What Shapes Controlling Party’s Behavior?: Factors behind Private Benefits of Control

Federico Pastre
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Federico Pastre, LL.M Fordham University 2011

Abstract

Several legal and non-legal factors determine and shape controlling party’s behavior and its ability of extracting private benefits of control through opportunistic conducts that harm minority shareholders. Initially, the paper briefly focuses on the concept of PBC and on the ways its magnitude can be assessed. Starting from the quality of the laws enacted and the level of enforcement granted to them in a given law environment (“law matter” thesis), to other law-related factors such as the level of competition, the labor in the firm, reputational constraints upon management, disclosure standards and the attitude of the judiciary, the paper analyzes the set of constraints preventing corporate control form extracting PBC.

Lastly, the paper focus on the impact that social norms have in influencing controlling party’s behavior, therefore curbing or raising the level of PBC. Differing social norms may provide an explanation for differing levels of PBC in countries where the “law matter” thesis fails to provide it.
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1. **Private benefits of control and their importance**

The expression “private benefits of control” (PBC) encompasses all the ways in which those in control of a corporation can siphon off corporate benefits for themselves without sharing them with minority shareholders.¹

PBC can result in an array of behaviors, most commonly: (i) implementing above-market salaries for corporate management, (ii) unfair self-dealing transactions between the corporation and the controlling party, (iii) insider trading and, more generally, exploitation of information management acquires due to its insider position, and (iv) the issuance of shares in favor of the controlling party at dilutive prices.

Private benefits for control fall under the category of *agency costs*. The recent “*Law and Finance*” literature argues that the expropriation of minority shareholders by the controlling shareholder is at the core of the agency conflict among ownership (shareholders) and control (management) in most of the jurisdictions.²

Empirical studies have demonstrated that private benefits of control differ significantly across countries, and there are important correlations between levels of PBC, corporate ownership structures, and capital market development. In countries with high levels of PBC are high, corporate entities tend to have a more concentrated ownership structure and less developed financial markets. On the other hand, in countries with low PBC, the ownership structures of the firms tends to be more dispersed and the financial markets are more developed (i.e. a higher level

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of capitalization).³

The rationale behind the correlation between the PBC and the capital structure of listed companies is intuitive. Controlling shareholders, in an environment with high level of private benefits for control, would tend to maintain a lock on control since surrendering that would attract others to assemble a controlling stake seeking to capture these private benefits.⁴ Moreover, since incumbents are more likely to retain control of the corporation after they take it public, there are fewer widely held listed companies in countries with high levels of PBC. At the same time, if PBC levels are high, corporations are less likely to list their shares in the financial market. Indeed, the listing decision commits firms to improve disclosure and enhance corporate governance practices due to the additional scrutiny by various capital market intermediaries (“gatekeepers”).⁵ Therefore, high levels of PBC may affect the development of deep and efficient capital markets, causing the curbing of equity financing in favor of intermediate credit.

The level of private benefits for control in a given jurisdiction is essentially a tangible sign of how much legal and non-legal institutions shape and determine the conduct of the party in control of the corporate entity, providing incentives and constraints to opportunistic behaviors that could harm minority shareholders.

Noting how the presence of high or low levels of PBC can shape the corporate and financial market landscape of a country, in this paper I will address why levels of PBC vary enormously

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from one legal system to another, and which factors (legal or not legal) curb or increase them. Before tackling this question, I will first determine how PBC can be evaluated.

2. How to evaluate private benefits of control

Studies have shown that it is possible to measure private benefits for control, which we have defined as benefits that those holding voting control over a corporation are likely to extract to the detriment of minority shareholders. Private benefits for control can be quantified through an estimation of the control premium. The control premium is the amount of money, in excess of the market price of the shares, which the acquirer of the control block is willing to pay in order to benefit from the control of the corporate entity. In other words, private benefits for control have been approximated using the average block premium in a “control transaction”. Control of a corporation can be defined as the direct power to cause more than 50% of existing shareholder votes to be cast in one direction.⁶

There are two methods for empirically assessing the magnitude of private benefits for control. The first is related to a transfer of corporate control and the concept of control premium. Whenever a control block changes hands, the difference between the price per share paid by the acquirer and the price quoted in the market the day after the acquisition is announced represents the control premium. This difference represents an estimate of private benefits for control enjoyed by the controlling party. Therefore a transaction, in order to serve as a model for the evaluation of the control premium, must involve a conveyance of control right over the entity, and the purchase price of the transaction must be compared with the exchange price of the shares.

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after the market has incorporated the identity of the new acquirer and the expected cash flow.\(^7\)

The second method for estimating the value of PBC uses the price difference between two classes of stock with similar or identical dividends rights but with different voting rights. If corporate control is valuable, then corporate votes that allocate control should be valuable as well. The aggregate premium at which the higher-voting class trades over the lesser voting class is assumed to represent the value of control.\(^8\)

2.1. *The “good” and the “bad” story about control premium*

Even though the control premium paid by the acquirer in a “control transaction” is a value used to appraise the level of PBC, it must be noted that PBC do not coincide with the control premium and that the two values are just correlated. Indeed other factors, other than the possibility of extracting private value from the corporation, may determine the amount of the control premium. For instance, the acquirer could be willing to pay a premium for corporate control because he expects to extract value from the corporate entity that could not be extracted by the seller. In other words, the acquirer that pays the control premium might think he can use the corporate assets in a more efficient way, therefore boosting the corporation’s profits.

Another significant factor that shapes the amount of the control premium is the level of control transferred in the transaction. Some control sales do not transfer voting control directly, but rather offer an uncertain opportunity to gain control. This would cause the control block to be traded at a discount price.\(^9\) Therefore, the control premium coincides with private benefits for

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control only when the expected change in profit for the acquirer at the time of the transaction is zero, and the traded control block transfers all the control over the entity with more than just a possibility to gain it.

The control premium could, to an extent, reflect the possible change in profit that the acquirer is expecting through the more efficient use of corporate assets and the level of control she is acquiring; however, it could also reflect the ease of the new controlling party in extorting PBC and looting minority shareholders and the corporate entity. PBC could thus be overestimated when there is a large profit expected by the change in control, and it could be underestimated when there is no profit expected at all.

There is a method, however, that could help an observer assess whether the transaction is motivated by a safe and sound business idea, or by the incentive of extracting private benefits for control. If the reason behind the control transaction were a business idea that could enhance corporate productivity, it would be reasonable for the acquirer to buy more than the simple control threshold. This is because if the idea is successful, the price of the shares will rise, and the more shares the acquirer owns the more she will benefit from the profits of her own idea. On the other hand, if the acquirer would want to benefit from PBC alone, the minimum threshold for control would suffice and, assuming that extracting private benefits for control would involve costs for the corporate entity (legal maneuvering, setting up pyramids, etc.), the ownership of a large of equity stake would reduce the marginal net-benefit of the appropriation.\(^\text{10}\)

However, the threshold transferred in the control transaction could also reflect the risk aversion of the acquirer, who, even if motivated by a safe business purpose, is not willing to risk too much. The relationship between the control premium and the percentage of the ownership

transferred is the real value that should be taken in account. If the percentage of ownership acquired is low, and the control premium is high, it is more likely that the underlying motivation for transaction is the extraction of PBC.

3. What shapes controlling party’s behavior

In assessing the variables that determine the level of private benefits for control in a given country, it is of primary importance to determine what shapes the conduct of the party in control of the corporation. In other words, what is the range of incentives and constraints that ultimately determine the controlling party’s behavior, and are these constraints effective in deterring the controlling party from engaging in opportunistic conduct to the detriment of minority shareholders and the corporate entity? It is interesting to note that these external constraints could be legal or non-legal.

3.1. Legal rules and enforcement systems

It is well recognized among scholars that the assessment of a legal system’s quality, notwithstanding the interaction of several other variables,\(^\text{11}\) is a two-factor evaluation that encompasses the quality and the accuracy of the laws enacted by the legislator and the level of enforcement granted to them.

In all jurisdictions, corporate and securities laws attempt, through the adoption of binding legal rules, to address and limit *agency costs* arising from the separation between ownership

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(shareholders) and control (management). Private benefits for control that could be extracted to the detriment of minority shareholders, as the main agency cost, is the specific target that corporate and securities laws try to tackle. Legal rules and legal principles require the party in control of the corporation to share these benefits with all shareholders, in a way that would benefit the corporate entity as a whole. Legal rules attempt to limit and constrain all the behaviors (self-dealing and related party transactions, insider trading, excessive compensations) that could result in a higher level of PBC. Therefore, it is obvious that there should be a correlation between the level of PBC and the accuracy and the quality of the laws (legal rules and principles) enacted in the corporate and capital markets landscape. “Good corporate governance rules” regarding the protection of the minority shareholders, should discourage opportunistic conduct by the controlling shareholder and “bad corporate governance rules” should fail in their task.12

Although legal rules are designed to mitigate the extortion of private benefits for control, their effectiveness and success is a matter of enforcement. With the term enforcement, we mean the ways in which the observance or obedience of a law or a set of laws can be compelled. Needless to say that a set of legal rules proscribing specific behaviors upon corporate management must come with an efficient enforcement system that will make the threat of liability posed by the laws credible. Only a credible threat of liability will effectively deter the controlling party from engaging in opportunistic conduct.13 The so called “in terrorem” effect provides an enforcement of the laws from one ex ante perspective.

The enforcement of the corporate and securities laws can be achieved through public or private

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enforcement mechanisms. Both types of enforcement systems can operate before the wrongdoing is committed (ex *ante*) or after its commission (ex *post*). The private enforcement of corporate laws and securities laws allows, from one *ex-post* point of view, aggrieved shareholders or investors to sue officers and directors in order to seek relief and recover damages whenever they are harmed by unlawful conduct.

As opposed to private enforcement, the public enforcement of a particular set of laws is the enforcement achieved through supervisory agencies and criminal sanctions. These public agencies have, *ex ante*, a power to specify the laws through further regulations and a duty of surveillance on the prospective wrongdoers and, *ex post*, a power to punish the illegal conduct through independent actions and to support private shareholder litigations.

There is a consensus among scholars\(^\text{14}\) - both in the European and in the American context - that an efficient level of enforcement for a law system should be achieved through the interplay between the public and the private enforcers, as a system based on just one type of enforcement would suffer from inevitable weaknesses.\(^\text{15}\) A system of enforcement based on the co-opetition (cooperation and competition) among the enforcers could achieve the best results in terms of efficiency and intensity.

High levels of PBC have thus become synonymous with weak minority shareholder protection by legal institutions (legal rules and enforcement systems) responsible for suboptimal separation between ownership and control, stock market underdevelopment in terms of capitalization, and lower rates of economic growth.\(^\text{16}\)

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Private benefits of control vary significantly among countries, and the simplest explanation is to ascribe these variations to differences in the laws and in the enforcement systems. For example, the laws enacted in Jurisdiction X could enable controlling shareholders to extract PBC from their corporations more than those in Jurisdiction Y. If the substantive law is similar in the two jurisdictions but PBC levels appear to be substantially different, the explanation should be found in the effectiveness of the enforcement system. The enforcement system fails to make the threat posed by the laws credible to the party in control. One jurisdiction may have established a powerful and well-incentivized mechanism of private enforcement, while another jurisdiction, despite similar substantive laws, may not. On the other hand, one jurisdiction may invest more heavily than the other on public enforcement.

The “law matter” thesis proposes that differences in levels of PBC among countries are a consequence of different levels of protection granted by the law and the enforcement system to minority shareholders.\(^1\)

It is interesting to note that scholars have found that common law jurisdictions seem to outperform civil law jurisdictions by a significant margin in terms of both liquidity and depth of capital market and in terms of the ownership structure of the firms (dispersed ownership structure). As we mentioned, scholars concluded that the superior quality of minority shareholders protection afforded in common law jurisdictions principally explains these differences. Specifically, investors may invest in public corporations more in common law legal regimes because they believe they have enforceable legal rights that can adequately constrain managers and controlling shareholders.

3.2. Other factors shaping controlling party’s behavior.

Other theories have followed the “law matter” explanation for varying levels of PBC across countries, and they have suggested that PBC is determined by a multitude of additional legal and non-legal factors that are difficult to precisely assess. Each of these factors potentially raises expectations of penalties for PBC-motivated activities and raises the cost for the controlling shareholder of diverting resources and activities for his own benefit.\textsuperscript{18}

3.2.1. Competition

Competition improves resources allocation and performance and is a unique disciplinary force in the economy. Scholars have determined that the intensity of product market competition significantly and consistently affects the level of private benefits for control.\textsuperscript{19} Results indicate that stiffer product competition rules limit the scope of managerial waste and sharpen insiders’ incentives to perform well. In other words, the threat posed by a highly competitive market could discourage insiders from redirecting precious corporate resources and information for personal gain, therefore incentivizing them to focus all corporate energies on the performance of the firm.

The distortion produced by the extraction of private benefits, in a competitive market, is more likely to jeopardize the survival of the firm. Thus competitive forces lead to a significant reduction of private benefits within the industry and the country and act as natural constraints on the controlling party.


3.2.2. Disclosure standards

Rules concerning disclosure play a fundamental role in the determination of the value of PBC, since they regulate the information available to minority shareholders. The more accurate this information is, the more difficult it is for a controlling shareholder to appropriate corporate resources without incurring legal penalties or reputational harms. As a result, high quality disclosure rules should be negatively correlated with the level of private benefits for control.\(^\text{20}\)

3.2.3. Reputational constraints

Controlling shareholders might limit their efforts to divert resources, not out of fear of legal sanctions, but rather out of concern for the reputational harms they might suffer. Public humiliation is an important regulatory tool. However, for the reputational constraint to be effective, the disclosure system has to be powerful and efficient.

It is also necessary, to have a public opinion formed by the combination of an independent press that publicizes the facts and a large scale of educated investors who read the newspaper and reprove improper behavior.\(^\text{21}\)

3.2.4. Labor as a monitor

Additional constraints on controlling shareholders may come from other economic entities inside the firm that keep an eye on the performance of the firm. From this perspective, it is clear how labor has the potential to monitor controlling shareholders with the ability to penalize diversion


without having to resort to legal action. Labor inside the firm has contact with customers and suppliers and can hold the controlling shareholder by threatening to withhold services and, in some cases, through their position on the board of directors. In this way, labor can act as a monitoring force on the behavior of controlling shareholders and thus reduce the level of PBC.\(^\text{22}\)

However, the efficiency of labor acting a monitor is threatened by the possibility that labor could combine with the controlling shareholder against the interest of outside directors.\(^\text{23}\)

3.2.5. Enforcement of tax-rules by the tax authority

Tax authorities and minority shareholders have a common interest in ascertaining the precise value produced by the company and get a share of it. Furthermore, tax authorities have the benefit of disciplinary power that minority shareholders do not have. If tax authorities better enforce their rules, controlling shareholders will find it more difficult to divert corporate gains to their own benefit, and private benefits of control will be subsequently reduced.\(^\text{24}\)

3.2.6. The judiciary

Corporate judges play an important role in shaping controlling shareholder behaviors. Indeed, even if the laws enacted are precise and accurate and the system of enforcement powerful and effective, judges could still pose a threat to the final message conveyed to the controlling party


through their decisions. For instance, the U.S. corporate judiciary, with its flexibility and predilection for substance over form, plays an excellent role in keeping directors and officers deterred, respecting *ex post* good faith bad business decisions, but tackling with severity any unfair behavior toward the corporation and minority shareholders.

On the other hand, legal formalism and doctrinal legal thought may have an adverse effect on corporate governance institution, thus leaving the controlling party free to extract PBC. In order to provide the right protection to minority shareholders and investors, substance must always trump form and standards have to be applied creatively with one eye toward the need of justice and the necessity of guiding corporate directors through decisions.²⁵

### 3.2.7. Social norms

Controlling party’s behavior might be shaped more by social norms than by legal rules.²⁶ Scholars have assessed that there are areas of internal corporate behavior that courts should monitor less vigorously because of the adequacy of social norms’ regulatory power.²⁷ If the legal environment cannot account for differences in the level of private benefits of control among countries social norms may provide a better explanation. In other words, if two jurisdictions, having similar legal rules and enforcement systems, appear to permit controlling shareholder to extract, on average, different levels of private benefits, then there should be a difference in the social norms underlying the legal landscape.


Specifically, investors may invest in public corporations in common law countries (and may not invest in similar corporations in civil law jurisdictions) not because they believe they have enforceable legal rights that adequately constraints managers and controlling shareholders, but because they believe controlling shareholders and managers will abide by a series of legally non-enforceable norms (social norms). These norms may, as a practical matter, restrict unfair self-dealing and limit the potential for expropriation of minority shareholders. In, short, investors invest because they expect to be treated “fairly” (and have so been treated in past) and refrain from making similar investments in a civil law regime because they have the opposite expectation (and the opposite experience in the past).

Indeed, social norms vary from country to country. Even though it is extremely difficult to define the presence of a particular social norm, it is relatively easy to observe the consequences of the underlying “good” and “bad” social norms in a given environment.

As we noted, researchers have shown how common law countries outperform civil law countries in the development of capital markets, ownership structure of public corporations, dividend policies and the access of the firm to external equity capital. These differences were ascribed to the different levels of protection that granted to minority shareholders by the law and by the enforcement system. Scholars concluded that the superior quality of legal protection afforded by common law jurisdiction could explain this difference. However, within the U.S. context, attempts to identify specific governance practice that actually enhance shareholder value and elicit a positive market reaction, addressing and limiting private benefits for control, have been unsuccessful.


Clearly, forces of social control seem to work more in some jurisdictions than in others and, even among civil law jurisdictions (with similar kinds of corporate laws and enforcement systems) controlling shareholders appear to have different attitudes about extracting private benefits for control. That is, if the substantive laws and the enforcement systems were highly similar but the average PBC differs dramatically, it would become more difficult to explain these differences on the relative efficiency of the legal system. Such consideration makes the “law matter” explanation weaker.

Any theory that assigns primary causal responsibility to laws would have to explain why civil law jurisdictions could outperform common law jurisdiction in some countries (Scandinavian countries) and underperform in others (Italy, French and Germany). The explanation could still lay in differences in the minority shareholder protection provided by Scandinavian countries and by the level of enforcement guaranteed for those rights. However, Scandinavian laws afford no special legal protection to “oppressed” minority shareholders in comparison with the others’ civil law countries.

Therefore, if we assess that differences in the levels of PBC among countries are not only explainable by differences among legal protection afforded to minority shareholders in the legal system, we infer that social norms are those constraints that ultimately shape and determine corporate behavior when internalized by the controlling shareholder.

Therefore, relevant for the purpose of determining what shapes PBC, the question that have to be addressed is how socially acceptable and diffuse is to behave in an opportunistic way towards the others, and providing an answer to that should explain differences in the PBC levels within countries of similar legal landscapes.

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It should be possible to identify the quality of social norms related to this question through the observation of external proxies of their effects. Scholars\textsuperscript{31} have identified the national crime rate and the level of social cohesion and homogeneity as rough proxies of the quality of the social norms underlying the legal environment. However, these proxies were able to explain some, but not all, of the differences in the levels of PBC among countries. For instance, while Scandinavian countries have low level of crime and, accordingly, a low level of PBC, and Brazil and Mexico have an high level of crime and high PBC, France and Italy, with very high level of PBC, showed a level of crime close to the Scandinavian one. U.S. and Canada, with low levels of PBC, showed, conversely, relatively high levels of crime.

Social cohesion and homogeneity could be another proxy of greater or weaker social norms. In this case too, Chile and Mexico with high level of PBC showed weaker social cohesion due to recent internal conflict and political tensions, and Scandinavian countries showed, accordingly to their low level of PBC, strong social cohesion. Nevertheless, while perhaps not cohesive and homogeneous as Scandinavian, neither French nor Italy approach Brazil and Chile with their internal tensions and instabilities.

One proxy of the quality of the underlying social norms that has not been frequently taken into a great consideration in determining what shapes PBC, is transactional costs. Transactional costs reflect the reciprocal trust among people in a given society, therefore high transactional costs are caused by the likelihood that people will behave in an opportunistic way and cause harm to the others. On the other hand, lower transactional costs mean stronger underlying social norms.

There should therefore be a correlation between the level of PBC and the level of transactional costs.

4. Conclusion

Determining the causes behind private benefits for control is a difficult task to accomplish, since the level is likely to be the result of the cooperation and interaction of a multitude of legal and non-legal factors. Many of these factors have been identified as independent variables that influence PBC, but they have ultimately failed to explain all of the differences in the levels of PBC cross-country examination. Needless to say, both legal factors (law rules, enforcement system, competition rules, etc.) and non-legal factors (social norms) deeply contribute to shaping the controlling party’s opportunistic conducts and the resulting levels of PBC.

One generalization however may be advanced: the impact of social norms in shaping controlling party behavior can be greater when the legal structure above is weak. Conversely, if the legal rules and the enforcement systems are powerful and effective, the influence of social norms on the controlling party is limited.\textsuperscript{32}