Corporate Ostracism: Freezing Out Controlling Shareholders

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I. INTRODUCTION 3
II. THE TRANSACTION-CENTERED APPROACH 7
III. DISTORTING OWNERSHIP STRUCTURES 8
A. Background 8
B. Allocating the Costs and Benefits of Control 9
1. The Upper Limit for the Extraction of Private Benefits 10
2. The Lower Limit for the Extraction of Private Benefits 10
C. The Failure of the Transaction-Centered Approach 12
1. Excessive Private Benefit Extraction 12
a. The Basic Problem 12
i. Indirect Forms of Self-Dealing 12
ii. Direct Forms of Self-Dealing 13
b. Counterpoint: Going-Private Transactions 14
2. Insufficient Private Benefit Extraction 16
a. The Problem 16
b. Counterpoint: Going-Private Transactions 17
D. Empirics 18
1. Private Benefits 18
a. Block Trades 18
i. Insufficient Private Benefit Extraction 19
ii. Excessive Private Benefit Extraction 20
b. Dual Class Shares 21
i. Insufficient Private Benefit Extraction 22
ii. Excessive Private Benefit Extraction 22
2. The Controller's Impact on the Value of the Firm 22
3. Summary 24

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IV. PRODUCING THE WRONG CONTROLLERS 24
A. Favoring Controllers Adept at Extracting Private Benefits 24
B. Deterring the Corporation's Business Partners 25
1. The Value of Business Partners as Controllers 25
2. The Self-Dealing Rules as an Obstacle 26
C. Counterpoint: Countervailing Incentives 27
D. Summary 28
V. UNDESIRABLE CONTROL WITHOUT BENEFIT EXTRACTION 28
A. The Problem 28
B. Family-Controlled Firms 29
C. Going-Private Transactions 31
VI. COURT-BASED ALTERNATIVES 32
A. How Would a Court-Based Alternative Function? 32
1. Insufficient Benefit Extraction 32
2. Excessive Benefit Extraction 33
B. The Drawback of Court-Based Alternatives 33
VII. THE EQUAL OPPORTUNITY RULE AND RELATED APPROACHES 34
A. The Equal Opportunity Rule 34
B. Mandatory Bid Rules that Do Not Offer an Equal Opportunity 35
VIII. THE CORPORATE OSTRACISM 36
A. The Basic Structure 36
B. Potential Benefits 36
1. Excessive Private Benefit Extraction 37
2. Other Undesirable Controllers 37
C. The Potential Costs 38
1. Uninformed Choices 38
2. Extortion 39
a. Extortion as a Chicken Game 40
b. Excessive Demands 41
3. Conflicts of Interest 41
4. Minimal Shareholdings 42
5. Summary 42
D. Why Don't Corporations Adopt the Corporate Ostracism on Their Own? 42
1. General Obstacles to Innovative Governance Arrangements 43
2. Agency Conflicts 44
a. Existing Firms 44
i. Without a Controlling Shareholder 44

Electronic copy available at: http://ssrn.com/abstract=1303712

ii. With a Controlling Shareholder 45
b. IPO Firms 45
E. The Corporate Ostracism as the Appropriate Default Rule 46
1. IPO Firms 47
a. The Ostracism Brings Net Costs 47
b. The Ostracism Brings Net Benefits 47
c. The Costs Weigh About as Heavily as the Benefits 48
2. Publicly Traded Firms 49
3. Summary 50
IX. TURNING THE TRANSACTION-CENTERED PROTECTIONS INTO DEFAULT RULES 51
A. The Mandatory Nature of Self-Dealing Rules 51
B. The Case Against Mandatory Protections 53
1. Potential Benefits 53
a. The Lower Limit of Desirable Benefit Extraction 53
b. Favoring the Most Desirable Controller 54
2. Potential Costs 54
a. Adequate Information 55
b. Looting 55
c. Shareholder Passivity 56
i. Legal Obstacles 56
ii. Damage Caused by Self-Dealing 57
iii. The Costs of a Takeover 58
3. Letting the Shareholders Decide 59
C. The Transaction-Centered Protections as the Default 59
X. CONCLUSION 60

I. INTRODUCTION

The ancient city-state of Athens had an ambivalent relationship with its political elite. On the one hand, the city relied on that very elite to bring forth the statesmen it depended on for its survival. On the other, there was always the risk that an overly ambitious politician might abuse his influence to replace democracy with tyranny. One mechanism to curb such ambitions was the so-called ostracism.[1] Once a year, the citizens

1. For an excellent and comprehensive analysis of the institution of ostracism, see SARA FORSDYKE, EXILE, OSTRACISM, AND DEMOCRACY (2005). Interestingly, scholars disagree as to the way in which ostracism was to prevent tyranny. Forsdyke stresses the deterrence value of ostracism by noting that it served as a reminder of the power of the demos and was therefore suited to discourage "ambitious elites from trying to seize power by force." *Id.* at 151. Others believe that ostracism was used to expel individuals who might become dangerous to democracy. *See, e.g.*, Antony E. Raubitschek, *The Origin of Ostracism*, 55 AM. J. ARCHAEOLOGY 221, 224 (1951) (arguing that "[t]he law of ostracism was instituted with particular reference to

of Athens were given the opportunity to expel one from among their number for a period of ten years.[2] The procedure consisted of two steps: first, a vote was taken on whether or not an expulsion was necessary.[3] If the outcome was positive, the citizens then proceeded to the second step: a vote on whom to expel.[4] Interestingly, ostracization was not perceived as a penalty for any wrongdoing.[5] Accordingly, the ostracized citizen's property was not confiscated,[6] and once the ten years had passed, he was free to return with all of his citizenship rights restored.[7]

Besides being of interest to historians, the institution of ostracism also holds the key to one of the most persistent challenges of modern corporate law, namely the question of how to deal with controlling shareholders in publicly traded corporations. It is well established that, given the right set of circumstances, the presence of a controlling shareholder can yield significant benefits for the corporation as a whole.[8] In particular, large shareholders do not suffer from the same collective action problems as small shareholders and can therefore be more effective at monitoring managers.[9] Moreover, one corporation's ownership of another corporation's stock can reduce the transaction costs that these two firms incur in their contractual dealings.[10] At the same time, of course, the presence of a controlling shareholder is not without risks. There is always the danger that the controller will abuse his power and enrich himself at the expense of the other shareholders.[11] Hence, the law faces a difficult task: It must protect the minority shareholders, but in doing so, it must also try to preserve the benefits associated with the

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the generals as potential supporters of tyranny (or oligarchy)" and suggesting that "it must have been the design of the legislator to place ostracism shortly before the elections in order to prevent a dangerous candidate from being elected general").

2. FORSDYKE, *supra* note 1, at 146–52.

3. *Id.* at 146.

4. *Id.* at 148.

5. *Id.* at 153.

6. *Id.* at 149.

7. FORSDYKE, *supra* note 1, at 149.

8. See MARK ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 235–53 (1996) [hereinafter ROE, STRONG MANAGERS], for an overview of the potential benefits associated with the presence of large shareholders.

9. *E.g.*, Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1932 (1996) (noting collective action problems of small shareholders and pointing out that large shareholders will often defend small shareholders' interests while defending their own interests); John C. Coffee, Jr., *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action*, 54 U. CHI. L. REV. 877, 894 (1987) (noting that "the large shareholder is the most effective monitor of management in the corporate setting"); Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1642, 1651 (2006) [hereinafter Gilson, *Controlling Shareholders*] ("[A] controlling shareholder is more likely to have the incentive . . . to monitor managers effectively . . . and . . . may be able to catch problems earlier."); Ronald J. Gilson & Jeffrey N. Gordon, *Doctrines and Markets: Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 785 (2003) [hereinafter Gilson & Gordon, *Doctrines and Markets*] (noting that "the presence of a large shareholder may better police management"); Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 76 (1982) (arguing that "outside shareholders benefit when a single, large shareholder dominates the firm").

10. *See, e.g.*, ROE, STRONG MANAGERS, *supra* note 8, at 248–53 (explaining how cross-ownership can reduce transaction costs).

11. *E.g.*, Gilson, *Controlling Shareholders*, *supra* note 9, at 1651 (noting that a controlling shareholder "may take more than her share of the gain"); Clifford G. Holderness & Dennis P. Sheehan, *Constraints on Large-Block Shareholders*, *in* CONCENTRATED CORPORATE OWNERSHIP 139, 139 (Randall K. Morck ed., 2000) (noting that the voting power of large shareholders also gives them the power to expropriate corporate resources).

presence of a controller.

Traditionally, corporate law has attempted to solve this dilemma by monitoring individual transactions that are suspected of benefiting the controller at the expense of the other shareholders. For example, in Delaware, all contracts between the controller and the corporation are subject to a test of entire fairness, even if they have been approved by a committee of independent directors.[12] In the literature, the desirability of this transaction-centered approach has never been questioned. This is particularly true for Delaware's version of the transaction-centered approach, which has been praised profusely for its perceived efficiency.[13] Admittedly, individual aspects of Delaware's version of the transaction-centered approach have met with criticism. Edward Rock has argued that Delaware courts may attach too much importance to hard bargaining in evaluating the fairness of a transaction.[14] Marcel Kahan and Ehud Kamar have suggested that Delaware's rules on self-dealing are particularly vague and therefore highly, and perhaps inefficiently, litigation-intensive.[15] And Mary Siegel has faulted Delaware's judiciary with being too quick to apply the entire fairness test in reviewing transactions involving the controlling shareholder.[16] Yet these criticisms concern the modalities of the transaction-centered approach, rather than its justification in principle, and they can be addressed within the framework of that approach.

By contrast, this Article argues that the transaction-centered approach is fundamentally flawed. Most importantly, the transaction-centered approach strikes the wrong balance between the interests of the controller and those of the other shareholders. As explained in more detail below, the amount of private benefits—i.e. benefits not shared by the other shareholders—that the controller should be able to extract from the corporation depends both on how valuable the controller's presence is to the corporation and on the extent to which the controller shoulders costs of control that are not shared by the other shareholders. The transaction-centered approach fails to take these factors into account. Instead, it focuses on the fairness of individual transactions, and, accordingly, the level of private benefit extraction depends on how well the individual controller is positioned to exploit loopholes in that fairness review. As a result, the level of private benefit extraction is bound to be too high in some corporations while being too low in

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12. Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997).

13. *See, e.g.*, Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 CAL. L. REV. 393, 429 (2003) (asserting that Delaware "has developed a coherent and very efficient solution to the self-dealing problem"); *cf.* Donald E. Schwartz, *In Praise of Derivative Suits: A Commentary on the Paper of Professors Fischel and Bradley*, 71 CORNELL L. REV. 322, 335–36 (1986) (lauding the willingness of the judiciary to enter into a substantive review of self-dealing transactions, despite corporation statutes like Delaware's that place the focus on procedure over substance).

14. Edward B. Rock, *Controlling the Dark Side of Relational Investing*, 15 CARDOZO L. REV. 987, 1014 (1994) (arguing that the focus on hard bargaining undermines judicial review because "a hard arm's length transaction between bad managers and a bad relational investor . . . can bind the relational investor . . . without protecting the shareholders").

15. Marcel Kahan & Ehud Kamar, *Price Discrimination in the Market for Corporate Law*, 86 CORNELL L. REV. 1205, 1233–37 (2001) (explaining that Delaware's self-dealing rules are highly litigation-intensive because they constitute "fact-intensive, standard-based tests," while conceding that there may be no way to prove that Delaware law is excessively litigation-intensive); *cf.* Jason M. Quintana, *Going Private Transactions: Delaware's Race to the Bottom?*, 2004 COLUM. BUS. L. REV. 547, 565 (calling Delaware's self-dealing rules "open-ended and unclear").

16. Mary Siegel, *The Erosion of the Law of Controlling Shareholders*, 24 DEL. J. CORP. L. 27, 69–70 (1999); *accord* Steven M. Haas, Note, *Toward a Controlling Shareholder Safe Harbor*, 90 VA. L. REV. 2245, 2304 (2004) (arguing that "[g]oing-concern transactions that are independently approved by disinterested directors or a majority of the minority shareholders should be reviewed under the business judgment standard").

others. Because of this and other shortcomings of the transaction-centered approach, this Article suggests that the existing law should be modified in two ways.

First, to prevent excessive benefit extraction, the law should give minority shareholders in publicly traded corporations the right to force the controller to sell his shares in the corporation. This mechanism, the "corporate ostracism," would ensure that minority shareholders can rid the corporation of any controller whose presence harms the corporation. The corporate ostracism should be a mere default rule. However, the ability to opt out via a charter amendment should be conditioned on the approval of the minority shareholders.

Second, to address the problem of insufficient benefit extraction, the existing transaction-centered protections should be stripped of their mandatory character and turned into default rules. As with the corporate ostracism, a charter amendment opting out of the default should require the approval of the minority shareholders.

At this point, a clarification is in order: The costs and benefits of the corporate ostracism are to some extent uncertain. This is unavoidable given that the law has until now followed a different approach. Consequently, it is impossible at the present stage to demonstrate that the right to ostracize the controller is the appropriate solution for most, let alone all, corporations. Against this background, it is all the more important to stress that the case for the default regime that I propose does not depend on any such findings. Rather, the crucial point is a different one: Not all default rules are equally easy to opt out of.[17] That is particularly true in the context at hand. If the applicable default rules fail to provide for a right to expel the controller, various factors make it difficult for corporations to create such a right on their own. By contrast, if the corporate ostracism is turned into the legal default, then those corporations for whom the corporate ostracism is not suitable will likely opt out. Consequently, designating the corporate ostracism as the default rule promises to increase the chance that corporations are governed by the rule that is most appropriate for them. In other words, I argue that the corporate ostracism is the preferable default rule regardless of whether or not the right to expel the controller is a desirable rule for most, let alone all, corporations.

A similar line of reasoning applies to the proposal to strip the transaction-centered protections of their mandatory nature: I do not claim to be able to show that abandoning the transaction-centered protections is desirable for most, let alone all, corporations. However, as shown below, the transaction-centered protections impose significant burdens. Against that background, it is at least plausible that some corporations would be better off without—or at least with a modified version of—these protections. Allowing these corporations to opt out of the transaction-centered protections is the best way to ensure that corporations are governed by the rules that are most appropriate for them.

Part II of this Article gives a brief description of Delaware's version of the transaction-centered approach. Part III explains how the transaction-centered approach distorts ownership structures by allowing either too much or too little benefit extraction. Parts IV and V explain various other drawbacks of the transaction-centered approach. Part VI explores and rejects court-based alternatives to the transaction-centered approach, in which the courts focus their attention on the controller's overall impact rather than on individual transactions. Part VII explains why the shortcomings of the transaction-

17. *See* Lucian Arye Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U.L. REV. 489, 492 (2002) [hereinafter Bebchuk & Hamdani, *Optimal Defaults*] (arguing that because charter amendments require the approval of managers, "for any level of shareholder support, corporations are much more likely to adopt amendments management favors than amendments management disfavors").

centered approach cannot be eliminated by requiring an acquirer of control to offer to purchase some or all of the shares of the minority shareholders. Part VIII argues that minority shareholders should be given the right to expel ("ostracize") the controller, and Part IX explains why corporations should be allowed to opt out of the transaction-centered protections that existing law imposes. Part X summarizes.

II. THE TRANSACTION-CENTERED APPROACH

To illustrate the transaction-centered approach, let us begin by considering the restraints that Delaware law, by far the most important corporate law,[18] imposes on the controlling shareholder in his dealings with the controlled corporation. Under Delaware case law, it is well established that a controlling shareholder has fiduciary duties towards the other shareholders.[19] Moreover, majority ownership is not a necessary prerequisite for these duties to apply. While a majority shareholder is automatically considered a controlling shareholder for fiduciary duty purposes,[20] even a non-majority shareholder is deemed a controlling shareholder if the actual exercise of control over the corporation's conduct is established.[21]

Of course, even where control is established, the level of scrutiny varies widely. Essentially, Delaware courts distinguish between two types of cases. First, there are those situations where the controller enters into a contract with the corporation and therefore literally stands on both sides of the transaction. Such cases are automatically subject to review for entire fairness.[22] Indeed, the entire fairness standard applies even if the transaction has been approved by a majority of the minority shareholders[23] or by a committee of independent directors.[24] The only thing that can change is the allocation of the burden of persuasion regarding the fairness of the transaction. Ordinarily that burden rests with the defendant.[25] However, it will shift to the plaintiff if a majority of the minority shareholders have approved the transaction in an informed vote.[26] The same result can be achieved via an informed vote of a committee of independent directors.[27] That said, a perfunctory special committee of outside directors is insufficient to achieve such a shift of the burden of proof.[28] Rather, the committee must function in a manner indicating that it exercises real arm's-length bargaining power.[29]

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18. More than half of all publicly traded corporations in the United States are incorporated in Delaware. Del. Div. of Corps., Why Choose Delaware As Your Corporate Home?, http://www.corp.delaware.gov/default.shtml (last visited Aug. 2, 2007).

19. Kahn v. Lynch Commc'n Sys., 638 A.2d 1110, 1113 (Del. 1994); Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987).

20. *Ivanhoe*, 535 A.2d at 1344; Superior Vision Servs. v. ReliaStar Life Ins. Co., No. 1668-N, 2006 Del. Ch. LEXIS 160, at *13 (Del. Ch. Aug. 25, 2006).

21. Weinstein Enters. v. Orloff, 870 A.2d 499, 507 (Del. 2005); *In re* W. Nat'l Corp. S'holders Litig., No. 15927, 2000 Del. Ch. LEXIS 82, at *28 (Del. Ch. May 22, 2000).

22. *See, e.g.*, Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997) (holding that "when a controlling shareholder stands on both sides of the transaction the conduct of the parties will be viewed under the . . . standard of entire fairness"); *In re* Tri-Star Pictures, Inc., Litig., 634 A.2d 319, 328 (Del. 1992); Bershad v. Curtiss-Wright Corp., 535 A.2d 840, 845 (Del. 1987).

23. Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985).

24. *Tremont Corp.*, 694 A.2d at 428.

25. *Id.*

26. *Id.*; *Bershad*, 535 A.2d at 846; *Rosenblatt*, 493 A.2d at 937.

27. *Tremont Corp.*, 694 A.2d at 428; Kahn v. Lynch Commc'n Sys., 638 A.2d 1110, 1117 (Del. 1994).

28. *Tremont Corp.*, 694 A.2d at 429.

29. *Id.*

In cases where the controller's conduct does not involve a contract with the corporation, the situation is more complicated. The leading case, in this context, continues to be *Sinclair Oil Corp. v. Levien*.[30] There, the controlling shareholder, Sinclair, used its control to make the controlled corporation pay large dividends.[31] The minority shareholders received their proportionate shares of these dividends,[32] but the plaintiff argued that the relevant dividend payments unfairly prevented the controlled corporation from expanding.[33] Perhaps not surprisingly, the Delaware Supreme Court concluded that Sinclair had not breached its fiduciary duties.[34] More importantly, the court clearly defined the extent of scrutiny to which the controller is subjected: While self-dealing transactions are subject to the entire fairness standard,[35] the controller's other actions enjoy the protection of the business judgment rule.[36] Admittedly, the court made it clear that a finding of self-dealing is not confined to those cases where the controller enters into a contract with the corporation. Rather, the court held that "[s]elf-dealing occurs when the parent, by virtue of its domination of the subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary to the exclusion of, and detriment to, the minority stockholders of the subsidiary."[37] However, the court placed the burden of proof on the plaintiff.[38] In other words, the plaintiff needs to prove the existence of self-dealing before the entire fairness standard can be applied.

III. DISTORTING OWNERSHIP STRUCTURES

The main problem with this and other versions of the transaction-centered approach is that they distort ownership structures. In the following Part, I will illustrate this problem by reference to Delaware's rules on self-dealing. However, it will also become clear that the same argument can be made with respect to other forms of the transaction-centered approach.

A. Background

For the sake of clarity, I begin by briefly reviewing some basic terms and principles that play a central role in the literature on controlling shareholders and that are of crucial importance to the analysis that follows. It is generally recognized that the presence of a controlling shareholder can have both costs and benefits.[39] Many of the benefits associated with the presence of a controller, such as better monitoring of the corporation's managers, accrue to the corporation as a whole. Hence, they are shared by all shareholders on a pro rata basis, and one can refer to them as "shared benefits."[40]

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30. Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).

31. *Id.* at 721–22.

32. *Id.* at 721.

33. *Id.* at 720.

34. *Id.* at 722.

35. *Sinclair Oil Corp.*, 280 A.2d at 722.

36. *Id.*

37. *Id.* at 720.

38. *See id.* at 722 (reasoning that the business judgment rule must be applied, "since there is no proof of self-dealing on the part of [the controlling shareholder]").

39. *E.g.*, Gilson, *Controlling Shareholders*, *supra* note 9, at 1651.

40. *E.g.*, Michael J. Barclay & Clifford G. Holderness, *The Law and Large-Block Trades*, 35 J.L. & ECON. 265, 268–69 (1992) [hereinafter Barclay & Holderness, *Large-Block Trades*]; John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301, 1332 (2001) [hereinafter Coates

Other benefits, by contrast, are reaped by the controlling shareholder alone, and these are typically called "private benefits."[41] For example, the social prestige associated with control is a psychic benefit that accrues to the controlling shareholder alone and therefore represents a private benefit of control.

Of course, control also has costs,[42] and these too can be categorized into private costs and shared costs. Examples of private costs are easy to find. Most importantly, ownership of a controlling stake means that the controller has to forego the benefits of diversification.[43] Moreover, in monitoring the controlled corporation, the controlling shareholder may incur significant expenses that he cannot share with the controlled corporation's minority shareholders. At the same time, it is not difficult to cite examples of shared costs. In particular, shared costs may be the direct result of the private benefits extracted by the controller as in the case where the controller buys goods from the corporation at below-market prices. Such transactions increase the private benefits of control. At the same time, they impose costs on the corporation that are borne by all shareholders—including the controller—on a pro rata basis.

One caveat is in order: While private benefits often come at the expense of the corporation, this does not have to be the case.[44] For example, the controlling shareholder may simply enjoy the feeling of being in control as well as the social prestige that comes with control.[45] These so-called psychic benefits of control[46] do not come at the expense of the corporation; they simply would not exist without the presence of a controlling shareholder. For the sake of analytical clarity, it is helpful to distinguish clearly between those benefits that are reaped at the expense of the corporation and those that are not.[47] In the following Parts, I refer to the former as "extracted private benefits" and to the latter as "independently created private benefits."

B. Allocating the Costs and Benefits of Control

How should the benefits and costs of control be allocated between the controller and

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IV, *Explaining Variation*].

41. *E.g.*, Barclay & Holderness, *Large-Block Trades*, *supra* note 40, at 269; John C. Coates IV & Guhan Subramanian, *A Buy-Side Model of M&A Lockups: Theory and Evidence*, 53 STAN. L. REV. 307, 395 (2000); Coates IV, *Explaining Variation*, *supra* note 40, at 1332; Gilson & Gordon, *Doctrines and Markets*, *supra* note 9, at 785; Clifford G. Holderness, *A Survey of Blockholders and Corporate Control*, ECON. POL'Y REV. (Fed. Reserve Bank of New York, New York, N.Y.), Apr. 2003, at 51, 55 [hereinafter Holderness, *Survey of Blockholders*]; Mark J. Roe, *Corporate Law's Limits*, 31 J. LEGAL STUD. 233, 246 (2002); Luigi Zingales, *What Determines the Value of Corporate Votes*, 110 Q.J. ECON. 1047, 1047 (1995).

42. *E.g.*, John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 5 n.10 (2001) [hereinafter Coffee, Jr., *Rise of Dispersed Ownership*]; Holderness, *Survey of Blockholders*, *supra* note 41, at 55; Mark J. Roe, *Rents and Their Corporate Consequences*, 53 STAN. L. REV. 1463, 1488 n.44 (2001) [hereinafter Roe, *Rents and Their Corporate Consequences*].

43. *E.g.*, Coffee, Jr., *Rise of Dispersed Ownership*, *supra* note 42, at 5 n.10; Holderness, *Survey of Blockholders*, *supra* note 41, at 55; Roe, *Rents and Their Corporate Consequences*, *supra* note 42, at 1488 n.44.

44. Holderness, *Survey of Blockholders*, *supra* note 41, at 55.

45. Robert B. Heglar, Note, *Rejecting the Minority Discount*, 1989 DUKE L.J. 258, 273.

46. *See, e.g.*, *id.*; Michael Klausner, *Investors' Choices: Institutional Shareholders, Private Equity, and Antitakeover Protection at the IPO Stage*, 152 U. PA. L. REV. 755, 779 (2003) [hereinafter Klausner, *IPO Stage*].

47. Essentially the same distinction is made by Gilson, *Controlling Shareholders*, *supra* note 9, at 1663–64. He uses the terms "pecuniary benefits" and "non-pecuniary benefits," but distinguishes between the two categories based on whether or not the relevant benefits involve a transfer of real resources from the corporation to the controller. *Id.*

the other shareholders? The answer depends, of course, on what goal the law is to pursue. In the following, I will assume that the purpose is to ensure that control emerges if and only if the benefits of control to the shareholders (including the controller) exceed its costs to the shareholders (including the controller). In other words, control should emerge if and only if the sum of the shared and private benefits of control is greater than the sum of the shared and private costs of control.[48] If one accepts that premise, two consequences follow.

1. The Upper Limit for the Extraction of Private Benefits

First, the law has to ensure that control does not emerge where its (shared and private) costs exceed its (shared and private) benefits. And to achieve that aim, the law needs to limit the controller's ability to extract private benefits. This insight is universally recognized,[49] and quite rightly so. After all, if the controller enjoyed an unlimited right to help himself to the corporation's assets, control would emerge regardless of whether its costs exceeded its benefits.

It does not follow, however, that the controller should be unable to extract *any* private benefits. Rather, to ensure that the controller's ability to extract private benefits from the corporation will not encourage the emergence of undesirable control,[50] it is sufficient that the controller be prevented from extracting private benefits that are greater than the net benefits that his presence bestows on the corporation.

To understand the justification of this statement, it is helpful to focus on a scenario in which the shared costs of control outweigh its shared benefits. In that case, the controller not only has to bear the private costs of control, but also has to shoulder his proportionate share of the excess of the shared costs over the shared benefits. Consequently, a controller will emerge only if the private benefits outweigh the aforementioned costs. Yet under the rule suggested above, the controller cannot extract private benefits if the shared costs of control outweigh its shared benefits. As a result, there is no risk that the extraction of private benefits renders it profitable for the controller to establish control where the shared costs of that control outweigh its shared benefits.

2. The Lower Limit for the Extraction of Private Benefits

The demand that control should emerge wherever its (shared and private) benefits exceed its (shared and private) costs also has a second implication for the rules on private benefits. That is, the law should not discourage a controlling shareholder from emerging in those cases where the (shared and private) benefits of control outweigh its (shared and

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48. From an efficiency perspective, a caveat is necessary: The costs and benefits to the shareholders (minority shareholders and controller) are not necessarily identical to the costs and benefits to society as a whole. *See generally* Richard S. Markovits, *Monopoly and the Allocative Inefficiency of First-Best-Allocatively-Efficient Tort Law in Our Worse-Than-Second-Best World: The Whys and Some Therefores*, 46 CASE W. RES. L. REV. 313, 329–30 (1996) (explaining the difference between the costs and benefits to society on the one hand and the costs and benefits to the parties to a transaction on the other hand).

49. *Cf.*, John C. Coffee, Jr., *Norms & Corporate Law: Do Norms Matter? A Cross-Country Evaluation*, 149 U. PA. L. REV. 2151, 2158 (2001) (noting that "[i]n all jurisdictions, corporate law attempts to address and limit the extraction of private benefits of control").

50. I use the term "undesirable control" to refer to those cases in which the (shared and private) costs of control exceed the (shared and private) benefits of control. Conversely, I use the term "desirable control" to refer to those cases in which the (shared and private) benefits of control exceed the (shared and private) costs of control.

private) costs. For that reason, a total ban on the extraction of private benefits is problematic. As pointed out above, the controller has to shoulder certain costs of control alone.[51] And of course, if the controller is forced to shoulder the costs of control alone while being forced to share the benefits of control with the other shareholders, the other shareholders are allowed to free ride at the controller's expense. This free rider problem can distort ownership structures: Even in those corporations where the benefits of control exceed its costs, a controller may fail to emerge if he is forced to share the benefits of control while having to bear certain costs of control alone.

At least in principle, this free rider problem has long been recognized.[52] Puzzlingly though, the awareness of this issue has not translated into criticism of the rules on self-dealing.[53] Instead, despite the fact that scholars are aware of the free rider problem, the idea that the controller should not be able to extract private benefits still tends to be accepted as a given.[54] For example, in one of the most important articles on the private benefits of control, Michael J. Barclay and Clifford G. Holderness note that "[i]f pro rata distributions were rejected, blockholders would consume most, if not all, corporate resources to the exclusion of minority shareholders."[55] Yet this statement contains a false choice. There is no a priori reason why the law should have to choose between allowing the controller to consume "most, if not all, corporate resources" and a strict pro rata distribution rule. Rather, just as the law should enforce an upper limit for the extraction of private benefits in order to protect the minority shareholders, it should also strive to set a lower limit for the permissible extraction of private benefits.

How should that lower limit be defined? It needs to be recalled that the controller shoulders both his private costs of control and his portion of the shared costs of control. At the same time, he enjoys both any independently created private benefits of control and his share of the shared benefits of control. Hence, in order to ensure that free riding does not prevent a desirable controller from emerging, the controller must be allowed to extract private benefits in an amount that is sufficient to cover any difference that may remain between his aforementioned costs and benefits. In other words, the controller must be able to extract private benefits that are sufficient to compensate the controller for any excess of his (shared and private) costs of control over his (shared and independently created private) benefits of control.[56] Needless to say, such benefit extraction should be possible only up to the upper limit of private benefit extraction described above.

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51. *See supra* Part III.A.

52. Zohar Goshen, *Controlling Strategic Voting: Property Rule or Liability Rule?*, 70 S. CAL. L. REV. 741, 751–52 (1997).

53. In the literature, the free rider problem is occasionally dismissed by pointing out that the minority shareholders can be frozen out at the pre-merger price. *See, e.g.*, Edward B. Rock, *Corporate Law Through an Antitrust Lens*, 92 COLUM. L. REV. 497, 536 (1992) ("By allowing an acquiring company to eliminate objecting shareholders at a price equal to the pro rata value of the firm, exclusive of merger gains, shareholders are unable to take a free ride on the benefits that a new controlling shareholder might bring."). Yet as explained in detail below, the availability of a freeze-out merger is at best a highly flawed answer to the free rider problem. *See infra* Part III.C.1.b.

54. *See, e.g.*, Gilson, *Controlling Shareholders*, *supra* note 9, at 1657, 1674 (defining a system with good law as one "that minimizes the potential for private benefit extraction" and arguing that it is essential for legal systems to make the extraction of significant pecuniary private benefits unlawful).

55. Barclay & Holderness, *Large-Block Trades*, *supra* note 40, at 289. *Cf.* Merritt B. Fox & Michael A. Heller, *Corporate Governance Lessons from Russian Enterprise Fiascoes*, 75 N.Y.U. L. REV. 1720, 1724 (2000) (noting that for investor owned firms, one "feature of good governance is that the residuals are distributed to shareholders and in a pro rata fashion").

56. By "his" shared costs of control, I mean the controller's share of the shared costs of control. Similarly, by "his" shared benefits of control, I mean the controller's share of the shared benefits of control.

C. The Failure of the Transaction-Centered Approach

As explained above,[57] the appropriate level of benefit extraction is determined by a number of factors, including the private costs of control and the extent to which the controller's presence benefits the corporation. Yet the transaction-centered approach fails to take these factors into account. Instead it focuses on the fairness of individual transactions.[58] As a result, the amount of benefits that the controller can extract is bound to be too high in some corporations and too low in others.

1. Excessive Private Benefit Extraction

That the transaction-centered approach can lead to an excessive level of private benefit extraction is easily explained.

a. The Basic Problem

The appropriate upper limit for the extraction of private benefits is equal to the net benefits that the controller's presence creates for the corporation.[59] That upper limit becomes particularly relevant in the all-too-realistic scenario where a controller mismanages the corporation, thereby leaving the corporation worse off than it would be without him. In that case, the controller should not be able to extract any private benefits at all. Yet depending on the circumstances of the individual corporation, the transaction-centered approach will allow such a controller to extract substantial private benefits.

i. Indirect Forms of Self-Dealing

Thus, the transaction-centered approach is ill-suited to prevent those self-dealing transactions that benefit the controller in an indirect fashion. While the extent to which corporations are vulnerable to such forms of self-dealing varies across corporations, there is nothing that would suggest that undesirable controllers will have fewer such opportunities than desirable controllers.

Opportunities for indirect forms of self-dealing arise whenever the controller can use his control to advance personal business interests that he pursues outside of the corporation. For example, consider the case of a controller who also is the corporation's main lender. Such a controller can use his control to steer the corporation away from profitable but risky operations and towards safer, but less profitable ones. The controller thereby reduces the risk that the corporation will default on its loans, but he does so at the expense of the corporation's profitability.[60] Another possible scenario involves the

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57. *See supra* Part III.B.

58. *See supra* Part II.

59. *See supra* Part III.B.1.

60. For the sake of clarity, two points should be noted. First, it is noteworthy that equity ownership may well be an efficient means to reduce the agency conflict between borrower and lender. As a general matter, a borrower has an incentive to be overly risk friendly because if he goes bankrupt, some of the resulting costs are borne by the lender. If the lender owns a controlling stake in the borrower, he can prevent opportunistic behavior of this type. Second, and more importantly, a lender who doubles as a controller and exercises his control to steer the corporation towards less risky investments does not *necessarily* extract private benefits. As pointed out above, one should speak of extracted private benefits only in those cases where the controller reaps private benefits *at the expense* of the corporation. Needless to say, it is quite possible that the terms of the loan—particularly the interest rate—compensate the corporation for the fact that the controller will steer the corporation away from risky investments. Assuming that the relevant bargain is at least as favorable to the corporation as an arm's-length transaction with an unrelated party would have been, no extraction of private

avoidance of competition. In order to protect his own profits, the controller may steer the corporation away from business areas where it might compete with the controller. Yet another way of extracting benefits concerns the preservation of bargaining power vis-à-vis the controlled corporation. For example, imagine that the controlled corporation's business is focused entirely on producing parts for a given manufacturer of automobiles and that this manufacturer happens to be the controller. In that case, the controller may use his control to prevent the corporation from also entering into business relationships with other manufacturers, a move that would lessen the controlled corporation's dependence on the controller.

In scenarios such as the ones described above, the transaction-centered approach offers little protection. That is particularly obvious with respect to Delaware's version of that approach. Under Delaware law, the controller's actions are subject to an entire fairness review where the controller seeks to gain an advantage at the exclusion and to the detriment of the other shareholders.[61] As explained above, however, it is the plaintiff who has to show that the controller has engaged in self-dealing.[62] In cases of indirect self-dealing, that burden is hard to meet. While it may be possible to show that the course of action taken by the corporation benefited the controlling shareholder, it is extremely difficult to prove that this advantage came at the expense of the other shareholders.

Admittedly, one might try to argue that the fault lies with Delaware's particular version of the transaction-centered approach rather than with the transaction-centered approach as such. However, at least to some extent, the lack of protection against indirect forms of self-dealing is inevitable if the transaction-centered approach is to be applied. If a controller has business interests other than his stake in the controlled corporation, especially in a line of business that is identical or complementary to that of the corporation, many if not most major corporate actions may have the potential to impact those other business interests in an indirect fashion. To subject all relevant decisions to an entire fairness review would presumably render control unworkable.

ii. Direct Forms of Self-Dealing

Regarding contracts between the corporation and the controller, the protections offered by the transaction-centered approach are much more stringent. Transactions of this type automatically qualify as self-dealing transactions and are subject to a test of entire fairness.[63] Moreover, barring approval by the minority shareholders or the independent directors, the burden of proof is on the controller.[64]

But the efficacy of these protections, too, depends on the circumstances. As the Delaware Supreme Court has pointed out, even independent directors can be swayed by the fear that the controlling shareholder will retaliate against them should they fail to go along with his wishes.[65] Consequently, the controller may be able to shift the burden of

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benefits occurs. However, none of this undermines the point made in the main text, namely, that steering a corporation away from risky investments *can* be a way for a controller doubling as a lender to extract private benefits.

61. *See supra* Part II (discussing a self-dealing transaction involving controlling shareholders).
62. *See supra* Part II.
63. *See supra* Part II.
64. *See supra* Part II.
65. *See* Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997).

> [T]hose who pass upon the propriety of the transaction might perceive that disapproval may result in retaliation by the controlling shareholder. . . . Consequently, even when the transaction is

proof even in cases where the terms of the contract are not what they would have been in a true arm's-length transaction.[66] For that reason, the Delaware Supreme Court has held that approval by independent directors only shifts the burden of proof to the plaintiff, but does not change the fact that the transaction is subject to entire fairness review.[67] However, that measure fails to eliminate the problem. After all, the plaintiff's chances of proving unfairness are highly dependent on the circumstances. In those cases where the market price is easily ascertained, it may be relatively easy for the plaintiff to show that a contract favors the controller. By contrast, in cases where the contract concerns unique goods or other goods with no readily ascertainable market value, it is likely to be much harder for the plaintiff to prove his case.

In sum, the degree to which the transaction-centered approach can prevent the extraction of private benefits depends on the circumstances. There is nothing to suggest that undesirable controllers are less adept at exploiting opportunities for the extraction of private benefits than are desirable controllers.

b. Counterpoint: Going-Private Transactions

As pointed out above, excessive private benefit extraction is problematic in that it can render it profitable for a controller to acquire or maintain control despite the fact that the (private and shared) costs of control outweigh its (private and shared) benefits. That leads to the following question: Can we not expect the problem of excessive benefit extraction to be solved via going-private transactions? After all, if the controller's presence imposes net costs on the corporation, and if these costs outweigh the net private benefits that control has for the controller, should we not expect some savvy investor to realize that money can be made by acquiring the controlling block, freezing out the minority shareholders, and thereby eliminating the agency conflict between the controller and the minority shareholders?

In fact, going-private transactions are at best a partial solution to the problem of excessive benefit extraction.[68] To begin, there are transaction costs to be considered. Few

> negotiated by a special committee of independent directors, 'no court could be certain whether the transaction fully approximate[d] what truly independent parties would have achieved in an arm's length negotiation.'

Id.

66. *Cf. id.* (noting that negotiation by a special committee of independent directors does not allow a court to be certain "whether the transaction fully approximated what truly independent parties would have achieve[d] in an arm's length negotiation").

67. *Id.*

68. In addition to the problems mentioned in the main text, there is also a free rider problem to be considered: Some desirable going-private transactions will be deterred if the resulting benefits have to be shared with the minority shareholders. To fully solve this problem, one would have to ensure that the acquirer is able to acquire the minority shareholders' shares at the no-transaction value, meaning the value that the shares would have without the change in control transaction. *See* Lucian Arye Bebchuk, *Efficient and Inefficient Sales of Corporate Control*, 109 Q. J. ECON. 957, 983–84 (1994) [hereinafter Bebchuk, *Efficient and Inefficient Sales*] (explaining that if courts are expected to award minority shareholders more than the value that their shares have without the change in control transaction, "the freezeout option cannot be relied on to ensure that all efficient transfers take place"). At least under Delaware law, however, that result is by no means assured. Admittedly, section 262(h) of the Delaware General Corporation Law explicitly provides that the "fair value" of shares shall be determined "exclusive of any element of value arising from the accomplishment . . . of the merger." DEL. CODE ANN. tit. 8, § 262(h) (2007). However, the Delaware Supreme Court has gone beyond the text of the statute, holding that "[o]nly the speculative elements of value that may arise from the 'accomplishment or expectation' of the merger are excluded." Weinberger v. UOP, Inc., 457 A.2d 701, 713 (Del. 1983).

would deny that going-private transactions tend to be rather expensive.[69]

Second, because going-private transactions require the voluntary participation of the incumbent controller, they have no deterrence value. While a going-private transaction may sometimes eliminate existing undesirable controllers, the prospect of a going-private transaction does nothing to prevent undesirable controllers from emerging in the first place.

Third, and perhaps most importantly, there can be potentially significant advantages to maintaining the controlled corporation's status as a publicly traded corporation that is a separate entity from its controller.[70] For example, the controlled corporation's status as a distinct publicly traded corporation allows the controlling corporation to make use of the information generated by the capital market in evaluating the controlled corporation's performance.[71] Moreover, the existence of a market price for the controlled corporation's shares facilitates tying the compensation of the controlled corporation's managers to the controlled corporation's performance.[72] In addition, the controlled corporation's status as a publicly traded corporation makes it easier for the controller to sell his stake once the association between the controller and the controlled corporation becomes unprofitable.[73]

All of the afore described advantages would be lost if the controlled corporation were merged with the controlling corporation or if it were turned into a privately held subsidiary. Therefore, in order to solve the problem at hand in an adequate fashion, taking the corporation private by freezing out the minority shareholders could only be the first step. The second step would be to take the corporation public again.

Unfortunately, such an approach runs into an obvious problem: How does one avoid the emergence of an undesirable controller the second time around? If the problem is that the law did not prevent the original controller from extracting excessive private benefits, why should one have any confidence that once the corporation has been taken public again, the corporation will not witness the emergence of the original or another controller who once more extracts excessive private benefits?[74]

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69. *See, e.g.*, Thomas M. McElroy, II, Note, *In re* Pure Resources: *Providing Certainty to Attorneys Structuring Going-Private Transactions, or Not?*, 39 WAKE FOREST L. REV. 539, 540 n.8 (2004) (noting that "[g]oing-private transactions are both time consuming and costly"); Joshua M. Koenig, Survey, *A Brief Roadmap to Going Private*, 2004 COLUM. BUS. L. REV. 505, 515 (pointing out that one "barrier to going-private is the high cost of the transaction").

70. Indeed, the occurrence of so-called equity carve-outs attests to the significance of these benefits. In an equity carve-out, a parent corporation sells a minority stake in the subsidiary corporation to the public. *See, e.g.*, George G. Triantis, *Organizations as Internal Capital Markets: The Legal Boundaries of Firms, Collateral, and Trusts in Commercial and Charitable Enterprises*, 117 HARV. L. REV. 1102, 1134 (2004).

71. *Cf.* Gilson & Gordon, *Doctrines and Markets*, *supra* note 9, at 791 (noting that "maintaining a publicly traded, majority-owned subsidiary may benefit the controlling shareholder by more effectively opening the controlled company's performance to public scrutiny, thereby assuring more accurate pricing of the controlled corporation's business than if it was [sic] bundled with that of the controlling shareholder").

72. *Cf. id.* (noting that "controlling shareholders may use market signals to devise more accurate incentive compensation for the management and employees of both corporations").

73. ROE, STRONG MANAGERS, *supra* note 8, at 235–53.

74. Admittedly, before the corporation is taken public again, its certificate of incorporation could be amended so as to make the emergence of a controller or the extraction of private benefits more difficult. For example, the certificate of incorporation could be amended to bar anyone from acquiring more than a 20% stake in the corporation. However, the drawbacks of such provisions should be obvious. For illustrative purposes, consider the disadvantages of the above mentioned 20% limit on shareholdings. Such a limit cannot even guarantee a controller will fail to emerge, because, depending on how widely dispersed the remaining shares are, a block of less than 20% may well suffice to convey de facto control. Moreover, to the extent that it is effective in preventing the emergence of controllers, the 20% limit does not distinguish between desirable and undesirable controllers, instead deterring all controllers alike. In addition, it threatens to prevent hostile

In sum, even though going-private transactions may sometimes help to reduce the problem of excessive benefit extraction, they constitute at best a very incomplete solution.

2. Insufficient Private Benefit Extraction

Ironically, the transaction-centered approach not only offers too little protection against the extraction of private benefits, it also offers too much. Or, more precisely, while leading to excessive private benefit extraction in some corporations, the transaction-centered approach allows too little private benefit extraction in others.

a. The Problem

To prevent the minority shareholders from free riding at the expense of the controller, a controller should—subject to the upper limit of desirable benefit extraction[75]—at the very least be able to extract private benefits in an amount that is sufficient to cover the excess of his (shared and private) costs of control over his (shared and independently created private) benefits of control.[76]

However, it has long been known that the shared benefits and costs of control, as well as the independently created benefits of control, vary across corporations.[77] For example, the costs of non-diversification are higher where the controlled corporation's stock is a high-risk rather than a low-risk investment. Similarly, the size of the independently created benefits differs across corporations. For example, the controller of a well-known newspaper or entertainment firm may enjoy tremendous social prestige.[78] The same may not be true for a firm that specializes in waste disposal.

It follows that the extent to which the controller should be able to extract private benefits must vary substantially across corporations. Just as there are bound to be cases where there is no need for *any* extraction of private benefits, there are also bound to be cases where the amount of private benefits extracted by the controller has to be substantial in order for a desirable controller to emerge.

The transaction-centered approach, however, fails to ensure that the beneficial controller can extract the necessary amount of private benefits. This may seem surprising

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takeovers, thereby increasing the agency conflict between managers and shareholders.

75. It needs to be kept in mind that this lower limit of private benefit extraction must not exceed the upper limit that is determined by the net benefits that the controller's presence creates for the corporation.

76. By "his" shared costs of control, I mean the controller's share of the shared costs of control. Similarly, by "his" shared benefits of control, I mean the controller's share of the shared benefits of control.

77. *Cf.* Harold Demsetz & Kenneth Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 J. POL. ECON. 1155, 1156–76 (1985) (explaining and providing empirical evidence for the thesis that the shared costs and benefits of control, as well as the independently created benefits, which the authors refer to as the "amenity potential of control," vary across corporations).

78. *See, e.g.*, Hollinger Inc. v. Hollinger Int'l, Inc., 858 A.2d 342 (Del. Ch. 2004). In this case, the court had to address the question of whether the sale of certain newspapers constituted a sale of substantially all assets and was therefore subject to shareholder approval. *Id.* at 375. In that context, the shareholder plaintiff urged the court to take into account the particular quality of one of the relevant newspapers, the *Telegraph*. *See id.* at 383–84. He quite literally argued that if you own the *Telegraph*, "you can have dinner with the Queen." *Id.* at 384. Of course, this benefit was bound to accrue to the controller of the corporation rather than to the other shareholders. The court recognized this fact quite clearly, noting that "investors in public companies do not invest their money because they derive social status from owning shares in a corporation whose controlling manager can have dinner with the Queen." *Id.* at 384. *Cf.* Coates IV, *Explaining Variation*, *supra* note 40, at 1332 (noting that "[o]wnership of sports teams, entertainment companies, vineyards, and cigar companies all plausibly offer private benefits").

at first glance. After all, as has been explained above, the transaction-centered approach is ill-suited to prevent the extraction of private benefits.[79] The crucial point is that the opportunities for the extraction of private benefits that the transaction-centered approach offers vary according to the circumstances of the individual corporation. That is quite obvious with respect to the indirect forms of self-dealing. After all, there may not always be an opportunity to further outside business interests. The same holds true for direct forms of self-dealing: the controller may not have any opportunity to enter into substantial contracts with the corporation, and even where he does, the existence of a readily ascertainable market price may render it difficult to extract a substantial amount of private benefits.

To the casual observer, it may seem as though the problem at hand can be solved within the confines of the transaction-centered approach. After all, one can reduce the extent of judicial scrutiny to which individual transactions are subjected and thereby increase the amount of private benefits that the controller can extract.[80] Yet this solution would address the problem of insufficient benefit extraction while exacerbating the above described problem of excessive benefit extraction. Those corporations in which the level of benefit extraction is too low would be helped, but the situation of those corporations whose controller already extracts too many benefits would be further exacerbated.

b. Counterpoint: Going-Private Transactions

In the literature, the free rider problem in controlled corporations is occasionally dismissed by pointing out that the minority shareholders can be frozen out at the value that the shares would have without a change in control, the so-called "no-transaction value."[81] However, as in the case of the problem of excessive benefit extraction, going-private transactions represent at best a partial solution.[82]

In part, this is due to the already mentioned problem of transaction costs.[83] More importantly, though, one has to consider once more the fact that maintaining the controlled corporation's status as a publicly traded firm distinct from its controller can have substantial benefits.[84] Unless these benefits are to be sacrificed, the corporation has to be taken public again after having been private. And, as a result, the corporation would yet again run into the problem of insufficient benefit extraction.

At this point, a caveat is in order. With the help of going-private transactions, the problem of insufficient benefit extraction can at least be reduced without permanently sacrificing the status of the controlled corporation as a publicly traded corporation. This is because even if one adheres to the transaction-centered approach, there is no reason to apply the transaction-centered protections to contracts with the controller that are concluded at a time when the controller is the corporation's only shareholder. And

79. *See supra* Part III.C.1. a.

80. In older cases, the Delaware Chancery Court occasionally applied the business judgment rule to transactions between the controller and the controlled corporation. *E.g.*, Puma v. Marriott, 283 A.2d 693, 695 (Del. Ch. 1971).

81. *See, e.g.*, Rock, *supra* note 53, at 536 ("By allowing an acquiring company to eliminate objecting shareholders at a price equal to the pro rata value of the firm, exclusive of merger gains, shareholders are unable to take a free ride on the benefits that a new controlling shareholder might bring."). Of course, as mentioned above, it is not at all clear that the minority shareholders can be frozen out "at a price equal to the pro rata value of the firm, exclusive of merger gains." *Id.*; *see supra* note 68.

82. *See supra* Part III.C.1.b.

83. *See supra* Part III.C.1.b.

84. *See supra* Part III.C.1.b.

indeed, Delaware case law makes it clear that in such a situation, the parties involved do not have to ensure that contracts are fair to the subsidiary because parent corporations do not owe fiduciary duties to their wholly owned subsidiaries,[85] and the directors of the wholly owned "are obligated only to manage the affairs of the subsidiary in the best interests of the parent and its shareholders."[86] Against that background, an investor can proceed as follows. First, he can acquire the controlling block and merge the controlled corporation with a newly formed subsidiary, freezing out the minority shareholders. Then he can enter into a long-term contract with the controlled corporation that is sufficiently generous to him to avoid any free rider problem. Once such a contract is concluded, he can then take the controlled corporation public again.

At least in theory, such a way of proceeding may help to eliminate the free riding problem. However, even setting aside the already mentioned transaction costs, the above described option faces a major shortcoming: The costs and benefits of control cannot be assumed to be constant over time. For example, the compensation that the original contract provides for may prove insufficient as the private costs of control increase over the years. To address this dilemma, one would have to amend the contract in question. However, in light of the fact that the controlled corporation now has minority shareholders, such an amendment would be subject to the transaction-centered protections that existing law imposes.[87] Consequently, unless the transaction-centered protections are abandoned, any amendment to the original contract cannot increase the level of private benefit extraction. In sum, going-private transactions present at best a highly flawed solution to the problem of insufficient benefit extraction.

D. Empirics

The theoretical considerations described above all lead to the same conclusion, namely, that the transaction-centered approach will sometimes set the level of private benefit extraction too low while at other times allowing controllers to reap an excessive amount of private benefits. In the following sections, I will show that this claim is consistent with findings in the empirical literature on controlling shareholders. Existing empirical studies not only fail to refute the analysis offered in this Article, but in fact tend to confirm some of the observations made above. The relevant studies can roughly be divided into two classes: those that seek to estimate the private benefits reaped by the controller, and those that focus on the impact that the presence of a controller has on the value of the firm.

1. Private Benefits

How can the private benefits of control be measured? Economists have developed two ways of doing so, and I shall address them in turn.

a. Block Trades

To begin, one can estimate the private benefits of control by focusing on so-called block trades.[88] These are trades in which the buyer acquires a block of shares from a

85. Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 173 (Del. Ch. 2006).

86. Anadarko Petroleum Corp. v. Panhandle E. Corp., 545 A.2d 1171, 1174 (Del. 1988).

87. Of course, one could carve out an exception for such transactions. However, such a measure would once more move beyond the confines of the transaction-centered approach.

88. Studies of this type include Michael J. Barclay & Clifford G. Holderness, *Private Benefits from*

single seller rather than purchasing individual shares through the market.[89] In such trades, the buyer typically pays a higher price than the price that individual shares command.[90] The difference between both prices is interesting for the following reason. Unlike the typical purchase of individual shares, the acquisition of a block will often give the buyer control of the relevant corporation. Therefore, the premium that is paid for purchasing shares en bloc rather than individually—the so-called control premium—will reflect the private benefits that control conveys.[91] The mean control premium found by studies of this type lies between 9% and 20%, the median control premium between 5% and 16%.[92]

These results have been interpreted as showing that the private benefits of control that controlling shareholders in U.S. corporations can extract are modest.[93] That, in turn, may seem to imply that the rules governing controlling shareholders are efficient because it is also alleged that "countries with low private benefits of control must have functionally good law."[94] In fact, such a cheerful interpretation of the studies at issue is unwarranted. As explained above, theoretical considerations suggest that the existing rules lead to an overly low level of benefit extraction in some corporations, while allowing excessive benefit extraction in others. As shown in the following, the studies at issue fail to refute either possibility.

i. Insufficient Private Benefit Extraction

Consider, first, the claim that the level of private benefit extraction may be too low in some corporations. It is fairly obvious that existing studies on block trades do not allow us to dismiss that possibility. As pointed out above, the level of benefit extraction is too low where it prevents desirable control from emerging.[95] Yet the empirical studies

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Control of Public Corporations, 25 J. FIN. ECON. 371 (1989) (arguing that premiums for block trades "reflect private benefits that accrue exclusively to the blockholder because of his voting power"); Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537 (2004) [hereinafter Dyck & Zingales, *Private Benefits of Control*]; Wayne H. Mikkelson & Hailu Regassa, *Premiums Paid in Block Transactions*, 12 MANAGERIAL & DECISION ECON. 511 (1991).

89. The relevant studies differ slightly in how they define a block. *See, e.g.*, Barclay & Holderness, *supra* note 88, at 372 (analyzing "block trades . . . involving at least 5% of the common stock"); Mikkelson & Regassa, *supra* note 88, at 511 (studying "negotiated trades of blocks of common stock that represent between 1.5% and 44% of a firm's outstanding shares").

90. *See, e.g.*, Barclay & Holderness, *supra* note 88, at 372 (finding that "trades of large-percentage blocks of common stock are typically priced at substantial premiums to the exchange price"); Mikkelson & Regassa, *supra* note 88, at 511.

91. *See, e.g.*, Barclay & Holderness, *supra* note 88, at 374 (noting that "any private benefits will be reflected in the difference between the block-trade price and the post-announcement exchange price").

92. *E.g.*, Barclay & Holderness, *supra* note 88, at 371–95; Mikkelson & Regassa, *supra* note 88, at 511–17. Barclay and Holderness examine 63 block trades between 1978 and 1982 that involve at least 5% of the outstanding stock. *See* Barclay & Holderness, *supra* note 88, at 371. They find a mean control premium of 20.4% and a median premium of 15.7% above the post-announcement price. *See id.* at 378. Mikkelson & Regassa examine 37 negotiated third party purchases of blocks between 1978 and 1987. *See* Mikkelson & Regassa, *supra* note 88, at 511–12. According to their study, the average premium is 9.2% over the share price in exchange trading whereas the median premium is 5.5%. *See id.* at 513 tbl.2. Dyck & Zingales, *Private Benefits of Control*, *supra* note 88, at 551, find that the mean (median) control premium amounts to 1% (2%) of the firm's value.

93. John C. Coffee, Jr., *Transfers of Control and the Quest for Efficiency: Can Delaware Law Encourage Efficient Transactions While Chilling Inefficient Ones?*, 21 DEL. J. CORP. L. 359, 400 (1996) (stating such benefits are a "relatively modest percentage of firm value" (citing Barclay & Holderness, *supra* note 88)).

94. Gilson, *Controlling Shareholders*, *supra* note 9, at 1654.

95. *See supra* Part III.B.2.

at issue only measure control premiums in those cases where a block of shares has in fact been amassed.[96] In other words, these studies focus solely on those cases where a large and perhaps controlling shareholder has emerged *despite* the existing restrictions on the extraction of private benefits. By contrast, the relevant studies tell us nothing about how often desirable control fails to emerge because of the relevant restrictions.

ii. Excessive Private Benefit Extraction

Regarding the problem of excessive benefit extraction, the studies at issue may initially appear to be more pertinent. After all, a 9% control premium may not seem all that high, and accordingly, the problem of excessive benefit extraction may seem to be of limited scope. However, there are two problems with such a line of reasoning.

One of these problems is well known. The control premium may not in fact reflect the full extent of the private benefits that the controller can extract.[97] Thus, some of the blocks on which the relevant studies focus may be insufficient to convey control; accordingly, the premium will be lower than it would be if the acquirer were sure to gain control of the corporation.[98]

Admittedly, one study tries to address that problem by focusing solely on those block trades that increase the acquirer’s stake from less than 20% of the shares to more than 20% of the shares.[99] But, that step hardly seems sufficient to solve the problem. In some cases the acquirer may already have enjoyed de facto control before crossing the 20% threshold, and hence the size premium may have reflected the fact that it only allowed the acquirer to cement his control rather than to gain control in the first place. In other cases, a 20% stake may not suffice to control the corporation, and the premium paid may not reflect the full value of control for that reason.

It has also been rightly pointed out that control may be worth more to the buyer than to the seller.[100] Depending on the parties’ negotiation skills, as well as on the presence of other potential buyers, the premium that the acquirer of control pays may well reflect the lower value that control has for the seller rather than the much higher value that it has for the buyer.[101] In sum, while the premium paid for a controlling block may reflect the minimum value of the private benefits that the control block conveys, it does not really allow us to determine the full extent of these benefits.

More importantly, it is essential to note that the median or mean value of control premiums has little to no relevance in the context at hand. After all, the weakness of the transaction-centered approach lies precisely in the fact that it can lead to excessive benefit extraction in some corporations while not allowing sufficient benefit extraction in others. Accordingly, an acceptable value for the median or mean control premium may

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96. Dyck and Zingales even seek to limit their analysis to those cases in which the block trade conveys control. Dyck & Zingales, *Private Benefits of Control*, *supra* note 88, at 545. For that reason, they only consider transactions that increase the acquirer’s stake from less than 20% of the shares to more than 20% of the shares. *Id.*

97. *See, e.g.*, Barclay & Holderness, *supra* note 88, at 374 (stressing that while “the premium of the block price over the post-announcement exchange price should provide an estimate of the private benefits from block ownership, it is likely to understate the magnitude of such benefits”).

98. *See id.* (noting that “some block sales do not transfer effective voting control directly, but only provide an uncertain opportunity to gain control (perhaps after a proxy contest or the purchase of additional stock)”).

99. This problem is pointed out by Dyck & Zingales, *Private Benefits of Control*, *supra* note 88, at 545.

100. *Cf., e.g.*, Barclay & Holderness, *supra* note 88, at 374 (noting that they “do not attempt to measure any consumer surplus associated with block ownership”).

101. *See, e.g.*, *id.*

disguise the fact that the control premium is excessively high in some corporations and far too low in others. Indeed, the above-cited studies find vast differences across corporations.[102] For example, in one study the control premium ranged from a negative 59.6% to a positive 107.0%.[103] In other words, the shares constituting the controlling stake were considered to be worth more than twice as much as individual shares in some cases, but were traded at a lower price than individual shares in others.

b. Dual Class Shares

Economists have also taken a second approach to estimating the private benefits of control: They have focused on corporations that have issued different classes of stock that only differ in the extent to which they provide voting rights.[104] Once more, the underlying idea is simple. In a contest for control, a contestant may be willing to pay a price for the additional votes,[105] but he will not pay more than control is worth to him.[106] Consequently, the argument runs, the price he is willing to pay will reflect the lower bound of the value of the private benefits of control.[107] Needless to say, the possibility of a control contest is priced into the value of voting shares. Hence, as long as one is willing to make assumptions regarding the probability of a control contest,[108] the value of the premium paid for voting over nonvoting shares can be used to estimate the lower bound of the benefits of control.[109]

The results that these studies have yielded can be summarized as follows: Voting shares tend to catch a premium over nonvoting shares.[110] In general, that premium is modest. Studies have found mean premiums of 5.44%[111] to 10.47%.[112] However, the voting premium fluctuates wildly across corporations[113] and can even be negative.[114]

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102. Mikkelson and Regassa don't disclose the range of percentage values, but find a standard deviation of 19.31%. Mikkelson & Regassa, *supra* note 88, at 513 tbl.2. That is more than twice the average premium that they find. *See id.*

103. *See* Barclay & Holderness, *supra* note 88, at 379. Dyck and Zingales find that the lowest control premium is -20 times the average value (-20% of the firm's equity), whereas the highest control premium is 25 times the mean value (25% of the firm's equity). Dyck & Zingales, *Private Benefits of Control*, *supra* note 88, at 551. They also find that the standard deviation is nine times the mean (9%). *Id.*

104. Studies of this type include Ronald C. Lease et al., *The Market Value of Control in Publicly-Traded Corporations*, 11 J. FIN. ECON. 439 (1983); Tatiana Nenova, *The Value of Corporate Voting Rights and Control: A Cross-Country Analysis*, 68 J. FIN. ECON. 325 (2003); Luigi Zingales, *What Determines the Value of Corporate Votes*, 110 Q. J. ECON. 1047 (1995) [hereinafter Zingales, *Value of Corporate Votes*].

105. *See, e.g.*, Nenova, *supra* note 104, at 326 ("The logic is that a controlling shareholder competing for control is willing to pay to minority vote-owners a positive price for their votes at the time of a control contest, up to her expected value of control.").

106. *Id.*

107. *Id.* (noting that the "vote value can permit the identification of a lower bound of control benefits").

108. *See, e.g.*, *id.* at 334 (pointing out the need to control for the probability of the votes being needed in a control contest).

109. *Id.* at 326.

110. Lease et al., *supra* note 104, at 466; Nenova, *supra* note 104, at 332.

111. Lease et al., *supra* note 104, at 469.

112. Zingales, *Value of Corporate Votes*, *supra* note 104, at 1060. Nenova focuses on the total value of control block votes as a share of a firm's market value and finds that the mean (median) value of control block votes is 2% (0.7%) of firm value. Nenova, *supra* note 104, at 332.

113. *E.g.*, Lease et al., *supra* note 104, at 459–62 (noting that the largest mean premium was 42.05% whereas the smallest was minus 1.75%); Zingales, *Value of Corporate Votes*, *supra* note 104, at 1060 (revealing that the lowest premium was minus 18.94% whereas the highest premium was 221.83% and that the standard deviation was 23.70%).

114. *See, e.g.*, Lease et al., *supra* note 104, at 461; Zingales, *Value of Corporate Votes*, *supra* note 104, at

What is the bearing of these findings on the problem at hand?

i. Insufficient Private Benefit Extraction

Let us start with the claim that the transaction-centered approach may sometimes set the level of benefit extraction too low. Like studies on block trades, studies on voting rights do not allow us to dismiss this possibility. The fact that buyers generally pay a premium for voting over nonvoting shares does not imply that it is *generally* profitable to create a controlling stake. Indeed, if it were, then we could expect all, or at least most, U.S. corporations to have a controlling shareholder. Yet with respect to the largest, and hence most important, publicly traded firms, that is not the case[115]—confirming the view that the private costs of control, such as the resulting lack of diversification, are often substantial.

So why are the markets willing to pay a premium for voting rights across the board? Among other things, it should be noted that even if it is not *presently* profitable to establish a controlling block in a given company, that may change in the future.[116] Accordingly, there is always the possibility that, at some point in the future, an investor will seek to amass voting shares in order to gain control. Share prices will reflect that possibility.

ii. Excessive Private Benefit Extraction

The relevant studies also fail to refute the possibility that the level of benefit extraction is sometimes too high. In that respect, the crucial problems are the same as with the studies on block trades: The control premium is determined by the price that the acquirer is expected to pay for control, and that price may not reflect the full value that control may have for the acquirer. Moreover, while the mean premiums may appear modest, the size of the premiums varies tremendously across corporations.[117] That finding is entirely consistent with the claim put forth in this Article: namely, that the transaction-centered approach allows too much benefit extraction in some corporations and too little in others.

2. The Controller's Impact on the Value of the Firm

Another strand of the empirical literature on controlling shareholders seeks to measure the impact that the presence of the controller has on the value of the firm and hence on the value of the shares held by the minority shareholders.[118] However, even

1060.

115. Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471, 492 tbl.2 (1999) (showing that only 20% of the 20 largest large publicly traded U.S. corporations have a shareholder holding 10% or more of their stock).

116. For example, a once well-managed corporation may come under bad management, thereby making it attractive for outside investors to acquire a controlling stake and replace the existing managers.

117. *See* Lease et al., *supra* note 104, at 459–62; Zingales, *Value of Corporate Votes*, *supra* note 104, at 1060.

118. Studies of this type include W.K. Adrian Cheung & K.C. John Wei, *Insider Ownership and Corporate Performance: Evidence from the Adjustment Cost Approach*, 12 J. CORP. FIN 906 (2006); Myeong-Hyeon Cho, *Ownership Structure, Investment, and the Corporate Value: An Empirical Analysis*, 47 J. FIN. ECON. 103 (1998); Harold Demsetz & Belén Villalonga, *Ownership Structure and Corporate Performance*, 7 J. CORP. FIN. 209 (2001) [hereinafter Demsetz & Villalonga, *Ownership Structure*]; Stacey R. Kole, *Measuring Managerial Equity Ownership: A Comparison of Sources of Ownership Data*, 1 J. CORP. FIN. 413 (1995); Randall Morck et

setting aside certain methodological limitations,[119] these studies are of limited use with respect to the problem discussed in this Article. This is because their results are inconclusive. The vast majority of studies find no statistically significant evidence that the presence of a controller increases or decreases firm value.[120] In those few studies where such an impact is found, that impact is quite small.[121]

One possible explanation for these findings is that the degree of ownership concentration has no substantial impact on firm value. But as has been rightly pointed out in the literature,[122] the relevant findings are equally consistent with the assumption that the costs and benefits of concentrated ownership vary across corporations.[123] And that, of course, is entirely consistent with the view I suggest in this Article—that the law sets the level of benefit extraction too low in some corporations and too high in others.[124]

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al., *Management Ownership and Market Valuation: An Empirical Analysis*, 20 J. FIN. ECON. 293 (1988); Steen Thomsen et al., *Blockholder Ownership: Effects on Firm Value in Market and Control Based Governance Systems*, 12 J. CORP. FIN. 246 (2006).

119. One problem that has proven particularly challenging concerns the direction of causality: Even assuming that the presence of a controlling shareholder typically goes hand in hand with a higher or lower firm value, it is difficult to tell whether the presence of the controller is responsible for the increase (or decrease) in firm value or whether the higher (or lower) firm value has prompted the presence of a controller. Holderness, *Survey of Blockholders*, *supra* note 41, at 58.

120. Most studies find no evidence at all that the extent of ownership concentration has a statistically significant impact on firm value. *See, e.g.*, Cheung & Wei, *supra* note 118, at 908 (finding no evidence that corporate ownership and corporate performance affect each other); Cho, *supra* note 118, at 118, 120 (finding that firm value affects ownership structure but not vice versa); Demsetz & Villalonga, *Ownership Structure*, *supra* note 118, at 209, 226 (finding no statistically significant relationship between ownership structure and performance); Thomsen et al., *supra* note 118, at 266 (finding no effect of blockholdings on firm value in Anglo-American market based economies). Some studies conclude that the extent of ownership concentration has an impact on firm value. But the relevant findings typically concern levels of ownership that may be insufficient to convey control. Thus, Kole finds a statistically significant and positive relationship for managerial ownership between 5% and 25%. Kole, *supra* note 118, at 427. The negative relationship that she finds for ownership stakes in excess of 25% is statistically insignificant. *Id.* Morck et al. find a positive relationship between managerial equity ownership in excess of 25% and firm value, but that relationship is statistically insignificant at the 5% level. Morck et al., *supra* note 118, at 300.

121. As pointed out above, Kole finds a statistically significant and positive relationship for managerial ownership between 5% and 25%. Kole, *supra* note 118, at 427. But she also finds that the variation in Tobin's Q, which can be explained by reference to the ownership variables she uses, ranges from 0.15% to 1.72% in one subsample and from 0.87% to 2.18% in another subsample. *See id.* Similarly, J.J. McConnell and H. Servaes fail to find a significant correlation between ownership concentration and firm value. John J. McConnell & Henri Servaes, *Additional Evidence on Equity Ownership and Corporate Value*, 27 J. FIN. ECON. 595, 595-96 (1990) (finding "no significant correlation between Q and the presence of a block stockholder or the fraction of equity owned by blockholders").

122. *See, e.g.*, Holderness, *Survey of Blockholders*, *supra* note 41, at 59; *see also* Demsetz & Villalonga, *Ownership Structure*, *supra* note 118, at 231 (pointing out that if ownership structures "were the outcomes of perfect markets for control, they would eliminate any systematic relation between firm performance and ownership structure").

123. *Cf.* Harold Demsetz & Kenneth Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 J. POL. ECON. 1155, 1176 (1985) [hereinafter Demsetz & Lehn, *Structure of Corporate Ownership*] (arguing that "the structure of corporate ownership varies systematically in ways that are consistent with value maximization").

124. Demsetz and Lehn argue that "corporate ownership varies systematically in ways that are consistent with value maximization." *Id.* But the logic underlying their approach does not imply that existing ownership concentrations maximize firm value. Indeed, Demsetz and Lehn explicitly concede that the private benefits enjoyed by the controller also matter. *See id.* at 1176; *accord* Demsetz & Villalonga, *Ownership Structure*, *supra* note 118, at 223. Admittedly, Demsetz and his co-authors only seem to have in mind independently created private benefits. *Cf.* Demsetz & Lehn, *Structure of Corporate Ownership*, *supra* note 123, at 1161 (defining the firm's "amenity potential" by reference to "the utility consequences of being able to influence the

3. Summary

In sum, the transaction-centered approach can set the level of private benefit extraction too low, thereby preventing the emergence of desirable control. It can also lead to an undesirably high level of private benefit extraction, thereby causing a controller to emerge despite the fact that the (shared and private) costs of control outweigh the (shared and private) benefits. Nothing in the empirical literature on controllers suggests that these concerns can be dismissed.

IV. PRODUCING THE WRONG CONTROLLERS

The previously described shortcomings are not the only drawbacks of the transaction-centered approach. A further weakness of that approach concerns the identity of the controller.

I assume that the law should try to maximize the net benefits of control, defined as the excess of the (shared and private) benefits of control over the (shared and private) costs of control.[125] Based on that assumption, a controlled corporation should ideally be controlled by the person or entity whose presence creates the greatest net benefits of control. However, the transaction-centered approach may fail to produce that result for two reasons.

First, the amount of private benefits that can be extracted under the transaction-centered approach varies across controllers, so that the corporation may end up being controlled by the person or entity that is best positioned to extract private benefits rather than by the controller whose presence creates the greatest net benefits. Second, the transaction-centered approach imposes a disproportionate burden on those potential controllers who maintain an ongoing business relationship with the corporation. As a result, such firms are unlikely to become controllers even in situations where they might create greater net benefits than any other potential controller.

A. Favoring Controllers Adept at Extracting Private Benefits

As long as control can be traded, a controlled corporation will tend to be controlled by the person for whom such control is most valuable because that person will be willing to pay a greater premium to acquire control than anyone else. Therefore, in order to ensure that control ends up in the hands of the person who creates the greatest net benefits of control, the law needs to make certain that the controller whose presence maximizes the net benefits of control is also the controller for whom control is most profitable.

Under the transaction-centered approach, however, that is not necessarily the case. The restrictions that that approach imposes on controllers are much easier to circumvent for some controllers than for others.[126] Where the controller has no other significant entrepreneurial engagements apart from his controlling stake in the corporation and is not employed by the controlled corporation either, he is unlikely to be able to extract sizable

type of goods produced by the firm"). But there is little reason to believe that extracted private benefits are less important than independently created private benefits in determining the level of ownership concentration.

125. It is noteworthy that this definition includes only those costs and benefits of control that accrue to the minority shareholders and the controller.

126. *Cf.* Bebchuk, *Efficient and Inefficient Sales*, *supra* note 68, at 963 (noting that "controllers may differ in their ability to capture private benefits of control").

private benefits.[127] For example, imagine a wealthy individual whose wealth is entirely invested in the controlled corporation but who, for some reason or another, does not wish to manage the controlled corporation. Such a person cannot hope to abuse his control of the corporation to further other business interests, simply because he does not have any other business interests. And the absence of contractual relationships with the corporation precludes any benefit extraction via direct self-dealing. Other controllers, by contrast, may be extremely well positioned to extract private benefits. For example, as pointed out above,[128] some controllers may be able to ward off competition for their own business by using their control to prevent the corporation from entering the relevant market.

Because the ability to extract private benefits varies across controllers, the controller for whom control is most profitable may be the one who is best at extracting private benefits rather than the one whose presence creates the greatest net benefits. Accordingly, control may end up in the hands of the wrong controller.

B. Deterring the Corporation's Business Partners

There is yet another way in which the transaction-centered approach can favor less desirable controllers over more desirable ones. Firms who happen to maintain an ongoing business relationship with the controlled corporation are systematically deterred from becoming controllers even though they can sometimes be highly suitable for that role.

1. The Value of Business Partners as Controllers

That the corporation's business partners—or the controlling shareholders behind them—can make particularly desirable shareholders has long been known.[129] The reasons are basically twofold. To begin with, the corporation's business partners will often be particularly well positioned to monitor the corporation's managements. After all, an ongoing business relationship means that the business partner will learn early on of financial difficulties, quality problems, or similar troubles that have befallen the corporation.[130] Moreover, the business partner will have an increased incentive to intervene because a crisis in the controlled corporation would affect him both as a shareholder and as a business partner.[131]

Yet there is another potential advantage to having a business partner as a controller: Ownership relations between two firms can help to lower transaction costs between these firms by reducing informational asymmetries as well as the risk of opportunism in long-term contractual relationships.[132] For example, assume that firm *A* would like firm *B* to produce a product for which there is no other customer than firm *A*. Firm *B* may fear that

127. *See* RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 1233 (2d ed. 1995) (stating "a unidimensional controlling shareholder has few channels by which to appropriate private benefits").

128. *See supra* Part III.C.1. a.

129. *Cf., e.g.*, ROE, STRONG MANAGERS, *supra* note 8, at 248–53 (detailing how equity investments can reduce transaction costs between firms).

130. Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 YALE L.J. 871, 888 (1993) [hereinafter Gilson & Roe, *Understanding the Japanese Keiretsu*].

131. *Id.*

132. *See, e.g.*, ROE, STRONG MANAGERS, *supra* note 8, at 248–53 (detailing how equity investments can reduce transaction costs between firms); Gilson & Roe, *Understanding the Japanese Keiretsu*, *supra* note 130, at 885–88 (describing how cross-ownership of equity can help to reduce opportunism in contractual relationships).

once it has made the relevant investments, firm *A* will squeeze the price knowing that *B* has no other customers to which to sell.[133] A contractual solution to this problem may be difficult because contracts are necessarily incomplete and cannot possibly anticipate all the eventualities that may arise.[134] In this situation, *B*'s acquisition of a large equity stake in *A* can provide some protection against ex post opportunism.[135]

Admittedly, another way to solving such contracting problems is to simply have *B* acquire all of *A*'s shares or even merge with *A*. However, as pointed out above, there are sometimes significant advantages to maintaining a controlled corporation's status as a publicly traded corporation that is a separate legal entity from its controller.[136] For example, a merger between corporations *A* and *B* would eliminate all contracting problems, but it might also create a bigger firm that is harder to manage well. Of course, none of this is to say that a firm's business partners *always* make good controllers. Rather, the point is simply that they can *sometimes* be highly suited for that role.

2. The Self-Dealing Rules as an Obstacle

The transaction-centered approach, if it is enforced strictly, makes it difficult for the firm's business partners to become controllers. As mentioned above, Delaware law requires the controller to bargain at arm's length with the controlled firm. Moreover, in order to escape the burden of proof for the fairness of the transaction, the controller has to ensure that the contract is approved either by a committee of independent directors[137] or by the minority shareholders.[138] In both cases, full disclosure is required.[139]

These requirements are not too difficult to meet when the controller and the controlled firm only enter into a select few transactions. However, an ongoing business relationship means that the controlled corporation and its controller will constantly strike deals of some type or another, and it would be unrealistic to expect the independent directors or the shareholders to get involved every time. In practice, therefore, the firms involved can be expected to proceed without having every single deal approved by the independent directors or the minority shareholders. But that does not solve the problem either. This is because now the controller has to demonstrate the entire fairness of the deal, and in the absence of arm's-length bargaining, entire fairness can be difficult to show, especially where a readily ascertainable market price is lacking.[140] Thus, a strictly enforced transaction-centered approach is bound to place a considerable burden on those controlling shareholders who double as the controlled corporation's customers or suppliers.

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133. ROE, STRONG MANAGERS, *supra* note 8, at 248.

134. *Id.* at 249.

135. *Cf. id.* (noting that equity ownership can encourage relation-specific investments and reduce opportunism).

136. *See supra* Part III.C.1.b.

137. Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997).

138. Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985).

139. *See* Kahn v. Lynch Commc'n Sys., 669 A.2d 79, 88 (Del. 1995) (holding that "[a] controlling shareholder owes a duty of complete candor when standing on both sides of a transaction and must disclose fully all the material facts and circumstances surrounding the transaction"); *see also Rosenblatt*, 493 A.2d at 937 (holding that the vote by the minority shareholders must be an informed one and that the controlling shareholder has to prove complete disclosure of all material facts).

140. Under Delaware law, the entire fairness test has two aspects, namely fair dealing and fair price. Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983). This test is "not a bifurcated one as between fair dealing and price." *Id.* Rather, "[a]ll aspects of the issue must be examined as a whole." *Id.*

The empirical evidence on the nature of controlling shareholders is consistent with this line of reasoning. The largest shareholder in publicly traded U.S. firms is typically a family or a financial institution, such as a pension fund or hedge fund, but only rarely a nonfinancial corporation.[141] While this unwillingness of nonfinancial corporations to take up the role of controlling shareholder in other publicly traded corporations may not be due exclusively to the costs imposed by the transaction-centered approach,[142] it is certainly consistent with the assumption that these costs play a significant role in determining the identity of controlling shareholders.

Of course, one could remedy the problem at hand by choosing a more generous version of the transaction-centered approach. For example, one could shift the burden of proof regarding the fairness of a transaction to the plaintiff attacking the transaction regardless of whether the transaction was ratified by the minority shareholders or by the independent directors. But such a step would come at a steep price in that it would exacerbate the already present risk of excessive benefit extraction. In other words, one problem would be avoided at the cost of making another one more severe.

C. Counterpoint: Countervailing Incentives

At this point, a caveat seems in order: To some extent, the distortions caused by the transaction-centered approach regarding the selection of controllers may cancel each other out. That can be explained as follows. The transaction-centered approach has a tendency to favor the emergence of controllers who are adept at extracting private benefits.[143] One way of extracting private benefits is to enter into contractual agreements with the corporation that favor the controller.[144] For that reason, the transaction-centered approach gives an edge to controllers who maintain business relationships with the controlled corporation.

Simultaneously, the transaction-centered approach also imposes higher costs on such firms. In that respect, the transaction-centered approach makes it less likely that the corporation's business partners will aspire to be its controllers. In sum, there is reason to believe that the two ways in which the transaction-centered approach distorts the selection of controllers will neutralize each other at least to some degree.

Nevertheless, that conclusion offers little reason for optimism. The outcome is unlikely to be an efficient one. Thus, it is important to note that not all controllers who are well positioned to extract private benefits are among those burdened by the transaction-centered approach. That is particularly true in those cases where the controller is well positioned to extract indirect benefits. For example, a controller who abuses his

141. According to Clifford G. Holderness, only 10% of the largest shareholders of publicly traded U.S. corporations are nonfinancial corporations, whereas 53% are families and 29% are financial firms. Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, REV. FIN. STUD. (forthcoming 2008) (manuscript at 20 tbl. 5) [hereinafter Holderness, *Myth of Diffuse Ownership*], *available at* http://rfs.oxfordjournals.org/ (search "Search This Journal" for "The Myth of Diffuse Ownership").

142. Another possible cause for the dearth of nonfinancial corporations among the largest shareholders lies in the field of taxation. At least in principle, corporate profits are taxed both at the level of the corporation and—once they are distributed as dividends—at the shareholder level. Thus, a parent–subsidiary structure adds another level of taxation. However, the importance of that problem is greatly reduced by the so-called dividends received deduction: A corporation can deduct from its taxable income 70% of the dividends it receives from a subsidiary, and that deduction increases to 80% if the parent corporation owns 20% or more of the stock of the subsidiary. I.R.C. § 243 (2000).

143. *See supra* Part IV.A.

144. *See supra* Part III.C.1.b.

influence to prevent the controlled corporation from competing with one of the controller's other subsidiaries does not transact at all with the controlled corporation and therefore does not bear the costs of the transaction-centered approach.

Similarly, there is no reason to believe that all of those controllers who maintain ongoing business relationships with the controlled corporation, and therefore bear the costs of the transaction-centered approach, are likely to abuse their position to extract private benefits. Rather, the circumstances of the case—such as the existence of readily ascertainable market prices—may make it difficult to extract substantial private benefits despite the existence of an ongoing business relationship. Moreover, not all controllers can be expected to be willing to break the law by extracting private benefits. That is particularly true in light of the fact that the person acting for the controller will typically be an agent. Depending on the circumstances, that agent may stand to reap only a small portion of the private benefits that he can extract by abusing the control that he exercises on behalf of his principal. At the same time, the agent may suffer disproportionately if his wrongdoing is detected.

Finally, even to the extent that those who are burdened with the costs of the transaction-centered approach are the same potential controllers that are particularly likely to extract private benefits, there is little reason to believe that the two distortions at issue will more or less neutralize each other. In order for that to happen, the additional transaction costs that the transaction-centered approach imposes as a result of the controller's business relationship with the corporation would have to be roughly equal to the additional amount of private benefits that can be extracted as a result of the business relationship with the controlled corporation.

Yet that is not necessarily the case. Rather, the actual result may combine the worst of two worlds. In those cases where the benefits that can be extracted via the contractual relationship are particularly excessive, the transaction costs that the transaction-centered approach imposes are unlikely to deter the business partner from becoming a controller because these costs will seem small by comparison. By contrast, where the controller, due to the circumstances of the case, expects to extract only very limited private benefits through the contractual relationship, he may perceive the transaction costs at issue to be prohibitively high.

D. Summary

In sum, the transaction-centered approach distorts the selection of controllers. It favors the emergence of controllers who are well positioned to extract private benefits, and it discourages the emergence of controllers who happen to maintain an ongoing business relationship with the controlled corporation. While these effects have the potential to cancel each other out to some extent, the result is likely to be far from perfect.

V. UNDESIRABLE CONTROL WITHOUT BENEFIT EXTRACTION

The transaction-centered approach has yet another weakness. It fails to deter those undesirable controllers whose presence is motivated by independently created private benefits rather than by extracted private benefits.

A. The Problem

The underlying problem is simple. In cases where control is undesirable because its

(shared and private) costs exceed its (shared and private) benefits, the controller bears only part of the shared costs of control, whereas he can reap all of the independently created private benefits of control. These independently created benefits may outweigh the sum of the controller's private costs of control and his share of the shared costs of control. If that is the case, then the controller will find it profitable to acquire or maintain control despite the fact that the total (shared and private) costs of control outweigh its total (shared and private) benefits and despite the fact that the controller may not be able to extract any private benefits.[145]

In that constellation, the transaction-centered approach offers no protection because it can at most prevent the controller from *extracting* private benefits, but it can never stop the controller from enjoying independently created benefits. In other words, the transaction-centered approach fails where undesirable control is motivated by independently created benefits rather than by extracted private benefits.

As a general matter, perhaps this problem should not be overestimated. In many cases, the independently created private benefits will be far too small to outweigh the sum of the controller's private costs and his share of the net shared costs of control. For example, while many controllers will enjoy the social prestige that comes with controlling a major newspaper, far fewer controllers will be willing to maintain that control if the price of doing so lies in a continuous decline of the value of their investment.

Moreover, the independently created benefits of control will often be available to any potential controller. For example, any controller can bask in the social prestige that comes with owning a leading newspaper.[146] That, in turn, means that undesirable controllers whose control is motivated by private benefits will tend to be replaced by more desirable ones. After all, an undesirable controller who likes to enjoy the independently created benefits of control will tend to value control less highly than a desirable controller, who can enjoy the relevant independently created benefits, but is also able to use his control in a more competent manner and is therefore spared the burden associated with falling share prices. In other words, to the extent that control can be traded from one controller to another, the risk that independently created private benefits will lead corporations to be controlled by undesirable controllers is at least reduced.

B. Family-Controlled Firms

Yet there likely is one exception to the picture painted above, namely, family-controlled firms. Compared to the frequency of other types of control, publicly traded corporations are relatively often controlled by families.[147] In family-controlled firms, however, there is a certain risk that independently created private benefits can cause

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145. *Cf.* Gilson, *Controlling Shareholders*, *supra* note 9, at 1666 (noting that non-pecuniary benefits of control can potentially lead to inefficient ownership structures).

146. That is not to say, of course, that all individuals will assign exactly the same value to a given independently created benefit of control. For example, some individuals may value the social prestige that comes with control more highly than others.

147. Belén Villalonga & Raphael Amit, *How Do Family Ownership, Control and Management Affect Firm Value?*, 80 J. FIN. ECON. 385, 390 (2006) (defining the family firm as a firm in which the founder, or a member of the founder's family, is an officer, a director, or the owner of at least 5% of the firm's equity, individually or as a group). Based on this definition, Villalonga and Amit find that 37% of all Fortune 500 firms are family firms. *See id.* at 394; *see also* Holderness, *Myth of Diffuse Ownership*, *supra* note 141 (manuscript at 20 tbl.5) (noting that 53% of the largest shareholders of publicly traded U.S. corporations are families).

undesirable controllers to maintain control.

Before turning to the reasons justifying this assessment, a clarification seems in order: Family control does not necessarily have to be a bad thing. Quite on the contrary, one relatively recent study finds that family-controlled firms tend to perform better than other publicly traded firms.[148] But, of course, that is not true for all family-controlled firms.[149] Moreover, the benign effects of family control tend to be limited to those cases where the firm is run by the founder.[150] Where family firms are run by a CEO who is a descendant of the original founder, by contrast, family control tends to reduce firm value.[151]

The fact that certain forms of family control tend to reduce firm value does not per se imply that such control is motivated by independently created benefits of control. However, two other factors suggest that independently created benefits may play an important role in allowing undesirable forms of family control to persist. As pointed out above,[152] the relative insignificance of independently created benefits as a cause of undesirable control is due to two factors: (1) the fact that independently created benefits will often be relatively limited and (2) the fact that these benefits can be reaped by desirable and undesirable controllers alike. Yet when it comes to family firms, neither factor can be taken for granted.

Thus, unlike in most other firms, the independently created private benefits in family-controlled firms may often be substantial enough to outweigh the costs of control borne by the controller.[153] In part, that is due to the distribution of voting rights within family-controlled firms. Controlling families tend to hold voting rights that exceed their share of the equity considerably.[154] Consequently, the controlling family bears a relatively low percentage of the shared costs of control, which in turn makes it easier for the independently created benefits to outweigh the costs of control borne by the controller.

Moreover, it is hard to explain the empirical findings on family firms other than by reference to the significance of independently created private benefits. After all, we know

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148. Ronald C. Anderson & David M. Reeb, *Founding-Family Ownership and Firm Performance: Evidence from the S&P 500*, 58 J. FIN. 1301, 1303 (2003).

149. Anderson and Reeb find the correlation between family ownership and Tobin's q to be weak (0.163). *Id.* at 1313.

150. *Id.* at 1303. All in all, studies on family ownership show mixed results. Morck et al., *supra* note 118, at 293, find that management by a founder-CEO tends to increase firm value. Villalonga and Amit find that family control adds value where the founder serves as CEO or chairman, whereas it reduces firm value when a descendant serves as chairman or CEO. Villalonga & Amit, *supra* note 147, at 414.

151. Villalonga & Amit, *supra* note 147, at 414. Other studies tend to confirm this finding. *See, e.g.*, Brian F. Smith & Ben Amoako-Adu, *Management Succession and Financial Performance of Family Controlled Firms*, 5 J. CORP. FIN. 341, 342 (1999) (examining management successions in Canadian family firms listed on the Toronto Stock Exchange and finding that the market reacts negatively to the appointment of family members as successors); Francisco F. Pérez-González, Inherited Control and Firm Performance 2 (July 2002) (unpublished manuscript) (finding that family successions harm performance in that return on assets decreases by 18% and Tobin's Q by 12% within three years of the transition relative to firms that promote unrelated CEOs), *available at* http://papers.ssrn.com/abstract=320888.

152. *See supra* Part V.A.

153. Assuming that the shared costs of control outweigh the shared benefits of control, the costs of control borne by the controller include his private costs of control and his share of the net shared costs of control.

154. Villalonga & Amit, *supra* note 147, at 396 (finding that the percentage of votes controlled by the controlling family in family-controlled Fortune 500 firms was on average 17 points larger than the percentage of outstanding shares owned by the family).

that family control often continues after the original founder leaves the firm,[155] and that descendants of the founder frequently function as CEOs in those firms.[156] Yet we also know that family control tends to reduce firm value if the CEO is a descendant of the original founder rather than the founder himself.[157] The most plausible explanation for these observations is that independently created benefits are often sufficient to motivate family control in cases where the firm would be better off without such control.[158]

Further, when it comes to family-controlled firms, there is no reason to believe that the relevant independently created benefits are available to all potential controllers alike. Of course, an outsider who acquires control from the controlling family will often be able to reap some independently created benefits of control, but he will not be able to enjoy the psychic benefits that come with upholding a family legacy. Rather, these benefits are idiosyncratic to the founder's family. Accordingly, one cannot necessarily expect control that is motivated by these benefits to be acquired by an outsider, even if that outsider is a more competent controller.

C. Going-Private Transactions

Even where family-controlled firms are concerned, going-private transactions should reduce the problem at hand. If the benefits to the controller are outweighed by the costs that his presence imposes on the corporation, then a savvy investor should find it in her interest to acquire the controlling stake from the undesirable controller, freeze out the minority shareholders, and take the corporation public again.

In this case, the threat that the undesirable controller will reemerge after the corporation has been taken public again can be controlled. After all, the problem at hand arises precisely in those cases in which the private benefits of control are idiosyncratic to the incumbent controller. Consequently, the investor who acquires the controlling stake can negotiate for a promise of the incumbent controller not to reacquire any shares of the corporation in the future.

However, even assuming that the minority shareholders can be frozen out at the no-transaction value,[159] the transaction costs incurred in going-private transactions limit their effectiveness as a means for solving the problem at hand. This problem should not be dismissed too easily. As mentioned above, family firms often have a CEO who is a descendant of the founder,[160] despite the fact that such an arrangement appears to reduce

155. Villalonga & Amit focus on those firms that were included in the Fortune 500 between 1994 and 2000. *Id.* at 388. Among the family-controlled firms that they find, only 32% are in their first generation, whereas 32% are in their second generation, 21% are in their third generation, and 14% are in their fourth or even in a later generation. *Id.* at 394.

156. *Cf. id.* at 404 tbl.6 (showing that out of a sample of 826 Fortune 500 family firms in which the founder did not serve as CEO, no less than 316 (38%) had a CEO who was a descendant of the founder).

157. *See* Villalonga & Amit, *supra* note 147, at 413 (finding that family firms run by a CEO who is a descendant of the founder tend to have a lower firm value than nonfamily firms); *see also* Smith & Amoako-Adu, *supra* note 151, at 342 (standing for the proposition that family descendants tend to reduce the value of the firm); Pérez-González, *supra* note 151, at 2 (same).

158. Admittedly, the fact that family control reduces firm value does not necessarily imply that such control is undesirable. After all, the private benefits of control may theoretically be greater than the costs that such control imposes on the controlled corporation. However, while that may sometimes be the case, there is no reason to believe that it always is.

159. Unless the minority shareholders can be frozen out at the no-transaction value, some desirable freezeout transactions will be deterred. *See supra* note 68. However, under Delaware law, the acquirer cannot be sure that he will be able to freeze out the minority shareholders at the no-transaction value. *Id.*

160. *See supra* note 156, and accompanying text.

firm value.[161] That phenomenon is hard to square with the assumption that going-private transactions can be counted on to quickly eliminate any controlling families whose presence harms the corporation.

Moreover, as pointed out above, going-private transactions have no deterrent effect.[162] At best, they may remove undesirable controllers. However, the prospect of a future going-private transaction will not persuade an undesirable controller to divest himself of control on his own accord.

VI. COURT-BASED ALTERNATIVES

The various drawbacks of the transaction-centered approach are directly related to the fact that that approach focuses on the fairness of individual transactions rather than looking to the overall costs and benefits of control. Below, I will argue that these weaknesses can be eliminated by giving minority shareholders the right to expel the controller while at the same time allowing corporations to opt out of the transaction-centered protections that existing law imposes.[163]

However, the approach I suggest is not the only possible alternative to the transaction-centered approach. Rather, one could also imagine a solution under which the courts rather than the other shareholders decide whether or not the controller's presence adds value to the corporation. Such a rule would constitute a much less radical departure from the transaction-centered approach than the one I suggest in this Article in that it would still be the courts rather than the minority shareholders that police the controller's conduct. The main difference to the transaction-centered approach would concern the focus of judicial monitoring: The courts' attention would shift from the individual transaction to the overall impact of the controller.

A. How Would a Court-Based Alternative Function?

There are several ways in which the existing law could be modified in order to allow for a court-based evaluation of the costs and benefits of control.

1. Insufficient Benefit Extraction

To address the problem of insufficient benefit extraction, one could take into account the overall benefits of the controlling shareholder's presence in evaluating the fairness of a transaction. For example, one could allow cooperation agreements between the controller and the controlled corporation that reward the controller for the benefits that his presence bestows on the corporation. At present, Delaware law would seem to preclude such an approach: There does not appear to be a single case in which the court invoked the benefits of control to classify an otherwise unfair contract between the corporation and the controlling shareholder as fair.[164] However, it is not inconceivable

161. *See supra* note 157, and accompanying text.

162. *See supra* Part III.C.2. b (noting that going-private transactions sometimes eliminate existing undesirable controllers, but do nothing to prevent their initial emergence).

163. *See infra* Part VIII (describing a process called "ostracism" which would allow minority shareholders to remove harmful controllers).

164. At most, one might point out that older cases have occasionally applied the business judgment rule to transactions between the controller and the controlled corporation. *E.g.*, Puma v. Marriott, 283 A.2d 693, 695 (Del. Ch. 1971). However, the aforementioned cases contain no indication that the application of the business judgment rule was based on the finding that the level of benefit extraction was too low. Moreover, it is

that Delaware law—vague as it is[165]—might be reinterpreted to allow transactions of this type.

2. Excessive Benefit Extraction

Different options exist for the problem of excessive benefit extraction. One would be to grant minority shareholders the right to have controlling shareholders expelled if the court decides that the controller's presence imposes a burden on the corporation. Another one would be to give minority shareholders an ever-present right to part with their shares at the price that these shares would have without the presence of the controller.[166]

B. The Drawback of Court-Based Alternatives

Needless to say, all of the afore-described court-based alternatives to the transaction-centered approach share a common drawback: They force courts to undertake an evaluation for which they are ill equipped.

Delaware's case law on corporate mergers illustrates this point. In the context of mergers, it often becomes necessary for the court to determine the fair value of the corporation's shares, either because the merger agreement is challenged or because shareholders exercise their appraisal right. Such valuations are notoriously difficult.[167] For example, in *Cede v. Technicolor Inc*., the valuations by the expert witnesses ranged from $13.14 a share to $62.75 a share,[168] and it has rightly been pointed out that this divergence was by no means exceptional.[169] Of course, the aforementioned case law concerns the value of a corporation's shares rather than the controller's impact on the value of the corporation, but it is hard to see how the latter should be easier to ascertain than the former.

Admittedly, valuation problems of this type cannot be entirely avoided even under existing law. In the context of a merger, appraisal proceedings require the court to

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difficult to argue that cases of this type still represent good law. In recent decades, Delaware courts have been consistent in holding that transactions between a controlling shareholder and a less than wholly owned subsidiary are subject to judicial review for entire fairness. *E.g.*, Weinberger v. UOP, 457 A.2d 701, 710 (Del. 1983) (merger); Kahn v. Lynch Commc'n Sys., 638 A.2d 1110, 1115 (Del. 1994) (merger); Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985) (merger); *In re* LNR Prop. Corp. S'holders Litig., 896 A.2d 169, 176 (Del. Ch. 2005) (merger). Moreover, while most of the relevant cases concerned mergers, the same principle has been applied outside the merger context. *See* Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997) (stock purchase).

165. *E.g.*, Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1909 (1998) (referring to "the well-documented indeterminacy of Delaware corporate law"); Kahan & Kamar, *supra* note 15, at 1233 n.120 ("Commentators are in wide agreement that Delaware corporate law lacks clarity.").

166. For example, one could give minority shareholders the right to sell their shares to the controller. Alternatively, one could give the minority shareholders an ever-present appraisal right in which case it would be the corporation—rather than the controller—that would compensate the shareholders for the loss of their shares. Existing Delaware law grants appraisal rights only in case of a merger or consolidation. DEL. CODE ANN. tit. 8, § 262(b) (2007).

167. *See, e.g.*, Heglar, *supra* note 45, at 280 (referring to the "already difficult valuation process"); *see also* E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992–2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1490 (2005) (pointing out that "valuation decisions are impossible to make with anything approaching complete confidence").

168. Cede & Co. v. Technicolor, Inc., No. 7129, 1990 Del. Ch. LEXIS 259, at *4–5 (Del. Ch. Oct. 19, 1990).

169. WILLIAM T. ALLEN ET AL, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 489 (2d ed. 2007).

determine the fair value of shares.[170] Moreover, Delaware's rules on self-dealing require courts to assess the fairness of individual transactions.[171] Accordingly, in a merger agreement where the corporation's shares are the object of the transaction, courts are forced to assess the value of these shares.[172] Yet mergers and other fundamental transactions, while they attract many of the headlines and hold much of the attention of corporate law scholars, are exceptional events in the life of a corporation. Many other sizable contracts concluded by corporations, such as contracts with suppliers over parts or licensing agreements, are much easier to evaluate.

In other words, it may be true that the valuation problems caused by court-based alternatives to the transaction-centered approach are not entirely new. However, if the courts had to evaluate the impact of the controller every time a transaction between the corporation and the controller is challenged, the valuation problems that now arise only in a limited set of circumstances would become much more pervasive. It is hard to argue, therefore, that court-based alternatives to the transaction-centered approach would be practicable, let alone efficient.

VII. THE EQUAL OPPORTUNITY RULE AND RELATED APPROACHES

Valuation problems of the type described above are avoided if—as I suggest in this Article—minority shareholders are protected via a right to expel the controller. However, there are two other plausible ways of protecting minority shareholders that also avoid the valuation problems inherent in court-based solutions.

A. The Equal Opportunity Rule

One of them is the so-called equal opportunity rule.[173] This rule concerns the acquisition of a controlling stake, and it comes in two flavors.[174] In one version, the acquirer of a controlling stake is required to purchase shares pro rata from all those shareholders willing to sell their shares.[175] The other version goes even further in that an investor who acquires a controlling stake has to offer to buy all the remaining shares at the same price paid to the seller of control.[176] While Delaware law has not adopted either version of the equal opportunity rule, federal law imposes the pro rata version in those cases where a controlling stake is acquired via a tender offer.[177]

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170. DEL. CODE ANN. tit. 8, § 262(h) (2007).

171. Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997).

172. *See, e.g.*, Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985) (noting the necessity to examine the fairness of the price to be paid to minority shareholders in a stock-for-stock merger).

173. On the equal opportunity rule, see generally Bebchuk, *Efficient and Inefficient Sales*, *supra* note 68, at 968–73; Marcel Kahan, *Sales of Corporate Control*, 9 J.L. ECON. & ORG. 368, 372–78 (1993) (using the term "tender offer rule").

174. *See, e.g.*, Bebchuk, *Efficient and Inefficient Sales*, *supra* note 68, at 968.

175. *Id.*

176. *Id.* This, in essence, is the solution that European Community law has adopted: Art. 5(1) of the Council Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids, Council Directive 2004/25, art. 5(1), 2004 O.J. (L 142) 12, 17 (EC), imposes a duty on the acquirer of control to make a mandatory bid for all the outstanding shares of the target corporation. The minimum price for the mandatory bid is "the highest price paid for the same securities" by the acquirer "over a period, to be determined by Member States, of not less than six months and not more than 12 before the [mandatory] bid . . . ." *Id.*

177. *Cf.* 17 C.F.R. § 240.14d-10(a) (2007). This section provides that no tender offer shall be made unless:

> [The] tender offer is open to all security holders of the class of securities subject to the tender offer;

At least in theory, both versions of the equal opportunity rule ensure that transfers of control do not harm minority shareholders.[178] Unfortunately, they also share a severe limitation in that they deter at least some efficient transfers of control.[179]

Just as importantly, the equal opportunity rule fails to offer any protection to the minority shareholders once a controlling stake has been created. Hence, the equal opportunity rule does not offer the controller any incentive to abstain from exploiting the minority shareholders once he has acquired control. Accordingly, the equal opportunity rule cannot serve as a bonding device that would require the acquirer to commit himself to future conduct that does not exploit the minority shareholders. In other words, the equal opportunity rule can only prevent transfers of control that are undesirable in light of the existing restrictions on the conduct of controllers. However, it cannot, per se, capture the benefits that would arise from imposing more effective restrictions on existing controllers and thereby make control desirable in a broader number of cases. [180]

B. Mandatory Bid Rules that Do Not Offer an Equal Opportunity

To reduce the risk that efficient control transfers are deterred, one can force the acquirer of control to offer to buy the minority shares, but allow him to pay a price that is lower than the price that he paid in acquiring the controlling stake. For example, one could provide that controlling shareholders only have to offer to buy the minority shareholders' shares at the no-transaction value. However, even setting aside the valuation problems that such a rule may engender,[181] this approach still threatens to deter some efficient control transfers in that the acquirer risks having to buy more shares than he otherwise would, increasing the amount of capital needed for the transaction.[182] And, more importantly, such a rule still would not offer any protection to minority

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> and . . . [t]he consideration paid to any security holder for securities tendered in the tender offer is the highest consideration paid to any other security holder for securities tendered in the tender offer.

Id.

178. *E.g.*, Bebchuk, *Efficient and Inefficient Sales*, *supra* note 68, at 971 (concluding that under the equal opportunity rule, if a transfer takes place, minority shareholders will always be made better off by it).

179. *E.g.*, *id.* at 971–72.

180. The fact that the minority shareholders may have been aware of the risk that the controller will become undesirable does not make the lack of adequate post-acquisition protection efficient. If the shareholders have taken into account the risk that the controller will become undesirable, but have chosen not to make use of the protection of the equal opportunity rule, this simply means that, ex ante, the shareholders expected the controller's presence to benefit them. However, this does not preclude the possibility that additional benefits are created where the law offers better post-acquisition protection to the minority shareholders.

181. One might be tempted to look to the pre-acquisition share price. However, it should be noted that controlling stakes can be created gradually. Accordingly, even if the law defines a certain threshold, the crossing of which prompts the duty to make a mandatory bid, the price that the shares were traded at before the threshold was reached may not reflect the no-control value, because the acquirer may only have had slightly less control before crossing the threshold than after crossing it. To avoid valuation problems of this type, those mandatory bid rules, which do not force the acquirer to pay the same price to the minority shareholders that he paid for the control block, typically resort to formulas in calculating the bid price. *Cf.* Paul Davies & Klaus Hopt, *Control Transactions*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 157, 180–81 (2004) (describing mandatory bid rules in various countries)*;* Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 839 (2006) (noting that "[i]n many countries, a shareholder who exceeds a threshold percentage of share ownership must offer to buy all remaining shares at a formula price").

182. *Cf.* Davies & Hopt, *supra* note 181, at 180 (noting that prohibition of partial bids that forms the focus of a mandatory bid rule makes control transactions more expensive for potential bidders).

shareholders once a controller has emerged.

In sum, both the equal opportunity rule and those mandatory bid rules that do not give minority shareholders an equal opportunity to sell their shares have significant limitations.

VIII. The Corporate Ostracism

How can the challenge that controlling shareholders have be solved without running into the disadvantages that the various above described approaches have? The key, in my view, is to grant minority shareholders the right to expel the controller, a mechanism I shall refer to as "ostracism." The ostracism would allow the minority shareholders to rid the corporation of controllers whose presence they believe to be harmful to the corporation.

Moreover, in light of the protection that the ostracism affords to shareholders, the law can and should turn existing transaction-centered protections into default rules. This would create a way for benign controllers to reap most of the benefits that their presence bestows on the corporation, thereby essentially eliminating the free rider problem.

In this Part of the Article, I focus solely on the first component of the proposed regime, namely, the right to ostracize the controlling shareholder. The second component, namely, the right to opt out of the transaction-centered protections, will be discussed in the next Part. Needless to say, if one seeks to address all shortcomings of the present legal framework, both components of the proposed regime need to be adopted. Nonetheless, it is useful to focus on the ostracism first. This is because even a reform that merely adds to the current system a default rule allowing the minority shareholders to ostracize controllers would be preferable to the status quo.

A. The Basic Structure

How would the corporate ostracism function in technical terms? There are various ways to implement such an approach. One plausible solution is to opt for a two-step process. At every shareholder meeting of a controlled corporation, a vote would be taken on whether or not to initiate proceedings against the controlling shareholder. If a certain percentage—e.g. 10%—of the outstanding minority shareholders vote in favor, then the board will have to call a special shareholder meeting at which the minority shareholders can vote on whether or not to expel the controller. If, at that special shareholder meeting, a simple majority of the minority shares is voted in favor of ostracizing the controller, the ostracism succeeds. In that case, the controller automatically loses the right to exercise any voting rights or to participate in the control of the corporation in any other way. He does not lose his ownership stake automatically, but is under an obligation to sell his shares within a given time frame, say two years. Further, the controller is prohibited from reacquiring any shares in the corporation within the next ten years.

As will be explained in more detail below, the corporate ostracism should constitute the default under state law for firms that go public. Corporations should be able to opt out of that default via a provision in their certificate of incorporation. However, once the corporation has issued shares, any opt out via a charter amendment should require the approval of the minority shareholders.

B. Potential Benefits

Even if it is not combined with the right to opt out of the transaction-centered

protections that existing law imposes, the corporate ostracism offers two major benefits. First, it provides powerful protection against the excessive extraction of private benefits. Second, it protects the minority shareholders against those undesirable controllers whose presence is motivated by independently created private benefits, rather than by extracted private benefits.

1. Excessive Private Benefit Extraction

The protection against excessive benefit extraction is a fairly obvious advantage. As explained above, the upper limit of desirable benefit extraction is equal to the net benefits that the controller's presence bestows on the corporation.[183] In other words, a controller should not be allowed to extract private benefits in excess of that amount.[184] The transaction-centered approach is insufficient to enforce this limit.[185] By contrast, the corporate ostracism provides a mechanism to solve the problem at hand. This is because the upper limit of desirable benefit extraction coincides with the point at which shareholders have an incentive to ostracize the controller. As soon as the controller starts extracting benefits in excess of the net benefits that his presence creates for the corporation, the other shareholders have every reason to ostracize him. Knowing that, controllers are unlikely to extract excessive private benefits in the first place.

2. Other Undesirable Controllers

The second benefit of the corporate ostracism is equally obvious. As laid out in detail above, the transaction-centered approach fails to protect the minority shareholders in those cases where the presence of a burdensome controller is motivated by independently created private benefits, rather than by extracted private benefits.[186] The corporate ostracism, by contrast, allows the minority shareholders to rid the corporation of undesirable controllers, regardless of whether extracted or independently created private benefits are the reason for the controller's presence.

At this point, it is helpful to consider a possible criticism. At first glance, the corporate ostracism may seem to create a problem of its own when it comes to controllers whose presence is motivated by independently created private benefits. One might be tempted to argue that the corporate ostracism is bound to lead to inefficient outcomes where, even in the absence of extracted private benefits, the independently created private benefits exceed the (shared and private) costs of control. For example, assume that the controller's presence imposes net costs on the corporation in the amount of $1 million annually,[187] that the controller bears private costs in the amount of $100,000, and that he enjoys independently created private benefits in the amount of $1,500,000. In such a scenario, the minority shareholders have a clear incentive to ostracize the controller because the impact of his presence on the corporation is a negative one. But, one could argue, ostracizing the controller would be inefficient because the total benefits of control including the private benefits to the controller exceed the total costs of control. This said, a more careful analysis reveals this problem to be illusory. If the controller wants to continue enjoying the independently created benefits of control, then he can, and in fact

183. *See supra* Part III.B.1.
184. *See supra* Part III.B.1.
185. *See supra* Part III.C.1.
186. *See supra* Part V ("Undesirable Control Without Benefit Extraction").
187. By this, I mean that the shared costs of control exceed the shared benefits of control by $1,000,000.

should, compensate the corporation for the harm he inflicts. As long as that compensation is at least equal to the burden which the controller's presence imposes on the corporation, the other shareholders have no reason to ostracize him. Thus, the ostracization of a desirable controller is avoided.

C. The Potential Costs

Granting minority shareholders the right to ostracize the controller is not without potential costs. In particular, minority shareholders may make uninformed choices, or they may even seek to extort the controller. These and other problems should not be dismissed too easily. However, as I show in the following, they should not be exaggerated either.

1. Uninformed Choices

One potential problem with the right to expel the controlling shareholder is that the shareholders may make badly informed choices.[188] That risk comes in two flavors. First, the minority shareholders may overestimate the benefits of a controller and therefore fail to ostracize an undesirable controller. Or, second, they may underestimate the benefits of a controller and, as a result, ostracize a desirable controller.

Errors of the first type do not provide an argument against giving minority shareholders a right to expel the controller.[189] After all, even if they occasionally fail to use their right to ostracize an undesirable controller, that still does not leave them worse off than they are under existing law, which does not accord them such a right in the first place.

By contrast, the risk that the minority shareholders might expel a beneficial controller deserves closer attention. Given the size of their investments and the minimal likelihood that their individual votes will matter to the outcome of the ostracization proceeding, most small shareholders will remain rationally uninformed regarding the costs and benefits of the controlling shareholder's presence.[190] So how can one be sure that the minority shareholders do not, as a result of inadequate information, expel benign controllers?

In fact, the risk that small shareholders will, out of ignorance, vote to expel benign controllers seems limited. Small shareholders are generally aware that they are not

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188. That small shareholders typically lack the incentive to become informed about matters on which they can vote is generally recognized. *See, e.g.*, Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437, 1473 (1992) (noting, with respect to reincorporation decisions, that "given the extremely small likelihood of casting a decisive vote, small shareholders will rationally decline to inform themselves even if they can do so at fairly minimal cost").

189. A different question is whether the risk at issue constitutes a persuasive reason against allowing corporations to opt out of the transaction-centered protections. That question will be addressed below. *See infra* Part IX.B.2.a.

190. The same problem exists with respect to other decisions in which the minority shareholders participate. *Cf.* Lucian Arye Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1837 (1989) [hereinafter Bebchuk, *Limiting Contractual Freedom*].

> Any shareholder holding a small stake in the company recognizes that his vote is highly unlikely to be pivotal. . . . Such a shareholder does not have sufficient reason to acquaint himself with [a] proposal [to amend the charter] . . . even if the cost of doing so is fairly small.

Id.

particularly well informed. Why should they vote in favor of ostracizing the controller? Such behavior would be rational only if, as a general matter, corporations were better off without controllers. If that were the case, uninformed shareholders would indeed be likely to adopt a general policy of voting in favor of ostracizing the controller. However, that would not be troublesome. After all, if it were true that controllers more often than not harm the controlled corporation, then the occasional ostracism of a benign controller would be a small price to pay for the elimination of controllers, who, by definition, tend to reduce firm value. By contrast, if the presence of a controller tends to benefit the controlled corporation, uninformed shareholders are much more likely to vote against the ostracism or abstain from voting—just as small shareholders tend to abstain or support management when it comes to most instances of corporate voting.[191]

2. Extortion

Another challenge involves the potential for opportunistic behavior on the part of the minority shareholders. What, one might ask, prevents the minority from abusing the corporate ostracism for purposes of extortion? The underlying problem can be summed up as follows: For the controller, being ostracized will often be costly. The controller will typically have incurred considerable costs in order to amass a controlling stake in the first place. In particular, he may have paid a premium to acquire the shares. If the controller is now forced to sell the controlling stake, he may not be able find a buyer who is willing to pay a similar premium. In addition, the controller may have made considerable corporation-specific investments after acquiring his controlling stake—e.g., by spending resources to become more informed about the corporation's business. Moreover, despite the two year period that an ostracized controller has to sell his shares, his attempts to sell his block may sometimes cause the share price to decline.[192] In other words, an ostracized controller may incur significant losses.

Correspondingly, most controllers are likely to have a strong incentive to avoid being ostracized. In principle, this incentive is quite desirable. Ideally, the corporate ostracism deters undesirable controllers, even if never exercised because the costs of being ostracized motivate controllers to avoid becoming burdensome to the corporation in the first place.

However, the costs of being ostracized also harbor an obvious risk in that the minority shareholders might attempt to "squeeze" the controller. For example, they might let him know that if he wishes to avoid ostracization, he will have to forego distributions that the other shareholders enjoy or enter into contracts with the corporation that are highly favorable to the latter. The controller, it seems, has an incentive to comply as long as the sacrifice that the minority shareholders demand is less burdensome than being

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191. *See, e.g.*, Ellen S. Friedenberg, *Jaws III: The Impropriety of Shark-Repellent Amendments as a Takeover Defense*, 7 DEL. J. CORP. L. 32, 77 (1982) ("Under normal conditions, the average shareholder in a publicly held corporation will fail to vote or will automatically return a proxy favoring management's position.").

192. The risk of such a decline should not be exaggerated. Usually, when a large shareholder tries to sell his stake, this sends a negative signal to the market. After all, the capital market expects large shareholders to have better access to inside information than other investors. Accordingly, if one of them sells his stake, this can be seen as a sign that the firm's future prospects do not look bright. Consequently, the selling of a large stake can have an adverse impact on the stock price because of its signaling value. Yet in the case at hand, no such signal is sent. After all, when a controller is ostracized, outside investors know that the controller does not leave of his own free will. In fact, the expulsion of a controller should often be read as a positive signal since it carries the promise that the corporation will no longer be burdened with the presence of an undesirable controller.

ostracized. As a result, benign controllers might fail to emerge in the first place for fear of being squeezed.

For lack of experience with the corporate ostracism, the risk of extortion cannot be dismissed out of hand. However, even setting aside the free rider problem that the extortionists may face,[193] two factors suggest that the risk of extortion should not be overemphasized either.

a. Extortion as a Chicken Game

As pointed out above, the desirable level of benefit extraction is defined by both a lower and an upper limit.[194] As long as the controller, in extracting private benefits, remains somewhat above the lower level of desirable benefit extraction, the minority shareholders reap part of the benefits of his control. In that case, both sides lose if the controller is ostracized.[195] That, in turn, makes it difficult for the would-be extortionist to mount a credible threat. In a nutshell, given that the controller knows that the minority shareholders will hurt themselves if they ostracize him, the controller has no reason to believe that they will carry out their threat.[196]

The situation at hand represents what is conventionally referred to as a "chicken game"[197] or a "hawk-dove game."[198] In such a game, each party is better off if the other backs down.[199] At the same time, each party knows that she will suffer more if the threat is carried out than if she simply backs down.[200] One way to win such a game is for party *A* to signal a credible commitment to party *B* that she (party *A*) will not back down.[201] Once party *B* has received that signal, she knows that she only has the choice between backing down and seeing the threat carried out. Because party *B* prefers giving in to seeing the threat carried out, she will rationally choose to back down.

Against the above described background, the controller can win the conflict if he can signal a credible commitment not to give in before the minority shareholders can make their final decision whether or not to ostracize him. And the law can do its part to secure such an outcome, namely, by adopting a rule according to which the resolution ostracizing the controller is both irreversible and unconditional. Against the background

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193. In order to camouflage the extortionist nature of their demands, the extortionist shareholders are likely to demand that the wealth transfer be made to the corporation rather than to themselves personally. That, of course, means that those minority shareholders who have mounted the effort to extort the controller reap only a fraction of the fruits that their efforts yield. At the same time, they bear the costs of extorting the controller alone. These costs particularly include the costs of coordinating a sufficient number of minority shareholders.

194. *See supra* Part III.B.

195. Of course, the minority shareholders could hope that another, equally desirable controller will take the old controller's place. Yet once the minority shareholders have resorted to squeezing the controller, other potential controllers will be reluctant to acquire a controlling stake in the relevant corporation for fear that they will meet the same fate.

196. One may be tempted to point to the phenomenon of greenmail—target corporations paying off hostile bidders to avoid being acquired—as evidence for the feasibility of the extortion scenario. However, greenmail was popular precisely because greenmailers were able to credibly threaten a hostile takeover. *See, e.g.*, Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1, 32 (1987) (noting that the "proliferation of junk bonds increases the danger of greenmail because easy access to financing allows almost any raider to mount a credible threat").

197. *E.g.*, Richard H. McAdams, *A Focal Point Theory of Expressive Law*, 86 VA. L. REV. 1649, 1674 (2000); Robert Sudgen, *Spontaneous Order*, J. ECON. PERSP., Fall 1989, at 85, 87.

198. *E.g.*, McAdams, *supra* note 197, at 1674; Sudgen, *supra* note 197, at 87.

199. *E.g.*, McAdams, *supra* note 197, at 1675.

200. *E.g.*, *id.*

201. THOMAS C. SCHELLING, THE STRATEGY OF CONFLICT 126–27 (1960).

of such a rule, the controller can refuse to give in to any demands made by the minority shareholders and can decline to attend the special meeting at which he is to be ostracized. Once the moment of the vote arrives, the controller's refusal becomes a credible commitment because, at that moment, it is no longer feasible for him to make any concessions. Hence, at the moment of the vote, the minority shareholders are left with only two choices. They can ostracize the controller and lose their portion of the benefits that the controller's presence bestows on the corporation, or they can vote against ostracizing the controller and thereby retain the relevant benefits. Rationally, they will vote in the latter way.

Admittedly, the minority shareholders could attempt to commit themselves even earlier. In particular, they could enter into an agreement among themselves to ostracize the controller unless he complies with their demands. However, complementing the rule that declares the ostracism resolution to be unconditional and irreversible, the law can declare agreements of the type at issue to be non-binding, thereby undermining their value as commitment devices. Moreover, assuming the existence of a legal ban on pre-commitments regarding the ostracism, it is not obvious that there are other commitment devices that are visible enough to allow the commitment to be signaled to the controller, while at the same time being sufficiently invisible to be safe from judicial scrutiny.

b. Excessive Demands

The extortion scenario also runs into a second problem: From the controller's perspective, it may be preferable to undertake the wealth transfer demanded by the minority shareholders rather than to be ostracized and bear the even higher costs that come with the duty to sell his shares. However, even if the sacrifice that is demanded is less burdensome than being ostracized, the controller knows that if he gives in to the minority shareholders' demands, the extortion scenario can repeat itself every year.

In other words, from the controller's perspective, the choice in any given year is not one between making a one-time sacrifice on the one hand and incurring the risk of being ostracized on the other hand. Rather, the choice is between making potentially unlimited sacrifices in the future versus incurring the risk of being ostracized. Therefore, giving in to extortive demands is a much less attractive option than it may seem at first glance. Even controllers who see a certain risk of being ostracized if they do not give in to extortive demands may not find it in their interest to pay.

As a result, would-be extortionists do not only have to find a way to commit themselves to ostracizing the controller in case he does not comply with their demands. Rather, they also need to make a credible commitment that neither they nor other minority shareholders will demand further wealth transfers in the following years. It is not clear how this can be achieved if the law declares agreements to this effect to be invalid. In sum, while the risk of extortion should not be dismissed too easily, it should not be exaggerated either.

3. Conflicts of Interest

One may further be concerned that benign controllers could be ostracized because a large minority shareholder hopes to gain control of the corporation or simply because he hopes to acquire the controller's stake on the cheap. However, this risk does not seem enormous. Even if a controller is ostracized, this does not mean that the next largest minority shareholder—or any other minority shareholder for that matter—will gain control. Rather, it is the person or entity that the controller sells his stake to that will be

the next controller.

Similarly, the danger that the controller is ostracized because a minority shareholder is trying to acquire the controller's stake at a price below the true value seems limited. The two-year period that the controller has to sell his stake should usually suffice to prevent a situation where the ostracized controller cannot line up any buyers for his stake other than the next largest minority shareholder.

4. Minimal Shareholdings

A final problem arises in those cases where the total number of outstanding shares held by minority shareholders is completely insignificant relative to the number of shares held by the controller. For example, the controller may own 99.8% of a publicly traded corporation. In cases like this, the outcome of the corporate ostracism may well become unpredictable because a decision by such a small voter population may be influenced by other factors besides economic rationality. Therefore, the corporate ostracism should only be available in those cases where the minority's percentage of shares is sufficiently high. One plausible option is to deny the minority shareholders the right to ostracize the controller once the latter holds 90% or more of the outstanding shares of each class, given that that is the threshold at which Delaware law considers the controller's stake big enough to undertake a so-called short-form merger.[202]

5. Summary

As the preceding analysis has shown, the corporate ostracism is not without potential costs. However, it also has significant benefits. Further, it should be noted that the weight of the relevant costs and benefits is bound to vary across corporations. For example, some corporations are more exposed than others to the risk of excessive benefit extraction.[203] Accordingly, the check that the corporate ostracism places on the controller's ability to extract excessive private benefits will be more useful in some corporations than in others.

Against this background, I do not assert the claim that the corporate ostracism is appropriate for all corporations. Rather, the crucial point is that the corporate ostracism may well be a superior solution for some corporations. Moreover, as explained in detail below, there is reason to believe that the corporate ostracism also represents the appropriate default rule for corporations that go public.[204] This is because it is likely easier for such corporations to opt out of the corporate ostracism than to opt in.[205] Accordingly, if the corporate ostracism were adopted as the default rule, a higher number of corporations would end up being governed by the regime that is appropriate for them.

D. Why Don't Corporations Adopt the Corporate Ostracism on Their Own?

My claim that at least some corporations would benefit from the introduction of the corporate ostracism provokes the following question. Even at present, nothing in Delaware law appears to prevent corporations from including in their articles of incorporation a provision allowing the minority shareholders to ostracize controlling

202. DEL. CODE ANN. tit. 8, § 253 (2007).
203. *See supra* Part III.C.1. a.
204. *See infra* Part VIII.E.
205. *See infra* Part VIII.E.

shareholders.[206] If the right to ostracize the controller promises to benefit at least some corporations, why do such corporations not habitually include such a right in their charter?

1. General Obstacles to Innovative Governance Arrangements

As part of the answer, one can point to the obstacles that innovative governance arrangements have to overcome in general. Even if such arrangements are superior to the status quo, if adopted by many or all corporations, no single corporation may find it in its interest to be among the first firms to adopt the relevant arrangement.[207]

In part, this is due to the fact that the user of an innovative governance arrangement has to forego the network benefits that more widely used arrangements offer.[208] Admittedly, the use of an innovative charter provision may also promise to yield network benefits, if one can expect the relevant provision to gain popularity. However, if the innovative governance arrangement is of some complexity—and that is certainly true for the corporate ostracism—there is the risk that even if the arrangement becomes popular, there will be a myriad of different versions of it, precluding the users from reaping the network benefits that a uniform version would have yielded.

Furthermore, there is the problem of innovation externalities.[209] The first firm to adopt an innovative governance arrangement incurs significant costs—costs that can largely be avoided by later adopters who can free ride on the efforts of the innovator.[210] To begin, there are the costs of drafting the relevant provision in a way that ensures its enforceability.[211] Then there are those costs that result because investors are unfamiliar with the relevant provision.[212] Moreover, given that the innovative governance arrangement is untested, its costs and benefits are to some extent uncertain. That uncertainty is bound to weigh particularly heavily where—as in the case of the corporate ostracism—a governance arrangement is likely to have a considerable impact on the

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206. *Cf.* DEL. CODE ANN. tit. 8, § 102(b)(1) (2007) (providing that the certificate of incorporation may contain "[a]ny provision . . . creating . . . the powers of . . . the stockholders . . . if such provisions are not contrary to the laws of this State").

207. *See, e.g.*, Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 791 (1995) [hereinafter Klausner, *Corporations, Corporate Law*] (pointing out that in the presence of network effects "[c]ontract terms that value-maximizing managers adopt in efficient capital markets may not be socially optimal—even though no readily identifiable third party is harmed").

208. *See, e.g.,* John C. Coates IV, *"Fair Value" as an Avoidable Rule of Corporate Law: Minority Discounts in Conflict Transactions*, 147 U. PA. L. REV. 1251, 1305 (1999) [hereinafter Coates IV, *Fair Value*] (noting that network externalities make standard terms more attractive than novel terms).

209. *Cf. id.* at 1305 (noting that "[t]hird parties can free ride on the costly efforts of earlier innovators").

210. *See, e.g.*, Marcel Kahan, *The Qualified Case Against Mandatory Terms in Bonds*, 89 NW. U. L. REV. 565, 599 (1995) [hereinafter Kahan, *The Qualified Case*] (noting, with respect to bonds, that "once a novel term is used for the first time, other companies . . . can free ride by copying the term"). Another potential obstacle to innovative charter arrangements may result from the agency conflict between the lawyer and his corporate client. *Cf.* Marcel Kahan & Michael Klausner, *Path Dependence and Corporate Governance: Path Dependence in Corporate Contracting; Increasing Returns, Herd Behavior and Cognitive Biases*, 74 WASH. U. L.Q. 347, 354 (1996) (noting that "[t]he relative certainty that standard terms offer may lead a lawyer to employ such a term even if the expected value of the term to his client is lower than the expected value of a customized term," in part because "lawyers will frequently be more risk averse than their clients").

211. *See, e.g.,* Coates IV, *Fair Value*, *supra* note 208, at 1298–99 (pointing out that a corporation adopting a new rule incurs the costs of learning how to set the new rule in a way that ensures that the relevant contract will be enforceable).

212. *Cf. id.* (noting that a corporation adopting a new rule has to bear the costs of "learning how to effectively sell investors on the benefits").

ownership structure of the firm rather than concerning some marginal issue. Consequently, the first firms to adopt innovative governance arrangements serve as guinea pigs. If the arrangement proves to be a failure, the firm that adopted it will bear the resulting costs. If, by contrast, the governance arrangement proves to be a success, it will quickly be emulated by other firms.[213]

2. Agency Conflicts

It is not just the above described "generic obstacles" to innovative charter amendments that are likely to prevent corporations from adopting the corporate ostracism on their own. Rather, agency conflicts within the firm may constitute an additional hurdle.

a. Existing Firms

That is particularly true for those firms that are already publicly traded. Such firms could theoretically create the right to ostracize the controller via a charter amendment. However, even in cases where the charter amendment promises to increase firm value, conflicts of interest on the part of incumbent directors and controlling shareholders may prevent the amendment from being adopted.

i. Without a Controlling Shareholder

Consider, first, those firms that currently lack a controller. There, it is the agency conflict between directors and shareholder that becomes relevant. Charter amendments require a board resolution,[214] and the directors may well come to the conclusion that the creation of a right to ostracize controllers, even if it promises to increase firm value, runs counter to their personal interests.

That can be explained as follows. In manager-controlled firms, managers have a personal interest in protecting their control. As it happens, existing law makes it relatively easy for managers to do so. In combination with an appropriately designed staggered board, poison pills are highly effective in deterring hostile investors.[215] Moreover, while the use of antitakeover devices must be guided by the directors' fiduciary duties, courts are largely deferential to directors in determining when the use of such devices is in the best interest of the shareholders.[216]

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213. *Cf.* Coates IV, *Fair Value*, *supra* note 208, at 1305 (noting, with respect to the default rules on appraisal, that "if an issuer were able to raise a greater-than-expected amount of capital by including a commitment to pay a non-discounted fair price in all conflict transactions, that issuer would not receive compensation from subsequent issuers that used identical commitments to enhance their stock offerings").

214. DEL. CODE ANN. tit. 8, § 242(b)(1) (2007).

215. *See* Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 950 (2002) [hereinafter Bebchuk, *Antitakeover Arrangements*] (concluding that effective staggered boards substantially increase the likelihood that a target receiving a hostile bid will remain independent); Lucian Arye Bebchuk, *Investors' Choices: Why Firms Adopt Antitakeover Arrangements*, 152 U. PA. L. REV. 713, 722 (2003) (noting that "the combination of the poison pill and an effective staggered board provides management with considerable veto power").

216. In Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1390 (Del. 1995), the Delaware Supreme Court stressed that if the defensive measures were "proportionate to the threat the Board believed [the acquirer] posed," then they were "entitled to review under the traditional business judgment rule." *Id.* Not surprisingly, this and related decisions have been interpreted to mean that "managers of Delaware corporations face few impediments when erecting defenses that deter unwanted acquisitions, provided that they are not selling control of the firm." Jennifer Arlen & Eric Talley, *Precommitment and Managerial Incentives: Unregulable Defenses*

It is not at all clear, however, whether courts would continue to be as deferential as they are now if a corporation were to adopt the corporate ostracism. After all, once the minority shareholders have the right to ostracize the controller, it is arguably no longer necessary to protect the shareholders by preventing a controller from acquiring a controlling stake. It follows that the directors may oppose the creation of a right to ostracize the controller for fear that it endangers their ability to entrench themselves.

ii. With a Controlling Shareholder

In firms with a controlling shareholder, it is the agency conflict between the controlling shareholder and the minority shareholders that stands to gain relevance. Given that the benefits of the corporate ostracism accrue to the minority shareholders, whereas the costs are borne by the controller,[217] the latter may not find it in his interest to vote in favor of a charter amendment that creates a right to ostracize controllers, even where such an amendment promises to yield more benefits than costs for the corporation. That is true for both desirable and undesirable controllers, but it is particularly obvious in those cases where the corporation is controlled by an undesirable controller. Such a controller could expect to be ostracized as soon as the relevant amendment is adopted. Hence, he would be foolish to vote for the amendment.

Moreover, at least in the presence of an undesirable controller, Coasian bargains between the controlling shareholder and the minority shareholders are unlikely to offer a solution. In theory, the undesirable controller might offer to vote in favor of the amendment in exchange for being compensated for the fact that he will likely be ostracized. However, in practice, such an approach hardly seems feasible. That is particularly true in those cases where the controller is undesirable because he extracts excessive private benefits. In order to secure the minority shareholders' consent to the bargain, the controller would have to convince them that they stand to gain from a charter amendment introducing the right to ostracize the controller. That, however, would basically require the controller to highlight the fact that he is stealing from the corporation. For the controller, that is hardly an appealing course of action. He will fear that once alerted to the full size of the extracted private benefits, the minority shareholders may try to enforce the transaction-centered protections more rigorously, thereby reducing the controller's private benefits of control without compensation.

b. IPO Firms

In Initial Public Offering (IPO) firms, too, agency conflicts may sometimes prevent the corporate ostracism from being adopted. To be sure, the traditional assumption has been that IPO charters are designed to maximize firm value. However, as has been noted in the literature,[218] that assumption is somewhat difficult to reconcile with the

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and the Perils of Shareholder Choice, 152 U. PA. L. REV. 577, 579 (2003).

217. Another question is whether controlling shareholders would be more inclined to vote for a charter amendment that combines the introduction of the corporate ostracism with a loosening or even elimination of the transaction-centered protections. However, at present, such charter amendments are not possible, given the mandatory nature of the transaction-centered protections. *See infra* Part IX.A. In any case, even if the transaction-centered protections were stripped of their mandatory nature, as this Article suggests, undesirable controllers—who stand to be expelled once the corporate ostracism has been introduced—would still not find it in their interest to vote in favor of a charter amendment creating a right to ostracize controllers.

218. *See* Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J.L. ECON. & ORG. 83, 111 (2001) (testing various theories for why the use of

proliferation of classified board provisions in IPO charters.[219] After all, such provisions, if combined with poison pills, provide considerable protection against hostile takeovers,[220] and their adoption is widely thought to reduce firm value.[221] Against this background, the more recent literature on IPO charters has advanced various reasons for why IPO charters may have a tendency to grant an inefficient amount of protection to incumbent managers.[222] For example, it has been suggested that the markets may not be completely efficient at pricing charter terms, thus allowing incumbent managers to entrench themselves without bearing the full extent of the costs.[223]

It is not yet entirely clear to what extent this and other explanations accurately describe the reasons for the proliferation of classified board provisions in IPO charters. However, it is at least plausible that IPO charters have an inefficient tendency towards charter terms that allow those in control to entrench themselves. Such a tendency, however, also means that the right to ostracize the controller may fail to be adopted even where it promises to increase firm value.

In sum, the fact that firms do not routinely provide for a right to ostracize the controller in their charter is explained not only by the general obstacles to innovative governance arrangements, but also by agency conflicts within firms.

E. The Corporate Ostracism as the Appropriate Default Rule

Against this background, it also becomes clear why the corporate ostracism should be chosen as the default rule. The traditional view on default rules has been that the default should equal the arrangement that the parties would have chosen, had they

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antitakeover provisions in IPO charters might be efficient, but finding no evidence supporting any of these theories and concluding that antitakeover provisions "seem to be used at the IPO stage to entrench management, just as they are used when firms amend their charters in midstream"). *But see* Bebchuk, *Antitakeover Arrangements*, *supra* note 215, at 730–34 (suggesting efficiency-based explanations for the proliferation of antitakeover devices in IPO charters).

219. *E.g.*, Klausner, *IPO Stage*, *supra* note 46, at 763–64 (noting, with a view to companies going public between 1988 and 1998, that "classified boards have become common among those companies that private equity firms take public" and that "restrictions on management's ability to adopt poison pills are absent"). *Cf.* Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779, 791 (2006) (noting that "no study has turned up a charter term at the IPO stage that limits management's discretion to adopt a poison pill").

220. *See* the sources cited *supra* note 215.

221. *Cf.* Lucian Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409, 430 (2005) (finding "that staggered boards are associated with lower firm value"). *But see* Arlen & Talley, *supra* note 216, at 666 (arguing that poison pills may be tolerated by managers because they are "in the end, less destructive of firm value than other blanket defenses managers might employ").

222. *See* Bebchuk, *Antitakeover Arrangements*, *supra* note 215, at 740–45 (describing shareholder and potential buyer actions that demonstrate IPO charters' inefficient tendency to protect incumbent managers).

223. *Id.* at 740–42. *Cf.* Bernard S. Black, *Is Corporate Law Trivial? A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 571–72 (1990) [hereinafter Black, *Is Corporate Law Trivial?*] (discussing various factors that may prevent IPO charter terms from being efficiently priced). Another explanation points to the agency conflict between lawyers and their corporate clients: If the firm manages to issue its shares at a slightly higher price, this fact is unlikely to be attributed to the lawyer, whereas the lawyer may well be blamed if the incumbent controllers lose control due to a lack of takeover defenses. *See* Bebchuk, *Antitakeover Arrangements*, *supra* note 215, at 736–39. In yet another attempt to explain the proliferation of poison pills in IPO charters, Michael Klausner has suggested that "based on private equity funds' need to maintain a reputation for dealing well with successful managers of portfolio companies," it may be "privately rational, but socially inefficient, for private equity funds to have their portfolio companies adopt takeover defenses." Klausner, *IPO Stage*, *supra* note 46, at 784.

bargained at no cost.[224] Of course, not all parties necessarily would have chosen the same arrangement. Therefore, one may be tempted to choose the rule that most parties would have agreed on.[225] The obvious attraction of such an approach is that it seems to minimize the number of cases in which parties need to opt out in order to reach their preferred solution, thereby minimizing transaction costs.[226] However, the picture changes once one acknowledges that in practice, some defaults can be easier to opt out of than others. If that is the case, it can be desirable for the law to choose the rule as a default that is easier to opt out of.[227]

1. IPO Firms

In the case at hand, the above considerations suggest that at least with respect to IPO charters, the corporate ostracism should be the default rule: It is difficult to predict how many firms would choose that rule in the absence of transaction costs. However, it is likely easier for IPO firms to opt out of the corporate ostracism than to create a right to ostracize the controller in their charter.

a. The Ostracism Brings Net Costs

First, consider those firms for which the costs of the ostracism exceed its benefits. Turning the corporate ostracism into the legal default imposes only a minimal burden on firms of this type, because such corporations can be expected to opt out of the corporate ostracism at very little cost. It is not difficult to draft—or hard to market to investors—a clause in the charter specifying that the minority shareholders do not have the right to ostracize the controller. Nor is there reason to believe that agency conflicts or informational asymmetries would prevent firms from opting out of the corporate ostracism if the latter's costs exceed its benefits.

b. The Ostracism Brings Net Benefits

At the same time, making the corporate ostracism the legal default rule creates considerable benefits for those firms for which the benefits of the corporate ostracism exceed its costs. As pointed out above, it is costly for corporations to create a right to ostracize the controller in their charters, not least because the first firms to do so incur the costs of drafting and marketing such a provision.[228] Also, given that the corporate ostracism is rather complex, there is the risk that the firms choosing to opt into such a

224. *E.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 15 (1991) (focusing on corporate law); Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829, 835–36 (1985) (focusing on the law governing fraudulent conveyances).

225. Ian Ayres and Robert Gertner use the term "majoritarian defaults" to refer to default rules of this type. Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 93 (1989).

226. *Id.*

227. *Cf. id.* (noting that "if the majority is more likely to contract around the minority's preferred default rule (than the minority is to contract around the majority's rule), then choosing the minority's default may lead to a larger set of efficient contracts"); Bebchuk & Hamdani, *Optimal Defaults*, *supra* note 17, at 492–93 (arguing that public officials should err on the side of choosing default rules that restrict managers because, in light of the veto power that managers enjoy over charter amendments, such rules are easier to opt out of than rules that do not restrict managers).

228. *See supra* Part VIII.D.1 (discussing obstacles to innovate governance arrangements).

regime will end up with a myriad of different versions, thereby precluding the relevant firms from reaping the network benefits that a uniform term would yield.[229] Both problems can be reduced by turning the corporate ostracism into the legal default.[230]

Admittedly, even if the corporate ostracism is adopted as the legal default, some firms for whom the ostracism is desirable will nonetheless fail to adopt it, i.e., because of agency conflicts at the IPO stage.[231] But these firms would also fail to use the corporate ostracism under existing law, so nothing is lost by turning the corporate ostracism into the default.

c. The Costs Weigh About as Heavily as the Benefits

Finally, there may be those firms for which, at the time of the IPO, the benefits of the corporate ostracism weigh about as heavily as its costs. Given the apparent tendency of IPO charters to protect incumbent controllers,[232] some of the firms at issue may well decide against the corporate ostracism no matter what the default is. Others, however, are likely to stick with whatever the default rule is.[233]

That leads to a further argument in favor of making the corporate ostracism the default: Over time, the availability of the corporate ostracism may very well develop relevance to the value of the firm.[234] In that case, it is preferable that the corporate ostracism be initially applicable because, for those firms that are already publicly traded, it is much easier to opt out of the corporate ostracism than to opt in.

That agency problems within the firm may well prevent publicly traded corporations from adopting the corporate ostracism midstream has already been explained above.[235] In particular, once a firm is controlled by an undesirable controller, that controller is very unlikely to vote for a charter amendment introducing the corporate ostracism.[236]

By contrast, opting out of the corporate ostracism via a midstream charter amendment seems a more manageable task. Admittedly, agency problems can occur in

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229. *See supra* Part VIII.D.1.

230. Another way of addressing these problems would be to include in state corporation statutes an opt-in provision that lays down detailed rules governing the corporate ostracism. In other words, the legislature could provide a rule governing the corporate ostracism without turning the right to ostracize the controller into the legal default. Such opt-in rules are used in other contexts as well. For example, section 216 of the Delaware General Corporation Law contains an opt-in provision on cumulative voting. DEL. CODE ANN. tit. 8, § 216 (2007). Rules of this type enable their users to avoid drafting costs and to at least reduce marketing costs. Moreover, they increase the likelihood that those firms opting out of the legal default will be subject to the same rule—namely, the one laid down in the opt-in provision—thereby making it possible for the rule's users to reap the resulting network benefits. *Cf.* Klausner, *Corporations, Corporate Law*, *supra* note 207, at 840 (noting that statutory menus of optional terms can be used "to promote coordination where network externalities make coordination valuable"). Against this background, introducing the right to ostracize the controller as an opt-in rule would be vastly preferable to the current status quo. However, turning the corporate ostracism into a default is likely to yield even greater benefits since, as explained below, this would at least reduce the agency problems that prevent companies from choosing the corporate ostracism.

231. *See supra* Part VIII.D.2.b (discussing agency conflicts in IPO firms).

232. *See supra* Part VIII.D.2.b.

233. Even where the benefits of staying with the legal default equal the costs of doing so, some parties may prefer the default. *Cf.* Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608, 612 (1998) (suggesting that "contracting parties view default terms as part of the status quo, and they prefer the status quo to alternative states, all other things equal").

234. *Cf.* Black, *Is Corporate Law Trivial?*, *supra* note 223, at 571 (noting that some charter terms may have little relevance to the firm at the time of the IPO but may become important at a later stage).

235. *See supra* Part VIII.D.2.

236. *See supra* Part VIII.D.2.

this context, too. After all, under the proposal set forth in this Article, opting out of the corporate ostracism requires the approval of the minority shareholders. That creates an obvious problem: To the extent that the corporation already has a controlling shareholder, a disproportionate part of the benefits of opting out of the corporate ostracism may accrue to the controller. Hence, even where the benefits of that decision outweigh its costs, the minority shareholders may not find it in their personal interest to approve of the opting out decision.

However, it will often be possible to overcome this agency problem because it is practically feasible for the controlling shareholder to offer the minority shareholders adequate compensation in exchange for approving the opt out.[237] For example, the board resolution providing for an opt out can be bundled with a board resolution according to which additional shares are issued to the minority shareholders at a discount.[238]

2. Publicly Traded Firms

The question remains whether the corporate ostracism should also be the default rule for those corporations that are already publicly traded at the time when the legislation introducing the ostracism is enacted. There is no easy answer to this question.

On the one hand, the application of the corporate ostracism has considerable allure. As pointed out above, agency problems may prevent publicly traded corporations from adopting the corporate ostracism, even where its benefits exceed its costs.[239] By designating the corporate ostracism as the default rule for all publicly traded corporations, one can overcome the hurdle that these agency problems cause.

On the other hand, there are also considerable drawbacks to such an approach. Perhaps most importantly, applying the corporate ostracism to corporations that are already publicly traded would, as a practical matter, necessitate federal intervention. If Delaware or some other state were to try to adopt legislation of the type at issue, abusive controllers could simply use their control to have the corporation reincorporate elsewhere before the relevant legislation enters into force. Thus, the right to ostracize the controller would be useless. Federal intervention would solve the problem, but, as others have convincingly argued, it is generally preferable to leave corporate law to the states.[240]

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237. As explained above, Coasian bargains of this type seem far less feasible in cases where the minority shareholders seek an undesirable controller's approval of a charter amendment that opts into the corporate ostracism. *See supra* Part VIII.D.2.

238. At most, one might be concerned about signaling effects. Given that the minority shareholders have imperfect information regarding the future plans of the controller, they might read his decision to opt out of the corporate ostracism as a signal that he plans to exploit the minority shareholders. To the extent that a controller with benign intentions cannot credibly signal his benign intentions, the minority shareholders will "overcharge" him for their consent to the charter amendment, which may prevent some desirable opt outs. However, in practice, there will often be reasons why the corporate ostracism is inappropriate for a particular corporation; by explaining these reasons to the minority shareholders, the controller may be able to make his benign intentions credible.

239. *See supra* Part VIII.D.2.

240. *Cf.* EASTERBROOK & FISCHEL, *supra* note 224, at 222 (arguing that state competition constrains managerial opportunism); ROBERTA ROMANO, THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION 63–64 (2002) (concluding that state competition in corporate law benefits shareholders). Of course, this benign view of state lawmaking has not gone unchallenged. For a different view see, Lucian Arye Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111, 130 (2001) (blaming state competition for excessive protection against hostile takeovers); Lucian A. Bebchuk & Assaf Hamdani, *Federal Corporate Law: Lessons from History*, 106 COLUM. L. REV. 1793, 1798 (2006) ("Federal policymakers should . . . abandon the presumption that corporate affairs should

Moreover, there are transaction costs to be considered. Unlike IPO firms, corporations that are already publicly traded will often find it burdensome to amend their charter.[241] Consequently, if the percentage of firms opting out turns out to be high, the total transaction costs are likely to be considerable.

Also, by applying the corporate ostracism to firms that are already publicly traded, the law would redistribute wealth from the controlling shareholders to the minority shareholders. To be sure, pure wealth transfers are not per se inefficient. However, it must be kept in mind that drastic changes in the law, particularly if they are of a redistributive nature, may raise doubts among investors regarding the predictability of the legal environment.[242]

Against this background, it seems preferable to abstain, for now, from designating the corporate ostracism as the default rule with respect to those corporations that are already publicly traded at the time that the relevant legislation is enacted. Of course, should it become clear, over time, that the corporate ostracism is indeed the desirable rule for most publicly traded corporations, then one can always revisit the issue.

3. Summary

In sum, state corporate law should designate the corporate ostracism as the default rule for IPO firms. By contrast, corporations that are already publicly traded at the time when the relevant legislation is enacted should only be subject to the corporate ostracism if they choose to opt in. Once a firm is subject to the corporate ostracism, either because it has gone public after the corporate ostracism was introduced or because it has chosen to opt in, the firm should only be able to opt out if a majority of the minority shareholders approve of the opt out.

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normally be left to the states.").

241. *See, e.g.*, Michael Abramowicz & M. Todd Henderson, *Prediction Markets for Corporate Governance*, 82 NOTRE DAME L. REV. 1343, 1401–1402 (2007) (noting that charter amendments have the potential to be "quite costly"); Jonathan R. Macey & Fred S. McChesney, *A Theoretical Analysis of Corporate Greenmail*, 95 YALE L.J. 13, 40–41 (1985) (pointing out that charter amendments are costly).

242. A different question is whether a federal statute designating the corporate ostracism as the legal default for publicly traded corporations would run afoul of the U.S. Constitution. That seems extremely unlikely. The Compact Clause does not even apply to federal legislation. U.S. CONST. art. I, § 10, cl. 1; *see* Mitchell v. Clark, 110 U.S. 633, 643 (1884) (holding that "no provision of the Constitution prohibits Congress from [interfering with the validity of contracts], as it does the States"). While federal legislation interfering with contracts has to respect the Due Process Clause, "Congress has considerable leeway to fashion economic legislation, including the power to affect contractual commitments between private parties." E. Enters. v. Apfel, 524 U.S. 498, 528 (1998). Even genuinely retroactive legislation, such as legislation imposing liability retroactively, does not violate the Due Process Clause if it "is supported by a legitimate legislative purpose furthered by rational means." Pension Benefit Guar. Corp. v. R. A. Gray & Co., 467 U.S. 717, 729 (1984). It should also be noted that corporate law is, quite generally, not shy in forcing shareholders to accept the loss of their shares. For example, minority shareholders can be frozen out via a merger. Particularly in the context of close corporations, even controlling shareholders may lose their shares against their will. For example, many states allow courts to dissolve close corporations where minority shareholders are being oppressed by those in control. *See, e.g.*, Douglas K. Moll, *Reasonable Expectations v. Implied-in-Fact Contracts: Is the Shareholder Oppression Doctrine Needed?*, 42 B.C. L. REV 989, 999 (2001) (noting that "many state legislatures have amended their corporate dissolution statutes to include 'oppression' by the controlling shareholder as a ground for involuntary dissolution of the corporation"). Indeed, the involuntary dissolution does not even necessarily require wrongdoing on the part of the shareholders. For example, state law often provides that close corporations can be dissolved in case of deadlock. *E.g.*, CONN. GEN. STAT. § 33-896 (2007) (allowing for the dissolution of a corporation if "the directors are deadlocked in the management of the corporate affairs and the shareholders are unable to break the deadlock").

IX. TURNING THE TRANSACTION-CENTERED PROTECTIONS INTO DEFAULT RULES

If the shortcomings of the transaction-centered approach are to be eliminated, it is not sufficient to grant the shareholders the right to expel the controller. Rather, subject to the approval of the minority shareholders, the corporation should also be allowed to opt out of the transaction-centered protections that existing law imposes. In the following, I will first address the mandatory nature of the existing transaction-centered protections before explaining why corporations should be allowed to opt out.

A. The Mandatory Nature of Self-Dealing Rules

That the transaction-centered approach is mandatory under existing law may be surprising at first glance. After all, state corporate law in general[243] and Delaware corporate law in particular[244] are characterized by the prevalence of default rules. Nonetheless, there is broad agreement that the rules on self-dealing are an expression of the duty of loyalty[245] and that the latter is mandatory.[246] Consequently, the self-dealing rules, too, are considered mandatory.[247]

Indeed, the view that the duty of loyalty—and the self-dealing rules that spring from

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243. *See, e.g.*, Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1596 (2005) (noting that "[s]tate corporate law consists principally of enabling provisions that operate as defaults from which firms opt out if tailoring better suits their organizational needs"); Guhan Subramanian, *Fixing Freezeouts*, 115 YALE L.J. 2, 47 (2005) (pointing out that "[t]he structure of corporate law in the United States has evolved . . . to a regime of largely default rules").

244. *See, e.g.*, Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1206 (2002) (noting that "most of the rules provided by Delaware are default rules").

245. *E.g.*, Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1271 (1999) [hereinafter Eisenberg, *Corporate Law and Social Norms*] (noting that "[t]he duty of loyalty is a shorthand expression for the duty of fair dealing by . . . financially interested" directors, officers, and controlling shareholders); Donald E. Schwartz, *In Praise of Derivative Suits: A Commentary on the Paper of Professors Fischel and Bradley*, 71 CORNELL L. REV. 322, 324 (1986) ("The duty of loyalty is concerned with self-dealing."); Randall S. Thomas, *What Is Corporate Law's Place in Promoting Societal Welfare?: An Essay in Honor of Professor William Klein*, 2 BERKELEY BUS. L.J. 135, 139 (2005) (noting that the "prohibition against self-dealing [is] contained in the duty of loyalty"); D. Kyle Sampson, Comment, *The Fiduciary Duties of Corporate Directors to "Phantom" Stockholders*, 62 U. CHI. L. REV. 1275, 1288 (1995) (noting that "[t]he most common duty of loyalty violation involves self-dealing transaction").

246. *E.g.*, Reza Dibadj, *The Misguided Transformation of Loyalty into Contract*, 41 TULSA L. REV. 451, 474 n.173 (2006) (noting that under the Delaware code, the duty of loyalty is mandatory, even though corporations can contract out of the duty of care); Tamar Frankel, *The Delaware Business Trust Act Failure as the New Corporate Law*, 23 CARDOZO L. REV. 325, 340 (2001) (observing that "corporate laws have maintained the duty of loyalty as mandatory"). Of course, because corporate scholarship has traditionally paid more attention to the conflict between managers and shareholders than to the conflict between controlling shareholders and minority shareholders, many of those who mention the mandatory nature of the duty of loyalty specifically refer to the duty of loyalty of directors. *E.g.*, Bebchuk & Hamdani, *Optimal Defaults*, *supra* note 17, at 496 n.16 (2002) (providing "the duty of loyalty of corporate directors" as an example of mandatory corporate governance regulation); Jill E. Fisch, *Picking a Winner*, 20 J. CORP. L. 451, 458 (1995) (reviewing ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993)); *see* Eisenberg, *Corporate Law and Social Norms*, *supra* note 245, at 1274–75 (noting that the duty of loyalty "may be limited in certain respects by agreement," but asserting that it "cannot be waived completely").

247. *See, e.g.*, Black, *Is Corporate Law Trivial?*, *supra* note 223, at 551–53 (citing self-dealing rules as one example of mandatory law); Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1486 (1989) (stating that self-dealing rules are "largely mandatory, at least for publicly held corporations"); Thomas, *supra* note 245, at 139 (stating self-dealing rules are mandatory for public corporations); *see also* Kahan, *The Qualified Case*, *supra* note 210, at 607 n.164 (claiming that the rules on self-dealing by managers are mandatory).

it—are default norms, finds strong support in the wording of section 102(b)(7) of the Delaware General Corporation Law and similar provisions[248] in other states. Under section 102(b)(7), a corporation's certificate of incorporation may limit or eliminate the personal liability of directors for breach of fiduciary duty, but the provision explicitly exempts breaches of the duty of loyalty.[249] Needless to say, if the liability that flows from a breach of the duty of loyalty cannot be limited, then the same must be true for the duty of loyalty itself, or else section 102(b)(7) could easily be circumvented.[250]

At this point, a caveat is in order. Whereas section 102(b)(7) and corresponding provisions in other states deal with the liability of directors, this Article is concerned with the liability of controlling shareholders, and though the latter may sometimes double as the corporation's directors, that does not have to be the case.[251] Consequently, one might be tempted to argue that section 102(b)(7) is of no relevance to the question of whether the controller's duty of loyalty—and the self-dealing rules that flow from it—are mandatory or default norms.

Yet such a line of reasoning would be unconvincing. If the law considers the duty of loyalty of corporate directors to be mandatory, the same must all the more be true for the duty of loyalty of controlling shareholders. After all, Delaware law has long treated self-dealing transactions by corporate controllers even more strictly than self-dealing by corporate directors. Self-dealing transactions by directors, once they have been approved by the shareholders or by independent directors, are generally protected by the business judgment rule.[252] By contrast, self-dealing transactions by controlling shareholders remain subject to the entire fairness standard, even after they have been approved by the minority shareholders[253] or by a committee of independent directors.[254]

Moreover, if the duty of loyalty of controlling shareholders were not considered mandatory, one would have to apply the general rules on charter amendments.[255] That would mean that the corporation could eliminate the duty of loyalty of the controlling shareholder as long as such an amendment is approved by the board and by a majority of the outstanding shares.[256] Of course, a controlling shareholder, especially if he owns a majority of the outstanding shares, has no trouble meeting these requirements. In other words, given the lack of special rules on charter amendments in controlled corporations, controlling shareholders, unlike directors,[257] simply are not constrained by default rules in any meaningful way.

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248. *Cf.* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 633 (2003) (noting that almost 40 other states have enacted statutory provisions imitating section 102(b)(7) of the Delaware code).

249. DEL. CODE ANN. tit. 8, § 102(b)(7) (2007).

250. In the literature, at least some of those who classify the duty of loyalty as mandatory explicitly invoke section 102(b)(7) to justify that conclusion. *E.g.*, Dibadj, *supra* note 246, at 474 n.173 (noting that under the Delaware code, the duty of loyalty is mandatory); Frankel, *supra* note 246, at 340 n.45 (citing the Delaware code to support the proposition that the duty of loyalty remains mandatory).

251. *See* DEL. CODE ANN. tit. 8, § 141(b) (2007) (stating each director "shall be a natural person").

252. Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987).

253. Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985).

254. Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997).

255. *See* DEL. CODE ANN. tit. 8, § 242 (2007) (setting forth the rules governing amendments to the certificate of incorporation).

256. *See id.*

257. Of course, that protection is not perfect. *See, e.g.*, Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 864–65 (2005) (noting that directors can obtain the shareholders' consent to charter amendments that the shareholders dislike by bundling the relevant amendments with other decisions that the shareholders like).

B. The Case Against Mandatory Protections

While the existing rules on controller self-dealing must be considered mandatory, this state of affairs is unsatisfying. A better approach would be to turn the transaction-centered protections into mere default rules. That way, those corporations for whom the transaction-centered protections prove unsuited could reduce or eliminate them and instead rely on alternative protections such as the corporate ostracism.

Technically, the opt out should be undertaken by inserting a provision to this effect in the certificate of incorporation. However, once the corporation has issued shares, any charter amendment seeking to opt out of the transaction-centered protection should require the approval of the minority shareholders. That way, the controlling shareholder cannot unilaterally opt out of the very provisions that are supposed to constrain him.

The reasoning underlying the proposal to strip the transaction-centered protections of their mandatory character is simple: Opting out of the transaction-centered protections can have benefits. It also has potential costs. However, there is no reason why the balancing of costs and benefits cannot be left to the shareholders.

1. Potential Benefits

The decision to opt out of the transaction-centered approach can yield benefits. That becomes clear if one considers the case in which the corporation has opted out of the transaction-centered protections, but is subject to the corporate ostracism.

a. The Lower Limit of Desirable Benefit Extraction

Most importantly, such opting out would essentially solve the free riding problem that the existing rules engender. As explained above, the transaction-centered approach may prevent desirable controllers from emerging because such controllers have to shoulder certain private costs of control and, depending on the circumstances, may be unwilling or unable to extract substantial private benefits that might compensate them.[258]

By opting out of the transaction-centered protections and allowing non-pro-rata distributions to the controller, a corporation could eliminate this problem. In particular, it is noteworthy that the corporate ostracism does not stand in the way of solving the free riding problem. In case of a desirable controller, the corporation can make sufficient distributions to the controller to solve the free riding problem without creating an incentive for the minority shareholders to ostracize him. This can be shown as follows. By definition, control is desirable if its (private and shared) benefits exceed its (private and shared) costs.[259] If that condition is met, then some portion of the benefits of control will remain in the corporation even after the controlling shareholder has extracted private benefits in an amount sufficient to compensate him for the excess of his private costs of control over his independently created private benefits of control. And, as explained above, the controller can avoid being expelled by sharing part of the benefits of control with the other shareholders.[260]

258. *See supra* Part III.C.2. For the sake of clarity, it should be noted that the controller has sufficient incentives to maintain control as long as the sum of his private costs and his share of the shared costs does not outweigh the sum of his private benefits and his share of the shared benefits.

259. *See supra* note 50 and accompanying text.

260. *See supra* Part VII.B.

b. Favoring the Most Desirable Controller

A second advantage pertains to the selection of controllers. Ideally, a controlled corporation should be controlled by the controller whose presence maximizes the net benefits of control.[261] Yet as pointed out above, the transaction-centered approach does not guarantee such an outcome.[262] First, the ability to extract private benefits varies from controller to controller. Hence, control may end up in the hands of the person who is best positioned to extract private benefits rather than in the hands of the person whose presence can be expected to maximize the benefits of control.[263] Second, the costs imposed by the transaction-centered approach are not uniform across all potential controllers. Rather, they tend to be particularly high for those potential controllers who maintain business relationships with the controlled corporation. Consequently, firms of this type are systematically discouraged from becoming controllers.[264]

By opting out of the transaction-centered protections, a corporation that is subject to the corporate ostracism can at least reduce these distortions. That is quite obvious with respect to the distortions that result from the burden which the transaction-centered approach imposes on the corporation's business partners. After all, once controllers no longer have to comply with the transaction-centered protections, they no longer have to bear the relevant costs.[265]

As for the distortions caused by the different levels of benefit extraction, this problem can at the very least be reduced. Concerning the selection of controllers, the problem is not that some controllers can extract more benefits than others. Rather, the problem is that under the transaction-centered approach, less desirable controllers can sometimes extract greater benefits than more desirable controllers, which means that less desirable controllers may sometimes find control to be more profitable than more desirable controllers.[266]

For a corporation that is subject to the corporate ostracism, opting out of the transaction-centered protections goes a long way towards solving this problem. Such a move would allow the controller to extract private benefits in whatever amount he likes, as long as that amount remains below the net benefits that the controller's presence creates for the corporation.[267] That, in turn, means that more desirable controllers—whose presence by definition creates greater net benefits—will be able to extract greater private benefits than less desirable controllers.

2. Potential Costs

Opting out of the transaction-centered approach not only has potential benefits, it also has potential costs. In particular, the alternative protections chosen by the corporation may not prove to be as effective as the transaction-centered protections. In the following, my goal is not to deny this risk. Rather, using the corporate ostracism as an example, I show that the potential costs of replacing the transaction-centered protections with a different approach do not necessarily outweigh the benefits.

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261. *See supra* Part IV.
262. *See supra* Part IV.
263. *See supra* Part IV.A.
264. *See supra* Part IV.B.
265. *But see infra* Part IX.B.2.a (discussing the need to inform the minority shareholders of self-dealing transactions).
266. *See supra* Part IV.A.
267. *See supra* Part VIII.B.1.

a. Adequate Information

The ostracism cannot offer adequate information if the shareholders are unaware of the transactions that take place between the controller and the controlled corporation. While securities law requires some disclosure for related party transactions,[268] it may be necessary to impose more far-reaching disclosure requirements. Needless to say, charter provisions to that effect will increase transaction costs and thereby reduce the benefits of opting out of the transaction-centered protections. Nonetheless, a general requirement to disclose all transactions between the controller and the controlled corporation to the minority shareholders, burdensome though it may be, will often be easier to comply with than the transaction-centered protections.

b. Looting

Another concern must be the possibility of looting. Even if minority shareholders are granted the right to ostracize the controller, there will necessarily be a time lag between the first occurrence of controller misconduct and the ostracization of the controller. That time lag causes an obvious problem: What prevents the controller, while he still controls the corporation, from extracting a huge amount of private benefits in the expectation that these benefits will outweigh any loss incurred as a result of being ostracized?

To remedy this problem, corporations that opt out of the transaction-centered protections should arrange for a limited exception from that opt out. That is, their charters should provide that in case of a successful ostracism, the controller is retroactively subjected to the transaction-centered protections that existing law imposes.

That retroactive application should, in turn, be subject to two limitations. First, to the extent that the controller can prove that his presence benefited the corporation during the time frame at issue, the court should be able to take these benefits into account.

Second, one should exempt from the entire fairness review all those transactions that were properly disclosed and that occurred before a prior opportunity to ostracize the controller was left unused. For example, assume that the minority shareholders fail to initiate ostracization proceedings at the annual meeting in 2005, but ostracize the controller in 2006. In that case, only the controller's self-dealing transactions between the annual shareholder meeting in 2005 and the sale of the controller's stake should be retroactively subjected to an entire fairness review.[269]

These rules would ensure that looting does not pay and that it can be corrected if it occurs anyhow. At the same time, the retroactive application of the transaction-centered protections imposes only a relatively minor burden. After all, it only applies to a limited time frame. More importantly, the financial burdens associated with being ostracized are likely to ensure that controllers will do their best to avoid being ostracized.[270] This in

268. Regulation S-K, 17 C.F.R. § 229.404(a) (2007).

269. While a failure on the part of the minority shareholders to ostracize the controller effectively prevents the retroactive application of the transaction-centered protections for the relevant period, it should be noted that there is a decisive difference between minority shareholder approval under existing law and the failure to ostracize the controller under the framework I suggest here. Within the context of the transaction-centered approach, minority shareholder approval seeks to ensure that a specific transaction is fair. By contrast, under the framework suggested here, it is the overall effect of the controller's presence rather than the fairness of any given transaction that is being judged by the minority shareholders.

270. *Cf. supra* Part VIII.C.2 (explaining that the controller will typically have an incentive to avoid being ostracized).

turn means that—just as in ancient Greece[271]—ostracisms will occur quite rarely.

c. Shareholder Passivity

A potentially more serious problem may result from the rational apathy of small shareholders. For most shareholders, the limited size of their investment in the corporation does not justify the effort to become informed about corporate matters.[272] Needless to say, that may also be true when it comes to evaluating the costs and benefits associated with the presence of a controlling shareholder. Consequently, there is a risk that minority shareholders will fail to make use of the corporate ostracism even in those cases where the controller extracts excessive private benefits.

However, the relevant risk should not be overestimated. Two factors are crucial in this context. First, large shareholders do not suffer from the collective action problems that small investors face,[273] and there will usually be large shareholders other than the controller. This becomes clear as one considers the ownership structure of publicly traded firms. In those corporations where at least one shareholder holds 5% or more of the stock, the accumulated blockholdings average 39%.[274] But on average, only 26% of the outstanding shares are held by the largest stockholder.[275] In other words, on average, another 13% is held by other large shareholders.

Second, and more importantly, there is a simple answer to the problem of rational apathy, an answer that is well-known from the discussion on mergers and takeovers. If shareholders fail to police the controller effectively, the share price will fall. This will prompt informed investors to buy the shares, take the necessary measures such as expelling the controller, and thereby make a profit. Admittedly, as a tool for controlling opportunistic managers, this mechanism has proven to be fraught with problems.[276] Yet as will be shown in the following, these problems are likely to be much less troublesome when it comes to disciplining controlling shareholders via the corporate ostracism.

i. Legal Obstacles

One important reason why the market for corporate control has limited value in curbing managerial opportunism is that the law gives managers access to powerful antitakeover defenses.[277] In theory, controllers might try to use these defenses to deter investors seeking to buy sizable portions of shares in the hope of expelling the controlling

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271. *See, e.g.*, Donald Kagan, *The Origin and Purposes of Ostracism*, 30 HESPERIA 393, 401 (1961) ("In more than ninety years . . . we know of fewer than twenty ostracisms, of which only nine are certain.").

272. *See, e.g.*, Bebchuk, *Limiting Contractual Freedom*, *supra* note 190, at 1837 ("Any shareholder holding a small stake in the company recognizes that his vote is highly unlikely to be pivotal . . . . Such a shareholder does not have sufficient reason to acquaint himself with [a] proposal [to amend the charter]—even if the cost of doing so is fairly small . . . .").

273. *See, e.g.*, Ralph K. Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 DUKE L.J. 945, 966 (1993) ("One method of overcoming the collective action problem is for a substantial block of stock to be acquired in one hand.").

274. Holderness, *Myth of Diffuse Ownership*, *supra* note 141 (manuscript at 38 tbl.1).

275. *Id.*

276. *Cf.* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 522 (1990) (summarizing the factors that make hostile takeovers "a costly and imperfect way to discipline wayward managers").

277. *See, e.g.*, *id.* (noting that hostile takeovers face strong legal obstacles such as poison pills); Edward M. Iacobucci & George G. Triantis, *Economic and Legal Boundaries of Firms*, 93 VA. L. REV. 515, 542 (2007) (noting that takeover defenses "blunt" the disciplinary effect of hostile takeovers).

shareholder. For example, the board, at the behest of the controller, might adopt a poison pill that is triggered whenever an investor acquires a stake of more than 5% in the corporation. However, it is doubtful whether courts would tolerate such an approach.[278] And, in any case, this problem can easily be avoided. As pointed out above, the decision to opt out of the transaction-centered protections needs to be made dependent on the approval of the minority shareholders. Minority shareholders can refuse to grant their approval unless the opt out is coupled with a ban on measures that seek to prevent the influx of blockholders.

ii. Damage Caused by Self-Dealing

Another common criticism of takeovers is that they are purely reactive.[279] A decline in the stock price caused by bad management will only attract a hostile bid if the hostile bidder can hope to make a profit by reversing the relevant decline,[280] and "losses caused by a self-dealing management can seldom be restored."[281] Consequently, the argument runs, hostile takeovers are "largely irrelevant to the problem of self-dealing."[282]

However, this line of reasoning is not all that relevant to the problem at hand. Why, after all, should it be impossible to repair damage caused by controller self-dealing? As pointed out above, a successful ostracism should lead to the retroactive application of the entire fairness standard.[283] Hence, if it is impossible to repair the damage caused by self-dealing on the part of the controller, this impossibility must be due to one of two reasons.

First, the relevant self-dealing transaction may fail to prompt liability under the entire fairness standard, for example, because it is impossible for the minority shareholders to prove that the transaction constitutes self-dealing. In that case, the relevant damage truly cannot be repaired, but the same would be true if the corporation had not opted out of the transaction-centered protections in the first place. Hence, this problem cannot be advanced as an argument against allowing corporations to opt out.

Second, it may be impossible to repair the damage caused by self-dealing because the controller lacks the necessary assets to compensate the corporation for the damage he has caused. In that case, too, the minority shareholders are not worse off than they would be under the transaction-centered approach. After all, the transaction-centered approach, too, fails to protect the minority shareholders where the controller is unable to repair the damage caused by a self-dealing transaction.

Admittedly, one could point out that under the transaction-centered approach, the minority shareholders can at least try to prevent unfair self-dealing transactions via a preliminary injunction.[284] But quite apart from the fact that Delaware courts tend to be

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278. The Delaware Supreme Court has upheld a 20% trigger. Moran v. Household Int'l, Inc., 500 A.2d 1346, 1355 (Del. 1985). In practice, the threshold for triggering a poison pill typically lies between 10% and 20% of the outstanding shares. Guhan Subramanian, *Bargaining in the Shadow of Takeover Defenses*, 113 YALE L.J. 621, 625 (2003).

279. John C. Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1201 (1984).

280. *Id.*

281. *Id.*

282. *Id.*

283. *See supra* Part IX.B.2.b.

284. *See, e.g.*, Sealy Mattress Co. of N.J. v. Sealy, Inc., 532 A.2d 1324, 1342 (Del. Ch. 1987) (granting an injunction to prevent a merger because "misrepresentation, self-dealing, and gross and palpable overreaching [had] been alleged and preliminarily established").

relatively reluctant to issue such injunctions,[285] it is easily possible for the law to remedy the problem at hand. Thus, in cases where there is reason to believe that the controller extracts excessive private benefits that he is unlikely to be able to repay later on, the law can allow the minority shareholders to obtain a preliminary injunction that both orders a special shareholder meeting aimed at the ostracization of the controller and prohibits the latter from extracting any private benefits until the meeting.

iii. The Costs of a Takeover

A final problem with takeovers is that they are both difficult to stage and costly, with the consequence that they will be attempted only where the profits to be made are sufficiently great.[286] Accordingly, one cannot rely on takeovers to correct minor inefficiencies in the management of the target corporation.

However, this line of reasoning does not extend to the corporate ostracism. That becomes clear if one considers the factors that make takeovers costly in the first place. One such factor lies in the availability of antitakeover measures.[287] If a controller needs to buy off incumbent managers to gain control or engage in prolonged legal battles with an uncertain outcome, this will make his quest more expensive. Yet, as pointed out above, there is reason to believe that the incumbent controller will not be able to use such defensive measures to obtain protection against the threat of ostracization.[288] Thus, this particular reason for the costliness of takeovers cannot be extended to the ostracism context.

The costliness of takeovers is also due to the fact that a successful takeover requires the acquisition of a controlling stake. Amassing a controlling stake is expensive, not only because of the accompanying lack of diversification, but also because the rapid acquisition of a large percentage of the outstanding shares typically requires the acquirer to pay a sizable premium.[289] However, that consideration does not apply with equal force to the corporate ostracism. This is because unlike a takeover, a successful ostracism does not presuppose the acquisition of control. Rather, those shareholders trying to ostracize the controller only need to gather a majority of the minority shares. Moreover, given the cost of getting informed and voting, some of the small shareholders usually fail to cast a

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285. *See, e.g.*, Ivanhoe Partners v. Newmont Mining Corp., 533 A.2d 585, 600 (Del. Ch. 1987):

> To obtain the extraordinary remedy of a preliminary injunction, the plaintiffs must demonstrate a reasonable probability that they will succeed on the merits of their claims, that they will suffer imminent irreparable harm if preliminary injunctive relief is denied, and that the harm to the plaintiffs if relief is denied outweighs the harm to the defendants if relief is granted.

Id.

286. *See, e.g.*, Zohar Goshen, *Shareholder Dividend Options*, 104 YALE L.J. 881, 893 (1995) (observing that raiders will emerge in a hostile takeover only if the expected return is greater than the "acquisition expenses"); *see also* Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 870–71 (1991) (calling takeovers "an expensive and inexact monitoring device").

287. *E.g.*, Gilson & Roe, *Understanding the Japanese Keiretsu*, *supra* note 130, at 877 (noting that "the discretion that the Delaware courts and other states' legislatures gave target management . . . made many takeovers too costly to attempt").

288. *Cf. supra* Part IX.B.2.b.1 (listing various factors that make it difficult for the controller to entrench himself).

289. *See, e.g.*, Gilson, *Controlling Shareholders*, *supra* note 9, at 1651 (noting that the large premiums that are necessary for the success of takeovers "make [] them appropriate only for very large problems").

vote.[290] Hence, only a limited part of the outstanding shares will be needed to ostracize the controller.

In sum, the factors that make it expensive to oust undesirable managers via a hostile takeover are far less likely to protect an undesirable controller from being ostracized.

3. Letting the Shareholders Decide

The preceding analysis does not imply that the right to expel the controller will always be sufficient to prevent the controller from going beyond the upper limit of desirable benefit extraction. However, it seems fair to conclude that the corporate ostracism offers minority shareholders a substantial amount of protection.

Against this background, there is no reason to believe that it is always preferable for corporations to be governed by the transaction-centered protections that existing law imposes. Rather, some corporations may be better off eliminating or at least drastically reducing these protections, while relying on the corporate ostracism to protect minority shareholders. Therefore, it makes sense to strip the transaction-centered protections of their mandatory nature and turn them into default rules.

Of course, one might be tempted to argue that the requirement of minority approval is not always sufficient to protect the minority shareholders because small shareholders are rationally ignorant,[291] leading them to approve charter amendments without being properly informed. Yet that concern, too, is ultimately unconvincing. Even if one harbored doubts regarding the ability of minority shareholders to safeguard their own interests, such doubts would be no reason to cling to the mandatory nature of the self-dealing rules. Rather, one would simply have to impose more demanding quorum and majority requirements to ensure that controlling shareholders cannot exploit the passivity of minority shareholders.

C. The Transaction-Centered Protections as the Default

The question remains what the legal default should be with respect to the transaction-centered protections. Should corporations have to opt into the transaction-centered protections, or should they be part of the legal default? In my view, the latter approach is preferable. In other words, the default should be that minority shareholders are protected not only by the corporate ostracism,[292] but also by the transaction-centered protections that existing law imposes.

The reasons are fairly obvious. As pointed out above, the choice of a default rule must take into account both: (1) the question of what rule most parties would choose in the absence of transaction costs and (2) the relative ease with which the parties can opt out of the various rules.[293] In the present context, these considerations suggest that the legal default should include the transaction-centered protections.

Thus, given the potential costs of opting out of the transaction-centered

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290. *See, e.g.*, James McConvill & Mirko Bagaric, *Opting Out of Shareholder Governance Rights: A New Perspective on Contractual Freedom in Australian Corporate Law*, 3 DEPAUL BUS. & COMM. L.J. 255, 313 (2005) (noting that "particularly in larger public companies, many shareholders will simply abstain from voting due to the belief that their vote could not possibly have any impact on the outcome of the resolution").

291. *See, e.g.*, Bebchuk, *Limiting Contractual Freedom*, *supra* note 190, at 1837 (noting that "in a vote on a charter amendment, small shareholders will often lack adequate information").

292. *See supra* Part VIII.E (explaining why the corporate ostracism should constitute the legal default rule).

293. *See supra* Part VIII.E (explaining why the corporate ostracism minimizes transaction costs and is easy to opt out of).

protections,[294] it is not clear that abandoning these protections is desirable for a majority of corporations. Moreover, just as in the case of the corporate ostracism, corporations are likely to find it easier to opt into the transaction-centered protections than to opt out of them: Given the complexity of the transaction-centered protections, there is the risk that corporations trying to provide for such protections in their charters will fail to settle on a uniform version. In addition, given the controller's interest in avoiding the application of the transaction-centered protections, agency conflicts between the controller and the minority shareholders may prevent the corporation from opting into the transaction-centered protections even in those cases where such a course of action would be desirable. Against that background, it seems justified to retain the transaction-centered protections as default rules.[295]

X. CONCLUSION

One of the most central challenges of corporate law is to protect minority shareholders against controllers without sacrificing the benefits that the presence of a controlling shareholder may bring. Traditionally, corporate law has sought to master this challenge by focusing on—and ensuring the fairness of—individual transactions between the controller and the controlled corporation. However, that approach has profound weaknesses. In some cases, it allows the controller to extract excessive private benefits. In others, it subjects the controller to free riding by the minority shareholders. Moreover, the transaction-centered approach distorts the selection of controllers, allowing control to end up in the hands of undesirable or at least less desirable controllers. Finally, it fails to prevent the emergence of those undesirable controllers who are motivated by what I have called the independently created private benefits of control, such as social prestige, rather than by the prospect of extracting benefits from the controlled corporation.

In this Article, therefore, I have presented an alternative approach. As a legal default, minority shareholders should be given the right to expel the controller. That way, controllers could not extract benefits in excess of what their presence yields. Moreover, corporations should be allowed to opt out of the transaction-centered approach if the minority shareholders approve. This would allow corporations to prevent the minority shareholders from free riding at the expense of the controller.

294. *See* Part IX.B.2 (exposing the potential costs of opting out of the transaction-centered protections).

295. That said, the law should also try to facilitate an opt out for those corporations for which opting out is desirable. It can do so by providing an opt-in provision that contains the various rules—such as a duty to disclose self-dealing transactions—that are likely to be desirable for those corporations that are subject to the corporate ostracism and choose to opt out of the transaction-centered protections.