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AGENCY COSTS OF CONTROLLING SHAREHOLDERS

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THE AGENCY COSTS OF CONTROLLING SHAREHOLDERS

Economists, legal scholars and courts focus on the wedge between controllers' cash flow and voting rights as perhaps the most important source of agency costs. In this Paper, however, we argue that another important source of agency costs is the nature and scale of other businesses owned by the controlling shareholder. Controllers' ownership of other businesses—especially in related industries—provides them with opportunities and motive to divert value from one business to another. We further show that controllers' ownership of such businesses allows them to divert value without engaging in self-dealing. We identify a new channel of value diversion—indirect tunneling—and set it apart from other forms of value diversion. We further argue that indirect tunneling cannot be eliminated by adopting new rules against self-dealing or strengthening the enforcement of existing rules. Thus, we reject the common view that a strong anti-self-dealing regime is sufficient to protect investors from value diversion. Lawmakers interested in limiting insiders' private benefits of control should consider other measures: expanding disclosure rules or structural remedies, such as limiting the scope of business groups.

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INTRODUCTION

This paper offers a new understanding of the agency costs underlying controlled companies. We challenge the pervasive view that self-dealing is the principal channel for minority expropriation. We identify a new channel of value diversion, which we label *indirect tunneling*, and set it apart from other forms of value diversion. We also show that insiders' ownership of other significant businesses—and not just the wedge between their cash-flow rights and voting rights—is an important source of agency costs.

We argue that indirect tunneling cannot be eliminated by adopting new rules against self-dealing or strengthening the enforcement of existing rules. Thus, we reject the common view that a strong anti-self-dealing regime is sufficient to protect investors from value diversion. Lawmakers interested in limiting insiders' private benefits of control should consider expanding disclosure rules or imposing structural remedies, such as limiting the scope of business groups.

Concentrated ownership is the predominant form of public-company ownership around the world. Public companies in Europe,

Asia, and Latin America normally have controlling shareholders.[1] In the United States, controlled firms—including such household names as Berkshire Hathaway, Facebook, Google, Viacom, Oracle, and Newscorp—constitute a sizeable minority of large, publicly traded firms,[2] and a 2012 study finds that the relative number of controlled firms going public in the United States seems to be growing.[3] As of January 1, 2015, the total market capitalization of companies with a shareholder holding 30% or more of the shares and included in the comprehensive SharkRepellent database was $1.16 trillion.[4]

Controlling shareholders have the incentive and power to monitor management and enhance company value. Controllers,

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[1] *See, e.g.*, Marco Becht & Colin Mayer, *Introduction* to THE CONTROL OF CORPORATE EUROPE (Fabrizio Barca & Marco Becht eds., 2001) (noting that in 50% of Dutch, French, and Spanish companies, more than 43.5%, 20%, and 34.5% of votes, respectively, are controlled by controlling shareholders); Stijn Claessens et al., *The Separation of Ownership and Control in East Asian Corporations*, 58 J. FIN. ECON. 81, 82 (2000) ("[M]ore than two-thirds of [East Asian] firms are controlled by a single shareholder"); Mara Faccio & Larry H. P. Lang, *The Ultimate Ownership of Western European Corporations*, 65 J. FIN. ECON. 365 (2002) (reporting that only around 37% of Western European firms are widely held); Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership around the World*, 54 J. FIN. 471 (1999) (finding that, after a review of large corporations in twenty-seven countries, "relatively few . . . firms are widely held").

[2] *See, i.e.*, Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 REV. FINANC. STUD. 1377, 1382 (2009) (using a sample of 375 U.S. public corporations and finding that the average size of the largest block is 26%); Ronald Anderson, Augustine Duru, and David M. Reeb, *Founders, Heirs, and Corporate Opacity in the U.S.*, 92 J. FIN. ECON. 205, 207 (2008) (showing that among the 2,000 largest industrial U.S. firms, 22.3% are founder controlled and 25.3% are heir controlled, with average equity stakes of approximately 18% and 22%, respectively).

[3] *See* IRRC INST., CONTROLLED COMPANIES IN THE STANDARD & POOR'S 1500: A TEN YEAR PERFORMANCE AND RISK REVIEW 3 (2012) (finding that the number of controlled firms included in the S&P 1500 index has risen from 87 in 2002 to 114 in 2012).

[4] SharkRepellent maintains coverage on nearly 4,000 U.S.-incorporated companies that are currently active and publicly traded. *See* XX.

however, might use their dominant position to divert value from public companies and their investors.[5] Investor protection at controlled companies requires effective mechanisms to prevent such value diversion. This, in turn, requires policy makers to recognize the nature of controllers' agency costs and identify the channels through which controllers can divert value.

In Part I, we question two fundamental premises underlying corporate law scholarship. We first challenge the pervasive view among academics and policy makers that self-dealing—that is, transactions between the company and the controller or its affiliates, or between the controller and investors—is the sole channel for controllers' value diversion[6] and the major source of pecuniary private benefits of control.[7] This conventional view, we argue, is incomplete. We identify a new channel of value diversion—*indirect tunneling*—and set it apart from other forms of value diversion. We also show that

[5] *See, i.e.*, Lucian A. Bebchuk & Assaf Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. PA. L. REV., 1269, 1281-2 (2009); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny, *Investor Protection and Corporate Governance*, 58 J. FINANC. ECON. 3, 4-6 (2000).

[6] *See* Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes, & Andrei Shleifer, *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430-1 (2008) (describing the increasing emphasis of academics on corporate self-dealing over the last twenty years); Tarun Khanna and Yishay Yafeh, *Business Groups in Emerging Markets: Paragons or Parasites?*, 45 J. ECON. LIT. 331, 343-48 (2007) (surveying empirical research on business groups and noting that "tunneling has become the main focus of much of the recent literature on business groups").

[7] *See, e.g.*, Djankov et al., *supra* note [__], at 430-1 (noting that academics have focused on the problem of investor expropriation through self-dealing or tunneling); Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV.1642, 1663-4 (2006) (explaining that "the existing literature, both analytical and empirical, focuses almost exclusively on pecuniary benefits of control and controller's tunneling"); Dyck & Zingales, *supra* note [__], at 542 (noting that the methods for measuring private benefits of control capture only pecuniary private benefits).

controllers can use myriad forms of indirect tunneling to divert value even without engaging in self-dealing.[8]

We then challenge the view that the difference between cash flow and voting rights is perhaps the most important source of controllers' agency costs. Indirect tunneling takes place when controllers—whether individuals or firms—own other businesses. Such situations, which are very common,[9] provide controllers with opportunities to engage in indirect tunneling rather than in conventional forms of self-dealing.[10] This insight leads us to identify another source of controller agency costs. Economists, legal scholars, and courts focus on the wedge between controllers' cash-flow rights and voting rights as an important source of agency costs. We argue, however, that another important source of agency costs is the nature and scale of other businesses owned by the controlling shareholder. Controllers' ownership of other businesses provides them with motive and opportunities to divert value from one business to another.

In Part II, we offer a typology of the main channels of indirect tunneling and explore the costs of this phenomenon. We identify three principal channels of indirect tunneling. First, we show that controllers can divert value through transactions with third parties—that is, parties that are seemingly unrelated to the controller. Second, we analyze the case in which one company's investments or other actions produces spillover effects, conferring benefits on other companies affiliated

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[8] Some scholars use the terms *tunneling* and *self-dealing* interchangeably. *See, e.g.*, Vladimir Atanasov et al., *Unbundling and Measuring Tunneling*, [2014] U. ILL. L. REV. 1697, 1698. Under our framework, *tunneling* refers to controllers' value diversion from companies or their investors, whereas *self-dealing* refers to value diversion through transactions with the public company or its investors.

[9] *See, e.g.*, Faccio & Lang, *supra* note [_], at 390 tbl.8 (presenting evidence on the prevalence of pyramidal ownership structures in Western Europe); Claessens et al., *supra* note [_] (presenting evidence on the prevalence of business groups in East Asia); Tarun Khanna and Yishay Yafeh, *Business Groups in Emerging Markets: Paragons or Parasites?*, 45 J. ECON. LIT. 331, 332 (2007) ("[I]n virtually all emerging markets, group affiliated firms tend to be relatively large and economically important").

[10] *See also* Bebchuk & Hamdani, *supra* note [_], at 1283-84.

with the controller. In this case, no transaction takes place between the public company and any other company affiliated with the controller, yet the public company making the investment and its investors essentially pay for the benefits captured by the controller and other group-affiliated firms. Third, we consider the controller's ability to pursue business opportunities for its own benefit. These channels share several common features: they depend on controllers' ownership of several businesses, especially in related industries; controllers can use them to divert value at the expense of public investors; and legal measures to constrain self-dealing cannot effectively contain them. We conclude this Part by assessing the costs and significance of indirect tunneling, showing that it not only leads to investor expropriation but also undermines economic efficiency by distorting firms' business decisions.

Part III considers the implications of our analysis for academics, policy makers, and investors. We show that lawmakers cannot use anti-self-dealing rules to eliminate indirect tunneling without adopting counterproductive rules that would be unduly intrusive and costly. Academics and public officials believe that anti-self-dealing measures are not only essential for protecting public investors in controlled companies but also sufficient to prevent value diversion. Under this view, a robust anti-self-dealing regime is all it takes to ensure that controllers do not benefit themselves at the expense of publicly traded firms and their investors.

Our analysis, however, questions the exclusive reliance on self-dealing rules—either *ex ante* mandatory restrictions or *ex post* judicial review. As long as controllers own other significant businesses, anti-self-dealing rules—no matter how strict they are or how efficacious their enforcement is—cannot effectively contain value diversion. Specifically, we argue that policy makers cannot adopt measures to contain indirect tunneling without fundamentally altering the governance and allocation of power at controlled companies.

The inevitability of indirect tunneling carries implications for lawmakers, investors, and academics. For policymakers concerned with protecting investors from value diversion by controlling shareholders, our analysis cautions against exclusive reliance on anti-self-dealing rules. Especially in countries where business groups are prevalent, policymakers should recognize the limited usefulness of

anti-self-dealing rules and consider other measures to enhance investor protection or allow investors to protect themselves. Policymakers wishing to contain value diversion by corporate insiders should consider structural reforms—such as imposing limits on large business groups—or expanding disclosure duties to include certain significant businesses owned by corporate insiders.

For investors and researchers, our analysis offers a new approach for assessing companies' governance risks or making cross-country investor protection comparisons. In their assessment of a company's quality of corporate governance, we argue, investors and researchers should take into account the scale and scope of other businesses owned by the company's controller. Likewise, when assessing countries' level of investor protection, investors and researchers should consider the pervasiveness of business groups within each country.

I. RETHINKING AGENCY COSTS

In this Part, we question two fundamental premises underlying corporate law scholarship. Specifically, we show that corporate insiders can divert value without engaging in self-dealing and that insiders' ownership of other significant businesses is an important source of agency costs.

Our analysis focuses on controlled companies. Controlling shareholders have the incentive and the power to monitor management and enhance company value. They might use their dominant position, however, to divert value from public companies and their investors. Investor protection at controlled firms requires effective mechanisms to prevent such value diversion. This, in turn, requires public officials to assess the nature of controllers' agency costs and identify the channels through which controllers can divert value from public companies and their investors.

Section A challenges the pervasive view shared by economists, legal scholars, and lawmakers that self-dealing transactions are the

sole channel for investor expropriation at controlled companies. We identify a new channel of value diversion —*indirect tunneling*—and set it apart from other forms of that practice.

Section B identifies a new source of controller agency costs. Controllers' wedge between cash-flow rights and voting rights is commonly viewed as an important source of agency costs. We argue, however, that the nature and scale of other businesses owned by the controlling shareholder can also be a source of agency costs. Ownership of such businesses, we argue, provides that shareholder with motive and opportunities to divert value from one business to another.

A. Two Channels of Value Diversion

The predominant approach has long viewed self-dealing transactions as controllers' major, if not sole, channel for extracting value from companies and their public investors. In this Section, we discuss an overlooked form of value diversion: indirect tunneling.

1. The Focus on Self-Dealing

Controllers' value diversion increases their private benefits of control (i.e., the value that controllers can capture without sharing it

with public investors).[11] Empirical studies show that, in many countries, private benefits of control are quite significant.[12]

Controllers can use various methods to divert value from the companies under their control,[13] an activity commonly referred to as "tunneling."[14] They can sell (or purchase) assets, goods, or services to

[11] Alexander Dyck and Luigi Zingales define control premium as "some value . . . [that] is not shared among all the shareholders in proportion of the shares owned, but it is enjoyed exclusively by the party in control." *See*, Alexander Dyck and Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537, 541 (2004). *See also* Sanford J. Grossman and Oliver D. Hart, *One share-one vote and the market for corporate control*, 20 J. FINANCE. ECON. 175, 177 (1988) (defining private benefits of control as "the benefits current management or the acquirer obtain for themselves, but that the target securityholders do not obtain"); and Lucian A. Bebchuk, *Efficient and Inefficient Sales of Corporate Control*, 109 Q. J. ECON. 957, 962 (1994) (modelling private benefits of control as a fraction of the total value flowing to shareholders, which flows directly to the controller).

[12] There are different ways to measure the level of private benefits of control. One approach focuses on assessing the magnitude of premiums paid when a control block changes hands. *See* Dyck & Zingales, *supra* note [__] (studying control premium in thirty-nine countries between 1990 and 2000 and finding high control premium in Austria (38%), Brazil (65%), the Czech Republic (58%), Israel (27%), Italy (37%), Mexico (34%), and Turkey (30%)). Another approach focuses on the market value of votes in companies with differential voting rights while calculating the premium on voting stock compared to nonvoting stock. *See, i.e.*, Tatiana Nenova, *The value of corporate voting rights and control: A cross-country analysis*, 68(3) J. FIN. ECON. 325, 340 (2003) (examining dual-class firms in eighteen countries and finding a high average value of control block in Australia (23% of firm value), Brazil (23%), Chile (16% to 23%), France (27% to 28%), Italy (29%), Mexico (36%), and South Korea (48%)).

[13] For a discussion and anecdotal examples of the different methods of tunneling and self-dealing transactions, *see* Atanasov et al., *supra* note [__], at 2-39; Johnson et al., *supra* note [__]

[14] *See* Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, *Tunneling*, 90 AM. ECON. REV. 22 (2000) (coining the term *tunneling*); Vladimir Atanasov, Bernard Black & Conrad S. Ciccotello,

(from) the company on terms that favor them.[15] They can pay excessive compensation to themselves or their family members who are employed by the company.[16] They can also acquire equity at below-market price from the company or use a freeze-out transaction to buy on the cheap all the shares held by public investors.[17]

Academics and policy makers view self-dealing transactions as the principal channel for controllers' value diversion,[18] and the major source of pecuniary private benefits of control.[19] Accordingly, containing self-dealing is deemed the most important—perhaps the

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Law and Tunneling, 37 IOWA J. CORP. L. 1 (2011) (providing a theoretical analysis of tunneling).

[15] *See* Kee-Hong Bae, Jun-Koo Kang and Jin-Mo Kim, *Tunneling or Value Added? Evidence from Mergers by Korean Business Groups*, 57 J. FIN. 57 2695 (2002) (finding evidence of intragroup transactions being used to divert value up the pyramidal ladder toward firms where cash-flow rights accrue more to the controlling family); Yan-Leung Cheung, Raghavendra Rau and Aris Stouraitis, *Tunneling, Propping, and Expropriation: Evidence from Connected Party Transactions in Hong Kong*, 82 J. FIN. ECON. 343-86 (2006) (providing evidence that "connected transactions" serve as a mechanism for tunneling); and Guohua Jiang, Charles M.C. Lee and Heng Yue, *Tunneling through Intercorporate Loans: The China Experience*, 98 J. FIN. ECON. 1 (2010) (finding evidence of tunneling through the use of intercorporate loans, with which controlling shareholders transfer significant amounts in order to siphon funds).

[16] For empirical evidence on the extraction of private rents through excessive compensation to controlling families, *see* Harry DeAngelo & Linda DeAngelo, *Controlling Stockholders and the Disciplinary Role of Corporate Payout Policy: a Study of the Times Mirror Company*, 56 J. FIN. ECON. 153, 154–56 (2000).

[17] *See* Jae-Seung Baek, Jun-Koo Kang and Inmoo Lee, *Business Groups and Tunneling: Evidence from Private Securities Offerings by Korean Chaebols*, 61 J. FIN. 2415 (2006). Equity tunneling can also be done if some of the minority shareholders subscribe to a new issuance of shares at an inflated price and the controller does not. In such case, value will be transferred from the shareholders who participate at the overpriced issuance to the controller and other nonsubscribing shareholders. *See* Borja Larrain & Francisco Urzúa I. *Controlling Shareholders and Market Timing in Share Issuance*, 109 J. FIN. ECON. 661 (2013).

[18] *See* note 6, *supra.*

[19] *See* note 7, *supra.*.

only important—goal of a regime aimed at protecting public investors at controlled companies.[20]

Consider first the economists' view. In a 2008 study, a leading group of financial economists developed an index to compare the quality of investor protection across seventy-two countries. This measure—the anti-self-dealing index—has become very influential, and a voluminous follow-up literature has relied on it.[21] The measure focuses exclusively on legal arrangements, such as disclosure and special approval requirements, that govern controllers' self-dealing transactions.[22] The study argues that the anti-self-dealing index is preferable to other investor-protection indices since it "pertains directly to the pervasive problem of corporate self-dealing" and that "the law's effectiveness in regulating this problem is the fundamental element of shareholder protection."[23]

Legal scholars also view self-dealing as the principal channel for controllers' value diversion. For example, in a 2013 article, Ronald Gilson and Alan Schwartz argue that as long as countries strive to improve legal rules against self-dealing, there is no justification for

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[20] *See, e.g.*, Luca Enriques, *Related Party Transactions: Policy Options and Real-World Challenges (With a Critique of the European Commission Proposal)* 16 EUR. BUS. ORG. L. REV. 1, [xx] (2015) (policy makers have recently singled out related-party transactions and designed special rules to address those conflicted transactions).

[21] For instance, as of January 2018, the paper had 2,677 citations on Google Scholar. For discussion of the impact of this research, *see* Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, *Law and Finance after a Decade of Research* 425 (In *Handbook of the Economics of Finance*, vol. 2A (George Constantinides, Milton Harris, and Rene M. Stulz eds)); Holger Spamann, *Empirical Comparative Law*, 11 ANN. REV. LAW SOC. SCI. 131, 136 (2015).

[22] Djankov et al., *supra* note [__], at 433-36.

[23] Djankov et al., *supra* note [__], at 445-47. Moreover, their study found that an increase in the anti-self-dealing score is associated with an economically significant reduction in the private benefits of control.

structural reforms to ban or limit the use of control-enhancing mechanisms (such as dual-class and pyramidal structures).[24]

Given the commonly accepted notion that containing self-dealing is vital for investor protection, countries around the world have adopted regulatory measures aimed at protecting public investors from self-dealing transactions.[25] Belgium, France, India, Israel, and Italy have recently expanded the scope of rules regulating related-party transactions,[26] and in 2014, the European Commission issued a proposal for a harmonized regulatory framework for related-party transactions throughout the European Union.[27]

While the legal definition for self-dealing varies across jurisdictions, the practice typically requires a transaction between the public company and the controlling shareholder or another entity that

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[24] Ronald J. Gilson & Alan Schwartz, *Constraints on Private Benefits of Control:* Ex Ante *Control Mechanisms versus Ex Post Transaction Review*, 169 J. INST. THEOR. ECON. 160, 180-81 (2013) ("[c]ontingent on intelligent enforcement by sophisticated commercial courts, ex post judicial review [of transactions with controlling shareholders or their affiliates] has a number of useful benefits, all of which are improvements over the ex ante prohibitions of leveraged control structures or, more generally, that restrict the emergence of controlling shareholder regimes through the mandatory bid rule").

[25] *See*, e.g., Enriques, *Related Party Transactions*, *supra* note [__] *at* 9, 14-34 (noting that the enforcement of anti-tunneling provisions has traditionally been common around the world, and assessing the different legal tools against tunneling via self-dealing used in different jurisdictions). *See also* Djankov et al., *supra* note [__] (studying anti-self-dealing rules in seventy-two countries); and Gilson & Schwartz, *supra* note [__], at 162.

[26] For a review of recent rules regulating related-party transactions in Belgium, France, India, Israel, and Italy, *see* OECD Report, *Related Party Transactions and Minority Shareholder Rights*, 49-60 (2012), *available* at http://www.oecd.org/daf/ca/50089215.pdf; For a review of self-dealing rules recently adopted in Asian countries, *see* OECD, GUIDE ON FIGHTING ABUSIVE RELATED TRANSACTIONS IN ASIA 25-31 (2009).

[27] See European Commission, Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement, Article 9c.

the shareholder controls.[28] Self-dealing also defines cases where the controller transacts directly with other shareholders—for example, by buying out investors in a freeze-out merger. To be sure, a controller can attempt to circumvent anti-self-dealing rules by having the company transact with seemingly unrelated parties that have secret side deals with the controller.[29] These cases, however, are no different from any other form of self-dealing, although they do require more enforcement.[30]

2. Tunneling without Self-Dealing

Controlling shareholders can divert significant value, however, without engaging in self-dealing transactions. For expositional convenience, we call the phenomenon of tunneling without self-dealing *indirect tunneling*.

From an economic standpoint, indirect tunneling is no different from self-dealing in that it transfers value from public companies to their controllers. However, the core feature of indirect tunneling is the lack of any transaction between the public company and the controller or any company that it controls. This feature is not a matter of pure legal formality. As we explain below, it implies that lawmakers cannot eliminate the risk of indirect tunneling by simply expanding anti-self-dealing rules or improving the enforcement of existing rules.

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[28] *See, e.g.,* Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997) (holding that courts will apply the entire fairness standard when "a controlling shareholder stands on both sides of the transaction"); Enriques, *Related Party Transactions*, *supra* note [__] at 10 ("technically, no RPT exists if the transaction does not have the corporation (or an affiliate of its) on the one side and a related party on the other").

[29] See Enriques, *Related Party Transactions*, *supra* note [__] *at* 9, 14-34.

[30] For example, the controlling shareholder of Hollinger was convicted in connection with his hiding of side deals that he had with parties that had transactions with the company. *See* U.S. v. Black, 625 F.3d 386 (7th Cir. 2010).

Controllers Agency Costs

Indirect tunneling is more likely to take place when controllers own substantial stakes in businesses other than the public company in question. Such ownership of multiple businesses is prevalent in many countries.[31] As our analysis will demonstrate, this feature makes indirect tunneling an important concern for public investors.

Before introducing the main forms of indirect tunneling, we would like to make two clarifications concerning its scope. First, it does not include transactions between the controller and other shareholders; rather, we view these transactions as another form of self-dealing. Thus, our analysis excludes transactions in which the controller acquires equity at below-market price from the company (through an equity offering or a change in the firm's capital structure) or from its public investors (by consummating a freeze-out transaction, going-private tender offer, or insider trading).[32]

Second, indirect tunneling does not include corporate actions that may benefit the controller without detriment to public investors. The benefits that controllers capture from such actions, commonly referred to as nonpecuniary private benefits of control,[33] are assumed to be harmless to public shareholders.[34] Indirect tunneling, in contrast, benefits the controller *at the expense of public investors.*

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[31] *See, supra* note 9**.**

[32] *See* Atanasov et al., *supra* note [__], at 8-9.

[33] Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV.1642, 1663-4 (2006) (noting that nonpecuniary private benefits of control "involve no transfer of real company resources and do not disproportionately dilute the value of the company's stock to a diversified investor"). See also, *See,* Dyck & Zingales, *supra* note [__], 542 (noting that if an incumbent enjoys psychic benefits from running the family company (benefits that are more idiosyncratic to the controlling shareholder), this value is unlikely to be shared by any other potential buyer and hence is unlikely to be reflected into the value of a controlling block when this changes hands).

[34] Yet even nonpecuniary private benefits could distort decisions in a manner that would adversely affect firm value (i.e., by preventing efficient changes in control in the future). *See* Alessio M. Pacces, *Control Matters: Law and Economics of Private Benefits of Control*, 9-10 (ECGI Working Paper, 2009), *available at* http://ssrn.com/abstract=1448164.

B. Two Types of Controllers

In this section, we call for a distinction between two types of controlling shareholders: those who control a stand-alone company and own no other significant businesses, and those with substantial stakes in significant businesses. We show that corporate insiders' ownership of significant business assets outside the corporation provide them with opportunities to engage in indirect tunneling. We first present the conventional view under which controllers' wedge between control and cash-flow rights is the most important source of agency costs. We then explain that ownership of significant business assets is also an important source of agency costs

1. The Focus on the Wedge between Cash-Flow and Voting Rights

Financial economists, legal scholars, and courts share the view that an important source—perhaps the only source—of agency costs is the difference between controllers' cash-flow rights and voting rights.[35] Controllers' ownership of sufficient voting rights secures their control over the corporation. But as their fraction of cash-flow rights decreases, controllers' incentives become less aligned with those of public investors. Controllers may therefore prefer to divert value from the company rather than share it with public investors on a pro-rata basis. In a recent decision, Vice Chancellor Laster noted,

> As control rights diverge from equity ownership, the controller has heightened incentives to engage in related-party transactions and cause the corporation to make other forms of non-*pro rata* transfers.[36]

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[35] For a literature review of studies that focus on effects of the wedge between cash-flow rights and voting rights, *see* Renee Adams & Daniel Ferreira, O*ne Share-One Vote: The Empirical Evidence*, 12 REV. FIN. 51, 62-77 (2008). For a theoretical analysis of the agency costs and distortion of incentives created by this wedge, *see* Bebchuk et al., *Stock Pyramids, Cross-ownership, and Dual Class Equity*, *supra* note [__].

[36] *See* In re Ezcorp Inc. Consulting Agreement Derivative Litigation, 2016 WL 301245 (Del. Ch.) at * 3.

Consistent with this view, numerous academic studies consider the wedge between controllers' cash-flow rights and voting rights to be a proxy for agency costs and find evidence to support this premise.[37] Studies show, for example, that when this wedge widens, the controller is more likely extract private benefits,[38] the distortion of controller's

[37] *See, i.e.*, Ronald W. Masulis, Cong Wang and Fei Xie, *Agency Problems at Dual-Class Companies*, 64 J. FIN. 1697 (2009) (finding that tunneling is more severe when managers have greater control rights than cash-flow rights, and reporting that, as the divergence widens at dual-class companies, corporate cash reserves are worth less to outside shareholders, CEOs receive higher levels of compensation, managers are more likely to make value-destroying acquisitions, and capital expenditures contribute less to shareholder value); Stijn Claessens, Minjung Kang, Ho-Young Lee, Myung-Gun Lee & Jong Chool Park, *The Association between Related-Party Transactions and Control-Ownership Wedge: Evidence from Korea*, 29 PACIFIC-BASIN FIN. J. 272 (2014) (providing evidence that, in Korea, a higher degree of separation between ownership and control correlates with greater related-party activities); Jiang et al., *supra* note [__] (showing that tunneling through intercorporate loans is more severe when the controlling right is much larger than the ownership right). *See also* Chen Lin et al., *Ownership Structure and Financial Constraints: Evidence from a Structural Estimation*, 102 J. FIN. ECON. 416, 417 (noting that "numerous studies have shown a negative relationship between the control rights-cash-flow rights deviation and corporate valuation in various countries and settings").

[38] Masulis et al, *supra* note [__]. For a theoretical analysis of this point, *see* also Bebchuk et al., *Stock Pyramids, Cross-ownership, and Dual Class Equity*, *supra* note [__] (discussing the different distortions created by the divergence).

incentives becomes more severe,[39] the profitability of group-affiliated firms decreases,[40] and firms face tighter financial constraints.[41]

Different ownership or governance structures enable controllers to retain control while significantly reducing their economic ownership. In a dual-class structure, for example, the controller holds shares with superior voting rights while public investors hold shares with inferior voting rights. In a pyramidal ownership structure, the controller of the parent holding company controls all of the company's direct and indirect subsidiaries. Yet the controller's economic ownership declines as companies are located farther down the ownership structure.[42]

Financial economists and legal scholars generally agree that these control-enhancing structures raise similar investor protection concerns.[43] After all, under the view that the wedge between cash-flow rights and control is the main source of controllers' agency costs, these

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[39] See supra notes [**Error! Bookmark not defined.**]. *See also* B ebchuk et al., *Stock Pyramids, Cross-ownership, and Dual Class Equity*, supra note [__] (theoretically showing that when the size of the controller's cash-flow rights decreases, the size of agency costs increases sharply).

[40] *See, i.e.*, Claessens et al., *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, *supra* note [__] (studying publicly traded corporations in eight East Asian countries and finding that firm value falls as the control rights of the largest shareholder decline relative to cash-flow rights); Karl V. Lins, *Equity Ownership and Firm Value in Emerging Markets*, 38 J. FINANC. & QUANT. ANAL. 159 (2003) (studying data on firms from eighteen emerging markets and finding that firm value is negatively correlated with the excess of insider blockholders' control rights over their cash-flow rights).

[41] *See* Lin et. al., supra note 37, at 418 (findings that "the divergence between insider control rights and cash-flow rights aggravates the risks of potential expropriation of outside shareholders and creditors by a firm's corporate insiders and thereby increases the firm's external finance constraints").

[42] [Note other forms of control-enhancing ownership structures]

[43] *But see* Adams & Ferreira, *supra* note [__] at 76-77 (concluding that to understand the consequences of different control-enhancing mechanisms, more work is needed to understand firms' choices).

structures are merely different platforms for separating ownership and control.

2. Stand-Alone Company versus Multiple Businesses under Common Control

To be sure, as their fraction of cash-flow rights decreases, controllers' incentive to engage in value diversion increases. Yet the conventional approach that focuses on controllers' economic ownership overlooks an important dimension that affects the nature of agency costs at controlled companies. Controllers' propensity to engage in value diversion depends not only on their fraction of cash-flow rights at any given firm but also on their outside holdings. Their opportunities (and perhaps even motives) for engaging in tunneling critically depend on the business assets and activities that they own outside the corporations.

Controlling shareholders—whether individuals or firms—may own substantial stakes of significant businesses other than the public company in question. These businesses can be unincorporated entities, private firms, or publicly traded ones. Although the ownership of multiple businesses is prevalent in many countries, where dominant families control public companies through pyramids and other forms of business groups,[44] it can be found in other countries as well.[45]

Even when its fraction of control rights substantially exceeds its fraction of cash-flow rights, a shareholder that controls one firm and has no other significant business assets is less likely to divert value from the company under its control. First, ownership of other businesses, especially in related industries, provides controllers with opportunities to engage in self-dealing between the companies that it owns.[46] Second, ownership of other businesses might provide controllers with motives to divert value. Consider a controller that decides to divert funds from a relatively successful company that it controls to an affiliated company that has a desperate need for cash. In this example, it is the struggling company's needs that motivate the

[44] *See*, note 9, *supra*.
[45] *See* the Tesla example that we discuss below.
[46] *See* Bebchuk & Hamdani, *supra* note [_], at 1283-84.

controller to divert value from the healthier company. Moreover, as we explain in detail in the Part IV, even when anti-self-dealing rules are strong, the ownership of multiple businesses facilitates controllers' engagement in indirect tunneling—that is, value diversion without self-dealing.

Our analysis thus calls for a distinction between two types of controlling shareholders: those who control a stand-alone company and own no other significant businesses, and those with substantial stakes in significant businesses.

The Table below represents our contribution to the analysis of controlled companies.

Table A

	Stand Alone	**Other Businesses**
Wedge	Facebook	Samsung
No Wedge	Walmart	Tesla

Existing analyses have thus far overlooked controllers' ownership of other businesses and focused only on the wedge between cash-flow rights and voting rights. Scholars have recognized the difference between the first and second row in Table A, but not the differences between the two columns. Under this common approach, a stand-alone dual-class company where the controller holds, say, only 10% of cash-flow rights presents the same investor protection concerns as a company that is part of a large pyramidal business group where the controller is ultimately entitled only to 10% of cash-flow rights.

Our claim, however, is that companies in the second row (where controllers own more than one significant business) are those

for which agency costs are likely to be higher. Therefore, the risk of investor expropriation is lower in a stand-alone company where the controller has only 10% of cash-flow rights than in a group-affiliated company where the controller owns the same 10% of those rights.

We should note that, for simplicity of discussion, our analysis assumes a clear distinction between these two types of controllers. In reality, however, controllers are more likely to be located on a spectrum: the more businesses they own and the larger those businesses are, the more severe the value diversion problem is.

II. THE ANATOMY OF INDIRECT TUNNELING

This Part introduces the three main channels of indirect tunneling and explores the costs of this phenomenon. In Section A, we show that controllers can divert value through transactions with seemingly unrelated parties. In Section B, we analyze the case in which one company's investments or other actions confer benefits on other companies affiliated with the controller, in which case, the company making the investment and its investors essentially pay for benefits captured by the controller and other group-affiliated firms. In Section C, we consider the controller's ability to pursue business opportunities for its own benefit. Section D assesses the costs and significance of indirect tunneling and shows how that practice can undermine economic efficiency.[47]

For convenience, we use the following notation. A controlling shareholder (C) may divert value from a publicly traded company (PT). C controls other firms (A1, A2, etc.); some of these firms are privately owned and others may be publicly traded companies that C controls directly or indirectly. In some of these firms, C's share of cash-flow rights is higher than its share in PT. In others, C's share of cash-flow rights is smaller than its share in PT. In each firm, however, C's control provides C with considerable influence over both parties with whom the firm will transact and the terms of those transactions.

[47] *See* also Choi & Talley, *supra* note [__], at 305-07.

Controllers Agency Costs

A. Transactions with Third Parties

Assume that C would like to divert value from PT to A1. A transaction between C and A1 would be subject to whatever restrictions govern self-dealing transactions. C, however, can use transactions with third parties to divert value without any formal transaction between PT and A1. This type of indirect tunneling occurs in two stages. In the first stage, a third party enters into a business transaction with A1 on terms that are favorable to A1. While this party hopes that C (or one of the firms under its control) will reward that party for providing A1 with favorable terms, there is no formal agreement to that effect.[48] In the second stage, PT enters into a transaction with the same third party. Value diversion takes place when C uses its influence over PT to reward the third party for transacting with A1 on favorable terms. From an economic standpoint, this latter transaction is a clear case of tunneling or value diversion, as the controller diverts value from PT (at the expense of its public investors) to A1. Yet no transaction has taken place between these two entities.

The dynamics underlying this form of indirect tunneling is quite intuitive. Those doing business with a party that controls several companies take into account the full size of their counterparty's business empire in setting the terms under which they will transact with the controller or each of the entities that it controls. In our case, third parties may offer favorable terms to C or A1 with the expectation that this will facilitate additional business transactions with C or any of the businesses it controls.

Consider the case of an individual who asks a large bank for a substantial loan. The bank normally would decide to extend the loan and set its terms on the basis of the individual's income and personal wealth. Assume, however, that the individual controls several successful companies that often borrow significant amounts and use other banking services. In this case, the bank would naturally take into account the expectation of future lucrative transactions with these

[48] The existence of a formal "kickback" arrangement would turn the transaction into another form of self-dealing, although one that is more difficult to identify.

companies when deciding whether, and under what terms, to provide their controller with a personal loan. As the controller's business empire increases in size, the bank will be more willing to offer her a personal loan on generous terms, knowing that it may be rewarded by future transactions with the companies she controls.

The case of the IDB Group, Israel's largest business group, illustrates the risk of value diversion through transactions with third parties. In February 2012, IDB Holdings Corp., the public company at the apex of the IDB Group, did a secondary offering of shares and warrants.[49] IDB Holdings was not an appealing investment at the time. Concerns over its ability to meet its obligations led to a steep decline of its share price, and returns on its bonds skyrocketed.[50] Nevertheless, IDB Holdings managed to raise $83 million.

IDB Holdings unraveled shortly after the offering. The list of those who bought shares at the offering included many entities and individuals that had actual or potential business ties with firms that IDB Holdings controlled.[51] To be sure, one cannot know whether the parties that had bought shares at the offering would have been

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[49] Guy Ben Simon, *Nochi Dankner under Fraud Investigation*, YNET, Nov. 27, 2012, http://www.ynetnews.com/articles/0,7340,L-4312264,00.html.

[50] *See* Jasmin Gueta and Efrat Neuman, *Former IDB Head Nochi Dankner to Be Indicted for Securities Fraud*, HAARETZ, Jun. 30, 2014, http://www.haaretz.com/business/.premium-1.602021 (summarizing the facts stated in an indictment for securities fraud that was filed against the IDB controller in connection with the securities offering described above). Twenty months after the securities issuance, the total debt of IDB Holdings amounted to approximately $500 million, and the controlling shareholder of the entire conglomerate had to relinquish its control. See Shelly Appelberg and Michael Rochvarger, *Tycoon Loses Control of IDB, Israel's Biggest Holding Group*, HAARETZ, Dec. 18, 2013, http://www.haaretz.com/business/1.564045.

[51] The underwriting companies that were involved in the share offering were Clal Underwriting (which belongs to the IDB conglomerate) and two competing underwriting firms, Apax Underwriting and IBI Underwriting. In addition, a number of wealthy Israeli businessmen participated in the offering, including Ilan Ben-Dov (who controlled a public cellular firm that competed with one of the cellular firms belonging to the IDB group). *See* Gueta and Neuman, *Supra* note [__].

rewarded with favorable transactions with firms affiliated with the IDB Group. As far as we know, there was no formal agreement between these investors and IDB Group's controlling shareholder. Yet the indictment of that shareholder in connection with that offering provided a unique opportunity to learn about the dynamics underlying indirect tunneling of this type. In their court testimony, underwriters who bought the shares admitted that although the offering was unappealing from a purely economic standpoint, they purchased shares in it with the belief that assisting IDB Group and its controller in time of need would enable them to serve as underwriters in future offerings of firms controlled by IDB Group.[52]

The underwriters' testimony suggests that their sole motivation for making the investment was the expectation of future business with other firms affiliated with the IDB Group. Using our notation, third parties (the underwriters) were willing to buy A1 shares with the hope that their loss on this investment would be offset by the benefits of future transactions with PT.

From the standpoint of PT's investors, value diversion takes place when C uses its influence over PT to reward third parties for their favorable treatment. Specifically, the concern is that C would make PT either hire an underwriter that it would not have otherwise worked with or overpay for underwriting services provided by third parties who bought shares at the offering.

To emphasize, this channel of indirect tunneling does not require a formal agreement between C and the third party stipulating that C, or any of the companies it controls, would reward the third party in the future. A tacit understanding or merely an expectation by the third party is enough to facilitate an initial engagement on terms that are favorable to C. A formal agreement is especially unnecessary if the parties are repeat players or have multiple interactions in different

[52] **[complete references on testimony http://www.calcalist.co.il/local/articles/0,7340,L-3644560,00.html]**.

markets, or when the prevailing social norms support such informal exchanges.[53]

With no transaction between PT and C or A1, legal measures to constrain self-dealing cannot prevent this type of indirect tunneling. In theory, the law could treat all of PT's transactions with entities or individuals that had any business relationship with C or any of its affiliates as self-dealing transactions—that is, it could subject such transactions to special board approval, majority-of-minority vote, or strict judicial review. However, as we explain in more detail in Part III, such a regime would be prohibitively costly and likely ineffective.

B. Investments with Spillover Effects

The second form of indirect tunneling arises when PT makes an investment, engages in a transaction, or takes any other action that externalizes benefits to C or other firms under C's control. In this case, C takes advantage of its control over PT to make that company take actions that benefit other companies under C's control. This practice diverts value to the extent that PT disproportionately pays for benefits that accrue to other firms affiliated with C. We discuss three examples below.

1. Investment in Suppliers or Customers

Common control of different businesses could create synergies for some of the companies within the group. Assume, for example, that C's control over one of A1's suppliers would be beneficial for A1 because it would provide it with a stable source of supply. Ideally, A1 should be the entity that acquires this supplier. C, however, prefers that PT make the acquisition—perhaps because A1 is cash-constrained.

Assume further that any future transaction between A1 and PT (C1's supplier) would be on fair terms (because of strong self-dealing

[53] *Cf.*, Randall Morck and Bernard Yeung, *Family Control and the Rent-Seeking Society*, 28 ENTREPRENEURSHIP THEORY & PRAC. 391, 400-4 (2004) (showing that repeated interactions between business groups and public officials can build trust among officials that they will gain future favors from the business groups' controllers because of the longevity of these groups and their controllers' implicit ability to precommit to outcomes).

rules or for any other reason). In this case, the *ex post* transaction between A1 and PT does not divert value from PT to C. However, PT's *ex ante* investment decision might not be optimal for PT and its investors. In other words, from the standpoint of its public investors, the concern is that PT would overinvest in the acquisition or should not have made the acquisition to begin with.

2. Acquisition of a Media Outlet

Perhaps the best example of externalizing benefits for other group companies is the ownership of media outlets, such as newspapers or radio stations. Media outlets provide their owners with an effective platform for exerting influence over public opinion and public officials. Ownership of a media outlet may therefore prove beneficial for the controller's business interests. When the controller has more than one business under its control, all these businesses may benefit from the controller's position of influence. However, only one firm will incur the cost of acquiring or operating the media outlet.

To illustrate, assume that a leading daily newspaper is up for sale. C genuinely believes that control of the newspaper will benefit many firms under its control, especially those operating in regulated industries, including A1 and PT. C decides that PT will be the entity to acquire the newspaper—either because it has cash available or because C holds a relatively small share of PT's cash-flow rights.

From the standpoint of PT's public investors, the concern is that PT will make the investment even if it is likely to result in a loss or will preclude other, more attractive investment opportunities. Although PT's ownership of the newspaper would likely benefit many firms controlled by C, including A1, only PT and its investors will incur the costs of acquiring and operating the newspaper.

This example presents a clear case of tunneling. The controller uses the resources of one group firm to provide benefits to other group firms. In theory, each firm that enjoys the benefits associated with control over the newspaper should pay its share of the costs. In practice, however, only one firm within the group bears these costs.

Conventional anti-self-dealing measures cannot contain this form of value diversion. After all, no transaction takes place between PT and C or any of the firms under C's control.

Many media outlets around the world are controlled by families.[54] This might lead to indirect tunneling when the controlling family also controls other companies for which control over a media outlet can be valuable, especially when these other companies are located at higher tiers of the group (i.e., tiers where the controller's ownership stake is larger).[55] In this case, some of the benefits from owning a media outlet are presumably captured by the controller or other group-affiliated entities.[56]

Consider the example of Italy's Espresso Group, a leading Italian publisher and a publicly traded company, which owns the popular newspaper *La Repubblica* and other media outlets. The Espresso Group is part of a business group consisting of more than 180 companies.[57] The business group has a pyramidal structure, with the Espresso Group located at the fourth tier of the pyramid, where the controlling family holds only 13% of equity rights.[58] There are many

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[54] Simeon Djankov, Caralee McLiesh, Tatiana Nenova, and Andrei Shleifer, *Who Owns the Media?*, 46 J. L. & ECON. 341, 357-64 (2003) (examining the patterns of media ownership in ninety-seven countries around the world and finding that, on average, family-controlled newspapers and TV stations account for 57% and 34%, respectively, of the total and that private ownership is particularly widespread in the West Europe and America).

[55] In France, for example, Groupe Dassault, controlled by a wealthy businessman and politician, purchased the country's leading newspaper, *Le Figaro,* in 2004. The family's conglomerate also has significant businesses in industries that are heavily regulated, such as aerospace and aircraft manufacturing. *See* Serge Dassault's profile at *Forbes,* available at http://www.forbes.com/profile/serge-dassault/.

[56] Morck et al., *Economic Entrenchment and Growth*, *supra* note [__] at 697-8 (explaining that controllers of large business groups can trade payments to third parties from lower-tier firms for favors that benefit higher-tier firms).

[57] COFIDE - Gruppo De Benedetti S.p.A., 2014 Annual Report, 197-210, *available at* http://www.cofide.it/uploads/media/COFIDE_FY_2013.pdf.

[58] *See* the company profile of De Benedetti group, *available at* http://www.cofide.it/index.php?id=61. Similarly, the Agnelli family controls

other examples of media outlets held at lower tiers of pyramidal business groups, where controlling shareholders' share of cash-flow rights is relatively low.[59]

One could argue that the ownership of a media outlet by one company affiliated with the business group creates synergies that promote the economic interests of the entire business group, thereby benefiting public investors of all group-affiliated companies. Indeed, the existence of business groups is often justified as creating synergies among affiliated firms.[60] But synergies that benefit the business group as

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the two other leading Italian newspapers, *La Stampa* and *Corriere della Sera*, through a complex pyramidal structure, and in both cases the media outlets are located at the lower tiers of the pyramid; the family is also the controlling shareholder of the carmaker Fiat and is heavily invested in many other areas. *See* the 2013 Annual Report of the FCA Group, *available at* http://www.fcagroup.com/en-US/investor_relations/financial_reports/FiatDocuments/Bilanci/2013/2013_annual_report.pdf.

[59] A study from 2003 shows that the Singapore Press Holdings, which publishes all of the top five daily newspapers in Singapore, is characterized by complex cross holdings, with the Lee family controlling 47.23% of votes through four different companies. Djankov et al., *Who Owns the Media?*, *supra* note [__], at 354. That study also makes reference to TVN, the second largest television station in Norway; indirectly controlled by the Schneider family through a complex ownership structure, the media outlet was located at the fifth tier of the pyramid. *See* Djankov et al., *Who Owns the Media?*, *supra* note [__], at 350-53. Another example is the purchase of *Ma'ariv,* one of the leading Israeli newspapers, by the IDB group, the biggest conglomerate in Israel. The group owned the paper for barely fifteen months and lost more than $100 million on its investment. But since the controller placed the newspaper at the fourth layer of IDB business group, the losses from this venture were borne mostly by public investors. *See* Amir Teig, *Shareholders sue IDB firm over purchase of Maariv*, HAARETZ, Sep. 19, 2012, http://www.haaretz.com/business/shareholders-sue-idb-firm-over-purchase-of-maariv-1.465523.

[60] *See, for instance,* Tarun Khanna and Jan W. Rivkin, *Estimating the performance effects of business groups in emerging markets*, 22(1) STRAT. MANAG. J. 45, 48 (2001) (noting that the multiple ties among group affiliates enable them, among other things, to raise capital jointly and allocate it internally to members in distress; to lobby politicians together; to recruit and train skilled managers as a group; and to pool resources to invest in new

a whole can be a source of minority expropriation at individual group-affiliated firms. Specifically, unless the costs involved in producing such synergies are proportionally allocated across each firm that enjoys the benefits, indirect tunneling will take place. Moreover, the transfer of wealth is likely to be in one consistent direction: from companies located at the lower tiers of the business group to those at the higher tiers, where the controller's equity interest is larger.

Our indirect-tunneling explanation for media ownership is different from the explanation that others have offered for the tendency of media companies to have controlling shareholders: that control over these firms is associated with substantial nonpecuniary private benefits of control.[61] Under this view, while controlling shareholders derive private benefits from their control over media outlets, the nonpecuniary nature of such benefits means that they do not come at the expense of public investors. Our analysis, in contrast, shows that controllers—through indirect tunneling—may indeed leverage their control over media companies to capture pecuniary private benefits of control at public investors' expense.[62]

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ventures); Tarun Khanna and Yishay Yafeh, *Business Groups in Emerging Markets: Paragons or Parasites?*, 45 J. ECON. LIT. 331, 336, 341 (2007) (stressing that when external markets and institutions are poor, a large business group can avoid dealing with them by doing so internally).

[61] Id., at 343 (explaining why media outlets are likely to have concentrated ownership); Gilson, *Controlling Shareholders and Corporate Governance, supra* note [__] at 1666-67 ("running a major national newspaper puts one at the center of major public and cultural issues, with the potential to influence the outcome"). *See also* Lucian A. Bebchuk, *A Rent-Protection Theory of Corporate Ownership and Control* (Working Paper No. 7203, Nat'l Bur. Econ. Res. 1999) (presenting a model that shows that the control of widely held firms with a high amenity potential is up for grabs and cannot be sustained in equilibrium).

[62] *See, i.e.,* Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1663–64 (2006) (using as an example the transformation of certain businesses associated with the Bronfman family from liquor and oil to entertainment).

3. Ties with Public Officials.

Another example of this type of indirect tunneling focuses on the ties between business groups and public officials. Well-established evidence suggests that firms benefit from ties with politicians and other government officials.[63] The benefits for business groups that control several firms operating in various industries are presumably higher than those for stand-alone companies.[64] Establishing ties with government officials requires costly investments, such as campaign contributions, donations to a politician's favored cause or project,[65] or the provision of employment or business opportunities to the politician's associates or relatives. With more than one entity under its control, the controller can decide which firm will make these investments.[66] But that firm is not necessarily the one that will capture the benefits.

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[63] *See* Mara Faccio, *Politically Connected Firms,* 96 AM. ECON. REV., 369-70, 383 (constructing a sample of politically connected firms with a large shareholder in forty-seven countries and finding that connections are relatively widespread.

[64] *See* Randall Morck, Daniel Wolfenzon and Bernard Yeung, *Economic Entrenchment and Growth*, 43 J. ECON. LIT. 655, 696-99 (2005). *See* also Randall K. Morck, David A. Stangeland & Bernard Yeung, *Inherited Wealth, Corporate Control, and Economic Growth: The Canadian Disease*, *in* CONCENTRATED CORPORATE OWNERSHIP 295, 298–301 (Randall K. Morck ed., 2000) (using Canadian and cross-country data to show that control pyramids give wealthy families enhanced lobbying power); Khanna & Yafeh, supra note [__], at 352-360 (showing that the vast majority of family-dominated business groups have strong ties to the government).

[65] *See, for example,* Guido Ferrarini & Paolo Giudici, *Financial Scandals and the Role of Private Enforcement: The Parmalat Case* in AFTER ENRON: IMPROVING CORPORATE LAW AND MODERNISING SECURITIES REGULATION IN EUROPE AND THE US 159, 162-65 (John Armour, Joseph A. McCahery ed., 2006) (noting that Parmalat, an Italian conglomerate, built one of its factories in a small town in southern Italy that is mostly known for being the hometown of Ciriaco De Mita, the leader of the ruling Christian Democrat party at the time).

[66] *See also* Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership around the World*, 54 J. FIN. 471, 5 11-10

Specifically, assume that C wants to establish a relationship with an influential government official, which C believes would benefit it personally or some of the firms that it controls. For simplicity, assume that A1 will be the entity that captures all the benefits from these ties. C decides, however, that PT will be the company to incur all the costs of establishing the relationship. Specifically, PT will hire the politician's spouse to serve in a senior position. From the perspective of PT's investors, the cost of hiring the official's spouse amounts to a pure transfer to A1. Thus, C effectively tunnels wealth from PT to A1 without directly transferring assets or income between these firms.[67]

Mara Faccio's empirical study of politically connected firms supports the hypothesis that controlling shareholders' business groups charge the costs of political connections to group-affiliated firms in which their ownership stake is low. She finds that announcement returns around appointments of politicians to boards of companies controlled through a pyramid are lower than those for companies directly controlled by their largest shareholder.[68]

From these two examples it is clear that conventional anti-self-dealing measures cannot prevent such forms of value diversion.[69]

(1999) ("Family control may facilitate corruption because it gives the controlling shareholders enormous autonomy in decision making, keeps the potential whistle-blowers out of major corporate decisions, and thus reduces the risk of getting caught.")

[67] *See also* Randall Morck, Daniel Wolfenzon and Bernard Yeung, *Economic Entrenchment and Growth*, 43 J. ECON. LIT. 655, 697-8 (2005) (arguing that lobbying costs of large pyramidal groups are likely to be especially low because of the ability of the controllers "to trade payments to politicians from lower tier firms for favors that benefit higher tier firms. . . . [P]ublic shareholders would pay the group's lobbying costs while the controlling family would reap most of the benefits of lobbying").

[68] *See* Mara Faccio, *Politically Connected Firms*, *supra* note [__], at 383 (finding that the difference between the two is statistically significant).

[69] *See* also Enriques, *Related Party Transactions*, *supra* note [__], at 13-14 (discussing the practical difficulties associated with detecting and enforcing indirect conflict-of-interest transactions rather than related-party transactions because of the need to decide on a case-by-case basis whether, on a given issue, a director or a dominant shareholder may have an indirect interest).

Acquiring a newspaper from an unrelated third party, for example, is a business transaction that would normally be subject to the business judgment rule (if Delaware law were to apply). What makes this acquisition problematic is the controller's motive behind it: to use the newspaper to promote its personal interests or the financial interests of other group-affiliated firms.[70]

Acquiring a newspaper and establishing ties with public officials are examples of a more general phenomenon. Controllers with more than one entity under their control can tunnel resources from one entity to another by having one entity make investments, enter into transactions, or take any other action that would largely benefit other companies within the group. While they do not amount to self-dealing, these investments, transactions, or actions divert value to other group firms at the expense of public investors.

Empirical studies lend support to the concern that indirect tunneling takes place through transactions that produce benefits for other group firms. Researching Korean business groups, Heitor Almeida and colleagues find that Korean controlling families tend to use certain group firms ("central firms") to acquire firms with low profitability and high capital requirements.[71] Their finding shows that pyramidal new investments are costly for these central firms' public investors. Indeed, the group's central firms, where public investors tend to have a larger fraction of cash-flow rights, trade at a discount relative to other public group firms because of the expected effect of

[70] Creating an effective mechanism for identifying such intent would be, however, prohibitively costly. *See* Stephen J. Choi & Eric L. Talley, *Playing Favorites with Shareholders*, 75 S. CAL. L. REV. 271, 277 (2002) (noting that while regulators might use ad hoc prohibitions on less direct forms of shareholder favoritism (such as the in-kind allocation of business opportunities), "so doing would not only add significant administrative costs, but it might simply induce managers to readjust their strategies yet again").

[71] Heitor Almeida, Sang Yong Park, Marti Subrahmanyam and Daniel Wolfenzon, *The Structure and Formation of Business Groups: Evidence from Korean Chaebols*, 99 J. FIN. ECON. 447 (2011).

value-destroying pyramidal investments.[72] A more recent study of Korean business groups finds that executive compensation at group-affiliated firms is positively linked to the stock performance of other group firms.[73]

C. Business Opportunities

Another channel for indirect tunneling is the taking of corporate opportunities. Corporate law treats insiders' taking of corporate opportunities as a breach of their fiduciary duty. As we explain in this Section, however, the fact that the controller has more than one business under its control significantly increases the risk of indirect tunneling, notwithstanding the prohibition on the taking of opportunities.

The starting point of our analysis is that C's dominant position provides it with access to many business opportunities for the firms under its control, especially those that operate in related industries. Parties with ideas for business ventures or transactions will prefer to present their ideas directly to C rather than to any specific company in its business group. C will then allocate these opportunities across the companies that it controls to its own advantage. More profitable opportunities, for example, would be allocated to C or to A1 rather than to PT, even if the opportunity "belongs" to PT or if it would be more efficient for PT to use it. As we explain below, C's unique position makes the existing measures against self-dealing and the taking of opportunities unlikely to work.

The allocation of opportunities within a business group can take a variety of forms. Assume, for example, that PT, a publicly traded car

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[72] *Id.*, at [__]. *See also* Sea-Jin Chang, *Ownership Structure, Expropriation and Performance of Group-Affiliated Companies in Korea*, 46 ACAD. MANAGE. J. 238- (2003) (finding that controlling shareholders increase their direct and indirect equity stakes in more profitable *chaebol*-affiliated firms and lower their stakes in the less promising ones).

[73] Hyungseok Kim & Woochan Kim, *Executive Compensation When a Firm is a Business Group Member,* ECGI Working Paper Series in Finance (February 2015).

manufacturer, needs certain parts for producing its cars.[74] Assume further that if PT were a stand-alone entity, it would find it optimal to produce the parts itself rather than buy them on the market. C, however, decides to have A1, its wholly owned firm, produce these parts and sell them to PT.

This scenario involves two types of tunneling. PT's purchase of parts from A1 is a self-dealing transaction and thus would presumably be subject to arrangements designed to ensure that PT does not pay excessive prices. However, C's decision that A1—and not PT—will produce the parts that are essential for PT can amount to indirect tunneling. Assuming that a stand-alone firm would find it efficient to produce the parts itself rather than buy them on the market, one might argue that the decision to have A1 produce the parts and then sell them to PT essentially diverts value from PT to A1.

As in all indirect tunneling cases, C's decisions concerning the allocation of business opportunities within the group involves no transaction between PT and C or A1. Thus, existing self-dealing rules cannot protect public investors from value diversion through the allocation of business opportunities.

The aforementioned comprehensive study of corporate acquisitions by Korean business groups suggests that controllers allocate to themselves profitable investment opportunities. Specifically, this study finds that when the controlling family directly acquires new companies, those companies have higher expected profitability.[75] In contrast, companies that are acquired by group-affiliated firms, where the controllers' cash-flow rights are lower, have lower profitability.

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[74] This example draws inspiration from the case of Hyundai Motor Group (one of the largest business groups in Korea). *See* Hwa-Jin Kim, Seung Hwan Lee, and Stephen M. Woodcock, *Favoritism and Corporate Law: The Confused Corporate Opportunity Doctrine in the Hyundai Motor Case* [4-8], 3 MICH. J. PRIVATE EQUITY & VENTURE CAPITAL L. (2013) (describing the case and the court holding).

[75] Heitor Almeida et. al., *supra* note 71.

To be sure, corporate law in many countries prohibits fiduciaries from usurping corporate opportunities. This prohibition, however, is unlikely to be effective in preventing the type of indirect tunneling that we identify here. To begin with, the corporate-opportunities doctrine applies to officers and directors, but it is unclear whether it applies to controlling shareholders.[76] In Delaware's *Digex* case,[77] for example, the court rejected the claim that a controlling shareholder usurped an opportunity allegedly belonging to the controlled company by steering a buyer away from a deal with Digex toward a deal with that shareholder.[78]

Moreover, even if that doctrine were to apply to controlling shareholders, theoretical and practical reasons would make it inherently unsuitable for preventing indirect tunneling by a shareholder who controls several firms in related lines of business. From a theoretical perspective, as long as controllers are allowed to control more than one firm operating in a related industry, there is no workable test for determining what opportunity belongs to which company. How should courts decide which of the firms under common

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[76] *See also* Paul Carrington & Dan McElroy, *The Doctrine of Corporate Opportunity as Applied to Officers, Directors and Stockholders of Corporations*, 14 BUS. LAW 957 (1959) (suggesting that there should be no liability for a shareholder's usurpation of a corporate opportunity); Victor Brudny & Robert Charles Clark, *A New Look at Corporate Opportunities*, 94 HARV. L. REV. 997, 1045-1049 (1981) (analyzing the difficulties of applying the corporate opportunity doctrine in parent-subsidiary relationship); David J. Greene & Co. v Dunhill International, Inc.) 249 A2d 427 (Del Ch.) (expressing concern with circumstances in which a stockholder, by virtue of his control of corporate functions, makes a choice advantageous to himself and against the corporate interest, and noting that the law on corporate opportunity should be imposed on stockholders as well).

[77] *See*, In re Digex, Inc. S'holder Litig., Consol. C.A. No. 18336, Chandler, C. (Del. Ch. Dec. 13, 2000).

[78] *Id.* The court, however, accepted the claim that the board of Digex breached its fiduciary duties by agreeing to waive the antitakeover protections of section 203 of Delaware's General Corporate Law in connection with a sale of control of Digex by its controlling shareholder. In fact, the court viewed the section 203 waiver as an interested transaction between the controlling entity and Digex, subjected it to the entire fairness standard, and concluded that the directors failed to pass this standard (although, for other reasons, this decision was purely theoretical).

control has the strongest right to the opportunity?[79] From a practical perspective, it is hard to determine whether a business opportunity belongs to PT and not to C or to other firms under C's control, as certain tools used by U.S. courts to determine whether a business opportunity was usurped by an insider are unlikely to apply in the group context. For instance, over the years U.S. courts have developed a safe harbor pursuant to which a director or officer who presents a business opportunity to her company will be free from the danger of later being found to have usurped it since the board has disclaimed it.[80] However, when a controller of a large business group seeks the protection of the safe harbor, it will have to present the business opportunity to all relevant group-affiliated firms, and this could be a very cumbersome process. Moreover, decisions such as whether to outsource certain business activities are day-to-day business decisions that fall under the business judgment rule,[81] and courts are unlikely to apply the corporate opportunities doctrine to them.[82]

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[79] *See* Kim et al., *supra* note [__], at 29-30. Also noting that "in U.S. cases, nearly all issues regarding appropriation of corporate opportunity are about individual corporations. There are not many cases besides Sinclair Oil Corp v. Levien (280 A. 2d 717 (Del. 1971) where appropriation between affiliates of conglomerates was concerned (and Johnston v. Greene [Johnston v. Greene, 121 A.2d 919 (Del. 1956)] (discussed above))".

[80] Broz v. Cellular Info Sys. 673 A.2d 148, 154 (Del. 1996). Note, however, that a director or officer may still avoid liability even without a formal presentation if such insider proves that the company is unable to pursue the opportunity. *See* Kim et al., *supra* note [__], at 16-17.

[81] Choi & Talley, *supra* note [__], at 305-07.

[82] Indeed, in the Hyundai Motor Case discussed earlier in this Section, certain limitations of this doctrine prevented the court from ruling that the controller had usurped Hyundai Motor Group's business opportunity, although the court did find the controller liable for unfairly raising freight charges to be paid to the private company that he and his son owned. *See* Kim et al., *supra* note [__], at 4-8; for a general discussion regarding the difficulties that U.S. courts face when applying the corporate opportunities doctrine or when screening the allocation of business activities, *see* Choi & Talley, *supra* note [__], at 306 (explaining that "courts may find it next to impossible to determine whether a particular allocation is driven from a self-dealing motivation").

D. Importance

The last three Sections have identified three principal channels that controllers can use for indirect tunneling and thereby capture disproportionate benefits at the expense of a company and its public investors. In this Section, we explore the costs of indirect tunneling and its significance.

1. Costs

From an efficiency standpoint, a transaction is desirable if its benefits to all parties involved exceed its costs. For a stand-alone corporation, a transaction is efficient if its value to the corporation outweighs its costs. From a controller's perspective, however, tunneling is worthwhile when the controller's share of a transaction's benefits outweighs its share of the costs. In the case of indirect tunneling, C's share of the benefits will be based on those benefits accruing to PT, A1, and any other firm under its control. C's share of the costs, however, will be based only on the costs imposed on PT. This asymmetry between C's share of costs and benefits distorts C's incentives and might lead to inefficient corporate decisions.[83]

[83] *See, i.e.*, Atanasov et al., *supra* note [__] at 5-22 (identifying three main contexts in which tunneling can distort controllers' incentives: "choosing investment projects, selecting investment policy and the scope of the firm, and choosing to transfer control"). *See also* Lucian Bebchuk, Reinier Kraakman & George Triantis, *Stock pyramids, cross-ownership, and dual class equity: The creation and agency costs of separating control from cash-flow rights*, in RANDALL K. MORCK: CONCENTRATED CORPORATE OWNERSHIP 295, 301 (2000) (showing that a controller may favor choices that increase the private benefits of control even if those choices are not optimal from the perspective of maximizing the value of the company's equity capital); Choi & Talley, *supra* note [__], at 304-05 (arguing that indirect favorites to shareholders create greater inefficiencies than a direct cash payment).

Controllers Agency Costs

We illustrate the risk of inefficiencies for each form of indirect tunneling that we introduced in the last part. For simplicity, we assume that C's share of cash-flow rights is 20% for PT and 50% for A1.[84]

a. *Transactions with a Third Party*. In this form of indirect tunneling, C induces PT to transact with a third party in order to reward this party for its favorable treatment of C or other firms affiliated with C. As we explained in the last part, these transactions are likely inefficient from the perspective of PT as a stand-alone entity. But as C's fraction of cash-flow rights is not the same for all the firms that it controls, these transactions may create inefficiencies even for the group as a whole.

Consider, for example, a third party that provided favorable terms to A1. Assume that the benefit for A1 is 100. C then induces PT to purchase an asset or service from this third party on terms that are favorable to that party. Assume that the transaction produces a loss of 120 for PT. This transaction is clearly undesirable for PT and the group as a whole as its loss for PT outweighs its benefit for A1. For C, however, it produces a net benefit of 26. Indeed, given the difference in cash-flow rights, C would find it worthwhile for PT to incur a loss of up to 250 to secure a benefit of 100 for A1. Thus, indirect tunneling may lead to transactions that are inefficient even from the entire group's perspective.

ii. *External Benefits*. Under this form of indirect tunneling, C channels the business activities of PT into projects that have a low or even negative net present value for PT but that produce benefits for A1. Again, since its share of the costs and benefits is not the same as that for all the businesses it controls, C might induce firms to take actions that could be inefficient for the group as a whole.

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[84] Lucian A. Bebchuk, *Corporate Pyramids in the Israeli Economy: Problems and Policies: A Report Prepared for the Committee on Increasing Competitiveness in the Economy*, at 7-9 (March 2012), available at http://mof.gov.il/Lists/CompetitivenessCommittee_4/Attachments/3/Opinion_2.pdf (analyzing the incentives problem with tunneling).

Consider, for example, PT's purchase of a newspaper that results in a loss of 200 for PT. Assume that only A1 will capture the benefit from this acquisition. Specifically, C's control over the newspaper will assist A1 in its negotiations with government officials over the renewal of A1's license, thereby producing a benefit of 100. The acquisition of the newspaper is clearly inefficient from the perspective of both PT and the group as a whole. For C, however, it produces a net benefit of 30 (C's share of the loss is 20% of 100, or 20; C's share of the benefit is 50% of 100, or 50).

iii. *Allocation of Business Opportunities*. This form of indirect tunneling arises from the allocation of business opportunities within the group. Inefficiencies may arise when C allocates to itself or to A1 an opportunity that would be more valuable in PT's hands.

For example, assume that C has an opportunity to purchase a company that has some synergies with both PT and A1. For PT, the value of the acquisition is 200; for A1, the value is 100. The efficient decision is to have PT acquire the company. From C's perspective, however, the benefit of having A1 make the acquisition (50% of 100) is higher than the benefit of having PT make it (20% of 200). Thus, C will likely make the decision that is inefficient for the group as a whole.

To summarize, indirect tunneling not only diverts value from companies and their public investors but also might produce inefficiencies by distorting business decisions by the firms affiliated with the controller.[85]

2. Significance

One may argue that anti-self-dealing rules, albeit imperfect, address the more significant tunneling opportunities. Under this view,

[85] Stephen Choi and Eric Talley argue that value diversion of this type may be costlier than an outright payment by the company to a dominant shareholder. In addition to the suboptimal allocation of business activities within a business group, these costs include the need to share the "rent" extracted from public investors with a third party, and the uncertainty and volatility of the returns that a controller derives from such activity, as indirect tunneling involves informal interactions with third parties. *See* Choi & Talley, *supra* note [__], at 304-05.

other forms of value diversion, such as the different types of indirect tunneling presented in this article, are likely to be on a substantially smaller scale and thus do not present significant investor protection or efficiency concerns. However, we do not find this argument persuasive.

Researchers have thus far overlooked the indirect tunneling phenomenon, so there is no direct evidence of its pervasiveness, its costs for investors, and its effects relative to those of self-dealing or direct tunneling. We do know, however, that many countries around the world have large business groups, which provide their controllers with many opportunities for tunneling on a large scale.

Moreover, as the rules that regulate direct self-dealing become more common in countries with concentrated ownership,[86] one would expect to see an increase in the scope of indirect tunneling as an alternative channel through which a controller could divert resources to itself. Indirect self-dealing is therefore expected to be a serious source of concern that should not be ignored by regulators or institutional investors.

III. IMPLICATIONS FOR CONTROLLED COMPANIES

Our analysis has implications for academics, policy makers, and investors. Section A explains why the agency costs associated with controllers' ownership of multiple businesses cannot be effectively contained by anti-self-dealing rules, no matter how strict these rules are. Section B calls on institutional investors and their advisors to take into consideration not only the mere existence of a controlling shareholder and its fraction of cash-flow rights, but also the organizational structure of a controlled company and its potential for indirect tunneling. Section C suggests that regulators and policy makers interested in limiting controllers' private benefits of control should not focus solely on tightening self-dealing regulation but should instead be more receptive to structural remedies, such as limiting the use and scope of business groups. Section D focuses on

[86] *See supra* notes [25-27] and accompanying text.

cross-company structural differences and their expected impact on the level of tunneling and controllers' private benefits. Section E shows that indirect tunneling can explain cross-country differences in the extent of controllers' private benefits and that these differences in the level of tunneling depend on the prevalence of business groups in a given country and on social norms, trust, and informal arrangements between the controller and its counterparties.

A. Inadequacy of Good Self-Dealing Rules

Academics and public officials believe that anti-self-dealing measures are not only essential for protecting public investors in controlled companies but also sufficient to prevent value diversion. Under this view, a robust anti-self-dealing regime is all it takes to ensure that controllers do not benefit themselves at the expense of publicly traded firms and their investors.[87] Our analysis, however, questions the exclusive reliance on self-dealing rules—either *ex ante* mandatory restrictions or *ex post* judicial review. As long as controllers own other significant businesses, anti-self-dealing rules—no matter how strict they are or how efficacious their enforcement is—cannot effectively contain value diversion.

Some might say that our analysis merely calls for modifying anti-self-dealing rules or bolstering their enforcement to ensure that they tackle indirect tunneling. Consider, for example, PT's transactions with parties that have some business ties with the controller or any of its affiliates. One could argue that lawmakers should simply subject all of these transactions to the same requirements that apply to self-dealing transactions.[88] We argue, however, that expanding anti-self-dealing rules to eliminate indirect tunneling would fundamentally constrain management's ability to make business decisions without close scrutiny by outsiders.

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[87] *See supra* note [20] and accompanying text. Of course, anti-self-dealing rules cannot contain the consumption of nonpecuniary private benefits of control. Yet it is commonly assumed that controllers' consumption of nonpecuniary benefits of control does not divert value from companies or their public investors.

[88] [reference "personal interest" rules in UK]

First, the direct enforcement costs of a regime designed to curb indirect tunneling would be quite substantial. Consider, for example, indirect tunneling through transactions with third parties. Under this hypothetical regime, all of PT's business transactions would need to be examined to determine whether their counterparties did some business in the past with C or with any of the firms that C controls. PT would then have to acquire information about all the third parties that currently have a business relationship with C or with any of the entities within C's business group and ensure that each such transaction is approved through the same procedure that governs self-dealing transactions. Needless to say, these examination and approval processes would be extremely cumbersome, especially when C owns substantial businesses other than PT.

Second, even if firms invested considerable resources in monitoring and enforcement, some types of indirect tunneling would continue unabated. Consider the first type of indirect tunneling: transactions with third parties. Our analysis in the last part assumed that the transaction between the third party and A1 took place before this party's transaction with PT. Indirect tunneling, however, may arise even in transactions between PT and any party with whom A1 *might* do business in the future. C could induce PT to transact on favorable terms with such a party with the expectation (not backed by any formal agreement) that this party would return the favor by transacting on favorable terms with A1. Clearly, it would be impractical to require PT to monitor *all* parties that *might* in the future do business with any of the firms under C's control.

Consider the second form of indirect tunneling: actions or transactions that may externalize benefits to other group members. In the absence of any transaction between PT and A1, how could one distinguish between PT's "regular" business decisions and those that may benefit not only PT but also A1 or other firms that C controls? This distinction often will depend exclusively on the motives underlying the investment, action, or transaction at stake. Moreover, assuming that a certain PT transaction does produce benefits for both PT and A1, should special approval requirements apply only to PT or also to A1 (if it were required to incur its share of the costs)?

Now consider the third type of indirect tunneling: the taking of opportunities. As we have explained above, as long as controlling shareholders control several firms operating in related lines of business, there is no conceptually coherent way to determine which opportunity belongs to which firm. Thus, even if one were to make a substantial investment in enforcement, eliminating indirect tunneling would be impossible without a workable legal rule to identify the taking of corporate opportunities.

Finally and most importantly, the analysis above suggests that policy makers cannot adopt measures to contain indirect tunneling without fundamentally altering the governance and allocation of power at controlled companies. One of the key principles underlying firms with controlling shareholders is that those shareholders or their appointed representatives have the freedom to set the firm's direction and make management decisions, a power that is limited only when necessary to protect public investors—that is, when a conflict arises between majority and minority shareholders. However, any regime to contain indirect tunneling would inevitably interfere with this capability.

Anti-self-dealing measures can be divided into two types. The first type subjects self-dealing transactions to *ex ante* cleansing mechanisms designed to ensure that these transactions benefit public investors. These mechanisms are approval by independent directors, a vote by disinterested shareholders, disclosure requirements, or a combination of these three. The second type is *ex post* judicial review, such as the "entire fairness" standard that Delaware courts use.[89]

Both types of measures share a fundamental feature: they depend on the identification of a corporate transaction or action as conflicted and therefore subject to special treatment. This *transactional approach* essentially transfers power over a subset of corporate transactions from controllers and managers to independent directors, minority shareholders, or courts. Controllers and managers,

[89] For a comprehensive analysis of these two approaches, *see* Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 CAL. L. REV. 393 (2003); *See also* Gilson & Schwartz, *supra* note [__], at 169-70 (strongly advocating for *ex post* judicial review instead of *ex ante* restrictions).

however, retain the power to manage all other corporate affairs not involving self-dealing. Thus, under the existing anti-self-dealing regime, a controller that would like to reduce external interference can simply refrain from engaging in transactions between itself (or firms that it controls) and the company.

As has already been noted, a serious attempt to target indirect tunneling would require pervasive interference with the ability of controllers—even those who do not engage in value diversion—to make business decisions. Outsiders—independent directors, for example—would have to constantly monitor the company's business decisions to ensure that they do not raise indirect tunneling concerns. The scope of this intervention increases in large business groups, where controllers have many businesses under their control. Most importantly, as long as they have other businesses under their control, controllers cannot prevent such external intervention in corporate affairs by deciding to forgo self-dealing transactions. The mere risk of indirect tunneling—created by the ownership of other businesses—would require outsiders to scrutinize the company's transactions to ensure that they are not used for value diversion. Such interventions would inevitably undermine the controller's ability to manage the firm's affairs.

The inevitability of indirect tunneling carries implications for lawmakers, investors, and academics. For policy makers concerned with protecting investors from value diversion by controlling shareholders, our analysis cautions against exclusive reliance on anti-self-dealing rules. Especially in countries where business groups are prevalent, policy makers should recognize the limited usefulness of anti-self-dealing rules and consider other measures to enhance investor protection or allow investors to protect themselves.

For investors and researchers, our analysis offers a new approach for assessing companies' governance risks and making cross-country investor protection comparisons. In their assessment of a company's quality of corporate governance, we argue, investors and researchers should take into account the scale and scope of other businesses owned by the company's controller. Likewise, when

assessing other countries' level of investor protection, they should consider the pervasiveness of business groups within each country.

B. Agency Costs and Other Business Assets

Institutional investors and their advisors increasingly rely on corporate governance metrics to guide them in making investment and voting decisions.[90] Existing measures of corporate governance focus on firm-level characteristics, such as the method for electing directors and board independence.[91] Even the anti-self-dealing index focuses mainly on firm-level characteristics such as disclosure, the approval process, and enforcement.[92] As we explained in Part I.B, it is commonly assumed that deviation from the one-share-one-vote principle is an important source of agency costs. Governance rankings normally assign a negative weight to measures that unbundle cash-flow and voting rights, such as a multiple-voting capital structure. Indeed, institutional investors have called on stock exchanges to prevent companies with dual-class shares from listing their shares for trading.[93]

This paper, however, identifies an important source of agency costs that is not captured by firm-level characteristics. Controllers' ownership of significant businesses outside the corporation creates

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[90] See Bebchuk & Hamdani, *The Elusive Quest for Global Governance Standards*, supra note [__].

[91] Indeed, two main pillars on which the ISS index focuses are board structure and shareholder rights. *See* INSTITUTIONAL SHAREHOLDER SERVICES INC, ISS GOVERNANCE QUICKSCORE: AN OVERVIEW, 13-21, 32-40, available at http://www.riskmetrics.com/cgq (last visited May 3, 2013). *See also* Bebchuk & Hamdani, *supra* note [__], at 1266-70, 1272-80 (criticizing the composition of influential indices that measure countries' level of investor protection, such as the Anti-Director Rights Index and Riskmetrics' Index, for giving weight to components such as voting rights that "are largely irrelevant to companies with a controlling shareholder").

[92] For a detailed description of the index components, Djankov et al. *supra* note [__], at 433-6.

[93] *See* Council of Institutional Investors Letter to NYSE Chief Regulation Officer, Oct. 2, 2012 (calling for a rule under which companies will be ineligible for listing on the NYSE if they have two or more classes of common stock with unequal voting rights).

opportunities for indirect tunneling,[94] the risk of which increases with the scope and scale of those other businesses and the fraction of cash-flow rights at each firm that the controllers control. Thus, when assessing the governance risk of publicly traded companies, institutional investors and their advisors should also consider whether controllers have other businesses under their control, the value of such holdings, and other factors that we discuss in more detail below.

C. Disclosure

The claim underlying this paper is that agency costs are likely to increase with the scale and scope of other businesses owned by controllers. We also argue, however, that tightening anti-self-dealing rules is unlikely to eliminate the agency costs that are associated with indirect tunneling. These insights, we argue, should lead the Securities and Exchange Commission (the SEC) to rethink the disclosure requirements that apply to public companies.

The U.S. disclosure regime does not require issuers to disclose information about other businesses owned by their controlling shareholders. Investors may have access to information about controllers' other businesses in two cases. The first case is when these other businesses are publicly traded entities that are required to disclose information about their largest shareholders. Consider, for example, the case of Tesla Motors Inc. Tesla's largest shareholder, Elon Musk, was for several years the largest shareholder of another publicly traded company, SolarCity.[95] Information about Musk's holdings was available from the SEC filings of both companies.

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[94] As we explain in the next Part, the governance threat arising from insiders' ownership of other businesses exists also in widely held companies.

[95] Elon Musk held 20.1% of Tesla and 21.7% of SolarCity shares. *See* Steven Davidoff Solomon, *Silicon Valley Style Puts Gloss on Tesla's Bid for SolarCity*, N.Y. TIMES DEALBOOK (Nov. 8, 2016), *at* *http://www.nytimes.com/2016/11/09/business/dealbook/silicon-valley-style-puts-gloss-on-teslas-bid-for-solarcity.html*.

The second case is when the company discloses a related-party transaction involving its controller.[96] In other words, the U.S. disclosure regime concerning affiliated entities generally follows the transactional approach: issuers are required to identify self-dealing transactions and disclose information about parties to these transactions. As we explained earlier, however, the transactional approach is ill-suited for addressing value diversion through indirect tunneling.

To assess the governance risks associated with controlled companies, investors need access to information about controllers' significant holdings in other businesses. Requiring issuers to obtain this information from controllers and make it publicly available would allow investors and potential investors to assess the risk of value diversion through indirect tunneling.

Notwithstanding its value to investors, a requirement that controlling shareholders who are individuals (and not corporations) disclose information about their private business investments raises significant privacy concerns.[97] Moreover, a requirement to disclose information about controllers' business assets would be solely based on the *potential* for indirect tunneling: controllers would be required to disclose information not because they engage in self-dealing or value diversion, but because of the risk that they *might* do so. Policy makers should weigh these valid concerns against the potential for agency costs and the value produced by investors' improved ability to assess issuers' governance risk. The disclosure regime, for example,

[96] For a comprehensive analysis and critique of the regime governing disclosure of related-party transactions, see generally Geeyoung Min, *The SEC and the Courts' Cooperative Policing of Related Party Transactions*, [2014] COLUM. BUS. L. REV. 663.

[97] Privacy concerns also arise in connection with issuers' duty to disclose their managers' health problems. *See generally* Joan MacLeod Heminway, *Personal Facts About Executive Officers: A Proposal for Tailored Disclosures to Encourage Reasonable Investor Behavior*, 42 WAKE FOREST L. REV. 749 (2007); Patricia Sánchez Abril & Ann M. Olazábal, *The Celebrity CEO: Corporate Disclosure at the Intersection of Privacy and Securities Law*, 46 HOUS. L. REV. 1545 (2010).

could focus on outside holdings that are of substantial value (relative to the value of the issuer) or that operate in related industries.

D. Legal Policy toward Business Groups and Pyramids

The prevalence of business groups worldwide has raised debate on whether countries should take measures to dismantle business groups and pyramidal ownership structures or otherwise discourage their formation.[98]

Some researchers argue that, especially in emerging economies, large business groups can produce efficiency benefits by substituting their internal markets of capital, labor, and managers for weak institutions and underdeveloped external markets.[99] Others argue that business groups create systemic risks, undermine competition, and facilitate controllers' ability to capture political rents and influence political decision making.[100]

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[98] See, for instance, Heitor Almeida, *Should Business Groups Be Dismantled? The Equilibrium Costs of Efficient Internal Capital Markets*, 79 J. FIN. ECON. 99 (2006); Randall Morck, *The Riddle of the Great Pyramids*, in ASLI M. COLPAN & TAKASHI HIKINO, EDS. THE OXFORD HANDBOOK OF BUSINESS GROUPS (Oxford, 2009) (discussing the persistance of pyramids in developed economies, the reasons to dismantle them, and the economic literature related to pyramids); Lucian A. Bebchuk, *Corporate Pyramids in the Israeli Economy*, supra note [__], 7-27 (analyzing the Israeli reform aimed at dismantling the current pyramids and presenting the agency problems associated with pyramids). For studies that support the existence of large pyramidal business groups, especially in emerging markets, see Tarun Khanna and Jan W. Rivkin, *Estimating the Performance Effects of Business Groups in Emerging Markets*, 22(1) STRAT. MANAG. J. 45 (2001); and Khanna & Yafeh, supra note [__].

[99] Khanna & Rivkin, *supra* note [__]; and Khanna & Yafeh, *supra* note [__], at 336-43. .

[100] Randall Morck, Daniel Wolfenzon and Bernard Yeung, *Economic Entrenchment and Growth*, 43 J. ECON. LIT. 655, 687-688; 695-699 (2005); Morck & Yeung, *The Rent-Seeking Society*, *supra* note [_] at 400-04; Morck, *The Riddle of the Great Pyramids*, *supra* note [__], at [7]; Bebchuk, *Corporate Pyramids in the Israeli Economy*, *supra* note [__], at 16-21.

Controllers Agency Costs

Our analysis of indirect tunneling offers a new perspective on the link between business groups, investor protection, and economic efficiency. As Part II has shown, large business groups provide their controllers with both the motive and the opportunity to divert value on a large scale by indirect tunneling.[101] Indirect tunneling not only hurts investors but also undermines economic efficiency. Moreover, improving anti-self-dealing rules cannot eliminate indirect tunneling, especially at large business groups. To be sure, we do not argue that business groups are necessarily undesirable or that they should be dismantled. We do suggest, however, that business groups inevitably produce social costs that anti-self-dealing rules cannot eliminate.

Our view differs from the one advanced by Ronald Gilson and Alan Schwartz, who argue against any prohibition or limits on the use of control-enhancing mechanisms (such as pyramidal business group structures). Under their view, the proper policy response to the investor-protection concerns raised by business groups is countries' tightening of their anti-self-dealing rules.[102] As we have explained above, however, this view overlooks the unique features of indirect tunneling. No matter how strictly they are enforced, anti-self-dealing rules cannot effectively contain indirect tunneling. Policy makers should take this insight into account when considering the proper policy concerning business groups.

E. Cross-Company Differences

The conventional view in both the economic and the legal literatures is that the divergence between controllers' cash-flow and voting rights is the most important source of agency costs. Our analysis suggests, however, that agency costs depend not only on controllers' fraction of cash-flow rights at any given firm but also on their outside holdings. Specifically, the ownership of other businesses provides controllers with both motives and opportunities for indirect tunneling. A shareholder who controls only one firm and has no other significant business activities is unlikely to engage in indirect tunneling even when its fraction of control rights substantially exceeds its fraction of cash-flow rights. Moreover, whereas strong anti-self-dealing rules can

[101] *See supra* Section III.B.

[102] Gilson & Schwartz, *supra* note [__], at 180-81.

contain value diversion at a stand-alone company, they cannot eliminate indirect tunneling at a large business group.

To illustrate, consider the difference between Google and Samsung Electronics. The ownership structure of both companies creates a wedge between controllers' control and cash-flow rights. Larry Page and Sergey Brin, Google's founders, together hold approximately 55% of the company's voting rights. Under Google's triple-class capital structure, however, their voting rights substantially exceed their share of any dividend that Google pays.[103] Samsung Electronics, on the other hand, is part of a complex business group characterized by pyramidal ownership and cross shareholding, a structure that creates a wedge between the control and cash-flow rights of the family controlling the company. Whereas Samsung is part of a large business group with many publicly traded and other companies operating in related and unrelated industries, Page and Brin control only one publicly traded entity. Thus, Google's controlling shareholders have little motive and significantly fewer opportunities to engage in indirect tunneling than Samsung's.[104]

In a more general fashion, our analysis leads to several predictions concerning the type of companies for which controllers' private benefits are likely to be higher:

Prediction 1. Indirect Tunneling and Outside Businesses. For any fraction of cash-flow rights in any given firm, the controller's private benefits are expected to increase when the scope of businesses the controller owns, directly or through group-affiliated companies, increases. In other words, the magnitude of value diversion at a given company will likely depend on whether that company is a stand-alone

[103] *See*, Google, Inc., Definitive Proxy Statement, (Schedule 14A) (Apr. 23, 2015), *available at* http://www.sec.gov/Archives/edgar/data/1288776/000130817915000157/lgoo2015_def14a.htm.

[104] Bae et al., *Tunneling or Value Added?*, *supra* note [__], at 2697 (using the case of the Samsung Group to illustrate how expropriation of minority shareholders takes place among member firms of a *chaebol*).

firm (i.e., the controller has no significant businesses outside the corporation) or part of a business group.

To illustrate this point, compare the following two examples. In the first example, C owns 40% of the shares of a PT1 and has no other businesses. In the second example, C owns 40% of the shares of PT2 through a pyramidal structure where the controller directly holds 66.6% of A1, a publicly traded holding company. A1 controls several businesses, including 75% of A2. A2 is a public company that controls several businesses, including 80% of PT2. The controller's ownership interest in PT2 is therefore 40% (0.8x0.75x0.666). Although in both cases the controller owns 40% of the company's cash-flow rights, company PT2 creates significantly more opportunities for indirect tunneling.

Prediction 2. Outside Cash-Flow Rights. Holding fixed both the scope of the controller's outside businesses and its cash-flow rights in a given firm, the risk of indirect tunneling is expected to be more severe when the percentage of cash-flow rights that a controller has in other firms increases. In that case, the controller has a stronger incentive to divert value to the firm where its cash-flow interest is higher.

Consider the following example. C owns 30% of the equity interest in both PT and A1. C acquires an additional 10% of A1's shares. As far as PT is concerned, C's wedge between cash-flow and voting rights has remained constant. Yet C's incentive to divert value from PT to A1 has clearly increased with the increase of C's equity stake in A1.

Prediction 3. Opportunities and Businesses in Related Industries. Holding all above equal, the risk of indirect tunneling, especially through the allocation of business opportunities, is greater when the controller owns more firms in related industries. First, an increase in the number of firms in related industries provides the controller with more firms to which it can allocate opportunities. Second, as we explained earlier, the ownership of several businesses in related industries makes it harder for courts or public investors to identify the company that is the "owner" of any specific business

opportunity, thereby making it easier for the controller to use this form of value diversion.

Prediction 4. Indirect Tunneling and Ownership Structure. A company for which indirect tunneling is expected to produce large private benefits of control is more likely to be controlled as part of a business group than as a stand-alone firm.[105] Consider, for instance, a company that publishes a popular newspaper. As we explained earlier, control over a newspaper can provide substantial benefits to business groups, especially when they own companies operating in regulated industries. For a controller with no other businesses, however, the private benefits of control are likely to be smaller. Thus, if the company is for sale, it is more likely to be acquired by a business group than by a controlling shareholder with no other businesses,[106] especially when public investors are the ones that incur the cost of acquisition.

Some of our predictions above may apply to other forms of tunneling, including self-dealing transactions. For example, an increase in the controller's cash-flow rights at other companies may increase that controller's motivation to engage in both direct and indirect tunneling. Other predictions, however, are closely related to indirect tunneling, especially when the rules against self-dealing are relatively tight. When enforcement of anti-self-dealing rules is lax, controllers can divert value by engaging in direct tunneling. As anti-self-dealing measures become more effective, however, controllers are more likely to divert value through indirect tunneling.

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[105] *Cf.* Lucian A. Bebchuk, *A Rent-Protection Theory of Corporate Ownership and Control* (NBER Working Paper, 1999), *available* at http://www.nber.org/papers/w7203 (showing that in countries in which private benefits of control are large, publicly traded companies will tend to have a controlling shareholder).

[106] *See* Section III.B.2 (discussing business group's incentives to purchase a media outlet).

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F. Cross-Country Differences

Our analysis also sheds light on existing studies of investor protection across countries. As we explained in Part II, the conventional view holds that strong anti-self-dealing rules significantly constrain controlling shareholders' value diversion, thereby reducing private benefits of control. Indeed, as we have previously noted, a very influential study from 2008 developed an anti-self-dealing index and used it to study investor protection across countries.[107] Consistent with the conventional view, this study finds a correlation between the anti-self-dealing index and the level of private benefits.

To the extent that self-dealing is the main source for tunneling, one would expect that private benefit levels would be largely driven by the anti-self-dealing index. In many cases, however, there seems to a significant gap between the two. Countries with strong anti-self-dealing rules, such as Chile, Colombia, and Israel, also have high levels of private benefits, as measured by their average control premium.[108] Chile's anti-self-dealing score, for example, is 0.63, far above the global average of 0.45. The average control premium in Chile, however, is substantially higher than the global average (18% compared to 14%).[109] Likewise, whereas the self-dealing scores of Israel and Colombia are 0.71 and 0.58, respectively, the average control premium in both countries is 27%.

There are several explanations for these findings. One may argue, for example, that these countries' enforcement of anti-self-dealing rules is weak,[110] or that their financial media are less active in

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[107] Djankov et al., *supra* note [__], at 445-49 (showing that five of the six measures of the regulation of self-dealing are robust predictors of lower control premiums, and that the overall anti-self-dealing index is negatively correlated with control premium).

[108] Indeed, Djankov et al. specifically examined that effect of the anti-self-dealing index on control premium and found that the R Square is only 0.31.

[109] *Id.* at 448.

[110] *See, i.e.*, Dyck & Zingales, *supra* note [__], at 576 (showing that countries with better law enforcement have lower private benefits of control); Ronald J. Gilson, *Controlling Shareholders and Corporate*

scrutinizing self-dealing transactions.[111] Furthermore, extralegal factors, such as product market competition, social norms, and reputational sanctions, may play an important role in curbing private benefits of control.

Our analysis offers another explanation. As explained in Part III, even robust anti-self-dealing rules cannot prevent indirect tunneling, which could be a major source of private benefits of control.[112] In countries where large-scale indirect tunneling is pervasive, controllers can capture substantial private benefits even if the rules against self-dealing are quite strict.

Moreover, two types of extralegal factors can further determine the prevalence of indirect tunneling in any given country: the existence of business groups, and the prevalence of certain social norms.

1. Business Groups

Indirect tunneling should be more common in countries where controllers of public companies often own other businesses either directly or through other companies.[113] Put differently, indirect

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Governance: Complicating the Comparative Taxonomy, 119 HARV. L. REV.1642, 1675 (2006) (noting that "[w]ithout effective enforcement, improved standards and tougher disclosure rules are unlikely to be enough"); and Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471, 501, 510 (1999) (explaining that "the protection of minority shareholders is determined not just by the legal rules but also by the quality of their enforcement").

[111] *See, for instance*, Alexander Dyck & Luigi Zingales, *The Corporate Governance Role of the Media*, in THE RIGHT TO TELL: THE ROLE OF THE MASS MEDIA IN ECONOMIC DEVELOPMENT 107, 139-140 (2002) (researching the impact of media on corporate governance and showing that media outlets are important in shaping corporate policy); Dyck & Zingales, *supra* note [__], at 577, 590 (finding that public opinion pressure resulting from the dissemination of information by the press helps to curb private benefits of control).

[112] *See supra* notes [69-70] and accompanying text.

[113] Djankov et al., *supra* note [__], at 463 (noting that, in many countries, firms are organized in business groups and that financial structures

tunneling is likely to be more pervasive in countries in which business groups are prevalent. As we explained above, the ownership of other businesses, especially those operating in related industries, provides controllers with both motive and opportunity to divert value through indirect tunneling. Thus, it is not surprising that the countries we discussed above—Chile, Colombia, and Israel—stand out in terms of the complexity and "depth" of their corporate pyramids.[114] These countries' complex pyramidal business groups provide their controlling shareholders with more opportunities for indirect tunneling.

2. Social Norms, Culture, and Institutions

As we explained in Section III.A above, one channel of indirect tunneling is transactions with third parties. A third party expects that its willingness to transact on favorable terms with one company affiliated with the controller will be rewarded by transactions with other firms affiliated with the same controller. This expectation is not backed, however, by any formal or legally binding agreement.[115] Such "honesty among thieves" is less important when the controller diverts value through direct self-dealing transactions, where the parties are more likely to use formal arrangements.

Indirect tunneling relies on, and is facilitated by, the prevalence of certain social norms within a country's business community.[116]

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in which group member firms are listed separately only encourage many intragroup transactions and self-dealing).

[114] Those countries receive relatively high scores in the different indices that measure the impact of a pyramid in an economy, including the percentage of market capitalization held by family group firms and the average pyramid layer. *See* Ronald W. Masulis, Peter Kien Pham and Jason Zein, *Family Business Groups around the World: Financing Advantages, Control Motivations, and Organizational Choices*, 24 REV. FINANC. STUD. 3556, 3569-70 (2011).

[115] If such an agreement were to exist, any transaction by a publicly traded firm with such party would probably be classified as a self-dealing transaction.

[116] Morck & Yeung, *Family Control and the Rent-Seeking Society*, *supra* note [__], at 400-4 (showing that a high level of trust and repeated interactions between business groups and public officials can build trust with officials to gain future favors from the controllers of business groups); *Cf.*

Under these norms, business partners expect the controller to reward them for their willingness to provide favorable terms to one group firm. Other things equal, indirect tunneling is more likely to take place in countries with social norms, conventions, and other aspects of transacting that facilitate such an informal exchange of business favors. Perhaps even family ownership is conducive to indirect tunneling because it makes implicit agreements more credible.[117] Likewise, indirect tunneling is more likely to take place in countries where business elites have stronger political ties or the level of corruption is high.[118]

IV. WIDELY HELD FIRMS

Our analysis has thus far focused on companies with controlling shareholders. The potential for value diversion through indirect tunneling arises whenever corporate insiders own substantial business assets outside the corporation—something that is more likely among controlling shareholders, especially those of large business groups, than among professional managers. But when professional managers have substantial business assets outside the corporation, indirect tunneling can take place at widely held companies as well.

Coffee, *supra* note [__], at 2154-2171 (discussing specific norms and governance practices that facilitate investment in controlled companies, and, in particular, the expectation of being treated "fairly," and noting that those norms differ across jurisdictions).

[117] On the impact on ownership structure on the practice of trading favors with government officials, see J. P. H. Fan & T. J. Wong, *Corporate Ownership Structure and the Informativeness of Accounting Earnings in East Asia*, 33 J. Acct. & Econ. 401, 408-409 (2002). *Cf.* Gilson, *Controlling Family Shareholders in Developing Countries*, *supra* note [__], at 648 (showing that family ownership can improve a corporation's capacity to act as a reputation bearer in the product market).

[118] Morck & Yeung, *Family Control and the Rent-Seeking Society*, *supra* note [__], at 400-4; Mara Faccio, *Politically Connected Firms*, *supra* note [__], at 383 (finding that politically connected firms are relatively widespread in countries that are perceived as being highly corrupt).

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When the CEO of a corporation with widely distributed shareholders has other outside businesses, she can divert value without formally engaging in self-dealing transactions. The CEO can usurp business opportunities, and third parties can provide services to her privately owned business at a below-market rate with the hope that she will later reciprocate by having the public company transact with them on favorable terms. As long as the CEO does not control other significant businesses, this value diversion activity is likely to be on a relatively small scale (especially when compared to that engaged in by families that control many other publicly traded companies). Yet policy makers and institutional investors should consider this risk and the proper way to address it.

Consider, for example, the case of Chesapeake Energy Corp., one of the biggest oil and gas companies in the United States. Chesapeake granted its former CEO the right to participate and invest (up to 2.5%), as a working-interest owner, in new oil and gas wells drilled by the company. The grant was formally approved by Chesapeake's shareholders, and the CEO became a co-investor in nearly every one of the thousands of oil and gas wells that Chesapeake drilled since the grant.[119]

On April 18, 2012, a Reuters report revealed that the CEO borrowed as much as $1.1 billion over the three preceding years, which were secured by his 2.5% stake in thousands of company wells. He used the loans to fund the operating costs for his investments in the wells.[120] The report further revealed that some of the $1.1 billion in loans came from investment firms that did business with Chesapeake.[121] In particular, the CEO's biggest lender, EIG Global

[119] *See* Chesapeake Energy Corp., Proxy Statement (Form DEF 14A) 20-21 (May 3, 2013). Https://www.sec.gov/Archives/edgar/data/895126/000130817913000264/lchesapeake2013_def14a.htm. The CEO made these investments under a plan that did not allow him to select the wells in which to invest.

[120] Anna Driver and Brian Grow, *Special Report: Chesapeake CEO Took $1.1 Billion in Shrouded Personal Loans*, Reuters (Apr. 18, 2012), available at http://www.reuters.com/article/2012/04/18/us-chesapeake-mcclendon-loans-idUSBRE83H0GA20120418.

[121] Even veteran analysts of the company were not aware of the loans until the Reuters' article. See Anna Driver and Brian Grow, *Special Report:*

Energy Partners, was a major investor in two units of Chesapeake.[122] In 2011–12, Chesapeake raised $2.5 billion from a group of investors, including EIG, through the sale of "perpetual preferred shares" in newly formed subsidiaries of Chesapeake.[123] The sale, according to analysts, offers lucrative terms to EIG investors, paying an annual dividend of 7% and royalty interests from oil and gas wells.[124] As we explained in Part III, transactions of this type raise the concern that Chesapeake's own financing terms were influenced by its CEO's personal borrowing. More generally, our analysis implies that there would be concern even if he did not enter any related-party transaction because his ownership of other business assets may have distorted his sense of discretion.

To summarize, although there are good reasons to expect indirect tunneling to be more substantial for companies with controlling shareholders, one cannot eliminate the concern that management of widely held firms would engage in it as well. However, assessing the extent to which this might be a pervasive concern at such firms requires more evidence—for example, on the extent to which CEOs have significant holdings in companies operating in related industries.

At any rate, our analysis indicates that public officials, boards, and institutional investors should pay attention to the concern of indirect tunneling even at widely held companies. For example, boards of directors should consider requiring newly appointed CEOs to disclose the nature of their material outside businesses and then set

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Chesapeake CEO Took $1.1 Billion in Shrouded Personal Loans, Reuters (Apr. 18, 2012), available at http://www.reuters.com/article/2012/04/18/us-chesapeake-mcclendon-loans-idUSBRE83H0GA20120418.

[122] *Id.* According to the Reuters report, in January 2012, the CEO borrowed $500 million from a unit of EIG Global Energy Partners, a private equity firm.

[123] Id.

[124] *Id.* (quoting an analyst explaining that dividends on preferred shares is a form of more expensive debt, as the holders of the preferred shares are paid before regular dividends owed to common shareholders).

policies to address the risk of value diversion through indirect tunneling.

Likewise, the SEC may ask for disclosure on the scale and nature of material assets held by (controlling shareholders and) CEOs, especially if these assets are in industries that are related to those of the company.

and explains that indirect tunneling is inevitable, that is, as long as controlling shareholders have more than one business under their control, lawmakers cannot eliminate indirect tunneling by modifying the rules against self-dealing or bolstering their enforcement.