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**MANAGEMENT CONTROLLED FIRMS v. OWNER
CONTROLLED FIRMS: A HISTORICAL PERSPECTIVE
OF OWNERSHIP CONCENTRATION IN THE US,
EAST ASIA AND THE EU**

Andrew C. Spieler & Andrew S. Murray***

ABSTRACT

This paper will present a historical perspective on the relationship between owner controlled firms and management controlled firms in the US, Europe, and East Asia, and the degree to which concentration of ownership correlates with higher firm valuation. We will discuss how agency theory defines the degree to which owner and manager interests diverge. We will also discuss how that divergence as well as the costs of aligning the interests contributes to lower valuations for these firms. In addition, we present theories as to why the US financial structure and corporate governance structure contribute to reducing owner's ability to reign in ineffective management. Finally, we present aspects of the German corporate governance system as a solution to many of the issues that contribute to lower valuations for management controlled firms.

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THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

I. INTRODUCTION

Corporate governance in the modern corporation is based on the assumption that the objective of each corporation is to maximize the value of its owners. Thus, the primary purpose for the existence of a corporation is to maximize shareholder value through the maximization of shareholder profits, and the distribution of those profits back to the owners after payment to the firm's debtors. Since the first case law established the corporation as a separate legal entity¹, there exist two broad forms of corporate structure. The first falls in the category Owner Controlled (hereinafter OCs) firms and the second falls into the category of manager controlled firms (hereinafter MCs). On the surface, the distinction may not seem dramatic or economically relevant. However, the decision to retain the day to day control over a firm, or delegate his powers to a professional manager to act in his stead, is one of the most important decisions of the entrepreneur in the life cycle of the firm. Regardless of corporate ownership distribution, the end goal of the corporation remains the same: maximize owner(s) wealth. However, debates on the optimal of ownership concentration and managerial autonomy have been debated for over 80 years. In part one of this paper we will analyze the relative advantages and disadvantages of owner and manager controlled firms in the US, Europe, and Asia. In Part two of this paper we discuss the following questions:

- (1) Do owner-controlled firms produce profits and returns on investment that are superior to manager-controlled firms?
- (2) If so, what agency costs do owners incur to maintain control over managers who fail to provide satisfactory returns?
- (3) Why is the market for control of large publicly traded corporations not efficient enough to smooth out any real differences in the returns on investment between OCs and MCs?
- (4) What structural and regulatory features of our financial system contribute to these inefficiencies?

II. COMPARISON OF OCs AND MCs

A. Defining Owner Control and Manager Control

In any analysis of the effects of manager and owner based control, the key questions becomes one of defining owner and manager control. In a broad sense, owner control occurs where the equity holders of a firm maintain

¹ *Trustee of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518 (1819).

MANAGEMENT CONTROLLED FIRMS V. OWNER CONTROLLED FIRMS

sufficient control over the board of directors to have a measurable influence on policy either by direct control of votes on the board of directors, or indirectly through a sufficiently large share of the voting stock. Therefore, manager control exists in a firm where the shareholders fail to achieve sufficient board representation or voting stock control allowing managers to exercise more judgment than would be possible under OC regime.

The Temporary National Economic Committee² defines control as the power to select or change management. An owner exercises this power by using his voting power to nominate the board of directors. Monson, Chiu and Cooley argue that the relevant question in determining whether a firm is management controlled or owner controlled is determined by the percentage of control exercised by an investor or group of investors.³

As the remainder of the stock becomes more widely and thinly held a smaller proportion of the total is required to retain control of the firm.

Monsen, Chiu and Cooley article analyze return on investment (ROI) between OC and MC firms. The control distinction criteria were as follows:⁴

Owner Control

- (1) One party owning 10 percent or more of the voting stock is represented on the board or in management or is otherwise known to be in control
- (2) One party owns 20 percent or more of the voting stock 'Party' herein indicates an individual, family, family holding company, etc.

Management Control

- (1) No single block greater than 5 percent of the voting stock exists
- (2) There is no evidence of recent control

² TNEC Bureaucracy and Trusteeship in Large Corporations", Monograph No. 11 p. 27 (Washington, DC: US Government Printing Office, (1940)).

³ Monsen, R.J., Chiu, J.S., and Cooley, D.E., "The Effect of Separation of Ownership and Control on the Performance of a Large Firm", *Quarterly Journal of Economics*, (1967).

⁴ *Id.*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

B. Early Studies

Berle and Means through their seminal work on corporate governance *The Modern Corporation and Private Property* (1932); the authors initiated a debate in the academic and financial world that still has far reaching implications today. Berle and Means wrote:

We must conclude that the interests of control are different from and often radically opposed to those of ownership; that the owners most emphatically will not be served by a profit seeking control group. In the operation of the corporation, the controlling group, even if they own a large block of stock can serve their own pockets better by profiting at the expense of the company than by making profits for it.⁵

Berle and Means argued that the interest of managers in manager-controlled firms tend more towards “empire building”, or maintaining the status quo that provided them with high salaries and excessive perquisites and benefits of control. While they would be mindful of their obligation to provide ownership with profits that were commensurate with the level of risk they were taking, any profits gained above that could be redirected towards the managers and justified as a necessary business expense. In the popular book highlighting Wall Street greed, *Barbarians at the Gate* describes the dramatic events leading up to what was at the time, the largest leveraged buy out (LBO) in history. Russ Johnson was described as CEO who never met a perk he did not like. The book describes the lavish compensation package that RJR Nabisco’s executives possessed, as well as the companies exorbitant spending on things such as 5 private jets, or as the authors described it “the RJR Air Force”. The stock price of RJR Nabisco languished at the time (Fall 1988) around \$60 per share despite RJR’s string of strong quarterly profit results.⁶

As the mid-20th Century approached the conventional means of restraint that owners held on the managers of their corporations began to breakdown. This mechanism is the corporation’s board of directors. The board of directors in US Corporate Law is voted in by and bound to represent the interest of the shareholders. However, by the early 1960s the boards of directors fell under the sway of the CEOs that they were supposed to be holding

⁵ Berle, A. and Means, G., “*The Modern Corporation and Private Property*” New York: Harcourt, Brace & World, (1932).

⁶ Burrough, B. and Heylar, J., “*Barbarians at the Gate: The Fall of RJR Nabisco*”, Harper Collins Publishers (2003).

MANAGEMENT CONTROLLED FIRMS V. OWNER CONTROLLED FIRMS

accountable.

After World War II, the trend was for the top executive managers of widely held corporations to anoint themselves chairmen and place their subordinates and friendly outsiders on their boards of directors. Internally, the ranks of middle managers swelled, as corporate offices grew to accommodate more and more managerial functions-few of which were eliminated . . . As labor costs rose, they also pushed up middle management salaries and perquisites.⁷

As the economies of Asia and Europe began to fully recover from World War II, the complacency and stagnation brought on by overly cautious managers left corporate America unable to cope with the economic downturn. There are many factors that lead to the economic stagnation in the 1970s and early 1980s, but one of the most important was the reluctance of managers to innovate or invest in relatively risky investments. Once again the very nature of their position as managers made them unwilling to risk benefits associated with their positions.

The reluctance of managers to implement the needed changes to corporate America does not account for poor performance of the US economy during this period. Ownership failed to provide adequate oversight over management and the breakdown in the neutrality of the corporate board inhibited their ability to hold managers accountable. In any event the economic slowdown of the 1970s combined with the failure of shareholders to remove poorly performing management demonstrates that owners and managers do indeed have divergent interests.

1. Owner Control

One of the most important questions in modern corporate governance is how can the interests of professional managers can be aligned with those of the shareholders. With the onset of the industrial revolution in the United States especially after the American Civil War, the practice of the entrepreneur/owner being able to manage all aspects of his vast and growing corporation were coming to an end. Admittedly, icons of the era like Andrew Carnegie, John D. Rockefeller, and J.P. Morgan would continue to exercise substantial control over their corporations and over the US economy until the 1920s. In hindsight it

⁷ Baker, G.P. and Smith, G.D., *"The New Financial Capitalists"*, Cambridge University Press (1998).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

is easy to see how the interest of owners and managers began to diverge.

Most corporate lifecycles have three distinct phases: Growth Phase, Stability Phase, and Decline Phase. During the initial growth phase a corporation is most in need of its original owner, who as the promoter and entrepreneur is best positioned to exploit the market opportunities provided by the demand for the company's product or service. During the growth phase the corporation is likely to spend large sums of money on capital expenditures. Net working capital needs are also likely to increase as the corporation grows and uses infusions of capital to expand its market position. Typically, during this phase the company's P/E ratios are higher than they will be at any other time during its life cycle. This is the time period that a company benefits the most by having its owner and founder in control.

An owner/entrepreneur first identifies an opportunity to profitably provide a new good or service or to provide an existing good or service of superior quality or for a cheaper price. Because his contribution to profitability is the greatest, many academics have argued that the OC is more productive and thus more accountable to the owner's wishes. However, as the industrial revolution required companies to obtain ever larger amounts of capital to fund their investments in future growth, owner/managers faced an important financing choice: raise capital through an equity offering – initial public offering (IPO) or through debt (loan or bond issue). The disadvantage for both of these approaches is that any potential equity or debt investor is going to require a higher level of control over the company. An equity investor by the very nature of their voting rights will be able to influence corporate decisions as they acquire a controlling interest in the company. Similarly, debt investors through either bond covenants or loan restrictions limit the financial and operational flexibility of the company by restricting additional levels of debt or investments that are deemed to be too risky.

The OC possesses the advantage of aligning the interests of the owner and the manager by default. The junction point and the means of control that owners use to monitor and discipline the managers of a corporation is the board of directors. Corporations with relatively simple operations in the early phases of their life cycle tend to thrive under the owner/manager model. As previously discussed, these companies tend to have a greater need for the close supervision provided by the company's founder.

Another advantage of OCs for owners is that the owners retain the ability to control the future direction of the company including directing future investments and risk levels. The basic financial model for valuation, the capital asset pricing model (CAPM), takes into account an investor's expected and

MANAGEMENT CONTROLLED FIRMS V. OWNER CONTROLLED FIRMS

desired return per unit of risk which is measured by the corporation's Beta⁸. For example, suppose a US manufacturer of widgets is currently experiencing an increased demand for its product that is likely to last for the next 5-10 years. Further, assume that the company management is lead by the original owner of the corporation. Most owners after taking their companies public are likely to be more risk averse than a manager in a similar position of control. This difference in risk aversion can lead to investment outcomes that are suboptimal.

2. Market for Control

Peter Holl (1977) discusses the impact of the market for corporate control when considering whether OC produce superior returns relative to MC firms. Holl theorizes that if the market for control is efficient, then all firms whether MC or OC should exhibit similar holding period returns and valuation ratios.⁹ Holl uses a valuation ratio (predecessor to the eventual Tobin's q - the measure of the value of the firms equity shares divided by the value of the company's assets) to determine how efficiently managers are utilizing the assets of a company to generate value for shareholders. The lower the valuation ratio, the less the current owners are receiving from their investment in the company and the greater their incentive to exercise the power of their voting stock to remove the current managers. A lower valuation ratio would also increase the likelihood that outside suitors would contest the current incumbents for control over the corporation. Therefore, if the market for control is efficient, the phenomenon of poorly performing management controlled firms should be relatively rare and self correcting. Holl describes two methods that an efficient market may use to discipline inefficient management: Punitive Discipline and Corrective Discipline.¹⁰

The most obvious example of punitive discipline is when the valuation ratio of a corporation becomes so low that outside bidders for a corporation see the potential to realize a large upside in bidding for control of the firm. However, most major US corporations possess defensive mechanisms known as poison pills¹¹ that reduce the ability of outside bidders to obtain a controlling quantity of voting stock in a target corporation.

⁸ Fama, E., "Efficient Capital Markets: A Review of Theory and Empirical Work", *Journal of Finance*, No.2 (1970).

⁹ Holl, P., "Control Type and the Market for Corporate Control in Large US Corporations, *Journal of Industrial Economics* Vol. XXV (1977).

¹⁰ Holl, P., "Control Type and the Market for Corporate Control in Large US Corporations", *Journal of Industrial Economics* Vol. XXV (1977) at

¹¹ Other entrenchment devices include supermajority voting, staggered boards, change of control provisions, white knights and counterattacks (pacman defense).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

The threat of takeover and ousting from their positions and damage to their personal reputation serves as a countervailing force to maintain a valuation ratio relatively close to its theoretical maximum. Hence, the management team in a corporation aims to prevent the current owner from tendering their stock to the outside bidders by increasing dividends to current shareholders and reallocating resources and profits toward projects that are likely to increase the valuation ratio of the firm thereby satisfying the current owners and reducing the potential upside for any outside bidders. This “counterattack” by the firm’s managers then becomes a benefit to the owners known as the market’s “corrective discipline”.

Hindley (1970) conducted a study whereby he compared the valuation ratios for US Fortune 500 companies who had experienced an attempt from outside bidders to obtain control of the firm, and compared those valuation ratios with those of a control group of US firms that had not experienced a takeover attempt. Not surprisingly, Hindley finds that valuation for the group subject to takeovers was lower than those of the control group suggesting that lower valuation ratios do tend to attract outside bidders for takeover. This however does not resolve the question as to how much corrective/long term discipline improves the long term financial results of the firm. Holl introduces an equation to determine the long term effect of corrective discipline. As stated earlier, if the market can have a long term influence on the behavior and returns of MCs, then the market for control is efficient and there should be relatively little difference between the valuation ratios within the same industry. The valuation ratio is empirically tested using the following equation, $VR_{it} = a + b \times VR_{it-1}$, where VR_{it} is the valuation ratio of the i th firm in a given industry and t and $t-1$ are long run time periods and a and b are constants.

By comparing firms with valuation ratios that were below average (based on their position in the Fortune 500) in time $t-1$ compared with the degree in which the firm’s valuation ratio comes closer to the average in time t , Holl captures the impact of the corrective discipline in the long term value of firms. Estimates of the coefficients a and b vary according to the firms in the sample. Holl’s results found that imperfections in the market for control allow some management controlled firms to consistently maintain lower valuation ratios, while allowing the underperforming management team to avoid the guillotine of the market. Although as a whole the market’s influence tends to minimize the return differences between MCs and OCs, there is still a level of inefficiency in the market for control that permits some management teams to stay in control of poorly performing firms.

MANAGEMENT CONTROLLED FIRMS V. OWNER CONTROLLED FIRMS

C. Later Studies in Manager Control and the Problem of Agency

Jensen and Meckling (1977) and Anderson and Reeb (2003) conducted further studies of MC and OC firms. These studies discuss other factors that tend to influence the performance of Management Controlled firms with diffuse ownership relative to those of Owner Controlled Firms. The relationship between the owner of a firm and its managers is of the most basic -agent relationship; the owners (principal) contract with the manager (agent) to carry out the day-to-day decision making of the firm. The basic premise of agency theory is that the managers and shareholders interests will naturally diverge as managers seek job security (assuming earning at least their reservation wage) while shareholders seek maximum profits. Jensen and Meckling (1977) demonstrate that owners incur not just reduced returns that occur from the failure of management to maximize the owners wealth, but also incur increased agency costs because of the owners need to reduce the degree that a managers divert from the owners interest.¹² These increased agency costs include the cost of monitoring managers to ensure that they act in the interest of the owners and reduce the managers' ability to act in their own self interest. Managers will expend bonding efforts, e.g. external audit, to provide assurances to shareholders that further increase agency costs.

Given these disadvantages, it may seem puzzling that there has been a dramatic expansion in the number of Owner Controlled firms over the past century. Mizruchi (2004) points out that as the complexity, scale, and scope of a company's operations expand, the owner's ability to steer his business through the various financial, legal, and technical minefields that it may face diminishes. This was the original reason why managerial capitalism became the norm for US corporations by the beginning of the 20th Century.¹³ In companies that produce and use complex goods and services, or whose scope of operations require a level of expertise in general management beyond that of the typical owner/entrepreneur, a professional manager is the ideal option.¹⁴

Recent research highlights the potential advantages that independent Managers and Directors bring to a firm. Since owner and manager interests sometimes diverge, independent managers may provide an important check to protect minority shareholders from aggressive majority shareholders. At first glance the agency conflict between Owners and Managers does tend to create the potential for a lower level return for management controlled firms with

¹² Jensen, M. and Meckling, W., "Agency Costs and the Theory of the Firm" *Journal of Financial Economics* (1977).

¹³ Mizruchi, M., "Berle and Means Revisited: The Governance and Power of Large US Corporations" *Theory and Society* (2004).

¹⁴ *Id.*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

diffuse ownership. Anderson and Reeb (2003) argue that independent managers and directors play an important role preventing majority owners from expropriating the assets of the firm for themselves at the expense of the minority shareholders. Anderson and Reeb's results show that while there is a positive relationship between family control and firm market value but that the correlation begins to taper off above ownership concentration levels of 30%. Anderson and Reeb note:

One mechanism that outside shareholders can employ to mitigate family opportunism is an independent board of directors. Independent directors contribute expertise and objectivity that ostensibly minimizes insider entrenchment and the expropriation of firm resources.¹⁵

On the opposite end of the spectrum, Jensen (1983) discusses the substantial agency costs that are incurred by owner/entrepreneurs who monitor managers. He argues that the net effect decreases the value of the firm. Further, this reduced value also results in reduced liquidity among those firms whose ownership is diffuse.

D. Answering the Obvious Objection

Fama and Jensen (1983)¹⁶ in their study, attempt to answer a fundamental question that the reader may have. If the separation of ownership and control can lead to increased agency costs and lower returns, then why do firms choose to employ an ownership structure that allows managers a great range of autonomy? Clearly there are some benefits to granting professional managers the decision making authority they need to run the firm the way they see fit. Fama and Jensen postulate two overarching justifications for the existence of management controlled firms. First, not only are most modern corporations extremely complex, effective management may require specific knowledge and education that the owners do not possess. Second, since investors prefer liquidity, they are unlikely to have high concentrations of their wealth tied up in any one firm. Hence, ownership in these firms is likely to be diffusing not because the owners see that structure as advantageous for the businesses they establish, but rather because owners find it cheaper to protect their wealth through diversification. Firms therefore are becoming more and more diffused

¹⁵ Anderson, R. and Reeb, D. "Who Monitors the Family?"

¹⁶ Fama, E. and Jensen, M. "Separation of Ownership and Control" *Journal of Law and Economics* (1983).

MANAGEMENT CONTROLLED FIRMS V. OWNER CONTROLLED FIRMS

in their ownership, which creates the potential for increased conflict among the owners. This increases the need for independent managers who can make decisions based on their expertise and neutrality among the firm's owners.

III. DISCUSSION OF RETURNS STUDIES OF OC AND MC FIRMS IN THE US, EU, AND EAST ASIA

A. Europe

The results of the Monsen, Chiu and Cooley analysis find statistically significant differences between OCs and MCs. In particular, to the following metrics differed between the OC and MC firms: Sales to Total Assets (S/TA), Net Income to total assets (NI/TA), Net Income to Sales (NI/S) and Long Term Debt to Total Capitalization (LTD/TC). It seems clear from the results in Table 1 that in the period between 1952 and 1963 OC firms performed better than MCs.¹⁷

These results tend to broadly affirm the results of the Hindley study which suggests that the market for control of major US firms is not completely efficient. After all, if inefficient managers tend to be replaced either through the punitive or corrective discipline of the market, then there should be no serious long term difference between the returns of OCs and MCs. As Hindley suggests, the very existence of a statistically significant difference in performance between OCs and MCs indicates that there are some managers whose underperformance goes unpunished by the market. In the final part of this paper we present two hypotheses to explain the residual inefficiency in the market. Put quite simply, there are two explanations as to why the market for shareholder control retains inefficiencies (1) owners lack the information to contest management decisions or (2) owners lack the legal recourse to do so. The factors that help create the inefficiency in the market for control are equity market liquidity, informational asymmetry, the Business Judgment Rule and the *Unocal* anti-takeover rule.

Grosfield (2006)¹⁸ studied the effect of owner concentration and productivity for firms in the Warsaw Stock Exchange on an annual basis for the 12 year period 1991-2003. In this study Grosfield employed regression analysis to predict the Tobin's *q* which can be used as a proxy for determining the relative value of the firms. This study reports that owner concentration and productivity were positively correlated. The author argues that in those firms

¹⁷ See Monsen, Chiu and Cooley data sheet (Table 1).

¹⁸ Grosfield, I., "Ownership Concentration and Firm Performance: Evidence from an emerging market" *William Davidson Institute Working Paper No. 834*.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

were managers tend to possess specialized highly valued skill, such as IT firms, excessive ownership may actually stifle productivity. Although she provides no direct evidence to prove this theory, she does show that the IT firms that are more likely to exhibit low concentration of ownership.

La Porta, Lopez-de-Silanes, F. and Shleifer (1999) document that a majority of Western European publicly owned firms are family controlled. Therefore it is useful to determine the effect of family concentration on Western European firms. Maury (2004) used a sample of 1,672 Western European firms. His results show that valuations (measured by Tobin's q) and return on assets are 7% and 16% larger for family owned western European firms, respectively.¹⁹

B. East Asia

Faccio, Lang and Young (2001)²⁰ discuss the effects of ownership concentration in East Asian firms. As is the case in Europe a majority of East Asian firms are family controlled. East Asian firms tend to conform to the scenario described by Anderson and Reeb whereby family ownership becomes too concentrated and entrenched and feels free to expropriate the assets of the firm even during period of substantial economic loss. This paper focuses on the differences in dividend payments in these East Asian family owned firms. To the extent that these dividend payments are higher in Europe, Faccio et al. argue that this would be symbolic of these firms's intention to pay out dividends to all investors before it can be expropriated by a significant owner group. Faccio theorizes that there will be a tendency of East Asian family owned firms to expropriate assets of the firm and minority shareholders. Unlike in the US and Europe, the concept of an independent board of directors is still an anathema in Korea and Japan. Additionally, most Japanese and Korean firms are less mature compared to their US counterparts. Since the majority of Korean industrialization occurred between the 1960s and the 1980s, most of these firms are still owned by the original entrepreneurs or controlled by family interests, typically second generation. The Faccio study compiles the accounting data of over 5000 firms with ownership concentrations at the 5%, 10%, and 20% levels in France, Germany, Hong Kong, Indonesia, Italy, Japan, Malaysia, Philippines, Singapore, South Korea, Spain, Taiwan, Thailand, and the United Kingdom. The study documents a higher level of dividend payouts to European firms

¹⁹ Maury, B., "Family ownership and firm performance: Empirical evidence from Western European corporations" *Journal of Corporate Finance* (2002).

²⁰ Faccio, M, Lang, LHP, Young, L., "Dividends and Expropriation" *American Economic Review* (2001).

MANAGEMENT CONTROLLED FIRMS V. OWNER CONTROLLED FIRMS

relative to East Asian firms. The results are consistent with the theory that European firm management curtails expropriation more effectively through higher dividends to all shareholders, majority and minority.

IV. EXPLANATIONS FOR RESIDUAL MARKET INEFFICIENCY

A. The Limits of Owner Activism: A Preference for Liquidity over Control

Modern corporate finance is dominated by the Efficient Capital Markets hypothesis.²¹ This hypothesis states that an investor's return on capital must be commensurate with a premium over the market risk free rate, or the rate of return the investor could receive by investing his money in an asset with a guaranteed rate of return. The diffuse and largely atomistic nature of individual shareholdings significantly reduces the incentive to change management behavior. Inevitably, most owners come to the conclusion that it is easier and less costly to simply liquidate their ownership stake in an underperforming company, rather than to launch a concerted effort to remove management via a proxy fight.

This preference also stems from the simple fact that replacing management through the board of directors is no simple task, even for an owner with a substantial stake in the company. Throughout the 1980s and 1990s, owner activism seemed to be making a comeback via institutional investors such as banks and pension funds and private investors like Carl Icahn. California Public Employees' Retirement System (CalPERS), the largest US pension fund, is famous for its list of poorly governed firms that made the front page of USA Today. Their large shareholdings often precluded selling their stakes. On the other hand, private investors were probably motivated by the substantial returns obtained by LBO firms in the 1980s. Firms such as KKR and then upstart Blackstone Group engaged in bootstrap deals or highly leveraged purchases of underperforming companies with large amounts of cash.²² They then used their substantial control of the firm to implement strict changes in the way the firm is run, driving up the valuation ratio, allowing them to sell the firm back to the public for profit.

It was not long however until institutional investors began to realize that the cost of organizing a campaign against an incumbent management far outweighed the benefits. As long as there are firms out there that are run

²¹ Fama, E., "Efficient Capital Markets: A Review of Theory and Empirical Work", *Journal of Finance*, No.2 (1970).

²² Baker, G.P. and Smith, G.D., "*The New Financial Capitalists*", Cambridge University Press (1998).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

prudently owners and institutional investors are more likely to perceive “cashing out” as the most cost efficient option. Bainbridge (2006) in his article in *UCLA Law Review* discusses the inherent problems for an owner looking to start an “uprising” against incompetent managers:

Outside the unlikely limiting case in which the activist institution controls a majority of the stock, such measures necessarily require the support of other shareholders, which makes a shareholder insurrection against inefficient but entrenched managers a costly and difficult undertaking. Despite the considerable institutionalization of U.S. equity markets, stock ownership of domestic corporations remains relatively widely dispersed. A shareholder insurrection therefore requires support from a relatively large number of investors.

Putting together a winning coalition will require, among other things, ready mechanisms for communicating with other investors. Unfortunately, SEC rules on proxy solicitations, stock ownership disclosure, and controlling shareholder liabilities have long impeded communication and collective action. Even though the 1992 SEC rule amendments somewhat lowered the barriers to collective action, important impediments remain²³

B. Informational Asymmetry in Management Controlled Firms

In any market where there are buyers and sellers of a given product or service, the most important factor in the maintenance of market efficiency is information. In the US equity and debt markets, large bureaucratic regulatory bodies such as the SEC and self regulatory agencies, such as the NASD, NYSE, and FINRA have been erected for the chief purpose of ensuring that the information gap between buyers and sellers is minimal. Disclosure rules, accounting standards, rules on the initial offer and sale of securities all require parties on both sides of a transaction to have access to the same information. After all, if the average investor seeks to maximize his return for every unit of risk he takes on; a failure to accurately gauge the risk of an investment through

²³ Bainbridge, S.M., “The Case for Limited Shareholder Voting Rights”, *UCLA Law Review* 53 *UCLA L. Rev.* 601 (2006).

MANAGEMENT CONTROLLED FIRMS V. OWNER CONTROLLED FIRMS

lack of information reduces investing to the luck rather than informed decision-making.

Salamon and Smith (1979) tested the theory that MC's are more likely to alter their financial results to satisfy the owners rather than the OCs. Salamon and Smith called this theory the "information misrepresentation hypothesis" (IMH). The authors tested this hypothesis by measuring the degree that MCs security returns and accounting earnings correlate with years in which the firm announced changes in their accounting policies. In other words, if the security returns for an MC were related more toward changes in accounting policy than changes in the accounting returns of the firm to a greater extent than OCs, this would provide support for the IMH. Second, the authors measured the timing of accounting policy changes for MC firms. Therefore, if there was a significant difference between the security returns for MC in years where there were no accounting policy changes, relative to differences in security returns for OCs, it is likely the MCs have instituted the accounting policy changes for the purpose of altering the appearance of their earnings reports during low performing years.

Table 2 displays the authors' main findings.²⁴ To test their conjecture, the authors use standard Cumulative Abnormal Return (CAR) and Unexpected Earnings (UE) methodologies. CAR denotes the sum of abnormal returns (standardized by historical volatility) relative to a benchmark. If the number of instances where the return on a security (CAR) is at variance with the actual earnings of the firm during years in which a firm underwent a significant change in accounting policy is greater for MCs than OCs, then the findings would support the IMH. Such a finding would confirm that MCs tend to owe their higher returns during years of accounting policy changes more to those changes than to actual earnings. If this phenomenon occurs, more often with MCs than OCs, then the study would provide strong evidence that managers in these MC are deliberately hiding information from the owners. The results of the Salamon study indicate that there is a significant difference in the proportion of cases where the CAR and UE are inconsistent with MCs as compared with OCs.

Table 3²⁵ tests the timing of the accounting policy change decisions. Specifically, the statistical tests detect if there is a difference between MC and OC performance for years with and without accounting policy changes. The results in Table 4 do not find significant differences between years with and without an accounting policy change. For MCs, however, there is a substantial difference in the security returns for accounting policy change years and normal years. These results provide evidence that a management team is more likely to

²⁴ See Salamon and Smith Data Sheet (Table 2).

²⁵ See Salamon and Smith Data Sheet (Table 3).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

alter financial earnings reports during accounting years to artificially maintain or inflate share price. The implications of this study lend credence to the thesis of this paper that although MCs tend to provide a lower level of return than OCs, outside factors create inherent inefficiencies in the market for control.

V. LEGAL AND REGULATORY HURDLES TO AN EFFICIENT MARKET
FOR CONTROL

A. Unocal and the Business Judgment Rule

The Delaware Corporate code 8 Del. C. § 141 has had the greatest effect on the market for control and its inefficiency than any other factor. It has fostered a culture of impunity and has seriously weakened the basis of the principal-agent relationship that the Directors and Owners of a corporation are supposed to represent. The code reads in part:

- (a) The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.²⁶
- (e) A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of such member's duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.²⁷

²⁶ The Delaware Corporate code; 8 Del. C. § 141(a).

²⁷ The Delaware Corporate code; 8 Del. C. § 141(e).

MANAGEMENT CONTROLLED FIRMS V. OWNER CONTROLLED FIRMS

The Delaware Court of Chancery has interpreted the Delaware Corporate code as endorsing a “Business Judgment Rule”. This rule creates a legal protection for the board of directors that allows them to use their business judgment to benefit the shareholders as they see fit. The problem is that the term “benefit” is not adequately defined and that these “benefits” can be conferred on shareholders against their will. In the seminal case on the Business Judgment Rule, *Sinclair Oil Corp v. Levien*,²⁸ the Delaware Supreme Court held:

[A] Court will not interfere with the judgment of a board of directors unless there is a showing of gross and palpable overreaching. *Meyerson v. El Paso Natural Gas Co.*, 246 A.2d 789 (Del.Ch.1967). A board of directors enjoys a presumption of sound business judgment, and *its decisions will not be disturbed if they can be attributed to any rational business purpose*. A court under such circumstances will not substitute its own notions of what is or is not sound business judgment.²⁹

Later in the *Unocal v. Mesa Petroleum*³⁰ the court did erect an extra hurdle for a board of directors to overcome. According to the Unocal standard a Board must “show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person’s stock ownership...Furthermore, such proof is materially enhanced, as here, by the approval of a board comprised of a majority of outside independent directors who have acted in accordance with the foregoing standards.” The court then indicated that after demonstrating that the transaction was fair and reasonable, the business judgment rule would apply:

When a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders. In that respect a board’s duty is no different from any other responsibility it shoulders and its decisions should be no less entitled to the respect they otherwise would be accorded in the realm of business judgment.³¹

²⁸ *Sinclair Oil Corp v. Levien*, Del Supr., 280 A.2d. 717; (1971); *see also*, *Meyerson v. El Paso Natural Gas Co.*, 246 A.2d 789 (1967).

²⁹ *Sinclair Oil Corp.*, 280 A.2d. at 720 (emphasis added).

³⁰ *Unocal Corp. v. Mesa Petroleum Co.*, Del. Supr., 493 A.2d 946 (1985).

³¹ *Id.*

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

After going through this initial analysis the courts then apply the business judgment rule discussed in *Sinclair*. In sum, a board of directors wishing to resist an outside takeover bid need only show:

- (1) That they had a reasonable fear that the bidder or potential owner posed a threat
- (2) That such a threat is shared by the majority of “disinterested” directors (people without a conflict of interest in the deal)
- (3) That the actions be rationally related to a business purpose.

B. Anti-Takeover Provisions (Poison Pills)

In response to the takeover and LBO wave in the 1980s, firms erected provisions in the by laws and certificates of incorporation that were designed to make it more difficult for a potential bidders to gain control of a target firm against its will. Many of these provisions provide for expensive “golden parachutes” (lavish executive retirement packages) or trigger provisions where the firms stock splits into two when a bidder purchases a substantial amount of stock. The latter known as a “flip in” provision would make it more costly for a bidder to purchase a controlling majority of the stock in the firm. Originally these anti-takeover provisions were designed to deter 1980s takeover raiders and greenmailers, but it is not hard to see how these provisions would also make it hard for an efficient market for control to develop. The same provisions that can be used by a board of directors to fend off coercive and unfair tender offers from the raiders and force more attractive counteroffers, came to be used as a means for the board to entrench itself in its management position.

In *Unocal*, the Delaware court created a two step analysis for deciding if an anti-takeover provision is valid. First the court stated that a board of directors may not create an anti-takeover provision “solely or primarily out of a desire to perpetuate themselves in office.”³² The second test, the court argued, is one of balancing the nature of the threat from the bidder with the severity of the defense against such action. “A further aspect is the element of balance. If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed.”³³ Some examples of a threat that a bidder may pose are (1) price inadequacy, (2) Nature and timing of the offer, (3) Questions of illegality, (4) impact on constituencies other than shareholders, (5) risk of non-consummation of the deal and (6) inadequacy of the quality of the securities offered in exchange.

³² *Id.* at 955.

³³ *Id.* at 956.

MANAGEMENT CONTROLLED FIRMS V. OWNER CONTROLLED FIRMS

The *Unocal* standard, though adequate in theory, in practice may have become unworkable. Courts have had trouble determining whether under the facts of a given case a board of directors has erected an anti-takeover provision for the purpose of entrenching itself, or for the purpose of defending the owner's interests in the corporation. The *Unocal* standard also raises questions of agency. The very nature of a tender offer, where a bidder bypasses management and approaches the owners with an offer to purchase the shares of an underperforming corporation, brings into question whether a board is truly representing the wishes and interests of the owners by resisting a tender offer that they may approve of. Furthermore, as the Monsen study has shown, a corporation is likely to be target for a tender offer if its valuation ratio has dropped to a level where a bidder sees an opportunity to make a profit by improving the management of the firm. What is also questionable is the interested director standard, where the court implies that a vote by a majority of uninterested directors approving an anti-takeover defense would imply its fairness. Since the *Unocal* case was decided in 1985 there have been many cases that have come along where a board of directors has erected defenses, and whose motives are questionable, that the facts of the case do not meet *Unocal*'s stringent "solely or primarily out of a desire to perpetuate themselves in office" standard. With such a high hurdle, it is likely the boards of directors will continue to use anti-takeover measures as a means to entrench themselves in offices, thus frustrating the desire among owners for an efficient market for control.

Given the preference for liquidity it is useful to determine if the existence of a poison pill in a corporate charter has the effect of lowering the overall value of a firm. The rationale of the *Unocal* decision was that the courts wanted to empower a board of directors to repel a bidder whose plans for the firm would be destructive to the interests of the shareholders. It is clear however that since the *Unocal* court has failed to provide any standards separating actions that are taken to defend the shareholders interests from those taken to entrench the corporate management, the decision may become a legal bulwark protecting management from the owners they are in place to serve.

Ryngaert (1989)³⁴ studied the effect of poison pills on the share prices of the firms. If the Efficient Capital Markets Hypothesis is correct, then the market price of a security should reflect all known information that would impact the value of the underlying firm. Ryngaert posits two possible results consistent with opposing theories on poison pills.

³⁴ Ryngaert, M. "Firm Valuation, Takeover Defenses, and the Delaware Supreme Court", *Journal of Financial Management* (1989).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

If the value of firms rose during and after the period of the *Unocal* decision, then the markets subscribed to the “Shareholder Interest” hypothesis. This hypothesis states that the poison pill provisions will be used to protect the shareholder’s interests against aggressive bidders, who underbid the price of the firm, either through lack of a competitive bidding process or through a two-tiered tender offer. A two tiered offer usually involves a bidder offering a higher premium on the current price for the first group of shareholders to tender their shares (such as the first 60%) and a lower premium for a second group (such as the last 40%). This is meant to coerce the shareholders by “herding” them and taking advantage of the reduced bargaining power that a minority shareholder would have after the completion of the first phase of the tender offer.

The “Management Entrenchment” hypothesis posits that the managers are likely to use a poison pill provision to entrench themselves and make it more difficult to purchase the company. This results in both extending the tenure of the poorly performing management team, but also reduces the value of the shares of the firm, making the shares harder to sell on the market without a loss.

The results of the Ryngaert study indicated that the *Unocal* decision had in fact lower the value of publicly traded firms incorporated in Delaware who had already adopted poison pills before the *Unocal* decision. The results did not indicate any statistically significant negative movement in stock price for those Delaware firms that adopted poison pills after the *Unocal* decision.

VI. A REVIEW OF GERMAN CORPORATE GOVERNANCE AND A SOLUTION TO THE AGENCY CONUNDRUM

Recall that in Section 3 of this paper we discussed the relationship between ownership concentration and profitability in Poland and by comparing the relative dividend payouts in Western European and East Asian firms. In this section we discuss the aspects of the German system of Corporate Governance that may make supervision of management by owners more effective and help to reduce agency costs. The corporate governance structures in the US and UK are founded on the idea that the officers and directors of a corporation represent the owners, but are granted wide latitude to make business decisions, even in the face of objections from the shareholders. In the US, the majority of firms in the S&P 500 have boards who are elected on staggered years so that an entire intransigent board cannot be removed for poor performance in once shareholder meeting. Therefore, in the absence of a breach of their fiduciary duties of care and loyalty, the average investor has no recourse against ineffective management other than the liquidation of his shares. Adaptation of the German two-tiered board model may provide the answer.

MANAGEMENT CONTROLLED FIRMS V. OWNER CONTROLLED FIRMS

The underlying philosophy of the German corporate structure reflects the European belief that all persons who have a “stake” in a firm’s policy should have a role in the management of the firm. Whereas, the ultimate authority to manage a firm ultimately lies in the owners in Anglo-Saxon countries, Germany focuses on giving non-owners such as employees and suppliers the ability to influence firm policy. In keeping with that philosophy, Germany incorporates a two-tier board consisting of a Management Board (Vorstand) and a Supervisory Board (Aufsichtsrat). The Management Board is charged with the actual operational decisions of the enterprise. Their role is analogous to the traditional board of directors in the US in that sense the Management Board represents the interests of the owners of the firm. The Supervisory Board is appointed by shareholders and employees of the company. It appoints non-managing members of the supervisory board and is designed to represent the interests of outside stakeholders. The Supervisory Board is governed by German tradition of labor codetermination. This concept means that a firm’s labor and management plays a strong role in the Supervisory Board, which in turn supervises the management board.³⁵

Recall that in the previous section we posited for the fundamental governance issues related to liquidity, information asymmetry, the *Unocal* decision, the business judgment rule, and the increased use of poison pills. Admittedly the German system of corporate governance is no panacea in the effort to align the interests of ownership and management. However, a US adaptation of the supervisory board will solve some of the issues below.

- (1) **Preference for Liquidity**-The Supervisory Board will provide supervision of the management board on behalf of shareholder’s whose focus would otherwise be strictly on being able to liquidate their interest.
- (2) **Information Asymmetry**-The Supervisory Board’s role in representing shareholder interests will give them access to inside information on firm performance and reduce information asymmetry issues.
- (3) **Business Judgment Rule and Poison Pills**-The Business Judgment Rule is a legal construction by the Delaware Court limiting the ability of shareholders to pursue the drastic and draconian measure of a lawsuit if they disagree with the decisions of management or the board of directors. A supervisory board will allow shareholders to have more direct representation, while still

³⁵ Mintz, S “A Comparison of Corporate Governance Systems in the US, UK, and Germany” *Corporate Ownership & Control* Vol. 3 Issue 4 (2006).

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

keeping agency costs low. The supervisory board's only role will be to supervise and monitor the decisions of the board of directors and management and to intervene when necessary. This authority will in effect eliminate the need for shareholder derivative lawsuits by giving owners recourse to monitor management outside of the courts. A US based Supervisory board will have the authority to approve revisions to the corporate charter, and to review the fairness of a tender offer.

VII. SUMMARY

In this paper, we have summarized the differences between OCs and MCs, and the relative advantages of each type of firm. Additionally, evidence was provided to demonstrate that OCs provide superior returns as measured by the valuation ratio (Tobin's q and several accounting performance metrics) of the respective firms. As far back as Berle and Means in 1932, authors have theorized that OCs provides returns that are superior to those of MCs because of the inherent difference between the interests of the owners and management. We discussed the apparent contradiction between a completely efficient market for control and a discrepancy in the valuation ratios of OCs and MCs. If the market for control of US firms was efficient, then Berle and Means' theory should be proven false. We have seen that clearly there are real differences in the returns between OCs and MCs, and that those differences do relate to diverging interests. Managers have an interest in at least partially diverting the profits of the corporation for themselves, and in advocating policies that help to entrench the incumbent management. On the other hand, the directors of a firm are charged with representing the owners, but in the modern firm, directors are more likely to be personally connected to the officers. This creates some inherent conflicts for a board that in theory should act as an agent for the shareholders but in practices is another tool that the officers use to entrench themselves.

Why are managers able to avoid the accountability of sub-par performance? The liquidity and diffuseness of the modern US equity market makes it more cost effective for an owner/investor to liquidate his holdings ("vote with your feet") in a poorly performing firm than to launch an insurgency against an entrenched and poorly performing management. Additionally, there are legal and regulatory disadvantages to any investor who tries to coerce poorly performing management through the legal system. While the "business judgment rule" and the "Unocal" anti-takeover have their merits, and on net benefit our system of corporate governance, the management of modern US firms have used these legal doctrines to entrench themselves in ways predicted

MANAGEMENT CONTROLLED FIRMS V. OWNER CONTROLLED FIRMS

by Berle and Means. It is incumbent on policy makers and business leaders to try to develop a new legal doctrine that strikes a better balance between the needs of a firm's management to be able to take risks on behalf of firm owners and the needs of those owners to retain control over the management of the firms that they own. Ultimately, until such a doctrine is established, the diverging interests of managers and owners, and the inherent difficulty in removing poorly performing management, will continue to drag down the returns of management controlled firms in the US.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

TABLE 1
COMPARISON OF FINANCIAL PERFORMANCE OF OCs AND MC's

S=Sales

TA=Total Assets

NI=Net Income

LTD=Long Term Debt to Equity

	S/TA	NI/TA	NI/S	LTD
CONTROL TYPE				
Owner Controlled	180.1	7.65	5.86	15.5
Manager Controlled	159.3	6.09	5.29	16.3
INDUSTRY				
Meat Products	504.7	2.96	0.69	16.2
Canning and Preserving	164.2	5.48	3.32	20.1
Industry Chemicals	101.1	9.11	9.47	16.6
Drugs	109.9	11.71	10.8	4.9
Oil Refiners	96.2	6.84	7.55	17.8
Iron and Steel	106.9	6.12	5.72	16.4
Nonferrous	70.0	5.57	8.21	25.8
Electrical	172.3	6.26	3.63	22.1
Motor Vehicles	187.9	5.40	3.02	11.6
Aircraft	246.4	6.97	2.95	11.3
Industrial Machines	140.7	6.58	4.55	14.4
Business Machines	136.3	9.45	6.96	13.1
YEAR				
1963	161	5.63	5.12	15.6
1962	159.7	6.41	5.41	15.4
1961	157.3	5.57	5.03	16.0
1960	160.4	6.17	5.28	15.5
1959	160.3	7.50	6.04	16.2
1958	157.8	6.22	5.4	16.9
1957	168.9	7.56	6.1	17.6
1956	174.9	7.61	6.16	17.0
1955	182.1	8.48	6.42	15.7
1954	177.8	7.00	5.38	15.4
1953	193.7	7.37	5.17	14.4
1952	182.9	6.93	5.43	14.8

MANAGEMENT CONTROLLED FIRMS V. OWNER CONTROLLED FIRMS

TABLE 2: CAR-UE CONSISTENCY (*SALOMAN AND SMITH*)

EARNINGS FORECAST MODEL	MANAGEMENT CONTROLLED	OWNER CONTROLLED	SIGNIFICANCE
MARTINGALE EPS MODEL			
CONSISTENT CASES	61	56	
INCONSISTENT CASES	42	23	0.072
EXPONENTIAL SMOOTHING MODEL			
CONSISTENT CASES	57	55	
INCONSISTENT CASES	46	24	0.035

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

**TABLE 3: CAR DURING POLICY DECISION YEARS COMPARED
TO OTHER YEARS (*SALAMON AND SMITH*)**

<u>MANAGEMENT CONTROLLED</u>	<u>SIGNIFICANCE OF CAR</u>		<u>SIGNIFICANCE LEVEL</u>
	+	-	
Policy Decision Years	44	59	
Other Years	107	76	0.01
<u>OWNER CONTROLLED</u>			
Policy Decision Years	39	40	
Other Years	110	96	0.32

MANAGEMENT CONTROLLED FIRMS V. OWNER CONTROLLED FIRMS

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