the common element that investors do not get any control rights in exchange for their funds, only the hope that they will make money in the future.

Reputation-building is a very common explanation for why people deliver on their agreements even if they cannot be forced to (see, for example, Kreps (1990)). In the financing context, the argument is that managers repay investors because they want to come to the capital market and raise funds in the future, and hence need to establish a reputation as good risks in order to convince future investors to give them money. This argument has been made initially in the context of sovereign borrowing, where legal enforcement of contracts is virtually nonexistent (Eaton and Gersovitz (1981), Bulow and Rogoff (1989)). However, several recent articles have presented reputation-building models of private financing. Diamond (1989, 1991) shows how firms establish reputations as good borrowers by repaying their short term loans, and Gomes (1996) shows how dividend payments create reputations that enable firms to raise equity.

There surely is much truth to the reputation models, although they do have problems. As pointed out by Bulow and Rogoff (1989), pure reputational stories run into a backward recursion problem. Suppose that at some point in the future (or in some future states of the world), the future benefits to the manager of being able to raise outside funds are lower than the costs of paying what he promised investors already. In this case, he rationally defaults on his repayments. Of course, if investors expect that such a time or state is reached in the future, they would not finance the firm in the first place. Under some plausible circumstances discussed by Bulow and Rogoff, the problem unravels and there is no possibility of external finance. While reputation is surely an important reason why firms are able to raise money, the available research suggests that it is probably not the whole explanation for external financing. For example, in Diamond's (1989) model of corporate borrowing, reputation plays a role alongside other protections of creditors that prevent managers from removing assets from the firm.

An alternative theory of how investors give their money to companies without receiving control rights in exchange appeals to excessive investor optimism. Investors get excited about companies, and hence finance them without thinking much about getting their money back, simply counting on short run share appreciation. An extreme version of this story is a Ponzi scheme, in which promoters raise external funds sequentially, and use the funds raised from later investors to pay off initial investors, thereby creating an illusion of high returns. Even without Ponzi schemes, if investors are sufficiently optimistic about short term capital gains and are prepared to part with their money without regard for how the firm will ultimately pay investors back, then external finance can be sustained without effective governance. DeLong, Shleifer, Summers, and Waldmann (1989, 1990) provide early models of external finance based on excessive investor optimism.

Pyramid schemes have been an essential element of all major financial markets, going back at least to the Louisiana and the South Sea Bubbles (Kindleberger (1978)). Most railroad booms in the world were financed by
investors who had virtually no protection, only hope. In the United States, such schemes were very common as recently as the 1920s (Galbraith (1955)), and still happen occasionally today. They also occur in many transition economies, as Russia's famous pyramid scheme, MMM, in which millions of people subscribed to shares of a company that used the proceeds to advertise on television while running a Ponzi scheme, vividly illustrates. Nor is it crazy to assume that enormous volumes of equity financing in the rapidly growing East Asian economies are based in part on investor optimism about near-term appreciation, and overlook the weakness of mechanisms that can force managers to repay investors.

In recent years, more systematic statistical evidence has pointed to the importance of investor optimism for financing in at least some markets. Kaplan and Stein (1993), for example, present evidence suggesting that the high yield bonds that were used to finance takeovers in the United States in the late 1980s were systematically overvalued by investors. Evidence from both the United States and other countries also indicates that the shares of companies issuing equity in initial or secondary offerings are systematically overvalued (Ritter (1991), Loughran, Ritter, and Rydqvist (1994), Pagano, Panetta, and Zingales (1995), Teoh, Welch, and Wong (1995)). This evidence points to concentration of new issues during times when stock prices are high, to poor long run performance of initial public offerings, to earnings manipulation prior to the issue, and to deterioration of profitability following the issue. In short, excessive investor optimism as an explanation of security issues appears to have at least some explanatory power.

Still, we do not believe that investors as a general rule are prepared to pay good money for securities that are actually worthless because managers can steal everything. As the evidence on agency theory indicates, managers can expropriate only limited wealth, and therefore the securities that investors buy do have some underlying value. To explain why these securities have value, we need theories that go beyond investor overoptimism.

III. Legal Protection

The principal reason that investors provide external financing to firms is that they receive control rights in exchange. External financing is a contract between the firm as a legal entity and the financiers, which gives the financiers certain rights vis a vis the assets of the firm (Hart (1995), part II). If firm managers violate the terms of the contract, then the financiers have the right to appeal to the courts to enforce their rights. Much of the difference in corporate governance systems around the world stems from the differences in the nature of legal obligations that managers have to the financiers, as well as in the differences in how courts interpret and enforce these obligations.

The most important legal right shareholders have is the right to vote on important corporate matters, such as mergers and liquidations, as well as in elections of boards of directors, which in turn have certain rights vis a vis the management (Manne (1965), Easterbrook and Fischel (1983)). (We discuss
voting rights as the essential characteristic of equity in Section VI.) Voting rights, however, turn out to be expensive to exercise and to enforce. In many countries, shareholders cannot vote by mail and actually have to show up at the shareholder meeting to vote—a requirement that virtually guarantees nonvoting by small investors. In developed countries, courts can be relied on to ensure that voting takes place, but even there managers often interfere in the voting process, and try to jawbone shareholders into supporting them, conceal information from their opponents, and so on (Pound (1988), Grundfest (1990)). In countries with weaker legal systems, shareholder voting rights are violated more flagrantly. Russian managers sometimes threaten employee-shareholders with layoffs unless these employees vote with the management, fail to notify shareholders about annual meetings, try to prevent hostile shareholders from voting based on technicalities, and so on. Besides, as Stalin noted, “it is important not how people vote, but who counts the votes,” and managers count shareholders’ votes. Still, even in Russia, courts have protected a large shareholder when a firm’s management erased his name from the register of shareholders. In sum, both the legal extent and the court protection of shareholder voting rights differ greatly across countries.

Even if shareholders elect the board, directors need not necessarily represent their interests. The structure of corporate boards varies greatly even across developed economies, ranging from two-tier supervisory and management boards in Germany, to insider-dominated boards in Japan, to mixed boards in the United States (Charkham (1994)). The question of board effectiveness in any of these countries has proved to be controversial. The available systematic evidence is mixed. In the United States, boards, especially those dominated by outside directors, sometimes remove top managers after poor performance (Weisbach (1988)). However, a true performance disaster is required before boards actually act (Warner, Watts, and Wruck (1988)). The evidence on Japan and Germany (Kaplan (1994a,b)) similarly indicates that boards are quite passive except in extreme circumstances. Mace (1971) and Jensen (1993) argue very strongly that, as a general rule, corporate boards in the United States are captured by the management.

In many countries, shareholder voting rights are supplemented by an affirmative duty of loyalty of the managers to shareholders. Loosely speaking, managers have a duty to act in shareholders’ interest. Although the appropriateness of this duty is often challenged by those who believe that managers also ought to have a duty of loyalty to employees, communities, creditors, the state, and so on (see the articles in Hopf and Teubner, Eds. (1985)), the courts in Organization for Economic Cooperation and Development (OECD) countries have generally accepted the idea of managers’ duty of loyalty to shareholders. There is a good reason for this. The investments by shareholders are largely sunk, and further investment in the firm is generally not needed from them. This is much less the case with employees, community members, and even creditors. The employees, for example, get paid almost immediately for their efforts, and are generally in a much better position to hold up the firm by threatening to quit than the shareholders are. Because their investment is
sunk, shareholders have fewer protections from expropriation than the other stakeholders do. To induce them to invest in the first place, they need stronger protections, such as the duty of loyalty.

Perhaps the most commonly accepted element of the duty of loyalty are the legal restrictions on managerial self-dealing, such as outright theft from the firm, excessive compensation, or issues of additional securities (such as equity) to the management and its relatives. In some cases, the law explicitly prohibits self-dealing; in other cases, courts enforce corporate charters that prohibit it (see Easterbrook and Fischel (1991)). Some legal restrictions on managers constrain their actions, by for example demanding that managers consult the board of directors before making major decisions, or giving shareholders appraisal remedies to stop asset sales at low prices. Other restrictions specify that minority shareholders be treated as well as the insiders (Holderness and Sheehan (1988a)).

Although the duty of loyalty is accepted in principle in most OECD countries, the strictness with which the courts enforce it varies greatly. In the United States, courts would interfere in cases of management theft and asset diversion, and they would surely interfere if managers diluted existing shareholders through an issue of equity to themselves. Courts are less likely to interfere in cases of excessive pay, especially if it takes the complex form of option contracts, and are very unlikely to second guess managers' business decisions, including the decisions that hurt shareholders. Perhaps most importantly, shareholders in the United States have the right to sue the corporation, often using class action suits that get around the free rider problem, if they believe that the managers have violated the duty of loyalty.

The United States is generally viewed as relatively tough on managers in interpreting the duty of loyalty, although some, including Bebchuk (1985) and Brudney and Chirelstein (1978), believe it is not tough enough. For example, in France the doctrine of corporate opportunities, which prohibits managers from personally profiting from business opportunities that are offered to the corporation, is not accepted by courts (Tunc (1991)). Outside the United States and Canada, class action suits are not generally permitted and contingent fees are prohibited (Romano (1993a)). Outside the OECD, the duty of loyalty is a much weaker concept, at least in part because courts have no capability or desire to interfere in business.

Like shareholders, creditors have a variety of legal protections, which also vary across countries. (Again, we say more about this in the discussion of debt and bankruptcy in Section VI.) These may include the right to grab assets that serve as collateral for the loans, the right to liquidate the company when it does not pay its debts, the right to vote in the decision to reorganize the company, and the right to remove managers in reorganization. Legal protection of creditors is often more effective than that of the shareholders, since default is a reasonably straightforward violation of a debt contract that a court can verify. On the other hand, when the bankruptcy procedure gives companies the right of automatic stay of the creditors, managers can keep creditors at bay even after having defaulted. Repossessing assets in bankruptcy is often
very hard even for the secured creditors (White (1993)). With multiple, diverse creditors who have conflicting interests, the difficulties of collecting are even greater, and bankruptcy proceedings often take years to complete (Baird and Jackson (1985), Gertner and Scharfstein (1991), Weiss (1990)). This, of course, makes debt a less attractive financing instrument to begin with (Bolton and Scharfstein (1996)). Still, while costly to the creditors, bankruptcy is very tough on the debtor firms as well, since their managers typically get fired, assets liquidated, and debt kept largely in place (Baird (1995)). Creditors' legal rights are thus enforced in a costly and inefficient way, but they are enforced.

Because bankruptcy procedures are so complicated, creditors often renegotiate outside of formal bankruptcy proceedings both in the United States (Gilson, John, and Lang (1990), Asquith, Gertner, and Scharfstein (1994)) and in Europe (OECD (1995)). The situation is worse in developing countries, where courts are even less reliable and bankruptcy laws are even less complete. The inefficiency of existing bankruptcy procedures has prompted some economists (Bebchuk (1988), Aghion, Hart, and Moore (1992)) to propose new ones, which try to avoid complicated negotiations by first converting all the claims of a bankrupt company into equity, and then allowing the equity holders to decide what to do with the bankrupt firm. It is possible that in the long run, these proposals will reduce the cost of enforcing creditor rights.

In sum, the extent of legal protection of investors varies enormously around the world. In some countries, such as the United States, Japan, and Germany, the law protects the rights of at least some investors and the courts are relatively willing to enforce these laws. But even in these countries, the legal system leaves managers with considerable discretion. In most of the rest of the world, the laws are less protective of investors and courts function less well and stop only the clearest violations of investor rights. As a result, legal protection alone becomes insufficient to ensure that investors get their money back.

IV. Large Investors

If legal protection does not give enough control rights to small investors to induce them to part with their money, then perhaps investors can get more effective control rights by being large. When control rights are concentrated in the hands of a small number of investors with a collectively large cash flow stake, concerted action by investors is much easier than when control rights, such as votes, are split among many of them. In particular, this concerted action is possible with only minimal help from the courts. In effect, concentration of ownership leverages up legal protection. There are several distinct forms that concentration can take, including large shareholders, takeovers, and large creditors. In this section, we discuss these forms of concentrating ownership, and how they address the agency problem. In the following section, we discuss some costs of having large investors.
A. Large Shareholders

The most direct way to align cash flow and control rights of outside investors is to concentrate share holdings. This can mean that one or several investors in the firm have substantial minority ownership stakes, such as 10 or 20 percent. A substantial minority shareholder has the incentive to collect information and monitor the management, thereby avoiding the traditional free rider problem. He also has enough voting control to put pressure on the management in some cases, or perhaps even to oust the management through a proxy fight or a takeover (Shleifer and Vishny (1986b)). In the more extreme cases, large shareholders have outright control of the firms and their management with 51 or more percent ownership. Large shareholders thus address the agency problem in that they both have a general interest in profit maximization, and enough control over the assets of the firm to have their interests respected.

In the United States, large share holdings, and especially majority ownership, are relatively uncommon—probably because of legal restrictions on high ownership and exercise of control by banks, mutual funds, insurance companies, and other institutions (Roe (1994)). Even in the United States, however, ownership is not completely dispersed, and concentrated holdings by families and wealthy investors are more common than is often believed (Eisenberg (1976), Demsetz (1983), Shleifer and Vishny (1986b)). Holderness and Sheehan (1988a,b) in fact found several hundred cases of over 51 percent shareholders in public firms in the United States. One other country where the rule is broadly dispersed ownership by diversified shareholders is the United Kingdom (Black and Coffee (1994)).

In the rest of the world, large share holdings in some form are the norm. In Germany, large commercial banks through proxy voting arrangements often control over a quarter of the votes in major companies, and also have smaller but significant cash flow stakes as direct shareholders or creditors (Franks and Mayer (1994), OECD (1995)). In addition, one study estimates that about 80 percent of the large German companies have an over 25 percent nonbank large shareholder (Gorton and Schmid (1996)). In smaller German companies, the norm is family control through majority ownership or pyramids, in which the owner controls 51 percent of a company, which in turn controls 51 percent of its subsidiaries and so on (Franks and Mayer (1994)). Pyramids enable the ultimate owners to control the assets with the least amount of capital (Barca (1995)). In Japan, although ownership is not nearly as concentrated as in Germany, large cross-holdings as well as share holdings by major banks are the norm (Prowse (1992), Berglof and Perotti (1994), OECD (1995)). In France, cross-ownership and so-called core investors are common (OECD (1995)). In most of the rest of the world, including most of Europe (e.g., Italy, Finland, and Sweden), as well as Latin America, East Asia, and Africa, corporations typically have controlling owners, who are often founders or their offspring. In
short, heavily concentrated share holdings and a predominance of controlling ownership seems to be the rule around the world.

The evidence on the role of large shareholders in exercising corporate governance is beginning to accumulate. For Germany, Franks and Mayer (1994) find that large shareholders are associated with higher turnover of directors. Gorton and Schmid (1996) show that bank block holders improve the performance of German companies in their 1974 sample, and that both bank and nonbank block holders improve performance in a 1985 sample. For Japan, Kaplan and Minton (1994) and Kang and Shivdasani (1995) show that firms with large shareholders are more likely to replace managers in response to poor performance than firms without them. Yafeh and Yoshia (1996) find that large shareholders reduce discretionary spending, such as advertising, Research & Development (R&D), and entertainment expenses, by Japanese managers. For the United States, Shivdasani (1993) shows that large outside shareholders increase the likelihood that a firm is taken over, whereas Denis and Serrano (1996) show that, if a takeover is defeated, management turnover is higher in poorly performing firms that have block holders. All these findings support the view that large shareholders play an active role in corporate governance (Shleifer and Vishny (1986b)).

Because large shareholders govern by exercising their voting rights, their power depends on the degree of legal protection of their votes. Majority ownership only works if the voting mechanism works, and the majority owner can dictate the decisions of the company. This may require fairly little enforcement by courts, since 51 percent ownership is relatively easy to prove, and a vote count is not required once the majority shareholder expresses his preferences. With large minority shareholders, matters are more complicated, since they need to make alliances with other investors to exercise control. The power of the managers to interfere in these alliances is greatly enhanced, and the burden on courts to protect large shareholder rights is much greater. For this reason, large minority share holdings may be effective only in countries with relatively sophisticated legal systems, whereas countries where courts are really weak are more likely to have outright majority ownership.

Again, the most vivid example comes from Russia. As one Russian investment banker has pointed out, a Western investor can control a Russian company with 75 percent ownership, whereas a Russian investor can do so with only 25 percent ownership. This comment is easy to understand once it is recognized that the management can use a variety of techniques against foreign investors, including declaring some of their shares illegal, requiring super majorities to bring issues on the agenda of shareholder meetings, losing voting records, and so on. While managers can apply these techniques against domestic investors as well, the latter have more mechanisms of their own to protect their power, including better access to other shareholders, to courts, as well as in some cases to physical force. The effectiveness of large shareholders, then, is intimately tied to their ability to defend their rights.
B. Takeovers

In Britain and the United States, two of the countries where large shareholders are less common, a particular mechanism for consolidating ownership has emerged, namely the hostile takeover (Jensen and Ruback (1983), Franks and Mayer (1990)). In a typical hostile takeover, a bidder makes a tender offer to the dispersed shareholders of the target firm, and if they accept this offer, acquires control of the target firm and so can replace, or at least control, the management. Takeovers can thus be viewed as rapid-fire mechanisms for ownership concentration.

A great deal of theory and evidence supports the idea that takeovers address governance problems (Manne (1965), Jensen (1988), Scharfstein (1988)). The most important point is that takeovers typically increase the combined value of the target and acquiring firm, indicating that profits are expected to increase afterwards (Jensen and Ruback (1983)). Moreover, takeover targets are often poorly performing firms (Palepu (1985), Morck, Shleifer, and Vishny (1988a, 1989)), and their managers are removed once the takeover succeeds (Martin and McConnell (1991)). Jensen (1986, 1988) argues that takeovers can solve the free cash flow problem, since they usually lead to distribution of the firm's profits to investors over time. Takeovers are widely interpreted as the critical corporate governance mechanism in the United States, without which managerial discretion cannot be effectively controlled (Easterbrook and Fischel (1991), Jensen (1993)).

There remain some questions about the effectiveness of takeovers as a corporate governance mechanism. First, takeovers are sufficiently expensive that only major performance failures are likely to be addressed. It is not just the cost of mounting a takeover that makes them expensive. As Grossman and Hart (1980) point out, the bidder in takeovers may have to pay the expected increase in profits under his management to target firm's shareholders, for otherwise they will not tender and simply hold on to their shares, which automatically become more valuable if the takeover succeeds. If minority rights are not fully protected, then the bidder can get a slightly better deal for himself than the target shareholders get, but still he may have to surrender much of the gains resulting from his acquisition of control.

Second, acquisitions can actually increase agency costs when bidding managements overpay for acquisitions that bring them private benefits of control (Shleifer and Vishny (1988)). A fluid takeover market might enable managers to expand their empires more easily, and not just stop excessive expansion of empires. Jensen (1993) shows that disciplinary hostile takeovers were only a small fraction of takeover activity in the 1980s in the United States.

Third, takeovers require a liquid capital market, which gives bidders access to vast amounts of capital on short notice. In the 1980s in the United States, the firm of Drexel, Burnham, Lambert created such a market through junk bond financing. The collapse of this firm may have contributed to the end of that takeover wave.
Last but not least, hostile takeovers are politically an extremely vulnerable mechanism, since they are opposed by the managerial lobbies. In the United States, this political pressure, which manifested itself through state anti-takeover legislation, contributed to ending the 1980s takeovers (Jensen (1993)). In other countries, the political opposition to hostile takeovers in part explains their general nonexistence in the first place. The takeover solution practiced in the United States and the United Kingdom, then, is a very imperfect and politically vulnerable method of concentrating ownership.

C. Large Creditors

Significant creditors, such as banks, are also large and potentially active investors. Like the large shareholders, they have large investments in the firm, and want to see the returns on their investments materialize. Their power comes in part because of a variety of control rights they receive when firms default or violate debt covenants (Smith and Warner (1979)) and in part because they typically lend short term, so borrowers have to come back at regular, short intervals for more funds. As a result of having a whole range of controls, large creditors combine substantial cash flow rights with the ability to interfere in the major decisions of the firm. Moreover, in many countries, banks end up holding equity as well as debt of the firms they invest in, or alternatively vote the equity of other investors (OECD (1995)). As a result, banks and other large creditors are in many ways similar to the large shareholders. Diamond (1984) presents one of the first models of monitoring by the large creditors.

Although there has been a great deal of theoretical discussion of governance by large creditors, the empirical evidence of their role remains scarce. For Japan, Kaplan and Minton (1994) and Kang and Shivdasani (1995) document the higher incidence of management turnover in response to poor performance in companies that have a principal banking relationship relative to companies that do not. For Germany, Gorton and Schmid (1996) find evidence of banks improving company performance (to the extent they hold equity) more so than other block holders do in 1974, although this is not so in 1985. For the United States, DeLong (1991) points to a significant governance role played by J. P. Morgan partners in the companies J. P. Morgan invested in in the early 20th century. More recently, U.S. banks play a major governance role in bankruptcies, when they change managers and directors (Gilson 1990).

The effectiveness of large creditors, like the effectiveness of large shareholders, depends on the legal rights they have. In Germany and Japan, the powers of the banks vis a vis companies are very significant because banks vote significant blocks of shares, sit on boards of directors, play a dominant role in lending, and operate in a legal environment favorable to creditors. In other countries, especially where procedures for turning control over to the banks are not well established, bank governance is likely to be less effective (see Barca (1995) on Italy).
The need for at least some legal protection is shared by all large investors. Large shareholders need courts to enforce their voting rights, takeover artists need court-protected mechanisms for buying shares and changing boards of directors, and creditors need courts to enable them to repossess collateral. The principal advantage of large investors (except in takeovers) is that they rely on relatively simple legal interventions, which are suitable for even poorly informed and motivated courts. Large investors put a lighter burden on the legal system than the small investors might if they tried to enforce their rights. For this reason, perhaps, large investors are so prevalent in most countries in the world, where courts are less equipped to meddle in corporate affairs than they are in the United States.

V. The Costs of Large Investors

The benefits of large investors are at least theoretically clear: they have both the interest in getting their money back and the power to demand it. But there may be costs of large investors as well. The most obvious of these costs, which is also the usual argument for the benefits of dispersed ownership, is that large investors are not diversified, and hence bear excessive risk (see, e.g., Demsetz and Lehn (1985)). However, the fact that ownership in companies is so concentrated almost everywhere in the world suggests that lack of diversification is not as great a private cost for large investors to bear as relinquishing control.

A more fundamental problem is that the large investors represent their own interests, which need not coincide with the interests of other investors in the firm, or with the interests of employees and managers. In the process of using his control rights to maximize his own welfare, the large investor can therefore redistribute wealth—in both efficient and inefficient ways—from others. This cost of concentrated ownership becomes particularly important when others—such as employees or minority investors—have their own firm-specific investments to make, which are distorted because of possible expropriation by the large investors. Using this general framework, we discuss several potential costs of having large investors: straightforward expropriation of other investors, managers, and employees; inefficient expropriation through pursuit of personal (nonprofit-maximizing) objectives; and finally the incentive effects of expropriation on the other stakeholders.

To begin, large investors might try to treat themselves preferentially at the expense of other investors and employees. Their ability to do so is especially great if their control rights are significantly in excess of their cash flow rights. This happens if they own equity with superior voting rights or if they control the firm through a pyramid structure, i.e., if there is a substantial departure from one-share-one-vote (Grossman and Hart (1988), Harris and Raviv (1988)). In this case, large investors have not only a strong preference, but also the ability not to pay out cash flows as pro-rata distributions to all investors, but rather to pay themselves only. They can do so by paying themselves special dividends or by exploiting other business relationships with the companies.
they control. Greenmail and targeted share repurchases are examples of special deals for large investors (Dann and DeAngelo 1983).

A small number of papers focus on measuring the degree of expropriation of minority shareholders. The very fact that shares with superior voting rights trade at a large premium is evidence of significant private benefits of control that may come at the expense of minority shareholders. Interestingly, the two countries where the voting premium is the lowest—Sweden and the United States—are the two countries for which the studies of expropriation of minorities have been made. Not surprisingly, Bergström and Rydqvist (1990) for Sweden and Barclay and Holderness (1989, 1992) for the United States do not find evidence of substantial expropriation. In contrast, the casual evidence provided by Zingales (1994) suggests that the expropriation problem is larger in Italy, consistent with a much larger voting premium he finds for that country.

Some related evidence on the benefits of control and potential expropriation of minority shareholders comes from the studies of ownership structure and performance. Although Demsetz (1983) and Demsetz and Lehn (1985) argue that there should be no relationship between ownership structure of a firm and its performance, the evidence has not borne out their view. Morck, Shleifer, and Vishny (1988b) present evidence on the relationship between cash flow ownership of the largest shareholders and profitability of firms, as measured by their Tobin's Qs. Morck et al. find that profitability rises in the range of ownership between 0 and 5 percent, and falls afterwards. One interpretation of this finding is that, consistent with the role of incentives in reducing agency costs, performance improves with higher manager and large shareholder ownership at first. However, as ownership gets beyond a certain point, the large owners gain nearly full control and are wealthy enough to prefer to use firms to generate private benefits of control that are not shared by minority shareholders. Thus there are costs associated with high ownership and entrenchment, as well as with exceptionally dispersed ownership. Stulz (1988) presents a formal model of the roof-shaped relationship between ownership and performance, which has also been corroborated by subsequent empirical work (McConnell and Servaes (1990), Wruck (1989)).

It has also been argued that German and Japanese banks earn rents from their control over industrial firms, and therefore effectively benefit themselves at the expense of other investors. Rajan (1992) presents a theoretical model explaining how banks can extract rents from investors by using their informational advantage. Weinstein and Yafeh (1994) find that, controlling for other factors, Japanese firms with main banks pay higher average interest rates on their liabilities than do unaffiliated firms. Their evidence is consistent with rent-extraction by the main banks. Even more telling is the finding of Hoshi, Kashyap, and Scharfstein (1993) that, when regulatory change enabled Japanese firms to borrow in public capital markets and not just from the banks, high net worth firms jumped at the opportunity. This evidence suggests that, for these firms, the costs of bank finance exceeded its benefits. Franks and Mayer (1994) present a few cases of German banks resisting takeovers of
their customer companies, either because they were captured by the management or because they feared losing profits from the banking relationship. On the other hand, Gorton and Schmid (1996) find no evidence of rent extraction by the German banks.

The problem of expropriation by large investors becomes potentially more significant when other investors are of a different type, i.e., have a different pattern of cash flow claims in the company. For example, if the large investor is an equity holder, he may have an incentive to force the firm to take on too much risk, since he shares in the upside while the other investors, who might be creditors, bear all the costs of failure (Jensen and Meckling (1976)). Alternatively, if the large investor is a creditor, he might cause the company to forgo good investment projects because he bears some of the cost, while the benefits accrue to the shareholders (Myers (1977)). Finally, large investors might have a greater incentive to redistribute rents from the employees to themselves than the managers do (Shleifer and Summers (1988)).

The available evidence of redistributions between different types of claim holders in the firm comes largely from corporate control transactions. Several studies, for example, ask whether shareholders expropriate bondholders in leveraged buy outs or leveraged recapitalizations. Typically, these redistributions are relatively small (Asquith and Wizman (1990)). Another group of studies ask whether takeovers lead to large redistributions of wealth from the employees in the form of wage reductions, layoffs, and pension cutbacks. Again, these redistributions typically do not appear to be large (Bhagat et al. (1990), Rosett (1990), Pontiff et al. (1990)). Of course, the significant protection of investors and employees in the United States may give an unrepresentative picture of expropriation in other countries.

Expropriation by large investors can be detrimental to efficiency through adverse effects on the incentives of managers and employees, who might reduce their firm-specific human capital investments when they are closely monitored by financiers or may be easily dismissed with the consequent loss of rents. Schmidt (1996) and Cremer (1995) make the general point of how a principal's high powered incentives can reduce an agent's effort. In the case of large shareholders, a similar point is made by Burkart, Grom, and Panunzi (1997), in the case of takeovers by Shleifer and Summers (1988), and in the case of banks by Rajan (1992). In all these examples, the idea is that a large investor cannot commit himself not to extract rents from the manager ex post, and this adversely affects ex ante managerial and employee incentives.

When the targets of expropriation by large investors are other investors, the adverse incentive effect of such expropriation is the decline of external finance. Many countries, for example, do not do much to protect minority investor rights, yet have large investors in the form of families or banks. While this governance structure may control managers, it leaves potential minority investors unprotected and hence unwilling to invest. Perhaps for this reason, countries in Continental Europe, such is Italy, Germany, and France, have relatively small public equity markets. In this regard, the existence of a large equity market in Japan despite the weak protection of minority investors is