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# Comments Respectfully Submitted to the Committee for Increasing Competitiveness of the Economy of the State of Israel

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In connection with its mandate, The Committee for Increasing Competitiveness in the Economy invited comment upon its proposed steps to improve the efficiency of the economy of Israel. I have been asked by the Association of Publicly Traded Companies to review the draft Recommendations of the Committee and to offer comments on the proposed recommendation for changes in corporate governance rules, which I am happy to do.

I am Professor William T. Allen, Nusbaum Professor of Law & Business at New York University. I am currently a member of the faculties of the NYU School of Law and the Department of Finance of the Stern School of Business. I am Director of the NYU Pollack Center for Law & Business and act *of counsel* to the New York City law firm Wachtell, Lipton, Rosen & Katz. From 1985 until 1997 I served as Chancellor (chief judge) of the Court of Chancery of the State of Delaware. My principal professional interests over the last twenty five years have been corporation law, corporate governance and related matters of finance. Attached is a copy of my professional *vita.*

I limit my comments to that part of the Recommendations addressing matters of corporate governance. I do not presume to comment on the legal status under the law of the State of Israel of the proposed changes that would alter existing property and contract rights.

In presuming to submit a comment to the Committee I assume that the purpose of the recommendations is to improve the efficiency of the so-called gap companies by empowering non-controlling shareholders in various ways. I put to one side for the moment the possibility that the recommendations are motivated to make

control and management of gap companies so burdensome and fragile that the controllers can be expected to gradually dismantle these structures.

Considered then as an effort to improve efficient governance of the gap companies, I conclude that implementation of these recommendations would be risky to the efficient or productive operation of gap companies, because in redistributing governance power the changes would weaken the power of the management of firms that are affected by these changes. The core of the evolutionary utility of the large scale corporate form was and continues to be the institution of centralized management. The recommendations would put Israel in the vanguard of a movement to constrain, and reduce the effectiveness of this central feature of the corporate form. The question such movement raises is whether an altered corporate form would be better at the commercial production of wealth than is the traditionally governed corporation.

What evidence or account is presented to lead responsible public actors to conclude these changes such as those recommended constitute improvements? The reasoning supporting these changes is largely theoretical and deductive. The corporate governances recommendations appear almost entirely founded upon a corporate finance theory – the agency cost theory specifically -- and appear to lack convincing evidence that the governance problems that the Report deduces from that theory as possible (e.g. tunneling), actually do exist to a problematic degree in Israel.

I suggest in Part I of this comment that that theory while deductively simple, widely used and very useful, is partial; it neglects to consider essential aspects of how corporations actually produce wealth and this absence makes this logical theory alone an unreliable guide to sensible policy formation. In Part II of this comment I address, albeit briefly, a few of the specific governance changes that the Recommendations propose. In Part III I suggest that if, alternatively, the real purpose of the changes is not to improve the efficiency of gap companies, but to make their control more difficult and less secure, so as to encourage their dismantlement, then they are likely to be successful and I can say nothing helpful about the cost and benefits that may be involved.

## I.

### The Agency Cost Theory That Forms the Premise for these Recommendations is Incomplete and Alone Provides an Inadequate Basis for Sensible Policy Formation.

Corporate Governance is a field of thought and practice that concerns itself with who, and through what processes, decisions respecting the exercise of decisional power over corporate assets or processes should be made. It is generally understood by U.S. corporate law and academic finance experts that, normatively, the principal goal of corporate governance policy should be the facilitation of coopera-

tive behavior among owners of capital and all of the other resource owners who must cooperate in the work of the corporation, so that, over some period of time, the organization produces the maximum wealth that is possible in the circumstances. This is the wealth maximization norm.[1] The comments I offer in this Part are premised on the assumption that the Israeli public policy is similarly aimed at achieving wealth maximization in the actual economy.

A Background Principle. Concerning the structure of decision making power in a large organization, I suggest that the first principle of distribution of such power is this: *allocate decisional power to the* person who has both *the best information* respecting the subject matter of the decision and its consequences and who has *the best incentives* (i.e. is most aligned with the fundamental purpose of the organization). This principle makes efficient allocation of power easy in the case of a small business with an engaged owner. Indeed it is simple commonsense. But this principle cannot take us far in the allocation of decision power in large organizations – especially after corporations sell shares on a public exchange. In publicly financed corporations those with best systemic incentives to increase shareholder wealth -- the owners of rights to the firm's residual cash flows -- are generally not incented to achieve deep knowledge about the firm and its management. Given their relatively small share of firm profits, financial investors are made rationally (relatively) passive by the costs of acquiring deep knowledge about the firm and its industry and by the costs that organizing collective action would entail. On the other hand those with best knowledge of the firm and all its many aspects, as well as the industry and its technology (i.e. senior management team and the Board) possess fewer cash flow rights and thus theoretically imperfect incentives. So allocating decisional power in a large enterprise is not simple; nevertheless the simple principle noted above – that both knowledge and incentives matter -- is very helpful in reminding us that in all organizations there is value derived from trying to have decisions made by the most informed part of the organization.

Agency theory is an academic finance theory that formalizes an ancient observation: people tend to be more careful with their own property than with the property of others. Thus, in the corporate governance context, agency cost theory considers the effects of management incentives on management decisions in publicly financed firms. This theory, posits that the main problem with which corporate law and governance must deal arises from the fact that cash flow owners and management face different incentive structures. Thus, it is observed that controllers of the firm (either managers, in a firm with widely dispersed shareholders, or controlling shareholders

[1] The wealth maximization norm is not the only rational approach to formation of corporate and securities law. One might rationally prefer greater worker voice, for example, in the control of a business enterprise than might be consistent with wealth maximization norm; or one might prefer smaller firms than would be consistent with wealth maximization because one prefers a society in which large institutions are disfavored. Such choices are of course rational and with respect to them all that should be required is that one understand, to the extent possible, the nature of the tradeoffs involved.

owning less than all shares) may be tempted to treat the assets of the firm in a way that benefits themselves, but does not proportionately benefit the public contributors of capital. Such activity by managers or controllers, should it occur, may be seen as morally unattractive of course, but more important for the theory it is seen as contributing to systemic inefficiency.

Thus the paradigm economic problem where control and management is badly split (as in any corporation controlled by a single person or entity) is sometimes called "tunneling," that is unfair transfers from the controlled company to the "parent" or other affiliated person or entity. Other threats are possible as a result of the disjunction between cash flow rights and control rights, but enrichment of the controller at the cost of the non-controllers through transactions is the basic posited evil.

If one accepts the logic (one must; it is simple deduction) and if one assumes that controllers (managers or controlling owners) are amoral opportunists, which is the general assumption of economics, the question arises: why do we observe so many publicly traded corporations, particularly those with controlling shareholders? Why should anyone expose his savings to this form of potential theft? The answers that conventional scholarship gives to this question largely relates to legal infrastructure of corporation law and governance. That is, in brief, the investors' rights to elect the board, to approve of fundamental changes etc, to sue for breach of fiduciary duty and to sell their investment at anytime.

Notably the optimal effectiveness of the voting based techniques to constrain agency costs is said to be present when cash flow rights (i.e. dividend and liquidation rights) are aligned with voting or control rights. That is in voting regimes of one share one vote. The Recommendations may be seen as a series of proposed changes designed to empower non-controlling shareholders in gap companies, so as to move them functionally closer to the theoretical ideal of matching control rights and cash flow rights, in controlled companies. What may motivate this is the observation in the Report, and otherwise a well known fact, that under a pyramid structure a given amount of investment capital can control a much larger group of productive assets than it could otherwise do under regime of one share one vote. In a pyramid structure, as the pyramid grows the controlling investor's capital investment per vote controlled will decline. Thus such system can function much as a dual voting structure does in jurisdictions (such as the United States) where such structures may lawfully be adopted.

## Agency Theory Ignores the Second Aspect of Rational Allocation of Decision Power in Organization: What Decision Maker Is (or Is Likely To Be) Best Informed (or Skilled)

In general the agency theory while a powerful and helpful way to understand problems in corporate governance is incomplete in an important respect. The agency theory addresses incentives but ignores the other aspect of making optimal decisions in organization: who has the best information (or skill) relevant to the substantive

decision to be made. But this element of organization decision design is as crucial as incentives. If one focuses only on the reduction of "agency costs" in corporate governance, one will inevitably risk running the bus off the road.

The fact is that *the heart of the wealth creation mission* of the private business corporation is accomplished largely or entirely by the committed full time professional management team of the organization and the internal elements of the firm they direct. It is the full time management, not the diversified providers of risk capital, that deeply understand the business and its industry. And in the case of a controlled company, it is the control group that has the constant exposure to the firm and its industry that will have the specialized knowledge and experience to make highly informed decisions respecting the firm's internal affairs and market oriented decisions. The law has long recognized the risk that controllers may abuse their control and has supplied judicial remedies. If in order to further reduce temptation to abuse management power we introduce constraints on management that retard its ability to function with effect – to make informed, expert decisions not always dominated by current financial market demands or fashions -- we likely will move away from wealth maximization not towards it.

Capital markets clearly do acknowledge that perfect alignment of cash flow rights and control rights is not always optimal. Investors show this when they buy shares in IPOs of companies with dual class voting structures. Such structures are the *bete noire* of agency cost purists, who appear to fail to recognize the incomplete nature of the theory. Let me use a hypothetical company "Boogle" to show the wealth creation potential of dual class voting structures.

"Boogle" was founded by young geniuses just out of graduate school who had developed an internet search engine. The product was technically astonishing to users and the venture capital backed firm grew rapidly. At some point the growth opportunities were so substantial that large amounts of new equity would be required to take advantage of them. The founders were of the view that they brought a certain combination of vision, talent and dedication to this firm that was essential for realization of the company's potential. They were fearful that if they issued sufficient shares to fund the growth they envisioned, they themselves would no longer be assured of controlling the company in the future. They determined they would not assume that risk. In a legal system that strictly implements the insights of the agency cost theory of corporate finance, and thus forbids deviations from the one share one vote principle, (Israel as it happens) the company of the young founders would be condemned to slow growth. In the U.S., which does not mandate one share one vote, the Boogle geniuses could issue dual class shares, with the high vote shares having any multiple of votes over the low vote shares that seemed appropriate to the controllers and agreeable to the market. Of course full disclosure would be mandated and judicial review of related party contracts would be available under fiduciary principles. Of course the market would buy the hypothetical shares at some price. If one looks only to management incentives under this structure one may assume that the price offered by buyers would be discounted from what they would pay under a one share one vote regime. But for those who understand that the agency cost theory is

incomplete, they may calculate that greater value is created by having the geniuses having control than may be risked by added agency costs of their control. But significantly under either interpretation allowing deviations from one share one vote allows for the supply of additional capital to a growing firm at an efficient price and not permitting it would under the hypothetical facts, not fund that growth.

## II.

### Does Moving Towards a Functional One Share One Vote Regime Justify the Risks; Are the Risks Understood?

Turning to the specific recommendations, I note first that expecting to get systemic efficiency gains from changing corporate governance rules and practices is itself a doubtful proposition. The connection between general corporate governance rules and practices and firm productivity presumed in conventional theory of corporate finance, is not easy to establish in the research. Consider for example the preeminent reform in U.S. corporate governance over the last twenty five years, the mandated shift to a board of directors comprising a majority (and in practice a large supermajority) of independent directors. Under the dominant agency cost theory of corporate finance this reform would clearly be a wealth improving change. One could suspect that under the prior system in which officers and others connected to the firm tended to dominate boards, the new system would reduce conflicting interests and thus improve incentives. This reform, supported by strong theory, swept the field. Today it is a mandated standard in all listed firms in the U.S. and is rarely questioned. Has it produced better companies? So far as we can detect from many studies there have been no systemic gains. See Bernard Black & Sanjay Bagat, The Non-Correlation Between Board Independence and Long-Term Firm Performance, 27 J. Corp. Law 231-273 (2002). The reason for that may be that while the potential for conflict is now reduced, so is the capacity to make informed decisions.

Incentives are not the only thing that matters to making sound decisions. Knowledge and expertise (or even talent) matter too. But the Recommendations appear to be an effort to move governance of gap companies towards theoretically better incentive alignment without apparent weighing of the impact on informed decision making.

It would seem evident that this step would be risky for the productivity of the firms themselves for the reasons alluded to above. I refer especially to three recommendations: (1) The recommendations respecting minority veto rights over certain types of important transactions; (2) The recommendation respecting minority shareholder veto rights on executive compensation; and (3) the recommendation mandating a buy or sell choice for a controller receiving any offer to buy at a 10% premium over market (referred to as creating an exist right for minority shareholders).

*Granting non-controlling shareholders veto rights and extending those rights to corporate transactions heretofore not requiring shareholder vote.*

This proposal would do two things: it would give non-control investors a veto right and it would broaden the transactions that the company must take to shareholders for approval. In both respects the change would imply a new cost on the operation of gap companies derived from the fact that diversified financial investors will not have the experience and specialized knowledge of the firm and its industry that management and the board will necessarily have. Thus, in terms of wealth production, the new vote will eventually lead to some poorer decisions. Equally important, however, is that even on an incentive level, financial investors may have dubious incentives from the point of view of building a long-term wealth creating organization. First, their time horizon will often not match the long-term perspective of other corporate stakeholders. Second, the agency cost theories sees the "shareholders" as simple holders of residual cash flow rights; it does not envision complex financial investors with portfolios of investment including blocs of other issuer's shares, short positions and various derivatives securities. In reality, we cannot even be certain (as we can in theory) what the economic incentives of these investors really are; one would have to see their whole portfolio, including derivatives, to tell.

*Granting non-controlling shareholder veto rights respecting senior management compensation.* The same basic criticism may be made of this recommendation. If any such arrangements violate law or fiduciary principles there are existing remedies. So the additional class of cases that will be subject the constraint of a new shareholder vote under this recommendation will be lawful contracts about which reasonable persons might disagree. But these contracts may be vital to the firm's progress and may be complex. When entered into in arm's length bargaining it seems costly and risky to require them to be subject to a plebiscite by less well informed financial investors.

*Mandating that that anytime a 10% premium offer is made to buy a gap or controlled company, the controller will be required to either accept the offer or should he rejected it he will be required to offer to buy the minority shares in the company at that same price.* Under this proposal every company owned by a controlling shareholder can be effectively put in play with a bid at only a 10% premium over current market price. Once put in play the "gap" structure of the firm will be eliminated. Either because the controller would be required to buy in all public shares or the offeror will.

The obvious purpose of this provision must be to destabilize the existing control structures of gap companies. Would this step be wealth increasing socially?

One argument that the forced transfers that would be beneficial might be e premised on the belief that stock markets prices are "correct" prices in the sense that the whole firm is worth at any moment only the market capitalization of its equity plus the market capitalization of its debt. Under this view, some would say that any transfer of control at a premium price over the price of a single share on the market must represent a transfer to a new controller who believes himself able to make changes that will raise the value of the firm at least to the point where its equity will be worth what he paid for it. Thus on this view there is a good change that all or

most such changes will lead to more productive firms. But of course a transfer under the contemplated circumstances would not be really voluntary.

More important, however, is the fact that the market price of a share is the market price of just a single share. It is an empirical fact that control blocs command a premium over non-controlling shares. There is academic debate over precisely why that is the fact. But it is notable that even in cases in which there is no controller a market transaction transferring control will be at a significant premium to the market price of a single share. Thus the notion that the market capitalization of a firm represents its value in a change in control transaction is demonstrably incorrect.

If enacted this provision would be costly in several respects. Under it existing controllers must have available sufficient capital to buy out a public minority (in every gap company in the chain) or be at constant risk of losing control of them. Either effect would be costly. The first would require financial arrangements that will be costly; the second would impact long-term planning and perhaps operations of the firm. One must rationally ask: For what benefit in terms of better economic performance are these costs imposed?

In reality, I suppose, this provision may be seen as a technique to try to "put companies in play," thereby requiring the dismantling of gap companies, either by the controller buying out all shares, if he can raise the finance or, if he cannot, by selling to a new controller who will be required to buy all shares. The relatively low premium that may commence this process is an indication that such transactions are to be encouraged.

## III.

### Problematic Governance Changes or A Means to a Social/Political End?

In these comments I have tried to show the source of a risk that these Recommendations, if enacted, would pose to the efficient operation of gap companies. The comments have been premised upon an assumption that the Recommendations are motivated by a desire to make the "gap" companies more efficient by empowering non-control investors. But certain aspects of the recommendations raise the question: Are these recommendations instead aimed at making the corporate governance of gap companies sufficiently cumbersome (e.g. shareholder consent with respect to acquisition transactions) and unstable (e.g. the mandated buy-sell requirement) as to encourage the gradual dismantling of the pyramids in which they currently are embedded?

To the extent these changes are justified as an attempt to make gap companies more efficient I doubt they will succeed. The changes are excessively based on deduction from a limited theory and fail to give due consideration to the limitations

that financial investors face as corporate decision makers. To the extent these recommendations represent a political choice for reasons not entirely economic in nature that the public interest will be served by forcing/encouraging the dismantling of the existing pyramids of "gap" companies, I have little to contribute to the process of considering them except the view that these changes are likely to have costs for economy. It would I think be incorrect to undertake them on a belief, founded on the incomplete agency cost theory, that the likely result of these changes will be more efficiently run gap companies.

If it were thought that there is any way that I might aid the Committee in its important deliberations, I would want to do so.

Respectfully submitted,

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