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The Law and Economics of Corporate Governance

Changing Perspectives

Edited by
ALESSIO M. PACCES

In association with the Belgian–Dutch Association for Institutional and Political Economy

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An introduction: changing perspectives on corporate law and economics

Alessio M. Pacces

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 (Bebchuk 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 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 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 at 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