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Comment on Brian R. Cheffins, *Dividends as a Substitute for Corporate Law: The Separation of Ownership and Control in the United Kingdom*

Lynne L. Dallas*

In his paper, Professor Cheffins advances our knowledge of the history of dispersed ownership and in the process sheds light on important corporate governance issues of our day. His research is prodigious and his footnotes are a treasure trove of valuable information. He offers theories that, while subject to challenge, are well supported and worthy of serious attention.

I limit my remarks to three essential points. The first is that the interrelationship among law, markets, and norms is much more complex than the "law matters" thesis articulated by Cheffins. Second, there are substantial hazards in using the LLSV study¹ in an analysis such as Cheffins does to determine the state of shareholder protections. And lastly, the role of dividends in explaining dispersed shareholding remains ambiguous.

First, let us consider the interrelationship among law, markets, and norms. Cheffins explains that the predominant corporate governance model, the contractarian model, views corporate law as "trivial."² Relations are driven according to this model by market forces supported by "norm-based governance."³ According to this model, law plays at most a "modest supplementary role," mainly in "help[ing] private parties effectuate their preferred goals."⁴ The law matters thesis, as articulated by Cheffins, provides that law is very important in explaining market developments such as, in this instance, dispersed shareholding.

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1. See generally Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Law and Finance*, 106 J. POL. ECON. 1113 (1998) (examining legal rules covering the protection of shareholders in forty-nine countries) [hereinafter LLSV study].

2. Brian R. Cheffins, *Dividends as a Substitute for Corporate Law: The Separation of Ownership and Control in the United Kingdom*, 63 WASH. & LEE L. REV. 1273, 1284 (2006).

3. *Id.* at 1283.

4. *Id.* at 1283-84.

I believe that this analysis creates a false dichotomy—law does or does not matter for market developments. This false dichotomy is apparent if one accepts the socioeconomic claim that laws provide the foundation for markets.⁵ Although it is analytically useful at times to distinguish law and economic forces, "markets" are defined by both laws and economic forces. Changes in the laws produce different markets.⁶ The law matters theory is thus not about whether law matters generally, but about the impact of a particular set of laws.

The interrelationship among economic forces, the law, and norms is also more complex than the law matters thesis suggests. The law matters thesis appears to imply a one-way relationship in which law explains or causes economic phenomena. But there are at least four possible interrelationships between law and economic forces, and law matters for each of these relationships. First, there is "coordination," where law and economic forces work hand-in-hand—with law fulfilling the contractarian vision of assisting parties in effectuating their business objectives. Second, there is "prohibition," where the law seeks to prohibit the operation of economic forces altogether when they represent socially irresponsible behavior such as human trafficking and child pornography. Third, there is "creation" or "causation"—implicit in the law matters thesis—where law *ex ante* creates economic forces by providing business incentives or a foundation for economic activity. Finally, there is "regulation," where the consequences of economic forces suggest the need for law *ex post* when these economic forces produce unfairness, harm, or demonstrate the need for coordination rules. For example, The Securities Act of 1933 was regulation that responded *ex post* to the 1929 stock market crash.⁷ Of course, the distinction between law operating *ex ante* and *ex post* becomes muddied because a law passed *ex post* becomes embedded in the market and may affect *ex ante* future economic forces. In addition, in some cases norms will substitute for law and make law unnecessary.⁸ "Soft" law is often sufficient to maintain social order and coordination. In that situation, law matters as well because it lies in the wings for a time when it may become necessary.

5. See LYNNE L. DALLAS, LAW AND PUBLIC POLICY: A SOCIOECONOMIC APPROACH 13 (2005) ("[L]aw and norms provide the foundations for a market economy.").

6. See *id.* at 14 (discussing the differences between the views of neoclassical economists and institutional economists).

7. See JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES AND MATERIALS 3 (3d ed. 2001) (providing legislative history on the Securities Act of 1933).

8. See DONALD BLACK, THE BEHAVIOR OF LAW 6–7, 107 (1976) (discussing the relationship between law and social control).

Cheffins argues that corporate law does not matter because dispersed shareholding evolved in Britain when there were insufficient shareholder protections.⁹ Assuming for the moment that this claim is true, corporate law nevertheless mattered because it worked hand-in-hand with the desires of businesses, regulating the transfer of corporate shares to the public and regulating mergers and acquisitions which contributed to the dispersion of shares. Also, when potential harms to the public were realized, law sought to influence and shape these economic forces to protect the public shareholders. Law mattered to the development of dispersed shareholding irrespective of whether shareholder protections preceded or followed these economic phenomena.

It is also important to point out that economic development involves an evolutionary process that is dynamic and fluid.¹⁰ No single factor such as the law can fully explain what a complex interaction of socioeconomic forces will produce. Law is embedded in a larger social canvas of socio-cultural relationships. A serious risk of the law matters thesis is that law is viewed in isolation from other factors contributing to these relationships. The prognosis of the law matters thesis is that by having specific laws, dispersed shareholding or other socioeconomic phenomena will likely emerge. A one-size-fits-all prescription, however, is unlikely to bear fruit.

This brings me to my second point concerning the LLSV study, which, according to its authors, sends the "message" that the "quality of legal protection[s] of shareholders help determine ownership concentration[s]."¹¹ The quality of legal protection is determined by an anti-director index composed of six pro-investor rights.¹² The six legal rules are: mail-in proxies, no requirements for depositing shares prior to shareholder meetings, cumulative voting, oppressed minority mechanisms, preemptive rights, and at least a ten percent shareholder call provision. A nation is allocated one point for each rule it has adopted. Cheffins uses the anti-director index to show that Britain did not have adequate shareholder protections in place when the dispersion of ownership purportedly occurred in Britain in the decades following WWII.

Despite the extensive use by comparative corporate law scholars of the LLSV study,¹³ I have a number of problems with it. First, the LLSV study

9. See Cheffins, *supra* note 2, at 1288–89 (discussing the power of shareholders under U.K. company law).

10. See generally DALLAS, *supra* note 3, at 693–722 (describing the purpose and consequences of introducing a liberalized market in Russia).

11. LLSV study, *supra* note 1, at 1151.

12. See *id.* at 1123 (listing the six anti-director rights).

13. See Sofie Cools, *The Real Difference in Corporate Law Between the United States*

considers law in isolation. This approach is suspect as too simplistic when law is viewed as embedded in specific socioeconomic contexts. In addition, each rule is treated equally, but no justification for this allocation is provided. Also, there are no reasons given for including these rules in the index and excluding other rules. For example, how about shareholder proposal rules, shareholder initiation rights, subjects on which shareholders may vote, removal of director provisions, or super-majority shareholder voting requirements for fundamental changes? Moreover, the index does not take account of the fact that dissimilar call provisions, for example, may operate similarly to provide minority shareholder protection, depending on the extent of concentrated or dispersed shareholding. The anti-director index is particularly suspect when a revision of it resulted in the United States receiving a relatively low score of 3.0 (out of a possible 6 points), even though the United States is supposedly the prime example of an economy with shareholder protections and dispersed shareholding.¹⁴

The anti-director index is also problematic for encouraging less detailed consideration of corporate laws as they bear on shareholder protections. For example, Cheffins notes that substantial amendments were made to the U.K. company law in 1967 but the "anti-director index . . . remained unchanged."¹⁵ His paper does not make an independent assessment of whether these amendments actually provided greater shareholder protection or created public perceptions of the existence of greater protections.

The literature evidences fundamental disagreements among U.K. scholars regarding when dispersed shareholding occurred and the state of shareholder protection. British scholar Julian Franks and his coauthors maintain that "dispersed ownership emerged rapidly in the first half of the 20th century,"¹⁶ whereas Cheffins claims that it occurred during the second half of the century.¹⁷ Franks claims that "1948 was a defining date for minority investor

and Continental Europe: Distribution of Powers, 30 DEL. J. CORP. L. 697, 699-700 (2005) ("One can say that *Law and Finance* is a standard reference in comparative corporate and financial law.").

14. See Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *The Law and Economics of Self Dealing*, (Nat'l Bureau of Econ. Research, Working Paper No. 11883, Table XII, 2005), available at <http://www.nber.org/papers/w11883> (showing the results of the revised anti-director index for countries around the world).

15. Cheffins, *supra* note 2, at 1291.

16. Julian Franks, Colin Mayer & Stefano Rossi, *Ownership: Evolution and Regulation* (March 25, 2005), http://papers.ssrn.com/so13/papers.cfm?abstract_id=354381 (last visited Nov. 14, 2006) (on file with the Washington and Lee Law Review).

17. See Cheffins, *supra* note 2, at 1285-86 (discussing the decline of the family empire and the rise of ownership separated from control).

protection,"¹⁸ whereas Cheffins claims it was in the 1980s.¹⁹ Although the disagreement over when dispersed shareholding occurred is troublesome and may be attributed to sample sizes, the disagreement concerning when shareholder protections were in place is probably due to the exclusive attention given by Cheffins to the London Stock Exchange (LSE) disclosure requirement index, which only takes into account statutory enactments.²⁰ In contrast, Franks considered the LSE listing rules as well as statutory enactments and found them effective in providing shareholder protections in 1947.²¹ Cheffins's analysis rests on the fact that Britain's disclosure requirement index score rose from .33 to .66 in the 1980s when the Financial Services Act of 1986 gave the "London Stock Exchange Listing Rules [the status] of subordinate legislation."²² At that point, the LSE listing rules were included in the index. If the significance of shareholder protections to the emergence of dispersed shareholding is being assessed, I would include shareholder protections provided by the quasi-legal listing rules. Unlike other nations, Britain has a tradition of relying on "soft" law.²³

It is also my belief that the authors of the LLSV study do not take sufficient account of the fact that correlations do not prove causation. After correlating the anti-director index with ownership concentrations, the authors state that their results "are at least suggestive that concentration of ownership is an adaptation to poor legal protection."²⁴ They claim that their results "support the idea that heavily concentrated ownership results from, and perhaps substitutes for, weak protection of investors in a corporate governance system."²⁵ It is just as likely, and consistent with other relationships between law and economic forces, however, that the situation is the reverse—that the laws are an adaptation or response to the needs of concentrated shareholding or a reflection of the political power of controlling shareholders.

My last point is that the role of dividends in explaining dispersed shareholding remains ambiguous. Cheffins claims that dividends played a

18. *Id.* at 15.

19. *Id.* at 1292.

20. *See id.* at 1293 (citing the LSE).

21. *See id.* (discussing the effects of the 1947 changes to the LSE's listing rules).

22. Cheffins, *supra* note 2, at 1295 n.92.

23. *See* JONATHAN P. CHARKHAM, *KEEPING BETTER COMPANY: CORPORATE GOVERNANCE TEN YEARS ON* 297–98, 301–02 (2005) (discussing the concept of corporate governance which includes an analysis of the way in which companies are directed and controlled as well as an examination as to how they relate to their financial sources).

24. LLSV study, *supra* note 1, at 1148.

25. *Id.* at 1151.

"significant role" although they were not a "sufficient condition" for the emergence of dispersed shareholding.²⁶ The problem is that the evidence Cheffins presents in his article shows no difference in the dividend policies of U.K. companies prior to and after WWII,²⁷ even though there was allegedly concentrated shareholding prior to WWII and dispersed shareholding after WWII.

On the sell side, if dividends were a significant factor, it would be important to show how dividends encouraged concentrated shareholders to sell their shares to the public in one period but not in the other. What causative role did dividends play? Although dividends generally may contribute to the liquidity of controlling shareholders and permit controlling shareholders to access public capital,²⁸ they do not explain why controlling shareholders decided to relinquish control to public shareholders in the decades following WWII.

Turning to the buy side, it is probable that buyers are motivated by dividends to acquire shares. Cheffins explains that dividends substitute for corporate law in two ways. First, dividends limit the amount of funds available to insiders and thus constrain their self-dealing.²⁹ Second, dividends provide information to investors by signaling to them the financial condition of the company, although this method is admittedly a coarse substitute for truthful disclosures.³⁰ But if dividend policies did not change in the years before and following WWII, dividends do not explain the increased buyer demand for stock leading to dispersed shareholding.

Cheffins' well-researched article, however, provides candidates, other than dividends, to explain the emergence of dispersed shareholding. I do not purport to know enough about the subject to assess the viability of these alternative explanations. However, I note that on the buy side, there was a demand for investments during the decades following WWII due to the "massive flow of funds to insurance and pension funds that had to be invested somewhere" and external controls that "tightly constrained investing abroad."³¹ There was also the rise of share ownership by institutions which had the incentive to encourage public ownership,³² although, admittedly, institutional

26. Cheffins, *supra* note 2, at 1335.

27. *Id.* at 1296–97.

28. *Id.* at 1301–06.

29. *Id.* at 1282–83.

30. *See id.* at 1309 (noting the relation of good shareholder protection and the payment of dividends).

31. Cheffins, *supra* note 2, at 1300.

32. *Id.* at 1282.

ownership may also produce greater share concentrations. On the sell side, controlling shareholders faced declining corporate profits and punishing taxes.³³ Individuals at high income tax brackets were taxed at very high tax rates on distributed dividends.³⁴ Moreover, if closely-held companies with five or fewer controlling shareholders failed to pay dividends, profits were apportioned among the owners and they were personally taxed.³⁵ The only way for these closely-held companies to avoid this tax was for them to become public companies with a stock market quotation and with at least 25% (and later 35%) of their shares held in the hands of the public.³⁶ These factors may have motivated controlling shareholders to sell their shares.

So what can we learn from the history of corporate law, which is the theme of this symposium? We can learn that explanations of economic phenomena are complex and that it is important to view law not separately, but as part of the mix, interacting in various ways with sociocultural and economic forces to produce economic developments. I believe Cheffins comes to appreciate this point when he concludes in his last sentence: "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."³⁷

33. *Id.* at 1302–03.

34. *Id.*

35. *Id.*

36. Cheffins, *supra* note 2, at 1302–03.

37. *Id.* at 1338.

