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THE ELUSIVE QUEST FOR GLOBAL GOVERNANCE STANDARDS

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Researchers and shareholder advisers have devoted much attention to developing metrics for assessing the governance of public companies around the world. These important and influential efforts, we argue, suffer from a basic shortcoming. The impact of many key governance arrangements depends considerably on companies' ownership structure: measures that protect outside in-

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vestors in a company without a controlling shareholder are often irrelevant or even harmful when it comes to investor protection in companies with a controlling shareholder, and vice versa. Consequently, governance metrics that purport to apply to companies regardless of ownership structure are bound to miss the mark with respect to one or both types of firms. In particular, we show that the influential metrics used extensively by scholars and shareholder advisers to assess governance arrangements around the world—the Corporate Governance Quotient (CGQ), the Anti-Director Rights Index, and the Anti-Self-Dealing Index—are inadequate for this purpose.

We argue that, going forward, the quest for global governance standards should be replaced by an effort to develop and implement separate methodologies for assessing governance in companies with and without a controlling shareholder. We also identify the key features that these separate methodologies should include and discuss how to apply such methodologies in either country-level or firm-level comparisons. Our analysis has wide-ranging implications for corporate-governance research and practice.

INTRODUCTION

Researchers, investors, and policymakers around the world have been focusing increasingly on corporate governance.[1] There is now widespread recognition that adequate investor protection can substantially affect not only the value of public firms and their performance[2] but also the development of capital markets and the growth of the economy as a whole.[3] This view has naturally led to heightened interest in identifying and bringing about corporate-governance improvements at both firm- and countrywide levels.[4]

These developments also have sparked substantial demand for reliable metrics for evaluating the quality of corporate governance in public firms.[5] Such metrics can facilitate research on corporate governance, inform investment decisions by institutional investors, and guide efforts to improve governance by both private and public decision makers. Both academic researchers and shareholder advisers have made considerable efforts to develop such metrics.[6] These met-

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[1] *See, e.g.*, Stijn Claessens, *Corporate Governance and Development*, 21 WORLD BANK RES. OBSERVER 91, 91 (2006) ("Corporate governance . . . has now become a mainstream concern—a staple of discussion in corporate boardrooms, academic meetings, and policy circles around the globe." (italics omitted)); Yair Listokin, *Interpreting Empirical Estimates of the Effect of Corporate Governance*, 10 AM. L. & ECON. REV. 90, 94 (2008) ("Over the last decade, a series of important empirical articles have evaluated the impact of many levers of corporate governance on firm value and performance.").

[2] *See, e.g.*, Sanjai Bhagat & Brian Bolton, *Corporate Governance and Firm Performance*, 14 J. CORP. FIN. 257, 264-69 (2008) (reporting a correlation between various measures of corporate governance and firms' operating performance); Bernard S. Black et al., *Does Corporate Governance Predict Firms' Market Values? Evidence from Korea*, 22 J.L. ECON. & ORG. 366, 410-11 (2006) (reporting evidence that corporate governance is an important factor in predicting the market value of Korean firms).

[3] *See, e.g.*, Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131, 1139 (1997) (finding evidence that the quality of investor protection affects the size and breadth of capital markets across countries); Ross Levine, *Law, Finance, and Economic Growth*, 8 J. FIN. INTERMEDIATION 8, 24 (1999) (finding that legal systems that protect outsiders can aid economic growth).

[4] *See* Stuart L. Gillan, *Recent Developments in Corporate Governance: An Overview*, 12 J. CORP. FIN. 381, 381 (2006) ("The amount of corporate governance research has increased dramatically during the last decade.").

[5] *See* Sanjai Bhagat et al., *The Promise and Peril of Corporate Governance Indices*, 108 COLUM. L. REV. 1803, 1807 (2008) ("[A] market for corporate governance ratings exists, with proxy-advising firms . . . using ratings to formulate voting recommendations and other governance-rating providers using them to advise on investment decisions.").

[6] For recent reviews of efforts by shareholder-advisory firms to provide commercial governance-ranking services, see *id.* at 1824-26; Robert Daines et al., *Rating the Ratings: How Good Are Commercial Governance Ratings?* 8-14 (John M. Olin Program in Law & Econ., Stanford Law Sch., Working Paper No. 360, 2008), *available at* http://ssrn.com/abstract=1152093.

rics in turn have been used by more than one hundred academic studies, have been extensively utilized by practitioners, and have had a large impact on corporate-governance research and practice.[7]

The notion of a single set of criteria to evaluate the governance of firms around the world is undoubtedly appealing. Both investors and public firms are, after all, operating in increasingly integrated global capital markets. This Article argues, however, that the quest for a single, global governance metric is misguided.

The incidence of controlled and widely held firms varies considerably around the world.[8] In the United States and the United Kingdom, most public companies do not have a controlling shareholder.[9] In most other countries, companies with a controller dominate.[10] The literature has recognized the fundamental differences both in the nature of the agency problems underlying controlled and widely held firms and in the means for addressing these problems.[11] But the criti-

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[7] *See* Bhagat et al., *supra* note 5. In Part I, we review the impact of academic and commercial efforts to develop governance-ranking systems.

[8] For purposes of this Article, we define a controlling shareholder as one who owns or controls sufficient votes to effectively determine vote outcomes and influence corporate decision making. *Cf.* Aronson v. Lewis, 473 A.2d 805, 816 (Del. 1984) (defining domination as "direction of corporate conduct in such a way as to comport with the wishes or interests of [those] doing the controlling" (quoting Kaplan v. Centex Corp., 284 A.2d 119, 123 (Del. Ch. 1971))), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

[9] *See* Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471, 491-93 (1999) (stating that most firms in the United States and United Kingdom are widely held). *But see* Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 REV. FIN. STUD. (forthcoming 2009) (manuscript at 1), *available at* http://rfs.oxfordjournals.org/cgi/reprint/hhm069v1.pdf ("The ownership of U.S. firms is similar to and by some measures more concentrated than the ownership of firms in other countries."). Our analysis holds even if U.S. companies with controlling shareholders are more prevalent than previously thought.

[10] *See* Stijn Claessens et al., *The Separation of Ownership and Control in East Asian Corporations*, 58 J. FIN. ECON. 81, 82 (2000) ("[M]ore than two-thirds of [East Asian] firms are controlled by a single shareholder."); Mara Faccio & Larry H.P. Lang, *The Ultimate Ownership of Western European Corporations*, 65 J. FIN. ECON. 365, 366 (2002) (reporting that only around thirty-seven percent of Western European firms are widely held); Thomas Kirchmaier & Jeremy Grant, *Corporate Ownership Structure and Performance in Europe* 4 (CEP Discussion Paper No. 0631, 2005), *available at* http://ssrn.com/abstract=616201 (finding that firms in continental Europe are dominated by concentrated ownership). Moreover, in many countries around the world, public firms are owned through pyramids or other forms of business groups. *See generally* Tarun Khanna & Yishay Yafeh, *Business Groups in Emerging Markets: Paragons or Parasites?*, 45 J. ECON. LITERATURE 331 (2007) (describing a variety of ownership structures and their prominence throughout the world).

[11] For works discussing differences between the agency problems in widely held and controlled companies, see, for example, Luca Enriques & Paolo Volpin, *Corporate*

cal implications of these differences have not been adequately reflected in either the design or the use of governance metrics.[12]

Because the fundamental governance problems of controlled and widely held firms differ significantly, the effect of many governance arrangements critically hinges on whether the company has a controlling shareholder. Arrangements that enhance investor protection in companies without a controlling shareholder are often inconsequential—or even detrimental—to outside investors in companies with a controlling shareholder, and vice versa. As a result, as we explain in this Article, governance-rating methodologies that use a single metric for assessing investor protection worldwide, at either the firm or the country level, are likely to produce an inaccurate or even distorted picture. Indeed, we demonstrate that this is the case with respect to the most influential and widely used global governance metrics.

Academics and practitioners, we argue, should abandon the effort to develop a single governance metric. Rather, they would do better to develop separate methodologies for assessing the governance of companies with and without a controlling shareholder. Such a two-track approach would best serve researchers, investors, and policymakers in assessing investor protection at either the country level or the firm level. We further identify the key features that these separate methodologies should have, thereby providing the necessary framework for developing and applying a new approach for assessing corporate governance around the world.

Our analysis has wide-ranging implications for corporate-governance research and practice. Among other things, it indicates that researchers may need to reexamine the findings of the large number of academic studies based on existing global governance metrics and reevaluate the governance ratings currently used by institutional investors and shareholder advisers. Furthermore, our analysis

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Governance Reforms in Continental Europe, 21 J. ECON. PERSP. 117 (2007); Ronald J. Gilson & Jeffery N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785 (2003); Henry Hansmann & Reinier Kraakman, *Agency Problems and Legal Strategies*, *in* THE ANATOMY OF CORPORATE LAW 21 (Reinier Kraakman et al. eds., 2004); Howell E. Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence*, J. FIN. ECON. (forthcoming 2009); Mark J. Roe, *The Institutions of Corporate Governance*, *in* HANDBOOK OF NEW INSTITUTIONAL ECONOMICS 371 (Claude Ménard & Mary M. Shirley eds., 2005); Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737 (1997).

[12] *But see* Katharina Pistor, *The Standardization of Law and Its Effect on Developing Economies*, 50 AM. J. COMP. L. 97, 122-123 (2002) (noting that the OECD principles of corporate governance focus on the problems underlying widely-held firms).

provides an approach that can facilitate and improve future governance assessments by researchers and practitioners.

We begin in Part I with an overview of the quest for global governance standards and the most influential global governance metrics. Among academics, the most influential effort has been made by a team of financial economists who put forward successively two indices for measuring countries' level of investor protection, the Anti-Director Rights Index and the Anti-Self-Dealing Index.[13] These indices have been applied by more than one hundred academic studies and have had considerable influence on corporate-governance research.[14] Among practitioners, the most influential effort to date has been RiskMetrics's Corporate Governance Quotient (CGQ) system for rating firms' corporate governance arrangements.[15] The CGQ system has been widely used by investors and pubic firms,[16] and its use among academics is growing.[17]

In Part II, we discuss the relationship between firms' ownership structures and the governance arrangements that would best protect their investors. We begin by describing the basic differences between controlled and widely held firms in terms of the governance problems that their outside investors face. We then analyze the implications

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[13] *See* Simeon Djankov et al., *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430, 432-33 (2008) (creating the Anti-Self-Dealing Index); Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1126-28 (1998) (establishing the Anti-Director Rights Index).

[14] *See, e.g.*, Mark J. Roe, *Legal Origins, Politics, and Modern Stock Markets*, 120 HARV. L. REV. 460, 463-64, 463 n.1 (2006) (describing the influence of the Anti-Director Rights Index and the extensive literature in its aftermath on policymakers at international economic organizations); *see also* Holger Spamann, *'Law and Finance' Revisited* (Harvard Law Sch., John M. Olin Ctr. Discussion Paper No. 12, 2008), *available at* http://ssrn.com/abstract=1095526 (documenting the large number of studies on the Anti-Director Rights Index).

[15] *See* RISKMETRICS GROUP, CORPORATE GOVERNANCE QUOTIENT, http://www.riskmetrics.com/cgq (last visited Mar. 15, 2009).

[16] *See* Jeffrey Sonnenfeld, *Good Governance and the Misleading Myths of Bad Metrics*, ACAD. MGMT. EXECUTIVE, Feb. 2004, at 108, 111.

[17] *See, e.g.*, Craig Doidge et al., *Why Do Countries Matter So Much for Corporate Governance?*, 86 J. FIN. ECON. 1, 11-12 (2007) (using firms' CGQ scores as a proxy for the quality of their corporate-governance arrangements); Vidhi Chhaochharia & Luc Laeven, *Corporate Governance Norms and Practices* (European Corp. Governance Inst., Finance Working Paper No. 165/2007, 2007), *available at* http://ssrn.com/abstract=965733 (studying the relationship between CGQ scores and their components and firm value); Reena Aggarwal & Rohan Williamson, Did New Regulations Target the Relevant Corporate Governance Attributes? 21-24 (Apr. 14, 2006) (unpublished manuscript), *available at* http://ssrn.com/abstract=891411 (reconstructing the CGQ Index to find correlation between governance and firm value).

that these differences have for key sets of governance arrangements: those regulating control contests, voting procedures, the allocation of power between directors and shareholders, the distribution of power among shareholders (i.e., the allocation of power between majority and minority shareholders), director independence, and corporate transactions that may divert value to insiders.

With respect to each of these important areas, we show that the impact of governance arrangements on outside investors depends significantly on whether the firm has a controlling shareholder. As a result, the failure of the Anti-Director Rights Index, the Anti-Self-Dealing Index, and the CGQ system to properly take into account the relationship between ownership structure and corporate governance substantially undermines the indices' ability to serve as effective metrics for the governance quality of firms or countries worldwide.

Consider, for example, antitakeover defenses such as the poison pill. These arrangements determine the extent to which a widely held company is subject, for better or worse, to the discipline of the market for corporate control.[18] In companies with a majority shareholder, however, a hostile takeover is not feasible even in the absence of antitakeover impediments. Thus, even though takeover defenses are consequential for outside investors in widely held firms, they are unimportant in controlled companies. Using a single metric for assessing both firms with and firms without a controller will therefore (1) overlook an important issue for widely held firms to the extent that the metric does not give sufficient weight to antitakeover considerations, (2) give weight to a largely irrelevant issue for controlled firms to the extent that the metric gives significant weight to antitakeover considerations, or (3) produce some combination of both outcomes. Likewise, using a single metric for comparing countries where concentrated ownership is prevalent to those where widely-held firms dominate, or more generally, countries that have a different mix of these two types of firms, is likely to produce results that would be inaccurate for many purposes.

Our analysis should be distinguished from another type of criticism that can be raised against existing governance metrics. Some writers question the value of *any* attempt to assess firms' corporate governance based on objective, externally verifiable criteria. They ar-

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[18] *See* John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271, 338 (2000) (noting the limited nature of the empirical research done on takeover defenses).

gue that any useful governance evaluation must take into account a rich set of dimensions (such as the character of the individuals involved) that can only be assessed subjectively.[19] In contrast, we do not question the feasibility of developing a methodology for large-scale governance assessments based on objective criteria. Rather, our critique is constructive: we seek to advance the project of developing governance metrics based on objective and generally applicable criteria, not to abandon it altogether.

We therefore discuss in Part III how the assessment of corporate-governance arrangements should proceed. We argue that academics and practitioners should seek to develop separate systems—one for controlled and another for widely held firms—with each based on a set of objective and externally verifiable dimensions. We contribute to this effort by identifying, for both controlled and widely held firms, which governance dimensions should occupy an important role and—no less important—which dimensions should not. When assessing an individual company, one should use the rating methodology that fits the company's ownership structure. We also discuss how one should use these separate systems to assess investor protection at the country level. Specifically, we explain why keeping separate scores for how a country protects investors in companies with and without a controlling shareholder is valuable for researchers, policymakers, and investors.

For ease of exposition, we shall refer throughout to companies with a controlling shareholder as "CS companies" and to those without a controller as "NCS companies." At the outset, we should acknowledge that some public companies lie in the gray area between these two pure types because they have a dominant shareholder with substantial influence but not a complete lock on control. We leave for another day the refinement of our analysis necessary for extending it to such companies. Here we wish to focus on the task that we view as most important and pressing given current practices: designing appropriate evaluation systems for the numerous public companies

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[19] *See, e.g.*, Bhagat et al., *supra* note 5, at 1808 ("[T]here is no one 'best' measure of corporate governance: The most effective governance institution depends on context and on firms' specific circumstances."); Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 887, 908 (2007) (arguing that one-size-fits-all methodologies "may not capture relevant nuances in corporate governance policies and behaviors"); *see also* J. Harold Mulherin, *Corporations, Collective Action and Corporate Governance: One Size Does Not Fit All*, 124 PUB. CHOICE 179, 180 (2005) ("The multidimensional nature of corporate governance indicates that the focus in many reform proposals on a narrow set of mechanisms ignores the substitutability and complementarity provided by the broad set of forces operating on the corporation.").

around the world that can easily be classified as either CS or NCS. These companies should be subject to the separate evaluation systems that we advocate, not to a single, global governance metric.

I. THE QUEST FOR GLOBAL STANDARDS

A. *The Demand for Global Standards*

In recent years, corporate governance has become an important topic for academics, institutional investors, and policymakers. There is a widespread belief that the quality of corporate governance and investor protection can affect the performance of firms and economies. At the firm level, inadequate investor protection may reduce firm value and increase firms' cost of capital.[20] At the country level, inadequate investor protection may impede stock market development and undermine financial growth.[21]

Not surprisingly, the growing recognition of corporate governance's importance has sparked substantial interest in measuring the quality of corporate-governance arrangements across firms and countries. Scholars have sought such measures to study the link between corporate governance and economic outcomes for both firms and economies.[22] Policymakers—including those affiliated with the World Bank, the Organisation for Economic Co-operation and Development (OECD), and the International Monetary Fund (IMF)—have been attracted to the promise of metrics that can facilitate efforts to improve countries' investor-protection systems and to assess their progress in doing so.[23] Finally, the growth of institutional investing and investors'

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[20] *See* Doidge et al., *supra* note 17, at 2 ("Better governance enables firms to access capital markets on better terms, which is valuable for firms intending to raise funds.").

[21] *See* Thorsten Beck & Ross Levine, *Legal Institutions and Financial Development* 32 (Nat'l Bureau of Econ. Research, Working Paper No. 10417, 2004), *available at* http://ssrn.com/abstract=476083 (citing studies showing a positive correlation between legal institutions that protect property rights and firm- and stock-price efficiency).

[22] *See, e.g.*, Lucian Bebchuk et al., *What Matters in Corporate Governance?*, 22 REV. FIN. STUD. 783 (2009) (documenting the negative effect of certain "entrenchment" corporate-governance practices); Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 110-14 (2003) (measuring the effects of different corporate-governance provisions on equity prices).

[23] For example, the World Bank's "Doing Business" survey, which provides objective measures of business regulations and their enforcement across 181 economies, relies on the Anti-Self-Dealing Index, which we discuss below, to measure countries' level of investor protection. *See* Doing Business, Protecting Investors, http://www.doingbusiness.org/MethodologySurveys/ProtectingInvestors.aspx (last visited Mar. 15, 2009). The IMF's Financial Sector Assessment Program uses the World

increased attention to corporate governance has induced shareholder advisers to develop governance metrics that could inform investment decisions in companies around the world.[24]

A comprehensive effort to survey all existing metrics and methodologies for assessing governance arrangements around the world would require substantial space and, we believe, is unnecessary for establishing our main points. It will be useful, however, to illustrate these points by reference to commonly used metrics. Section B discusses the most influential ranking system developed by a shareholder adviser—RiskMetrics's CGQ system. Section C describes the most influential global metrics developed by academics—the Anti-Director Rights Index and the Anti-Self-Dealing Index.

B. *Shareholder Advisers' Efforts: The CGQ System*

RiskMetrics is the world's dominant provider of shareholder-advisory services to institutional investors.[25] Prior to being acquired by RiskMetrics in 2007, its shareholder-advisory services operated independently as Institutional Shareholder Services (ISS).[26] When going public in 2007, RiskMetrics reported that it "served approximately 1150 financial institutions that together manage an estimated $20 trillion,"[27] provided research coverage on more than 7400 U.S.-based companies and approximately 22,000 non-U.S. companies,[28] and had issued vote recommendations for more than 38,000 shareholder meetings across

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Bank's Doing Business database to assess countries' level of investor protection. *See* IMF, FINANCIAL SECTOR ASSESSMENT: A HANDBOOK 74 box 4.1 (2005), *available at* http://www.imf.org/external/pubs/ft/fsa/eng/pdf/ch04.pdf.

[24] *See, e.g.*, Marco Becht et al., *Corporate Governance and Control* 4-13 (European Corp. Governance Inst., Finance Working Paper No. 02/2002, 2005), *available at* http://ssrn.com/abstract=343461 (noting the impact of institutional investors' growing presence and the demand for governance-related services).

[25] *See, e.g.*, U.S. GOV'T ACCOUNTABILITY OFFICE, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING 8 (2007), *available at* http://www.gao.gov/new.items/d07765.pdf (describing ISS as "the dominant advisory firm" and perhaps even "a potential barrier to competition in this industry"); Rose, *supra* note 19, at 889-90 (reporting some executives' belief that RiskMetrics—then ISS—"may control a third or more of the shareholder votes" in the industry).

[26] RiskMetrics Group, Inc., Amended Registration Statement for Face-Amount Certificate Companies (Form S-1/A), at 14, 87 (Nov. 2, 2007), *available at* http://investor.riskmetrics.com/phoenix.zhtml?c=215573&p=irol-sec (click "last"; then choose document).

[27] *Id.* at 87.

[28] *Id.* at 88.

100 countries during the preceding year.[29] It is widely assumed that RiskMetrics's voting recommendations can affect vote outcomes,[30] and academic studies on the effects of shareholder advisers commonly focus on RiskMetrics's recommendations.[31]

Since 2002, ISS and RiskMetrics have offered a corporate-governance-rating system named the Corporate Governance Quotient. RiskMetrics currently rates the governance arrangements of more than 7400 companies in more than thirty markets.[32] Many institutional investors receive these ratings as part of their subscription to RiskMetrics's services.[33] Given the dominance of RiskMetrics in the proxy-advisory market, it is not surprising that its CGQ ratings receive much attention in the marketplace.[34] Law firms advise their public-

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[29] *Id.* at 87.

[30] *See* Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681, 693 (2007) ("Getting a favorable ISS recommendation is therefore frequently essential to victory."); *see also* Jie Cai et al., *Electing Directors*, J. FIN. (forthcoming 2009) (manuscript at 4), *available at* http://ssrn.com/abstract=1101924 (finding that directors with negative ISS recommendations receive nineteen percent fewer votes than other directors); Ying Duan, The Role of Mutual Funds in Corporate Governance: Evidence from Mutual Funds' Proxy Voting and Trading Behavior 2 (Jan. 2008) (unpublished manuscript), *available at* http://ssrn.com/abstract=1028367 (stating that mutual funds are more likely to vote against management than to sell when management's recommendations on proposals conflict with those of ISS).

[31] *See, e.g.*, Stephen Choi et al., *Director Elections and the Influence of Proxy Advisors* 1 (NYU Ctr. for Law, Econ., & Org. Working Paper No. 08-22, 2008), *available at* http://ssrn.com/abstract=1127282 (noting that ISS was "claimed to sway" between twenty and thirty percent of proxy votes); Cindy R. Alexander et al., The Role of Advisory Services in Proxy Voting 2 (2006) (unpublished manuscript), *available at* http://ssrn.com/abstract=966181 (quoting one Merrill Lynch analyst describing an ISS recommendation, "If it had gone the other way, the deal would have been dead. Now, it's a horse race.").

[32] *See* RISKMETRICS GROUP, FREQUENTLY ASKED QUESTIONS ABOUT CORPORATE GOVERNANCE QUOTIENT, http://www.riskmetrics.com/sites/default/files/CGQ%20FAQ.pdf (last visited Mar. 15, 2009).

[33] *See* Daines et al., *supra* note 6, at 2, 4 (reporting varied empirical accounts of the influence of governance ratings and noting that RiskMetrics was the largest commercial rater).

[34] *See* Rose, *supra* note 19, at 898-99 ("Proxy advisers generally base their decisions on corporate governance standards that are derived from the same policies as those used to formulate governance ratings and related governance advice."); *see also* INSTITUTIONAL S'HOLDER SERVS., ISS US CORPORATE GOVERNANCE POLICY 2007 UPDATES 24 (2007), *available at* http://www.riskmetrics.com/sites/default/files/2007_US_Policy_Update.pdf (describing steps taken to align governance ratings with the company's voting policy).

company clients on how to improve their CGQ scores,[35] public companies with high CGQ scores boast about them,[36] RiskMetrics offers public companies fee-based consulting services for improving their CGQ scores,[37] and the popular "Yahoo! Finance" web site includes CGQ scores in companies' online profiles.[38]

Although the CGQ system was developed by a commercial-shareholder adviser, academics increasingly use it as a measure of the quality of firms' governance arrangements. Researchers, for example, have analyzed the link between RiskMetrics's governance scores and firm performance,[39] tried to assess which CGQ factors affect firm valuation,[40] and used companies' CGQ scores to study governance differences between banking and nonbanking firms.[41]

Although RiskMetrics has one set of criteria (also referred to as factors) for rating U.S. firms and another set for rating non-U.S. firms, the two sets largely overlap. Both divide corporate-governance factors into eight categories: board (including board size and the nominating committees); audit; charter/bylaws (including features such as poison pills and special meetings); antitakeover provisions; executive and director compensation; progressive practices (for example, CEO-succession planning); ownership (including board-performance re-

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[35] *See, e.g.*, MICHAEL J. KOLAR & ANDREW J. NEUHARTH, OPPENHEIMER WOLFF & DONNELLY LLP, WHAT'S YOUR "CGQ" IQ? WHAT EVERY CORPORATE EXECUTIVE SHOULD KNOW ABOUT THE CORPORATE GOVERNANCE QUOTIENT (2007), *available at* http://www.oppenheimer.com/newsletters/CGQ_IQ.pdf.

[36] *See, e.g.*, Alliant Techsystems Inc., Corporate Governance, http://www.atk.com/CorporateGovernance/corpgov_commitment.asp (last visited Mar. 15, 2009) (proudly touting its CGQ score).

[37] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING 10 (2007), *available at* http://www.gao.gov/new.items/d07765.pdf (noting that ISS "offers corporate governance consulting services to help clients understand and improve their corporate governance ratings").

[38] *See, e.g.*, Yahoo! Finance, Microsoft Corporation, http://finance.yahoo.com/q/pr?s=MSFT (last visited Mar. 15, 2009).

[39] *See, e.g.*, Ruth W. Epps & Sandra J. Cereola, *Do Institutional Shareholder Services (ISS) Corporate Governance Ratings Reflect a Company's Operating Performance?*, 19 CRITICAL PERSP. ON ACCT. 1135 (2008) (presenting methodology for comparing CGQ scores and corporate performance and concluding that there is no relationship).

[40] *See* Lawrence D. Brown & Marcus L. Caylor, *Corporate Governance and Firm Valuation*, 25 J. ACCT. & PUB. POL'Y 409, 411 (2006) (identifying seven governance factors that are the key drivers of the link between governance and valuation).

[41] *See* Chenchuramaiah Bathala et al., *Industry Differences in Corporate Governance: The Case of Banking and Non-Banking Firms*, 13 ICFAI J. APPLIED FIN. 17 (relying on CGQ scores to study governance differences between bank and nonbank firms).

view and stock ownership by directors); and director education. Both sets include similar criteria within each of the eight areas.[42]

The CGQ system rates the performance of any given company with respect to each factor and then uses this rating to produce both a raw score for the company and a relative score that rates the company in comparison to others in the same investment index or industry group.[43] For our purposes, the key feature of the CGQ system is that it applies the same criteria to companies that do and do not have a controlling shareholder. As we shall show in subsequent sections, this uniform approach is unwarranted.

Perhaps because RiskMetrics is headquartered in the United States, where CS companies are less common, a significant fraction of the CGQ factors may be valuable for outside investors in NCS companies but are irrelevant, or even harmful, for investor protection in CS companies. Whatever the reason for this feature, we shall show that the CGQ system clearly illustrates the problems that arise when a single metric is used for assessing governance around the world.

C. *Academics' Efforts: The Anti-Director Rights Index and the Anti-Self-Dealing Index*

Among academic researchers, the most influential metric for evaluating governance arrangements worldwide has been the Anti-Director Rights Index, developed by a team of four financial economists. More recently, three members of this team joined a World Bank economist to construct a new metric, the Anti-Self-Dealing Index, as an alternative to the Anti-Director Rights Index.

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[42] For a list of the U.S. governance attributes, see RISKMETRICS GROUP, SUMMARY: CGQ RATINGS CRITERIA FOR US COMPANIES, http://www.riskmetrics.com/sites/default/files/CGQ_Criteria_US.pdf (last visited Mar. 15, 2009) [hereinafter RISKMETRICS, U.S. CRITERIA]. For a list of the non-U.S. governance variables, see RISKMETRICS GROUP, SUMMARY: CGQ RATINGS CRITERIA FOR NON-US COMPANIES, http://www.riskmetrics.com/sites/default/files/CGQ_Criteria_exUS.pdf (last visited Mar. 15, 2009) [hereinafter RISKMETRICS, NON-U.S. CRITERIA]. A more detailed description of the U.S. CGQ factors may be found in RISKMETRICS GROUP, CGQ BEST PRACTICES MANUAL (US) (2008) [hereinafter, RISKMETRICS, U.S. BEST PRACTICES]. A more detailed description of the non-U.S. CGQ factors may be found in RISKMETRICS GROUP, CORPORATE GOVERNANCE QUOTIENT: INDICATOR DEFINITIONS (NON-U.S. COMPANIES) (2007) [hereinafter, RISKMETRICS, NON-U.S. INDICATOR DEFINITIONS]. The latter two documents may be requested from RiskMetrics at http://www.riskmetrics.com/contact.

[43] *See* RISKMETRICS GROUP, CORPORATE GOVERNANCE QUOTIENT: METHODOLOGY, http://www.riskmetrics.com/cgq/methodology (last visited Mar. 15, 2009).

1. The Anti-Director Rights Index

In a 1998 article titled *Law and Finance*, four financial economists—La Porta, Lopez-de-Silanes, Shleifer, and Vishny (commonly referred to in subsequent work as LLSV)—developed the Anti-Director Rights Index and used it to study and compare investor protection across forty-nine countries.[44] Their findings sparked a vast academic literature. Indeed, academics have thus far used the Anti-Director Rights Index in almost one hundred cross-country quantitative studies,[45] for example, to examine the association between investor protection and firm valuation, voting premia, firm-level corporate-governance mechanisms, the prevalence of earnings management, and the depth of financial crises.[46] The use of the index has not been

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[44] La Porta et al., *supra* note 13; *see also* Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3, 24 (2000) (arguing that strong investor protection is empirically linked with "valuable and broad financial markets"); La Porta et al., *supra* note 3, at 1132 ("We compare external finance across 49 countries as a function of the origin of their laws, the quality of legal investor protections, and the quality of law enforcement."). *See generally* Rafael La Porta et al., *The Economic Consequences of Legal Origins*, 46 J. ECON. LITERATURE 285, 286-87 (2008) [hereinafter La Porta et al., *Economic Consequences*] (developing a "Legal Origins Theory" based on historical differences between various legal traditions).

[45] *See* Spamann, *supra* note 14, at 1-3 (reporting that the Anti-Director Rights Index has been used in almost one hundred such studies but challenging the accuracy of the underlying data).

[46] *See generally* Art Durnev & E. Han Kim, *To Steal or Not to Steal: Firm Attributes, Legal Environment, and Valuation*, 60 J. FIN. 1461 (2005) (studying the extent of variation between firm governance and the strength of the legal regime); Simon Johnson et al., *Corporate Governance in the Asian Financial Crisis*, 58 J. FIN. ECON. 141, 142 (2000) (presenting "evidence that the weakness of legal institutions for corporate governance had" an impact on the Asian financial crisis); Rafael La Porta et al., *Investor Protection and Corporate Valuation*, 57 J. FIN. 1147 (2002) (analyzing the theoretical and empirical effects of investor protection on firm valuation); Tatiana Nenova, *The Value of Corporate Voting Rights and Control: A Cross-Country Analysis*, 68 J. FIN. ECON. 325 (2003) (examining control premia); Christian Leuz et al., *Earnings Management and Investor Protection: An International Comparison*, 69 J. FIN. ECON. 505, 506 (2003) (providing "comparative evidence on corporate earnings management across 31 countries"). More recent studies have also explored these themes. *See, e.g.*, Jay Dahya et al., *Dominant Shareholders, Corporate Boards, and Corporate Value: A Cross-Country Analysis*, 87 J. FIN. ECON. 73, 73-76 (2008) (examining the role of board composition and independent directors in relation to external investor protections in firms with a dominant shareholder); Ivalina Kalcheva & Karl V. Lins, *International Evidence on Cash Holdings and Expected Managerial Agency Problems*, 20 REV. FIN. STUD. 1087, 1087-88 (2007) (finding a relationship between cash management and firm valuation when external investor protection is weak but not when it is strong); Mariassunta Giannetti & Yrjö Koskinen, Investor Protection, Equity Returns, and Financial Globalization 1-3 (Mar. 2008) (unpublished manuscript), *available at* http://ssrn.com/abstract=942513 (arguing that weak investor-protection mechanisms create an incentive for shareholders to purchase controlling stakes).

limited to corporate-finance research but has extended to the study of other issues, such as financial integration[47] and the relationship between risk sharing and industrial specialization.[48]

The Anti-Director Rights Index consists of six components.[49] Three focus on shareholder voting rights: the requirement that shareholders deposit their shares before a shareholder meeting, the ability of shareholders to cast a vote by mail, and the minimum percentage of share ownership that allows a shareholder to call a special shareholder meeting.[50]

A fourth component focuses on shareholders' preemptive rights—whether the law grants shareholders the first opportunity to buy new issues of stock (unless the shareholders have waived their right by a vote).[51] A fifth component focuses on cumulative voting—whether there is a mechanism by which minority interests may name a proportional number of directors to the board.[52] The final component, often referred to as "oppressed minority mechanisms," focuses on whether minority shareholders objecting to fundamental changes (such as mergers, asset dispositions, and changes to the articles of incorporation) have a right to challenge those decisions in court or to "exit" by requiring the company to purchase their shares.[53]

As we will explain, the Anti-Director Rights Index cannot provide an adequate measure of investor-protection levels around the world. Most notably, three of the index's components—shareholders' ability to vote by mail, to vote without depositing shares, and to call a special meeting—are largely irrelevant to companies with a controlling shareholder: in such companies, regardless of the voting arrangements in place, minority shareholders normally will lack effective power either to pass resolutions that the majority shareholder opposes or to block resolutions that the majority shareholder favors.

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[47] *See* Jean Imbs, *The Real Effects of Financial Integration*, 68 J. INT'L ECON. 296, 318-19 (2006) (including the Anti-Director Rights Index in the calculation of financial integration).

[48] *See* Sebnem Kalemli-Ozcan et al., *Risk Sharing and Industrial Specialization: Regional and International Evidence*, 93 AM. ECON. REV. 903 (2003) (using the indices as part of a study of industrial specialization).

[49] *See* La Porta et al., *supra* note 13, at 1127-28.

[50] *Id.* at 1127.

[51] *Id.* at 1128.

[52] *Id.*

[53] *Id.* In addition to the Anti-Director Rights Index, LLSV also take into account two variables: "one share, one vote" and "mandatory dividends." *See* La Porta et al., *supra* note 13, at 1122-23.

To be sure, as we will discuss in Part II, these voting arrangements may not be the most important governance provisions even in NCS companies, but they do provide some protection for outside investors in such companies. This is not the case for CS companies. Thus, the Anti-Director Rights Index well illustrates our thesis concerning the problems involved in using investor-protection measures that purport to apply to all companies regardless of their ownership structure.[54]

2. The Anti-Self-Dealing Index

Three of the designers of the Anti-Director Rights Index recently teamed with a World Bank economist (together commonly referred to as DLLS) to develop a new index.[55] The DLLS team offered this Anti-Self-Dealing Index as a superior alternative to the Anti-Director Rights Index.[56] Although relatively new, the Anti-Self-Dealing Index has already been used significantly in research by financial economists.[57]

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[54] Commentators have questioned the Anti-Director Rights Index on a variety of grounds. Some argue that the index does not capture all the arrangements that are important for investor protection. *See* John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Role of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 4 n.6 (2001) (arguing that the shareholder rights captured by LLSV "supply only partial and sometimes easily outflanked safeguards, which have little to do with the protection of control and the entitlement to a control premium"). Others argue that the index adopts a U.S.-centric approach. *See* Priya P. Lele & Mathias M. Siems, *Shareholder Protection: A Leximetric Approach,* 7 J. CORP. L. STUD. 17, 20-21 (2007) (noting that the inclusion of variables like cumulative voting and the exclusion of variables like director entrenchment reflect a U.S. bias). Lawyers have been skeptical of the attempt to use a single measure for evaluating the quality of legal protection across countries and have identified some mistakes. *See, e.g.*, Udo C. Braendle, *Shareholder Protection in the USA and Germany—"Law and Finance" Revisited,* 7 GERMAN L.J. 257, 258 (2006) (arguing that LLSV did not adequately consider German company law); Luca Enriques, *Do Corporate Law Judges Matter? Some Evidence from Milan*, 3 EUR. BUS. ORG. L. REV. 765, 769-83 (2002) (U.K.) (evaluating differences between corporate law on and off the books and the impact of enforcement). Others explore the methodological difficulties associated with coding such legal variables. *See, e.g.,* Spamann, *supra* note 14 (attempting, and failing, to replicate the data presented by LLSV). Our thesis, however, is markedly different. We argue that any attempt to develop a single measure for evaluating corporate governance for both controlled and widely held firms is inherently misguided.

[55] Djankov et al., *supra* note 13.

[56] *See id.* at 432 (discussing improvements vis-à-vis the Anti-Director Rights Index).

[57] *See* Doidge et al., *supra* note 17, at 16 (using the Anti-Self-Dealing Index as a measure of investor rights); Valentina G. Bruno & Stijn Claessens, *Corporate Governance and Regulation: Can There Be Too Much of a Good Thing?* 14 (European Corp. Governance Inst., Working Paper No. 142/2007, 2006), *available at* http://ssrn.com/abstract=956329 (using the Anti-Self-Dealing Index as a measure of investor protection); Augusto de la Torre et al., *Capital Market Development: Whither Latin America?*, 7 (World Bank Pol-

This index focuses on the extent to which outside investors are protected from expropriation by insiders using self-dealing transactions, and it includes measures such as disclosure, public enforcement, approval of self-dealing transactions by disinterested shareholders, shareholders' legal standing to challenge a self-dealing transaction in court, and the ability to hold controlling shareholders and directors liable for self-dealing transactions.[58] The DLLS team argued that the Anti-Self-Dealing Index is theoretically grounded and found it to be a more robust predictor of the development of stock markets than the Anti-Director Rights Index.[59]

As we shall explain below, however, the Anti-Self-Dealing Index also cannot provide an adequate yardstick for assessing investor protection around the world. Whereas the Anti-Director Rights Index was shaped largely by reasoning relevant to investor protection for NCS companies, the Anti-Self-Dealing Index focuses on measures relevant primarily to CS companies. As a result, the Anti-Self-Dealing Index ignores dimensions that are quite important for investor protection in NCS companies. To be sure, CS firms are presumably dominant in most countries. Yet, as Part III will explain, researchers assessing a country's level of investor protection should keep separate scores for how well it protects outside investors at CS firms and how well it protects such investors at NCS firms.

II. INVESTOR PROTECTION AND OWNERSHIP STRUCTURE

We now turn to analyzing the relationship between ownership structure—that is, the presence or absence of a controlling shareholder—and investor protection. As we will explain, differences in ownership structure affect the nature of problems that outside investors face and, in turn, the measures that could be most effective in addressing these problems.

Section A begins by describing the fundamental differences between CS and NCS companies. We then analyze the implications of these differences for different areas of corporate governance. Specifi-

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icy Res. Working Paper Series, Paper No. 4156, 2007), *available at* http://ssrn.com/abstract=967890 (same).

[58] For a detailed description, see Djankov et al., *supra* note 13, at 433-36.

[59] *See* La Porta et al., *Economic Consequences*, *supra* note 44, at 294 ("[A] two–standard deviation increase in the anti-self-dealing index is associated with an increase in the stock-market-to-GDP ratio of 42 percentage points, an increase in listed firms per capita of 38 percent, and a reduction in ownership concentration of 6 percentage points.").

cally, we discuss control contests (Section B), voting procedures (Section C), the allocation of power between the board and shareholders (Section D), the allocation of power between majority and minority shareholders (Section E), director independence (Section F), and arrangements governing potential value diversion (Section G).

A. *Some Fundamental Differences Between CS and NCS Companies*

We begin with some general observations about the fundamental dissimilarities between CS and NCS companies. In particular, we focus on differences in terms of (1) the nature of the agency problem for outside investors, (2) the contestability of control, (3) the ability of a majority of shareholders to exercise their formal power, and (4) the main ways in which opportunism benefits insiders.

1. Nature of the Agency Problem

When outside investors provide capital to a public firm, they face the risk that the insiders who influence the firm's decisions will act opportunistically and advance their own private interests. Although this general problem exists in both CS and NCS firms, these firms differ in the identity of the insiders from whom outside investors need protection.

In NCS companies, shareholders' inability to use effectively their power to monitor officers and directors (to whom we refer collectively as "management") provides management with a significant measure of de facto control. Because management's interests may diverge from those of shareholders, the fundamental concern that governance arrangements need to address is management's potential to behave opportunistically at the expense of shareholders.[60]

In CS companies, in contrast, controlling shareholders commonly have both the effective means to monitor management and the incentives to do so.[61] Thus, to the extent that the controllers have some interests in common with those of outside investors, the controller's

[60] For an in-depth analysis of the divergence of interests between shareholders and management in NCS firms, see generally Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

[61] *See* Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1651 (2006) ("[A] controlling shareholder may police the management of public corporations better than the standard panoply of market-oriented techniques employed when shareholdings are widely held.").

presence lessens the concern that management will act contrary to these interests. Controllers, however, may also have interests that do not overlap with those of outside investors, and they may use their power to advance such interests. In CS companies, therefore, the fundamental concern that needs to be addressed by governance arrangements is the controlling shareholder's opportunism.[62]

2. Contestability of Control

In CS companies, control is not contestable. The controlling shareholder has a lock on control by virtue of its ownership of a majority of the voting rights—or at least a sufficient percentage of voting rights to secure an effective lock on control. In NCS companies, in contrast, control is at least in theory contestable, though the extent to which it is contestable in practice depends on the governance arrangements that we will discuss later.

The difference in contestability has important implications for corporate governance. When an active market for corporate control exists, insiders are subject to the threat of removal if they fail to maximize shareholder value. This disciplinary mechanism, the strength of which depends on the governance arrangements in place, can enhance share value and reduce the need for other mechanisms for constraining management. In CS companies, however, the threat of a control contest does not exist and cannot constrain insider opportunism.

3. Ability of a Majority of Shareholders to Exercise Their Formal Power

In NCS companies, governance arrangements must be assessed against the background of collective action and free-rider problems that often prevent outside shareholders from effectively using whatever formal powers that they have to constrain and influence management.[63] Consider a shareholder with a one-percent stake who is contemplating whether to take an action that would enhance share value. The shareholder may be discouraged by the prospect of having to bear the full cost of taking such an action while capturing only one percent

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[62] *See also* Enriques & Volpin, *supra* note 11, at 117 ("[C]oncentrated ownership can create conditions for a new agency problem, because the interests of controlling and minority shareholders are not aligned.").

[63] *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 66-67 (1991).

of the benefits. The arrangements governing NCS companies must be assessed against the background of collective action and free-rider problems. Put differently, one generally cannot assume that outside shareholders holding a majority of the shares collectively will use their formal powers to advance the course of action that they prefer.

In CS companies, in contrast, the controller is likely to use its formal powers to maximize the value of the shares it owns. The controller will generally capture at least a significant share of the appreciation in value that these actions produce and thus will have significant incentives to exercise power.[64] Accordingly, it is reasonable to assume that controllers will make significant use of their formal powers to advance the course of action that they prefer.

4. The Main Ways in Which Opportunism Benefits Insiders

CS and NCS companies differ not only in the identity of the insiders whose potential opportunism should be constrained, but also in the main ways in which insider opportunism is manifested. Compared to professional managers in NCS companies, controllers often have extra avenues for diverting significant value.

Controllers are often individuals or firms that have businesses other than the public firm in question and considerable outside wealth. This is especially true in the many countries in which a relatively small number of dominant families controls many public companies through pyramids and other forms of business groups.[65] In contrast, professional managers at NCS companies are less likely to own—fully or partly—significant businesses outside the public company that they manage. The ownership of significant outside businesses provides controllers with additional ways to divert value.[66] For controlling shareholders, large self-dealing transactions with other en-

[64] Moreover, for a holder of the majority of the votes, the cost of monitoring and disciplining management is likely to be lower than it is for outside shareholders. For example, directors and officers are more likely to provide a controlling shareholder with information concerning the company's performance, and the controller does not need to communicate with other shareholders to secure a majority of the votes.

[65] *See, e.g.*, Faccio & Lang, *supra* note 10, at 390 tbl.8 (presenting evidence on the prevalence of pyramidal ownership structures in Western Europe); Khanna & Yafeh, *supra* note 10, at 332 ("[I]n virtually all emerging markets, group affiliated firms tend to be relatively large and economically important.").

[66] *See* Vladimir Atanasov et al., *Unbundling and Measuring Tunneling* (Univ. of Tex. Sch. of Law, Law & Econ. Working Paper No. 117, 2008), *available at* http://ssrn.com/abstract=1030529 (discussing the different ways in which controlling persons may extract wealth from firms).

tities affiliated with them and freezeout transactions often provide an important channel for extracting private benefits.[67]

Diversion of value through executive compensation, however, is a concern of lesser importance in CS companies than in NCS companies. First, to the extent that the company's executives are professional managers not affiliated with the controller, the controller generally has an interest in setting executive compensation to maximize shareholder value.[68] Second, even when individuals affiliated with the controller serve in a managerial capacity, the controller may well elect not to maximize diversion through excessive compensation, given its ability to extract private benefits on a larger scale through other means, such as related-party transactions.[69]

There is yet another related difference in the ways that insider opportunism manifests itself in CS and NCS companies. Managerial shirking and empire building are more serious concerns in NCS companies than in CS companies.[70] Such practices provide insiders with

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[67] For evidence on self-dealing involving companies within the same business groups, see, for example, Kee-Hong Bae et al., *Tunneling or Value Added? Evidence from Mergers by Korean Business Groups*, 57 J. FIN. 2695 (2002); Marianne Bertrand et al., *Ferreting Out Tunneling: An Application to Indian Business Groups*, 117 Q.J. ECON. 121 (2002). For a comprehensive analysis of legal issues that arise in the context of freezeout transactions, see generally Guhan Subramanian, *Fixing Freezeouts*, 115 YALE L.J. 2 (2005).

[68] Controllers might use generous compensation arrangements to induce managers to facilitate controllers' value diversion through self-dealing and other transactions. Controllers, however, are often quite influential in making a decision to hire or terminate managers. This means that managers who want to get hired or keep their job have an incentive to cater to the controller preferences even without being paid for their cooperation with value diversion.

[69] Another difference is the role of directors' stock ownership. In NCS companies, stock ownership can incentivize outside directors to monitor management. *See, e.g.*, Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 864 (1993) (arguing that encouraging directors to hold substantial equity interests would provide better oversight incentives). *But see* Assaf Hamdani & Reinier Kraakman, *Rewarding Outside Directors*, 105 MICH. L. REV. 1677, 1682-83 (2007) (arguing that equity pay for directors "cannot substitute for direct monitoring incentives"). In CS firms, however, directors' stock ownership might be less important. If the director is the controller or its affiliate, then equity ownership is unlikely to provide incentives beyond those already provided by owning the control block. Even when the director is independent, however, the incentives provided through stock ownership are likely outweighed by the controller's influence over director elections.

[70] *See* Mike Burkart & Samuel Lee, *The One Share–One Vote Debate: A Theoretical Perspective* 28 (European Corp. Governance Inst., Finance Working Paper No. 176/2007, 2007) ("In spite of stock option plans and the like, compensation packages for top executives typically dwindle in comparison to the equity stakes of most large owners.").

nonpecuniary benefits while reducing share value,[71] and a controller with a large ownership stake will bear a substantial fraction of the costs. A controlling shareholder therefore has an incentive to avoid such actions when managing the company[72] and to prevent them when the company is run by professional managers. Thus, in the presence of a controller with a large ownership stake, managerial shirking and empire building are relatively less important concerns.

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With these four fundamental differences in mind, we now consider the relationship between ownership structure and several key sets of governance arrangements. As our analysis will demonstrate, one should distinguish between CS and NCS companies when assessing each of these key sets of governance arrangements.

B. *Control Contests*

1. The Difference Between CS and NCS Companies

One important difference between CS and NCS companies concerns the potential role of battles for corporate control—that is, hostile takeover bids and proxy contests. Although such contests and the governance arrangements regulating them are quite important for NCS companies, they are largely irrelevant to CS companies.

Anyone approaching governance arrangements from a U.S. perspective finds it natural to assume that the arrangements governing control contests are a key element in the governance of public companies. After all, these arrangements have long occupied a central role in discussions of corporate and securities laws by academics and policymakers in the United States.[73] Textbooks or treatises on United States corporate law devote substantial space to arrangements govern-

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[71] *See* Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 323 (1986) ("Managers have incentives to cause their firms to grow beyond the optimal size.").

[72] *See* David Yermack, *Flights of Fancy: Corporate Jets, CEO Perquisites, and Inferior Shareholder Returns*, 80 J. FIN. ECON. 211 (2006) (finding that firms whose CEOs personally use company jets underperform market benchmarks).

[73] *See* Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973, 974 (2002) ("In the last thirty years, takeover law has been the subject most hotly debated by corporate law scholars.").

ing takeovers and proxy fights .[74] Lawmakers have devoted considerable legislative effort to enacting antitakeover statutes and promulgating regulatory rules governing tender offers and control contests.[75] The Delaware courts have developed an extensive body of takeover case law.[76] Numerous studies by legal scholars, as well as financial economists, focus on the arrangements governing hostile bids and proxy fights.[77] And investors have devoted considerable attention to antitakeover defenses and have made them the subject of a large fraction of all shareholder proposals.[78]

The dominant view among U.S. scholars and shareholder advisers is that firms should adopt governance arrangements that facilitate control contests.[79] Because the threat of a hostile takeover or a proxy fight is commonly viewed as providing an important market-based check on management, a vibrant market for corporate control can reduce the agency problem underlying NCS firms.[80] This view is supported by a substantial body of empirical evidence indicating that exposure to the threat of a hostile takeover is associated with higher firm value and better performance.[81] Such evidence has led U.S. academics

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[74] *See, e.g.*, MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 315-24, 1040-1114 (9th ed. 2005).

[75] *See* Lucian A. Bebchuk & Assaf Hamdani, *Federal Corporate Law: Lessons from History*, 106 COLUM. L. REV. 1793, 1801-02 (2006) (describing three decades of state antitakeover legislation).

[76] *See* Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 248 (1989) (analyzing the standard of review applied by the Delaware courts to defensive measures taken by the target board).

[77] *See generally* Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) (criticizing managerial resistance to premium tender offers); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 819-21 (1981) (noting the conflict of interest that managers face in the tender-offer setting and proposing a structural solution); Lucian A. Bebchuk, Comment, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982) (advocating a rule of auctioneering to promote competition among premium tender offers).

[78] *See* GEORGESON, 2007 ANNUAL CORPORATE GOVERNANCE REVIEW 6 (2007), *available at* http://www.georgeson.com/usa/download/acgr/acgr2007.pdf (noting that, while currently in decline, shareholder proposals addressing antitakeover defenses have dominated the proxy landscape for years).

[79] We share this view. *See* Bebchuk & Hamdani, *supra* note 75, at 1805-07.

[80] *See* Henry G. Manne, Op-Ed., *Bring Back the Hostile Takeover*, WALL ST. J., June 26, 2002, at A18 ("New scandals will continue until we bring back the most powerful market mechanism for displacing bad managers: hostile takeovers.").

[81] *See, e.g.*, Marianne Bertrand & Sendhil Mullainathan, *Is There Discretion in Wage Setting? A Test Using Takeover Legislation*, 30 RAND J. ECON. 535, 545 (1999) (finding that the adoption of antitakeover statutes led to higher labor costs); Kenneth A.

to use the extent to which control is contestable as a standard measure of a firm's quality of corporate governance.[82]

For similar reasons, proxy contests also can play an important role in disciplining managers of NCS companies. U.S. law provides a variety of arrangements to regulate and facilitate such contests, including allowing insurgents to reimburse their expenses in the event that they gain control, providing shareholders with some access to the company's proxy machinery, and preventing fraud and manipulation of voting.[83] And Delaware courts have expressed their willingness to intervene when management has tried to adopt measures impeding proxy contests.[84]

To be sure, some U.S. scholars and practitioners believe that exposing managers to control contests may be counterproductive and produce short-termism as well as wasteful distraction for management.[85] But even those who support insulating boards from control contests share the views that the arrangements governing hostile bids and proxy challenges are important and that the choice of such arrangements can significantly affect—for better or worse—firm value.

In contrast, the arrangements governing control contests are largely irrelevant to CS companies. When a company has a majority

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Borokhovich et al., *CEO Contracting and Antitakeover Amendments*, 52 J. FIN. 1495, 1515 (1997) (stating that executives with stronger antitakeover defenses enjoy higher compensation levels); Gerald T. Garvey & Gordon Hanka, *Capital Structure and Corporate Control: The Effect of Antitakeover Statutes on Firm Leverage*, 54 J. FIN. 519, 520 (1999) (reporting that antitakeover statutes "allow managers to pursue goals other than maximizing shareholder wealth"); Gompers et al., *supra* note 22, at 111, 129 (concluding that companies with managers who enjoy more protection from takeovers are associated with poorer operating performance).

[82] *See* Bhagat et al., *supra* note 5, at 1811-12 ("Firms that adopt devices to impede control changes are . . . conventionally characterized as firms with poor corporate governance, because the managers of those firms are not subject to the disciplining force of hostile bids."); *see also* Bebchuk et al., *supra* note 22 (measuring corporate governance quality based on provisions that affect entrenchment); Gompers et al., *supra* note 22, at 111 (using voting rights, director/officer protection, and the ability to delay hostile bidders as measures of corporate governance).

[83] For a review of these mechanisms, see WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION ch. 7 (2d ed. 2007).

[84] *See, e.g.*, Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 660-62 (Del. Ch. 1988) (holding that a board action with the primary purpose of interfering with the shareholder franchise must be supported by a "compelling justification").

[85] *See, e.g.*, Martin Lipton, *Pills, Polls, and Professors Redux*, 69 U. CHI. L. REV. 1037, 1039 (2002) (arguing that there are substantial costs to having companies constantly subjected to control contests); Lynn A. Stout, *Takeovers in the Ivory Tower: How Academics Are Learning Martin Lipton May Be Right,* 60 BUS. LAW. 1435, 1436 (2005) (supporting Lipton's thesis both positively and normatively).

shareholder, or at least a controller with an effective lock on control, the management team supported by the controller cannot be replaced even in the absence of any impediments to hostile bids and proxy fights: the controller simply has enough votes to prevent the team's removal.[86] For the level of investor protection at CS companies, therefore, the presence of arrangements providing protection against a hostile takeover or a proxy fight is neither good nor bad, but simply irrelevant.[87]

2. Treatment by Governance Standards

We have seen that the arrangements governing control contests are important for NCS companies but not for CS companies. These arrangements should therefore get substantial weight in assessing the governance of NCS companies but not of CS companies. It follows that any governance-rating system that assigns a given weight to the arrangements that govern control contests, without distinguishing between CS and NCS companies, is bound to overweight this factor in assessing CS companies, underweight it in assessing NCS companies, or both.

Consider first RiskMetrics's CGQ system. Regardless of a company's ownership structure, this system assigns considerable weight to companies' antitakeover arrangements. Antitakeover provisions are one of the eight categories of factors in the CGQ's list of rated factors.[88] The factors included in this category represent a significant fraction of the rated factors for both U.S. and non-U.S. firms: for U.S. firms, six out of more than sixty factors focus on poison pill features,

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[86] *See* Gilson, *supra* note 61, at 1667-68 (discussing the economic implications of inefficient controllers' failure to relinquish control); Randall K. Morck et al., *Inherited Wealth, Corporate Control, and Economic Growth: The Canadian Disease?*, *in* CONCENTRATED CORPORATE OWNERSHIP 319 (Randall K. Morck ed., 2000) (same).

[87] Although the rules governing control contests do not affect significantly the level of investor protection at CS firms, it should be noted that such rules can affect founders' initial decision whether to retain a control block. When control is contestable, entrepreneurs with substantial private benefits of control are less likely to relinquish control to the market when taking their companies public. *See* Lucian Arye Bebchuk, *A Rent-Protection Theory of Corporate Ownership and Control* (Nat'l Bureau of Econ. Research, Working Paper No. 7203, 1999), available at http://ssrn.com/abstract=203110.

[88] *See* RISKMETRICS, NON-U.S. CRITERIA, *supra* note 42, ¶ 34. The U.S. CGQ criteria refer to this category as "State of Incorporation." *See* RISKMETRICS, U.S. CRITERIA, *supra* note 42.

while seven other factors focus on state antitakeover provisions.[89] For non-U.S. firms, seven rating provisions out of fifty-five in the list of rated factors focus on features of the company's poison pill and takeover defenses.[90]

Although the CGQ systems attach substantial weight to antitakeover provisions in rating both U.S. and non-U.S. firms, in neither case do they distinguish between CS and NCS firms. In both cases, a company with a controlling shareholder can receive a perfect score on all the antitakeover variables, thus substantially increasing its overall governance ranking, even though the absence of defenses against a hostile bid is irrelevant in protecting outside investors in such a company.

Like the CGQ system, the Anti-Director Rights Index also gives significant weight to arrangements that could affect control contests. As noted earlier, it assigns considerable weight to three arrangements concerning shareholder voting: shareholders' rights to call a special meeting, to vote by mail, and to vote without depositing shares.[91] Although each of these arrangements can sometimes facilitate the wresting of control from the incumbent directors of an NCS company, these provisions are probably not the most important arrangements with respect to control contests; the Anti-Director Rights Index does not consider, for example, whether management can use a poison pill. But while the three arrangements given weight by the index can affect the extent to which control contests are facilitated and are thus relevant to assessing the governance of NCS companies, they have little relevance to assessing the governance of CS companies.

The Anti-Self-Dealing Index suffers from the opposite shortcoming. Unlike the Anti-Director Rights Index, it includes none of the governance arrangements that affect the extent to which control contests are facilitated or impeded.[92] This feature does not undermine the index's usefulness for assessing the governance of CS companies, but does undermine it in the case of NCS companies.

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[89] *See* RISKMETRICS, U.S. BEST PRACTICES, *supra* note 42, ¶¶ 27–32, at 18-21 (giving standards for poison pill adoption, shareholder approval, and trigger level, among other things); *id.* ¶¶ 40–46, at 26-27 (giving standards for state antitakeover law).

[90] *See* RISKMETRICS, NON-U.S. CRITERIA, *supra* note 42, ¶¶ 22–27, 34. Note that we do not have information concerning the relative weight that RiskMetrics assigns to each governance measure for purposes of generating a company's ultimate CGQ score.

[91] *See* La Porta et al., *supra* note 13, at 1122 tbl.1; *see also supra* subsection I.C.1.

[92] *See* Djankov et al., *supra* note 13, at 434 tbl.1.

C. *Voting Procedures*

1. The Difference Between CS and NCS Companies

Corporate law statutes typically include detailed procedures that govern shareholder voting.[93] These often-technical rules aim to facilitate the ability of a majority of shareholders to express their preferences by voting on certain issues. These rules affect the cost of casting a vote—for example, by allowing shareholders to vote by mail or proxy or by requiring shareholders to deposit their shares before voting. They also affect the extent to which voting outcomes accurately reflect the undistorted opinions of a majority of shareholders—for example, by regulating broker-voting and confidential-voting arrangements.[94] In addition, the rules affect shareholders' ability to act in a timely manner by calling a special meeting or by acting by written consent. Finally, voting rules can facilitate shareholders' ability to influence management by specifying the conditions under which shareholder proposals must be included in the company's proxy materials and the issues on which such proposals may be submitted.[95]

The arrangements that govern shareholder voting can be quite important for investor protection at NCS companies. In these companies, shareholders' power to elect directors and to vote on other fundamental issues has long been considered one of the key mechanisms for aligning management's and shareholders' interests. Although some of the rules governing shareholder voting may appear to deal mainly with technicalities, they can affect voting outcomes significantly. For example, a shareholder with a limited stake may not initiate a proposal to amend the company's bylaws—even if the proposal is likely to win majority support—unless the shareholder has the right to have the proposal included in the company's proxy materials. For similar reasons, shareholders may not bother to vote for a pro-

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[93] For a review of the arrangements governing shareholder voting under U.S. federal law and state corporate statutes, see generally ALLEN ET AL., *supra* note 83, ch. 7.

[94] *See, e.g.*, Marcel Kahan & Edward Rock, *The Hanging Chads of Corporate Voting*, 96 GEO. L.J. 1227, 1250 (2008) (discussing the ability of brokers to use their discretion to vote shares when proxy materials are not delivered).

[95] *See* Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 61-63 (2003) (arguing that changing proxy rules to increase shareholder access to voting will reduce management's insulation). *But see* Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67, 83-84 (2003) (arguing that elections are disruptive of the company's time and resources).

posal that they support (or against a proposal that they oppose) if casting a vote is too costly or burdensome. Because some outside shareholders may decide not to vote their shares, brokers can have a significant influence on vote outcomes.[96] Finally, confidential voting may make a difference when some shareholders fear retaliation if they vote against the company's incumbent directors.[97]

Given the foundational role of shareholder voting, some U.S. scholars and shareholder advisers believe that it is desirable to facilitate the ability of a majority of the shareholders to express their views.[98] To be sure, some of those who support insulating boards from control contests hold the opposite view.[99] But all commentators would agree that the arrangements governing shareholder voting are likely to be consequential, one way or another, especially with the recent increase of institutional-shareholder activism.[100]

In CS companies, in contrast, the rules governing voting procedures are likely to be inconsequential. Controllers—unaffected by the collective action and free-rider problems that discourage action by dispersed shareholders—will exercise their voting power even without rules to facilitate shareholder voting. Furthermore, as long as a controller has enough votes to determine voting outcomes,[101] even rules that facilitate voting by minority shareholders will not enable them to pass resolutions not favored by the controller.

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[96] *See* REPORT AND RECOMMENDATIONS OF THE PROXY WORKING GROUP TO THE NEW YORK STOCK EXCHANGE 8-9 (2006), *available at* http://www.nyse.com/pdfs/pwg_report.pdf (discussing the significant influence of broker votes in "routine" matters such as "just vote no" campaigns).

[97] *But see* Roberta Romano, *Does Confidential Proxy Voting Matter?*, 32 J. LEGAL STUD. 465, 465-67 (2003) (reporting evidence that the adoption of confidential voting has no significant effect on voting outcomes).

[98] *See, e.g.*, Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005) (arguing that allowing shareholders to intervene in major corporate decisions will improve overall corporate governance).

[99] *See, e.g.*, Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006) (challenging the proposal to empower shareholders as not inherently value enhancing and arguing to retain the current regime of limited shareholder voting rights).

[100] *See, e.g.*, Jeffrey N. Gordon, *Proxy Contests in an Era of Increasing Shareholder Power: Forget Issuer Proxy Access and Focus on E-Proxy*, 61 VAND. L. REV. 475, 477 (2008) ("The ability of . . . institutional actors to coordinate at a much lower cost changes the collective action equation and rejuvenates a shareholder activism that depends on voting as a credible mechanism for shareholder influence, even outside of a control contest."); Kahan & Rock, *supra* note 94, at 1229 ("Never has voting been more important in corporate law.").

[101] We discuss majority-of-minority voting conditions in the next Section.

2. Treatment by Governance Standards

The CGQ rating system includes two factors concerning voting procedures—shareholders' ability to call a special meeting and shareholders' ability to act by written consent.[102] Similarly, the Anti-Director Rights Index includes three components related to shareholder voting—voting by mail, voting without depositing shares, and the minimum ownership required to call a special shareholder meeting.[103]

As explained above, shareholder voting arrangements are important for investor protection at NCS companies but not at CS companies. Measures that enable minority shareholders to call a special meeting, act by written consent, vote by mail, or vote without depositing shares are unlikely to provide effective constraints on opportunism by controlling shareholders. The fact that the CGQ system and the Anti-Director Rights Index give significant weight to voting procedures thus undermines their effectiveness in assessing governance in CS companies (or countries with a significant presence of CS companies).

In contrast to the CGQ rating system and the Anti-Director Rights Index, the Anti-Self-Dealing Index gives no weight to voting arrangements.[104] That feature of the index does not affect its usefulness for assessing governance of CS companies. It does, however, undermine its effectiveness in assessing corporate governance at NCS companies (or countries in which NCS companies are common).

D. *Allocation of Power Between the Board and Shareholders*

1. The Difference Between CS and NCS Companies

In recent years, researchers and investors have paid significant attention to mechanisms strengthening shareholders' ability to have their preferences followed by the board—that is, measures reducing the extent to which the board is insulated from shareholder wishes.[105] Because the primary agency problem in NCS companies is that management's interests may diverge from those of shareholders, arrange-

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[102] *See* RISKMETRICS, NON-U.S. CRITERIA, *supra* note 42, ¶¶ 30–31.

[103] *See supra* text accompanying notes 49-54.

[104] *See* Djankov et al., *supra* note 13, at 434 tbl.1.

[105] *See* Bebchuk, *supra* note 98, at 870 (arguing that the current system of corporate governance, in which shareholder-initiated change is ruled out, demands reform); *see also* Lisa M. Fairfax, *Making the Corporation Safe for Shareholder Democracy*, 69 OHIO ST. L.J. 53, 55 (2008) ("Recently shareholders have launched an aggressive campaign to increase their voting power within the corporation.").

ments making it difficult for the board to disregard shareholder preferences can enhance investor protection in such companies.

Indeed, the arrangements facilitating hostile takeovers and proxy fights, which we discussed in Section B, can be viewed as mechanisms that enable shareholders to have their preferences followed when they wish to sell the company or replace its management. The prospect of removal in a control contest or a proxy fight may induce directors to follow shareholder preferences on various other matters. Nonetheless, directors and officers may be more likely to follow shareholder preferences if shareholders can express those preferences on matters other than takeovers or director elections.[106]

Scholars, shareholder advisers, and policymakers have advocated a variety of measures that strengthen shareholders' ability to influence board decisions. One set of proposals aims at enhancing shareholder influence on the "rules of the game"—the company's governance arrangements.[107] Examples include measures preventing the board from amending the bylaws (or at least shareholder-adopted bylaws) without shareholder approval, enabling shareholders to place proposals for governance changes on the company's proxy statement, or encouraging the board to implement majority-passed shareholder proposals.

Other measures concerning the allocation of power between shareholders and the board are those that provide shareholders with a say on specific business decisions. For example, the so-called "say on pay" arrangements, which were adopted by legislation in the United Kingdom and Australia,[108] as well as by some companies in the United States,[109] enable shareholders to express their views on the company's compensation policy. The same approach has been adopted in the

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[106] *See* Bebchuk, *supra* note 98, at 856-61 (explaining why the power to replace management is insufficient to allow shareholders to have their wishes followed).

[107] *See* Lucian A. Bebchuk, Reply, *Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784 (2006) (proposing to allow shareholders to make rules-of-the-game decisions and addressing counterarguments thereto); *see also* Brett H. McDonnell, *Shareholder Bylaws, Shareholder Nominations, and Poison Pills*, 3 BERKELEY BUS. L.J. 205, 208 (2005) ("[S]hareholder bylaws regulating corporate governance are desirable.").

[108] *See* Jennifer G. Hill, *Regulatory Show and Tell: Lessons from International Statutory Regimes*, 33 DEL. J. CORP. L. 819, 829 & n.66 (2008) (describing a reform, enacted in Australia and the United Kingdom and also recommended for the United States by the Paulson Committee, granting shareholders an annual advisory vote on employee compensation).

[109] *See* Claudia H. Deutsch, *Say on Pay: A Whisper or a Shout for Shareholders?*, N.Y. TIMES, Apr. 6, 2008, at BU9 ("The votes on compensation may be nonbinding, but they are still popular."); Gretchen Morgenson, *Verizon Shareholders To Vote on Pay for Top Executives*, N.Y. TIMES, Nov. 2, 2007, at C8 (reporting Verizon's decision to put its executive-compensation arrangements to a shareholder vote).

United States by stock-exchange requirements that shareholders approve certain option plans.[110] Finally, some measures empower shareholders to influence the composition of the board without a control contest. This category includes majority voting (enabling shareholders to oppose the election of underperforming directors even though there are no challengers on the ballot),[111] shareholder access to the ballot (empowering shareholders to use the company's proxy statement to nominate a small number of directors),[112] and shareholder power to determine the size of the board or to fill board vacancies.

Some opponents believe that such measures may adversely affect outside investors in NCS companies.[113] Yet there is no dispute that the allocation of power between boards and shareholders can have a substantial impact (for better or worse) on outside investors in such companies. These arrangements are likely to significantly influence corporate decisions by affecting the extent to which directors and officers are attuned to the preferences of the majority of shareholders.

In CS companies, in contrast, such arrangements are unlikely to have significant consequences. Given their ability to elect directors, controllers can usually have boards follow their preferences even without the measures designed to enable dispersed shareholders to overcome their collective action problems. Consider, for example, shareholders' rights to have their governance proposals or board nominees appear on the company's proxy materials for a shareholder meeting. Given the collective action problems that they face, dispersed share-

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[110] *See* Order Approving NYSE and Nasdaq Proposed Rule Changes Relating to Equity Compensation Plans, Exchange Act Release No. 34-48108, 68 Fed. Reg. 39,995 (July 3, 2003) (requiring shareholder approval of all equity compensation plans and material revisions thereto).

[111] For a comprehensive analysis of majority voting and the legal issues that this regime raises, see J.W. Verret, *Pandora's Ballot Box, or a Proxy with Moxie? Majority Voting, Corporate Ballot Access, and the Legend of Martin Lipton Re-Examined*, 62 BUS. LAW. 1007 (2007).

[112] *See* McDonnell, *supra* note 107, at 211-12 (reviewing recent efforts by institutional shareholders to propose bylaw amendments concerning director nomination).

[113] *See* Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 574 (2006) (arguing that increasing shareholder power might encourage shareholders to advance what is in their own—not the company's—best interests); Stephen M. Bainbridge, Response, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1749 (2006) (arguing that active shareholder involvement would disrupt the centralization of decision-making authority in the board of directors); Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1764-66 (2006) (expanding on the traditionalist view that the incentives of institutional investors differ significantly from those of individual stockholders).

holders may not engage in the costly process of soliciting proxies for their proposal or board nominee, even when such a proposal is likely to receive significant shareholder support. Controlling shareholders, on the other hand, typically have no difficulty making the board include their proposals or nominees on the company's ballot, and can in any event bring the proposals that they favor to a vote at the shareholder meeting even if, for some reason, those proposals were not included in the company's proxy materials.

Similarly, even without formal requirements of shareholder approval or advisory vote, directors in CS companies are unlikely to decide important issues, such as the CEO's compensation package, without getting the controller's implicit or explicit consent or at least a sense of the controller's views on the matter. Likewise, even without formal requirements to give weight to shareholder preferences expressed in a nonbinding proposal, a board effectively elected by a controlling shareholder is unlikely to disregard such shareholder's preferences (or at least those preferences that the controller chooses to express).[114]

Most importantly, whereas making directors follow the preferences of the majority of shareholders may enhance the protection of outside investors in NCS companies, it cannot be expected to do so in CS companies. In CS companies, outside investors' main concern is not that management will make decisions that diverge from the interests of the majority of the shareholders, but rather that management will make decisions that divert value from outside investors to the controlling shareholder. Given the nature of the agency problem in CS companies, measures that increase the board's adherence to the majority shareholder's preferences would exacerbate—rather than alleviate—the risk of controller opportunism. Thus, in CS companies, giving the majority of shareholders more power vis-à-vis the board would operate to weaken—not enhance—the protection of outside investors.

The measures that we considered earlier in this Section therefore cannot improve the protection of minority shareholders in CS companies. Indeed, they might even undermine it. By contrast, measures that insulate the board of an NCS company from following the preferences of the majority of shareholders might actually enable the board

[114] In some rare cases, a conflict may arise between the board and controlling shareholders. *See* Hollinger Int'l, Inc. v. Black, 844 A.2d 1022, 1088-89 (Del. Ch. 2004) (approving board action to install a poison pill in order to prevent the controlling shareholder—who was suspected of fraud—from selling its control block), *aff'd*, 872 A.2d 559 (Del. 2005).

of a CS company to counterbalance the controller's power and even constrain controller opportunism.[115]

2. Treatment by Governance Standards

We now examine how the leading governance metrics treat measures that increase the power of the majority of shareholders to influence corporate decision making. The CGQ system grades positively the presence of four arrangements concerning shareholder power: requiring that shareholders annually ratify management's selection of an auditor,[116] requiring that shareholders vote on new poison pills and material amendments to existing ones,[117] requiring shareholder approval for any bylaw amendments,[118] and requiring responsiveness to shareholder proposals passed with majority support.[119]

Although such measures may benefit outside investors in NCS companies, they are likely to have little practical relevance for CS companies. Consider the provisions calling for shareholders to ratify the choice of auditors or board actions to amend the bylaws. Even when directors of a CS company have the formal power to select auditors or amend the bylaws without shareholder approval, they are unlikely to make decisions in these matters that are opposed by the controller.[120] Furthermore, even assuming that formal approval requirements would provide the controller with *more* power over auditor

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[115] This might be especially true for arrangements that make it difficult for a controller to fire directors quickly. While they might lead to entrenchment and exacerbate the problem of insider opportunism in an NCS company, measures that make it difficult for the majority of shareholders to fire the board might provide the board in a CS company with some independence from the controller.

[116] *See* RISKMETRICS, NON-U.S. INDICATOR DEFINITIONS, *supra* note 42, ¶ 21, at 13 ("Shareholders should be permitted to ratify management's selection of auditors each year.").

[117] *See id.* ¶ 22, at 13 ("Shareholders should be permitted to approve shareholder rights plans (i.e., poison pills).").

[118] *See id.* ¶ 32, at 17 ("Management should not be permitted to amend the bylaws without shareholder approval.").

[119] *See id.* ¶ 14, at 10 ("Management should take action on all shareholder proposals supported by a majority vote within 12 months of the shareholders' meeting."). Though the standard calls on the board to take action within twelve months, the action does not have to be implementation. Either partial implementation or issuance of an analysis explaining why the board does not implement seems to be within the take-action standard. What the standard opposes is just ignoring the passed proposal.

[120] We should note, however, that there are rare cases in which boards decide to take active steps against controlling shareholders. *See supra* note 114.

selection or bylaw amendments, it is doubtful that such a change would enhance the protection of outside investors.

The CGQ rating system also grades positively several provisions that strengthen the ability of the majority of shareholders to determine who will serve on the board. These provisions include annual board elections,[121] shareholder approval for changes in board size,[122] shareholder power to fill board vacancies,[123] shareholder power to act by written consent,[124] and shareholder power to call a special meeting.[125] These provisions—which we discussed earlier as facilitating control contests—also enhance shareholder influence over board composition in the absence of a control contest. Thus, they increase the extent to which directors are accountable to the majority of shareholders. But even though making directors more accountable to the majority of shareholders may constrain management's opportunism in NCS companies, it cannot address controller opportunism in CS companies, and it may even undermine the ability and willingness of directors in such companies to serve as a check on the controller.

One of the six key provisions of the Anti-Director Rights Index focuses on shareholder power to call a special meeting. This power enhances the ability of the majority of shareholders to have their preferences followed. But having the power to call a special meeting does not materially affect the balance of power in CS companies. The fact that the Anti-Director Rights Index gives significant weight to the presence of an arrangement that is largely inconsequential for outside investors in CS companies undermines the index's effectiveness as an accurate measure of investor protection in countries where such companies dominate.

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[121] *See* RISKMETRICS, NON-U.S. INDICATOR DEFINITIONS, *supra* note 42, ¶ 5, at 7 ("Directors should be accountable to shareholders on an annual basis.").

[122] *See id.* ¶ 7, at 7 ("Shareholders have the right to vote on changes to expand or contract the size of the board.").

[123] *See id.* ¶ 16, at 10-11 ("Shareholders should be given an opportunity to vote on all directors selected to fill vacancies.").

[124] *See id.* ¶ 30, at 16 ("Shareholders should be permitted to act by written consent.").

[125] *See id.* ¶ 31, at 16-17 ("Shareholders should be permitted to call special meetings.").

E. *Allocation of Power Between the Majority and the Minority*

1. The Difference Between NCS and CS Companies

We have thus far assumed that empowering shareholders as a group to make a decision means that a majority of shareholders will have the effective power to make the decision. But whether the majority of shareholders can exercise the power held by shareholders generally depends on the governance arrangements in place. Corporate law or the company's governance arrangements can limit the majority's ability to exercise shareholder voting power and can empower the minority to make certain decisions or exercise veto power over others. A corporate action may require supermajority approval, for example, or even approval by a majority of the minority shareholders. We will refer to any arrangement that prevents the majority from exercising the full power that shareholders acting unanimously would wield as an arrangement that empowers minority shareholders.

The impact of measures that limit the power of the majority of shareholders depends on the company's ownership structure. This variance is again due to the fundamental difference between CS and NCS companies with respect to the agency problems that confront outside investors. In NCS companies, because the main agency problem is opportunism on the part of management, and because shareholders face collective action problems, arrangements that make it difficult for the majority to act may undermine shareholders' ability to constrain insider opportunism.

In contrast, in CS companies, making it easier for the majority of shareholders to have its way cannot alleviate, and may exacerbate, the key concern of controller opportunism. Indeed, one strategy for addressing this agency problem is constraining the voting power of the majority of shareholders or empowering minority shareholders as a group to influence certain decisions. Delaware case law, for example, encourages controllers to subject self-dealing transactions to a majority-of-minority vote.[126] And some jurisdictions condition self-dealing transactions on the approval of a majority of disinterested shareholders.[127]

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[126] Specifically, a majority-of-minority requirement shifts the burden to the minority to show that the transaction is unfair. *See* Kahn v. Lynch Commc'n Sys., 638 A.2d 1110, 1117 (Del. 1994) ("[A]n approval of the transaction by an independent committee of directors or an informed majority of minority shareholders shifts the burden of

2. Treatment by Governance Standards

The CGQ system disfavors two arrangements that require supermajority approval for fundamental changes: the supermajority voting requirement for mergers and the supermajority requirement for charter amendments.[128] This negative treatment of supermajority voting arrangements may be sensible for NCS companies, and its presence may reflect the NCS mindset of those designing the CGQ system. In NCS companies, supermajority requirements can insulate the board from shareholder intervention and serve as an antitakeover device. Indeed, a study coauthored by one of us that focused on NCS companies in the U.S. market finds that such supermajority requirements are negatively correlated with firm value.[129]

Supermajority voting arrangements are likely to have different effects in CS companies, however. When the company has a controlling shareholder, these arrangements limit the controller's ability to pass

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proof on the issue of fairness from the controlling or dominating shareholder to the challenging shareholder-plaintiff.").

[127] *See* FINANCIAL SERVICES AUTHORITY HANDBOOK § 11.1.7(4) (2007), *available at* http://fsahandbook.info/FSA/handbook/LR/11/1.pdf (requiring companies listed on the London Stock Exchange to ensure that the related party does not vote on the resolution and to take reasonable steps to ensure that the related party's associates do not vote); Pierre-Henri Conac et al., *Constraining Dominant Shareholders' Self-Dealing: The Legal Framework in France, Germany, and Italy* 10-12 (European Corp. Governance Inst., Working Paper No. 88/2007, 2007) (describing how the legal systems in France, Italy, and Germany regulate self-dealing transactions and noting that in France self-dealing transactions require an ex ante approval by the board of directors and ratification at the annual shareholder meeting). *But see* Gerard Hertig & Hideki Kanda, *Related Party Transactions*, *in* THE ANATOMY OF CORPORATE LAW, *supra* note 11, at 101, 122 (noting that the requirement for a minority vote on controller transactions has not been adopted by most major jurisdictions).

[128] *See* RISKMETRICS, NON-U.S. INDICATOR DEFINITIONS, *supra* note 42, ¶¶ 28–29, at 15-16 ("A simple majority vote should be required to amend the charter/bylaws and to approve mergers or business combinations."). Note that we do not consider here the optimal scope of minority empowerment—that is, what issues should be left for the minority to vote on. Rather, we claim that empowering shareholders as a group to vote cannot enhance minority protection in CS companies.

[129] *See* Bebchuk et al., *supra* note 22, at 784-85 (finding a negative correlation between these arrangements and firms' Tobin *Q*). This study thus included these arrangements in its entrenchment index, which subsequent researchers have used as a measure of corporate governance. *See, e.g.*, Amy Dittmar & Jan Mahrt-Smith, *Corporate Governance and the Value of Cash Holdings*, 83 J. FIN. ECON. 599, 603 (2007) (using degree of managerial entrenchment caused by takeover defenses and large-shareholder monitoring as measures of corporate governance).

resolutions, thereby empowering minority shareholders and potentially limiting controller opportunism.[130]

The Anti-Director Rights Index does not include provisions for supermajority voting or similar arrangements that empower minority shareholders. The Anti-Self-Dealing Index, however, does take into account one type of minority-empowering provision—a requirement that related-party transactions be approved by a majority of "disinterested" shareholders.[131] Such majority-of-the-minority votes, which are not given weight in the CGQ system, should be taken into account in assessing investor protection in CS companies. Such requirements, however, are not practically relevant to the protection of outside investors in NCS companies.

The arrangements that we have thus far discussed concern decisions that are not "divisible"—that is, either the majority or the minority of the shareholders will have its way. With respect to director elections, however, some arrangements provide minority shareholders with partial power, enabling these shareholders to influence the selection of some—but not all—directors. Cumulative voting, for example, enables minority shareholders to elect some directors even against the controller's wishes.[132] Both the CGQ and the Anti-Director Rights Index treat cumulative-voting arrangements favorably.[133]

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[130] Supermajority voting requirements will fail to protect the minority when the controller has enough voting power to overcome even the supermajority requirement. For example, a requirement for a seventy percent vote would not contain controllers holding eighty percent of the voting power.

[131] *See* Djankov et al., *supra* note 13, at 434 tbl.1.

[132] *Cf.* BERNARD BLACK ET AL., CORPORATE GOVERNANCE IN KOREA AT THE MILLENNIUM: ENHANCING INTERNATIONAL COMPETITIVENESS: FINAL REPORT AND LEGAL REFORM RECOMMENDATIONS TO THE MINISTRY OF JUSTICE OF THE REPUBLIC OF KOREA (2000), *reprinted in* 26 J. CORP. L. 537, 564-65 (2001) (recommending that Korea strengthen cumulative voting to protect minority shareholders); Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1947-49 (1996) (describing the virtues of cumulative voting as including enhancing shareholder access to company information, increasing the independence of directors from managers, and supporting the idea that directors have a primary duty to shareholders and not to officers); Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124, 127-28 (1994) (arguing that large institutional shareholders should advocate cumulative-voting systems and suggesting that cumulative-voting systems improve corporate governance and benefit overall shareholder welfare).

[133] *See* RISKMETRICS, U.S. BEST PRACTICES, *supra* note 42, ¶ 8, at 8 ("Shareholders should have the right to cumulate their votes for directors."); *supra* text accompanying note 52.

Assessing the advantages and disadvantages of cumulative voting in CS and NCS companies is outside the scope of this Article. For our purposes, what is most important is that the impact of cumulative voting on investor protection could well depend on ownership structure. Cumulative voting, we suggest, is more important for investor protection in CS companies than in NCS companies.

In an NCS company, a challenger enjoying the support of a majority of the outside shareholders will be able to get board seats (indeed, all the board seats up for election), even under the winner-takes-all system of elections. Moreover, in an NCS firm, cumulative voting may impede a challenger's ability to quickly replace the incumbent board by giving minority shareholders (who may be aligned with the incumbents) the ability to elect some board members. In contrast, in a CS company, a challenger enjoying the support of minority shareholders will not be able to get any board seats without cumulative voting. Thus, even if one takes the view that cumulative voting is desirable in both CS and NCS companies, its value, and thus the weight given to its presence, should differ between CS and NCS companies.

F. *Director Independence*

1. The Difference Between CS and NCS Companies

Legal systems around the world increasingly require boards to have a significant number of independent directors.[134] These independent directors are often assigned the task of deciding matters that raise potential conflicts of interest between corporate insiders and outside investors.[135]

Independent directors may be less willing to go along with insider opportunism in both CS and NCS firms. Indeed, a growing body of empirical research shows that independent directors who serve on the

[134] For a comprehensive analysis of director independence in U.S. firms, see generally Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465 (2007).

[135] On the role of independent directors in Britain and Japan, see Donald C. Clarke, *Three Concepts of the Independent Director*, 32 DEL. J. CORP. L. 73, 99-102 (2007). For a review of the statutory requirements for independent directors in China, see Chao Xi, *In Search of an Effective Monitoring Board Model: Board Reforms and the Political Economy of Corporate Law in China*, 22 CONN. J. INT'L L. 1, 3-9 (2006).

board or on certain key committees could enhance investor protection even in countries where concentrated ownership is prevalent.[136]

But even though independent directors may improve governance at both NCS and CS companies, assessing director independence should proceed differently in these two types of companies. The critical question is from whom should directors be independent? In NCS companies, the principal concern is managerial opportunism, so it is important to ensure directors' independence from the company and its management. Indeed, a director affiliated with a significant outside blockholder may be especially likely to act independently of management, because such a director may have stronger incentives to enhance share value by monitoring management effectively and constraining insider opportunism.

In contrast, the principal concern in CS companies is controller opportunism, so assessment of their governance should focus on director independence from the controller. Ties between directors and the controller (or entities affiliated with it) may make the directors less effective in limiting controller opportunism.

To be sure, under the assumption that the controlling shareholder dominates the company, a director's close ties with the company would normally imply her lack of independence from the controller as well. But the opposite does not hold: independence from the company does not necessarily imply independence from the controller. Seemingly independent directors may depend, for example, on another business controlled by the company's controlling shareholder. In sum, when one evaluates the governance of CS companies, significant weight should be given to director independence from (or dependence on) the controlling shareholder.

2. Treatment by Governance Standards

Both the Anti-Director Rights Index and the Anti-Self-Dealing Index give no weight to director independence, thus overlooking a factor that is relevant for both CS and NCS companies. In contrast, the

[136] *See* Black et al., *supra* note 2, at 407-10 (finding that, even in developing countries with emerging markets, there is a strong connection between board independence and market value); Jay Dahya et al., *supra* note 46, at 96 (conducting a study of firms in twenty-two countries and concluding that a dominant shareholder in a country that provides little legal protection for shareholders can increase the market value of a firm by electing independent directors).

CGQ rating system does attach significant weight to the presence of independent directors and their decision-making role.

The CGQ system grades boards with at least a two-thirds membership of independent directors and boards with nominating, compensation, and governance committees consisting solely of independent directors.[137] In evaluating director independence, however, the CGQ rating system focuses almost exclusively on ties between directors and the firm on the board of which they serve. In discussing director independence for purposes of the CGQ rating system, RiskMetrics notes directors' "adequate independence from management" but does not explicitly refer to director independence from controlling shareholders.[138]

RiskMetrics also provides various measures of independence that seek to cover a range of possible links between a director and the company, but it does not cover to the same extent the possible relationships between a director and a controlling shareholder.[139] Under RiskMetrics's definition of independence, for example, a company employee would likely be defined as an "inside director," but an employee of another company that the controller owns would not be so defined.[140] Given the prevalence of business groups around the world, this failure to take into account directors who depend on other firms controlled by the company's controlling shareholder is problematic. Similarly, under RiskMetrics's definition of independence, a controller sitting on the board would be defined as an inside director if she has more than fifty percent of voting power but not, for example, if she has forty-five percent of voting power.[141]

Several other components of the CGQ system reinforce the impression that its designers were mostly concerned with director independence from management, not controlling shareholders. The CGQ system includes several provisions that address the relationship between the board and the CEO: former CEOs are discouraged from serving on the board; the positions of CEO and board chair should be

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[137] RISKMETRICS, NON-U.S. INDICATOR DEFINITIONS, *supra* note 42, ¶¶ 1–4, at 4-6. Note that neither the Anti-Director Rights Index nor the Anti-Self-Dealing Index lists director independence as one of the criteria for evaluating investor protection. These indices thus assign no weight to a factor that, albeit in different ways, could be useful for both CS and NCS companies.

[138] *Id.* ¶ 1, at 4-5.

[139] *Id.* (designating three categories of directors—inside, affiliated, and independent—and emphasizing the need for board independence from management).

[140] *Id.*

[141] *Id.*

separated; and directors are encouraged to meet without the CEO present.[142] The view underlying these provisions is that the CEO is the key, powerful insider who needs to be monitored by directors.[143] But the situation in CS companies run by professional managers is often different.[144] In such companies, the key, powerful figure whose opportunism needs to be constrained may well be the controller. Where this is the case, it is unlikely that having CEO-chair separation with the controller serving as the chair will enhance the protection of outside investors.

G. *Arrangement Governing Potential Value Diversion*

1. The Difference Between CS and NCS Companies

An important set of governance arrangements directly regulates actions and transactions that might divert value from outside investors to corporate insiders. As we explained earlier, controlling shareholders may divert value from outside investors by using channels different from those through which NCS company insiders might attempt to do so. Accordingly, limiting insider-value diversion effectively may require different sets of arrangements in NCS and CS companies.

Specifically, assessing the governance of CS companies requires close attention to the arrangements governing freezeouts, related-party transactions with the controller or entities affiliated with it, and taking corporate opportunities.[145] These types of actions are relatively less important in NCS companies, as professional managers commonly have fewer opportunities to engage in related-party transactions or to take corporate opportunities on a large scale.[146] In contrast, an assessment of the governance of NCS companies should

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[142] *Id.* ¶¶ 11–12, at 53.

[143] *See* Gordon, *supra* note 134, at 1472 ("[A]n increasingly important element of the independent board's monitoring role came to be the appropriate use of market signals . . . in CEO termination decisions.").

[144] A "professional CEO" connotes a CEO who is neither the controlling shareholder nor related in any meaningful way to the controlling shareholder.

[145] Establishing a case against controlling shareholders for taking corporate opportunities might be a complicated task, especially when the controller is another corporation that operates within the same industry. *See, e.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717, 722 (Del. 1971) (finding that an international oil company did not usurp corporate opportunities that belonged to its Venezuelan subsidiary).

[146] Management can also divert value from shareholders by buying a public company from its outside investors and taking it private in a management buyout. *See generally* Louis Lowenstein, *Management Buyouts*, 85 COLUM. L. REV. 730 (1985).

assign an increased weight to the arrangements governing executive compensation.[147]

2. Treatment by Governance Standards

Beginning with the modes of value diversion that are relatively more important for NCS companies, we should note that more than ten components of the CGQ system—almost one-fifth of all the components—deal with executive compensation and stock ownership by directors and officers.[148] Although this approach may be appropriate for NCS companies, where executive compensation is a central issue, it is inappropriate for CS companies, where concerns about value diversion through executive compensation typically do not occupy such a central role. It is especially inappropriate in CS companies with a professional manager who is not affiliated with the controller, where one can expect the controller to monitor executive pay and constrain excessive pay arrangements.

Turning to CS companies, it is important to note that the CGQ system assigns little weight to the regulation of freezeouts and related-party transactions involving controlling shareholders. The non-U.S. system has only one provision related to this important set of insider actions, and it applies only to transactions involving the CEO.[149] In CS companies, however, the related-party transactions that deserve most attention are those involving the controller (directly or indirectly).

Furthermore, the CGQ system's provisions do not focus on the scope of related-party transactions. The provisions presumably reflect the view that the sheer existence of such transactions is a sign of governance problems. But in many CS companies, especially those that are part of a business group or a holding company structure, some related-party transactions are common, and the mere existence of such transactions is not an important signal of governance failures. What is important for assessing the quality of governance in such companies is the scope of self-dealing transactions and the mechanisms for monitoring them. These considerations further reinforce the conclusion that the CGQ system does not provide a good measure of governance problems in CS companies.

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[147] When the controller is hired by the firm, her executive compensation could be classified as controller self-dealing.

[148] RISKMETRICS, NON-U.S. INDICATOR DEFINITIONS, *supra* note 42, ¶¶ 3, 35–44, at 6, 19-23.

[149] *Id.* ¶ 17, at 11.

In contrast, the Anti-Director Rights Index and the Anti-Self-Dealing Index do pay significant attention to potential value diversion by controllers, but they pay little attention to executive compensation. One of the six key components of the Anti-Director Rights Index concerns oppressed-minorities mechanisms, broadly defined to include measures that grant minority shareholders rights either to challenge controller opportunism in court or to have their shares redeemed in the presence of such opportunism.[150] The Anti-Self-Dealing Index, in turn, focuses exclusively and in detail on measures that regulate related-party transactions.[151] Thus, these two indices, and especially the Anti-Self-Dealing Index, pay close attention to value-diversion channels that are important for CS companies,[152] but they tend to overlook executive-compensation issues that are relatively important for NCS companies.

This conclusion is especially strong in the case of the Anti-Self-Dealing Index. This index focuses on the regulation of a paradigmatic related-party transaction between a public company and a private company owned by the public company's controlling shareholders.[153] The constraints on such a transaction might well be vital for CS companies, but they are far less important for assessing governance at NCS companies. Thus, although the index was intended to serve, and has been used, as a metric for investor protection around the world, its design renders it ineffective as a measure of the quality of investor protection in NCS companies.

III. GOING FORWARD

As we stressed at the outset, we do not wish to undermine the important project of developing objective metrics for measuring the quality of corporate governance around the world; we would like to see the project pursued more effectively, not abandoned. Nor do we wish to limit ourselves to pointing out the shortcomings in past work

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[150] La Porta et al., *supra* note 13, at 1122 tbl.1.

[151] *See supra* text accompanying notes 57-58.

[152] We should note here that, although the title of this provision refers to "minority oppression," its definition is so broad that it could perhaps also include remedies that would be available for shareholders at NCS companies. *See* Spamann, *supra* note 14, at 9 (referring to this provision as being "extremely broad").

[153] *See* Djankov et al., *supra* note 13, at 432-33 (setting forth an example of a stylized self-dealing transaction and using the Anti-Self-Dealing Index to measure whether a hypothetical controlling shareholder will be able to get away with the transaction).

by academics and practitioners; rather, we seek to identify ways to improve the development of governance metrics.

In Section A, we discuss the proper approach for evaluating companies' governance arrangements. In Section B, we consider the desirable approach for assessing countries and legal systems.

A. *Evaluating Companies*

Our thesis is that different sets of standards should be used to evaluate the governance of CS and NCS companies. In this Section, we outline several key elements of these separate rating systems.

We fully recognize that, as noted in the Introduction, some companies belong to a gray area and cannot be easily classified as CS or NCS. These are companies in which a shareholder has a block large enough to make control difficult to contest but not large enough to make control de facto uncontestable. For these companies, it would be necessary to appropriately combine elements of the two rating systems that we discuss below. We defer this additional task to another day and focus instead on the more fundamental task: putting forward standards for assessing corporate governance at the large number of public companies that can easily be classified as either a CS or an NCS company.[154]

We begin by outlining the basic elements necessary for assessing corporate governance at NCS firms and then discuss the necessary elements for assessing CS firms. We do not purport to provide a complete and fully detailed account of the two evaluation systems. Rather, we identify the type of governance arrangements on which each evaluation system should focus.

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[154] Another complication arises because a company may change from one type to another over time. Thus, an NCS company might turn into a CS company if a majority of shareholders accepts a tender offer for its shares. When a controlling shareholder emerges, the company's governance and the value of minority shares will have to be assessed according to the CS standard. Thus, shareholders trying to estimate the value of minority shares in the event of a takeover would do well to use a CS standard rather than the NCS standard applicable to the company pretakeover. Governance arrangements can also affect the transition from one ownership structure to another. *See generally* Lucian Arye Bebchuk, *A Rent-Protection Theory of Corporate Ownership and Control* (Nat'l Bureau of Econ. Research, Working Paper No. 7203, 1999), *available at* http://ssrn.com/abstract=203110. Finally, governance arrangements such as supermajority vote requirements also can affect the percentage ownership that would allow a shareholder to become a controlling shareholder.

1. NCS Companies

a. *Control Contests*

As we explained earlier, an active market for corporate control has an important effect on management of NCS companies. Any system for assessing the corporate governance of NCS companies should thus assign substantial weight to the arrangements governing hostile takeovers and proxy fights, even though scholars and practitioners may differ in their views on which arrangements concerning such control contests are optimal.

b. *Shareholder Voting Procedures*

In NCS companies, shareholder voting power is one of the primary mechanisms for aligning the interests of directors and officers with those of shareholders. The extent to which shareholders' voting power is not only formal but also effective depends on the detailed set of procedures that governs shareholder voting. A system for evaluating corporate governance at NCS companies should thus give significant weight to the existence of arrangements that facilitate the ability of a majority of shareholders to express its will on certain key issues through voting. Thus, among other things, governance evaluation at NCS companies should give weight to arrangements such as shareholder ability to (1) vote by mail, proxy, or written consent, (2) vote without depositing shares, (3) place governance proposals and board nominees on the company's ballot, and (4) be protected by confidential voting.

c. *Allocation of Power Between the Board and Shareholders*

In addition to voting procedures, governance in NCS companies depends significantly on the scope of shareholders' voting power—or what shareholders can vote on. A system for evaluating corporate governance at these companies should therefore take into account such issues as shareholders' effective power to initiate governance changes, as well as the existence of requirements for a shareholder vote on fundamental transactions, firm-governance arrangements, and manager-compensation packages. Again, there may be room for reasonable disagreement about the most desirable allocation of power between shareholders and the board. But there is a good basis for agreement that the nature of the arrangements governing such allocation should be given weight in assessing the governance of NCS firms.

d. *Executive Compensation*

Suboptimal compensation arrangements can be a main channel for insider opportunism at NCS companies. Therefore, a system of governance assessment for these companies should consider the extent to which compensation arrangements are consistent with the goal of enhancing firm value. The assessment could include not only the substantive aspects of compensation arrangements but also the process for setting executive-pay schemes—for example, the composition of the compensation committee, the committee's decision-making process, and the requirements (if any) for shareholder ratification of option plans or other pay package components. And while any evaluation of governance in NCS companies should pay some attention to the arrangements governing self-dealing transactions with officers and directors, the weight given to self-dealing should be less than that accorded in a system that evaluates governance in CS companies.

e. *Director Independence*

Director independence can enhance the protection of outside investors at both CS and NCS companies. A company's ownership structure, however, determines the type of relationships that should be considered when assessing director independence. In NCS companies, that assessment should focus on the ties between directors and management, and (assuming management's control over the company) the ties between directors and the company on whose board they serve. In contrast, ties between directors and outside blockholders who are not themselves tied to management might be beneficial, making directors more attentive to, and focused on, shareholder interests.

2. CS Companies

a. *Allocation of Power Between the Majority and the Minority*

In CS companies, the distribution of power among shareholders is important. Is the majority able to wield all the power reserved for shareholders, or does the minority have a say? One important way to protect outside investors at CS companies is to empower minority shareholders to block certain corporate transactions and other actions. In particular, such power might be desirable when the interests of the controller and minority outside investors diverge.[155] A system for rating corporate governance at CS firms should thus pay attention to arrangements that empower minority shareholders (or limit the power of the majority shareholders) with respect to certain decisions—for example, the extent to which minority shareholders are in a position to block related-party transactions between the controller and the company. In addition, assessments of governance in CS companies should take into account the existence of arrangements, such as cumulative voting, that provide minority shareholders with the ability to influence board composition.

b. *Self-Dealing and Freezeouts*

In CS companies, self-dealing transactions that involve controlling shareholders or their affiliates provide a principal channel for diverting value from the firm and its outside shareholders. The risk of value diversion through self-dealing is exacerbated when dominant families control a relatively large number of public companies through pyramids and other similar structures. To be sure, the quality of the mechanisms that govern self-dealing should not serve as the exclusive metric for evaluating corporate governance at CS companies.[156] Yet a system for evaluating corporate governance at such firms should assign considerable weight to the mechanisms—such as disclosure, voting requirements, and fiduciary duties—that govern self-dealing transactions in general and "going private" freezeouts in particular. Moreover, the relative weight of these mechanisms when assessing the overall governance of CS firms should be significantly higher than their weight when assessing the governance of NCS firms.[157]

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[155] In NCS firms, in contrast, arrangements that require more than a standard majority vote would tend to protect managers, undermine their accountability to the majority of shareholders, and even discourage hostile takeovers. A system for evaluating governance at NCS firms should thus treat negatively any supermajority voting requirements.

[156] As we explained earlier, the Anti-Self-Dealing Index focuses exclusively on measures for regulating controlling shareholders' self-dealing transactions. *See supra* subsection I.C.2.

[157] Other types of arrangements that should be evaluated in CS firms are those that prevent controllers from selling their control block when the sale would likely increase the diversion of value from the firm to the new controller. *See, e.g.*, Einer Elhauge, *The Triggering Function of Sale of Control Doctrine*, 59 U. CHI. L. REV. 1465, 1473 (1992) ("[C]ourts have sometimes held controlling shareholders liable when a control transaction effectively 'diverts' a corporate or collective opportunity.").

c. *Director Independence*

As stressed earlier, independent directors can enhance investor protection in both CS and NCS companies. In CS companies, however, directors can be genuinely independent only when they have no ties to the controlling shareholder or its affiliates. Thus, an assessment of director independence that focuses only on ties between directors and the company on the board of which they serve may miss the mark. Moreover, in evaluating director independence at CS companies, one should also consider the extent to which the controller can influence the process of nominating and electing independent directors. Relatedly, CS companies should get little credit, if any, for having directors meet for "executive" sessions in which management is not present but the controller or its representative is.

d. *Control Contests*

Because control in CS companies is not contestable, any assessment that credits CS companies for the presence of arrangements facilitating control contests would introduce substantial noise and might make overall governance scores less accurate and informative. The absence or unavailability of a poison pill, for example, has virtually no impact on the likelihood of a hostile takeover in a company with a majority shareholder. A system for rating CS companies should therefore not include elements based on the presence of arrangements that facilitate or impede hostile bids and proxy contests.[158]

e. *Shareholder Voting Procedures*

The procedures governing shareholder voting are substantially less important for CS than for NCS companies. To be sure, there is no good reason why even CS companies should have procedures that impede, discourage, or distort voting by outside shareholders. Given the ability of a controller to determine the outcome of votes, however, the absence of such procedures does not necessarily improve the protection of outside investors in CS companies. Thus, any methodology for assessing governance in CS companies should generally assign little weight (if any) to arrangements governing voting procedures, such as shareholder ability to vote by mail, proxy, or written consent; share-

[158] The presence of such arrangements—and especially those included in the bylaws or charter—might have some indirect impact to the extent that a CS firm might become an NCS firm in the future.

holder right to vote without depositing shares and by secret ballot; and shareholder ability to place proposals on the company's proxy statement.

The discussion above focuses on matters subject to a majority-vote rule. As we explained earlier, however, shareholder voting can play a valuable role in enhancing minority protection at CS companies when the requirement for shareholder approval is combined with measures to empower the minority, such as majority-of-minority voting requirements. In the case of such votes, procedures that facilitate undistorted voting by minority shareholders may well be consequential, and their presence or absence should be duly taken into account when evaluating governance.

f. *Allocation of Power Between Boards and Shareholders*

In CS companies, measures that expand the scope of issues on which shareholders can vote or strengthen the ability of the majority of shareholders to influence board decisions would be unlikely to enhance the protection of outside investors. Indeed, as we explained earlier, measures that insulate directors from the controller—for example, making it difficult to fire directors—may sometimes enhance the protection of minority shareholders at CS companies. It follows that a system for evaluating governance in CS companies should not give significant positive weight to the presence of arrangements, such as requirements for a shareholder ratification of auditor selection or shareholder advisory vote on executive compensation, that expand the formal scope of shareholder voting power.

g. *Executive Compensation*

As explained earlier, even though excessive-compensation arrangements could be an issue in CS companies, they are probably less important in such companies than in NCS companies.[159] Accordingly, in evaluating corporate governance, the substantive and procedural limitations on executive compensation should occupy a less central role in CS companies than in NCS companies.

[159] *See supra* text accompanying notes 68-69 (noting a controller's interest in maximizing shareholder value).

h. *Controlling Minority Shareholders*

Controlling shareholders may use arrangements such as pyramids, dual-class shares, and other mechanisms to separate cash-flow and voting rights.[160] When such arrangements are in place, the controller can have an absolute lock on control even though it has less—and sometimes substantially less—than half of the company's cash flows. Other things being equal, the interests of the so-called controlling minority shareholders overlap with those of outside investors to a lesser degree than do the interests of a controlling majority shareholder.[161] As a result, concerns about insider opportunism should increase when control is locked in the hands of controlling minority shareholders. Indeed, evidence indicates that firm value decreases as the difference between equity ownership and voting control increases.[162] A system of governance assessment at CS companies should thus take into account the presence of controlling minority shareholders and the degree to which voting rights and cash-flow rights are separated.

B. *Evaluating Legal Systems*

Our analysis has thus far focused on the appropriate approach for comparing the quality of corporate governance across firms. But another important task for academics, investors, and policymakers is to evaluate the extent to which countries differ in terms of the level of protection that they provide—through their legal rules and institutional arrangements—to outside investors in their public firms.

Thus far, research conducting cross-country comparisons has generally been based on a single standard for measuring countries' levels of investor protection. To date, there have been more than one hundred cross-country studies based on either the Anti-Director Rights Index or

[160] For an analysis of these devices and their corporate-governance implications, see Lucian A. Bebchuk et al., *Stock Pyramids, Cross-Ownership, and Dual Class Equity*, *in* CONCENTRATED CORPORATE OWNERSHIP, *supra* note 86, at 295.

[161] The term "controlling minority" was introduced by Bebchuk et al., *id.* This study shows that agency costs can be expected to increase, and to do so at an increasing rate, with declines in the fraction of cash-flow rights owned by the controlling minority shareholder.

[162] *See, e.g.*, Stijn Claessens et al., *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, 57 J. FIN. 2741 (2002); Paul Gompers et. al., *Extreme Governance: An Analysis of Dual-Class Companies in the United States* (Rodney L. White Ctr. for Fin. Research, Working Paper No. 12-04, 2008), *available at* http://ssrn.com/abstract=562511.

the Anti-Self-Dealing Index.[163] As in the case of companies, however, our analysis suggests that the use of a single metric is inappropriate.

Because many rules and arrangements have different effects on investor protection in CS and NCS companies, a given country may provide outside investors in CS and NCS companies with different levels of protection. For example, one country may do much better than others in protecting outside investors in NCS companies but do a relatively poor job of protecting them in CS companies. Researchers, investors, and policymakers, we suggest, should not assign each country a single score for its quality of investor protection, but rather two scores: one for the quality of protection accorded to investors in NCS companies (the country's NCS score) and one for the quality of protection accorded to investors in CS companies (the country's CS score).

At first glance, it might appear that assigning two different scores should be only an intermediate step, followed by combining the two into a single score representing the country's overall quality of investor protection. One could, for example, simply average the country's NCS and CS scores. Such an approach, it might be argued, would provide a single, easy-to-use metric for cross-country comparisons while taking into account the relationship that we have analyzed between ownership structures and corporate governance. For many important purposes, however, keeping two separate scores and not combining them would be far more useful for researchers, investors, and policymakers.

Consider first a researcher or policymaker who wants to know how two countries compare in their overall level of investor protection. The combined measure considered above could be misleading to the extent that controlled and widely held structures are not equally represented in each country's public equity market. For example, if most of the countries' companies have controlling shareholders, basing the comparison on the countries' CS scores would be more appropriate than basing it on the countries' combined CS and NCS scores. If NCS companies dominate in both countries, basing the comparison on NCS scores would be more appropriate. And if NCS companies dominate in one country and CS companies dominate in the other, then the comparison may be best when based on comparing the NCS score of the first country with the CS score of the second.

Next, consider a researcher or an investor who is interested in only a limited subset of particular companies. In this case, it would be

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[163] *See supra* notes 5-7 and accompanying text.

best to use the country's CS score to examine companies that have a controller and its NCS score to review companies that do not. Clearly, even if NCS companies dominate in a country, using the country's NCS score to analyze investor protection in a set of CS companies would be inferior to using the country's CS score and vice versa. Accordingly, a researcher comparing firms from around the world and seeking to control for the level of investor protection in each firm's country should use a country's CS score as a control for a CS firm in this country and the country's NCS score as a control for an NCS firm in this country.

Consider now researchers or policymakers seeking to improve a country's level of investor protection or to track improvements in this level over time. As our discussion above indicates, looking separately at each of the CS and NCS scores would commonly provide a better picture than using a single, combined measure. For example, an increase in the country's combined CS and NCS score would not represent a meaningful improvement to the extent that it resulted from an increase in the country's NCS score when most of the country's public companies have controlling shareholders.

Similarly, those interested in the political economy of investor protection would do well to keep a country's CS and NCS scores separate.[164] Consider a researcher or a policymaker who is interested in understanding the forces that produced a country's current arrangements and identifying possible impediments to reform. The country's existing ownership structures determine what type of insiders—controllers of CS companies or professional managers of NCS companies—wield more power in the country's interest-group politics. Controllers and professional managers, in turn, do not focus on the same corporate-governance issues.

In a country where CS companies dominate, the corporate insiders with the most political power—controlling shareholders—may well care more about the country's protection of outside investors at CS firms than at NCS firms;[165] they thus may be more open to reform that

[164] For a detailed analysis of the impact of political economy on corporate governance, see Lucian A. Bebchuk & Zvika Neeman, *Investor Protection and Interest Group Politics*, 22 REV. FIN. STUD. (forthcoming 2009).

[165] Controlling shareholders may have substantial political power when they are wealthy families that control a large number of public companies through pyramids. *See, e.g.*, Randall Morck et al., *Corporate Governance, Economic Entrenchment, and Growth*, 43 J. ECON. LITERATURE 655, 655 (2005) (arguing that disproportionate control of large areas of an economy can result in "greatly amplified political influence").

will increase the country's NCS score but not its CS score. Conversely, in a country where NCS companies dominate, professional managers, who wield significant political power, may well be more focused on the country's NCS score.

It is worth noting, however, that even though it might be easier politically to adopt measures to improve the NCS score of a country in which CS companies dominate, such a reform would be less useful for the country's overall investor protection and thus for the development of its financial markets. Conversely, even though it might be more politically palatable to adopt reforms increasing the CS score in a country dominated by NCS companies, such reforms would have limited consequences for the country's overall investor protection. Clearly, it is important to keep a country's NCS and CS scores separate in order to obtain a good understanding of all the forces shaping that nation's investor-protection system and impeding reforms in this area.

We conclude that researchers, shareholder advisers, and policymakers should not overlook the rich and useful information provided by keeping separate scores for a country's level of protection for investors in CS and NCS companies. Doing so is vital for assessing how well the country's system protects investors in particular companies or in public companies generally, how this protection has evolved over time, what forces have led to prevailing arrangements, and which reforms would be more or less difficult to obtain.

CONCLUSION

We have shown in this Article that any attempt to assess the governance of public firms around the world should depend critically on ownership structure. Some arrangements that benefit outside investors in companies without a controlling shareholder are either practically irrelevant or even counterproductive in the presence of a controlling shareholder, and vice versa.

Because of this fundamental difference between companies with and without a controlling shareholder, any governance-rating methodology that applies a single metric to companies or countries worldwide is bound to produce an inaccurate or even distorted picture. We have demonstrated that this problem afflicts—and undermines the effectiveness of—the CGQ system and the Anti-Director Rights and the Anti-Self-Dealing indices, the most influential and widely used global governance metrics.

Going forward, the quest to design a single, global rating methodology should be replaced by an effort to design two separate methodologies for assessing the governance of companies with and without a controlling shareholder. We have identified in this Article the key elements that should and should not be included in each of these methodologies. When assessing an individual company, one should use the rating methodology that fits the company's ownership structure. When assessing the quality of investor protection in a given country, one should keep separate scores on how well the country protects investors in companies with and without a controlling shareholder. We hope that our analysis will provide researchers, policymakers, and investors with a useful framework for evaluating and improving the governance of public companies around the world.