Report of Professors Ronald J. Gilson and Alan Schwartz Concerning Recommendations of the Committee on Enhancing Competitiveness

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I. Introduction

We have been retained by the the Norstar Holdings Inc., Gazit Globe Ltd. and Alony Hetz Properties & Investments Ltd**.** to assess those of the October 11, 2011 recommendations of the Committee on Enhancing Competitiveness (the "Committee") that concern the corporate governance of related Israeli corporations organized as pyramids. We have received and reviewed an English language translation of the Committee's report. For purposes of our report, we define a pyramid organization as a vertical chain of corporations in which a controlling shareholder group controls the top corporation in the chain, which in turn owns voting control of a subsidiary, which in turn owns voting control of another corporation, and so on down the chain. The controlling shareholder thus maintains control of each corporation in the chain, though without owning equity in each corporation that corresponds to its voting control. The divergence between actual and ownership right control may increase as one moves down the chain of ownership.

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Law School and a Professor at the Yale School of Management. He is an independent director of Cliffs Natural Resources Co., an S&P and Fortune 500 company, and Furniture Brands International, the second largest United States furniture company by revenue. Both are New York Stock Exchange listed companies. Our vitaes are attached as Exhibits A and B respectively.

We show here that the Committee's recommendations concerning the corporate governance of pyramids suffer from three important flaws, which vitiate each recommendation.

First, the Committee's analysis is analytically incomplete. Its Report argues only that a difference between a controlling shareholder's equity stake in a corporation and its voting rights create the potential for an agency problem, and that this potential is increasing in the degree of divergence. The Committee leaves out (i) an assessment of the extent of this agency problem; (ii) a comparison of the character and magnitude of this agency problem with the same agency problem that inheres in corporations with widely dispersed shareholdings, the form of shareholder distribution that the Committee apparently prefers; and (iii) an assessment of the offsetting benefits in the form of better monitoring of management that the presence of a controlling shareholder makes possible.

Regarding the second flaw in the Committee's analysis, the relevant question for policy is whether a problem that may be serious in theory actually is serious in practice. The Committee does not provide an empirical analysis of the agency problem on which it focuses. Thus, the legislature cannot know whether the

Committee's far reaching recommendations respond to an actual rather than a potential concern and, if actual, to the magnitude of the problem.

Third, the Recommendations consider structural responses to the potential agency problem, but the Committee does not ask whether existing legal responses sufficiently deter the misbehavior that concerns it. The experience of other jurisdictions with effective legal systems, however, shows that potential agency costs can be effectively constrained by ex post legal enforcement. The Committee assumes that Israel has an effective judicial system. Indeed, Israel has recently established a specialized court to deal with precisely the kinds of interested transactions that underlay the Committee's concerns. ITherefore, the Committee's recommendations are both partial and premature: partial because the Committee advocates ex ante structural restrictions on particular distributions of shareholdings or control structures without assessing existing legal responses to possibly conflicted controlling shareholder acts; and premature because the Committee recommends major interventions without considering how the new Israeli court would function in this area. Part II of this Report provides an analytic framework with which to assess the potential agency problem associated with the pyramid organization and the appropriate response to that problem. Part III then assesses particular Committee Recommendations.

II. Analytic Framework: Matching the Character of Particular Agency Costs to the Best Responses

A. The Potential for Agency Costs is the Result of Beneficial Specialization

The potential for an agency problem exists whenever shareholders invest in a company that they do not control. This agency cost is the reciprocal of the benefits that result from the specialization – investors in risk bearing and managers in managing -- that public capital markets make possible. Because a shareholder can cheaply and easily hold a diversified portfolio of stocks – a small minority of stock in each company in his or her portfolio – the shareholder does not bear firm specific risk, and so need not be paid to bear it. The result is to lower the corporation's cost of capital. In turn, the opportunity for an entrepreneur to secure external capital allows managers to specialize in management: a good manager need not contribute capital to the enterprise. This specialization has allowed the professionalization of management.[1]

The benefits of specialization necessarily carry with them the potential for agency costs. The managers, who are in control, may manage inefficiently (violate the duty of care)); and they may favor themselves at the expense of shareholders (violate the duty of loyalty). Efficient specialization would be constrained if these possible agency costs cannot be effectively addressed. Minority shareholders cannot monitor the performance of management. Precisely because of risk bearing specialization (diversification), these non-controlling shareholders lack both the expertise to monitor the performance of specialized managers and the incentive to do so – their individual holdings are too small to warrant the effort. Diversified shareholders are rationally passive.

[1]See Alfred Chandler, The Managerial Revolution in American Business (1993).

B. Methods to Address Agency Costs in the Absence of a Controlling Shareholder[2]

1. Lack of diligence and poor performance

Effective methods of addressing agency costs are thus necessary to capture the benefits of specialization in risk bearing and in management. The techniques for protecting the minority shareholders should differ depending on the type of agency cost presented.

Courts are a poor institution for policing a lack of managerial diligence and/or poor performance. The results of an investment reflect the realization of a probability distribution. A poor outcome may be the result of bad luck – a good investment ex ante with an unlucky outcome – or the result of management's bad judgment in pursuing a poor project. Courts cannot effectively distinguish between bad luck and bad judgment based on the single observation presented in litigation. As a result, legal remedies for managerial poor performance typically are severely restricted, as by the business judgment rule in the United States.

In contrast, markets are a good institution for policing managerial performance. The policing task is undertaken by specialized analysts who are paid to do so and who can evaluate a pattern of events rather than a single occurrence. Poor performance results in a drop in stock price and the potential for more dramatic market responses, such as a hostile takeover, a proxy fight or an activist investor seeking to change corporate policy.

[2] We refer to a company in which the managers have effective control though holding only a small fraction of the cash flow rights and the shareholders are widely diversified as a Berle and Means ("B&M") company.

To summarize, the task of identifying and responding to management's lack of diligence or poor performance in B&M companies is sensibly allocated to the market rather than to the courts. There is an effective match between problem and remedy.

2. Disloyalty and Self-interested Transactions

In contrast, legal rules provide the front line defense to agency costs that are manifested through disloyalty and self-interested transactions. Interested transactions may have economic value, so they should not be, and are not, prohibited ex ante. Rather, these transactions are subjected to very careful judicial review to assess whether the terms are fair to non-controlling shareholders. Statutes and courts can articulate standards to which interested transactions will be held. In brief, these standards require the terms of a self dealing transaction to be equivalent to the terms that would be in the same transaction type were it conducted at arm's length. The facts concerning challenged transactions commonly are observable to reviewing courts. Hence, courts can remedy self-dealing transactions that fail the equivalence test. Parties that anticipate effective judicial oversight then can conform their behavior to the rule ex ante.

Thus, in B&M companies, which lack a controlling shareholder, the law matches agency problems to their most effective responses. Conflicts of interest are policed by legislatures and courts; lack of diligenceor poor performance are policed by the capital market.

C. Methods to Address Agency Costs in the Presence of a Controlling Shareholder

1. Lack of diligence and poor performance

Controlling shareholders have an advantage over both widely dispersed shareholders and markets in policing the diligence and performance of management.[3] A controlling shareholder commonly has both the skills and, because of its investment, the incentive to monitor management's diligence and performance. The controlling shareholder may also choose to manage the corporation itself. Thus, the controlling shareholder can efficiently observe and evaluate managerial behavior.

In comparison, market mechanisms for policing management diligence and performance are subject to substantial frictions. They are suitable only for obviously poor performance, where the magnitude of the lost value is large and the steps necessary to address poor performance are straightforward. For example, markets cannot conveniently remedy problems that require deep knowledge of the corporation's business and operations to evaluate. Moreover, the large premiums associated with takeovers are evidence that managerial under performance must be very significant before markets act.

From this perspective, controlling shareholders are an effective alternative to market policing of the agency cost of managerial lack of diligence and poor performance that result from the specialization of risk bearing and management. Pyramids, and other means of expanding the reach of a controlling shareholder's

[3] See Ronald J. Gilson, Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy, 119 Harv. L.Rev.1642 (2006); Ronald J. Gilson & Jeffrey Gordon, Controlling Controlling Shareholders, 152 U.Penn. L. Rev. 785 (2003).

authority, thus capture economies of scale associated with monitoring management's diligence and performance.

2. Disloyalty and Self-interested Transactions

While controlling shareholders are more effective than markets at monitoring management performance, they present their own agency problem – the potential for self-dealing at which the Committee directs its recommendations. Taking advantage of scale economies in monitoring through the pyramid organization can increase the incentive for self-dealing. Controlling shareholders may shift profits to themselves at the expense of minority shareholders because the controlling shareholder bears only a portion of the costs of creating the profits it diverts. The more attenuated the controlling shareholder's cash flow rights are, the greater is this incentive. Thus, there is a trade off in pyramids between more effective performance monitoring and increased incentives for self-dealing.

Loyalty issues and self dealing by controlling shareholders, however, can be constrained by legal rules that are not different in their framing or application from the legal rules that constrain self dealing by management of B&M corporations. This is not surprising. The position of management as regards self dealing in a corporation with widely distributed shareholders presents an extreme version of the position of a controlling shareholder in a pyramid organization: the management has very little equity *and* complete control, a correspondence to which we will return in our assessment of the Committee's recommendations.

The analysis of how to address the potential for self-dealing in a pyramid organization thus parallels the analysis of how to address the potential for self-dealing in the B&M setting. Because interested transactions conducted within pyramid organizations may have economic value, they should not be prohibited or discriminated against ex ante. Instead, interested transactions should be subjected to careful ex post judicial review by courts, who can observe the terms of a transaction and apply fairness rules to which the parties can conform their transactions ex ante. Thus, efficient legal rules and effective judicial enforcement permit the state to capture the agency cost gains from more effective monitoring of management by controlling shareholders, in the pyramid organization and in others, while still constraining the incentive for controlling shareholders to self-deal.

As is apparent, this analysis presupposes an effective legal system that can constrain agency costs by enacting control structures that also allow more effective monitoring of management. Controlling shareholders and pyramids present entirely different problems in jurisdictions that lack an effective legal system.[4] The Committee's recommendations, thus, appear to be premised on the unstated but incorrect assumption that Israeli courts cannot effectively police interested transactions. As discussed in Part I, this assumption ignores the ability of Israel's regular courts, and its recently established corporate court, to deal with precisely these kinds of interested transactions.

In contrast to legal constraints on self-dealing, market mechanisms such as takeovers are of limited value with respect to controlling shareholders in

[4] See Gilson, Controlling Shareholders and Corporate Governance, supra note 2.

jurisdictions like Israel that have effective legal systems. As discussed in greater detail later in this Report, requiring that minority shareholders participate in a control premium received by a controlling shareholder for sale of its control by means, for example, of tag long rights or a mandatory bid rule, makes minority shareholders worse off by reducing the number of control sales. As long as effective legal rules prevent a new controlling shareholder from increasing the amount of self-dealing that the selling controlling shareholder had engaged in, the buyer can earn a return on its investment only by increasing the company's economic performance. In an effective legal system, the value gain from better performance is shared proportionately with minority shareholders.

D. Summary

The Committee's recommendations follow from the premise that controlling shareholders in a pyramid organization present fundamentally different governance problems than the problems that attend the separation of ownership and management in the B&M corporation. This premise is incorrect.. The incentive for self-dealing in both pyramid and B&M corporations arises from the disjunction between control and cash flow rights. With widely distributed equity, this disjunction is enormous. This creates incentives for self-dealing equal to or worse than those presented by pyramid organizations. Corporate governance deals with this potential agency cost in widely held corporations through effective legal rules that police self-dealing. There is no reason to deal differently with the same problem when presented by controlling shareholders or a pyramid organization. In both settings, ex post legal rules and an effective

legal system can constrain self dealing resulting from agency costs. The Committee's recommendations largely seek to use new governance mechanisms to constrain self-dealing, when legal rules do so more effectively. The recommendations thus represent a mismatch between problem and remedy.

III. Assessment of Specific Committee Recommendations

A. Committee Recommendation 1: Definition of a Wedge Company

Committee recommendation 1 defines a "wedge company" as a corporation that (i) has public shareholders; (ii) has a controlling shareholder that owns 50% or less of the corporation's stock; (iii) the "controller" has voting rights that exceed its cash flow rights; and (iv) the controller acquired its control "as a result of the holding of capital interest through another public company". A wedge company, that is, is a subordinate company in a pyramid. The Committee believes that this corporate structure poses special risks to a wedge company's public minority shareholders. Hence, the Recommendations that follow would restrict what today are the controller's governance rights in order better to protect the minority shareholders. As developed in Part II of this Report, and as we discuss further below, a wedge company, so defined, poses no unique risks to non-controlling shareholders; it is only a special case of the problem presented by corporations that lack a controlling shareholder. Hence, there is no need for a separate definition of these companies. Rather, the matching of problem with remedy dictates that the critical definitions are those of an interested transaction and of the arm's length standards that measure its fairness.

The premise for the definition, and the regulation that rests on it, is that the public shareholders' rights are endangered when a controlling shareholder's control rights exceed its cash flow rights. The premise is correct, but the problem is general: it exists under a variety of corporate structures. In the United States, for example, many public companies are widely held, with the managers and directors holding a tiny fraction of the cash flow rights. The "wedge" between the managers' ability effectively to control these companies and their cash flow rights exceeds by a wide margin the wedge in the typical Israeli pyramid. Thus, the better regulatory strategy is to identify the particular dangers that various "wedge form" companies pose, and to create tailored responses to those dangers.

The dangers that the separation of control rights from cash flow rights pose can be grouped under two broad headings: (a) possible violations of the *duty of care*; and (b) possible violations of the *duty of loyalty*. The best responses to duty of care concerns (i) should be a function of the particular corporate structure at issue; and (ii) should be made by private actors. The best responses to duty of loyalty concerns (i) do not importantly depend on the particular corporate structure; and (ii) should be made in the first instance by private actors, but these actors should function in the shadow, and under the constraint, of the positive law.

We begin with the duty of care, as it can be enforced in a B&M company: there, the managers are in effective control but hold a very small fraction of the cash flow rights. The danger is that the managers will shirk. They bear all of their effort costs but internalize few of the monetary gains from those efforts. In

consequence, the managers' equilibrium level of effort is too low. Managerial shirking can persist because each "principal" – each public shareholder -- also holds a small fraction of the cash flow rights; hence, the equilibrium effort of shareholder monitoring of the managers' performance also is too low.

There are two solutions to the managerial shirking problem in B&M companies. First, shareholders can exit. This can depress the share price, which would both reduce the value of the stock the managers do own, and call attention to the managers' poor performance. Second, there is the market for corporate control. Poor managers are displaced in takeovers. Also, the threat of a takeover reduces the returns to managerial shirking and so helps to deter it.

The duty of care concern is ameliorated somewhat differently in controlling shareholder companies. The relevant question there, from the viewpoint of value maximization, is not whether control rights and cash flow rights differ. Rather, the question is whether the controller holds sufficient cash flow rights to warrant incurring significant monitoring costs. If the controller can internalize a sufficient portion of the gains from actively overseeing the managers of a subordinate company, then the controller will fire bad managers, promote good ones and evaluate the subordinates' plans. Though the issue is empirical, it is our impression that the controller in most pyramids in Israel holds substantial (in absolute value terms) shares of the cash flow rights in the lower companies. To the extent that our impression holds, monitoring in controlling shareholder companies is an effective substitute for the shareholder exit and corporate control responses that B&M companies require.

We note that the analysis here is general. All B&M companies should be treated alike for duty of care purposes. More relevantly, all controlling shareholder companies should be treated alike. The issue is not how control came to be exercised, whether as a result of the absence of control by shareholders or the fact of effective control by a controlling shareholder Rather, the issue is whether the controller, whatever the source of its control, holds sufficient cash flow rights to make managerial monitoring cost justified.

Turning to the duty of loyalty, there are *internal* and *external* responses. The internal response is to have self-dealing transactions evaluated by representatives of the public shareholders. The consent of the "majority of the minority" or by committees of independent directors to interested transactions typically is required, and is commonly considered effective In addition, minority shareholders who consider themselves disadvantaged despite these internal safeguards can obtain judicial review of self-interested transactions. Such review is effective when, as in Israel, the courts are honest, capable and, as with the new Israeli corporate court, also expert.[5]

This analysis too is general. Self-dealing in pyramids will take some of the same forms as in B&M corporations, and may take some different forms. The internal and external solutions to those problems, however, are appropriate for all forms of self-dealing. Representatives of the public shareholders commonly have the ability and incentives to evaluate self-dealing transactions, and the

[5] Although the Committee does not address the role of lenders in monitoring controlling shareholders, we note that lenders to a wedge company also monitor interested transactions between the controlling shareholder and the wedge company. Such transactions reduce the assets available to pay lenders. The lenders thus protect themselves – and the minority shareholders – by contractual restrictions on interested transactions.

courts in Israel are capable of identifying and deterring it. All of this analysis leads to our conclusion regarding Recommendation One:

Conclusion: (a) The pyramid organization poses the same duty of care and duty of loyalty problems as do controlling shareholder companies generally and as do B&M corporations; (b) existing responses to those problems, *and responses along the lines of existing responses*, are appropriate for those problems; so that (c) there is no need for Israeli law to create a separate category for subordinate companies in pyramids.

B. Committee Recommendation 4: Restrictions on Creating a New Wedge Company

This Recommendation applies when the acquisition of a controlling interest in a public company that is not a wedge company (i.e., not part of a pyramid) causes the acquired company to become a wedge company. The acquirer must then offer to purchase the shares of the non-controlling shareholders at the same price paid for its controlling interest. In effect, the recommendation imposes a mandatory bid obligation if through an acquisition of control the target company becomes part of a pyramid.

Although the Committee recognizes that a transfer of control can create value, it believes that the mandatory bid is necessary to prevent transactions that "negatively influence minority shareholders by turning a company into a wedge company." A similar obligation is not created with respect to other acquisitions of control, again reflecting the Committee's mistaken belief that the pyramid organization presents a unique problem of the separation of ownership and control. As discussed in Part II, the standard B&M company presents the most

extreme example of a wedge company, where there is no controlling shareholder and management holds little equity. In that setting, the same or worse incentives exist for controlling management to engage in self-dealing as exists in pyramid organizations. Other countries recognize the correspondence between the two manifestations of a separation of ownership and control, and impose a mandatory bid obligation on the acquirer of control of any public company. While we do not favor mandatory bid rules in general, the distinction drawn by the Recommendation between the acquisition of control by a wedge company and by a B&M company is not defensible.

Recommendation 4 reflects the Committee's preference for addressing the potential of self-dealing in pyramid organizations by regulating corporate structure and ownership, rather than through legal rules, as is done in every other corporate context. Part II and IIIA above show, however, that clear legal standards and judicial review of interested transactions allow value creating transactions to go forward while deterring exploitive transactions much more effectively than the recommended mandatory bid rule can. The Recommendation thus also reflects the Committee's ignoring the use of effective ex post legal rules in favor of over broad ex ante regulation.

United States law, which neither requires a mandatory bid in connection with a sale of control, nor the sharing of any control premium with the minority, draws precisely this distinction. A controlling shareholder is prohibited from selling control at a premium not shared with the minority only in circumstances

where the selling shareholder has reason to believe that the new controller will increase the level of self-dealing.

Conclusion: Acquisition of a controlling interest through a pyramid organization presents no different potential for self-dealing than other acquisitions of control. Legal rules address the potential for self-dealing more precisely than overbroad ex ante regulation.

C. Committee Recommendation 5: Creating an Exit Right for the Public Shareholders

This Recommendation grants an exit right to the public shareholders of a subordinate company in a pyramid if the company (a) receives an offer "to acquire all of the shares"; (b) "the offer is at least 10% higher than the market price"; and (c) "the offer would have been approved by the majority … if the controlling shareholder had not refused". When these conditions are met, the controller must "submit a complete tender offer to the remaining shareholders at a price equal to the tender offer submitted by the third party." As discussed in Part II and in our assessment of Recommendations 1 and 4, pyramid companies should be regulated no differently than other controlling shareholder companies. Controlling shareholders have the same incentive to sell, or not sell, regardless of the source of their control. Recommendation 5 also rests on the premise, which we address now, that a controlling shareholder is more reluctant to sell into an all shares bid than it should be. This premise is mistaken.

To see why Recommendation 5 should be rejected, suppose first that a potential buyer wants to buy only the controller's block. Denote the value of this block as V. This value is the sum of two elements: v_1: the value attributable to

the controller's cash flow rights; v_2: the private value attributable to the ability to exercise control. The latter value is constrained by the internal and external solutions to the duty of loyalty concern. The controller will not sell his control position, v_2, for less than it is worth. The acquirer will pay this value. It too would be subject to the same constraints regarding the exploitation of control as the selling controller. Hence, it could not violate the duty of loyalty to a greater degree than the controller of the pyramid company. On the other hand, the acquirer would have control rights that exceed its cash flow rights, so that it would have the same ability to exploit as the seller. The acquirer thus would pay v_2 as a control premium. From the perspective of capturing private benefits, minority shareholders thus are not affected by a sale of control

A potential acquirer therefore will not purchase the controller's block unless the acquirer expects to increase the value of the pyramid company. The acquirer is paying full price for the legally constrained value of control – v_2 – so it cannot make money *unless* it expects to increase the value of the pyramid company's returns. Because the controller has bargaining power (each target is to some extent unique), the acquirer will have to share increases in expected value with the controller. As a consequence, the controller would receive more than v_1 for its cash flow rights. The controlling shareholder in a pyramid company thus would sell its block. Denoting a bid as b, the controller will only see bids for its stake that satisfy $b > v_1 + v_2 = V$. The controller will accept all such bids.

Now consider a potential acquirer that makes a bid for all of the pyramid target's shares. If the bid is successful, the acquirer would own 100% of the

target's cash flow rights, and so would not have an incentive to transfer resources away from minority shareholders. We have shown, however, that the acquirer could purchase effective control by buying the controlling target shareholder's block. The acquirer thus must expect to realize more value by acquiring all of the pyramid target's shares than it could realize by buying only the controlling shares. The acquirer could compensate the controller for its loss of control rights out of this increased value. And because the controller will accept an offer that gives it the control premium and the usual cash flow premium, pyramid controllers will tender into attractive offers for all of a subordinate company's stock.

This analysis also implies that a controller's response to bids should not be regulated. Given effective legal constraints on any increase of private benefits as a result of the sale of control, the controller has appropriate incentives to sell, and so also has appropriate incentives not to sell. The best inference from rejection, then, is that the controller believes the market will pay more for the company or that the discounted future cash flows from the company, which must be shared proportionately with the public shareholders, exceed the offer price.

Conclusion: Recommendation 5 should not be adopted. The recommendation rests on the premise that the controlling shareholder of a pyramid will not tender to bids for all target shares, though a premium is 10% or more above the pre-bid price. This premise is false because in a jurisdiction with

an effective legal system controllers will tender into any bid for all of the shares that is acceptably above the cash flow rights of those shares.

D. Committee Recommendation 6: Strengthening the Board's Independence

This Recommendation is in four parts. We do not object to Parts A, C and D. Part B provides that "the voting process of the wedge company (parent) … for the appointment of director in a wedge company (subsidiary) will require the approval of the wedge company's (parent) audit committee." It is unclear whether the parent's audit committee would be given the power to approve all of the directors of a subsidiary company, or only the independent directors. These, under other parts of Recommendation 6, would ordinarily be a third of the board. We assume initially that the Recommendation requires audit committee approval of all of a subordinate company's directors. Our argument against granting approval power to audit also applies, though with less force, if the power is limited to a third of the directors.

Recommendation 6 assumes that audit committee members have the ability and the incentives to make informed decisions regarding the appointment of directors of subordinate companies. To our knowledge, no audit committee in the world has the power to make such decisions, and for good reason. An audit committee is tasked with overseeing a company's financial performance, its risk control structure (although separate risk management committees are beginning to appear) and, more recently, its sustainability performance. Audit committees thus review a company's financial reports; oversee the company's system of internal controls; review both the company's outside and inside audit plans;

otherwise hire and oversee the company's accountants; and exercise supervisory oversight over the company's controller and risk manager including review of interested transactions. The director nomination process is lodged either in the entire board or in a nominating committee.

Public companies usually have two, and more commonly, three other board committees. It is commonly the governance committee's task to match board appointments to committees with the skill sets those committees require. In addition, the governance committee reviews the company's corporate governance structure and the governance structure of other board committees; and it also evaluates board performance. The compensation committee creates and approves the managers' compensation contracts and evaluates managerial performance. The strategy committee oversees the company's business plan and helps shape the company's strategic direction.

Each board committee thus should be composed of directors whose skills match the committee's tasks. As a consequence, audit committee members are chosen primarily for their financial expertise. In the United States, for example, financial literacy is a required qualification for audit committee membership.

Approving the directors of subsidiary committees, in contrast, requires business, governance and strategic expertise. The approving entity must be able to match director qualifications to a subsidiary's business because it is the task of directors to manage that business. The parent pyramid company also must assemble a team of directors to subsidiary boards that have complementary skills. In sum, appointing, or approving, directors to a company requires

knowledge of how the company is run, what it does and how its directors function, individually and as a group.

This analysis implies that four bad consequences may flow from giving the parent's audit committee the power to approve directors of lower level companies. The first two would affect the parent audit committee adversely; the last two would affect the performance of the subsidiaries adversely. Beginning with the audit committee, its principal functions could be compromised because the recommendation may cause the parent's board to appoint to the audit committee persons that have the skills to approve or veto the directors of subsidiaries, but not necessarily the skills to perform core audit committee functions. Also, given how important it is for a subsidiary to have a capable board, the parent board may choose audit committee members, not for their financial or business skills, but for their tractability. Audit committee members will implement the parent board's preferences regarding a subsidiary's board because they were chosen to do what they are told.

Turning to the subordinate companies, the parent's audit committee may do a poor job of approving subsidiary directors for two reasons. First, if the parent's audit committee members are chosen primarily for their financial and related expertise, they will lack the skills to approve only good and to reject only bad subsidiary directors. Second, and in any event, the parent's audit committee will lack the incentive to approve good directors. This is a time consuming and difficult task. Members of the parent's audit committee do not hold financial positions in the subordinate companies. Thus, their power to approve would be

completely separated from their cash flow rights. Recommendation 6 therefore would create what the Committee believes is the worst feature of a wedge company in the service of regulating wedge companies.

Perhaps the Recommendation is intended to be less prescriptive than its current framing. The Committee may want no more than that independent directors of a subsidiary be approved by the pyramid controlling shareholder's audit committee. So limiting the Recommendation would reduce the burden on the audit committee, but it would still represent a mismatch of problem and remedy. As we have stressed, the problem is the potential for self-dealing. The most effective remedy is legal oversight of interested transactions. Given that the controlling shareholder approves the selection of independent directors of the parent corporation, approval of subsidiary directors by those independent directors whom the controller selects adds little to the protection already provided by direct legal review of interested transactions.

Conclusion: Recommendation 6B should be rejected. The consequences of giving the parent's audit committee the power to approve all of a subsidiary company's directors would be bad for the committee itself and for the subsidiaries.

E. Committee Recommendation 7: Approval of Executive Remuneration

Recommendation 7 would require the compensation of senior executives in wedge companies to be approved by a majority of the minority shareholders. Shareholder approval of senior executive compensation in B&M companies, where senior managers may have a greater incentive to assign themselves

above-market levels of compensation, is not required. The Committee's recommendation is supportable only if non-controlling shareholders will do a better job than a controlling shareholder in monitoring executive compensation. There is no reason to believe that they can

As shown above, a central efficiency of controlling shareholders is that they are more effective monitors of management than are minority shareholders. Minority shareholders are rationally passive with respect to monitoring because they typically lack the incentive and skills to monitor managers effectively, including the effective oversight of executive compensation. We note in this regard that, in the United States, compensation disclosure is rapidly becoming the largest part of a company's annual proxy statement. In our view, it is unlikely that minority shareholders will invest the time necessary to understand complex compensation arrangements, and exercising an approval right without fully understanding the issue runs the risk of damaging the company.

It also should be stressed that Recommendation 7 does not involve the potential for self-dealing by a controlling shareholder. We understand that under Israeli law, the compensation of a controlling shareholder as well as his or her relatives would be an interested transaction, and subject to stricter oversight under existing law.

Conclusion: Minority shareholder oversight of non-controlling shareholder executives in wedge companies is unlikely to improve monitoring of levels and forms of executive compensation. This is an important advantage of controlling shareholder monitoring. Policing self-dealing by a controlling

shareholder regarding their own compensation and that of their affiliates is already subject to strict review under Israeli law.

F. Committee Recommendation 8: Corporate Governance and Disclosure: Interested Party Transactions

Recommendation 8 is in two parts. Part A requires that a wedge company either adopt a policy that all interested transactions be awarded through a formal competitive process supervised by the audit committee, or disclose why it has not. If the company has adopted such a policy and does not follow it with respect to a particular transaction, the fact of the deviation and the explanation for it must be disclosed. Part B appears to allow the audit committee to exempt interested transactions of negligible size from the competitive process.

Part A assumes that establishing a competitive bidding process for all transactions between the company and its controlling shareholder or an affiliate will reduce the instances of actual, as opposed to potential, self dealing. The problem Part A presents is with this assumption: as is the case with respect to other of the Committee recommendations, Part A would use ex ante structural regulation as opposed to ex post legal enforcement when the former is likely to be costly and the latter is not.

In a large percentage of commercial transactions, the contracting parties have continuing relations with each other, and rely on their mutual knowledge of each other's skills and capabilities in deciding whether to continue a commercial relationship. This is especially true in contracts involving technology and

innovation.[6] In contrast, an auction process tends to reduce the decision criteria to price alone, which ignores centrally important and difficult to observe characteristics such as trust, loyalty and the capacity to cooperate. The difference in success between Toyota's relational contracting with its suppliers, and GM's competitive process with its suppliers, has become an iconic example of one important reason why the US automobile industry collapsed.[7] A pyramid relationship also can further relational contracting without actual vertical integration, which presents its own difficulties.[8]

Part A is seriously misguided because it imposes a substantive requirement on how corporations can produce products in order to constrain a potential problem of self-interest. In contrast, existing legal rules governing interested transactions allow corporations to structure their substantive business transactions in the most efficient form and police self-dealing through ex ante legal rules.

Conclusion: The Committee proposes to let the tail wag the dog as a result of a mismatch of problem and remedy. Part A favors a form of contracting that will be inefficient in a significant number of circumstances, especially in technology-based companies and ones where innovation is central to competitive advantage – both of which characterize much of the Israeli economy. Because interested transactions can be policed directly, there is no reason to impose this inefficiency on a corporation's line activities.

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[6] See, e.g., Ronald J. Gilson, Charles Sabel & Robert Scott, Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration,109 Col. L. Rev. 431 (2009).
[7] See James P. Womack, Daniel T. Jones & Daniel Roos, The Machine that Changed the World: The Story of Lean Production (1991).
[8] Gilson, Sabel & Scott, supra note 4.

G. Committee Recommendation 9: Corporate Governance and Disclosure – Strengthening the Minority Shareholders

*R*ecommendation 9 also is in two parts. We object only to Part A. This Part sets out three decisions that "will require the approval of the general meeting with a majority of the minority shareholders". These decisions are (i) the acquisition of a "substantial operation"; (ii) the "acquisition of control in another public company"; and (iii) "raising substantial funds or debt". These decisions are described abstractly. For example, it is difficult to know how "substantial" an "operation" or a debt issue must be to trigger the minority approval requirement. The deeper concern is twofold: (a) the reforms are unnecessary and (b) as with the audit committee recommendation, this Recommendation would produce bad outcomes, largely because it contradicts the premise on which all of the recommendations allegedly rest.

Beginning with the first concern, the underlying premise is that the controller in a pyramid has an incentive to engage in "empire building": to pursue negative net present value projects just because they will increase the size of the pyramid. . As Part II of this Report shows, the empire building danger is more acute in B&M companies than in pyramid companies. This is so for two related reasons. First, as managerial compensation studies show, compensation in B&M companies is importantly a function of a company's gross revenue, rather than its profitability. Hence, managers that are not constrained by a controlling shareholder have an incentive to grow their companies even through negative net present value investments. Second, the managers hold a tiny fraction of the cash flow rights; hence, they bear only a tiny fraction of the costs that growth

motivated rather than profit motivated decisions create. In contrast, a controller with substantial cash flow rights internalizes more of the costs of bad decisions than B&M managers do, even when a controller's voting rights exceed its cash flow rights. This reasoning implies another result that studies confirm: empire building is a more serious problem in B&M companies than in controlling shareholder companies.

Legal regulation of empire building should thus be more thorough for B&M companies than for controlling shareholder companies. As a matter of fact, however, there is no legal regulation of empire building in B&M companies. Rather, corporate law treats empire building, as a species of poor performance, with the private actor methods described above: shareholder exit and the market for corporate control.[9] When the more serious danger – empire building in the B&M company – is not legally regulated, it requires much more argument and evidence than now exists to justify legal regulation of the less serious danger – empire building in the controlling shareholder company.

Turning to the second concern, controlling shareholders with substantial cash flow rights have the expertise and the incentive to choose efficient projects to pursue. In contrast, the public shareholders lack the ability and the incentives to make the major decisions on which Recommendation 9 focuses. It requires ability and experience to make or oversee major corporate decisions. The typical minority public shareholder lacks these traits. Though much stock is held by institutional investors, their expertise and incentives lie largely in their ability to

[9] See Kenneth Lehn & Mark L. Mitchell, Do Bad Bidders Become Good Targets. 98 J. Pol. Econ. 372 (1990).

manage portfolios, not actually to manage companies. Nor can the individual investor specialize in the companies whose stock he holds.

Public shareholders also lack the incentive to make informed corporate decisions. Reflecting the specialization in risk bearing discussed in Part II, these shareholders commonly diversify away from firm specific risk. Also, the typical public shareholder holds a relatively small fraction of a company's cash flow rights.

To be concrete, the board of a public company meets four to six times a year, and more frequently if necessary. Board committees meet from two or three – governance – to six to eight – audit – times a year. Major corporate decisions are taken on the record that is developed for these meetings and analyzed at them. A minority public shareholder likely will not attend the Annual Meeting and will, at most, read analysts' reports and the company's public documents. Thus, there is little reason to believe that the minority member of the public is better informed or more strongly motivated than the controlling shareholder to decide whether the company should issue debt or equity, in what amounts and for what purposes, or whether the company should make an acquisition or pursue a project. Rather, Recommendation 9A, as with other recommendations, would give control to persons whose cash flow rights are small and whose expertise is light, though the animating logic of the report is to shrink the gap between cash flow and control rights in the service of getting better and fairer corporate decisions.

Conclusion: Recommendation 9A should be rejected. The Recommendation assumes that the minority shareholders who cannot effectively monitor the management of a B&M company can effectively monitor the controller of a controlling shareholder company. This assumption is implausible on its face and even less plausible when subject to analysis and evidence. It may be responded that the goal is to prevent the controlling shareholder of a wedge company to increase the size of the controlled corporation in order to acquire more private benefits. As shown above, however, the existing internal and external responses to duty of loyalty violations are adequate. There is no need materially to weaken companies by transferring the locus of control from expert and motivated decision makers to inexpert and unmotivated decision makers, just in order to curb any additional pursuit of private benefits.

H. Committee Recommendation 11: Encouragement of Private Enforcement by Shareholders

Recommendation 11 makes two recommendations that the Committee believes will improve private enforcement of claims by minority shareholders, presumably with respect to interested transactions involving controlling shareholders. We are not specialists in the details of private enforcement and so offer no assessment of the effectiveness of these recommendations. We note only that an efficient private enforcement mechanism is a necessary complement to substantive legal rules that police self-interested transactions. Thus, well designed improvements in private enforcement will further support the use of ex post legal rules as a more precise method of attacking self interested transactions that favor a controlling shareholder than the general approach of

overbroad ex ante structural restrictions that animate the Committee's general approach.

I. Committee Recommendation 16; Limiting the Controlling Shareholder's Power in the General Meeting

This Recommendation proposes that the voting rights of a controlling shareholder be limited to the percentage of the equity owned by the controlling shareholder.[10] It is perhaps appropriate that the Committee hesitates to put forward its most expansive recommendation.

In Part II, and in our discussion of the Committee's other recommendations for structural regulation that restrict the operation of pyramid organization, we emphasized two important points. First, the Committee's recommendations do not balance the efficiency gains from better monitoring by a controlling shareholder relative to the monitoring of diversified minority shareholders or by the capital market against the potential for self-dealing. Second, preventing self-dealing by controlling shareholders, presumably the motive for the Committee's governance recommendations, could be more effectively addressed through ex post enforcement of legal rules than through ex ante structural regulation. Given an effective legal regime, ex post enforcement constrains self-dealing while permitting the gains from better monitoring by concentrated owners. Only actual misbehavior is punished.

Recommendation 16 reaches further than the Committee's proposals for ex ante structural regulation. Rather than acknowledging the efficiency gains

[10] The Committee states that it has not yet determined whether to propose a cap on the voting rights of controlling shareholders. We assume for purposes of this Report that the Committee will go forward with Recommendation 16.

from more effective monitoring, this Recommendation effectively eliminates the means by which that monitoring is carried out. In place of a controlling shareholder with the incentives and experience to monitor management, Recommendation 16 shifts the monitoring responsibility to minority shareholders, who are rationally passive participants in public companies. The result may be to limit self-dealing, but at the expense of leaving management monitored only by those who are not up to the task, or to a capital market that intervenes only in very serious cases. In contrast, legal enforcement of rules prohibiting interested transactions that do not survive careful judicial review address the problem of self-dealing without deterring efficient behavior.

The ironic result is that Recommendation 16 would mimic the control structure of the B&M corporation. As we discussed in Part II, this result would not eliminate wedge companies, but rather would mandate them, though now with the wedge in favor of management rather than with a controlling shareholder that has substantial cash flow rights. Recommendation 16 thus would make the problem the Committee purports to address worse rather than better.

IV. Conclusion

We make two points in this Report that correspond to the two dangers that the corporate form presents. The first is that those who control a corporation may shirk when their control rights exceed their cash flow rights. In these cases, the controllers bear the full cost of their efforts to manage well but realize only a fraction of the gains. This danger is analyzed under the duty of care. The second danger is that the controllers may shift resources away from the public

shareholders, largely through self-dealing transactions. This second danger is analyzed under the duty of loyalty.

Corporate law delegates policing duty of care violations largely to private actors. In the B&M corporation, shareholder exit and the threat of takeover increase the managers' incentive to maximize value. This "market monitoring" is crude: exit must be substantial in order to affect managers, and takeovers remedy only very material deviations from value maximization. Monitoring by a controlling shareholder is more effective than the market when the controller's cash flow rights, though below its control rights, nevertheless are substantial relative to monitoring costs.

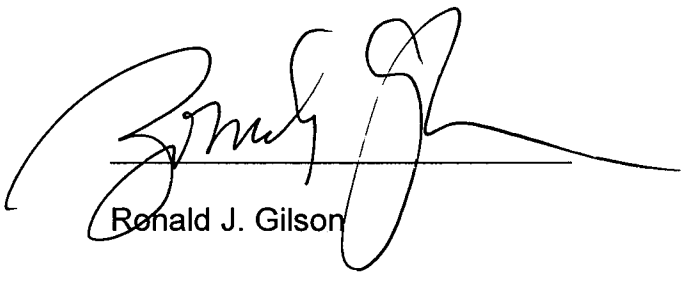
Corporate law delegates policing duty of loyalty violations initially to private actors, but ultimately to courts. Self-dealing transactions must initially pass the screen of "majority of the minority" approval. Shareholders who believe that this screen was too easily leaped in a particular case can obtain judicial review of an interested transaction. When courts are honest and capable, the prospect and actuality of judicial review materially curbs self-dealing transactions.

We apply these insights to the pyramid organization. This organization's particular strength is its ability to control duty of care violations by controlled companies. The controller usually holds cash flow rights in amounts that make monitoring cost justified. Pyramids permit the usual forms of self-dealing and some that might be special to them, such as intra-corporate transactions at incorrect prices. The usual methods of controlling self-dealing – approval by a majority of the minority and judicial review -- can effectively deter these duty of

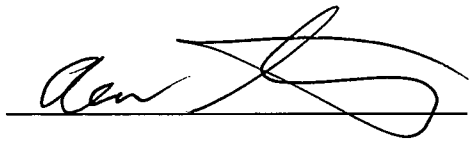
loyalty violations. The ability of the law to act is particularly strong in Israel, which recently created a special corporate court that can police loyalty violations.

Our analysis here shows that the Committee's recommendations are seriously misguided. The Committee never acknowledges the strength of the pyramid organization at deterring duty of care violations. In addition, the Committee's recommendations ignore the ability of courts, especially the new Israeli corporate court, to deter duty of loyalty violations. Instead, the Recommendations unnecessarily impose costly and ineffective governance restrictions on pyramid corporations just in order to curb self-interested transactions. As one egregious example, a Recommendation would give to rationally passive public investors the power to overrule such core business decisions as whether a company should issue debt or should acquire a complementary operation.

These recommendations not only are unwise. In our opinion, they would materially deter entrepreneurs from creating Israeli companies. No other advanced country imposes such costly and inapt restrictions on the governance of public companies. An entrepreneur with a choice – most of them – would locate in more hospitable jurisdictions.



Ronald J. Gilson



Alan Schwartz