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Dividends as a Substitute for Corporate Law: The Separation of Ownership and Control in the United Kingdom

Brian R. Cheffins*

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I. Introduction

As the twentieth century drew to a close, corporate law scholarship "found the market" as "contractarian" analysis became the dominant mode of analysis. A key underlying presumption of this economically oriented school of thought was that market dynamics define primarily how directors, shareholders, and others associated with companies interact. Corporate law, the thinking went, had only a supplementary and supportive role to play, namely facilitating efficient contracting. No sooner had legal academics started to push law to the margins when economists began to assert that the extent to which law provides protection for investors is a key determinant of the configuration of corporate governance structures around the world. The claim made was that the "quality" of corporate and securities law does much to determine whether a country will have strong securities markets and a corporate economy dominated by firms with widely dispersed share ownership.

The "law matters" thesis economists have advanced has important normative implications because it suggests countries will not develop a robust stock market or escape from potentially backward family capitalism unless laws are in place that provide suitable protection for investors. Not surprisingly, the thesis has attracted much attention from legal academics.[1] But is "investor

1. To illustrate, a search carried out in May 2006 to find articles mentioning economist Rafael La Porta and "corporate law" on the Westlaw "JLR" database yielded 212 "hits." Rafael La Porta is one of a number of co-authors whose work provides the foundation of the law matters thesis. *See infra* notes 22–28 and related discussion (discussing La Porta's work with Florencio López-de-Silanes and Andrei Shleifer).

friendly" corporate and securities law in fact a necessary condition for a country to develop strong securities markets and a corporate economy where large firms are generally widely held? The experience in the United Kingdom suggests not.

Currently, Britain has an "outsider/arm's-length" system of ownership and control, so called because most U.K. public companies lack a shareholder owning a large block of equity, and those owning shares (typically institutional investors) generally refrain from taking a "hands-on" approach to the management of companies. This system became entrenched between the 1940s and the 1980s, as company founders and their heirs exited and institutional investors rose to prominence. By the end of this period, the widely held company so often identified as the hallmark of corporate arrangements in the United States had moved to the forefront in the United Kingdom. The law matters thesis implies that Britain should have had laws in place that were highly protective of shareholders as the transition occurred. In fact, from the perspective of investor protection, Britain had "mediocre" corporate and securities legislation during the relevant period.

If corporate and securities law did not provide the foundation for the separation of ownership and control in U.K. public companies, what did? A number of possibilities have been canvassed in the literature, including regulation by the privately run London Stock Exchange, which supplemented the protection investors had under corporate and securities legislation, and takeover activity, which acted as a catalyst for the reconfiguration of existing ownership patterns.[2] This paper identifies a new candidate: the dividend policy of publicly quoted firms.

Essentially, dividends contributed to the unwinding of share ownership structures in U.K. public companies by mimicking the role that the law matters thesis attributes to corporate and securities law, namely, constraining corporate insiders and providing investors with information flow about companies with publicly traded shares. Regulation of dividend policy by corporate law was minimal in the United Kingdom as ownership separated from control. Hence, while economists have been stressing the importance of law as a determinant of corporate governance systems, at least in Britain, corporate behavior lightly

2. On the role of regulation by the London Stock Exchange, see Brian R. Cheffins, *Does Law Matter? The Separation of Ownership and Control in the United Kingdom*, 30 J. LEGAL STUD. 459, 473–76, 481–82 (2001) [hereinafter Cheffins, *Does Law Matter?*]. On takeovers, see Brian R. Cheffins, *Mergers and the Evolution of Patterns of Ownership and Control: The British Experience*, 46 BUS. HIST. 256, 259–62 (2004) [hereinafter Cheffins, *Mergers*]; Julian Franks, Colin Mayer & Stefano Rossi, *Spending Less Time With the Family: The Decline of Family Ownership in the U.K.*, *in* A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD 581, 601–05 (Randall K. Morck ed., 2005).

constrained by legal rules played a significant role. The paper does not claim that the payment of dividends by U.K. public companies was a sufficient condition for a separation of ownership and control to occur because it was the norm for publicly traded firms to pay dividends in the decades before dispersed ownership became standard. Nevertheless, with other conditions being favorable, dividends were an important supplementary factor.

The paper proceeds as follows: Part II outlines the law matters thesis, using a simple hypothetical involving a family-dominated public company to illustrate the key dynamics. Part III assesses the extent to which the law matters story accounts for developments in the United Kingdom, primarily by tracing back through history how Britain would have scored on corporate and securities law indices that economists advancing the law matters thesis have constructed. Part IV discusses in general terms how dividends might have helped to reconfigure ownership patterns in U.K. public companies despite financial economics precepts that imply dividends are a "mere detail." Part V outlines how the pattern of dividend payments by U.K. public companies imposed discipline on the use of corporate earnings by those in a controlling position. Part VI explains how dividends, by performing a "signaling" function, helped to supply the informational foundation investors would have required to buy shares in sufficient volume for diffuse share ownership to evolve. Part VII assesses a potential objection to the thesis that dividend policy helped to prompt the unwinding of ownership patterns in U.K. public companies, namely that, due to tax, dividends were too "expensive" to function as a shareholder-friendly substitute for corporate and securities law. Part VIII concludes with some general remarks on the need to take into account both law and the market to understand fully the evolution and operation of systems of corporate governance.

II. The "Law Matters" Thesis

A. The Theory

Assume, by way of a highly stylized example, ABC Co. has 100 shares and became a public company under the leadership of its founder.[3] The founder's son is now chief executive, the family continues to own 50 of the shares, and the remainder are widely held. The total value of the company's

3. The departure point for this example is a scenario set out by Lucian Arye Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127, 143–46 (1999).

shares is $100, but a key differential exists. The controllers' equity is worth $60, or $1.20 per share. The outsiders' shares—the ones traded publicly—fetch a price of $0.80 per share, meaning their equity is worth $40 collectively. The $0.40 differential per share constitutes the "control premium," partly reflecting the private benefits of control that the dominant faction can extract at the expense of outside investors.[4]

Assume further the chief executive of ABC Co. is a poor manager and the company's performance is suffering accordingly. Correspondingly, if the family's control block was completely unwound and he was replaced by a competent successor, the company would be worth $1.10 per share, or $110 overall.[5] A move to diffuse share ownership would therefore increase firm value.[6] Will this happen?

To sharpen the analysis, assume the family has two choices, one being the status quo and the other being for the family to exit by selling its shares in a public offering to dispersed investors.[7] Assuming a sale price of $1.10 per share, the total proceeds the family would receive would be $55 (50 x $1.10). A sale would therefore yield the family $5 less than the value of its shares under current arrangements. The move to diffuse share ownership would increase the value of the equity that was already publicly held from $40 to $55. Still, this would not be a benefit the family would capture, so it would refrain from unwinding its stake. This "controller's roadblock"[8] would thus preclude a shift towards a more efficient ownership structure.

The controller's roadblock would not be the only obstacle to a value-enhancing transition to diffuse share ownership. There could be problems on the investors' side, too. The point can be illustrated by changing the facts

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4. On the contribution that extracting private value makes to the control premium, see Diane K. Denis & John J. McConnell, *International Corporate Governance*, 38 J. FIN. & QUANTITATIVE ANALYSIS 1, 24–25 (2003); Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537, 540–41 (2004).

5. A pro rata valuation of $1 per share is appropriate because each would have one vote attached and would thus benefit equally from a control premium. On this, see Tatiana Nenova, *The Value of Corporate Voting Rights and Control: A Cross-Country Analysis*, 68 J. FIN. ECON. 325, 330 (2003).

6. It should not be taken for granted that diffuse ownership is in fact more efficient than concentrated ownership. *See* Brian R. Cheffins, *Corporate Law and Ownership Structure: A Darwinian Link?*, 25 U. NEW S. WALES L.J. 346, 356–67 (2002) (discussing the advantages and disadvantages of diffuse ownership).

7. In practice, there may well be other options. One would be for the family to retain its stake, persuade the current chief executive to resign, and hire a talented outsider to manage the company. Another would be for the family to try to sell its stake to a purchaser willing to pay a control premium.

8. Bebchuk & Roe, *supra* note 3, at 143.

slightly. Assume the market value of ABC Co. is, as before, $100, but that the private benefits of control that ABC Co. yields are no longer as lucrative. As a result, the family's shares are worth $55, or $1.10 per share. The publicly quoted shares trade at $0.90 per share, meaning the equity of the outside shareholders is worth $45 collectively. Under these facts, the controller's roadblock should not deter a transition to the more efficient diffuse ownership structure because the sale price the controlling faction would receive—$1.10 per share—would be equal to the value of its stake. Correspondingly, the family might well decide it was time to obtain the benefits of risk-spreading and unwind its holding.

The potential hitch would be on the other side of the equation—convincing investors to buy the shares. The scenario we have been considering will be characterized by asymmetric information, in the sense that the family will know more about ABC Co.'s assets, risks, and prospects than outside investors.[9] The family, or the investment bankers acting on the family's behalf, would assert that the additional profits generated by a change of ownership justified a sale price of $110, or $1.10 per share. Investor reaction would likely be sceptical. Buyers who realize that a seller knows more about the quality of an asset than they do and who cannot readily verify assertions offered can only safely assume that what is on offer is a sub-standard "lemon."[10] By analogy, with respect to ABC Co., investors might well interpret the family's decision to sell as a panicky bailout on a failing business. A widespread reaction of this sort would drive down the price of ABC Co. shares already trading well below the existing $0.90 level. The family's plan to sell out at $1.10 would then collapse, and the status quo would be maintained even though net overall benefits would have been generated if a change in ownership structure had taken place.

Currently, a widely held belief is that corporate law—the rules governing the rights and duties of directors, senior executives, and shareholders—is a variable that does much to explain how strong securities markets and diffuse share ownership can emerge in the face of possible rent extraction, information asymmetries, and the potential inefficiencies of family-oriented management.[11]

9. On asymmetric information and the issuance of shares, see RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 412, 511–13 (7th ed. 2003).

10. The intuition here is what drives the well-known "market for lemons," first described by George A. Akerlof, *The Market for "Lemons": Quality, Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970).

11. On the popularity of this line of thinking, see Luca Enriques, *Do Corporate Law Judges Matter? Some Evidence from Milan*, 3 EUR. BUS. ORG. L. REV. 765, 766–67 (2002); Mark J. Roe, *Corporate Law's Limits*, 31 J. LEGAL STUD. 233, 236–37 (2002) [hereinafter *Corporate Law's Limits*].

The basic logic underlying the law matters thesis is that where corporate law is deficient, potential outside investors will be hesitant about buying shares because of fear that corporate "insiders" (large shareholders and/or senior executives) will skim or squander firm profits.[12] Corporate insiders, being aware of such scepticism, will refrain from using the stock market to exit and will opt instead to retain the potentially ample private benefits of control available due to weak regulation. The widely held corporation will therefore not become dominant, regardless of whatever inherent economic virtues it might offer.

The law matters thesis implies that things might well unfold differently if a country has "quality" corporate law.[13] Outside investors, cognizant that the law constrains rent extraction by corporate insiders, will be reassured about the logic of owning tiny holdings in publicly traded companies. Concomitantly, controlling shareholders, aware that the law largely precludes them from exploiting their position, will be favourably disposed towards unwinding their holdings.[14]

Securities law and, more precisely, disclosure regulation are also potentially important.[15] In an unregulated environment, by virtue of information asymmetries, potential investors may well shun corporate equity because they cannot distinguish "high-quality" companies from their less meritorious counterparts.[16] With compulsory disclosure rules in place, investors will find it easier to separate the good firms from the "lemons." As deserving companies begin to receive support from the market, they will begin to carry out public offerings with increasing regularity. As the process continues, a country's

12. For summaries of the thesis, see *Corporate Law's Limits*, *supra* note 11, at 236–39; Troy A. Paredes, *A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn't the Answer*, 45 WM. & MARY L. REV. 1055, 1063–64 (2004). The "law matters" terminology was coined by John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 644 (1999).

13. The phrase is borrowed from Peter A. Gourevitch, *The Politics of Corporate Governance Regulation*, 112 YALE L.J. 1829, 1830 (2003) (referring to the "quality of corporate law").

14. For a mathematically oriented version of this proposition, see Andrei Shleifer & Daniel Wolfenzon, *Investor Protection and Equity Markets*, 66 J. FIN. ECON. 3 (2002).

15. On the contribution disclosure regulation can make to the growth of stock markets, see Bernard Black, *The Core Institutions that Support Strong Securities Markets*, 55 BUS. LAW. 1565, 1567–68, 1571–73 (2000).

16. On how information asymmetries can deter investment in shares, see Peter Blair Henry & Peter Lombard Lorentzen, *Domestic Capital Market Reform and Access to Global Finance: Making Markets Work*, *in* THE FUTURE OF DOMESTIC CAPITAL MARKETS IN DEVELOPING COUNTRIES 179, 197 (Robert E. Litan et al. eds., 2003).

securities market will become stronger, and a suitable economic platform will have been established to allow the widely held company to become dominant.

Disclosure regulation can also potentially help to foster ownership dispersion by encouraging dominant shareholders to exit.[17] If the law requires substantial transparency, the odds of detection of improper diversion of corporate assets grow. If corporate insiders are in fact discovered exploiting minority shareholders, adverse publicity, lawsuits, and regulatory sanctions could follow. Apprehension about such outcomes should discourage dominant shareholders from extracting private benefits of control and lead them to contemplate unwinding their holdings.

The law matters thesis offers a message that policymakers potentially ignore at their peril: Countries will struggle to reach their full economic potential unless laws that protect minority shareholders are in place.[18] America's rich and deep securities markets are frequently cited as a key source of innovation and economic dynamism.[19] The law matters thesis suggests that such benefits are only likely to be secured if the correct regulatory environment is in place. Leading proponents of the law matters thesis have acted as consultants for the International Monetary Fund and the World Bank, which in turn have promoted corporate law reform globally with a particular emphasis on protection of minority shareholders.[20] The message has seemingly been heard by policymakers, because governments around the world over the past decade have been strengthening regulations affecting outside investors.[21]

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17. *See* Allen Ferrell, *The Case for Mandatory Disclosure in Securities Regulation Around the World* 14–15 (Harv. Olin Ctr. for Law, Econ. & Bus., Faculty Discussion Paper No. 492, 2004) (stating that "an increase in mandatory disclosure requirements in a country is associated with a substantial lower level of private benefit of control for firms in that country"), *available at* http://www.law.harvard.edu/programs/olin_center/papers/pdf/Ferrell_492.pdf.

18. On the policy implications of the law matters thesis, see Brian R. Cheffins, *Law as Bedrock: The Foundations of an Economy Dominated by Widely Held Public Companies*, 23 OXFORD J. LEGAL STUD. 1, 6 (2003); Paredes, *supra* note 12, at 1067.

19. *See, e.g.*, Mark J. Roe, *Political Preconditions to Separating Ownership from Corporate Control*, 53 STAN. L. REV. 539, 542 (2000) (stating that "European policymakers and academics . . . see Europe's inability to develop rich and deep securities markets as stymieing innovation and reducing competition").

20. *See New Twist on Corporate Governance*, N.Y. TIMES, Jan. 11, 2005, at A18 (identifying Florencio López-de-Silanes as a consultant to the World Bank); Rafael La Porta, Professor of Finance, Dartmouth College, Curriculum Vitae, http://mba.tuck.dartmouth.edu/pages/faculty/rafael.laporta/publications/La%20Porta%20CV.pdf (last visited September 26, 2006) (identifying him as an International Monetary Fund consultant) (on file with the Washington and Lee Law Review). On the activities of the International Monetary Fund and the World Bank, see *Corporate Law's Limits*, *supra* note 11, at 237.

21. On the trend in favor of stronger minority shareholder protection, see Henrik Cronqvist & Mattias Nilsson, *Agency Costs of Controlling Minority Shareholders*, 38 J. FIN. &

B. The Evidence

Economists Rafael La Porta, Florencio López-de-Silanes, and Andrei Shleifer have, in various studies, tested whether corporate and securities law in fact constitutes a determinant of ownership structure. In a 1998 paper published together with Robert Vishny, they constructed an index of "anti-director rights" designed to measure how strongly the corporate legislation of forty-nine countries favoured minority shareholders over managers.[22] Regressions they ran yielded statistically significant correlations between their index and various indicators of stock market development, including the percentage of large public companies with diffuse share ownership.[23] A follow-up 1999 study, focusing on fewer countries and using a richer set of data on ownership patterns, did the same.[24] According to La Porta, López-de-Silanes, and Shleifer, their "results suggest[ed] that dispersion of ownership goes together with good shareholder protection, which enables controlling shareholders to divest at attractive prices."[25]

La Porta, López-de-Silanes, and Shleifer did not treat disclosure regulation as an aspect of shareholder protection when calculating the quality of corporate law.[26] In a follow-up study, however, they examined securities law in forty-nine countries to determine whether laws governing prospectuses—documentation circulated to prospective investors by those organizing public offerings of securities—were a determinant of the size of national stock markets and corporate ownership structures.[27] They found that private enforcement of prospectus regulation, as measured by the strictness of disclosure requirements and the burden of proof private investors had to meet to sue successfully in the event of misdisclosure, was strongly associated with the configuration of securities markets and the diffusion of share ownership.[28]

La Porta, López-de-Silanes, and Shleifer's efforts have been criticized from various angles. One objection has been that law simply is too complex to

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QUANTITATIVE ANALYSIS 695, 696 (2003).

22. Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998).

23. *Id.* at 1145–51.

24. Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999).

25. *Id.* at 496.

26. *See id.* at 512 (justifying the choice on the basis that improved disclosure is not essential to preventing expropriation of minority shareholders).

27. Rafael La Porta et al., *What Works in Securities Laws?*, 61 J. FIN. 1 (2006).

28. *Id.* at 20. They also tested the impact of "public enforcement," as determined by the powers government regulators had to investigate and sanction misdisclosure, but found this variable had little explanatory power. *Id.* at 21–23.

be reduced to numbers.[29] Another is that La Porta, López-de-Silanes, and Shleifer, due to relying on a few seemingly random proxies, may not have captured properly variations in the quality of corporate and securities law.[30] It has also been suggested that various mistakes were made in the coding of countries, a problem compounded with their study of corporate law because they did not explain in any detail how countries were scored on particular variables.[31]

La Porta, López-de-Silanes, and Shleifer responded to their critics in a 2005 working paper co-written with Simeon Djankov.[32] They acknowledged their original index had been criticized for its "ad hoc nature" and for mistakes in coding.[33] One response they offered was to present and test a revised anti-director index they said was constructed with greater precision.[34] With the revised index, a number of the correlations that La Porta, López-de-Silanes, and Shleifer found previously with their proxies for stock market development remained statistically significant, but some disappeared, including the one involving ownership concentration.[35] A paper by Holger Spamann casts

29. On this line of criticism, see Mathias M. Siems, *Numerical Comparative Law: Do We Need Statistical Evidence in Law in Order to Reduce Complexity?*, 13 CARDOZO J. INT'L & COMP. L. 521, 529–30 (2005) [hereinafter *Numerical Comparative Law*]; Mathias M. Siems, *What Does Not Work in Comparing Securities Laws: A Critique on La Porta et al.'s Methodology*, 16 INT'L COMPANY & COM. L. REV. 300, 301–03 (2005) [hereinafter *Critique on La Porta*].

30. On the argument that La Porta, López-de-Silanes, and Shleifer's anti-director index is underinclusive, see *Corporate Law's Limits*, *supra* note 11, at 252; José M. Garrido Garcia, *Company Law and Capital Markets Law*, 69 RABELS ZEITSCHRIFT 761, 766–67 (2005); Detlev Vagts, *Comparative Company Law—The New Wave*, *in* FESTSCHRIFT FÜR JEAN NICOLAS DRUEY ZUM 65. GEBURTSTAG 595, 601–02 (Rainer J. Schweizer et al. eds., 2002).

31. On the lack of transparency with the anti-director index research, see *Numerical Comparative Law*, *supra* note 29, at 539. The study done on securities law is less vulnerable to criticism on this ground because the authors made available extensive background information on the internet. *See* Harvard University, Securities Law Research Project, Securities Data, http://post.economics.harvard.edu/faculty/shleifer/papers/securities_data.xls (providing the raw data La Porta et al. used for their securities law index); Harvard University, Securities Law Research Project, Securities Documentation, http://econweb.fas.harvard.edu/faculty/shleifer/data/securities_documentation.pdf (providing expert reports on securities law, organized by country).

32. *See* Simeon Djankov, Rafael La Porta, Florencio López-de-Silanes & Andrei Shleifer, *The Law and Economics of Self-Dealing* (Nat'l Bureau of Econ. Research, Working Paper No. 11883, 2005), *available at* http://www.nber.org/papers/w11883.

33. *See id.* at 4.

34. On how the anti-director index was revised, see *id.* at 27–31.

35. On the results, see *id.* at 31. For the purposes of the paper, Djankov, La Porta, López-de-Silanes, and Shleifer also constructed and ran regressions using a new index of corporate law that focused specifically on self-dealing. The self-dealing index, which was designed to measure on a cross-border basis how a hypothetical self-dealing contract was regulated, has

additional doubt on the initial results, as he found that after recoding the anti-director rights index with the help of local lawyers and rerunning the relevant regressions, most of the statistically significant outcomes had disappeared.[36] While the follow-up research on the anti-director index casts doubt on at least some of the initial findings, the law matters research remains important, particularly because, as of yet, La Porta, López-de-Silanes, and Shleifer's findings on securities law remain unchallenged. At the very least, their work constitutes ground-breaking comparative research that has put corporate law in the spotlight in a manner that has not occurred before and is not likely to be replicated soon.[37]

C. *The Implications for Academic Corporate Lawyers*

The law matters story offers a potentially reassuring message to corporate law scholars who might be wondering whether the rules they teach in class and write about are more than a side-show. The economically oriented "contractarian" model of the corporation emerged as the dominant school of thought among academic corporate lawyers during the 1980s and 1990s, particularly in the United States.[38] The contractarian model treats the corporation as a set of consensual transactions with relations being driven primarily by market dynamics, supported at various key junctures by norm-based governance.[39] From this perspective corporate law seemingly has only a

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three dimensions: (1) public enforcement (fines and other criminal sanctions); (2) private enforcement *ex ante* (regulation of the approval process by which the hypothetical transaction could be validated); and (3) private enforcement *ex post* (the ease with which aggrieved minority shareholders could prove wrongdoing). The authors found with regressions they ran that there were statistically significant correlations between all three of their self-dealing measures and various indicators of the development of stock markets. However, only *ex post* private control of self-dealing correlated with the topic of primary concern here, namely ownership concentration. *Id.* at 25. As a result, this paper does not subject the self-dealing index to the same scrutiny as the anti-director rights and securities law indices.

36. On the key results, see Holger Spamann, *On the Insignificance and/or Endogeneity of La Porta et al.'s "Anti-Director Rights Index" Under Consistent Coding* 67 (Harv. Olin Ctr. for Law, Econ. & Bus., Fellows Discussion Paper No. 7, 2006), *available at* http://www.law.harvard.edu/programs/olin_center/fellows_papers/pdf/Spamann_7.pdf.

37. On the innovative nature of the work done, see *Corporate Law's Limits*, *supra* note 11, at 252. For examples of studies using the anti-director index as a departure point, see those cited by Siems, *Numerical Comparative Law*, *supra* note 29, at 525–26, as well as Marco Pagano & Paolo F. Volpin, *The Political Economy of Corporate Governance*, 95 AM. ECON. REV. 1005 (2005).

38. *See* BRIAN R. CHEFFINS, THE TRAJECTORY OF (CORPORATE LAW) SCHOLARSHIP 44–49 (2004) (discussing the history of the contractarian model of the corporation).

39. For various papers where authors use norms-driven analysis to supplement

modest supplementary role to play, this ideally being to help private parties "effectuate their preferred goals."[40] Put more strongly, from an economic perspective, corporate law, at least in the United States, might only be "an empty shell that has form but no content"; in a word "trivial."[41]

Corporate law academics understandably might be troubled that the subject matter of their research is "trivial."[42] For those worried on this count, the law matters thesis is welcome news. To the extent the empirical work of La Porta, López-de-Silanes, and Shleifer verifies a link between law and the strength of securities markets, the quality of corporate law does not simply influence how those associated with individual companies conduct themselves but dictates the configuration of national corporate governance arrangements. Hence, at a more fundamental level than most corporate law academics would have likely envisaged, law seemingly does "matter."

III. The "Law Matters" Thesis in a British Context

A. Setting the Scene

The intuition underlying the law matters thesis is easy to grasp, and there is empirical evidence that supports the claims made. Still, while the law matters thesis provides a good "story," at least with respect to Britain, history casts doubt on its persuasiveness. The United Kingdom, uniquely within Europe, has an "outsider/arm's-length" system of ownership and control akin to that in the United States.[43] Ownership is diffuse in the sense that most large companies are publicly quoted and lack an "insider" shareholder who owns a

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contractarian insights, see Symposium, *Norms & Corporate Law*, 149 U. PA. L. REV. 1607 (2001).

40. Thomas W. Joo, *Corporations and the Role of the State: Putting the "Law" Back Into "Private Law,"* 35 U.C. DAVIS L. REV. 523, 523 (2002).

41. Bernard S. Black, *Is Corporate Law Trivial? A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 544 (1990).

42. For an example of a corporate law academic seeking to establish that contractarian analysis fails to recognize sufficiently law's contribution to the functioning of corporations, see Therese H. Maynard, *Law Matters. Lawyers Matter*, 76 TUL. L. REV. 1501, 1506–07 (2002).

43. On the nature of the outsider/arm's-length system of ownership and control, see Erik Berglöf, *A Note on the Typology of Financial Systems*, *in* COMPARATIVE CORPORATE GOVERNANCE: ESSAYS AND MATERIALS 151, 157–64 (Klaus J. Hopt & Eddy Wymeersch eds., 1997). On the fact that the United Kingdom has such a system and is largely unique in so doing, see John Armour, Brian R. Cheffins & David A. Skeel, Jr., *Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom*, 55 VAND. L. REV. 1699, 1704, 1715, 1750–52 (2002).

large block of equity.[44] Share ownership is institutionally dominated, with domestic institutional investors (primarily pension funds, insurance companies and collective investment vehicles known as unit trusts and investment trusts) owning 49% of the shares in U.K. public companies as of 2004 and foreigners—again primarily institutional investors—owning 33%.[45] Though there are instances of activism,[46] institutional shareholders tend to be passive investors. As a 2001 review of institutional investment commissioned by the U.K. government said, "[i]t remains widely acknowledged that concerns about the management and strategy of major companies can persist among [company] analysts and fund managers for long periods of time before action is taken."[47] The "outsider/arm's-length" nomenclature thus is apt for the United Kingdom.

How did this system of ownership and control take shape? The law matters thesis implies that the law would have offered a protective environment to potentially vulnerable outside investors as control structures unwound. In fact, matters developed differently.[48]

Larger British industrial and commercial firms first began to join the stock market in the late nineteenth century. Prior to World War I, however, the original proprietors retained large blocks of shares, and the companies continued to be managed and owned on a local basis.[49] Between World War I

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44. Marc Goergen & Luc Renneboog, *Strong Managers and Passive Institutional Investors in the U.K.*, *in* THE CONTROL OF CORPORATE EUROPE 259, 280 (Fabrizio Barca & Marco Becht eds., 2001) (providing empirical evidence indicating that "[t]he ownership structure of British listed companies differs radically from that found on the Continent"); *see also* Mara Faccio & Larry H.P. Lang, *The Ultimate Ownership of Western European Corporations*, 65 J. FIN. ECON. 365, 378 (2002) (finding that "[w]idely held firms compromise 63.08% of U.K. firms").

45. National Statistics Online Database, *available at* http://www.statistics.gov.uk/stat base/TSDTimezone.asp (select "Share Ownership" on the menu and click "Go"; then select "Table A" and click "Go"; then select all menu options and click "Go"; then from the drop-down menu select "Download" and click "Go"; then from the drop-down menu select "View On-Screen" and click "Go"). Among U.K.-based institutional investors, the breakdown as of 2004 was: insurance companies 17.2%, pension funds 15.7%, investment trusts 3.3%, unit trusts 1.9%, and other financial institutions 10.7%. For additional background on recent growth in the percentage of shares owned by foreign investors, see Lina Saigol & Tony Tassell, *International Investors in the UK are Buying Up the Keys to the Kingdom*, FIN. TIMES, June 22, 2005, at 21.

46. *See* PAUL MYNERS, INSTITUTIONAL INVESTMENT IN THE UK: A REVIEW 89 (2001) ("There has been considerable movement in recent years . . . towards an activist stance on certain corporate governance issues by institutional investors.").

47. *Id.*

48. For a more detailed account of the chronology than is provided here, see Brian R. Cheffins, *History and the Global Corporate Governance Revolution: The UK Perspective*, 43 BUS. HIST. 87, 89–90 (2001).

49. On the basic configuration of ownership and control in U.K. public companies prior to World War I, see LANCE E. DAVIS & ROBERT E. GALLMAN, EVOLVING FINANCIAL MARKETS

and World War II, share ownership became commonplace among a considerably wider circle of investors, in particular the middle classes.[50] Still, as of the mid-1930s, even among the largest companies in the United Kingdom, a majority continued to have a "dominant ownership interest."[51]

By the beginning of the 1950s, family control of some form remained the norm in major U.K. companies.[52] Nevertheless, among the very largest firms, a trend towards a divorce between control and ownership was becoming clear.[53] The unwinding of voting control in U.K. public companies continued apace, and by the end of the 1970s, family owners had been largely marginalized. A study of British business carried out in 1969 remarked upon the "steady decline of family power in British industry"[54] and suggested that "the family empire" was "being steadily swept away by the forces of nature."[55] Business historian Geoffrey Jones, in a 1999 paper, concurred, saying of the decades following World War II: "Personal capitalism and family ownership was swept away in these decades. Britain became the classic Big Business economy, with an unusually unimportant small and medium-sized sector, and with ownership separated from control."[56]

AND INTERNATIONAL CAPITAL FLOWS: BRITAIN, THE AMERICAS, AND AUSTRALIA, 1865–1914 162–63 (2001). *See also* Julian Franks, Colin Mayer & Stefano Rossi, *Ownership: Evolution and Regulation*, 30–31, tbl.4, tbl.10 (ECGI Fin. Working Paper No. 09/2003, 2005) (reporting from a sample of forty companies incorporated around 1900, many of which were publicly traded by 1920, that the directors owned 54% of the shares as of 1910 and 49% as of 1920, and that, based on a sample of 26 of the 40 companies, the proportion of ordinary shareholders living within six miles of the city of incorporation as of 1910 was 56%).

50. G.D.H. Cole, *The Evolution of Joint Stock Enterprise*, *in* STUDIES IN CAPITAL AND INVESTMENT 51, 89–90 (G.D.H. Cole ed., 1935).

51. P. SARGANT FLORENCE, OWNERSHIP, CONTROL AND SUCCESS OF LARGE COMPANIES: AN ANALYSIS OF ENGLISH INDUSTRIAL STRUCTURE AND POLICY 1936–1951 240–41 (1961). Florence was summarizing the results of his study of ownership patterns in eighty-two "very large" manufacturing and commercial (e.g., shipping and newspapers) companies as of 1936. He categorized these as "very large" on the basis they had issued share capital with a par value of £3 million or over. *Id.* at 36.

52. *See* DEREK F. CHANNON, THE STRATEGY AND STRUCTURE OF BRITISH ENTERPRISE 75 (1973) (finding in a study of the largest 100 manufacturing companies in the United Kingdom as of 1970 that ninety-two were carrying on business as of 1950 and that fifty of the ninety-two were under family control at that point); Leslie Hannah, *Visible and Invisible Hands in Great Britain*, *in* MANAGERIAL HIERARCHIES: COMPARATIVE PERSPECTIVES ON THE RISE OF THE MODERN INDUSTRIAL ENTERPRISE 41, 53 (Alfred D. Chandler & Herman Daems eds., 1980) (stating that 119 of the largest 200 British firms had family board members in 1948).

53. *See* FLORENCE, *supra* note 51, at 186–87 (comparing share ownership in "very large" manufacturing and commercial companies as of 1936 and 1951).

54. GRAHAM TURNER, BUSINESS IN BRITAIN 221 (1969).

55. *Id.* at 239.

56. G.G. Jones, *Corporate Governance and British Industry* 14 (Univ. of Reading Dep't

The decline of family capitalism was accompanied by the rise of institutional investment. As of 1957, United Kingdom-based institutional investors owned between them 21% of all U.K. quoted equities. This figure rose to 30% in 1963, 48% in 1975, and 60% in 1991.[57] Over the same period, the percentage of shares owned directly by individuals dropped from 66% in 1957 to 54% in 1963, 38% in 1975, and 20% in 1991.[58]

If institutional shareholders had chosen to work together to dictate to managers how firms should be run, the institutions could have replaced family owners as "hands on" controllers of Britain's public companies. This potential for control was not turned into reality.[59] According to a 1978 report prepared for the Institute of Chartered Accountants of England and Wales, "[i]nstitutional participation in managerial decision-making has been favoured generally," but "[f]inancial institutions have generally been unwilling to act collectively in the use of their voting strength, or to accept those responsibilities which others would assign to them."[60] With institutional investors shying away from direct involvement in the management of U.K. public companies, Britain's version of an "outsider/arm's-length" system of corporate governance was firmly entrenched by the end of the 1970s.[61]

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of Econ. Discussion Paper in Econ. & Mgmt., No. 399, 1998–99).

57. For 1957, see John Moyle, *The Pattern of Ordinary Share Ownership 1957–1970* 18 (Univ. of Cambridge Dept. of Applied Econ., Occasional Paper #31, 1971). Otherwise, see National Statistics Online, *supra* note 45.

58. National Statistics Online, *supra* note 45.

59. On the distinction between potential and reality in this instance, see Paul Davies, *Institutional Investors in the United Kingdom*, *in* CONTEMPORARY ISSUES IN CORPORATE GOVERNANCE 69, 82 (D.D. Prentice & P.R.J. Hollard eds., 1993).

60. RICHARD J. BRISTON & RICHARD DOBBINS, THE GROWTH AND IMPACT OF INSTITUTIONAL INVESTORS 54 (1978). Similarly, Jack Coffee and Bernard Black noted in a 1994 article on British institutional investors that "complete passivity" was absent but remarked upon "the reluctance of even large shareholders to intervene." Bernard S. Black & John C. Coffee, *Hail Britannia? Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997, 2086 (1994).

61. The evidence on this point is not entirely clear-cut. *See* Steve Nyman & Aubrey Silberston, *The Ownership and Control of Industry*, 30 OXFORD ECON. PAPERS (NS), 74 (1978) (finding that 56.3 % of 224 of the largest U.K. companies, by either net assets or sales as of 1975, were "owner-controlled"). Nyman and Silberston, however, relied on an expansive definition of "owner-controlled," bringing into this category not only any company with a shareholder having a stake of 5% or more of the equity, but also any firm with a family chairman or managing director. According to their data, if "owner-controlled" was simply defined to include only those companies where a shareholder owned 10% of the equity, only 42.4% would have qualified and only 30.8% would have done so with a 20% cut-off. *Id.* at 85.

B. Company Law

Given the chronology, in order for events occurring in Britain to fall into line with the law matters thesis, the country should have had "quality" corporate and securities law in the decades following World War II. In fact, U.K. company law did not provide extensive protection for outside investors during this period.[62] Contemporaries generally recognized this. Some did suggest that outside shareholders were, in fact, well protected. For instance, L.C.B. Gower observed in the 1969 edition of his well-known text on company law that a shareholder "now has an impressive array of remedies at his disposal, especially where fraud or unfairness is alleged."[63] On the other hand, Tom Hadden remarked in the 1972 edition of his company law text on the "relative impotence of shareholders, and especially minority shareholders" and suggested "the minority shareholder's effective powers of intervention are insufficient to allow him to protect his legitimate interests."[64] Economist J.F. Wright observed similarly in a 1962 chapter on the finance of industry that "[a]lthough shareholders have certain legal rights, these are little more than minimal requirements of good faith from directors."[65] R.R. Pennington concurred in his 1968 text on investors and the law, explaining the reluctance of shareholders to intervene in corporate affairs in the following terms:

> [I]t is worth asking whether the history of company law over the last hundred years with its tolerance of voteless shares, the exclusion of minority shareholders' representatives from boards of directors, and the obstacles placed in the way of shareholders seeking legal remedies, is not largely responsible for the apathy.[66]

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62. *See* Cheffins, *Does Law Matter?*, *supra* note 2, at 468–72, 476–81 (highlighting the lack of significant companies' legislation or common law principles that afforded explicit protection to minority shareholders).

63. L.C.B. GOWER, THE PRINCIPLES OF MODERN COMPANY LAW 614 (3d ed., 1969).

64. TOM HADDEN, COMPANY LAW AND CAPITALISM 278 (1972).

65. J.F. Wright, *The Capital Market and the Finance of Industry*, *in* THE BRITISH ECONOMY IN THE NINETEEN-FIFTIES 461, 463 (G.D.N. Worswick & P.H. Ady eds., 1962).

66. R.R. PENNINGTON, THE INVESTOR AND THE LAW 502 (1968). Pennington also said about shareholder voting:

> [T]he law should provide minimum guarantees for shareholders so that they may exercise their voting rights freely and not be overborne by controlling groups acting against the interests of the average shareholder, either out of self-interest or otherwise improperly. At present the *laisser-faire* attitude of the mid-nineteenth century still permeates the case law, and . . . controlling shareholders are permitted to vote without restraint in their own self-interest and to the detriment of the minority shareholders.

Id. at 477.

It is understandable why contemporaries generally asserted that U.K. company law was not highly protective of outside investors in the decades following World War II. Minority shareholders in U.K. public companies, unlike their counterparts in the United States, had little chance of gaining standing to sue directors for breaches of duty or relying on an "appraisal remedy" (the right of shareholders to demand a buy-out of their shares after dissenting on specified fundamental issues).[67] Moreover, insider dealing was not made illegal until 1980.[68]

Scoring U.K. company law over time on the anti-director index compiled by La Porta, López-de-Silanes, and Shleifer offers further confirmation that outside investors in Britain were not afforded extensive legal protection as ownership structures unwound. La Porta, López-de-Silanes, and Shleifer's anti-director rights index was composed of six elements. These were: (1) the ability of a shareholder to cast votes at a shareholder meeting by mailing in a proxy form; (2) a possible requirement to deposit shares before a proxy vote; (3) the availability of cumulative voting, which permits minority shareholders to "bundle" their votes and thereby increases the likelihood they can elect their representatives to the board of directors; (4) mechanisms offering relief to oppressed minority shareholders; (5) rules obliging a company to give existing shareholders a right of first refusal when new shares are issued ("pre-emptive" rights); and (6) the ability of shareholders owning up to 10% of the shares to call, on their own initiative, a shareholders' meeting.[69] Currently, according to the index La Porta, López-de-Silanes, Shleifer, and Vishny compiled, Britain scores "5" out of "6," with the only "0" occurring because U.K. companies legislation does not provide for cumulative voting.[70] As Table I indicates, however, historically matters were much different.[71]

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67. On the law governing minority shareholder litigation and appraisal rights, see Cheffins, *Does Law Matter?*, *supra* note 2, at 469–70, 477.

68. On the legal status of insider dealing, see *id.* at 470–71, 478.

69. On the elements of the anti-director rights index, see La Porta et al., *supra* note 22, at 1127–28.

70. *Id.* at 1130. The United Kingdom's score remains the same under the revised anti-director index compiled by Djankov et al. *See* Djankov et al., *supra* note 32, tbl.XII (showing Britain's score as a "5" out of "6").

71. For others who have examined the evolution of U.K. corporate law by reference to La Porta et al.'s anti-director index, see Franks, Mayer & Rossi, *supra* note 49, at 14, 41 tbl.1, 54; Kathrina Pistor, Yoram Keinan, Jan Kleinheisterkamp & Mark D. West, *The Evolution of Corporate Law: A Cross-Country Comparison*, 23 U. PA. J. INT'L ECON. L. 791, 802–03 (2002).

Table I: Historical Evolution of U.K. Company Law, as Measured by La Porta, López-de-Silanes, and Shleifer's Anti-Director Index

	Anti-Director Index Score	Explanation
Mid 19C–1900	1	British companies legislation has never required shareholders to deposit their shares with the company or a financial intermediary prior to a shareholder meeting and thus has always scored at least one out of six on the anti-director index.[72]
1900–1948	2	A 1900 amendment authorized shareholders owning 10% of the shares to call a shareholders meeting.[73]
1948–1980	3	The Companies Act 1948 created a statutory right for shareholders to vote by proxy.[74]

72. Deducing how a country's company law should be scored on this issue is not fully straightforward. La Porta et al. indicated a country would receive a "1" on the proxy deposit variable "if the company law . . . does not allow firms to require that shareholders deposit their shares prior to a general shareholders meeting." La Porta et al., *supra* note 22, at 1122. The authors also said, however, that a "1" would be appropriate so long as the depositing of shares was not required. *Id.* at 1127. Presumably because U.K. companies legislation was silent on the issue, they gave Britain a "1" on this count.

73. The relevant provision was the Companies Act, 1900, 63 & 64 Vict., c. 48, § 13 (Eng.). Others tracing the United Kingdom's anti-director index score over time erroneously cite different dates for the introduction of the change to the law. *See, e.g.*, Franks, Mayer & Rossi, *supra* note 49, at 14, 41 tbl.1 (citing 1948 as the date for the introduction of the change to the law); Pistor et al., *supra* note 71, at 803 (citing 1909 as the date for the change to the law and incorrectly stating that the percent dropped to 5% in 1948).

74. On the right to vote by proxy, see Companies Act, 1948, § 136 (Eng.). Section 210 of the Companies Act, 1948 was addressed specifically to the protection of oppressed shareholders, which is one of the criteria upon which the La Porta et al. anti-director index is based. *Supra* note 69 and accompanying text. Nevertheless, the protection afforded was so weak that a "0" score is more appropriate than "1." *See* HADDEN, *supra* note 64, at 260 (saying that "it is clear that the restrictive interpretation of § 210 adopted by the courts has largely destroyed its efficacy as a genuine protection for minority interests"). Pistor, Keinan, Kleinheisterkamp, and West give U.K. company law a "1" on the protection of minority shareholder count all the way back to 1844, saying a "direct shareholder suit" was authorized by companies legislation enacted in that year. Pistor, et al., *supra* note 71, at 803. It is not clear what shareholder rights the authors had in mind, since La Porta et al. focused on "oppression" in

1980–present	5	Companies issuing new shares were required to make the equity available on a pro-rata basis to existing shareholders in accordance with the percentage of shares already owned.[75] The judiciary was authorized to grant a remedy to a shareholder who had been unfairly prejudiced by a company's actions.[76]

For present purposes, the aspect of the table that deserves the closest attention is 1948–80, because it was during this period that Britain's outsider/arm's-length system of corporate governance became entrenched. During this period, one major piece of corporate legislation was passed, the Companies Act, 1967.[77] This legislation made various changes to the existing statutory scheme, including the introduction of more rigorous disclosure requirements for large blocks of shares, director shareholdings, and contracts between directors and their companies.[78] Nevertheless, since the changes did not relate to any of the variables in La Porta, López-de-Silanes, and Shleifer's anti-director index, the U.K.'s score would have remained unchanged.[79] Hence, during the decades Britain's outsider/arm's-length system of control

their anti-director index rather than the possibility of bringing a "shareholder suit." Pistor, Keinan, Kleinheisterkamp, and West state erroneously that the right of shareholders to bring a derivative suit was only recognized in 1975. The right to do so—which U.K. company law tightly circumscribed—had in fact been recognized since *Foss v. Harbottle* (1843), 67 Eng. Rep. 189.

75. The relevant provision was Companies Act, 1980, c. 22, § 17 (Eng.).

76. The relevant provision was Companies Act, 1980, § 75 (Eng.); now Companies Act, 1985, § 459 (Eng.). Franks, Mayer, and Rossi erroneously date the change for oppression of minority shareholders as 1985. Franks, Mayer & Rossi, *supra* note 49, at 14, 41 tbl.1.

77. Companies Act, 1967, c. 81 (Eng.).

78. *See* Companies Act, 1967, § 16 (Eng.) (requiring companies, via annual directors' reports, to disclose publicly directors' interests in contracts with the company and details of directors' holdings of shares); *id.* §§ 33–34 (requiring companies to maintain a register of shareholders owning 10% or more of the outstanding shares that was to be open for inspection by the public).

79. The changes in 1967 would have improved the United Kingdom's score on Djankov, La Porta, López-de-Silanes, and Shleifer's private enforcement *ex post* self-dealing index because with this index, a country's score is governed partly by whether its corporate legislation obliges companies to divulge publicly the existence of large share blocks and report material facts about transactions in which directors have a personal interest. On the elements, see *supra* note 35.

became locked in, the country's company law simply equalled the average (3.00) for the forty-nine countries upon which La Porta, López-de-Silanes, and Shleifer focused when constructing the 1990s version of their anti-director rights index.

Only in 1980 did Britain's score become "5." This pushed the United Kingdom ahead of the anti-director index average for common law countries (4.00) and into line with countries such as the United States and Canada.[80] By this point, however, the United Kingdom's outsider/arm's-length system of ownership and control was firmly in place, meaning, contrary to what the law matters thesis implies, the quality of corporate law (at least as La Porta, López-de-Silanes, and Shleifer measure it) did not prompt the separation of ownership and control.

C. Securities Law

Given the correlations La Porta, López-de-Silanes, and Shleifer found between private enforcement of prospectus regulation on the one hand and the size of national stock markets and the configuration of share ownership on the other, one would expect that the United Kingdom would have scored well on this count as control structures unravelled. As with company law, however, this was not the case. Again, La Porta, López-de-Silanes, and Shleifer measured private enforcement with two components, the extent of disclosure required in prospectuses and the burden of proof an investor was required to meet when suing a company, its directors, and its accountants for misdisclosure. With both, for the period when ownership separated from control, the United Kingdom's scores were lower than would have been anticipated if law was the catalyst for the unwinding of control blocks.

La Porta, López-de-Silanes, and Shleifer focused on six variables when calculating their private enforcement disclosure scores. One was the presence or absence of a legal requirement that a company deliver a copy of a prospectus to those contemplating buying shares in a public offering. The other five were matters to be discussed in prospectuses companies issued, namely executive compensation, equity ownership structure, share ownership by directors, "irregular" contracts, and "related party" transactions.[81] La Porta, López-de-Silanes, and Shleifer give Britain a 0.83 disclosure rating (five "1"s out of a possible six), with the gap being that companies are not required to deliver prospectuses to prospective investors.[82] This

80. Under the revised anti-director index compiled by Djankov et al., the United States scored only a "3." Djankov et al., *supra* note 32, at tbl.XII.

81. For background on the variables, see La Porta et al., *supra* note 27, at 6.

82. For a detailed breakdown of the United Kingdom's score, see Harvard University, Securities Law Research Project, Securities Data, http://post.economics.harvard.edu/

figure is only slightly above average for common law countries (0.78) but is well ahead of the norm for countries of French legal origin (0.45) and German legal origin (0.60).

In a sense, the United Kingdom's high disclosure regulation score should not be surprising because Britain was a pioneer with respect to the regulation of prospectuses.[83] Nevertheless, as Table II shows, in historical terms Britain's disclosure requirement rating was not very flattering. To put the United Kingdom's disclosure score into proper context, it is essential to bear in mind the status of the London Stock Exchange's Listing Rules. Through its Listing Rules, the Exchange regulated corporate disclosure and obliged listed companies to provide more information than was required by U.K. companies legislation.[84] Particularly from the 1960s onwards, the London Stock Exchange imposed tough disclosure requirements on listed companies.[85] These reforms, however, would not have affected the United Kingdom's disclosure regulation score.

In grading the quality of securities law, La Porta, López-de-Silanes, and Shleifer focused on "actual laws, statutes . . . and any other rule with force of law."[86] Before the mid-1980s, the Listing Rules did not fall into this category because the obligations they imposed on companies listed on the London Stock Exchange were at most contractual in orientation.[87] The Financial Services Act of 1986, gave the London Stock Exchange's listing rules the status of subordinate legislation, which would have qualified the relevant provisions for inclusion in the United Kingdom's disclosure

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faculty/shleifer/papers/Securities_data.xls (United Kingdom entry) (on file with the Washington and Lee Law Review). La Porta, López-de-Silanes, and Shleifer, in compiling their securities law scores, relied on reports of local experts. Professor Alistair Alcock prepared the expert report on the United Kingdom. Harvard University, Securities Law Research Project, Securities Documentation, 275 *available at* http://econweb.fas.harvard.edu/faculty/shleifer/data/securities_documentation.pdf.

83. *See* Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1063 (1995) (citing the Companies Act of 1900 as the first statute in Anglo-American law to impose comprehensive disclosure requirements on companies selling securities to the public).

84. On the relationship between the Stock Exchange Listing Rules and statutory measures over time, see Douglas M. Branson, *Some Suggestions from a Comparison of British and American Tender Offer Regulation*, 56 CORNELL L. REV. 685, 710 & n.122 (1971); Cheffins, *supra* note 48, at 98.

85. On the reforms the London Stock Exchange made in 1964 to bolster disclosure requirements, see HAROLD ROSE, DISCLOSURE IN COMPANY ACCOUNTS 57–58 (2d ed., Institute of Economic Affairs Ltd. 1965); Charles Anderson, *The Stock Exchange and Disclosure*, BANKER, Oct. 1964, at 619.

86. La Porta et al., *supra* note 27, at 5.

87. On the legal status of the London Stock Exchange's listing rules before the mid-1980s, see L.C.B. GOWER, J.B. CRONIN, A.J. EASSON & LORD WEDDERBURN OF CHARLTON, GOWER'S PRINCIPLES OF MODERN COMPANY LAW 506 n.90 (4th ed. 1979).

regulation score and, therefore, accounts for a dramatic 1986 improvement from 0.33 to 0.75, as shown in Table II below.[88]

Table II—Historical Evolution of Disclosure Requirements for Prospectuses Under U.K. Law

	Prospectus Delivery	Director Share Ownership	Executive Compensation	Irregular Contracts	Ownership Disclosure	Related Party Transactions	**Disclosure Requirement**
1867–1986	0	0[89]	0	1.00[90]	0	1.00[91]	0.33

88. *See* Financial Services Act, 1986, § 142(6) (Eng.) (designating the Stock Exchange as the "competent authority" for the part of the Act dealing with the official listing of securities); *id.* § 144(2) (authorizing "the competent authority" to require the submission of listing particulars—essentially equivalent to a prospectus—as a condition of listing). Franks, Mayer, and Rossi offer some historical information on how the United Kingdom's disclosure regulation score would have evolved over time and generally find Britain's score would have improved earlier than is set out here. Franks, Mayer & Rossi, *supra* note 49, at 55 panel B. They do not explain in the text or supporting tables the scores they give over time and simply refer the reader to a general chronology of company law and financial regulation they have prepared. *Id.* at 14, 53 tbl.A.3. As a result, there is insufficient detail available to account properly for the discrepancies between the version of events they provide and the one offered here. For a particular instance where Franks, Mayer, and Rossi's lack of documentation is problematic, see *infra* note 89.

89. Franks, Mayer, and Rossi say that the appropriate score for director share ownership should be "1" from 1929 onwards. Franks, Mayer & Rossi, *supra* note 49, at 55 panel B. This is incorrect. The statutory rules governing the content of prospectuses in the Companies Act, 1929 were set out in Part I of the Fourth Schedule to the Act. The only potentially relevant provision in Part I (paragraph 2) stipulated that a prospectus must specify "[t]he number of founders or management or deferred shares, if any" and "[t]he number of shares, if any, fixed by the Articles as the qualification of a director." "Founders shares" were a special class of stock that would be issued to the promoter of a public offering in consideration for the promoter's services and typically were entitled to the lion's share of the profits distributed as dividends after the preference shares and common shares had been paid a fixed amount. By the 1950s, founder's shares were rarely used. L.C.B. Gower, MODERN COMPANY LAW 281–82 (1956). Hence, a requirement to disclose "founders shares" would have revealed little, if anything, about the share ownership of a company's directors. The "qualification" requirement meant that if a company's articles of association (equivalent to the bylaws in a U.S. corporation) stipulated that an individual had to own a specified number of shares to qualify as a director, the prospectus had to identify this. Frequently, individual directors' shareholdings were many times the nominal qualification. Hargreaves Parkinson, SCIENTIFIC INVESTMENT 142 (1932). As a result, disclosure of qualification requirements in a prospectus would have provided few clues on how many shares a company's directors actually owned.

90. *See* Companies Act, 1867, 30 & 31 Vict., c. 131, § 38 (Eng.) (requiring companies issuing a prospectus to disclose contracts that would influence whether an applicant would take up shares).

91. *See id.* (requiring companies issuing a prospectus to disclose corporate transactions to which its directors were parties); *see also* PALMER'S COMPANY LAW 350–51 (A.F. Topham ed.,

1986–1995[92]	0	1.00	0.50	1.00	1.00	1.00	0.75
1995–present	0	1.00	1.00[93]	1.00	1.00	1.00	0.83

With the burden of proof investors are required to meet in civil suits involving allegations of misdisclosure, La Porta, López-de-Silanes, and Shleifer award Britain a grade of 0.66. This is only slightly above average for common law countries (0.60) but again is well ahead of the norm for countries of French (0.39) and German legal origin (0.42). The 0.66 mark is based on an average of three components, these being identical 0.66 burden of proof grades for suits brought against a company, its directors, and its accountants.[94] As Table III

19th ed. 1949) (indicating that due to judicial interpretation of the relevant provision, the contracts in question also had to be material to a potential purchaser of shares).

92. With the version of the London Stock Exchange Listing Rules that was in effect when the Listing Rules were transformed into subordinate legislation, four of the five topics specified by La Porta, López-de-Silanes, and Shleifer were dealt with in a manner where a score of "1" was appropriate. *See* COUNCIL OF THE STOCK EXCHANGE, ADMISSION OF SECURITIES TO LISTING Section 3, chapter 1, ¶ 3.9 (1984) (addressing equity ownership structure); *id.* ¶ 4.8 (addressing fundamental/irregular contracts); *id.* ¶ 6.5 (addressing related party transactions); *id.* ¶ 6.6 (addressing director share ownership). With the fifth topic, executive pay, the score would have been ".50" rather than "1" because the Listing Rules only required that aggregate figures be divulged. *Id.* ¶ 6.3. On a "1" only being appropriate when the executive pay arrangements of individual executives have to be disclosed, see La Porta et al., *supra* note 27, at 6. The chronology provided here glosses over a complex situation existing during 1985 and 1986. During these years, certain items in the London Stock Exchange Listing Rules would have qualified as "rules of law" and other provisions would not have. For background, see PALMER'S COMPANY LAW 272, 276–77, 297–98 (Clive M. Schmitthoff ed., 24th ed., 1987).

93. La Porta, López-de-Silanes, and Shleifer give the United Kingdom a "1" on executive compensation disclosure. In so doing, they rely on § 80 of the Financial Services and Markets Act, 2000, which stipulates that listing particulars must include all information investors would reasonably require. On this reasoning, see Harvard University, Securities Documentation, *supra* note 82, at 275–76, saying regulators in the United Kingdom would expect companies to provide detailed remuneration data for senior executives in listing particulars. Accepting, for the sake of argument, that La Porta, López-de-Silanes, and Shleifer's analysis is correct, it is unclear when companies carrying out public offerings would reasonably have been expected to divulge information on the remuneration arrangements of individual executives. The Financial Services Act, 1986 contained a provision (§ 146) equivalent to § 80 of the Financial Services Markets Act, 2000. However, 1995 has been selected for present purposes rather than 1986, with the rationale being that until the London Stock Exchange's Listing Rules were amended that year to require listed companies to disclose annually on an individualized basis the pay arrangements of their directors, there was no expectation that companies should engage in disclosure of this sort. On the 1995 changes, see BRIAN R. CHEFFINS, COMPANY LAW: THEORY, STRUCTURE AND OPERATION 663 (1997). The United Kingdom's score with executive pay now has a firmer foundation due to the Prospectus Regulation, a European Union measure that came into force in 2005 and is directly applicable as law in Member States such as the United Kingdom. Commission Regulation (E.C.) 809/2004 O.J. 2004 L149/1, Annex 1, ¶ 16.2 stipulates that information on the service contracts of directors must be provided in a prospectus.

94. *See* Harvard University, Securities Data, *supra* note 82 (detailing the United Kingdom

indicates, however, between 1948 and 1986, which again encompasses the period when the United Kingdom's outsider/arm's-length system of ownership and control became entrenched, Britain's score was only 0.44. The Financial Services Act, 1986, boosted the United Kingdom's score to its current level. The relevant statutory provisions were revised as part of an overhaul of financial services regulation occurring in 2000, but the United Kingdom's score did not change.[95]

Table III—Historical Evolution of the Burden of Proof for Prospectus Misdisclosure Under U.K. Law

	Suing the Company	Suing Directors	Suing Accountants	**Burden of Proof Score**
Mid 19C–1890	0.66[96]	0[97]	0[98]	0.22

entry).

95. *See* Harvard University, Securities Documentation, *supra* note 82, at 278–80 (discussing the Financial Services and Markets Act, 2000, c. 8. (Eng.)). Franks, Mayer, and Rossi offer some historical background on how the burden of proof index evolved over time and identify 1929 and 1948 as important dates. Franks, Mayer & Rossi, *supra* note 49, at 55 panel B. As with the U.K. disclosure regulation score they provide (*see supra* note 88), they do not explain in the text or supporting tables the scores they give over time and simply refer the reader to a general chronology of company law and financial regulation they have prepared. *Id.* at 14, 53 tbl.A.3. As a result, there is insufficient detail available to account properly for the discrepancies between the version of events they provide and the one offered here.

96. Under the common law, those allotted shares as part of a public offering could sue the company for recission of the purchase if there was misdisclosure in the prospectus. Lynde v. Anglo-Italian Hemp Spinning Co. [1896] 1 Ch. 1789; Collins v. Associated Greyhound Racecourses [1930] 1 Ch. 1. The plaintiff could do so without proving that the misrepresentations were made knowingly or recklessly. Smith's Case (1867) 2 Ch. App. 604, 615, *aff'd* Reese River Silver Mining Co. v. Smith (1869) L.R. 4 H.L. 79. The plaintiff, however, had to establish the materiality of the misrepresentation and reliance upon it. Harvard University, Securities Documentation, *supra* note 82, at 280. According to La Porta, López-de-Silanes, and Shleifer's methodology, this means a score of 0.66 is appropriate, not 1.00. On how they measure the liability standard for companies issuing shares, see La Porta et al., *supra* note 27, at 7.

97. *See* Derry v. Peek, (1889) 14 App. Cas. 337 (H.L.) (appeal taken from Eng.) (providing case law authority for the proposition that investors could only sue directors on the basis of a misleading prospectus by showing that the directors made the misstatement with knowledge of its falsity or did so recklessly). La Porta, López-de-Silanes, and Shleifer say a "0" should be awarded in this context if a plaintiff can only sue directors successfully when misdisclosure in a prospectus is intentional or characterized by gross negligence. On how they measure the liability standard of directors, see La Porta et al., *supra* note 27, at 7.

98. Under the common law, an investor buying equity in a public offering could only succeed in a suit against a company's accountants if they were part of a conspiracy to defraud potential investors. On the common law position, see Committee on Company Law Amendment (Mr. Justice Cohen, chair), Report, Cmnd. Paper 6659, 24 (1945). This meant that the standard of proof score should be "0," which La Porta et al. say is correct if a plaintiff can

1890–1948	0.66	0.33[99]	0	0.33
1948–1986	0.66	0.33	0.33[100]	0.44
1986–present	0.66[101]	0.66[102]	0.66[103]	0.66

A way of synthesizing the historical trends for U.K. securities law is to use the disclosure and burden of proof figures to formulate an overall private

only win a suit against accountants if misdisclosure in a prospectus is intentional or characterized by gross negligence. On how they measure the liability standard of accountants, see La Porta et al., *supra* note 27, at 7.

99. As a result of the Directors' Liability Act, 1890, 53 & 54 Vict., c. 64, a person who subscribed to purchase shares in a public offering supported by a misleading prospectus had a statutory right to sue the directors of the company in question. Liability existed regardless of the absence of fraud or recklessness, but investor reliance on the misstatement was explicitly required. The relevant phrase was "on the faith of the prospectus." Directors' Liability Act, 1890, § 3(1). Also, by virtue of Director's Liability Act, 1890, § 3(1)(a), directors could escape liability by establishing that they believed on reasonable grounds that what was said was true. The United Kingdom's burden of proof score for suing directors thus would have been 0.33, which La Porta et al. stipulate is appropriate if investors can only bring a successful suit if they prove that a director acted with negligence and that there was reliance on the prospectus.

100. The Companies Act, 1948, § 43(1) stipulated that experts (e.g., accountants) who consented to a report being included as part of a prospectus could be liable to compensate for losses sustained by reason of untrue statements in the report. Companies Act, 1948, § 40 governed when experts were deemed to consent. Companies Act, 1948, § 46 deemed statements made in supporting reports to be part of a prospectus. The legislative change would have moved the burden of proof score concerning accountants from 0.00 to 0.33, but no higher because a plaintiff still had to establish reliance on the misdisclosure, and accountants were absolved of responsibility if they were not negligent (i.e., they reasonably believed the statements made were true).

101. Since the mid-1980s investors have had a statutory option for suing a company on the basis of misdisclosure in listing particulars. The statutory remedy does not qualify for a "1" score because the issuer can rely on a reasonable belief defense. On the logic involved, discussed in terms of current legislation, see Harvard University, Securities Documentation, *supra* note 82, at 280.

102. The Financial Services Act, 1986 repealed the rules in U.K. companies legislation regulating civil liability for misleading prospectuses and introduced a regime authorizing suits against "persons responsible for any listing particulars." Financial Services Act, 1986, c. 60 §§ 150–52. The 1986 legislation deemed company directors to be "persons responsible" for listing particulars. *Id.* § 152(1)(b). A 0.66 score is appropriate for directors because an aggrieved investor could bring a successful claim against "persons responsible" without proving reliance, but defendants had a defense if they had reasonable grounds for believing listing particulars were accurate. *Id.* §§ 150–52. On the justification for a 0.66 score under the Financial Securities and Markets Act, 2000 c.8, see Harvard University, Securities Documentation, *supra* note 82, at 278–80.

103. "Persons responsible for listing particulars" was defined to include those accepting responsibility for any part of the particulars. *Id.* § 152(1)(b). On the fact that this would have encompassed an accountant whose report appeared in listing particulars with his consent, see PALMER'S, *supra* note 91, at 312. On the justification for a 0.66 score under the Financial Securities and Markets Act, 2000, see Harvard University, Securities Documentation, *supra* note 82, at 279–80.

enforcement index score.[104] Extrapolating from La Porta, López-de-Silanes, and Shleifer's data, Britain would currently have a score of 0.75, calculated on the basis of an average of its disclosure requirement (0.83) and burden of proof (0.66) figures. Britain's score exceeds the common law average (0.69), if only modestly, but is considerably higher than the French legal origin average (0.42) and the German legal origin average (0.51). As Table IV indicates, however, matters were much different historically, with Britain's private enforcement score being much lower during the decades when ownership separated from control than it is currently. Of particular note is the 0.39 score for 1948–1986, which covers the decades when the United Kingdom's outsider/arm's-length system of ownership and control became entrenched.

Table IV—Historical Evolution of Prospectus Regulation, as Measured by a Cumulative Private Enforcement Index

	Disclosure Requirements	Burden of Proof	Private Enforcement Score[105]
1867–1890	0.33	0.22	0.28
1890–1948	0.33	0.33	0.33
1948–1986	0.33	0.44	0.39
1986–1995	0.75	0.66	0.71
1995–present	0.83	0.66	0.75
English legal origin (average)	0.78	0.60	0.69
French legal origin (average)	0.45	0.39	0.42
German legal origin (average)	0.60	0.42	0.51

As Table IV shows, in historical terms, the pattern with securities law is much the same as it is for company law. Currently, as is the case with company law, the United Kingdom scores highly with respect to private enforcement of securities law, but the score can be attributed primarily to legislation enacted after the transition to outsider/arm's-length corporate governance was complete.

104. La Porta, López-de-Silanes, and Shleifer took this step in the version of "What Works" they circulated as a National Bureau of Economics Research working paper but did not do so in the published version. *See* Rafael La Porta et al., *What Works in Securities Laws?* tbl.2 (Nat'l Bureau of Econ. Research, Working Paper No. 9982, 2003) (averaging the disclosure and burden of proof scores to formulate a private enforcement score for each country).

105. *See id.* (providing the "private enforcement scores" for the United Kingdom currently, English legal origin, French legal origin, and German legal origin).

Pivotally, during the decades when ownership structures of larger public companies decisively unwound, Britain's private enforcement rating was inferior to the current average score for common law countries, countries of German legal origin and even countries of French legal origin. Thus, as with company law, the legal protection afforded to investors was considerably below the standard that the law matters story would predict. To the extent La Porta, López-de-Silanes, and Shleifer's anti-director and prospectus disclosure indices constitute reliable proxies for the quality of protection afforded to outside investors, factors other than corporate and securities law must have accounted for the unwinding of control blocks in publicly quoted companies in the United Kingdom.

IV. The Relevance of Dividends

As the highly stylized example outlined in Part II illustrates, the widely held company might not become dominant in a country even if it enjoys inherent economic advantages. One obstacle is the "controller's roadblock": The dominant shareholders in companies might not capture a sufficient portion of the gains available from a transition to dispersed ownership to compensate them for the loss of private benefits of control. Investor scepticism is another: Potential buyers of shares for sale would reason logically—if incorrectly—that optimistic claims made about future shareholder returns were implausible. Given that corporate law in the United Kingdom was not highly protective of minority shareholders, what eroded the private benefits of control sufficiently to motivate blockholders to exit? And how were the information asymmetries affecting potential investors addressed?

Various factors played a role. For instance, the profitability of U.K. companies began to decline in the 1960s and fell precipitously in the 1970s.[106] This should have diminished the private benefits of control eligible for extraction, which would have provided those owning large blocks of shares in U.K. companies with an incentive to exit. In addition, particularly beginning in

106. *See* Christine Oughton, *Profitability of U.K. Firms*, *in* THE FUTURE OF U.K. COMPETITIVENESS AND THE ROLE OF INDUSTRIAL POLICY 55, 59 (Kirsty Hughes ed., 1993) (providing annual data on gross and net profit rates between 1954 and 1991 for companies in the manufacturing and services sectors); *see also* Committee to Review the Functioning of Financial Institutions (Chairman, Sir Harold Wilson), 3 EVIDENCE ON THE FINANCING OF TRADE AND INDUSTRY 230 (1977) (showing that the pre-tax, inflation-adjusted rate of returns for companies fell from 13% in 1960 to 9% in 1969 and again to 3.5% in 1976); W.A. THOMAS, THE FINANCE OF BRITISH INDUSTRY 218, 310 (1978) (providing data indicating that gross trading profits, as a percentage of total source of company funds, fell from 72% in 1952–1955 to 69% in 1956–1960, to 64% in 1961–1965, and again to 59% in 1966–1970).

the mid-1960s, the London Stock Exchange regulated disclosure by listed companies and transactions potentially tainted by conflicts of interest with increasing strictness.[107] This should have simultaneously reduced the scope for "skimming" by dominant shareholders and fostered confidence among investors contemplating buying shares. Additionally, the financial intermediaries who organized public offerings of shares had, due to concerns about building up and retaining highly valued reputations for competence and propriety, strong incentives to ensure that when companies sold equity to the public, arrangements were attractive to potential investors. Such "quality control" would have deterred to some degree sharp practice by controlling shareholders and would have been reassuring to investors.[108]

Merger activity further hastened the unwinding of incumbent ownership structures, as numerous family owners sold out and many of the companies carrying out acquisitions issued shares publicly to finance the deals involved.[109] Also important was a demography and tax-driven "wall of money," namely a massive flow of funds to insurance companies and pension funds that had to be invested somewhere.[110] Shares in U.K. public companies stood out, if only by process of elimination, as a promising potential candidate. Due to inflation, government bonds ("gilts") were generally a bad investment.[111] Exchange controls tightly constrained investing abroad.[112] Thus, if only by default, shares of United Kingdom-based public companies deserved serious consideration by investors.

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107. On disclosure, see Anderson, *supra* note 85, at 619. On related party transactions, see Federation of Stock Exchanges in Great Britain and Ireland, Admission of Securities to Quotation sched. II, Pt. A, ¶ 29, Pt. B, ¶ 26 (1966), Memoranda of Guidance, Acquisitions and Realisations of Subsidiary Companies, Businesses or Fixed Assets by Quoted Companies, and Bids and Offers for Securities of a Company, ¶ 6.

108. *See* Cheffins, *Does Law Matter?*, *supra* note 2, at 472–73 (describing the increased importance of screening by financial intermediaries of public offerings following World War I).

109. On the contribution mergers made to the unwinding of share blocks, see Cheffins, *Mergers*, *supra* note 2, at 261.

110. On the post-World War II increase in funds available for investment by insurance companies and pension funds, see JOHN LITTLEWOOD, THE STOCK MARKET: 50 YEARS OF CAPITALISM AT WORK 255 (1998); JOHN PLENDER, THAT'S THE WAY THE MONEY GOES: THE FINANCIAL INSTITUTIONS AND THE NATIONS SAVINGS 26 (1982); Brian R. Cheffins, *Are Good Managers Required for a Separation of Ownership and Control?*, 13 INDUS. & CORP. CHANGE 591, 604 (2004).

111. *See* Cheffins, *supra* note 110, at 605 (stating that returns on government bonds were substantially less than the inflation rate).

112. On the post-World War II exchange controls and their impact on investment patterns, see *id.* at 607–09.

While these various factors no doubt contributed to the separation of ownership and control in Britain, the story remains incomplete. For instance, though declining profitability in the U.K. corporate sector would have eroded private benefits of control, the situation only became chronic in the 1970s. Similarly, prior to the reforms of the mid-1960s, the requirements the London Stock Exchange imposed on listed companies were not particularly onerous, meaning there was scant information available on public companies.[113] As for scrutiny by financial intermediaries, because this hinged on public offerings occurring, this was only an episodic constraint on those controlling U.K. public companies. Moreover, there was a bias against tapping equity markets. In Britain, as in all major economies, retained earnings have traditionally constituted the dominant source of corporate finance, and the contribution of equity has been, in comparison, modest.[114] An abrupt decline in new issues during the mid-1960s even led the *Economist* to remark upon "how unimportant economically is the London equity market."[115]

While constrained choices dictated that institutional investors consider seriously buying shares in public companies, they had good reason to pause. Throughout the 20th century, the real (i.e., inflation-adjusted) return investors obtained by way of capital gains on U.K. shares was, on average, only 1% annually.[116] Moreover, U.K. companies did not seem promising targets for investment during the decades following World War II. A 1956 report on management succession in British companies bemoaned "[t]he shortage of good managers, particularly at the top."[117] Critics in the early 1970s said there was "a certain claret-grouse-and-port induced somnolence in British boardrooms"[118] with "the unconscious ambition of most directors [being] to retire and become a

113. On disclosure gaps prior to the mid-1960s, see *British Companies Urged to Disclose More*, TIMES (London), Feb. 11, 1964, at 16; Clyde H. Farnsworth, *Corporate Data Scarce in Britain*, N.Y. TIMES, Oct. 5, 1963, at 28; *U.S. Analysts' Views of British Industry*, TIMES (London), Apr. 13, 1959, at 17.

114. On the bias in favor of internal finance, see Colin Mayer, *Financial Systems, Corporate Finance, and Economic Development*, *in* ASYMMETRIC INFORMATION, CORPORATE FINANCE, AND INVESTMENT 307, 310–12 (R. Glenn Hubbard ed., 1990); Jenny Corbett & Tim Jenkinson, *How is Investment Financed? A Study of Germany, Japan, the United Kingdom and the United States*, 65 THE MANCHESTER SCHOOL 69, 74–75 (Supp. 1997).

115. *New Issues—Less Important and Much Less Fun*, ECONOMIST, Mar. 16, 1968, at 107.

116. ELROY DIMSON, PAUL MARSH & MIKE STAUNTON, TRIUMPH OF THE OPTIMISTS: 101 YEARS OF GLOBAL INVESTMENT RETURNS 151 (2002).

117. ACTON SOCIETY TRUST, MANAGEMENT SUCCESSION: THE RECRUITMENT, SELECTION, TRAINING AND PROMOTION OF MANAGERS 1 (1956).

118. Robert Ball, *Jim Slater's Global Chess Game*, FORTUNE, June 1973, at 188, *quoted in* CHARLES RAW, SLATER WALKER: AN INVESTIGATION OF A FINANCIAL PHENOMENON 170 (1977).

country squire."[119] Indeed, as Britain lost ground relative to its major industrial rivals in the decades following World War II, inferior corporate leadership was identified by many as the single most important cause.[120] As Robin Marris, a noted economist, said in a 1979 essay, "[t]he principal source of British decline . . . is its managerial malaise."[121] To the extent such criticism of the executives running U.K. public companies was on the mark, institutional investors had a plausible justification for forsaking corporate equity in favour of other asset classes.

Since the explanations for the unwinding of ownership in U.K. public companies summarized thus far each suffer from notable limitations, there is scope for decisions companies made about distributing cash to shareholders by way of dividends—doing so by repurchasing shares was prohibited until the early 1980s and was irrelevant for tax reasons until the mid-1990s[122]—to constitute an important supplementary variable. The contribution dividends made to investment returns is one point that must be borne in mind. While purely from a capital gains perspective, U.K. shares delivered only a 1% average annual real return during the 20th century, with dividends taken into account the annualized real return improved to 5.8%.[123] Thus, dividends were a key "sweetener" that would have given investors an incentive to buy equity.

The dividend policy U.K. public companies adopted also operated in ways more directly relevant to the unwinding of control blocks. Dividends served as a check on the squandering of corporate assets by those running public companies and generated information that should have addressed, at least partially, apprehension among investors concerned about lack of knowledge of the companies involved. Dividends thus mimicked the role attributed to companies legislation by the law matters thesis, and in so doing, acted as at least a partial substitute in fostering the unwinding of control blocks.

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119. George Norman, *The English Sickness*, BANKERS' MAG., Nov. 1973, at 192, 195.

120. On the contribution the alleged inadequacies of British managers made to Britain's economic decline, see GEOFFREY OWEN, FROM EMPIRE TO EUROPE: THE DECLINE AND REVIVAL OF BRITISH INDUSTRY SINCE THE SECOND WORLD WAR 418 (1999); Derek H. Aldcroft, *The Missing Dimension: Management Education and Training in Postwar Britain*, *in* ENTERPRISE AND MANAGEMENT 93, 93, 110–11 (Derek Aldcroft & Anthony Slaven eds., 1995).

121. Robin Marris, *Britain's Relative Economic Decline: A Reply to Stephen Blank*, *in* IS BRITAIN DYING? PERSPECTIVES ON THE CURRENT CRISIS 89, 93 (Isaac Kramnick ed., 1979).

122. *See* Companies Act, 1981, c. 62, §§ 45–62 (authorizing share buybacks under prescribed circumstances); Trevor v. Whitworth, (1887) 12 App. Cas. 409 (H.L.) (appeal taken from Eng.) (establishing the common law rule prohibiting the repurchase of shares); P. Raghavendra Rau & Theo Vermaelen, *Regulation, Taxes and Share Repurchases in the United Kingdom*, 75 J. BUS. 245, 251–59 (2002) (describing the tax position from 1981 onwards).

123. DIMSON, MARSH & STAUNTON, *supra* note 116, at 151 (assuming dividends were fully reinvested in the stock market).

Especially for those familiar with the basic tenets of modern corporate finance theory, the proposition that dividends "mattered" in the manner just described requires elaboration and justification. During the late 1950s and early 1960s, economists Merton Miller and Franco Modigliani formulated a series of "irrelevance" propositions that effectively launched financial economics as a body of knowledge.[124] Their propositions were offered under a deliberately restrictive set of assumptions, such as tax neutrality between dividends and capital gains, full symmetry of information, the absence of managerial agency costs, perfectly competitive capital markets, and no transaction costs.[125] From this departure point, Miller and Modigliani characterized decisions about corporate finance, including decisions about dividend policy, as nothing more than ways of dividing up and repackaging for distribution to investors the net cash flow companies generated.[126]

Of particular relevance in the present context, under the assumptions Miller and Modigliani made, a company's market value will be determined by "real" economic considerations such as its investment policy and the earning power of its assets rather than by any sort of balance between dividends and retained earnings.[127] Dividend policy will thus be nothing more than packaging of a company's real value; "a mere detail."[128] A corollary is that, assuming a company has settled upon its business strategy and its choice of ventures to pursue and exploit, dividends will not affect returns to investors.[129] This is because the higher (lower) the dividend, the

124. *See generally* Merton H. Miller & Franco Modigliani, *Dividend Policy, Growth and the Valuation of Shares*, 34 J. BUS. 411 (1961) [hereinafter Miller & Modgliani, *Dividend Policy*]; Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958) [hereinafter Modigliani & Miller, *Cost of Capital*]. On the significance of Miller and Modigliani's contribution to the study of corporate finance, see JONATHAN B. BASKIN & PAUL J. MIRANTI, A HISTORY OF CORPORATE FINANCE 12, 18 (1997); Alan J. Auerbach, *Taxation and Corporate Financial Policy*, *in* 3 HANDBOOK OF PUBLIC ECONOMICS 1250, 1252 (Alan J. Auerbach & Martin Feldstein eds., 2002).

125. For a summary, see RONALD C. LEASE, KOSE JOHN, AVNER KALAY, URI LOEWENSTEIN, & ODED H. SARIG, DIVIDEND POLICY: ITS IMPACT ON FIRM VALUE 36–37 (2000).

126. On this characterization of Miller and Modigliani's arguments, see Donald H. Chew, *Introduction: Financial Innovation in the 1980s*, *in* THE NEW CORPORATE FINANCE: WHERE THEORY MEETS PRACTICE ix, xii (Donald H. Chew ed., 1993).

127. On the dividend policy and a company's stock market value under the relevant assumptions, see Daniel R. Fischel, *The Law and Economics of Dividend Policy*, 67 VA. L. REV. 699, 701 (1981); Miller & Modigliani, *Dividend Policy*, *supra* note 124, at 430.

128. On this characterization of dividend policy, see Modigliani and Miller, *Cost of Capital*, *supra* note 124, at 266.

129. On the importance of holding investment policy constant for the purpose of analysis,

less (more) an investor will receive in capital appreciation.[130] Moreover, since investors can always create a "homemade dividend" by selling some of their own shares, a company's decision to pay or withhold a dividend should be a matter of indifference to them.[131]

While, as a matter of pure theory, dividends might be a "mere detail," real-world conditions in the United Kingdom diverged substantially from Miller and Modigliani's assumptions during the period when ownership separated from control.[132] For instance, during the decades following World War II, transaction costs were hefty.[133] This meant that, for investors seeking a regular cash flow, receiving dividends from the companies in which they owned shares could well be preferable to creating a "homemade dividend" by selling equity. Tax was anything but neutral, with individual investors usually having a strong tax bias in favor of retained earnings, institutional investors, and particularly pension funds, the converse.[134] Also, capital markets were not perfectly competitive. For instance, the system of dealing in corporate equity, involving "brokers" on the "buy" side and "jobbers" on the "sell" side, was subject to anti-competitive practices that attracted the attention of U.K. antitrust regulators in the 1980s.[135] Given the manner in which markets operated in practice, dividends potentially could function as a substitute for corporate law in a way that would have been impossible under Miller and Modigliani's restrictive assumptions.

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see Jeremy Edwards, *Does Dividend Policy Matter?*, 5 FISCAL STUD. 1, 1 (1984).

130. On this point, see Fischer Black, *The Dividend Puzzle*, 2 J. PORTFOLIO MGMT. 5, 5 (1976); Zohar Goshen, *Shareholder Dividend Options*, 104 YALE L.J. 881, 885–86 (1995).

131. On how investors can generate cash from shares in the absence of dividends, see Fischel, *supra* note 127, at 701–02.

132. Those who derive insights from Miller and Modigliani's work in fact generally acknowledge that their assumptions were not realistic. *See* Peter H. Huang & Michael S. Knoll, *Corporate Finance, Corporate Law and Finance Theory*, 74 S. CAL. L. REV. 175, 178–79 (2000) (noting that the precepts in question are treated as a valuable intellectual departure point, with real world frictions then being introduced and inferences drawn about the contributions of theoretically irrelevant financial practices).

133. On estimates of the profits investors had to make to cover transaction costs, see ADRIENNE GLEESON, PEOPLE AND THEIR MONEY: 50 YEARS OF PRIVATE INVESTMENT 136 (1981) (estimating "at least 10 percent"); P.J. NAISH, THE COMPLETE GUIDE TO PERSONAL INVESTMENT 25 (1962) (estimating that investors require "10 per cent"); HAROLD WINCOTT, THE STOCK EXCHANGE 141 (1946) (estimating 19 percent).

134. *See infra* notes 283–84, 291–92 and accompanying text (discussing taxation of dividends in the hands of individual investors and pension funds).

135. For background, see RANALD MICHIE, THE LONDON STOCK EXCHANGE: A HISTORY 483, 486, 544–55 (2000).

V. Dividends and the Private Benefits of Control

A. The Agency Cost Theory of Dividends

The managing director of a leading U.K. fund manager said in a 1994 article in the *Financial Times* newspaper that dividend policy imposes "vital discipline on company boards."[136] What is known as the "agency cost" theory of dividends formalizes the logic involved, ascribing to dividends an important role in curbing the potential excesses of insiders controlling public companies.[137] The theory, in turn, offers clues as to how ownership separated from control in U.K. public companies when the law did not offer substantial protection to outside investors.

The agency cost theory of dividends is conventionally discussed with the widely held company as the reference point, with the thinking being that dividends impose constraints on managers otherwise liable to act contrary to the interests of arm's-length shareholders.[138] The theory is also relevant, however, for companies where a shareholder owns a sufficiently large block of shares to exercise *de facto* control.[139] In a company of this sort, the blockholder should be both able and willing to keep management in line. On the other hand, there is potential for blockholders to exercise their influence in a manner that is contrary to the interests of outside investors. Dividends can act as a potential check, since the regular distribution of earnings to investors reduces the scope a dominant shareholder has to skim or squander corporate profits.[140]

To elaborate, corporate insiders will generally have a bias against dividends because the retention of earnings increases the size of the assets under their control and reduces the need to turn to capital markets for additional finance.[141] Companies, however, with leftover income (cash flow in excess of that required to fund economically worthwhile projects) may well fail to

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136. Paddy Linaker, *City Must Defend its Capital Position*, FIN. TIMES, Apr. 19, 1994, at 17. Linaker was the managing director of the Prudential, a major insurance company and fund manager.

137. For the label, and original statement of the theory, see generally Frank Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650 (1984).

138. For an overview of agency cost theory in this context, see LEASE ET AL., *supra* note 125, at 80–81.

139. On the agency cost theory of dividends in the context of companies with blockholders, see Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Agency Problems and Dividend Policies Around the World*, 55 J. FIN. 1, 4–6 (2000).

140. On the check dividends potentially impose, see *id.* at 4; Mara Faccio, Larry H.P. Lang & Leslie Young, *Dividends and Expropriation*, 91 AM. ECON. REV. 54, 55 (2001).

141. For background, see Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, 76 AM. ECON. REV. (PAPERS & PROC.) 323, 323 (1986).

maximize shareholder value.[142] Self-serving behavior is one danger. For instance, "sweetheart" deals might be engineered to siphon off a disproportionate share of accumulated earnings to firms the large shareholder controls.[143] Also, because blockholders of public companies will generally have most of their wealth tied up in their own firms, they might drive their companies to pursue value-destroying diversification strategies in the interests of spreading risk.[144] Another possibility, at least in companies dominated by families, is that amateurish family management will squander accumulated profits through a combination of bad business decisions and policy errors.[145] When companies make regular dividend payments, corporate insiders have less discretionary cash to dissipate in these various ways.

An ongoing commitment to pay dividends also places inherent limits on the ability of a company to finance its business plans from retained earnings and thus can compel a return to the capital markets to obtain needed funds. Raising capital exposes those running a company to "screening" by investors and scrutiny by financial intermediaries (e.g., investment banks, often referred to in the United Kingdom as merchant banks). Hence, dividends can activate beneficial capital market discipline on companies with de facto controlling shareholders.[146] In sum, the payment of dividends potentially acts as a check on the skimming or squandering of corporate profits that should simultaneously give blockholders an incentive to exit and encourage outside investors to buy shares.

B. The Propensity of U.K. Public Companies to Pay Dividends

There is a substantial body of empirical evidence that is consistent with the agency cost characterization of dividends.[147] Nevertheless, the discipline dividends can impose is potentially illusory because corporate insiders might

142. On the risks involved where there is "free cash flow," see *id.*; Randall Morck & Bernard Yeung, *Dividend Taxation and Corporate Governance*, J. ECON. PERSP., Summer 2005, at 163, 170.

143. On this danger, see Ronald J. Daniels & Jeffrey G. MacIntosh, *Toward a Distinctive Canadian Corporate Law Regime*, 29 OSGOODE HALL L.J. 863, 885 (1991).

144. *See* Easterbrook, *supra* note 137, at 653 (making a similar point with respect to managers of widely held companies).

145. On the risk of incompetent management in family dominated companies, see Cheffins, *supra* note 6, at 357.

146. On dividends and capital market discipline, see Easterbrook, *supra* note 137, at 653.

147. For a summary, see LEASE ET AL., *supra* note 125, at 89–91.

reverse field and stop distributing cash to shareholders.[148] Dividends can therefore only play the role ascribed to them by agency cost theory if those controlling a company are bound in a credible way to continue to make regular, ongoing dividend payments.[149] The available evidence suggests U.K. public companies conducted themselves as if they were operating under such constraints.

The dividend payouts of public companies were not strikingly large when the United Kingdom's outsider/arm's-length system of ownership and control took shape. The ratio of dividends to profits in such firms was approximately 40% in the 1950s, 45% in the 1960s, and 30% in the 1970s.[150] Dividend/payout ratios in the United States were similar, and indeed moderately higher, over the same period (48% in the 1950s, 42% in the 1960s, and 42% in the 1970s).[151] Moreover, U.K. companies paid out a considerably higher percentage of their reported net profits in the form of dividends during the 1920s and 1930s than was the case from the 1940s onwards.[152] This discrepancy, however, was not generally due to the adoption of a markedly more conservative dividend policy.[153] Instead, the declining ratio of dividends to profits was primarily a result of changes in accounting practice that led companies to report earnings more fully.[154]

148. On the possibility that managers might reverse field, see Franklin Allen & Roni Michaely, *Payout Policy*, *in* 1A HANDBOOK OF THE ECONOMICS OF FINANCE, CORPORATE FINANCE 337, 384 (George M. Constandines, Milton Harris & Rene M. Stulz eds., 2003); Goshen, *supra* note 130, at 889.

149. On why the agency cost theory of dividends only works under such circumstances, see Goshen, *supra* note 130, at 881, 890.

150. For the 1950s, the average for the decade was calculated on the basis of annual figures set out in ROYAL COMMISSION ON THE DISTRIBUTION OF INCOME AND WEALTH, REPORT NO. 2: INCOME FROM COMPANIES AND ITS DISTRIBUTION, 1975 Cmnd. 6172, at 161 tbl.P7. On the 1960s and 1970s, see Steve Toms & Mike Wright, *Corporate Governance, Strategy and Structure in British Business History, 1950–2000*, BUS. HIST., July 2002, at 91, 105. The report by the Royal Commission on the Distribution of Wealth and Income also provided annual figures for the 1960s, and the average for these was 53.9%, slightly higher than the figure Toms and Wright offer.

151. MARY O'SULLIVAN, CONTESTS FOR CORPORATE CONTROL: CORPORATE GOVERNANCE AND ECONOMIC PERFORMANCE IN THE UNITED STATES AND GERMANY 192 (2000).

152. *See* Steven A. Bank, *The Dividend Divide in Anglo-American Corporate Taxation*, 30 J. CORP. L. 1, 11–12 (2004) (finding that U.K. companies paid out 80% of their earnings in dividends in the 1920s). Figures on retained earnings compiled by Thomas imply that during the 1920s and 1930s, the dividend/profit ratio typically ranged between 70% and 85%, with companies apparently paying more in dividends than they generated in profits in 1921. THOMAS, *supra* note 106, at 89 tbl.4.2.

153. *See* THOMAS, *supra* note 106, at 108 (identifying continuity between dividend policies adopted in the 1930s and the years after World War II).

154. *See* A.J. Arnold & D.R. Matthews, *Corporate Financial Disclosures in the U.K.*,

Though dividend payments were not inordinately generous, U.K. public companies did act as if they felt compelled to make regular cash distributions to shareholders as ownership separated from control. According to empirical evidence from the 1970s, only a tiny minority of companies listed on the London Stock Exchange refrained from paying dividends and, of the companies that paid dividends, very few reduced the payout level from the previous year.[155] During the decades following World War II, most U.K. public companies set their dividend policies at least partially by reference to profits and, as mentioned, earnings declined markedly during the 1970s.[156] The percentage of companies failing to pay dividends therefore was probably smaller during the 1950s and 1960s than it was during the 1970s.

Why did U.K. public companies nearly universally pay dividends and generally refrain from cutting payout levels? A 1966 text on share valuations provides a hint.[157] As the author acknowledged, some boards were tempted to settle dividend policy by asking, "'How little can we pay in order to keep the shareholders quiet?'"[158] Directors generally refrained, however, from departing from past practice because they were "aware of hardships that might be caused by reduction of dividend."[159]

1920–50: The Effects of Legislative Change and Managerial Discretion, 32 ACCT. & BUS. RES. 3, 9 (2002) (finding, based on a study of the accounts of fifty large U.K. public companies as of 1920, 1935, and 1950, that profits were significantly higher in 1950, while dividend payments remained largely constant, and attributing the pattern primarily to accounting reforms introduced by the 1948 Companies Act).

155. *See* G. Chowdhury & D.K. Miles, *An Empirical Model of Companies' Debt and Dividend Decisions: Evidence from Company Accounts Data* tbl.4 (Bank of Eng., Discussion Paper No. 28, 1987) (finding with a sample of 653 U.K. public companies for the years 1970 to 1979, the percentage of companies failing to pay a dividend ranged from 0.9% to 3.5% annually and the percentage of companies cutting their dividend payment ranged from 9% to 33.8%, with the exception of 1974 at 47.2%); *see also* Andrew Benito & Garry Young, *Hard Times or Great Expectations?: Dividend Omissions and Dividend Cuts by U.K. Firms* 18–21 (Bank of Eng., Working Paper No. 147, 2001) (finding, on the basis of a somewhat larger sample, that the percentage of non-payers ranged between 5% and 7% annually between 1974 and 1979 and that the proportion of companies cutting their dividends varied from 6% to 15%).

156. For evidence on how U.K. companies determined dividend payouts partially by reference to profits, see *infra* note 242 and accompanying text. On declining profits in the 1970s, see *supra* note 106 and related discussion.

157. T.A. HAMILTON BAYNES, SHARE VALUATIONS 84 (1966).

158. *Id.* (quoting a pamphlet entitled *Standard Boardroom Practice*); *see also* F.R. JERVIS, THE ECONOMICS OF MERGERS 74 (1971) (characterizing the philosophy of U.K. managers in very similar terms).

159. BAYNES, *supra* note 157, at 84.

C. Company Law

What "hardships" might have come into play for publicly quoted firms that reduced dividends or suspended dividend payments entirely? Company law is one possibility that needs to be taken into account. There was no common law or statutory rule directing those in control of a company to declare a dividend, and company law placed few restrictions on the dividend policy companies adopted.[160] However, according to a 2000 study by La Porta, López-de-Silanes, Shleifer, and Vishny, company law can induce firms to pay dividends even if there are no rules directly compelling companies to make dividend payments.[161]

La Porta, López-de-Silanes, Shleifer, and Vishny hypothesized that if corporate law provides strong investor protection, shareholders will be able to use their legal powers to force companies to disgorge cash and thereby preclude corporate insiders from using company earnings in a self-serving or misguided way.[162] They tested their conjectures by conducting a study of dividend policies adopted by large firms in thirty-three countries, grouping those countries that scored between 0 and 3 on their anti-director index into a "low protection" category and grouping those with a score of 4 or above into a "high protection" category.[163] They found, consistent with their dividend/company law hypothesis, that companies from countries with good shareholder protection paid higher dividends, all else being equal, than companies from countries where investors were poorly protected.[164] However, at least for the decades when ownership separated from control in the United Kingdom, their analysis lacks explanatory power. Again, between 1948 and 1980, U.K. company law scored a 3 on La Porta, López-de-Silanes, Shleifer, and Vishny's anti-director index, thus relegating Britain to the "low protection" category. Following their logic, company law rules should not have been a source of

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160. The only legal constraints in place were common law rules, supplanted largely by statute in 1980, that restrained a company from prejudicing creditors by paying dividends when it lacked the financial wherewithal to distribute the cash. On the common law, see *In re* Exchange Banking Co., Flitcroft's Case (1882) 21 Ch. D. 519, 533–34. On statutory reform, see Companies Act, 1980, c. 22, §§ 39–45. On the fact that there were no rules compelling companies to declare dividends, see ALEX RUBNER, THE ENSNARED SHAREHOLDER: DIRECTORS AND THE MODERN CORPORATION 22 (1965); HORACE B. SAMUEL, SHAREHOLDERS' MONEY: AN ANALYSIS OF CERTAIN DEFECTS IN COMPANY LEGISLATION WITH PROPOSALS FOR THEIR REFORM 145 (1933).

161. La Porta et al., *supra* note 139, at 4–6.

162. For a summary of the theory, see *id.* at 5.

163. *Id.* at 12.

164. *See id.* at 27 (summarizing the results of the tests run).

"hardship" for corporate insiders contemplating cutting or passing on dividend payments.

While La Porta, López-de-Silanes, Shleifer, and Vishny's analysis suggests company law did little to compel U.K. public companies to pay dividends, the corporate constitutions of such firms conceivably could have played a role. It was standard practice for a public company's articles of association to provide shareholders with the right to veto the dividend policy proposed by the board of directors, though not to vary the size of the dividend.[165] This qualified right served to distinguish Britain from the United States,[166] and Graham and Dodd took the view that that distinction was potentially important in the 1940 edition of their well-known text on securities analysis, saying, "[T]he mere fact that the dividend policy is submitted to the stockholders for their specific approval or criticism carries an exceedingly valuable reminder to the management of its responsibilities, and to the owners of their rights, on this important question."[167]

While shareholders in the United Kingdom theoretically could influence dividend policy in a way that was unavailable to their U.S. counterparts, in practice, the additional rights they had were largely irrelevant. A 1950 British text on investment acknowledged that the dividend decision was "not . . . at the unfettered discretion of the directors" but indicated that "[shareholder] confirmation [was] normally a mere formality."[168] A study based on a 1984 survey of senior managers of fifty of the United Kingdom's largest companies confirmed the irrelevance of shareholder voting on dividends. Respondents said that even if a dividend cut was proposed, they were not concerned shareholders would veto what was proposed.[169] Hence, U.K. company law apparently did not impose serious constraints on the dividend policy public

165. On what the articles of association of U.K. companies typically provided on this issue, see GOWER, *supra* note 63, at 353; PENNINGTON, *supra* note 66, at 440; Bank, *supra* note 152, at 13.

166. On the differences between the legal positions in the United States and the United Kingdom, see Bank, *supra* note 152, at 13.

167. BENJAMIN GRAHAM & DAVID L. DODD, SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUE 383 n.1 (2d ed. 1940) (quoted in Bank, *supra* note 152, at 14).

168. LEWIS G. WHYTE, PRINCIPLES OF FINANCE AND INVESTMENT 91 (1950); *see also* GOWER ET AL., *supra* note 87, at 408 (arguing that the control that shareholders had was merely "theoretical," citing the fact that shareholders had no say over interim dividends the directors might opt to declare).

169. *See* Jeremy Edwards & Colin Mayer, *An Investigation into the Dividend and New Equity Issue Practices of Firms: Evidence from Survey Information* tbl.2 (Inst. for Fiscal Studies, Working Paper No. 80, 1985) (indicating that when respondents were asked about the adverse consequences of cutting dividends, they were more concerned the share price might decrease than they were that the shareholders would vote to disapprove the proposed dividend).

companies adopted during the period when ownership was separating from control. Other "hardships" must therefore have come into play.

D. Retaining the Option to Issue New Shares

While company law did little to deter managers from reneging on a policy to make expected and continuing dividend payments, a desire to retain the option to raise capital by issuing new shares likely had such an effect. A 1933 book dealing with the position of the British private investor vis-à-vis the public company described the dynamics involved as follows:

> Most Companies hope to extend their business, and in fact do so from time to time. For this purpose, fresh money is necessary. Fresh money is usually raised by new issues. But the success and attractiveness of a new issue are to a large extent determined by the earnings and dividend record of the Company during previous years.[170]

Matters changed little over time. Typically, when U.K. publicly quoted companies offered new shares for sale, they did so by way of a rights issue, meaning that the company offered to current shareholders the right to subscribe for new shares in proportion to their existing holdings.[171] With this practice in mind, the author of a 1979 text on U.K. business finance observed that "[d]irectors should always try to keep shareholders satisfied because then they represent a very good source of new capital."[172] This in turn made dividends important:

> [Directors'] dividend policy will be influenced by the knowledge that at some future time they may have to encourage the investing public to provide their company with more funds. This will only be possible if the profits earned and dividends paid by the company in past years have been adequate to reward the risk involved.[173]

The 1984 survey of senior managers on dividend policy just cited confirms that those running public companies thought precisely along these lines, with

170. SAMUEL, *supra* note 160, at 145–46.

171. On the fact that rights issues have traditionally been standard practice in the United Kingdom, see DAVID BLAKE, PENSION SCHEMES AND PENSION FUNDS IN THE UNITED KINGDOM 580 (2d ed. 2003); Martin Dickson, *Last Rites are Premature for the British Rights Issue*, FIN. TIMES, Aug. 5, 2000, at 13.

172. KENNETH MIDGLEY & RONALD G. BURNS, BUSINESS FINANCE AND THE CAPITAL MARKET 253 (3d ed. 1979).

173. *Id.*

executives saying that they feared dividend cuts would make it more difficult to raise cash by selling newly issued equity.[174]

Because, as previously discussed, there is a managerial bias in favour of financing companies by way of retained earnings, it may seem surprising that retaining the option to obtain external finance by issuing shares would have influenced the dividend policy of U.K. companies. Empirical studies are lacking on the relationship between dividends and the issuance of shares in British public companies during the decades following World War II.[175] Nevertheless, the available evidence suggests that keeping open the option of carrying out a public offering was sufficiently important to give public companies a meaningful incentive to refrain from reducing or eliminating dividends.

Consider the 1950s. Between 1949 and 1953, one in three companies quoted on the London Stock Exchange carried out a public offering; for larger firms, this figure was nearly three out of five.[176] The Radcliffe Committee, a committee struck by the U.K. government to examine the workings of the monetary system, observed in its 1959 report that "the new issue market has been a far from marginal source of capital in the calculations of most of the larger British firms."[177] Reliance on public offerings in turn influenced dividend policy. In his 1978 history of the finance of British industry in the twentieth century, economist W.A. Thomas said of the late 1950s that "with an increased volume of new issues companies wanting to come to the market frequently sought to maintain the status of their shares by dividend 'sweeteners.'"[178] A press report from 1962 echoed the theme, saying: "Shareholders' dividends are limited to rates which will enable the concern to raise fresh capital at reasonable rates."[179]

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174. *See* Edwards & Mayer, *supra* note 169, at 8–10 (finding that the second greatest concern of firm managers following a dividend cut was the difficulty of raising additional money).

175. On the difficulties associated with using aggregate evidence on dividend payouts and the issuance of shares to test the relationship between the two, see Geoffrey Meeks & Geoffrey Whittington, *The Financing of Quoted Companies in the United Kingdom*, 32–33 (Royal Comm'n on the Distribution of Income & Wealth, Background Paper No. 1, 1976).

176. On the data, see R.F. Henderson, *Capital Issues*, *in* STUDIES IN COMPANY FINANCE: A SYMPOSIUM ON THE ECONOMIC ANALYSIS AND INTERPRETATION OF BRITISH COMPANY ACCOUNTS 64, 69–70 (Brian Tew & R.F. Henderson eds., 1959).

177. COMMITTEE ON THE WORKING OF THE MONETARY SYSTEM, REPORT, 1959, Cmnd. 827, at 80. For additional evidence on share offerings by U.K. public companies during the 1950s, see Wright, *supra* note 65, at 478–79.

178. THOMAS, *supra* note 106, at 241.

179. Margot Naylor, *The Merger Crunch*, STATIST, Jan. 26, 1962 at 289–90. For additional background, see RUBNER, *supra* note 160, at 97, 151.

Primarily due to increased borrowing from banks, the percentage of externally raised funds that U.K. public companies derived from the issuance of shares dropped markedly through much of the 1960s and the first half of the 1970s.[180] On the other hand, because external funds were growing steadily as a percentage of the total internal and external sources of finance,[181] the proportion of finance generated from the issuance of shares remained more or less constant over time.[182] The evidence also confirms that public offerings of shares retained practical significance after the 1950s.[183] In a number of individual years between 1960 and the mid-1970s, new issues surged markedly, with the purpose primarily being to finance acquisition activity.[184] Indeed, during the latter half of the 1960s, the United Kingdom's largest companies (the top 100, calculated by net assets) financed more of their growth by public offerings than by retained earnings, with the driver again being the need to pay for mergers.[185] Also, when, as a result of a dramatic rise in inflation, the market for corporate bonds collapsed in the latter half of the 1970s, the percentage of external funds raised by way of the issuance of equity rose substantially.[186] In sum, a desire to retain the option to return to equity markets helped to deter corporate insiders from abandoning dividends as dispersed share ownership became the norm in larger U.K. public companies.

E. Liquidity

Keeping open the option to raise capital was not the only factor that would have discouraged the reduction or elimination of dividend payments. A desire

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180. On the surge in bank borrowing in comparison with the issuance of shares, see MERVYN KING, PUBLIC POLICY AND THE CORPORATION 209 (1977); THOMAS, *supra* note 106, at 326.

181. For data, see THOMAS, *supra* note 106, at 310, 315.

182. *See* Meeks & Whittington, *supra* note 175, at 4–5 (providing data for U.K. public companies from 1948 to 1971).

183. *See id.* at 4 (referring to equity issuance as playing a "not trivial" but "subsidiary" role in the financing of growth).

184. *See* S.J. PRAIS, THE EVOLUTION OF GIANT FIRMS IN BRITAIN: A STUDY OF THE GROWTH OF CONCENTRATION IN MANUFACTURING INDUSTRY IN BRITAIN 1909–70 130 (1976) (discussing the pivotal role that the issuance of shares played with takeovers); THOMAS, *supra* note 106, at 155, 326 (providing annual data on the issuance of ordinary shares indicating that 1960, 1961, 1968, and 1972 were years when the volume of issues surged substantially).

185. For data, see Geoffrey Meeks & Geoffrey Whittington, *Giant Companies in the United Kingdom 1948–69*, 85 ECON. J. 824, 831–32 (1975).

186. On inflation and corporate borrowing in the 1970s, see *The U.K. Corporate Bond Market*, BANK ENG. Q. BULL., Mar. 1981, at 54, 56–57.

to create and preserve a liquid market for shares also would have come into play. Large shareholders will generally be badly diversified because most of their wealth will be tied up in the company in which they own the dominant stake.[187] One way for a blockholder to address this problem is to partially unwind their equity stake so as to spread some of the risk.[188] For shareholders who treat this as a priority, the stock market will be thought of primarily as a source of liquidity rather than capital.[189] Many companies going public in the United Kingdom following World War II apparently fell into this category. Only a minority of initial public offerings actually raised new money for the company concerned, meaning the objective of going public often was to allow the incumbent shareholders to at least partially cash out.[190]

When creating liquidity is a priority, a blockholder will be keen to ensure that there will be buyers for the company's equity at an acceptable price as and when a partial unwinding of the block occurs. Investors, in turn, will be looking for evidence that the shares will deliver sufficiently good value over time to make a purchase worthwhile. Dividends can then come into play. Once a company has gone public, the blockholder's continuing interest in liquidity can serve as an implicit bond to investors that the company will be run so that dividends will continue to be paid at a rate sufficient to maintain an active market in the company's shares. A collateral benefit for investors will be that paying dividends will erode excess cash building up in the firm that a dominant shareholder might otherwise squander or expropriate.[191]

In the decades following World War II, dividends plausibly performed these functions in British public companies with a dominant shareholder. Due in large part to the financial intermediaries orchestrating public offerings of shares (generally merchant banks operating as "issuing houses"),[192] companies

187. For prior discussion of this point, see *supra* note 144 and accompanying text.

188. For instance, after the family foundations that had been the dominant shareholders in the Rank Organisation entertainment group lost majority control due to a decision by the company to enfranchise the company's non-voting shares, they announced that they would begin selling out. The explanation was that under the new circumstances "it made little sense for them to keep all their eggs in one basket." *Compensation for the Voters*, TIMES (London), Jan. 26, 1976, at 19.

189. For more detail on this characterization, see Armando Gomes, *Going Public Without Governance: Managerial Reputation Effects*, 55 J. FIN. 615, 634 (2000).

190. On the fact that permitting blockholders to cash out frequently was the motive for initial public offerings, see JERVIS, *supra* note 158, at 73. For data indicating that public offerings often did not raise fresh capital for the company, see A.J. MERRETT, M. HOWE & G.D. NEWBOULD, EQUITY ISSUES AND THE LONDON CAPITAL MARKET 84–85 (1967); G.D. Newbould, *The Benefits and Costs of a Stock Exchange Quotation*, BANKER'S MAG., June 1967, at 359–60.

191. On dividends and the erosion of "excess" cash, see La Porta et al, *supra* note 139, at 7.

192. On how issuing houses captured the new issue market from stockbrokers in the

that went public faced immediate pressure to pay dividends. For an issuing house organizing a "flotation" (an initial public offering), the company's prospective dividend yield, calculated by dividing the dividend per share by the share price, was an important factor in setting the price of the issue. Accordingly, the issuing house would advise the company on the proportion of earnings that the company should propose to distribute by way of dividends.[193] The issuing house would do its best to get this right because the dividend yield ascribed to shares when a company was seeking to go public did much to fix the price at which the shares would be accepted by the market.[194]

It was also understood that once a company had carried out a public offering, refraining from paying dividends could cause the market for its shares to decline.[195] Correspondingly, so long as family owners and other blockholders were concerned about taking advantage of the liquidity the stock market provided, they were under an onus to ensure that their company continued to pay dividends to outside investors. This likely helps to explain why a 1962 text on personal investment offering guidance on how to choose shares for income recommended "medium-sized provincial [i.e., regional rather than national] companies with family management and a reasonably secure market for their products," reasoning that their dividend policy tended to be "unexciting but . . . gently progressive."[196]

While a desire to maintain liquidity can motivate those running a company to arrange for a meaningful annual dividend to be paid, retaining the option to exit will not necessarily remain important after a company has gone public. For those owning a substantial percentage of shares in a public company, the opportunities that exist to extract private benefits of control will help to determine the priority they attach to liquidity. If such opportunities are meagre, diversification will look attractive and preservation of an exit option will be important. On the other hand, if there is much to gain from exploiting control, liquidity will not be a serious concern. A blockholder who has taken a company public will instead forsake unwinding his or her ownership stake and focus fully on skimming private benefits. As part of the strategy, with those

decades following World War II, see MICHIE, *supra* note 135, at 354–55, 412–15.

193. On issuing houses offering advice on this point, see BAYNES, *supra* note 157, at 31.

194. On the dividend yield as a key determinant of the pricing of shares in a public offering, see BAYNES, *supra* note 157, at 106–09; MERRETT ET AL., *supra* note 190, at 97.

195. On dividends and investor loyalty, see A.R. ENGLISH, FINANCIAL PROBLEMS OF THE FAMILY COMPANY 62–63 (1958); SAMUEL, *supra* note 160, at 145–46.

196. NAISH, *supra* note 133, at 128.

running the company no longer under any compunction to maintain liquidity, the company might simply stop paying dividends.[197]

Though in theory a dominant shareholder might forsake liquidity to exploit potential private benefits of control, in the decades following World War II, owning a large interest in a U.K. public company was not a particularly attractive proposition. Corporate profits began declining steadily in the 1960s.[198] Taxes on income and accumulated wealth were punishing.[199] Owning a large business offered little in the way of "psychic income," with businessmen generally being held in low esteem and not being major players on the national political scene.[200] Given all of this, preserving liquidity likely was a higher priority for owners of large blocks of shares than exploiting their position as major shareholders.

The tax system, as well as penalizing wealth and high incomes, provided those running U.K. public companies with an additional and more direct incentive to refrain from forsaking liquidity by eliminating dividends. In the decades following World War II, for individuals in higher income brackets, dividends were usually taxed much more severely than retained and accumulated earnings.[201] This gave families with a large stake in a public company a tax incentive to prefer that no dividends be paid. U.K. tax legislation provided, however, that if a company controlled by not more than five persons failed to distribute a reasonable amount of its profits, tax officials could allocate the company's earnings to the shareholders personally and thereby deem the profits to be taxable at the punishing personal rates standard following World War II.[202]

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197. On this possibility, see La Porta et al., *supra* note 139, at 7.

198. *See supra* note 106 and accompanying text (discussing profit trends after World War II).

199. *See* Steven Bank, Brian Cheffins & Marc Goergen, *Dividends and Politics*, tbl.3 (ECGI Working Paper, No. 24/2004, 2004) (original version on file with the Washington and Lee Law Review) (listing 98% as the top tax rate on dividends between April 1974 and April 1979). On taxes on inheritance, see DAVID J. JEREMY, A BUSINESS HISTORY OF BRITAIN, 1900–1990S 118 (1998).

200. *See* JOHN FIDLER, THE BRITISH BUSINESS ELITE: ITS ATTITUDES TO CLASS, STATUS AND POWER 183–86 (1981) (discussing a survey of 130 directors in large U.K. companies conducted in the mid-1970s, which included founding entrepreneurs and family businessmen, and reporting that many respondents felt they were held in low esteem); KEITH ROBBINS, *British Culture Versus British Industry*, *in* BRITISH CULTURE AND ECONOMIC DECLINE 1, 12–13 (Bruce Collins & Keith Robbins eds., 1990) (saying senior business leaders could not achieve high political office in Britain because being a successful politician was a full-time occupation incompatible with being a business leader).

201. *See infra* Part VII (discussing the tax treatment of dividends and retained earnings).

202. On the powers of tax officials under such circumstances, see Finance Act, 1965, c. 25, § 78; H.G.S. PLUNKETT, THE INCOME TAX ACT 1952 (1952), § 245 (discussing Income Tax Act,

The definition of a company potentially subject to this sort of direction—referred to as a "close company" from 1965 onwards[203]—was ultimately cast very broadly. As a practical matter, most every family-owned company qualified.[204] Almost the only way out was to take advantage of an exemption created for companies that obtained a stock market quotation and ensured that at least 25% (later 35%) of the ordinary shares were publicly held.[205] L.C.B. Gower observed in the 1969 edition of his company law text that "this is undoubtedly a very strong factor in impelling substantial private companies to convert themselves into public companies."[206]

Continued protection from being designated as a "close company" hinged not merely on maintaining a stock market listing and a "free float" of 25% but on dealings in the shares occurring during the year for which tax officials were seeking to impose additional income tax.[207] The problem was not merely an academic one because thinness of trading was quite common for U.K. public companies of the time, even among those listed on the London Stock Exchange rather than provincial stock markets.[208] It was in this context that dividends came into play. The maintenance of a reasonable dividend policy was an important step companies could take to ensure that trading activity would occur.[209] If a company refrained entirely from paying dividends, the market for the shares might wither away completely, and the tax advantages of being publicly quoted would disappear. Hence, while U.K. tax law for individuals was generally biased strongly against dividends, once a company with a family

1952, 15 & 16 Geo. 6/1 Eliz. 2, c. 10, §§ 245, 256).

203. Finance Act, 1965, c. 27, § 79, sched. 18, § 1(1).

204. On family companies typically being "close companies," see GOWER, *supra* note 63, at 177. On the position prior to 1965, see DAVID R. STANFORD, TAX PLANNING AND THE FAMILY COMPANY 106 (2d ed. 1964).

205. The 25% threshold was introduced in 1940. *See* Finance Act, 1940 3 & 4 Geo. 6, c. 29, § 55(4). On the 35% threshold, see GOWER, *supra* note 63, at 177 (discussing Finance Act, 1965, c. 25, § 79, sched. 18, § 1(3) (Eng.)).

206. GOWER, *supra* note 63, at 177; *see also* Wright, *supra* note 65, at 467 (making the same point).

207. On the need for dealings on the stock exchange to occur, see Income Tax Act, 1952, c. 10, § 256(5); Finance Act, 1965, c. 25, § 79, sched. 18, § 1(3).

208. *See Is New Issue Procedure in Keeping with 1966?*, TIMES (London), Jan. 10, 1966, at 14 (saying of smaller companies listed on the London Stock Exchange: "Frequently, after the initial opening flurry, dealings in these stocks slow down to an extent that barely justifies official listing"); *see also* J.R. Franks, J.E. Broyles & M.J. Hercht, *An Industry Study of the Profitability of Mergers in the United Kingdom*, 32 J. FIN. 1513, 1519 (1977) (finding in a study of mergers in the Breweries and Distilleries sector of the Official List of the London Stock Exchange that 14% of recorded prices were more than thirty days old).

209. *See* ENGLISH, *supra* note 195, at 62–63 (noting that a "reasonable dividend policy" prevents shareholders from having to "dispose of their shares at uneconomic prices").

owner had gone public, tax-driven concerns about share liquidity provided an incentive for the company to continue making dividend payments to shareholders.

F. Takeover Bids

In circumstances where a public company has a family blockholder that has unwound its holding to the point where the percentage of shares the family owns is insufficient to block an unsolicited offer to obtain control through the purchase of shares held by outside investors, fear of an unwelcome bid can motivate those running the company not only to make regular dividend payments but to increase payout levels. It is well known that takeovers have a disciplinary aspect: If a company's share price is depressed because a company is failing to maximize shareholder return, prospective bidders may begin to contemplate unlocking shareholder value by acquiring the company and replacing the incumbent managers.[210] This is contingent, however, upon the ownership structure of potential targets.

So long as a family owns a majority of the shares in a public company or close to it, a bidder who cannot persuade the family to sell will not be able to force the issue.[211] On the other hand, as a family's stake becomes too small (perhaps at 20% to 25% of the shares) to provide a de facto veto, a "hostile" takeover bid emerges as a realistic and—for the family—a worrying possibility.[212] Bidders, aware of the family's weak position, will be able to

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210. On the disciplinary role of takeovers, see FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 172–73 (1991).

211. On the de facto veto held by a controlling shareholder in a takeover context, see Les Hannah, *Takeover Bids in Britain Before 1950: An Exercise in Business 'Pre-History'*, 16 BUS. HIST. 65, 67–68 (1974). For a post-World War II example, see Warwick Brophy, *Trustees Reject New General Foods Bid for Rowntree*, TIMES (London), Apr. 21, 1969, at 17 (discussing how the managing trustee of three trusts, which together controlled 56% of publicly quoted chocolate manufacturer Rowntree, rejected a takeover offer from General Foods of the United States in favor of a bid by another British company, even though the General Foods bid was approximately 50% higher). On the fact that it was controversial for controlling shareholders to deny minority shareholders a large premium by rejecting a bid, see John Gilmore, *Gloves Off in the Bids Game*, TIMES (London), June 21, 1967, at 25; *Guarding the Rights of the Minority*, TIMES (London), Apr. 23, 1969, at 29.

212. For example, see GEORGE BULL & ANTHONY VICE, BID FOR POWER 158–60 (3d ed. 1961) for a description of the House of Fraser's successful hostile takeover of Binns, a retailer, even though the directors of Binns and their families owned 29% of Binns's ordinary shares and opposed the bid. *See also Take-over Fever Mounting to High Pitch*, TIMES (London), Oct. 12, 1965, at 16 (describing a 1965 bid by British Shoe, part of a conglomerate controlled by Charles Clore, for Lewis Investment Trust, owner of a number of department stores). The article noted:

> The key to the success of the Clore bid will rest largely with the Cohen family, who

structure their offers to acquire the company so that little, if any, control premium is made available. Also, if family members have been exercising managerial prerogatives, the chances of this continuing will be nil if the hostile takeover succeeds because the bidder will put in a new executive team.

In a milieu where dividends are popular with investors, blockholders fearing takeover bids have an incentive to adopt dividend policies that are sufficiently generous to keep share prices high enough to discourage prospective bidders.[213] Corporate Britain first experienced hostile takeovers in the early 1950s, and contemporaries quickly surmised that the trend might prompt U.K. companies to pay more generous dividends than had been the norm previously.[214] For instance, in 1954 Labour politician Roy Jenkins proposed a motion in the House of Commons that "this House deplores recent manifestations of the technique of takeover bids in so far as they have . . . seriously undermined the policy of dividend restraint" (Britain had a "voluntary" system of dividend controls in place between 1949 and 1951).[215] Subsequently, there was much speculation that fears of an unwelcome bid were indeed inducing U.K. public companies to adopt increasingly liberal dividend policies.[216] The 1961 edition of a book on takeovers concurred with this logic, saying of the mid-1950s that it was "clear that take-over bids in general . . . roused boards of directors to the risks of a conservative dividend policy. They were impressed by how easily companies which had been following a conservative dividend policy fell to the take-over bidder . . . ."[217]

> control at least 20 per cent and possibly 30 or 40 per cent of the Lewis's shares . . . .
>
> British Shoe [is] geared to go ahead and try to wrest control of the company, even if the Cohen family are unwilling to sell out.

Id. On the fact that that Clore's bid succeeded, see JERVIS, *supra* note 158, at 84–85.

213. On the incentives that the threat of a takeover bid provides to those running a company to increase dividend payouts, see Fischel, *supra* note 127, at 713; M.A. King, *Corporate Taxation and Dividend Behaviour—A Comment*, 38 REV. ECON. STUD. 377, 379 (1971).

214. For an example, see Anthony Crosland, *The Case Against Take-over Bids*, LISTENER, Sept. 2, 1954, at 347.

215. LITTLEWOOD, *supra* note 110, at 86 (quoting Roy Jenkins' motion).

216. For examples of observers who speculated that the threat of a takeover bid had prompted companies to make generous dividend payments, see WILLIAM MENNELL, TAKEOVER: THE GROWTH OF MONOPOLY IN BRITAIN, 1951–61, at 34 (1962); MIDGLEY & BURNS, *supra* note 172, at 254–55, 314–15; H.B. ROSE, THE ECONOMIC BACKGROUND TO INVESTMENT 231 (1960).

217. BULL & VICE, *supra* note 212, at 35; *see also id.* at 11 (noting that company directors feared their "cautious dividend policies made their companies tempting targets for the bidder").

Though the evidence on point is not entirely clear cut, from the 1940s to the 1970s, U.K. public companies that paid high dividends, given levels of profits and investment, apparently did face a reduced risk of a takeover.[218] It is less clear whether takeover activity in fact prompted the adoption of more liberal dividend policies. Empirical studies based on tests for a correlation between the level of acquisition activity and aggregate dividend payouts by U.K. public companies have yielded mixed results.[219] Nevertheless, it is plausible that, at least in companies where blockholders failed to own a sufficiently large percentage of shares to veto a takeover offer, the threat of a hostile takeover bid provided companies with an incentive to continue to pay, and perhaps increase, dividend payments.[220]

G. Drawing Matters Together

To sum up, U.K. companies were not obliged by law to pay dividends, so in theory, they could renege and stop distributing cash to shareholders. Despite this, for reasons largely, if not entirely, unrelated to company law, the vast majority of public companies in fact did pay dividends, and most shied away from cutting the payout level from the previous year. The cash distributions being made would, all else being equal, have reduced the scope for blockholders to skim or squander profits that their companies were generating. This would have given large shareholders an incentive to exit and should have fostered, in some measure, investor confidence in shares. As this paper next discusses, the dividend policy of U.K. public companies would have helped to underpin demand for shares in another way, namely by playing a "signaling" function.

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218. *See* Andrew P. Dickerson, Heather D. Gibson & Euclid Tsakalotos, *Takeover Risk and Dividend Strategy: A Study of U.K. Firms*, 46 J. INDUS. ECON. 281, 281 (1998) (finding that between 1948 and 1970, higher dividend payments were associated with a significantly lower probability of a takeover). *But see* DOUGLAS KUEHN, TAKEOVERS AND THE THEORY OF THE FIRM 103–04, 122, 127 (1975) (failing to find, between 1959 and 1967, a strong correlation between dividend policy and the likelihood of takeover).

219. *Compare* King, *supra* note 213, at 379–80 (finding, using data from 1950–1971, a statistically significant link), *with* Steven Bank, Brian Cheffins & Marc Goergen, *Dividends and Politics* (Revised) 40–41 (ECGI Working Paper, No. 24/2004, 2006) (finding, using data from 1949–2002, that takeover activity was inversely correlated with dividend payouts).

220. If only a small sub-set of such U.K. companies in fact felt under direct pressure to raise dividends in response to takeover fears, studies based on aggregate data may well fail to capture the effect because figures for other companies would wash out the effect.

VI. *Dividends and "Signaling"*

A. *The Theory*

The work done by La Porta, López-de-Silanes, and Shleifer on securities law suggests that strong disclosure rules are associated with robust stock markets and diffuse share ownership.[221] Between the 1940s and the 1980s, though, the law in the United Kingdom was not particularly rigorous in comparison with modern legal standards.[222] How, then, did investors acquire sufficient knowledge about companies to feel confident enough to buy shares in the volume required to provide a platform for the dispersion of share ownership? Dividends likely played a key role.

Corporate insiders are apt to know much more about a company's future prospects than do investors.[223] Dividend payout policy constitutes a potential means for those controlling a company to "signal" such private information.[224] The process will not operate under all circumstances. In order for dividends to perform a signaling function, dividend payments ultimately must impose costs on firms that perform poorly in a way they do not for successful firms.[225] Otherwise, companies lacking a promising future could adopt a generous dividend policy and deceive investors with impunity, thereby devaluing the dividend signal completely.

In contrast, if those responsible for setting dividend policy know a penalty is associated with sending a false signal they will refrain from doing so, at least when the anticipated costs exceed the likely benefit.[226] Decisions to raise, cut, or maintain dividend payments can then potentially communicate information about a company's prospects over and above that provided by publicly filed accounting data and other corporate announcements. In other words, dividends

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221. For a summary of La Porta, López-de-Silanes, and Shleifer's work on point, see *supra* notes 22–28 and accompanying text.

222. For evidence on point, see *supra* notes 89–93 and *infra* note 278 and accompanying text.

223. On the information asymmetries in this context, see ANDREI SHLEIFER, INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE 6–7 (2000).

224. For summaries of formal models of dividend "signaling," see LEASE ET AL., *supra* note 125, at 102–06.

225. On the fact that signaling theory presupposes that dividend payments must have adverse consequences for firms with bad prospects, see LUIS CORREIA DA SILVA, MARC GOERGEN & LUC RENNEBOOG, DIVIDEND POLICY AND CORPORATE GOVERNANCE 38–39 (2003); LEASE ET AL., *supra* note 125, at 97; Edwards, *supra* note 129, at 12–13.

226. *See* Avner Kalay, *Signaling, Information Content, and the Reluctance to Cut Dividends*, 15 J. FIN. & QUANTITATIVE ANALYSIS 855, 858 (1980) (noting that companies "signal correctly . . . if the benefit from a false signal . . . is less than the cost of dividend reduction").

can function as a "peacock's tail," a signal "only profitable, well-managed companies can afford to pay."[227]

It can in fact be "dangerous to lie with dividends."[228] A company that chooses and adheres to a generous dividend policy without the cash flow to back it up will, over time, have to resort to the capital markets to raise the cash required to continue to pay dividends to shareholders and finance day-to-day operations. Investment bankers and investors, aware of the company's disappointing track record, will be difficult to win over. If the efforts to raise fresh capital fail and the company continues to pay dividends at the same rate, the company could end up in serious financial difficulty in short order. Assuming that lying with dividends is likely to result in this sort of fate, investors can infer sensibly from a company's decision to maintain or increase gradually its dividend payout that those setting dividend policy believe the company's prospects are good enough to support current payout levels for some time to come.

By the same token, a sizeable dividend increase will plausibly constitute good news. Companies lacking a promising future can fairly readily mimic public announcements offering optimistic forecasts.[229] In contrast, given the downside associated with the adoption of an untenably generous dividend policy, companies are unlikely to opt to boost their dividend payout substantially unless those in charge are confident that the company's future is sufficiently bright to sustain matters over time.[230] Conversely, a dividend cut can reasonably be taken to represent bad news because the decision implies that those running a company are apprehensive about the future and thus are conserving cash to avoid a problematic effort to rely on capital markets to raise fresh capital.[231] In sum, dividends can, as signaling theory implies, offer a valuable profit forecast.

There is little empirical U.K. data on the signaling theory of dividends, and that which is available only covers from the late 1980s onwards.[232]

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227. *Dividends' End*, ECONOMIST, Jan. 12, 2002, at 68.

228. David Davies, *Upending Some Sacred Cows*, FIN. TIMES, June 3, 1985, at 21. For background on the theory involved, see BREALEY & MYERS, *supra* note 9, at 438–41.

229. On the potential for all firms to make optimistic forecasts, see LEASE ET AL., *supra* note 125, at 98.

230. On the reluctance of managers to increase dividends when they are not optimistic about the company's prospects, see Black, *supra* note 130, at 6.

231. For background on why investors imply dividend cuts are bad news, see Harry DeAngelo, Linda DeAngelo & Douglas J. Skinner, *Dividends and Losses*, 47 J. FIN. 1837, 1838–39 (1992).

232. The first study, which tested dividend announcements made between 1989–1992, was carried out by economist Paul Marsh. For background on this study, see Paul Marsh, *Why*

Nevertheless, as we will see now, there is ample circumstantial evidence indicating that during the decades when the separation of ownership and control became entrenched in the United Kingdom, dividends were conveying information valued by shareholders. Thus, for investors who could not count on corporate and securities legislation to induce companies to divulge a sufficient volume of reliable information to provide a foundation for investing, the dividend policies companies adopted likely served as a viable substitute.

B. The Pervasiveness of Dividends

During the decades following World War II the vast majority of U.K. public companies paid annual dividends, and only a small number reduced their payouts from the previous year.[233] This pattern would have helped to ensure that dividend policy could perform a signaling function. Decisions companies make concerning dividends are only apt to convey useful information when a change in policy is likely to cause a company to stand out from the crowd.[234] Hence, when the proportion of U.S. publicly quoted companies that paid dividends fell from 67% in 1978 to 21% in 1999,[235] investors were much less likely to interpret cutting or suspending dividend payments as a confession of failure.[236] The available evidence suggests that signals conveyed by dividend announcements of U.S. public companies indeed were considerably weaker in the 1990s than they had been in previous decades.[237] The declining percentage of dividend payers is a plausible explanation why.

The situation was considerably different in Britain during the decades following World War II. In contrast with the United States in the 1990s, there was nowhere to hide. Given the dividend policies adopted almost universally by U.K. public companies, a firm that omitted to pay dividends or reduced its

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Dividend Cuts are a Last Resort, FIN. TIMES, Aug. 12, 1992, at 16; *Revisiting the Dividend Controversy*, ECONOMIST, Aug. 15, 1992, at 69.

233. On the prevalence of dividends and the reluctance to cut payouts, see *supra* notes 155–56 and related discussion.

234. On this point, see Chowdhury and Miles, *supra* note 155, at 8.

235. Eugene F. Fama & Kenneth R. French, *Disappearing Dividends: Changing Firm Characteristics or Lower Propensity to Pay?*, 60 J. FIN. ECON. 3, 4 (2001).

236. *See Shares Without the Other Bit*, ECONOMIST, Nov. 20, 1999, at 93 (describing the changing attitudes towards dividends).

237. *See* Yakov Amihud & Kefei Li, *The Declining Information Content of Dividend Announcements and the Effect of Institutional Holdings*, 41 J. FIN. & QUANTITATIVE ANALYSIS 637 (2006) (finding that by the end of the 1990s, the U.S. stock market reacted less strongly to dividend changes than before).

dividend payment from the previous year would have stood out as an exception from the norm. This would have served to reinforce the message its dividend policy communicated to investors.

C. Companies Feared Adverse Consequences if They Failed to Pay Dividends in Accordance with Investor Expectations

Signaling theory again presupposes that for dividends to convey meaningful information to shareholders, those running companies need to fear penalties for adopting dividend policies inconsistent with long-term corporate prospects. During the period when ownership separated from control in the United Kingdom, dividend policy in fact was set as if there was apprehension about creating a misleading impression when distributing cash to shareholders. More precisely, there was a marked tendency among companies to treat stability as a high priority and to refrain from significantly adjusting payout levels absent exceptional circumstances.

A study of aggregate dividend payouts by U.K. public companies by Steven Bank, Brian Cheffins, and Marc Goergen illustrates that caution was indeed the watchword with decisions about dividend policy.[238] Work done by economist John Lintner in the 1950s puts the findings of this study into context.[239] Lintner gleaned from interviews with managers of U.S. public companies that such firms had long-term target dividend payout/earnings ratios in mind but avoided altering the payout rate if the change might need to be reversed in the short term.[240] Managers instead engaged in "dividend smoothing," meaning they only adjusted dividend policy in response to substantial and persistent changes in earnings. Lintner in turn used his findings to formulate an empirically testable "partial adjustment" model of dividends, with the foundations being the notion of a target dividend/profit ratio, changes in current earnings, and the dividend level in the previous year.

Subsequent empirical tests of the Lintner model and variations upon it designed to incorporate explicitly past financial performance and future earnings potential verified that the model had considerable explanatory power.[241] Thus, the evidence suggests public companies have generally

238. Bank, Cheffins & Goergen, *supra* note 219.

239. His leading paper on point is John Lintner, *Distribution of Incomes of Corporations Among Dividends, Retained Earnings, and Taxes*, 46 AM. ECON. REV. 97 (1956).

240. On Lintner's interview evidence, see *id.* at 99–102.

241. For overviews of subsequent empirical tests of the Lintner model, see DA SILVA, GOERGEN & RENNEBOOG, *supra* note 225, at 41–42; LEASE ET AL., *supra* note 125, at 128–29; Terry A. Marsh & Robert C. Merton, *Dividend Behavior for the Aggregate Stock Market*, 60 J.

aimed to provide shareholders with a dependable flow of cash payments, have resisted cutting dividends in response to a temporary decline in earnings, and have only increased distributions to shareholders when management was confident the higher payments could be maintained. The Bank/Cheffins/Goergen study of dividend payouts by U.K. public companies between 1949 and 2002 falls into line with this pattern, as a partial adjustment model based on Lintner's work performed well in explaining the data.[242] Those setting dividend policy for U.K. public companies thus were apparently using earnings as a key reference point in determining dividend policy but also smoothed dividends rather than adjusting cash distributions purely in response to annual financial results.

U.K. public companies likely smoothed their dividends because of concerns about a negative investor reaction if they set dividend policy differently. In the decades immediately following World War II, it was widely known that the stock market implied a very bleak future from dividend cuts, and companies therefore strongly resisted them.[243] The authors of the 1979 edition of a text on U.K. business finance described the implications as follows: "[S]hareholders value steadily increasing dividends very highly because they think such a rise would not be implemented unless directors had confidence in being able to maintain it. Hence . . . [d]irectors try hard not to reduce dividends, resorting if necessary to past undistributed profits to maintain them."[244] The 1984 survey of senior managers cited earlier also illustrates that those running U.K. public companies feared a share price "hit" if they failed to smooth dividends.[245] Respondents said a dividend cut would be perceived as an indicator that current earnings were suffering and as a signal that longer-term profitability was in jeopardy. They acknowledged, moreover, that the manner in which they were setting dividend policy constituted an important method of conveying information to investors.[246]

A study of the financial performance of quoted and unquoted companies during the 1980s confirms that among British publicly quoted companies,

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BUS. 1, 3 (1987).

242. On the results of the Lintner model test, see Bank, Cheffins & Goergen, *supra* note 219, at 28–30.

243. On investor reaction to dividend cuts, see ANDREW GLYN & BOB SUTCLIFFE, BRITISH CAPITALISM, WORKERS AND THE PROFITS SQUEEZE 118 (1972).

244. MIDGLEY & BURNS, *supra* note 172, at 253.

245. *See* Edwards & Mayer, *supra* note 169, at 8 (stating that "by far the most adverse consequence of a cut in dividends is seen to be a fall in share prices"); *see also* Peter Martin, *A Corporate Conundrum*, FIN. TIMES, Jan. 26, 1991, at 8 (quoting a U.K. investment manager as saying "[m]ost major companies that cut their dividend for short-term reasons live to regret it").

246. On the survey results in this context, see Edwards & Mayer, *supra* note 169, at 10.

concerns about investor reactions prompted dividend smoothing.[247] Drawing upon a list of the 1,000 largest U.K. firms as of 1980, the study matched private companies with publicly quoted firms on the basis of size and industry and compared the financial results over the next seven years. One finding was that private companies were more likely to cut dividends in the face of deteriorating financial conditions than their stock market counterparts. This result can be explained on the basis that the privately held companies, lacking an investor base equivalent to those of the publicly quoted firms, failed to attribute to dividends a signaling function and thus felt free to adjust payouts promptly in accordance with short-term changes in earnings.[248] The evidence suggests, in sum, that U.K. companies in fact were sufficiently apprehensive of investor reactions for dividends to perform a signaling function.

While investors generally would have reacted negatively to a reduction in dividend payouts, a key category of investor—pension funds—had a particular reason to discourage dividend cuts during the period when the U.K.'s outsider/arm's-length system of ownership and control became entrenched. Statistics illustrate just how important pension funds were becoming. The percentage of shares of U.K. public companies they owned rose from 3% in 1957 to 9% in 1969, to 17% in 1975, and to 31% in 1991, by which point pension funds owned a higher percentage of shares than any other category of investor.[249]

Until the mid-1960s, U.K. pension funds conventionally valued assets in which they invested at book value.[250] Since book value is an accounting measure focusing on the position at the date of purchase, this produced the odd result that identical investments were attributed different values depending on when they were bought. To improve matters, pension fund actuaries began valuing assets on the basis of the expected future income stream, which, with equities, involved using a "dividend discount model" based on dividend payouts.[251]

Pension fund managers, being aware of how shares were valued under the dividend discount model, took a dim view of dividend cuts.[252] Because pension

247. *See* Colin P. Mayer & Ian Alexander, *Stock Markets and Corporate Performance: A Comparison of Quoted and Unquoted Companies, Centre for Economic Policy and Research* (Discussion Paper No. 571, 1991).

248. *See id.* at 45 (explaining private companies' willingness to cut dividends in hard times).

249. On sources, see National Statistics Online, *supra* note 45; Moyle, *supra* note 57.

250. On the history, see S.J. Head et al., *Pension Fund Valuations and Market Values*, 6 BRIT. ACTUARIAL J. 55, 60 (2000).

251. On the change in practice, see *id.*

252. On the attitude of pension fund managers, see Barry Riley, *Survey of Pension Fund Investment*, FIN. TIMES, May 6, 1993, at I.

contributions a corporate employer was obliged to make were determined in part by the match of assets and liabilities, if the value ascribed to shares held by company pension plans fell significantly, the companies would be under pressure to correct matters by making additional contributions. Pension funds therefore generally discouraged companies in which they owned shares from cutting dividends and welcomed sustainable increases in dividend payments.[253] With pension funds moving to the forefront as investors in U.K. shares from the 1950s through to the 1980s, those deciding dividend policy on behalf of public companies had to be mindful of this bias because they could lose crucial institutional support if they failed to do so. This would have reinforced any signaling-driven bias against cutting dividends.

D. Dividends and Share Prices

While the pervasiveness of dividends and the prevalence of dividend smoothing both suggest that dividends were performing a signaling function in the decades following World War II, a strong link between dividend payouts and share prices is perhaps the strongest evidence that dividends were conveying information valued by investors. In purely theoretical terms, dividend policy should not be a determinant of share prices. According to corporate finance theory, the return shares offer to investors over time is a risk-adjusted function of what a company will pay out to shareholders throughout its existence, whether as cash distributions or a final payment upon liquidation. Correspondingly, ascertaining the value of a company's shares at any one time should involve estimating what the company's net cash flow will be throughout the remaining life of the business.[254]

Assuming, as did Miller and Modigliani, full symmetry of information between managers and investors, market participants should immediately digest any new data on future profitability that becomes available, and a company's share price will reflect fully the information "in the market." If the stock market in fact prices information in this manner, then, as Miller and Modigliani hypothesized, there will be no scope for a company's dividend policy to convey anything meaningful to investors. With dividends failing to play any sort of signaling role, the size and pattern of

253. On the approach pension funds took, see *id.*

254. On the variables that should logically determine share prices, see CHEFFINS, *supra* note 93, at 55.

annual cash distributions will be irrelevant to a company's stock market valuation.[255]

Matters generally worked much differently in practice in the United Kingdom during the decades following World War II, with dividends in fact constituting a key determinant of share prices. According to a 1955 report issued by the Royal Commission on the Taxation of Profits and Income, "[i]t is the distributed profits that tend most directly to influence the market value of a share."[256] A study based on 1949–1957 data derived from a sample of 165 companies quoted on the London Stock Exchange confirmed that the value of shares of U.K. public companies depended far more on dividend payments than reported earnings.[257] According to this study, variations in the last declared dividend per share and the most recent published data on retained earnings combined to explain much about share price fluctuations. Dividends and undistributed profits were not treated equally, however. Instead, cash distributions were capitalized in the share price at a much higher rate.[258]

In this milieu, dividend announcements made by public companies captured considerable attention. For investors and stockbrokers, private knowledge of the dividend a company would declare was prized information that could induce heavy buying and selling of shares.[259] Hence, as early as 1939 the London Stock Exchange had set up "Trans Lux," which used a large screen to convey dividend announcements and other news simultaneously to all members of the London Stock Exchange.[260] By the mid-1960s, the London Stock Exchange's Listing Rules required that a company not only notify the Stock Exchange

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255. On the implications of Miller and Modigliani's corporate finance insights in this context, see LEASE ET AL., *supra* note 125, at 29–35.

256. Royal Commission on the Taxation of Profits and Income, FINAL REPORT, Cmd. 9474 (London: HMSO, 1955), 17 (majority report); *see also id.* at 386–87 (minority report) (exploring the point in more detail).

257. *See* G.R. Fisher, *Some Factors Influencing Share Prices*, 71 ECON. J. 121, 141 (1961) (finding that "[v]ariations in the last declared dividend per share explain a considerable proportion of the variation in corresponding share prices between companies").

258. For additional empirical evidence supporting the same conclusion, see ROSE, *supra* note 216, at 459–60; P. Sargent Florence, *New Measures of the Growth of Firms*, 67 ECON. J. 244, 246 (1957).

259. On dividend policy as an example of inside information that could be exploited successfully, see RICHARD SPIEGELBERG, THE CITY: POWER WITHOUT ACCOUNTABILITY 48 (1973). On the legal status of insider dealing in the United Kingdom, see *supra* note 68 and accompanying text.

260. For background on TransLux, see F.E. ARMSTRONG, THE BOOK OF THE STOCK EXCHANGE 123 (5th ed., Sir Isaac Pitman & Sons Ltd.) (1957).

immediately of a decision by the board concerning the declaration or omission of a dividend payment but also provide advance notice of board meetings where such matters would be considered.[261] Press coverage also reflected the interest in dividends. Newspapers that dealt with business issues in detail routinely reported on the dividend announcements of public companies and offered a comparative figure for the previous year, perhaps supplemented by supporting analysis.[262]

Contemporaries were well aware of the attention investors paid to dividends and of the impact that dividend policy had on share prices. A 1957 edition of a book on the London Stock Exchange characterized dividend announcements as being of "great importance," saying:

> Frequently they mean a reconstruction of yield shown on a share, based on a distribution which it is deemed by directors unwise to continue, on which it is decided to improve. This alteration of yield frequently leads to realisations or further buying, which quickly brings in its train a price adjustment as a natural consequence.[263]

A 1960 text on investment characterized the price readjustment process as follows:

> If a change in dividend has been fully anticipated, the news of the change will leave the price of the share concerned more or less unaltered . . . . If an increase in dividends proves to have disappointed a sufficient number of investors, its announcement will be accompanied by a fall in share prices; and the failure of dividends declared to be reduced as much as had been feared will be accompanied by a rise.[264]

Dividends admittedly are a coarse method of conveying information to investors. One source of potential misapprehension is that a dividend cut conceivably could be good rather than bad news because the reduction could signify that a company is conserving capital to exploit valuable growth opportunities. Similarly, a dividend increase could be bad rather than good news, as the decision might be an implicit concession by management that the company is struggling and thus is disinvesting by returning money to shareholders.[265]

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261. *See* Federation of Stock Exchanges in Great Britain and Ireland, Admission of Securities to Quotation, *supra* note 107, at 42 (Communication of Announcements).

262. On newspaper coverage of dividend announcements, see NAISH, *supra* note 133, at 141–42.

263. ARMSTRONG, *supra* note 260, at 123–24.

264. ROSE, *supra* note 216, at 456; *see also* NAISH, *supra* note 133, at 41–43 (offering a description of the process based on hypothetical facts).

265. On the potentially contradictory messages that changes in dividend policy can send,

Despite the potential ambiguities or contradictions of dividend action, the language may in fact be clear to those to whom it matters.[266] Certainly, in Britain, the fact that dividends were strongly correlated with share prices in the decades following World War II suggests that decisions companies made on the distribution of profits conveyed information investors relied upon. This does not mean that the signaling effect remained equally strong as time progressed. Instead, it likely diminished as investors increasingly relied on additional sources of information to assess the prospects of companies.[267] The rise of investment analysts, who specialize in the researching of companies and the offering of recommendations on the buying and selling of shares, illustrates how additional information was becoming available to investors.

Investment analysts, a U.S. export, first arrived in Britain during the mid-1950s, and by the 1960s, the detailed study of companies and industries had become a widely adopted practice in the London financial community.[268] Nevertheless, the efforts undertaken were rudimentary by today's standards, in part because investment analysts generally lacked direct access to the executives managing companies.[269] Over time, matters improved considerably. A 1998 history of the stock market makes the point, remarking on how things had changed since the 1960s:

> [The 1960s] were exciting, pioneering days for investment analysts. With no apparent limit to their horizons, they enjoyed the satisfaction of pure research and discovery in a competitive search for basic information. It was very different from the prospect today for the trainee analyst entering a mature business with a high level of shared information.[270]

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see Victor Brudney, *Dividends, Discretion, and Disclosure*, 66 VA. L. REV. 85, 110 (1980); Easterbrook, *supra* note 137, at 651–52.

266. On investors being able to sort out potentially ambiguous dividend signals, see Brudney, *supra* note 265, at 112.

267. On the fact that the dividend signal will weaken as the quality of other forms of disclosure improves, see Nils H. Hakansson, *To Pay or Not to Pay Dividends*, 37 J. FIN. 415 (1982); *see also* Amihud & Li, *supra* note 237 (arguing that as institutional ownership of U.S. public companies increased, dividends became a less meaningful signal because the institutional investors had better access to other sources of information on companies than did individuals).

268. On the emergence of investment analysts in the United Kingdom, see Walter A. Eberstadt, *Investment Ties Across the Atlantic*, TIMES (London), July 17, 1967, Wall Street (special section), at VIII; *see also Investment Analysts' Society*, TIMES (London), May 2, 1955, at 19 (announcing the establishment of the United Kingdom's Society of Investment Analysts).

269. *See* Eberstadt, *supra* note 268, at VIII (saying British managers were generally reluctant to talk to analysts).

270. LITTLEWOOD, *supra* note 110, at 126.

As better sources of information became available, U.K. investors placed increasing emphasis on annual and interim earnings figures and company profit forecasts when valuing shares.[271] This in turn meant that investors paid less attention to dividends. For instance, during 1968, the share price of retailer and market favourite Tesco Ltd. doubled despite a dividend yield of 0.9%, which was considerably lower than the yield on government bonds.[272] While the signaling effect of dividends did diminish over time, investors nevertheless continued to treat dividend policy as an important barometer of corporate performance. Economist Mervyn King (later governor of the Bank of England) said in his 1977 book *Public Policy and the Corporation* that "the payment of the dividend is the principal direct line of communication from management to shareholder."[273]

Others concurred. A 1975 text on analysis of the British stock market said, "Dividend forecasts are needed as they are an important factor in share price determination; indeed they form the basis used [for an investment analysis technique known as] the intrinsic value approach and in many computer-based stock evaluation models."[274] Similarly, the *Economist* observed in 1979 that the "preoccupation with (dividend) yields can reduce investment analysis to a simple question of whether a dividend is likely to be held or not."[275] Moreover, an empirical study covering 1962 to 1986 found that dividend payouts of the United Kingdom's 500 largest publicly-quoted companies correlated in a statistically significant manner with fluctuations in the aggregate market capitalization of those firms.[276] Thus, even if the attention that investors paid to dividend announcements waned somewhat over time, dividends continued to be a significant determinant of share prices through to the 1980s.

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271. On how the investment community's approach began to change, see ROBERT HELLER, THE NAKED INVESTOR 223–24 (1976); LITTLEWOOD, *supra* note 110, at 159; WILLIAM G. NURSAW, THE ART AND PRACTICE OF INVESTMENT 38 (1963). On the emergence of the price/earnings ratio as a particularly popular way of measuring how highly investors valued earnings companies were producing, see Janette Rutterford, *From Dividend Yield to Discounted Cash Flow: A History of U.K. and U.S. Equity Valuation Techniques*, 14 ACCT., BUS. & FIN. HIST. 115, 138 (2004).

272. R.J. BRISTON, THE STOCK EXCHANGE AND INVESTMENT ANALYSIS 372 (3d ed. 1975).

273. KING, *supra* note 180, at 175.

274. MICHAEL FIRTH, INVESTMENT ANALYSIS: TECHNIQUES OF APPRAISING THE BRITISH STOCK MARKET 117 (1975).

275. *To Cut or Not to Cut*, ECONOMIST, June 9, 1979, at 119.

276. *See* Stephen Leithner & Heinz Zimmerman, *Market Value and Aggregate Dividends: A Reappraisal of Recent Tests, and Evidence from European Markets*, 129 SWISS J. ECON. & STAT. 99, 111–12 (1993) (finding that the correlation between dividends and market capitalization was statistically significant for data from the United Kingdom but not for data from France, Germany, Switzerland, or the United States).

E. Summary

In the United Kingdom, the signaling effect of dividends continued to diminish after outsider/arm's-length corporate governance was firmly entrenched. For instance, in 1992, the *Economist* acknowledged that, while a dividend cut was taken far more seriously by the markets than "glossy hand-outs and analysts' briefings," "investors are increasingly clear-eyed . . . looking less to the dividend and more to the profits covering it."[277] Nevertheless, during the period when ownership separated from control, there was an informational feedback loop between investors and companies operating via dividend policy. In the decades immediately following World War II, U.K. legislation did not impose extensive disclosure requirements on publicly quoted firms, with the only periodic disclosure obligation imposed by statute being a requirement to file annually audited financial statements.[278] In this milieu, the dividend policy adopted by U.K. companies would have acted as at least a partial substitute for investors seeking information on which shares to buy and sell. Thus, to the extent that standards of corporate disclosure influence demand for shares among outside investors, the payout policy adopted by U.K. companies would have helped to provide the foundation for the unwinding of ownership and control.

VII. A Potential Caveat: Dividends Could Be Costly to Shareholders

The signaling and agency cost characterizations of dividends both imply that those owning equity benefit from dividend payments, either from the transmission of information or the disciplining of management.[279] For shareholders, however, the virtues of dividends can be illusory.[280] More particularly, even if dividends do convey information to shareholders and serve to constrain to some degree those in control of companies, if there are substantial costs involved with the paying and receipt of dividends,

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277. *Dividend Dilemmas*, ECONOMIST, Aug. 15, 1992, at 14–15; *see also A Modest Sort of Problem, Made Powerful by Myth*, ECONOMIST, Jan. 25, 1992, at 73–74 (saying "the value of dividends as signals may be fading . . .").

278. The key statutory provisions governing the preparation and filing of annual financial statements were Companies Act, 1948, §§ 38, 126(1), 127, 149, 156, sched. 4, sched. 8.

279. *See* Francisco Pérez-González, *Large Shareholders and Dividends: Evidence from U.S. Tax Reforms* 4–5 (Colum. Univ. Bus. Sch., Working Paper, 2003).

280. *See, e.g.*, Benito & Young, *supra* note 155, at 10 (describing how tax can affect matters).

shareholders may fail to benefit overall.[281] Applying this reasoning to circumstances in Britain, if dividends were subject to tax penalties as compared with retained earnings, the dividend policies that U.K. public companies adopted may have been a net deterrent to investment in shares. If this were the case, dividends logically would not have contributed in a meaningful way to the unwinding of ownership structures.

U.K. tax rules in fact did penalize certain recipients of dividends, these being individuals with high incomes who owned shares directly rather than via an investment intermediary. The point can be illustrated by calculations taking into account the relevant tax variables (e.g., taxations of corporate profits, taxation of investment income, and taxation of capital gains) where a score of 1 implies indifference between dividends and retained earnings, a score of less than 1 represents a tax bias in favor of retained earnings, and a score of greater than 1 signals the converse.[282] The "tax preference ratio" for individuals paying the top marginal rate of tax ranged between 0.03 and 0.18 between 1949 and 1979, largely due to very high rates of tax on high incomes, and an absence of capital gains tax up to 1965 and taxation of capital gains at a considerably lower rate than income thereafter.[283] Hence, when U.K. public companies in this era paid a dividend rather than retaining earnings, they were essentially imposing a substantial tax penalty on a major group of investors.[284]

While for individuals owning shares the tax system was biased against dividends, U.K. companies that were paying dividends were not imposing a meaningful tax penalty on institutional investors, the constituency that was moving to the forefront as the United Kingdom's outsider/arm's-length system of ownership and control became entrenched. From the end of World War II onwards, ownership of shares by individuals dropped quickly. As the *Economist* noted in 1953, "In the last five years there has been no net personal

281. On the potential trade-off, see Jean Crockett & Irwin Friend, *Dividend Policy in Perspective: Can Theory Explain Behavior?*, 70 REV. ECON. & STAT. 603, 603–04 (1988).

282. On the methodology, see JAMES POTERBA & LAWRENCE SUMMERS, *The Economic Effect of Dividend Taxation*, *in* RECENT ADVANCES IN CORPORATE FINANCE 227 (Edward Altman & Marti Subrahmanyam eds., 1985). Their model, in turn, was based upon parameters developed in KING, *supra* note 180, at 75–77.

283. Bank, Cheffins & Goergen, *supra* note 199, at 55–57, tbl.3. Also relevant was a tax on corporate profits in place between 1947 and 1965, under which the tax rate was higher for distributed earnings than for retained earnings between 1947 and 1958. The tax preference ratio rose to 0.51 in 1980 due to a cut in the top rate of income tax.

284. Managers indeed sometimes sought to resist pressure to pay out more dividends with the argument that "if we increase your dividends, we increase your taxes." Clive Wolman, *Why it Pays Dividends to Pass on Profits*, FIN. TIMES, May 14, 1985, at 26.

investment on the Stock Exchange. Sales of securities from private portfolios seem to have clearly exceeded the purchases that individuals have made."[285]

A 1980 survey of U.K. financial markets, relying on data from a study of the flow of funds prepared by the Bank of England, confirmed that individuals were net sellers of corporate equity. Each year between 1963 and 1977 individuals sold more shares than they bought, with the amounts involved varying from a low of £1.22 billion in 1969 to a high of £3.79 billion in 1973.[286] The proportion of shares of U.K. public companies owned by individuals correspondingly declined dramatically.[287]

As private investors exited, the "buy" side of the market for shares in U.K. public companies became thoroughly dominated by institutional investors, with pension funds and insurance companies taking the lead role.[288] As the London Stock Exchange said in written evidence submitted in 1977 to a committee struck by the U.K. government to review the functioning of financial institutions, "[t]he personal sector has been for over twenty years a consistent net seller of securities at a fairly steady rate in constant price terms" and "[t]he institutions . . . have been absorbing the sales by the private individuals."[289] Data compiled for a 1978 study of the growth of institutional investors confirmed the point, indicating that, collectively, key British institutional investors were net purchasers of shares in each and every year through the 1960s and 1970s.[290]

Insurance companies paid tax on income received—including dividends paid out by companies in which they owned shares—at a rate much lower than

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285. *Corpse in the Capital Market*, ECONOMIST, Feb. 7, 1953, at 375.

286. Marshall E. Blume, *The Financial Markets*, *in* BRITAIN'S ECONOMIC PERFORMANCE 276–77, 294 (Richard E. Caves & Lawrence B. Drause eds., 1980) (citing precise amounts for 1966 to 1977 only).

287. For statistics illustrating the trend, see *supra* note 58 and accompanying text.

288. The percentage of shares of U.K. public companies owned by unit trusts consistently trailed far behind those for insurance companies and pension funds. For instance, as of 1975, unit trusts owned 4.1%, insurance companies owned 15.9%, and pension funds owned 16.8%. National Statistics Online database, *supra* note 45. Investment trusts generally owned more shares than unit trusts in the decades following World War II but they struggled to raise new funds and thus were the "weakest of the four legs of the institutional market." LITTLEWOOD, *supra* note 110, at 262; *see also* BRISTON & DOBBINS, *supra* note 60, at 17 (saying investment trusts remained a "non-growth sector").

289. Committee to Review the Functioning of Financial Institutions (Chairman, Sir Harold Wilson), 3 EVIDENCE ON THE FINANCING OF TRADE AND INDUSTRY 208, 214 (1977).

290. *See* BRISTON & DOBBINS, *supra* note 60, at 189 exhibit 51 (showing the total acquisition of equities by institutional investors); *see also* Blume, *supra* note 286, at 286 tbl.10 (showing net purchases of shares by institutional investors in the United Kingdom).

that imposed on individuals paying the top rate of tax.[291] This meant that the tax penalty associated with dividends—if any—was much less substantial than it was for highly paid individuals. Up to the late 1990s, pension funds, which were essentially exempt from both income tax and capital gains tax, typically had a strong tax preference in favor of dividends.[292] The upshot is that for those buying shares in any volume during the period when ownership separated from control, the tax "downside" of dividend payments should not have detracted substantially from whatever disciplinary and signaling benefits there in fact were. Tax, therefore, should not have disrupted the momentum in favor of diffuse share ownership that dividends created.

VIII. Conclusion

As we have seen, via a highly stylized example involving a single publicly quoted firm, the widely held company might not become dominant in a country even if it enjoys inherent economic advantages. If dominant shareholders expect that they will fail to capture a sufficient portion of the gains available from a transition to diffuse share ownership to compensate them for the loss of private benefits of control, they are unlikely to exit. Also, potential buyers of shares for sale may deduce logically, if incorrectly, that optimistic claims made about future shareholder returns are implausible. The law matters thesis hypothesizes that corporate and securities law can address both obstacles to diffuse share ownership. In the United Kingdom, however, law was not highly protective of outside shareholders as ownership separated from control. What constraints, then, induced blockholders to exit? And what motivated outside investors to buy shares?

This paper has argued that dividend policy played a significant role. The payment of dividends was not a sufficient condition for the separation of ownership and control. The fact that separation of ownership and control in United Kingdom public companies did not crystallize until after World War II,

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291. On taxation of investments held by insurance companies, see BRISTON, *supra* note 272, at 199–200. According to economist Mervyn King the effective dividend income tax rate for insurance companies ranged between 22.8% and 27.8% between 1947 and 1975, which was far below the tax rates that individuals paid on investment income. KING, *supra* note 180, at 266 tbl.A.4.

292. Between 1965 and 1973 the pension funds' tax preference ratio was 1 (i.e., the indifference between capital gains and dividends). Otherwise, until 1997, the score was always above 1, ranging from a low of 1.18 (April 1956 to April 1958) to a high of 1.70 (April 1964 to April 1965). From 1997 onwards, the tax preference ratio again was 1. Bank, Cheffins & Goergen, *supra* note 199, at 58–60, tbl.4.

despite companies having a penchant for paying dividends in prior decades, illustrates the point.[293] Nevertheless, as other factors contributed to the reconfiguration of the corporate economy in the United Kingdom, dividend policy played an important supplementary role.

For instance, although declining profitability in the United Kingdom corporate sector during the post-World War II period likely would have only motivated blockholders to begin to think of exit during the 1960s, the implicit commitment to pay dividends would have imposed discipline on public companies throughout the entire period when ownership separated from control. Similarly, while stock exchange rules imposed various new disclosure requirements on listed companies during the 1960s, the manner in which share prices were determined indicates that prior to this point, investors could and did rely heavily on dividend payouts to gauge how to proceed.[294] Hence, while other factors contributed to the separation of ownership and control in the United Kingdom, dividend policy constituted an important variable that helped to substitute for the lack of protection offered to minority shareholders under Britain's corporate and securities laws.

Does this mean, as contractarian analysis might be taken to imply, that the law is trivial? That would read too much into what occurred in the United Kingdom. The analysis presented here does illustrate that the market can contribute significantly to the rise of a system of corporate governance oriented around the widely held company. Nevertheless, the law's role should not be ignored. Jack Coffee has made this point with respect to the United States.[295] Share ownership unwound sufficiently before the enactment of federal securities legislation in the early 1930s for Berle and Means to make their well-known claim that ownership had separated from control in many large U.S. companies.[296] Coffee acknowledges, accordingly, that robust securities markets can arise when statutory protection offered to outside investors is minimal but

293. On the dividend policy of U.K. public companies prior to World War II, see *supra* note 152 and accompanying text (discussing the 1920s and the 1930s); *see also* BASKIN & MIRANTI, *supra* note 124, at 192 (going further back in history).

294. *See supra* notes 256–64 and accompanying text (discussing the strong influence dividend policy had on share prices prior to the mid-1960s).

295. *See* John C. Coffee, *The Rise of Dispersed Ownership: The Roles of Law and State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 64–71 (2001) (discussing how a strong legal framework is still necessary even when the market is self-regulatory).

296. *See* Cheffins, *supra* note 18, at 8 (discussing how Adolf Berle and Gardiner Means set out their separation of ownership and control thesis before the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934).

argues that regulation might be required subsequently to sustain matters, particularly since market shocks can batter investor confidence.[297]

This insight could be pertinent for the United Kingdom. A case could be made that a shift in favour of formalized regulation occurring during the 1980s made the stock market orientation of U.K. corporate governance more durable than otherwise might have been the case. As we have seen, statutory reforms carried out in the 1980s—after diffuse share ownership had gained a firm foothold—served to increase significantly the protection of outside investors.[298] A key reason why the United Kingdom's score on La Porta, López-de-Silanes, and Shleifer's securities law index improved substantially was that the London Stock Exchange's listing rules were vested with the status of subordinate legislation.[299] The change was part of a broader trend in favour of greater regulation of U.K. capital markets during the mid-1980s.

Prior to this point, Britain's equity markets and important components of the country's financial services sector were governed by a system where self-regulation was integral. A series of privately operated organizations, with the London Stock Exchange being among the most prominent, supervised the relevant activities without drawing upon statutory powers and without being directly accountable or answerable to government officials.[300] Serious doubts arose about the viability of self-regulation in the early 1980s in the wake of increasing globalization of financial markets, a series of scandals affecting the London financial community and an investigation of the London Stock Exchange's share dealing system by antitrust regulators.[301] The government responded with legislative reform oriented primarily around the Financial Services Act 1986, which was designed to create "self-regulation within a statutory framework."[302] The United Kingdom's outsider/arm's-length system of ownership and control retained its vitality despite a stock market crash in 1987 and a series of corporate governance scandals in the early 1990s, and the

297. *See* Coffee, *supra* note 295, at 66 (suggesting that governmental regulation can mitigate the "risks and consequences" of market crashes).

298. *See supra* notes 75–76, 80, 88, 92 and accompanying text (discussing statutory changes occurring in the 1980s).

299. *Supra* note 88 and accompanying text.

300. For an overview of the system, see MICHAEL MORAN, THE POLITICS OF THE FINANCIAL SERVICES REVOLUTION 61–68 (1991).

301. *See* J.J. FISHMAN, THE TRANSFORMATION OF THREADNEEDLE STREET: THE DEREGULATION AND REREGULATION OF BRITAIN'S FINANCIAL SERVICES 31–40 (1993) (discussing the increase in public concern about financial scandals and the government response); MICHIE, *supra* note 135, at 483, 486, 544–55 (discussing the antitrust investigation).

302. Department of Trade and Industry, FINANCIAL SERVICES IN THE UNITED KINGDOM: A NEW FRAMEWORK FOR INVESTOR PROTECTION, 1985, Cm. 9432, at 13.

shift in favour of formal legal regulation might be part of the reason why.[303] To the extent this is correct, and to the extent dividends contributed to the separation of ownership and control in Britain, developments in the United Kingdom illustrate that it is necessary to take into account both the market and law to understand fully how systems of corporate governance evolve and operate.

303. There also was a prompt and effective self-regulatory response to the corporate governance scandals of the early 1990s, see CHEFFINS, *supra* note 93, at 372, 611–13, but remaining self-regulatory aspects of financial services regulation in the United Kingdom were largely swept away in the wake of the enactment of the Financial Services and Markets Act, 2000.