendations are mainly cosmetic and their fundamental corporate governance problems are not addressed. As we will see in the following section, none of the new corporate governance measures directed towards managers can solve the specific problems of expropriation risk at the hands of the controlling shareholder. For most European listed firms, this renders those measures largely irrelevant in the best case, and counterproductive in the worst case, because they tend to reinforce the power gap between the controlling shareholder and the outside shareholders. All these corporate governance reforms might have some merit, and certainly they

[38] L Enriques, "The Law on Company Directors' Self-Dealing: A Comparative Analysis" (2000) 2 International and Comparative Corporate Law Journal 297. This underdevelopment is in clear contrast with the ample fiduciary duties that the European jurisdictions had carefully envisaged for shareholders towards the corporation. According to the model of corporation that is behind the European regulation, the shareholders are clearly identified as the ones in control, and hired managers are expected to follow their instructions.

have raised the corporate governance standards of European listed firms, but, as we argued in the introduction, they have not been accompanied by a substantial reduction in the gap in capital markets development in continental Europe relative to Anglo-American countries. Europe still lags behind in the number of listed firms, with fewer firms accessing stock market financing.

In the next two sections, we will analyse in detail the challenges and shortcomings of the governance of controlled, listed firms. We will see that all the different extensive rights granted to shareholders in Europe, while very effective in keeping managers in check vis-à-vis shareholders, fail to protect outside shareholders from the inside shareholders who exert control.

3. Controlling shareholders and liability

The idea underlying the liability mechanism is that the agents who exert control over the corporation should be accountable for the decisions they make affecting shareholders. In this sense, liability is a very powerful tool to overcome the problems of asymmetric information in fiduciary relationships and limit the extraction of private benefits of control. Additionally, given that liability rules are costly to enforce, they set the right incentives to induce controlling shareholders to commit to effective ex ante decision mechanisms, like "majority-of-the minority" rules, in order to reduce the risk of ex post litigation.

Interestingly, in the U.S., judicial control works as an additional control to restrain controllers' opportunism,[39] irrespective of whoever the controllers might be—managers or shareholders.[40] Nevertheless, in jurisdictions where concentrated ownership structures are the

[39] RB Thompson and RS Thomas, "The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions" (2004) 5 Vanderbilt Law Review 133 report that, in 1998 and 1999, 824 class actions, 87 individual direct actions, and 137 derivative actions were brought in Delaware based on alleged violations of fiduciary duty.

[40] In Delaware, it has been held that the breadth of the majority shareholders' fiduciary duty is dependent on the circumstances of each case. Generally, the "business judgment rule" will apply to the decisions of the majority that have a rational business aim. But where the minority shareholders (plaintiffs) manage to prove that the activity of the majority involves "self-dealing", the court adopts the "intrinsic fairness" test and the burden of proving the fairness of the transaction shifts to the majority (defendants). Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. Sup. Ct. 1971); Gabelli & Co. v. Liggett Group Inc., 444 A.2d 261(Del. Ch. 1982), a_d, 479 A.2d 276 (Del. Sup.Ct. 1984); Weinberger v. UOP Inc., 457 A.2d 701 (Del. Sup. Ct. 1983).

norm and there is clear evidence of minority expropriation,[41] the rate of derivative suits against managers and controlling shareholders is close to zero.[42]

Why do we observe this striking lack of accountability through liability for breaches of fiduciary duties of controlling shareholders precisely in jurisdictions characterized by high ownership concentration? The explanation that we find in the literature is that derivative suits face enforcement problems, but nevertheless accountability is achieved through other means, such as rescission suits.[43] However, in this section we will argue first that rescission suits are not good substitutes for derivative suits to punish breaches of fiduciary duties. Second, we claim that, even if there were no enforcement problems, liability for breaches of fiduciary duties is difficult to apply to a controlling shareholder in European jurisdictions because the controller is treated as a shareholder, with fiduciary duties applying equally to all shareholders for decisions made in their exercise of their voting rights. Finally, we maintain that the prevalence of business groups in Europe, which base their business strategy in intra-group self-dealing operations, represents a challenge for the efficient enforcement of fiduciary duties for controlling shareholders towards outside investors.

[41] See references on n 12.

[42] Gelter looks for derivative suits where self-dealing by controlling shareholders is alleged between 2000 and 2007 and reports finding only two cases in Germany, two in Italy, and one in France. M Gelter, "Why do Shareholder Derivative Suits Remain Rare in Continental Europe?" (2012) 37 Brooklyn Journal of International Law 843.

[43] This problem is discussed by Gelter (n 42) and S Johnson, R La Porta, F López-de-Silanes, and A Shleifer, "Tunneling" (2000) 90 American Economic Review 2 and L Enriques, "Do Corporate Law Judges Matter? Some Evidence from Milan" (2002) 3 European Business Organization Law Review 765. Moreover, economic history research by NR Lamoreaux and JL Rosenthal, "Corporate Governance and Minority Shareholders before the Depression" in EL Glaesser and C Goldin (eds), *Corruption and Reform: Lessons from America's Economic History*, (University of Chicago Press 2006) show that the difficult problem that the courts faced in the 19th century was to protect minority shareholders without promoting rent seeking behavior by minority shareholders that would undermine the power of controlling shareholders. For this reason, the courts were very conservative in defining what constituted an abuse of trust by those in control, and they tended to give the controlling group the benefit of the doubt on the grounds that its members were unlikely to take actions that eroded the value of their own stock.

3.1. Enforcement problems and rescission suits

There is a widespread belief that continental European countries do not generally have a deficit in the substantive law applying to controlling shareholders, but a deficit in litigation, which does not work well in Europe because of problems in enforcement.[44] Sáez and Riaño point out that the use of liability challenges in Europe may be reduced because of technical problems related to procedural law not being up to date and deficiencies in the litigation system (standing, the allocation of litigation risk, access to information, etc.)[45] Moreover, Ferrarini and Guidici suggest that other problems regarding draft deficiencies, lack of expertise, or formalistic approaches to the law might also hinder the use of litigation to control large shareholders in these jurisdictions.[46] These shortcomings are also true for derivative actions against managers, but there is much less at stake here because managers are already closely monitored by controlling shareholders.

However, most legal scholars consider that accountability of controlling shareholders is achieved in continental European jurisdictions through specific remedies and doctrines to constrain the controlling shareholders' power, particularly through unique litigation devices that substitute for derivative suits.[47] In Europe, a resolution of the SGM can be challenged by a minority of shareholders (or even an individual shareholder) and nullified by the courts under certain circumstances. Rescission suits are considered to be an important instrument to protect minority shareholders through litigation if the decision made is unlawful or harmful to their interests. But a closer look reveals that this (widely used) litigation mechanism is not actually

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[44] L Enriques, G Hertig, H Kanda, and M Parlendger, "Related Party Transactions" in R Kraakman (ed), *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn, Oxford University Press 2017), 164 state that 'In its core content (fairness), the duty of loyalty is similar in common and civil law jurisdictions, but its bite crucially depends on how often and how stringently courts enforce it'. Gilson and Schwartz (n 7) focus on judicial enforcement as the key in reducing private benefits, and suggest the introduction of a specialized European court for corporate governance and dispute resolution that could play a similar role to the Delaware Court of Chancery in the U.S. In spite of this, we believe that enforcement problems would persist due to the deficiencies of an outdated litigation system, and specialized courts would face other risks, particularly in small countries, such as capture.

[45] MI Sáez and D Riaño, "Corporate Governance and the Shareholders' Meeting: Voting and Litigation" (2013) 14 European Business Organization Law Review 343.

[46] G Ferrarini and P Guidici, (2006) "Financial Scandals and the Role of Private Enforcement: The Parmalat Case" in J Armour and JA McCahery (eds) *After Enron: Improving Corporate Law and Modernizing Securities Regulation in Europe and the U.S.* (Hart Publishing 2006).

[47] As an example of this view, see Conac, Enriques, and Gelter (n 23). Ringe (n 23) on page 505 states that 'this means of legal action was officially introduced back in the nineteenth century with the aim of allowing individual shareholders to "police" misconduct by block-holders'.

designed to protect the interest of outside investors from the power of the controlling shareholders, but to protect the interest of the corporation as such from disputes among active shareholders. This conceptual difference limits the effectiveness of rescission suits relative to derivative suits in three important ways.

First, some tunnelling practices and the extraction of private benefits by the controlling shareholder are tolerated so far as they are considered to be beneficial (or at least not harmful) for the corporation. In fact, there are no clear criteria to distinguish between conflicted and non-conflicted decisions, so courts rely heavily on other judgments in similar cases, the lawfulness of the resolution taken (especially regarding the procedure), or a sort of rule of thumb that compares the harm the plaintiff would suffer following the resolution with the harm the company would suffer if the resolution were not implemented.[48] The flaws of this approach show that the main agency problem of controlled, listed firms is not well understood. In most cases, jurisdictions consider the extraction of private benefits as an asymmetric distribution among shareholders. So operations easily pass the ex post efficiency test that evaluates which undertaking and decisions are harmful to the interest of the company, because the transfers among shareholders by definition do not affect the efficiency of the operation (in other words, they are neutral to the interest of the corporation). However, this analysis is not accurate. It overviews that ex ante, the selection among different projects is distorted by the existence of private benefits, and controlling shareholders have incentives to choose projects with high private benefits, even at the expense of destroying value or bringing harm to the company[49].

Second, it is not clear whether these actions have significant deterrence power against wrongdoing by controlling shareholders, because the negative consequences for a disloyal block-holder are minimal, consisting at most of the nullification of the resolution.[50]

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[48] In particular, Johnson et al. (n 43) analyse three regular decisions in Continental jurisdictions—the Peronnet case, the Flambo case, and the Masilli case—which are very illustrative of the tendency of judges to evade the substantive examination of corporate disputes submitted to their consideration involving a controlling shareholder. They resolve not to make the insiders liable by a merely formal or doctrinal analysis (for example, a hollow appeal to the interest of the group, or the claim that the decision cannot be challenged in court, or the idea that the operation is not ruinous for the firm).

[49] The nature and the consequences of the conflict of interest between outside investors and controlling shareholders are clearly explained by M Gutiérrez and M Sáez, "A Contractual Approach to Discipline Self-dealing by Controlling Shareholders" (2017) 2 Journal of Law, Finance and Accounting 173.

[50] Challenges to shareholder resolutions constitute an imperfect device to enforce controlling shareholders' fiduciary duties. Sáez and Riaño (n 45) provide an empirical study of rulings applying the section of the Spanish Public Companies Act governing rescission suits. They show that this litigation mechanism faces both under- and over-

And third, accountability of controlling shareholders through this mechanism has strong limitations because most of the transactional self-dealing operations that generate conflicts between controlling shareholders and outside investors only need board approval and are not taken to the SGM. One could argue that the number of issues that the shareholder meeting must vote on is greater in Europe than in the U.S., creating more space for rescission suits.[51] But the scope of decisions that can be assigned to the SGM is limited by the need for specialized management. Clearly, derivative suits and rescission suits are far from being functional equivalents.

3.2. Lack of specific fiduciary duties for controlling shareholders

On a more conceptual level, liability litigation does not work well in European jurisdictions because, as we saw in Section 2, the traditional approach of corporate law is to prevent conflicts of interest among active shareholders harming the firm and to give the shareholders ample powers to control the managers. Because of this, all shareholders owe loyalty duties towards the aggregate interest of the firm. To the contrary, specific fiduciary duties of controlling shareholders towards noncontrolling shareholders for business decisions are not well developed, and in most countries they are not even identified by case law.

One could argue that some jurisdictions have built elaborated doctrines that come close to imposing fiduciary duties on controlling shareholders. In particular, the abuse of majority powers doctrine (*abus de majorité* in France; *abuso della maggioranza* in Italy; *abuso de mayoría* in

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enforcement problems, and it is, therefore, in need of reform. It is not effective at restraining the powers of controlling shareholders in the general meeting and it leads to holdup problems. These holdup problems have also been reported with special severity in Germany by A Cahn and DC Donald, *Comparative Company Law* (Cambridge University Press 2010) and T Baums, A Keinath, and D Gajek, "Fortschritte bei Klagen gegen Hauptversammlungsbeschlüsse? Eine empirische Studie" (2007) 27 Zeitschrift Für Wirtschrift (ZIP) 1629. The common solution to these holdup problems caused by "predatory shareholders" is to increase standing requirements, and Spain has recently joined the jurisdictions that have followed this path.

[51] For example, capital increases, which generate an opportunity for dilution of stock, require a shareholder vote in European countries more frequently than in the U.S. In fact, one strategy to ensure minority protection through the exercise of rescissions suits is to "open" the array of decisions that the general meeting is competent to vote on (the so called unwritten shareholders' competence regarding business decisions). This is crucial when minority shareholders have no other mechanism to protect themselves from controlling shareholders. According to these judicial decisions, consent of the shareholders meeting is required before the management can take decisions that alter the structure of the corporation and may significantly affect the rights and interests of the shareholders (even if the law does not explicitly provide for such a consent requirement). For the German experience, see the "Macrotron" decision in a case of delisting, BGHZ 153, 47, 51.

Spain) is intended to restrict majority shareholders' voting rights when the shareholder pursues his own self-interest to the detriment of the company's or the minority shareholders' interest[52]. But although this doctrine allows courts to review the most egregious examples of conflicted transactions voted at the general meeting, it is rarely invoked successfully in practice and does not encompass related party transactions and self-dealing.[53]

Moreover, some other jurisdictions, and in particular Germany, have developed by case law a doctrine of duties of loyalty between shareholders. There are some court decisions regarding the scope of fiduciary duties of controlling shareholders and of minority shareholders.[54] Some authors have praised this doctrine as an effective tool for minority protection.[55] Nevertheless, its usefulness should not be overrated. First, there have been few such court decisions. Second, most of these cases do not really discuss shareholders' liability, but rather deal with the nullification of resolutions on the grounds of a breach of fiduciary duties. One can consider the loyalty duties doctrine to be a kind of substitute for the minority oppression doctrine that applies in the U.S. for closely held corporations. It has shown some merit in limiting the abuse of the majority voting power in key "structural or organizational" decisions potentially harmful for minority shareholders, such as the liquidation of the company and capital increases. But, similarly to the abuse of majority powers doctrine, it has not proven to be a workable mechanism to limit expropriation through self-dealing or related parties' transactions or to make the controlling shareholder liable.

[52] Conac, Enriques, and Gelter (n 23) on page 501.

[53] E Rock, P Davis, H Kanda, R Kraakman, and WG Ringe, "Fundamental Changes" in R Kraakman (ed), *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn, Oxford University Press 2017) p. 178. The abuse of majority doctrine is designed to protect minority shareholders in conflicted transactions of the controlling shareholder that are decided in the general meeting, like fundamental changes, charter amendments, issue of stock, etc. In fact, this doctrine is a kind of response, at least on the books, to the great power of the general shareholders' meeting in these jurisdictions, which reflects the strong position of shareholders in general, and of controlling shareholders in particular.

[54] See German court decisions: "Linotype", BGHZ 103, 184, 193; "Hilgers", Urteil vom 5. 7. 1999 - II ZR 126-98, BGHZ 42, 167, 170 (capital decrease and increase to the detriment of small shareholders); BGH, Beschluss v. 20. April 2009 – II ZR 148/07, ZIP 2009, 1317; KG, Urteil v. 17. 9. 2009 - 23 U 15/09, NZG 2010, 462 (convening of an extraordinary general meeting while a shareholder is temporarily excluded).

[55] For example, Ringe (n 23) on 504 'For the most part, these loyalty duties apply to majority shareholders, thus making the principle an important tool of minority protection, and responding to the prevalence of blockholders in the German corporate landscape' and also H. Fleischer, § 53 a, Aktiengesetz Kommentar, K. Schmidt, and M. Lutter (ed.), (Ottoschmidt 2015), and the references they cite in footnote 156).

So it is fair to say that fiduciary duties—as they are designed in these jurisdictions—provide a poor foundation for curtailing the controlling shareholders' deviation of value at the expense of outside investors. The current design of fiduciary duties makes it very difficult to hold controlling shareholders accountable for cases of tunnelling and minority expropriation that occur in the course of regular business decisions (rather than financial or ownership decisions taken at the SGM).

3.3. Problems for the evaluation of specific fiduciary duties for controlling shareholders in business groups

From a legal point of view, considering the controlling shareholder as an inside manager rather than a mere shareholder makes it possible to make him or her liable towards market investors. But even if European jurisdictions were to apply the abuse of majority powers doctrine to issues such as related party transactions, judges would face difficulties in determining when the controlling shareholder is abusing the outside investors because of the prevalence in Europe of complex corporate structures, such as groups or pyramids, or intricate control arrangements among inside shareholders.[56] These complex structures exacerbate the problems for determining when controlling shareholders have breached their duties towards outside investors.

The first problem appears because it is difficult to clarify whose interest should prevail. It is hard to disentangle the interest of the corporation from the interest of the controlling shareholder and the interest of outside investors, especially in the case of business groups and cross-holdings. On the one hand, to the extent that they can control business decisions, controlling shareholders act as agents of the outside shareholders. But on the other hand, controlling shareholders may defend their own interest as shareholders.[57] In a business group or

[56] For a discussion of these structures, see Enriques and Volpin, (n 18) and M Becht and A Röell, "Blockholdings in Europe: An International Comparison" (1999) 43 European Economic Review 1049. As an example of how complex and intricate these structures can be, see The Economist Nov 30th 2006 "Creative Construction" on how the Bouygues brothers worked from within to gain control of one of the largest construction firms in the world.

[57] Z Cohen, "Fiduciary Duties of Controlling Shareholders: A Comparative View" (1991) 12 University of Pennsylvania Journal of International Law 379 explains how English case law recognizes a shareholder's voting rights as property whose owner may use them as she wishes. Only two limitations have been recognized to limit this property right. The first limits changes in the company's constitution without the minority's approval, and the second applies in cases of "fraud on the minority" when there is expropriation of the company's property by the majority or expropriation of the minority's property (shares) by the majority. In particular, Justice Walton declared: 'When a shareholder is voting for or against a particular resolution, he is voting as a person owing no fiduciary duty to the company who is exercising his own right of property as he sees fit. The fact that the result of the voting at the meeting

Electronic copy available at: https://ssrn.com/abstract=3091729

when there are cross-holdings or differential voting rights, the interest of the minority and the interest of the controlling shareholder are likely to differ, and it is also difficult to identify the "interest of the company". Consequently, legislators and judges find it hard to make controlling shareholders liable when they cause damages to the minority, but not to the "interest of the company", usually interpreted as the interest of the majority, which necessarily coincides with the controlling shareholder.[58] It seems self-evident that managers as fiduciaries should subordinate their own interests and act in the interest of the firm (that is, in the interest of the shareholders as a group). But it is far from clear where to set the limits if someone holds a controlling stake among the owners. Therefore, unless controlling shareholders act as directors or officers, they are rarely exposed to liability.[59]

The second problem arises because controlling shareholders can usually extract private benefits in the course of business transactions where the business judgment rule applies and these transactions are difficult to identify and regulate. Liability rules are easier to apply to transactions where the block-holder enters into a direct contract with the corporation and stands on both sides of the transaction. Examples of these cases include salaries, pensions, personal loans, etc. In these cases, the treatment of the controlling shareholder should be similar to the treatment of a manager. But more frequently, controlling shareholders can extract private benefits by altering business or strategic decisions.[60] This can involve different business decisions, like acquisitions

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(or at a subsequent poll) will bind the company cannot affect the position that in voting, he is voting simply in exercise of his own property rights.' Northern Counties Sec. Ltd. v. Jackson & Steeple Ltd., [1974] 1 W.L.R. 1133, 1144 (Ch.).

[58] It has become a commonplace in continental European jurisdictions to define the interest of the corporation as an open standard that needs to be translated into more concrete terms through the legal procedure established to adopt corporate decisions. In practice, the interest of the corporation is hard to pin down for the courts, so they are inclined to accept the definition of the corporate interest suiting controlling shareholders. Notice also that because the standard should not be understood substantively, judges are likely to confront it on procedural terms. In other words, the majority rule determines each time that is in the interest of the company. But then, the standard is no longer useful and allows too much discretion to the majority group, as argued by G Spindler Münchener Kommentar zum Aktiengesetz, ∫ 76 comment 70 (2008). Because of this, D Schmidt, *Les confflics d'interets dans la societe anonyme* (Joly Editions 2004) criticizes the prevailing interpretation of "the interest of the company" as being too friendly to controlling shareholders.

[59] Enriques, Hertig, Kanda, and Pargendler (n 44) on page 162, 'The European approach reflects a general reluctance to hold controlling shareholders liable so long as they are not directly involved in the company's management'.

[60] Regarding controlling shareholder's influence over the operations and management of the controlled corporation, the case law distinguishes between business decisions that affect all shareholders versus conflict-of-interest (or self-dealing) transactions between a controlling shareholder and a controlled company. Courts apply the business judgment rule to the first type of transaction but they apply the entire fairness test to the second. Those transactions that do not carry a direct conflict with the minority are more likely to receive deferential business judgment rule

or other investments, that can somehow benefit the insiders but might not be the best decision according to minority interests. Although this problem may exist in any jurisdiction, it is most acute where vertically or horizontally integrated business groups prevail and each of the firms in the group engages in frequent business operations with the rest of the group.

Business groups may well form naturally in economies with weak market institutions, where there are clear advantages to creating internal markets for capital, products, or labour. As explained by Enriques[61], in these opaque firms, controlling shareholders can add value if self-dealing transactions help firms to avoid markets characterized by strong asymmetric information and/or inefficient institutions. In particular, firms may choose opaque or complex business structures to protect themselves from corporate taxation,[62] from inefficient courts,[63] and from inheritance taxes.[64] Nevertheless, there is evidence on how they impede competition and on the corporate governance problems that they suffer.[65]

In this regard, traditional mechanisms and doctrines intended to balance the interests of the group as a whole and those of its subsidiaries clash with the elemental protection of market investors when the company is listed[66]. Conversely, it seems clear that strong liability for

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protection according to J Dammann, "Corporate Ostracism: Freezing out Controlling Shareholders" (2008) 33 Journal of Corporation Law 683 and n 9 and n 12.

[61] L Enriques, "Related Party Transactions: Policy Options and Real-World Challenges (With a Critique of the European Commission Proposal)" (2015) 16 European Business Organization Law Review 1.

[62] The tax treatment of corporate capital gains influences corporate cross-ownership patterns (MA Desai and WM Gentry, "The Character and Determinants of Corporate Capital Gains" (2004) 18 Tax Policy and the Economy 1). For Germany, C Edwards, MH Lang, EL Maydew, and DA Shackelford, "Germany's Repeal of the Corporate Capital Gains Tax: The Equity Market Response" (2004) 26 Journal of the American Taxation Association 73 investigate market reactions to the 1999 announcement of a major German tax reform that repealed the sizable capital gains tax on sales of corporate cross-holdings. They report a positive association between firms' event period abnormal returns and the extent of their cross-holdings, consistent with taxes acting as a barrier to the efficient allocation of ownership. Subsequent anecdotal evidence is consistent with the tax reform leading to a major overhaul of the ownership patterns in Germany. M Holmen and P Högfeldt, "Pyramidal Discounts: Tunneling or Overinvestment?" (2009) 9 International Review of Finance 133 also trace the role of tax changes in influencing pyramidal ownership in Sweden.

[63] The creation of groups allows medium and large-size firms to profit from incentives aimed at small firms that exempt these firms from rules regarding unionization, hiring and firing practices, taxation, etc.

[64] In many countries, inheritance law imposes a minimal stake to be left to non-controlling heirs, and this reduces the wealth that the controlling heir can invest in the family. On this issue, see A Ellul, M Pagano, and F Panunzi, "Inheritance Law and Investment in Family Firms" (2010) 100 American Economic Review 2414.

[65] For a discussion of these problems, see R Morck, B Yeung, and D Wolfenzon, "Corporate Governance, Economic Entrenchment, and Growth" (2005) 43 Journal of Economic Literature 657 and T Khanna and Y Yafeh, "Business Groups in Emerging Markets: Paragons or Parasites?" (2007) 45 Journal of Economic Literature 331.

[66] Groups are in fact the most extreme form of block-holder control. Enriques, Hertig, Kanda, and Pargendler (n 44) on page 1623 report that the main jurisdictions in Europe allow courts to evaluate whether intra-group transactions are fair "as a whole", so it is hard to challenge an individual transaction harming the subsidiary if the overall

controlling parties is largely incompatible with complex corporate structures because it would expose most of their business decisions to judicial review. It is worth noting that this conflict is less intense when the group is composed of non-listed firms. In that case, minority shareholders should be able to contract the terms and the protection of their investment on a long-term basis when they enter the group using shareholders' agreements. In fact, Gutiérrez and Sáez present a model that proves that, when contracting on private benefits is possible, a combination of simple contractual sharing rules coupled with very tough default rules for self-dealing induces the controlling shareholder to contract with the minority and increase total firm value.[67] However, this type of contracting is less feasible in a listed firm. In addition, the lobbying power of European groups is likely to block any reform aimed at increasing liability for controlling shareholders.[68]

Interestingly, groups and pyramids are now extremely rare in the U.S., but this has not always been the case. In fact, Kandel and coauthors show that, until the 1930s, the ownership structure of listed U.S. firms was similar to the European one, with more than 50 large pyramidal business groups. They argue that the disappearance of these groups was the result of a series of legal reforms that were explicitly targeted at them.[69] These reforms made diversion of private

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management of the group offsets the damage from the individual transaction. Not surprisingly, given the importance of its business groups, German law has addressed this problem through complex and elaborate regulation, which has proved rather ineffective. In order to avoid litigation based on loyalty duties, they have enacted codified law on corporate groups based on special report and audit duties of the activity of the group, as explained by W Zöllner, "Qualizierte Konzernierung im Aktienrecht", in Gedähtnisschrift für B. Knobbe-Keuk (2007). In France, the Rozenblum doctrine subordinates the interest of the subsidiary to the interest of the parent company if the group has a balanced and firmly established structure and the subsidiary is incorporated into a long-term and coherent group policy, in the understanding that the loss suffered by the company will be balanced by future benefits.

[67] Gutiérrez and Sáez (n 49).

[68] The regulation of intra-group transactions has been traditionally kept out of the picture, although it is a fertile ground for expropriation. The EU Commission has opted not to keep groups out of the reach of corporate law. So the plan to impose rules on related party transactions of controlling shareholders has not been welcome among the German doctrine, very supportive of its own group law, which does not consider specific duties of the controlling shareholders. On this issue, see KJ Hopt, "Groups of Companies—A Comparative Study on the Economics, Law and Regulation of Corporate Groups" in J Gordon and WG Ringe (eds), *Oxford Handbook of Corporate Law and Governance* (Chapter II, Oxford University Press 2015) and TH Tröger, "Corporate Groups—A German's European Perspective" in H Fleischer, JL Hansen, and WG Ringe (eds), *German and Nordic Perspectives on Company Law and Capital Markets Law* (Mohr Siebeck 2015), 157-199.

[69] E Kandel, K Kosenko, R Morck, and Y Yafeh, "The Great Pyramids of America: A Revised History of U.S. Business Groups, Corporate Ownership and Regulation, 1930-1950" (2013) NBER Working Paper No. 19691. See also R Morck, "How to Eliminate Pyramidal Business Groups: The Double Taxation of Inter-Corporate Dividends and Other Incisive Uses of Tax Policy" (2004) 19 Tax Policy and the Economy 135 arguing that the first Roosevelt administration associated pyramidal business groups with corporate governance problems, corporate tax avoidance,

benefits more difficult for controlling shareholders. Moreover, they show that the enactment of the Securities and Exchange Act of 1934, which enhanced shareholders' rights vis-à-vis corporate insiders and introduced liability for controlling parties, was a severe blow for these groups.

Summing up, under the current regulation, liability does not seem a significant threat for disciplining the key insiders in European listed, controlled firms or inducing them to subject conflicted transactions to reliable ex ante mechanisms.[70] Moreover, the prevalence of business groups in Europe is likely to block any attempt to introduce clear fiduciary duties for controlling shareholders. As a consequence, a "legal" rate of private benefits for controlling shareholders is allowed. This rate can be higher or lower depending upon the strength of alternative disciplinary corporate governance mechanisms. But as we will see in the next section, exit and voice are not good substitutes for liability when we are dealing with a controlling shareholder.

4. Exit and voice as imperfect substitutes for liability in controlled, listed firms

In the previous section, we argued that the different approach to liability for controlling shareholders in European jurisdictions compared to the U.S. leaves passive outside investors poorly protected from the controlling shareholders of European listed firms. Nevertheless, many scholars have stressed the potential complementarity and substitutability between liability, exit, and voice as alternative corporate governance mechanisms.

In this section, we will show that neither exit nor voice can substitute successfully for clear and enforceable liability for the controlling shareholder towards market investors. This is interesting because the debate on how to improve corporate governance has especially focused on strengthening the voice mechanisms available for minority investors. Moreover, there is a common perception among European scholars that continental jurisdictions offer strong voice protection for minorities. We will argue that far from substituting for liability, the current design

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market power, and an objectionable concentration of economic power; and undertook a sustained program that rapidly broke up large American pyramidal groups.

[70] This is the case in the U.S., where majority of the minority approval is intended to complement liability rules. In this sense, Delaware courts have accepted the majority of the minority approval as a reliable method of screening conflicted transactions of a controlling shareholder, and it shifts the burden of proof in cases of breaches of fiduciary duties. Dammann (n 60), 7 states that 'The entire fairness standard applies even if the transaction has been approved by a majority of the minority shareholders or by a committee of independent directors. The only thing that can change is the allocation of the burden of persuasion regarding the fairness of the transaction'.

of voice rights in Europe tends to increase the power of controlling shareholders in controlled, listed firms and reinforce the "strong shareholders, weak outside investors" paradox.

4.1. Exit

When we think about exit, we usually allude to individual investors selling their shares in the secondary capital markets. But there is a second dimension of exit that refers to outside shareholders acting as a group to induce the insiders to give them back part of the funds invested in the company in the form of dividends. In this section, we will discuss how each of these dimensions can work to discipline the insiders both in companies controlled by the managers and in companies with a controlling shareholder.

Regarding the first dimension of exit, even small, uncoordinated market investors have the power to check managers and large investors by "voting with their feet", i.e., by refusing to provide their funds to the firm. If many outside investors wish to sell, the price of the shares will go down and this can help discipline the insiders who control the funds.[71]

In the case of managers, the negative consequences of low market prices are stronger because their salaries and reputation, and the probability of being fired, or losing their job because of a takeover, are all linked to stock market values. Of course, the recent crisis has shown that, if market prices are biased because of short-term bubbles, relying too much on them to discipline managers may be a bad idea.[72] But notice that none of this applies in the case of a controlling

[71] The idea that stock prices can play a role in monitoring managers' actions was first formalized by Holmstrom and Tirole (n 3). They present a model where secondary stock market traders learn about managers' actions and trade accordingly and the manager is disciplined via the stock holdings on his remuneration contract. They argue that this effect is higher when ownership is more dispersed and market liquidity is higher, because liquidity increases the profits that speculators can realize in trading on information. Because of this, Bhide (n 3) argues that exit is an alternative to activism by large shareholders. But AR Admati and P Pfeiderer, "The "Wall Street Walk" and Shareholder Activism: Exit as a Form of Voice" (2009) 22(7) Review of Financial Studies 2445 present a model where the threat of exit (also known as the "Wall Street Walk") by an informed large shareholder can also discipline a stock-incentivized manager for particular decisions, although it may have a negative effect on managerial initiative.
[72] When market imperfections make prices in the short term deviate from the long-term value (market myopia), the value of long-term investments that may be crucial for long-term competitiveness (such as R&D capabilities) is not reflected in (and may even depress) short-term prices. When faced with this situation, stock-incentivized managers (and managers with career concerns) will underinvest. In an interesting survey, JR Graham, CR Harvey, and S Rajgopal, "The Economic Implications of Corporate Financial Reporting" (2005) 40 Journal of Accounting and Economics 3 find that 78% of executives would be willing to sacrifice long-term value to meet earnings targets. For a complete discussion of the issue, see the Kay Review (available at http://www.johnkay.com/2012/07/23/the-kay-review).

shareholder, whose control is incontestable, since he or she cannot be fired or suffer a hostile takeover.[73]

Nevertheless, both for companies with dispersed or concentrated ownership, lower market prices make access to new financing more difficult and expensive and reduce the investment opportunities of the firm. This financial market pressure will be effective for firms with large investment needs, whose retained earnings are low compared to their investment opportunities. Therefore, for companies that do not have free cash flows, the threat of having many dissatisfied outside investors selling their shares in the stock market will be a strong exit mechanism that will keep the insiders in check and prevent minority expropriation.

But what happens in the case of firms that can satisfy their investment needs using the proceeds from previous equity issues and retained earnings as their sole sources of funds? Does exit have a role to play in the corporate governance of these firms that do not need to raise funds in the capital markets?

This bring us to the second dimension of exit, which relates to outside investors forcing or inducing a generous dividend policy that allows them to get back the money they have invested in the firm and reduce free cash flows. Insiders have incentives to retain free cash flows inside the firm, where they can make use of them to generate private benefits for themselves at the expense of outside investors. The financial literature makes a strong case for the usefulness of a generous dividend policy as a means to reduce this agency conflict.[74] Easterbrook and Jensen argue that in this context high dividend payouts can reduce the ratio of retained earnings to investment and subject these firms to the discipline of having to raise funds in the capital markets, so that exit becomes a powerful threat again. With high dividends, insiders will be unable to fund their suboptimal investment projects with free cash flows and will be forced to issue either debt or equity if they want to raise money for investment. Therefore, although issuing securities is a

[73] There could still be some incentives for long-term shareholders to keep prices up for reputational reasons. Controlling shareholders might pledge their shares as a security for getting loans, with margin calls if the price of the security drops below a minimum as defined in the loan contracts. Then, if the price drops below the minimum threshold, margin calls are triggered, and the borrower has to provide either more security or return the loan. This encourages controlling shareholders to take measures to keep the price of stock at least above the level fixed in the loan agreement.

[74] For a review of the large literature on dividend policy, see F Allen and R Michaely, "Payout Policy" in G Constantinides, MG Harris and R Stutz (eds), *Handbook of the Economics of Finance* (Elsevier 2003).

costly process that could be avoided by retaining earnings, it has the advantage of allowing outside investors to monitor investment policy and reduce agency conflicts.[75]

The recent empirical research on dividend policy is consistent with the idea that dividends are used as a corporate governance mechanism that allows outside investors to reduce their investment in the firm when free cash flows appear.[76] This suggests that dividends are the perfect exit mechanism to keep insiders in check, but an important question remains: who will bell the cat? It is unclear, in a firm where the dividend policy is controlled by the insiders, why these insiders voluntarily select a dividend policy that reduces their discretion and prevents them from pursuing their preferred investment strategy.

We would expect that when insiders control dividend policy they will use the policy to reduce free cash flows only if there is an incentive to do so. Thus, dividend policy will be complementary to other corporate governance mechanisms, such as the fear of a takeover, stock options in the remuneration packages of the executives, the pressure of independent board members, the activism of institutional investors, etc.[77]

If alternative disciplinary mechanisms are lacking, dividends will be low. In fact, La Porta and coauthors show that in countries with concentrated ownership and weak minority protection, dividend payout tends to be lower. This is consistent with more recent empirical

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[75] FH Easterbrook, "Two Agency-Cost Explanations of Dividends" (1984) 74 American Economic Review 650 and MC Jensen, "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers" (1986) 76 American Economic Review 323.

[76] L DeAngelo, DJ DeAngelo, and RM Stulz, "Dividend Policy and the Earned/Contributed Capital Mix: A Test of the Lifecycle Theory" (2006) 81 Journal of Financial Economics 227 show that propensity to pay dividends is positively related to the ratio of retained earnings to total equity, which proxies for free cash flows. DJ Denis and I Osobov, "Why Do Firms Pay Dividends? International Evidence on the Determinants of Dividend Policy" (2008) 89 Journal of Financial Economics 62 find that the likelihood of paying dividends is strongly associated with the ratio of retained earnings to total equity, and that the fraction of firms that pay dividends is high when firms' equity consists primarily of retained earnings and is low when retained earnings are negative.

[77] M Gutiérrez and MI Sáez, "Dividend Policy with Controlling Shareholders" (2015) 16 Theoretical Inquiries in Law 107 address this question in detail. They analyse the legal rules governing cash distributions and show that the law grants the control of dividend policy to the powerful insiders with weak protection for the interests of outside shareholders in this regard. Because of this, they argue that dividend policy will be closely related to the overall quality of other corporate governance mechanisms. When insiders are in control of the dividend policy and overall corporate governance is weak, dividend policy will fail to reduce agency conflicts. But when insiders are in control of the dividend policy but other corporate governance mechanisms are functioning well, and they give the insiders the right incentives, dividend policy will be designed so as to reduce free cash flows.

evidence that analyses the differences in dividend policy depending on ownership structure and shows that companies with controlling shareholders have lower payout ratios.[78]

Therefore, exit in the financial markets will be a useful corporate governance mechanism in growing firms that need external funding to invest and for firms where complementary corporate governance mechanisms discipline insiders. But firms with concentrated ownership that generate free cash flows cannot be disciplined by exit. Additionally, consistent with the idea of strong shareholder protection, in European jurisdictions, the law grants control over the dividend decision to the SGM, where the controlling shareholder enjoys dominant voting power. Clearly, leaving this key decision in the hands of the controlling shareholder facilitates minority expropriation. This is another manifestation of the paradox of "strong shareholders, weak outside investors" that is prevalent throughout European jurisdictions.

4.2. Voice

The traditional view on voice as a corporate governance mechanism is that reinforcing the voice rights for the shareholders lessens the agency conflict by reducing the decision power of the managers. Moreover, voice is always more effective in the presence of large shareholders because they are able to overcome the asymmetric information and collective action problems that limit the use of voice by dispersed shareholders. This reduction in the agency conflict between managers and shareholders is the bright side of voice.

The most relevant corporate governance reforms in the last decades have been aimed at strengthening the voice rights of investors. In fact, the changes to the regulation of independent directors, the introduction of say on pay, and the modifications to proxy regulation and "shareholder rights" have gone hand in hand with the increasing importance of activist investors.

[78] R La Porta, F López-de-Silanes, A Shleifer, and R Vishny, "Investor Protection and Corporate Governance" (2000) 58 Journal of Financial Economics 1. Denis and Osobov (n 75) also find important differences between the dividend policies of firms in Germany, France, and Japan, characterized by significant ownership concentration. They find that in the U.S., Canada, and the UK, the firms with poor growth opportunities are more likely to pay dividends, while in Germany, France, and Japan, the result is the opposite. In order to identify the causality link, K Gugler and BB Yurtoglu, "Corporate Governance and Dividend Pay-Out Policy in Germany" (2003) 47 European Economic Review 731 study market reactions to announcements of dividend decreases in Germany and find that the negative effects are larger for companies where corporate insiders have more power. Investigating causality, S Thomsen, "Conflicts of Interest or Aligned Incentives? Blockholder Ownership, Dividends and Firm Value in the U.S. and the EU" (2005) 6 European Business Organization Law Review 201 finds that increases in block ownership are correlated with posterior decreases in dividend payouts.

The major upheaval in corporate governance is the result of the concentration of ownership in the hands of activists and institutional investors that have become large shareholders and therefore have both the power and incentives to make their voice heard and oppose managerial decisions that are not aligned with the interest of investors.

But there is also a dark side of voice. As explained by Shleifer and Vishny, voice encourages the creation of large stakes. When these stakes are significant but do not render control, as happens in the case of institutional investors, they are used to reduce the agency conflict. When one of these stakes becomes large enough to give control, the agency conflict may simply be replaced by a conflict between the controlling shareholder and the minority.[79]

Concentration of ownership up to levels that render control can happen for different reasons. One possibility is that the agency conflict is very costly for companies that have strong investment needs which may be in conflict with short-term pressures from the stock market. In this case, one could say that there are large public benefits of control for all shareholders because their interests are difficult to reconcile with the career concerns of risk-averse managers. This might be why there is an increase in listed, controlled firms when founders choose to retain control at the time of taking the company public and when these companies have high growth opportunities, where a long-term vision is crucial. [80] On the other hand, a more worrying situation arises when control is valuable because there are large private benefits of control. When the party in control can extract rents, large shareholders will become controlling shareholders simply to extract these rents more effectively and even to a greater extent than managers. A combination of large private benefits of control and significant voice rights will lead to a fortification of the power of controlling shareholders and to the expropriation of the minority. For these firms, more voice rights lead to the paradox of strong shareholders, weak outside investors.

It is challenging to design good voice rules for these firms because improving voice rights over the board simply reinforces the power of the controlling shareholder. The common way to address this problem in European jurisdictions has been to establish specific rights for the minority to counter the power of the controlling shareholder. The first set of legal rules

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[79] Shleifer and Vishny (n 1).

[80] Bebchuk and Kastiel (n 7) on page 604 ss explain that the potential advantages of dual-class structures (such as those resulting from founders' superior leadership skills) tend to decline, and the potential costs tend to rise, as time passes after the IPO.

traditionally used to give a kind of veto power to minority shareholders are rules that restrict the voting power of the controlling shareholder for some salient decisions, by altering the majority rule requiring supermajority rules[81] (sometimes in conjunction with high quorum requirements) or norms that force the conflicted party (not necessarily the controlling shareholder) to refrain from voting.[82]

The second set of rules establishes mandatory rights for the minority as a class.[83] Some examples of these rules are rules granting minority shareholders the power to call a SGM through court order following management inaction, the right to place items on the agenda, rules allocating power between the board and the shareholders, extensive rights of information, appraisal rights, cumulative voting, etc.

These rules are effective at preventing flagrant cases of expropriation where there is a direct attempt of unequal distribution of profits (such as abusive share issues or excessive compensation for board members). However, there are two important caveats to be made.

First, these rules are not effective in dealing with situations where the profits to be distributed have been reduced because of business transactions that have redirected cash flows to other beneficiaries through transfer pricing (such as acquisitions or sales of assets above or below market prices). This is where the bulk of expropriation can happen in listed, controlled corporations, and particularly in groups.

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[81] For an overview of the use of this method for limiting the decision rights of controlling shareholders in different jurisdictions, see Enriques, Hansmann, Kraakman, and Pargendler (n 44) on page 84.

[82] It is worth noting that the development of these rules in continental Europe is linked to the law of non-listed corporations. In origin, they are designed to protect minority shareholders in situations of conflict of interest, like the transfer of shares or a waiver of the non-competition obligation and the like. Another alternative is the majority of the minority rule. But this option has no tradition in European jurisdictions because deviations from the majority rule, which gives all control rights to "some" shareholders, appear to be contrary to the principle of "equal treatment for all shareholders" granted by the law. So even though it is becoming more popular, the introduction of rules that impose a majority of the minority approval in listed corporations regarding conflicted transactions and self-dealing operations is still rare (see Enriques, Hertig, Kanda, and Pargendler (n 44) at page 157, reporting that France has been the continental jurisdiction more inclined to give shareholders a say on related party transactions, although with important shortcomings in effectiveness—controlling shareholders have wide discretion deciding which transactions are non-routine, and the voting only express the precatory dissatisfaction ex post). Some jurisdictions—like Italy—have already enacted rules in this direction, and this was also the direction taken by EU legislation, which finally has not been approved (Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholders' engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statements).

[83] For a general description of these tools to protect minorities, see Enriques, Hansmann, Kraakman, and Pargendler (n 44), 79ff.

Second, effective use of these rules, as they are formulated at present, requires the active participation of the minority and does not make controlling shareholders accountable to passive investors. This means that passive investors will only be protected if their interests are aligned with those of significant minorities, otherwise it could lead to holdup problems. The holdup problems caused by organized minorities and the protection of the company from (minority) shareholder pressure have received focal attention in European jurisdictions where, paradoxically, there exist general fiduciary duties for voting shareholders but not specific fiduciary duties for controlling shareholders making decisions as de facto managers.[84] Consequently, the veto power of minority shareholders to counter the power of controlling shareholders is less effective "in action" than it appears to be "on books".

In sum, in their current formulation, participation rights in controlled, listed companies fail to solve the "strong shareholders, weak outside investors" paradox because they are not well suited to protect passive investors or to control expropriation that arises from self-dealing in the course of business operations and decisions that are delegated and do not reach the SGM.

5. Discussion: Can we overcome the "strong owners, weak outside investors" paradox?

Our previous analysis highlighted the difficulties of protecting market investors in listed, controlled firms. In particular, exit and voice have important limitations when applied to a controlling shareholder who will not face serious adverse consequences if other investors sell or vote against his/her proposals. In particular, we have seen how exit via financial markets will not

[84] In fact, for part of the continental legal literature, the risk of minority abuse—rather than the majority abuse—emerges as the real danger that needs to be curtailed. As it seems, European legal scholars and legislators fear more the minority holdup risk than the majority disposition to expropriation. Two examples can illustrate this view. The first example, in Germany, refers to the shareholders' fiduciary duties leading case, the so-called "Girmes" decision (BGHZ 129,136 [142ff.] = NJW 1995, 1739), which is aimed at reducing minorities' holdup, as explained by Cahn and Donald (n 50). Notice that unlike controlling shareholders, in this case, a group of minority shareholders is seen as in principle liable for their voting behavior infringing fiduciary duties. The second example refers to the rescission of shareholder resolution. This tool faces many restrictions to protect minority interest, but the spotlight on this matter has been put on the problem of abusive suits launched by professional litigants, as argued by D Zetzsche and E Vermeulen, "Use and Abuse of Investor Suits—An Inquiry into the Dark Side of Shareholder Activism" (2010) 7 European Company & Financial Law Review 1. And as a matter of fact, minority shareholders might be liable on the grounds of a breach of fiduciary duties for filing a claim for annulment of a resolution; see OLG Frankfurt a. M., Urteil vom 13.1.2009- 5 U 183/07 (NZG 2009, 222).

discipline the controlling shareholder who holds an illiquid stake, especially if the company generates free cash flows, does not need the financial markets, and the control of the dividend decision rests with the GSM where the controlling shareholder can make use of his or her voting power. Moreover, we have discussed the limitations of voice in listed, controlled firms. Rules that restrict the voting power of the controlling shareholder in the setting of private firms and mandatory rights for the minority as a class are not particularly well suited to protect the interests of passive market investors, especially when expropriation can take place in the course of standard business transactions in the everyday management of the business. Moreover, we have seen that the regulation in continental Europe does not consider specific fiduciary duties for the controlling shareholder towards outside investors and arguably allows a high rate of private benefits. The alternative option, exemplified by the U.S. case, treats controlling shareholders just like any other fiduciary agent and restricts the private benefits for anyone who controls the decisions of the firm.

As we have seen, the European model produces the paradox of "strong owners, weak outside investors", and this constrains stock market development. Our analysis leads to the question of what could be done to improve this situation.

Regarding liability, we have argued that the introduction of specific liability for the controlling shareholder towards outside investors would improve the protection of these investors and bring Europe closer to the U.S. However, the prevalence of groups in European stock markets and the strong impact that a liability rule would have for their operations suggests that any attempt to introduce strong fiduciary duties for controlling shareholders will encounter fierce resistance from the status quo.

Regarding exit, we have seen that high dividends can keep insiders in check, but right now the dividend decision is in the hands of the SGM, where the controlling shareholders can make use of their voting rights.

This leaves us with changes to the regulation of voice as the most promising alternative. In the previous section, we argued that, in their present formulation, the established veto mechanisms and mandatory rights for the minority as a class are not well suited for the protection of passive investors because (i) they do not reach the operational related party transactions and (ii) they protect the interests of organized minorities rather than the interests of passive shareholders, and thus may give rise to holdup problems.

We believe that effective implementation of majority-of-the-minority (MOM) rules would be a promising avenue to overcome these problems. However, the introduction of MOM rules should not be envisaged to substitute the liability rule, but rather to downgrade the judicial standard of review, so some risk of litigation is not completely excluded. Otherwise, the companies would not have the right incentives to implement effective self-cleansing mechanisms. MOM rules apply to controlled firms and require all related party transactions to be approved ex ante by a majority of the minority, excluding the related party from voting either at the board level or at the SGM.[85] In the case of board approval, effective application of MOM requires conflicted decisions to be taken up by a committee of independent or disinterested directors (unaffiliated with the controlling shareholder.)[86]

To what extent can MOM rules improve the protection of passive investors relative to existing mandatory rights for the minority? First, they can be carefully targeted to be applied both to the operational and financial self-dealing transactions that represent severe conflicts of interest and require a check on the bargaining power of the controlling shareholder, protecting all other decisions from holdup problems. Second, they can be designed to give voice to parties whose interests are aligned to market investors, rather than to organized minorities. Outside investors in listed firms are rationally passive and will not search for information or act upon it. This is in fact the reason that investors delegate control to management in the first place. Expecting these investors to exhibit rational inaction, effective application of MOM rules requires the interposition of some informed party with interests aligned with those of the outsiders and enough power to affect key decisions—parties such as institutional investors and independent directors. It follows that a precondition for MOM rules to work well is to have truly independent and well informed directors and active institutional investors.[87]

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[85] For a detailed explanation of these rules, see Enriques (n 62).

[86] As explained in Enriques, Hertig, Kanda, and Pargendler (n 44) 154, most European jurisdictions rely heavily on board approval to police self-dealing, although the specific approval requirements vary across countries, in issues such as who should vote and whether the conflicted parties should be allowed to be present or not. And interestingly, M Bianchi, A Ciavarella, L Enriques, V Novembre, and R Signoretti, "Regulation and Self-Regulation of Related Party Transactions in Italy. An Empirical Analysis" (2014) ECGI - Finance Working Paper No. 415/2014 provide empirical evidence showing that, to the extent that companies are given some freedom in their application through internal codes regulating boards, controlling shareholders exercise their power to water down as much as possible board approval requirements.

[87] In fact, independents and activists seem to work better as complements rather than substitutes. Kastiel (n 28) documents cases of hedge fund activism in U.S. controlled firms and finds that this activism is facilitated by the right to nominate and elect minority directors, the right to veto going-private transactions, and the use of litigation as a

Both independent directors and institutional investors present shortcomings that would need to be addressed before the application of MOM rules could be effective.

The independent directors of controlled firms have incentives to go along with controllers' wishes, or at least inadequate incentives to protect public investors. This happens because controlling shareholders have the power to nominate not only directors who directly represent their interest on the board, but even a majority of independent directors.[88]Therefore, it seems necessary to change the way in which independents are nominated in listed, controlled firms. However, even if that is the case, most jurisdictions have chosen more lenient types of board approval to preserve the influence of controlling shareholders in the conflicted decision.[89]

Institutional investors are likely to remain passive investors even if they can benefit from MOM rules, leaving hedge funds (teaming up with other institutional investors) as the most likely activists to oppose controlling shareholders in listed firms and to make use of MOM rules.[90] The academic literature on hedge funds almost unanimously finds that they generate valuable policy changes in the companies where they challenge the insiders. [91] But European jurisdictions do not seem to be very friendly towards activists, and they have enacted block-holder disclosure

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means to put pressure on controllers. Interestingly, controllers' reputational concerns also play a role in encouraging activism and disciplining controllers when these forces operate in conjunction with other legal threats.

[88] Gutiérrez and Sáez (n 28) and Bebchuk and Hamdani, "Directors" (n 27).

[89] Spanish law is interesting, because it goes a step further compared to other European jurisdictions. In most jurisdictions, the mandate of "disinterested" directors restrains a director from voting when the director himself or herself is involved in a conflict of interest, but not if the controlling shareholder who nominated him or her is the one conflicted. The new Spanish regulation, recently adopted, states that the shareholders' designated directors ("consejeros dominicales") should refrain from voting if the shareholder whose interest they represent is conflicted in the transaction (art. 529 ter h LSC). Notice though that the rule is less effective if there are voting pacts that allow a group of several significant block-holders to share control (as usually happens in Spain), because the transaction could be approved with the consent of the other members of the voting pact.

[90] Unlike hedge funds, most large investment and pension funds suffer from agency costs and restrictions based on their business model—which lacks the correct pay incentives and the concentrated positions in a small number of companies that motivate hedge funds—to be active investors, as explained in A Brav, W Jiang, F Partnoy, and R Thomas, "Hedge Fund Activism, Corporate Governance, and Firm Performance" (2008) 63 The Journal of Finance 1729. Thus, MOM rules would be most helpful to promote activism by hedge funds in companies where currently high ownership concentration is a clear and unavoidable barrier. BR Cheffins and J Armour, "The Past, Present and Future of Shareholder Activism by Hedge Funds" (2012) 37 Journal of Corporation Law 51argue that the only avenues that activists can exploit in companies with concentrated ownership are disagreements between significant block-holders, especially in family firms, and the use of rights available to minority shareholders, such as the right to select a director in a company that provides for "cumulative" voting for directors. See also Massimo Belcredi and Luca Enriques, 'Institutional Investor Activism in a Context of Concentrated Ownership and High Private Benefits of Control: The Case of Italy' in Jennifer G Hill and Randall S Thomas (eds.), Research Handbook on Shareholder Power, (Elgar 2015).

[91] L Bebchuk, A Brav, and W Jiang, "The Long-term Effects on Hedge Fund Activism" (2015) 115 Columbia Law Review 1085.

requirements that discourage activism.[92] Moreover, the Shareholders Right Directive,[93] which aims to promote engagement of long-term institutional investors, does not seem to welcome the entrance of non-permanent institutional investors as activists are.

In any case, the final version of Art. 9c of the Shareholders Right Directive, regulating related party transactions, has left out MOM rules and has maintained the decision power of the controlling shareholder regarding conflicted transactions, requiring only that companies publicly disclose ex post material related party transactions that are most likely to create risks for minority shareholders, at the latest at the time of their conclusion, and to submit these transactions for approval of the SGM or of the board. Unfortunately, it seems that this new reform is a lost chance to tackle the key problems that we have discussed.

6. Conclusion

In this paper, we have addressed the corporate governance problems of controlled, listed firms both in the U.S., where they are a growing phenomenon, and in Europe, where they constitute a majority of listed firms. While large shareholders may bring important advantages in monitoring managers and managing the company with a long-term horizon, they do this by controlling the firm's decisions, and this implies control over the investment made by market investors. Many empirical studies provide evidence of self-dealing and expropriation of the minority in firms with concentrated ownership. This reduces the market value and growth opportunities of these firms.

We have discussed how the corporate governance tools that are employed to keep managers in check and align their incentives with those of market investors lose effectiveness when they are applied to control a controlling shareholder. When dealing with hired managers, exit and voice mechanisms serve as disciplinary mechanisms to the extent that the manager will suffer adverse consequences if the investors leave or vote against the manager's proposals: they may see the value of their stock options decrease, suffer a hostile takeover, get fired, or face a

[92] L Bebcuk and R Jackson, "The Law and Economics of Blockholder Disclosure" Harvard Business Law Review 2-1 40.
[93] Directive 2017/828 of the European Parliament and of the Council of 17 May 2017, amending Directive 2007/36/EC as regards the encouragement of long-term shareholders engagement.

liability suit. But the controlling shareholder is not paid with stock options, can stop a hostile takeover, and cannot get fired.

Moreover, in European jurisdictions, the regulation protecting market investors in listed firms is not substantially different from the one adopted to deal with the conflicts among active shareholders in private and close corporations. Because of this, in Europe the controlling shareholder does not even face the threat of liability. While in the U.S. the law recognizes the fiduciary duty of whoever is in control of the firm's decisions; in Europe the fiduciary duties of controlling shareholders towards market investors for business decisions are underdeveloped. Additionally, in Europe the extended voting rights of the SGM give the controlling shareholder additional power to monitor the managers but do not discipline the controlling shareholder. This means that the controlling shareholder becomes incredibly powerful relative to market investors. This generates a "strong shareholders, weak investor paradox".

Therefore, when talking about investors' protection in Europe, it is important to distinguish between the level of protection that the law offers to active shareholders, which is high, and the level of protection that it offers to passive market investors, which is low.

Unfortunately, the situation seems unlikely to change in the near future. Liability for controlling parties seems largely incompatible with the complex group structures that are used by many of the largest European firms, and the lobbying power of European groups is likely to block any reform aimed at increasing liability for controlling shareholders. And even more modest proposals, targeted at improving the voice of the minorities through the right to appoint minority directors and use MOM rules for some salient decisions, have been ignored in the most recent EU regulation.

Table 1. Controlled listed firms across countries in 2016

		All firms in sample				Largest 100 firms by total assets				Largest 50 firms by total assets			
Country	N of firms	No shareholder owns more than 25% of the shares	A shareholder owns more than 25% but less than 50% of the shares	A shareholder owns more than 50% of the shares indirectly	A shareholder owns more than 50% of the shares directly	No shareholder owning more than 25% of the shares	A shareholder owning more than 25% but less than 50% of the shares	A shareholders owning more than 50% of the shares indirectly	A shareholders owning more than 50% of the shares directly	No shareholder owning more than 25% of the shares	A shareholder owning more than 25% but less than 50% of the shares	A shareholders owning more than 50% of the shares indirectly	A shareholders owning more than 50% of the shares directly
Denmark	65	14%	34%	9%	43%					12%	28%	12%	48%
Italy	212	15%	26%	4%	55%	12%	24%	6%	58%	10%	28%	8%	54%
Portugal	44	16%	23%	18%	43%								
Austria	52	19%	29%	6%	46%					20%	28%	6%	46%
Greece	157	21%	52%	3%	24%	15%	54%	5%	26%	16%	56%	6%	22%
Belgium	89	25%	40%	6%	29%					16%	46%	4%	34%
France	531	30%	27%	6%	36%	38%	22%	8%	32%	46%	22%	4%	28%
Germany	428	31%	30%	4%	36%	34%	26%	7%	33%	42%	26%	8%	24%
Cyprus	59	34%	32%	3%	31%					30%	34%	2%	34%
Luxemburg	46	37%	22%	0%	41%								
Switzerland	155	47%	27%	1%	25%	50%	22%	2%	26%	50%	24%	4%	22%
Spain	121	47%	21%	3%	29%	48%	19%	4%	29%	52%	14%	8%	26%
Norway	115	46%	35%	0%	19%	44%	34%	0%	22%	38%	38%	0%	24%
Netherlands	110	48%	29%	2%	21%	49%	30%	2%	19%	52%	28%	4%	16%
Sweden	492	51%	33%	1%	14%	47%	39%	3%	11%	42%	42%	4%	12%
Finland	116	62%	25%	3%	10%	64%	24%	2%	10%	74%	12%	2%	12%
Great Britain	1164	67%	24%	1%	8%	83%	11%	1%	5%	80%	14%	0%	6%
Ireland	69	78%	13%	1%	7%					82%	12%	2%	4%
US	4252	66%	18%	2%	14%	85%	8%	2%	5%	88%	8%	2%	2%
Canada	2371	73%	15%	3%	9%	64%	14%	0%	22%	60%	22%	0%	18%

Data from the Osiris database of Bureau Van Dijk. We start with a total of 13772 active, listed, non-financial firms in the selected countries. We restrict the sample to guarantee that all firms have financial data for year 2016, which results in 10892 firms, and finally drop firms with no ownership data available, obtaining a final sample of 10648 firms.