An introduction: changing perspectives on corporate law and economics

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1. SYNOPSIS

This book includes the proceedings of the conference on ‘Changing Perspectives on Corporate Law and Economics’, held in Rotterdam on 6 November 2008 in honour of one of the founders of the economic analysis of law, Guido Calabresi. The collection is made up of six main contributions and six shorter comments by the speakers who acted as discussants. The subject matter of the book – corporate governance – is one of the most heated topics in the economic analysis of law. In the aftermath of the largest global financial crisis after the 1930s, the negative consequences of which we are still experiencing, the connection between law and corporate finance has been evident from the news. More generally, this connection is extremely important for the governance of enterprises, which affects not only the financial markets, but also the efficiency of production, economic growth, and the overall well-being of our societies.

In addressing the above issues, this book takes an interdisciplinary perspective. Economic analysis of law is a fruitful intellectual challenge for economists and lawyers alike. It offers new views on legal and economic theory, questioning or reinforcing the traditional ones. It enhances the quality of counselling available to individuals and businesses. It allows policymakers to design better rules for society. Above all, in corporate governance, research, practice, and lawmaking are all based on the interaction of economics with the law. The present collection of chapters is an exemplary illustration of the virtues of this approach.

Within law and economics, corporate governance can be approached from different angles. The contributions to this book perform in-depth theoretical and empirical analyses from which different regulatory implications are derived. Some provide fresh empirical evidence on controversial theories of corporate law. Others attempt to develop new theoretical insights for addressing unresolved problems of corporate governance. They all analyse the economics of corporate governance with a view to
how it should, or should not, be regulated. The coverage of the book is very broad in this respect. It ranges from regulatory competition to harmonization of company law; from the law and economics of mergers and acquisitions to the risks of overregulating the market for corporate control; from enforcement of investor protection to the balance between authority and accountability in the corporation. These are all hot issues in the international debate, and they are more intimately related with each other than might appear at first glance. This book shows, like the conference before it, that economic analysis of law provides economists and lawyers with a single framework for discussing diverse issues in corporate governance.

Perspectives on corporate law and economics are changing though. This is the leitmotiv of this book, as it was of the conference. Perspectives differ between the economic and the legal standpoint. They vary from continent to continent, from country to country. They evolve over time. This book includes the views of three scholarly generations of corporate law and economics, from its very founder – Henry Manne – to the younger researchers in the field. Economists and legal scholars contribute to this collection of chapters in a balanced proportion. Their views are based on different geographical experiences and cultural backgrounds. The authors are all top scholars in corporate law and economics, affiliated to highly prestigious universities around the world. While all the chapters take an international approach to the corporate governance debate, different countries are represented among the authors. These are Britain, Italy, Germany, the Netherlands, and the United States. This additional layer of diversity offers a unique opportunity to compare the views of corporate governance from the two sides of the Atlantic and of the Channel.

As the following overview is going to illustrate, this combination of changing perspectives yields a number of new insights into the functioning of corporate governance and its legal underpinnings. Unsurprisingly, they also identify many interesting avenues for future research.

2. REGULATORY COMPETITION: EFFICIENCY OR PATH-DEPENDENCY?

The first contribution to this book (Carney et al.) tackles one prominent issue in the Law and Economics of Corporate Governance: the competition for corporate charters. Following Tiebout’s (1956) celebrated insights, economic analysis of corporate law has focused on the competitive dimension of the production of legal rules in those countries where companies can choose to incorporate under different sets of rules. In
particular, this debate was initiated in the US where the ‘Internal Affairs Doctrine’ allows companies to choose between the corporate laws of 50 federal states, regardless of where they actually do business. While this process has apparently led the vast majority of publicly held companies in the US to incorporate under Delaware law (Bechuk and Cohen 2003), the determinants of this outcome are far from settled.

In principle, under freedom of incorporation, jurisdictions can compete on offering companies the set of rules best suited to their needs. They have prominent incentives to offer attractive terms to companies, since incorporations bring revenues in the form of both taxes and increased demand for local services. The long-standing question is whether this competitive process unravels efficiently. The two opposite views on this, originally articulated by Cary (1974) and Winter (1977), are that regulatory competition leads to a ‘race to the bottom’ or to a ‘race to the top’. On the one hand, states of incorporation may compete by offering rules that are attractive for those who control the (re-)incorporation decision – most prominently, corporate management – at the expenses of shareholders and other stakeholders. On the other hand, the quality of corporate charters and of the rules governing them is priced by efficient stock markets, and this guarantees that corporate jurisdictions compete on offering efficient terms for protection of shareholders and, when it is relevant, of stakeholders. In an influential paper, Romano (1985) found evidence of a race to the top. Her results have subsequently been questioned on different grounds, most prominently that US states do not actually compete with each other (Kahan and Kamar 2002) and that firms incorporated in Delaware do not (or at least, no longer) exhibit statistically significant excess values on the stock market (Subramanian 2004).

Carney at al. bring fresh insights to the debate. Their contribution is essentially twofold. On the one hand, they show that Delaware law scores worse than other jurisdictions on exactly those substantive aspects that would support winning a race to the top, namely flexibility and predictability of corporate governance regulation. On the other hand, they identify the reason for Delaware’s success in attracting incorporations. This is US corporate lawyers’ limited knowledge of better alternatives. As a result, Delaware’s primacy as supplier of corporate law in the US does not reflect any virtuous or vicious competitive process, but only the ‘bounded rationality’ of American lawyers due to the biases in their education.

These results are derived from a combination of different methodologies. In contrast to the majority of previous studies, Carney et al. open the ‘black box’ of corporate law. They do not infer superiority of one jurisdiction over another, based on market outcomes. Instead, they look at the details of Delaware law in a number of critical situations (for
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example, mergers and sale of assets) that may occur during the operation of a company. In these situations, Delaware law is extremely intricate and this results in the outcome of corporate litigation often being unpredictable. One prominent source of indeterminacy in Delaware law is the celebrated Business Judgment Rule, a norm of judicial abstention from second-guessing directors’ choices as to how to conduct the corporate business. Delaware’s courts are courts of equity, which encourages judges to undertake an ex post and fact-intensive review of directors’ actions that undercuts the deference of the Business Judgment Rule. Under Delaware law, this doctrine features so many nuances and exceptions that shareholder litigation occurs nearly every time it is invoked. This stands in sharp contrast to the race to the top explanation of Delaware’s superiority in attracting incorporations. Short of reducing transaction costs in the relationship between the company and its investors, incorporating in Delaware means facing a number of legal rigidities (selective application of the Business Judgment Rule) and uncertainties (on the meaning and the scope of the Business Judgment Rule) in corporate governance. Why then does Delaware still outperform its competitors?

Carney et al. answer this question in a most original fashion. In US law schools, they report, prospective lawyers do not study any corporate law other than those of Delaware and (normally, but not always) their home state. It may well be that Delaware managed to secure its competitive advantage by offering companies more efficient rules in the past, but this need not necessarily be the case – to be sure, it is not the case when we look at how Delaware law has evolved. Due to their education bias, lawyers tend to recommend incorporation under the law they are familiar with. Only in a specific subset of circumstances is this their home state. Most often, given the existing network effects favouring Delaware law at the initial public offering (IPO) stage and the narrow specialization of lawyers handling IPOs, they recommend Delaware law because they mistakenly believe that it is the best to secure deals and to handle litigation. In fact, they know little, if anything, about potential alternatives that may effectively reduce transaction costs. This understanding of the US incorporation puzzle by Carney et al. is supported by two complementary empirical investigations, a survey of lawyers’ motivations in advising (re-)incorporation and a regression analysis of Delaware incorporations depending on the state of origin of the company and of its legal counsels.

In his comment on Carney et al., Kroeze takes stock of these arguments for analysing regulatory competition in European company law. The situation on this side of the Atlantic is notably different from the US. There is no ‘Internal Affairs Doctrine’, but rather, the opposite ‘Real Seat Doctrine’ (mandating incorporation where the firm effectively carries
out its main business) holds in most European member states. There is no Federal Constitution, but rather, a Treaty whose implementation by European courts and legislature has to struggle with individual resistance from the member states. Finally, there is no homogeneous set of property and contract law, but rather, the company law of most member states is embedded in their particular private law. Therefore, it could seem that regulatory competition in European company law is less developed than in the US. However, when we look at it more carefully, this competitive process exhibits a number of similarities (as well as differences) between Europe and the US.

After initial attempts to harmonize company laws in order to promote freedom of establishment of European companies without running the risk of a race to the bottom, European law seems to have taken a more decisive stance in favour of regulatory competition. To be sure, whether regulatory competition is effectively in place in European company law is still uncertain (Kraakman et al. 2009). However, developments in case law by the European Court of Justice (ECJ) have broadened the conditions for freedom of incorporation (for example, C-212/97 Centros of 1999; C-208/00 Überseering of 2002), albeit still incompletely (see C-210/06 Cartesio of 2008). Moreover, the EU legislation has recently taken positive steps in the direction of creating a level playing field (through the various initiatives adopted within the framework of the Company Law Action Plan of 2003 – COM/2003/0284) and of facilitating re-incorporation (most prominently, through the Directive 2005/56/EC on cross-border mergers). This suggests that, soon enough, Europe may experience competition in the production of corporate law very similar to what – for good or evil – we have been observing in the US. Then the warning by Carney et al. stands: competition may not occur on the merits, but rather, be driven by path-dependency. In this case – Kroeze observes – some member states stand to lose in the establishment of the network effects that, at least according to the American experience, has proved persistent. The difference is that, in Europe, the set of rules that minimizes transaction costs in dealing with shareholders and stakeholders has yet to be identified. When market forces are allowed to make this selection, companies are not expected to choose rigidity and indeterminacy. As a result, the Netherlands, which shares with Delaware not only a tradition of flexibility, but also a process whereby this flexibility has degenerated into more interventionist courts and unpredictability of litigation outcomes, is ‘doomed to fail in a competitive environment’.

Beyond this, Kroeze is sceptical that situations of bounded rationality on the part of legal counsel can last for long. Rather, he seems to suggest that market mechanisms will, in the end, restore the lawyer’s incentive to select
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the best (that is, the most efficient) corporate law for incorporation. States, in turn, will compete to offer the most efficient set of rules. This argument parallels the debate on the effectiveness of arbitrage in securities markets, which is particularly topical in these times of financial crisis (Posner 2009). As arbitrageurs, lawyers may not respond immediately to changes in the relative quality of legal products, partly because – as Kroeze nicely puts it – ‘they prefer a greater risk of being wrong collectively than a smaller risk of being wrong alone’. But, as Shleifer and Vishny (1997) show for arbitrage, this outcome only holds so long as the number of ‘smart traders’ is insufficient to make trading on fundamentals profitable. Therefore, it can be expected that choice of law will continue to be driven by efficiency concerns as soon as a sufficient number of players (lawyers or the companies they advise) realize that there are more profitable alternatives than relying on a flawed Delaware law. There is one important element of regulatory competition, surprisingly neglected in this debate, which points exactly in this direction. Regulatory competition is not just a horizontal process between states, but also a vertical process between the prevailing state jurisdiction and the federal legislature that may pre-empt it when it turns out to be unsatisfactory. This has recently turned out to be a key element of regulatory competition in the US (Roe 2008), and – as the following contributions show – it seems to be even more relevant in Europe.

3. EUROPEAN LAW AS A VEHICLE FOR REGULATORY COMPETITION

In Chapter 2, Eidenmüller et al. investigate the size and the determinants of a unique phenomenon on both sides of the Atlantic. This is the Societas Europaea (SE), which is a pan-European model of incorporation available for companies established in any of the EU member states. Established by Regulation 2157/2001/EC and effective since 2004, the SE has long been considered a failure of European lawmaking. And yet, after a somewhat disappointing start, the SE has turned out to be surprisingly popular among European companies, at least in certain European countries (most prominently, Germany and the Czech Republic). Eidenmüller et al. do not only document the success of the SE with empirical data. Perhaps most importantly, they analyse the variety of choice of this corporate form across European jurisdictions to infer the determinants of this success. As it turns out, the SE is illustrative of the ongoing process of framework harmonization of European company law and of its ability to lead to regulatory competition in a very special fashion.

The SE does not offer a fully-fledged alternative to the national models
of incorporation. Rather, it provides a number of options, some of which may not be available under the law of the company’s state of origin. Likewise, the SE does not allow opting out of the ‘Real Seat Doctrine’. Although the SE allows transference of the company’s registered office, the latter must still be located where the company has its main place of business. Finally, in a number of respects, the SE is governed by the corporate law of the state where the company has its registered office. Little wonder that, in view of the costs of setting up the SE as opposed to its limited benefits, commentators have been sceptical about the practical utility of this form of incorporation (Bratton et al. 2009). The study by Eidenmüller et al. proves that they have been wrong. The options for corporate governance made available by the SE may be limited, but they matter a lot. The attempt by the European legislature to mediate between different national traditions, especially regarding board models and the involvement of employees in corporate governance, has transformed this example of framework harmonization into a ‘vehicle for legal arbitrage’. Despite the evolution of ECJ case law, restrictions on re-incorporations still make it difficult for European companies to shop around among jurisdictions for suitable legal solutions. Transforming (or merging) into a SE provides an alternative. Formally, it is a model of incorporation partly governed by European law. In practice, however, it is a synthesis of different European models, which allows companies to opt out of some of the rigidity of their national corporate laws, while exploiting the advantages of relocating to a more favourable tax jurisdiction (Enriques 2004).

Eidenmüller et al. are the first to test this proposition empirically, through a combination of regression analysis and a survey of the motives for establishing SEs in Germany, which aims to compensate for the small sample size in statistical inference. In spite of this difficulty, their results are statistically robust and highly plausible. The choice of SE seems to be effectively motivated by legal arbitrage, albeit with some qualifications. The SE is most prominently a vehicle to reduce the impact of mandatory co-determination at the board level and to opt out of a mandatory two-tier board structure. This is consistent with the popularity of the SE, especially in those jurisdictions that feature these restrictions. However, neither the data nor the survey support the hypothesis that the SE is used to shop for more attractive company laws in general. This may have to do with the limitations on choice of law resulting from the Real Seat Doctrine. Noticeably, this factor does not undermine the tax incentives for relocation through the SE. Taxes remain a major driver of corporate mobility in the EU, which explains why the small European jurisdictions have the highest rates of SE incorporations to population.

Within these limits, the SE does promote regulatory competition in
European company law. Surprisingly enough, the European legislature has achieved this result by stepping into the competition directly. In contrast to the US picture, where federal legislation enters only as a potential competitor, the European approach to regulatory competition is based on a formal mandate to harmonize national laws. As previous attempts to establish a common European company law failed, framework harmonization has now become an instrument for allowing the selection of the best rules by market forces. Vesting different national traditions as eligible options under European law has proved more successful than forcing their mutual recognition or identifying their common core by binding legislation.

The comments by Leyens intervene exactly at this point. With special regard to Germany, the study by Eidenmüller et al. shows that publicly held companies suffer from a number of national legal restrictions that may undermine their competitiveness. The SE as a ‘vehicle for legal arbitrage’ has finally shown that companies may wish to opt out of these restrictions in the interest of their investors, but without jeopardizing the position of other stakeholders (more precisely, the employees). The choice as to board structure is not available to public companies governed by German law as opposed to companies registered in other European jurisdictions. Albeit repeatedly denounced by German legal scholars, this rigidity was ignored before the introduction of the SE showed that German companies too are willing to choose a one-tier structure. A similar argument applies to co-determination, which leads to impressively high numbers of directors sitting on the supervisory board. The empirical evidence on the use of SE shows that German companies are actually willing to negotiate with employees different, and less burdensome, forms of participation in corporate governance. Only within the limit of these negotiations, do the SE regulations allow for co-determination to be opted out of. But while the data provide unequivocal evidence of the efforts by German companies to devise more flexible solutions through the SE, most of the national rigidities remain. In only one case – Eidenmüller et al. report – the SE has allowed opting out of co-determination entirely. And none of the companies subject to co-determination has managed so far to opt for a one-tier board structure. Legally, this circumstance may frustrate the requirement that the SE allow an effective choice of board structure.

According to Leyens, it will eventually be the ECJ that restores the full potential for regulatory competition established by the SE against the rigidities maintained by the member states. Yet the outlook may be even more promising than that. One of the goals of the SE was to facilitate cross-border mergers. Eidenmüller et al. show that the experiment has been successful (also) in this respect. The matter has been subsequently addressed
by a potentially more powerful piece of EU legislation, which does not require the establishment of a corporate vehicle governed by European law. This is Directive 2005/56/EC on cross-border mergers, which has removed the national constraints on this technique for re-incorporation (see Kraakman et al. 2009). Whether and how one can expect cross-border mergers to lead to selection of the most efficient rule in European company law is an empirical question, addressed by the following contributions.

4. HOW DOES LAW MATTER? EVIDENCE FROM CROSS-BORDER MERGERS AND ACQUISITIONS

Economists are usually less insistent on the details of the law. Rather, they focus on the overall effects of legal institutions on economic performance. In this perspective, Martynova and Renneboog (Chapter 3) investigate the question of whether the wealth effects of cross-border mergers and acquisitions (M&A) in Europe are dependent on the quality of law. Their answer is positive, but more importantly, they show that – regardless of the direction of the acquisition – it is always the best law that prevails. This approach complements the legal debate reviewed so far. In particular, it supports the high expectations of academics and policymakers on the implementation of the European Directive on cross-border mergers. This offers the prospect of fruitful regulatory competition in European company law.

In their detailed empirical study, Martynova and Renneboog disentangle the effects of company law standards on both the bidder and on target returns after the announcement of a takeover. To this end, they have constructed a set of indices of quality of corporate law independent from those prevailing in the law and finance literature (La Porta et al. 1998; Djankov et al. 2008). As with previous studies, they find that ‘law matters’ – that is, it does affect economic results. However, both the ‘measurement’ of company laws and the setting in which their impact is tested are novel. With regard to the quality of law, the authors study the effects of three different indices of investor protection: the first is an index of shareholder powers; the second is an index of minority shareholder protection from expropriation; the third is an index of creditor rights. All indices are interacted with an enforcement variable to account for the relative efficiency of the judicial systems. More importantly, the indices account for the legal changes that have occurred every fifth year over the past 15 years, which allows a more precise estimate of the differences in investor protection between the bidder and the target company at the time of a takeover.

These differences in corporate governance standards may, in principle, have opposite effects when a change in control occurs. Martynova and
Renneboog distinguish between spillover (positive and negative) and bootstrap effects. Positive spillover depends on the target benefiting from the higher standards of investor protection of the bidder, either because the target is merged with the bidder (and therefore, changes nationality) or because the change in control is sufficient for the target to adopt the higher standards on a voluntary basis. Spillover can be also negative, when the corporate governance standards of the bidder are lower than the target’s and the latter is merged with the former. However, in this case, the bidder may alternatively decide to bootstrap to the higher standards of the target on a voluntary basis. This bootstrap effect is also possible as an alternative to each company’s sticking to its own standard when acquisitions are partial. Which of these effects prevails in cross-border M&A is ultimately an empirical question.

Carefully controlling for endogeneity and omitted variables in multiple specifications of their regressions, Martynova and Renneboog show that upgrading to the higher investor protection standards dominates this setting. Positive spillovers are unambiguously borne out by the empirical evidence. Negative spillovers are not. On the contrary, when the bidder’s standards are lower than the target’s, neither of them experiences lower returns upon announcement of the takeover – which supports the bootstrap effect in both full and partial acquisitions. This suggests that, all else being equal, cross-border M&A are an instrument for shareholders to reap the benefits of higher investor protection, regardless of whether the enhancement derives from the bidder’s or the target’s jurisdiction. This virtue of the market mechanisms is confirmed by the likelihood that companies are engaged in a cross-border, rather than a national, acquisition. This likelihood is higher the lower the shareholder powers under either the bidder’s or the target’s jurisdiction, although minority shareholder protection has exactly the opposite effect on bidders (high protection of minority shareholders makes national acquisitions more expensive).

In his comment, de Jong makes two important additions to these findings. First, he notes that spillover and bootstrap effects are only presented in terms of statistical significance. However, the framework set up by Martynova and Renneboog also allows the economic magnitude of these effects to be estimated. Despite his limited access to the data, de Jong manages to perform an interesting exercise, showing that the direction of the acquisition matters after all. Specifically, it is not a matter of indifference whether the bidder comes from a high-standards jurisdiction or the other way round, for the magnitude of the wealth effects is expected to be substantially larger under the first hypothesis. Secondly, de Jong notices that the increased sophistication with which the quality of law is measured relative to the first attempt by La Porta et al. (1998) still does not account...
for firm-specific choices regarding compliance with standards higher than those mandated by law. This may be particularly relevant in the case of cross-listing.

More generally, the measurement of quality of law based on numerical indices makes two conceptual issues problematic. One is the inclusion of all the relevant legal information, which is an extension of de Jong’s argument that goes much beyond the relevance of listing rules and corporate governance codes. The other, which is surprisingly taken for granted by both, is the judgement as to what ‘good’ corporate governance regulation is. Renneboog and Martynova draw an important distinction between protection of minority shareholders and empowerment of shareholders as a class. Similar distinctions, traditionally supported by the comparative legal literature (for example, Kraakman et al. 2009), are becoming increasingly important in empirical corporate law and economics (for example, Djankov et al. 2008). So far, however, the alternative specifications of investor protection have been too greatly correlated with each other to allow for separate empirical analyses. Whether, and to what extent, protection of shareholders in corporate governance requires their legal empowerment remains a theoretical question, to which we now turn.

5. BACK TO CORPORATE GOVERNANCE BASICS: MARKETS OR LAW?

Commentators tend to disagree on what constitutes ‘good law’ in corporate governance and on the virtues of the market mechanisms in selecting the most efficient rules. The question – do we need corporate law at all? – is hardly ever asked any more. Conceptually, however, this is a fundamental issue, and the very pioneer of corporate law and economics reminds us of its importance. In his contribution, Manne shows that, in corporate governance, legal rules may create more inefficiencies than they help to solve.

Taking stock of the ‘corporate-governance-as-promise’ approach recently proposed by Macey (2008), Manne warns in his usually provocative style that corporate governance needs little else than enforceable contracts, an active market for corporate control, and some insider trading in order to work efficiently. Any legal restriction on these market institutions undermines efficient separation of ownership and control, instead of promoting it. His argument is essentially threefold. First, there is actually no point in debating about the optimal structure, powers, and independence of board of directors vis-à-vis the rights of (minority) shareholders. Regulation can fare no better than the contractual arrangements devised by the company’s founders, for the simple reason that they bear
the wealth effects of these arrangements when the company’s shares are sold to the investing public – regulators have far lower-powered incentives. Secondly, and similarly, any regulation of the takeover process can only lessen the power of this fundamental mechanism of corporate governance. Unbridled competition in the market for corporate control most prominently protects investors by disciplining the management and making sure that incumbents who fail to maximize shareholder returns are promptly replaced. While there might be good reasons for limiting contestability by contract, especially considering the price that founders have to pay for this deal, any regulation reducing the bite of the market for corporate control in the name of protecting minority shareholders turns to their very disadvantage – the more regulatory restrictions on takeovers, the lower the returns to shareholders of prospective targets. Finally, prohibition of insider trading only undermines the incentives to produce valuable information, which could be timely impounded in stock prices otherwise. Once again, under the false claim that this is aimed at protecting investors’ ‘fair play’, regulatory restrictions on insider trading limit both insiders’ and outsiders’ ability to correct misperceptions of corporate performance to the ultimate advantage of shareholders as a whole.

Manne does not argue that corporate law is unimportant, but he stresses that its role should be limited to minimizing transaction costs. Enabling and default rules should suffice for this purpose, perhaps with the sole exception of ‘real acts of misbehavior by directors’ – a concept upon which he does not elaborate. Manne’s trust in the contracting process goes as far as to admit – in contrast to Macey (2008) and the majority of commentators – that the corporate charter may exclude contestability of control at the outset. This is not particularly surprising, for Manne himself (1965) never argued for more contestability than companies are willing to choose. On this point, he is sympathetic to the work by Bainbridge (2008), to which he compares my own (Pacces 2007). Manne agrees that the decision as to whether to resist a hostile takeover could be left with the directors, if the contract so stipulates, for reasons of protecting managerial firm-specific investments that ultimately benefit shareholders as well. But he sees neither what role corporate law should play in this nor why other mechanisms (for example, insider trading) could not solve the problem of rewarding managerial firm-specific investments without interfering with the market for corporate control.

In my reply, I try to address these points. Manne’s reasoning has an implicit Coasian flavour, which is one approach that other contributors to this book discuss at length (see Chapter 6 and Comment on Chapter 6). However, Manne overlooks two important issues. First, the virtues of the bargaining process between shareholders and the corporate management
face the limitations of the contractual technology. These are most prominently due to the problem of contractual incompleteness, which explains why legal entitlements matter. This part of Coase’s reasoning (1960) is often hidden behind the formulation of a theorem that he never stated. In corporate governance, this means that the failure to enable managerial empowerment through the legal system creates potential inefficiencies that cannot be remedied by contract. An illustration of this is that, in most parts of continental Europe, large shareholdings are the only way to secure control from outsiders’ interference. Secondly, for exactly the same reason, the corporate contact cannot entirely protect non-controlling shareholders from expropriation. This holds for both the incumbent management and successful bidders in a takeover contest, provided that they have sufficient powers to alter the original terms of the contract with investors. Again, legal rules matter, but given the asymmetric distribution of powers between (actual and prospective) corporate controllers and non-controlling shareholders, investor protection needs to be mandatory. While this provides a good argument against insider trading, to the extent that it corresponds to an expropriation of outsiders’ returns, it does not imply that regulation should weaken the market of corporate control by favouring minority shareholders in the distribution of takeover gains. Manne is quite right in contending that an active market for corporate control protects shareholders better than their legal empowerment, although I am sceptical that this can work efficiently in the absence of legal rules that both define control entitlements and limit their abuse.

6. POWERS VS TRIALS: ENFORCEMENT OF CORPORATE GOVERNANCE IN THE UK

The divide between shareholder protection and shareholder empowerment is one major issue in the analysis of UK corporate governance by Armour (Chapter 5). Moving away from the question, what is ‘good law’, Armour scrutinizes the patterns of enforcement of corporate governance regulation across its varied content (corporate law, securities regulation, takeover regulation). One emerging view in the international literature (La Porta et al. 2006; Djankov et al. 2008) is that investor protection under both corporate and securities law is most effective when it is enforced by private litigation. Apparently, effective private enforcement is also efficient for it allows higher separation of ownership and control, which in turn nurtures vibrant stock markets. Armour does not question the importance of enforcement of investor protection in corporate governance. However, he notices that while the patterns of separation of ownership and control
in the UK are comparable to those in the US, in the former ‘shareholder
lawsuits are conspicuous by their absence’. In British corporate govern-
ance, investors are just protected differently from shareholder litigation. 
Partly (but minimally), this protection is based on public enforcement. 
Most importantly, the enforcement of corporate governance in the UK is
type as it is carried out outside the courts by players who can cred-
ibly threaten the management refusing to comply with the rules protecting outside shareholders.

Armour himself notices that this enforcement pattern is based on
corporate governance powers, rather than on procedural rules making
shareholder rights actionable. Yet these rules exist, although, in contrast
to the US, they are ill suited to mass litigation. In Armour’s view, informal
enforcement is still a form of enforcement, for it operates ‘in the shadow
of the law’. It is ultimately the latter that confers upon the main players
of this mechanism – the institutional investors – the power to threaten
managers credibly. In Britain, shareholders can oust incumbent directors
any time, by outvoting them (which is an option for sufficiently large coali-
tions of institutional investors) or by setting up a hostile takeover (which
directors have very limited possibilities to resist). Indeed, these legal
entitlements of shareholders are protected by courts or by self-governing
bodies (like the Takeover Panel) having no less power to sanction the
ouster of recalcitrant management from the financial community. But
the fact that these are entitlements to exercise governance powers, rather
than to claim compensation for directors’ misbehaviour, is not a matter of
indifference. Armour shows that shareholders in Britain enjoy very little
protection of their investment by courts and public authorities (that is,
almost no private enforcement and quite negligible public enforcement),
but they are otherwise very powerful in disciplining managers who fail
to maximize their returns. Whether this solution is preferable to the US
approach – allowing non-controlling shareholders little interference with
management, but powerful instruments for litigation – is a question that
Armour does not address.

Armour provides a distinctive roadmap of all the possible enforce-
ment patterns available in UK corporate governance, both formal and
informal. Description of the former combines essential legal information
with a patient collection of data. The results, reported as an impressively
low frequency of enforcement actions, show that shareholder litigation is
effectively a dead letter in the UK. Public enforcement scores somewhat
better, although the frequency of actions per year barely reaches two digits
in most of the ‘formal’ settings. Informal public enforcement is a different
story, dominated – as expected – by the activism of the Takeover Panel.
But, with this exception, data on informal enforcement are naturally dif-

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ficult to collect. At this point, the empirical evidence reported by Armour becomes mostly suggestive. The combination of legal and economic arguments is sufficiently convincing though. With respect to informal private enforcement, institutional investors and takeovers are the major players. While the latter leave some traces behind (perhaps raising the question why, just like in the rest of the world, the vast majority of takeovers in the UK are friendly), the former operate ‘behind closed doors’ (Stapledon 1996). And yet, the comprehensive voting guidelines and the otherwise inexplicable CEO turnovers are indirect evidence of institutional investors’ activism in the UK.

In his comment, Pardolesi is somewhat sceptical that informal enforcement can effectively substitute for formal enforcement. Like many other legal phenomena, its relevance is hard to prove empirically – which casts doubts on the popularity of ‘numerical comparative law’ (Siems 2005), especially in corporate governance, over the past decade. More importantly, informal enforcement is conceptually difficult to disentangle from the more general categories of public and private enforcement. The last two are more intertwined than the current debate – mostly centred on antitrust law – tends to suggest. Aside from the specific experiences of private and public enforcement on either side of the Atlantic, it seems that efficient enforcement of law needs an optimal combination of the two. The proportions defining the efficient combination may vary according to the institutional context. In this perspective, informal enforcement is undoubtedly part of the equation. One can agree that, at one extreme, informal enforcement suffices to compensate for lack of formal enforcement. But the very notion of informal enforcement is ill defined, for it tends to encompass forms of private and public action that do induce compliance with the law, albeit without resulting in formal legal proceedings. On this basis, any statement of preponderance of one form of enforcement over another is arbitrary. Conversely, if we narrow down the definition of informal enforcement based on the pursuit of specific goals (for example, investor protection) without the involvement of the courts or regulatory agencies, its equivalence to formal enforcement is yet to be proved. Both entail costs and benefits, and a detailed analysis of them is necessary for a sound judgment of relative efficiency.

7. CORPORATE LAW AND ECONOMICS IN A THEORY OF THE FIRM

The last two contributions to this book look at the very foundations of corporate governance. Somewhat in the spirit of Manne (Chapter 4), legal
rules initially disappear from the picture. But their absence does not last for long. Corporate governance is not analysed merely as the outcome of a market process, but rather, as an alternative to this process that must rely on a particular combination of public and private ordering. The corporation emerges for the same reason that market exchange is ‘superseded’ by authority in establishing a firm (Coase 1937): minimization of transaction costs. But the question still not completely answered by the law and economics literature is why the corporate form is chosen. In Chapter 6, Pagano endeavours to answer this question. Following Coase, he characterizes the firm as a centralization of market transactions. Where does the necessary authority come from (Alchian and Demsetz 1972)? Based on legal thought (Fuller 1969), the answer suggested by Pagano is decentralization of public ordering, which depends on the same problem of transaction costs as applied to lawmaking. The corporation emerges as a response to these two efficiency pressures. On the one hand, there is pressure to centralize transactions when they would be too costly to coordinate on the market. On the other hand, there is pressure to decentralize public ordering when it would be too costly to tailor legal rules to the specific requirements of firm production. Corporate governance is therefore a system of private ordering established by corporate law in order to satisfy these needs.

Guiding the reader through a fascinating theoretical journey, Pagano describes this result as a ‘marriage’ between the two fundamental contributions by Coase (1937) and Fuller (1969). The core of his argument is the – so far, neglected – link between them. To this end, he borrows from two additional contributors to Transaction Cost Economics. One is Williamson (1985), the very founder of this discipline and now Nobel Prize laureate for that reason. Surprisingly, the other (Calabresi 1970, 1991) is somebody who has hardly ever entered the debate on the theory of the firm, in spite of his laying down some of the very foundations of economic analysis of law. The marriage between Coase and Fuller is assisted by these two metaphorical best men, but it takes place in the framework developed by the latter. Telling enough, Coase and Fuller marry ‘in the Cathedral’, namely the ideal place where Calabresi and Melamed (1972) famously articulated their distinction between property rules and liability rules. Here is the missing link with the economic theory of the corporation identified by Pagano. Corporations are decentralized systems of private orderings for all transactions between insiders, which are governed by an internal set of property rules (that is, entitlements) in order to preserve relationship-specific investments. But corporations are also made accountable to society for these transactions via (joint) liability rules which enable outsiders to claim compensation for their own entitlements without undermining authority within the corporate enterprise.
Building on Coase (1937), the theory of the firm has been analyzing the consequences of the ‘fundamental transformation’ (Williamson 1985) that occurs after relationship-specific investments are made by two previously independent parties. After this transformation, the parties face a situation of bilateral monopoly where they are subject to mutual hold-up (Klein et al. 1978). The hierarchical structure of the firm solves this problem by centralizing distribution of the surplus ex post. But who decides? One intuitive answer, developed by the Property Rights Theory of the Firm (Grossman and Hart 1986; Hart and Moore 1990), is the owners of the firm. Yet – as Pagano notices – the answer is unsatisfactory, for it is mechanical (all decisions are effectively taken ex ante) and unidirectional (only the owners can be in control). In other words, the Property Rights Theory does not explain corporations as governance structures characterized by separation of ownership and control (Zingales 1998). Contrariwise, the transaction costs framework allows governance structures to be created on a purely contractual basis (Williamson 1991), without the limits (but also without the support) of property rights. Pagano attempts to fill this gap, hypothesizing a transfer of authority by decentralization of public ordering which goes beyond the existing set of property rights. With the help of Calabresi’s (and Melamed’s 1972) distinction between two ways to protect (alienable) entitlements, Pagano suggests that the state decentralizes to the corporation the definition of entitlements (property rules) within the firm. However, the corporation is exclusively responsible towards the rest of society for how these entitlements are exercised (liability rules). While legal personality is efficaciously presented as the unifying concept of power inside the corporation and responsibility outside it, Pagano’s framework still raises a number of important questions for institutional analysis.

In his reply, van Oosterhout identifies a major weakness of Pagano’s analysis. Pagano derives decentralization of public ordering as a necessary condition for the establishment of authority within the (corporate) firm. However, he fails to model the role of the government in this respect. Van Oosterhout observes that this cannot be taken for granted, for any form of private ordering arises as a delegation of powers from the state. This delegation may be implicit, but then its existence needs to be validated by unequivocal evidence. Except for his reference to the corporate legal personality, Pagano overlooks this fundamental issue. Yet legal personality tell us neither why courts should abstain from adjudicating controversial issues within the firm nor why third parties should be content with corporate liability for any misconduct by the firm’s constituencies. To be sure, corporate law supports elements of each proposition, namely the Business Judgment Rule regarding courts’ abstention and limited liability concerning the claims of third parties against shareholders. These elements
are neither included in the notion of legal personality nor specifically discussed by Pagano. More importantly, as with legal personality, the above-mentioned circumstances are explicitly supported by legal rules and they only hold within the boundaries defined by public ordering (courts do adjudicate intra-firm controversies when the conditions of the Business Judgment Rule do not hold; and limited liability only protects shareholders). In conclusion, a theory of firm based on decentralization of public ordering cannot just assume delegation of authority, but must model it explicitly.

Despite these criticisms, Pagano’s theory addresses and tries to solve one problematic issue touched upon by various contributions to this book. That is, how are entitlements created by corporate law and how are they allocated among the firm’s constituencies in order to ensure that they receive sufficient protection in corporate governance? If anything, the foregoing discussion shows that we do not yet have an answer to this fundamental question. Corporate governance seems to be about protecting investors, and yet the relevant investments in the corporate enterprise are not necessarily made only by shareholders – the ultimate owners of the firm’s assets. Opinions differ on how to balance the interests of different constituencies in corporate governance, and so do the corporate laws that address this question in different jurisdictions. This variety suggests that there is no optimal solution readily available – at least, not that we know of. But, exactly for this reason, corporate law may be even more important than is commonly understood. The persistence of alternative solutions in spite of the global pressures towards convergence of legal standards may just be explained by the theoretical gap identified by Pagano. We still do not know how corporate law does (and should) complement the property rights system (Pacces 2007).

8. CONCLUDING REMARKS

The main results of this study can be summarized as follows. First, regulatory competition is neither good nor bad for corporate law. It may simply be misdirected, but the question is for how long. Secondly, harmonization of company law is not just a substitute for regulatory competition. As the European experience shows, it can actually be a complement. Thirdly, we may not need to worry about the quality of corporate law rules, for takeovers naturally tend to select the best. The question is whether we understand which rules actually enhance firm value and how much. Fourthly, we may have forgotten that the best of all worlds is one featuring few, if any, mandatory rules in corporate governance. The only problem is how
to make investors comfortable with unregulated control powers, takeovers, and insider trading, given the problem of contractual incompleteness. Fifthly, strong governance powers, as well as courts and regulatory agencies, may protect investors from expropriation, and perhaps even better. However, this pattern of ‘informal enforcement’ does not have clear defining boundaries, and thus it is hard to generalize outside the British context. Sixthly, corporate law may be understood as a decentralization of public ordering complementing the centralization of market transactions within the corporate enterprise. Unfortunately, we still know too little about whether, and under what conditions, corporate law can effectively establish a system of private ordering.

At the end of a long journey along these changing perspectives on corporate law and economics, it is not easy in summing up to do justice to the importance of each contribution. Perhaps a way out of this impasse is to stress the role of the interdisciplinary, international, and intergenerational approach of this book in its numerous achievements. The above results have one fundamental aspect in common. They are all derived by combining legal and economic analysis of the institutions of corporate governance. The authors’ backgrounds differ as far as education, experience, and geography are concerned. This explains the selection of topics among the various issues debated in corporate governance, but not the choice of methodology for addressing them. Regardless of whether the contributions are authored by lawyers or economists, all evidence is reported and discussed with a rigorous empirical methodology. Equally impressively, lawyers and economists discuss legal and economic theory interchangeably. Economic analysis of law has thus established a common ground where changing perspectives on corporate governance are mutually reinforcing in the build-up of new knowledge.

Diversity between the contributors matters in two additional respects. Mapping the authors geographically, this book represents three major models of corporate governance in the developed world, namely the US, the UK, and continental Europe. Although all contributions take an international perspective, they naturally reflect the different relevance of corporate governance issues in the country of origin of the authors. Finally, the latter differ in terms of the generation of corporate law and economics they represent. The first generation reminds us of the importance of the origins of this debate (the market for corporate control), notwithstanding our improved understanding of the complexity of corporate governance. The second takes up the challenge of integrating new quantitative methodologies into the analysis of corporate law and of its economic effects. The third generation explores the recent developments in our knowledge of contracts, property rights, and their enforcement as applied to corporate
governance. Once again, these changing perspectives add substantially to the coverage, depth, and quality of the debate.

One of the contributors (Pardolesi, in his comment on Chapter 5) concludes, ‘A good paper raises more questions than it can solve’. The same conclusion applies to this book as a whole. A similar point was made by Guido Calabresi in the final address to the conference organized in his honour, where all the contributions to this volume were first presented. In view of the financial crisis, these questions were particularly relevant when that conference took place, and so are they at the present times of reflection on how to prevent this from happening again in the future.

All the open questions raised in this book, identifying as many avenues for future research, revolve around the fundamental trade-off between authority and responsibility at both the firm and the government levels. It is thus no surprise that we have not yet found all the answers. Over the past decades, the ‘giants’ of law and economics have advanced our knowledge of this matter and they have stimulated us to carry their insights further. A few of them have joined this venture across the changing perspectives on corporate law and economics either in person (Calabresi), in letter (Manne), or just in spirit (Coase, Williamson). However little this book may contribute to the fundamental debate on how law can improve the welfare of society, we hope to be standing on their shoulders.

Rotterdam, November 2009
The Editor

REFERENCES

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