Hidden Government Influence over Privatized Banks

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In this Article we examine Israel's ongoing process of bank privatization to explore the link between privatization programs and the ownership structure of public companies. Our thesis is that concentrated ownership provides regulators with a platform for exerting informal influence over corporate decision-making. This platform serves regulators as a safety valve when all else fails, especially when they would like firms to terminate senior executives or board members. Communicating with controlling shareholders increases the likelihood that both the regulatory intervention and the reasons underlying it will remain confidential. Moreover, controlling shareholders can make swift decisions and implement them quickly, with no need for formal group deliberation. When informal influence is important — as in the case of banks — the government may prefer firms with controlling shareholders to widely held firms. It may therefore prefer to sell a control block in the firm undergoing privatization rather than distribute its shares through the stock market.

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Introduction

The 2008 global crisis that began with the collapse of the mortgage-backed securities market has forced governments around the world to become dominant shareholders or debt holders of many financial institutions, mostly banks. The government's new role, in turn, has sparked academic interest in the corporate governance implications of this new landscape.[1]

In this Article, however, we focus on the government's *exit* from such investments. In 1983, the Israeli government responded to a severe banking crisis by nationalizing the country's largest banks. We use the ongoing process of reprivatizing these banks to explore the link between privatization programs and ownership patterns of publicly traded firms. Our thesis is that concentrated ownership provides the government with a platform for exerting informal influence over corporate decision-making. When informal influence is important — in the case of banks, for example — the government may prefer firms with dominant shareholders to widely held firms.[2] It may therefore prefer to privatize through the sale of a control block rather than by distributing shares widely through the stock market.

Studies have shown that governments prefer to privatize firms in a manner that allows the government to retain *formal* influence over the privatized firm, typically by keeping voting stock in the government's hands.[3] We claim that the presence of a controlling shareholder provides the government with a supplementary channel for exerting *informal* influence over privatized firms.

Our claim consists of two elements. First, although regulators have a variety of legal measures at their disposal to influence firms' conduct, formal

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1 *See, e.g.*, Marcel Kahan & Edward B. Rock, *When the Government Is the Controlling Shareholder*, 89 Tex. L. Rev. 1293 (2011); Marcel Kahan & Edward B. Rock, *When the Government Is the Controlling Shareholder: Implications for Delaware*, 35 Del. J. Corp. L. 409 (2010).

2 We do not have in mind control in the sense of politicians wishing to influence bank lending decisions, as described, for example, in Serdar Dinc, *Politicians and Banks: Political Influences on Government-Owned Banks in Emerging Markets*, 77 J. Fin. Econ. 453 (2005). Rather, what we have in mind is regulators with a legitimate ground for close monitoring of certain industries wishing to exercise their supervisory power in an informal manner.

3 In many cases, the government retains veto power, *see* Bernardo Bortolotti & Mara Faccio, *Government Control of Privatized Firms*, 22 Rev. Fin. Stud. 2907 (2009); Steven Jones et al., *Share Issue Privatizations as Financial Means to Political and Economic Ends*, 53 J. Fin. Econ. 217, 219, 221 (1999); Nemat Shafik, *Selling Privatization Politically*, 31 Colum. J. World Bus. 20, 27-28 (1996).

intervention is often more costly than the informal variety. The reason is that informal intervention does not require regulators to comply with procedural requirements and meet burdensome evidentiary standards, making intervention cheaper, faster, and potentially quieter. Second, it is often easier to exercise informal influence over a controlling shareholder than over managers or directors of a widely held firm, for two reasons: (1) a controlling shareholder has no legal obligation to disclose discussions with regulators and is less prone than a group of directors to information leaks; and (2) a controlling shareholder can act quickly, with no need to hold meetings, discussions, or other group deliberation processes.

We are not claiming that regulators exercise informal influence over controlling shareholders on an ongoing basis. They do not need to. Bank supervisors, for example, can use their statutory powers either to regulate bank actions directly or to exert informal influence over banks' management. However, controlling shareholders can serve the government as a last resort when other means prove ineffective or costly, especially when the government seeks key personnel changes at the bank or when the bank's management is unresponsive to the government's demands.

Our analysis provides new insights into the link between privatization techniques and government regulation. Economists have studied in depth the privatization phenomenon in general and bank privatizations in particular.[4] One question that arises in any privatization scheme is whether the government should sell its shares through the stock market (the "share issue" method) or by auctioning a control block (the "asset sale" method).[5] This Article argues that the government's desire to retain influence over privatized firms is a reason for favoring asset sale privatizations.

Our study also sheds light on the factors that may affect the evolution of ownership patterns around the world. Starting in the late 1990s, empirical studies have shown that public companies' ownership structure varies considerably across countries.[6] These findings have sparked research trying to explain this variability.[7] We show that government officials may play an

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4 *See, e.g.*, William L. Megginson, *The Economics of Bank Privatization*, 29 J. Banking & Fin. 1931 (2005).

5 *See* William L. Megginson et al., *The Choice of Private Versus Public Capital Markets: Evidence from Privatizations*, 59 J. Fin. 2835 (2004).

6 *See* Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. Fin. 471 (1999).

7 *See, e.g.*, A History of Corporate Governance Around the World (Randall K. Morck ed., 2005); John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Role of Law and the State in the Separation of Ownership and Control*, 111 Yale L.J. 1 (2001).

active role in preserving existing ownership patterns. In the case of Israel, bank regulators' preference for dealing with controlling shareholders has considerably impacted the bank privatization program and the ultimate ownership structure of Israel's banking industry. The account we offer may not necessarily explain bank privatizations or the evolution of ownership structures in other countries. Our insights draw primarily on the experience in Israel, and differences in culture, regulatory environment, or legal landscape clearly can matter. Nevertheless, our analysis is consistent with the fact that many banks around the world have controlling shareholders.[8]

The analysis proceeds as follows. Part I provides background on the two principal methods of privatization — sale of a control block and stock distribution — and ownership structures around the world. Part II offers a brief overview of Israel's slow process of bank privatization and its policy of ensuring that dominant shareholders control privatized banks. Part III explains how the government can use controlling shareholders as a channel for exerting informal influence over corporate decision-making, and discusses several recent examples. Part IV considers alternative explanations for the Israeli government's preference for structuring bank privatizations as private sales of control.

I. Privatization Methods and Ownership Structure

Governments may privatize state-owned firms for a variety of reasons.[9] Some privatization programs are motivated by a decision to reduce state

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8 *See* Gerard Caprio et al., *Governance and Bank Valuation*, 16 J. Fin. Intermediation 584 (2007). *But see* Mara Faccio & Harry H.P. Lang, *The Ultimate Ownership of Western European Corporations*, 65 J. Fin. Econ. 365 (2002) (finding that financial firms in Western Europe are more likely to be widely held). Canada, a country with many controlling shareholders, is a notable exception in that its largest banks are widely held. The explanation for this anomaly lies in a 1967 statutory ban on holding more than ten percent of the stock of a large bank, designed to prevent Canadian bank acquisitions by foreign banks, which was only recently relaxed somewhat at the behest of the local banking industry, *see* Eric J. Gouvin, *The Political Economy of Canada's "Widely Held" Rule for Large Banks*, 32 Law & Pol'y Int'l Bus. 391, 399-400 (2001) (describing the history of the rule); Blair W. Keefe & Stéphane J. Fournier, *Canada Adopts Major Revisions to Its Financial Institution Regulation*, 8 Law & Bus. Rev. Am. 237, 245 (2003) (describing the recent modification of the rule).

9 *See generally* Ekkehart Boehmer et al., *Bank Privatization in Developing and Developed Countries, Cross-Sectional Evidence on the Impact of Economic and*

involvement in certain market sectors in order to improve their performance through the removal of political barriers to cost-cutting and other efficiency enhancing measures.[10] These programs often involve the transfer to private hands of industries (such as infrastructure, energy, or telecommunications) that historically have been owned by the state. Privatization programs may also stem from the government's need to raise revenues, typically in order to cover a deficit.[11] Other privatization schemes are designed to provide the government with an exit strategy following past nationalization, especially in the banking sector.[12]

While there are several methods of privatization, we focus on the choice between two: the asset sale technique and the share issue technique. In an asset sale, the state sells a company or a controlling block of stock to an investor or an investor group, typically in an auction. This type of sale can draw both local and foreign investors to the process.[13] Under the share issue technique, the state sells stock on public capital markets primarily to domestic investors.[14] Share issues often take longer to complete because governments tend to divide them into several issues to maximize returns and to avoid flooding the market.[15]

Political Factors, 29 J. Banking & Fin. 1981 (2005); William L. Megginson & Jeffry M. Netter, *From State to Market: A Survey of Empirical Studies on Privatization*, 39 J. Econ. Literature 321 (2001).

10 *See* Megginson, *supra* note 4, at 1936, 1942-43; Isaac Otchere, *Competitive and Value Effects of Bank Privatization in Developed Countries*, 33 J. Banking & Fin. 2373, 2380 (2009).

11 *See, e.g.*, Boehmer et al., *supra* note 9; Maria K. Boutchkova & William L. Megginson, *Privatization and the Rise of Global Capital Markets*, 29 Fin. Mgmt. 31 (2000) ("[G]overnments usually adopt privatization programs primarily to raise revenue, and in order to improve the economic efficiency of former state-owned enterprises"); Megginson, *supra* note 4, at 1945.

12 *See, e.g.*, Mark A. Edwards, *Nationalization, De-Nationalization, Re-Nationalization: Some Historical and Comparative Perspective*, 30 Pace L. Rev. 124 (2009).

13 *See* George Clarke et al., *Bank Privatization in Developing Countries: A Summary of Lessons and Findings*, 29 J. Banking & Fin. 1905, 1916-17 (2005); Megginson, *supra* note 4.

14 A third privatization method is the distribution of stock vouchers to all citizens of voting age. This technique was used during the 1990s by East European countries. Although this technique has been considered by the Israeli government, we do not discuss it because it resembles a share issue for our purposes: Both techniques produce widely held firms.

15 *See* James A. Verbrugge et al., State Ownership and the Financial Performance of Privatized Banks: An Empirical Analysis, Paper Presented at the World Bank/

Most countries use both share issues and asset sales in different privatizations or within privatizations.[16] The specific mix correlates with market structure: Asset sales are common in countries with concentrated ownership, and share issues are common in markets with dispersed ownership.[17] Even in the latter markets, however, share issues are less common than asset sales.[18]

Three considerations in the choice between these privatization techniques are relevant to our discussion. The first consideration is financial market development. Governments can use share issue privatization to develop local financial markets and foster financial development. Underpricing the offering, for example, can promote wider stock ownership by local investors. On the other hand, absorbing large stock issues can be difficult in less developed securities markets, in which buyers have only limited access to financing. This consideration warrants smaller issues and slower privatization.[19]

A second consideration is maximization of revenues from privatization. Sometimes this consideration points in the same direction as the first consideration, that is, the share issue option both fosters financial market development and maximizes revenues. This is the case, for example, in large firm privatizations, where dividing the transaction into several share issues is expected to produce higher revenues.[20] At other times, the two considerations point in opposite directions. This is the case, for example, in small firm privatizations, which are more profitable when conducted as auctions among bidders who pay a premium to acquire control.[21] By contrast,

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Federal Reserve Bank of Dallas Conference on Bank Privatization 1 (June, 1999), *available at* http://faculty-staff.ou.edu/M/William.L.Megginson-1/prvbkpap.pdf.

16 *See* Jones et al., *supra* note 3, at 219, 230, 234; Megginson & Netter, *supra* note 9, at 338-39; William Megginson & Jeffry Netter, *History and Methods of Privatization*, *in* International Handbook on Privatization 25, 36 (David Parker & David S. Saale eds., 2003).

17 *See* Bernardo Bortolottia et al., *Privatization: Politics, Institutions and Financial Markets*, 2 Emerging Markets Rev. 109, 134 (2001); Megginson et al., *supra* note 5, at 2851.

18 *See* Bortolottia et al., *supra* note 17, at 109-10, 134; Megginson et al., *supra* note 5, at 2844.

19 *See* Bortolottia et al., *supra* note 17, at 133-34; Megginson et al., *supra* note 5, at 2839, 2844-45, 2851.

20 *See* Shafik, *supra* note 3, at 25-26.

21 *See* Carliss Baldwin & Sugato Bhattacharya, *Choosing the Method of Sale: A Clinical Study of Conrail*, 30 J. Fin. Econ. 69, 86-87, 90-91 (1991); Francesca Cornelli & David Li, *Large Shareholders, Private Benefits of Control and*

fostering financial market development through share issues often requires the government to offer the shares at a discount.

A third consideration is post-privatization performance. Government officials want privatized firms to perform well because poor performance draws criticism and undermines subsequent privatizations. The need to ensure post-privatization performance is particularly important when financial institutions are privatized given their significant role in the economy. In this regard, each privatization method has a different advantage. On the one hand, share issues are more likely to gain political support because they place shares in the hands of domestic voters. On the other hand, asset sales are more predictable because they enable the government to determine who will run the privatized firm, an important consideration when privatizing a firm of national importance.[22]

A common feature in many privatizations is the retention of *formal* government control, especially in privatized firms of national importance, such as firms in the sectors of finance, telecommunications, energy, or transportation. The OECD governments, for example, have retained formal control of over sixty percent of privatized firms through majority holdings, pyramidal structures, or golden shares.[23] Once in place, however, these channels of control are rarely used, but rather are kept for dealing with extreme circumstances.

II. Privatization in Israel

This Part provides an overview of Israel's privatization program. We begin by describing the two distinct privatization processes that have taken place in Israel over the last two decades: the privatization of traditional state-owned firms, and the privatization of recently nationalized banks. We then outline the main features of the privatization in the banking industry, the focus of our inquiry.

Optimal Schemes of Privatization, 28 RAND J. Econ. 585 (1997); Megginson et al., *supra* note 5, at 2851, 2867-68; Shafik, *supra* note 3, at 24.

22 *See* Megginson et al., *supra* note 5, at 2842, 2858.

23 *See* Boehmer et al., *supra* note 9; Bortolotti & Faccio, *supra* note 3; Jones et al., *supra* note 3, at 220; Megginson & Netter, *supra* note 9; Rafael La Porta et al., *Government Ownership of Banks*, 57 J. Fin. 265 (2002); Shafik, *supra* note 3, at 26-27; Verbrugge et al., *supra* note 15, at 26, 48-50.

A. Two Parallel Privatization Processes

In the last two decades, Israel has implemented an extensive privatization program. The program has consisted of two distinct processes. The first process has been the sale of partial or full ownership in industries that the government had traditionally controlled, including the national airline, the national telephone company, oil refineries, and several defense contractors. This process is yet to be completed. The government currently plans to privatize at least some of the national seaports,[24] and it is still the sole owner of major enterprises such as the national power company, the national water company, and the country's only aircraft parts producer. The entity responsible for this privatization process is the Government Companies Authority.[25]

The second process has been the privatization of Israel's largest banks. Unlike other state-owned enterprises, these banks had been privately owned until 1983, when they came under state control in a government bailout following a severe banking crisis.[26] To avoid concerns of political influence over banking activities, the government held these banks indirectly through a state-owned corporation — M.I. Holdings — designed to be insulated from political pressure. Moreover, the Parliament enacted a statute that established an independent committee for nominating bank directors.[27]

In the early 1990s, the government decided it was time to sell its shares in the nationalized banks. Because the shares were not directly owned by the government, this privatization process was not led by the government Corporations Authority, but rather by the Bank of Israel. As of early 2012, M.I. Holdings has remained the controlling shareholder of the largest bank, Bank Leumi le-Israel (hereinafter Bank Leumi). M.I. Holdings had not been the largest shareholder, but it was the only shareholder with a control permit.

Both of the privatization programs followed a template of selling a control block in the company undergoing privatization to a single investor or investor

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24 *See Privatization of Eilat Port Company Ltd.*, Government Companies Authority, http://www.gca.gov.il/gcaeng/privatizations/namaleilat (Isr.) (last visited Apr. 17, 2012).

25 Government Companies Authority, http://www.gca.gov.il/GCA/HomePage (Isr.) (last visited Apr. 17, 2012).

26 *See* Yaron Zelekha & Ayelet Zur-Nayberg, *Mashber Menayot Habankim — Mehal'ama Ve'ad Lehashlamat Hafrata* [*The Banks' Share Crisis: From Nationalization to Completion of the Privatization*], 40(160) Rivon Lebankaut [Q. Banking Rev.] 61 (2007) (Isr.). Some of these banks remained publicly traded even under the government's control.

27 *See* The Bank Shares in Arrangement Law (Temporary Order), 5754-1993, SH No. 1438 p. 10 (Isr.).

group, and selling the government's remaining shares on the stock market.[28] However, we focus on the privatization of banks for two reasons. First, as the events that unfolded after the 2008 financial crisis demonstrate, nationalization followed by privatization is a common government reaction to banking crises. Second, banking is an example of an industry in which the government has a strong interest in retaining influence after the privatization. This interest underlies the modern system of banking supervision and regulation. We argue that this interest helps to explain the Israeli government's preference for using asset sales in bank privatizations.

B. The Characteristics of Bank Privatizations

We do not intend to provide a detailed history of bank privatization in Israel. For our purposes, it suffices to point out a few notable features of this process that will facilitate our analysis of it and the manner in which it has evolved.

Government Actors: Two state actors play key roles in bank privatizations. The Ministry of Finance drives the government's privatization project and collects the revenues from privatization. The Bank of Israel, the state's central bank, is responsible for bank supervision and regulation. Its formal role in the privatization process is limited to issuing a control permit to anyone who wishes to become controlling shareholder of a bank, but its actual influence over the privatization process is substantial.

Unfinished Process: The privatization process has been protracted. Although the number of banks is relatively small — only seven banks were slated for privatization — the process is yet to be completed: As noted above, the government still retains formal control over the largest bank.

Privatization Method: The government's preferred privatization technique has been a combination of a private sale of control and share issuance. On several occasions, the government sold shares on the market directly or through financial intermediaries. Some share distributions took place after the government had sold its controlling stake. This was the case, for example, in the privatization of Israel Discount Bank. In other instances,

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28 The fact that both privatization programs relied on the asset-sale method does not undermine our claim concerning the link between the government's interest in retaining informal influence and its choice of privatization method. The government's interest in preserving its influence may be strongest with respect to banks, yet this interest exists quite generally. Moreover, as we explain below, the government's efforts to sell controlling stakes in banks encountered serious difficulties, putting in doubt the claim that the asset sale method was the natural choice.

Table 1: Stages in the Privatization of Israel's Three Largest Banks

Bank Hapoalim	1993: 20% is sold on the market in two public offerings and an option.	1994: The government auctions 20%-40%. The auction fails because most of the bidders fail to obtain approval.	1997: 43% is sold to Arison Holdings. Arison Holdings buys an option for another 21.5%, but does not exercise it.	1998-2000: The remainder is sold to the public in various sales: a public offering, an intermediary sale, and an offering to institutional investors.		
Discount Bank	1996-1997: 27% is sold in two public offerings including an option.	1998: 30%-53% is auctioned. Of three bidders, one quits and two fail to obtain approval.	2004: 25%-51% is auctioned. The only bidder buys 25% and an option to buy another 26%, but does not exercise the option.	2006-2010: The remainder is sold to the public in a series of placements through intermediaries.		
Bank Leumi	1993: 13.5% is sold on the market.	1994: 20%-40% is auctioned. The only bidder fails to obtain approval.	1997-1999: 40% is sold in public offerings, intermediary sales, and option exercise.	2002-2005: 16% is sold in a public offering and intermediary sales.	2005: 10% is sold to Cerberus Capital Management and Gabriel Capital with an option to buy another 10%. The buyers fail to obtain approval and are forced to sell.	2011: 5% is sold through an intermediary.

the distribution through the stock market took place, if at all, before the government selected the new controlling shareholder. This was the case, for example, in the privatization of Bank Leumi. In all of these cases, however, the government insisted that the privatized banks have controlling shareholders. Table 1 presents a list of the controlling stakes sold by the state.

Difficulty of Auctioning Control: The process of auctioning control has been very complicated. Potential bidders have been difficult to come by, and those that have expressed interest have not always been cleared by the banking supervision authorities. In light of this history, selling control blocks does not appear to be the best way for the government to maximize revenues.

The history of Bank Leumi is a good example. The government first tried to auction its control block in this bank in 1994. Only one bidder emerged: the banker Edmond Safra. After protracted negotiations with the Ministry of Finance and the Bank of Israel, however, Safra decided to withdraw. In 2001, the Ministry of Finance again attempted to auction the government's shares, but no bidder surfaced.[29] The government then began to consider a change in the method of privatization from auctioning a control block to conducting a public stock offering. Three commissions were appointed to examine issues related to the future privatization of the bank, including the need for legal reform to tighten state supervision of widely held banks.[30]

In 2005, the government tried to find a buyer. The bidding process sparked a police investigation concerning suspicions of corruption by Ehud Olmert, then Minister of Finance and later Prime Minister, who was said to have had undisclosed ties to one bidder. The winners in the auction, however, were other bidders, the private equity funds Cerberus Capital Management and Gabriel Capital Corp., who together paid $500,000,000 for a 9.99% stake and an option to acquire an additional 10.01% upon obtaining regulatory approvals.[31] Ultimately, the funds failed to obtain the approvals and sold their

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29 *See* Ohad Marani et al., Doh Hava'ada Lebhinat Hebetim Hakshurim Bemihirat Bank Leumi Be'emtza'ut Shuk Hahon [Report of the Committee for Examination of Aspects Related to a Sale of Bank Leumi Through the Capital Market] 5 (2002) (Isr.) (noting that Merrill Lynch was hired in 2001, but failed in its effort to find a strategic buyer).

30 In 2004, the Israeli Parliament adopted the Banking (Licensing) Law (Amendment No. 13), 5764-2004, SH No. 1956 p. 508 (Isr.), which imposed several restrictions on the rights of shareholders of widely held banks to nominate directors.

31 These included not only a control permit from the Bank of Israel, but also similar approvals by banking supervisors in countries where Bank Leumi has banking operations, most notably the Federal Reserve Board, *see* Tal Levy, *Bank Leumi Sells U.S. Bank So Cerberus Can Buy Controlling Stake*, Haaretz, Mar. 29,

Table 2: Stock Holdings in Israel's Three Largest Banks in April 2012

Bank Hapoalim		**Discount Bank**		**Bank Leumi**	
25.54% Blockholders 3.07% Institutional Investors 71.39% Public		25.16% Blockholders 74.84% Public		15.65% Blockholders 84.35% Public	
Percent of Stock	**Name**	**Percent of Stock**	**Name**	**Percent of Stock**	**Name**
20.20	Arison Holdings	15.10	Treetops Acquisition Group (owned by the Bronfman family)	9.59	Shlomo Eliahu
2.45	Excellence Investments	10.06	Treetops Acquisition Group II (owned by the Schron family)	6.03	Government of Israel
2.40	Salt of the Earth			0.02	Galia Maor
1.71	Phoenix			0.01	Ehud Shapira
0.01-0.70 each	Excellence Provident Fund, Delek Investments and Properties, Excellence Trust Fund, Phoenix Provident Fund, Phoenix Insurance, Isaac Tshuva				

shares. Today the government remains the bank's controlling shareholder.[32]

Percentage Ownership Constituting Control: In some cases, the new owners hold significantly less than half of the bank's shares. To the best of our knowledge, this pattern is not the outcome of the government's preference for a controlling shareholder with less than fifty percent of the shares. Rather, it illustrates the government's difficulty in finding a buyer for a majority stake. For example, the government allowed the Cerberus-Gabriel group to control Bank Leumi with only twenty percent of its shares. Similarly, the Bronfman-Schron group controls Israel Discount Bank with 25.16% of the stock, and Arison Holdings controls Bank Hapoalim with 22.59% of the stock. Table 2 presents the controlling shareholders' stake today. Note that the largest shareholder of Bank Leumi is Shlomo Eliahu, who holds 9.59% of the stock. But since Eliahu does not have a control permit, the bank is controlled by the state with 6.03% of the stock.

The government's current plan is to privatize the last control block it holds in a bank — its holding in Bank Leumi — through share distribution or through the sale of smaller blocks to a number of buyers. However, the Bank of Israel is demanding legislative changes that would impose further constraints on shareholders' ability to nominate directors before it consents to such privatization.

III. Controlling Shareholders as a Channel for Government Remote Control

In this Part, we argue that selling a control block to a single investor or a group of investors in the course of the privatization leaves in the government's hands a means of influencing the firm after it has been privatized. We are not claiming that this effect is inevitable or universal. In Israel, however, it has been on the mind of bank regulators.

A. The Benefits of Informal Influence

This Section lays out our claim that concentrated ownership creates a platform for the government — especially in regulated industries like banking — to

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2007, http://www.haaretz.com/news/bank-leumi-sells-u-s-bank-so-cerberus-can-buy-controlling-stake-1.216960 (Isr.).

32 *See* Sarit Menahem, *Deutsche Bank Buys Gabriel, Cerberus Shares in Bank Leumi*, Haaretz, June 24, 2009, http://www.haaretz.com/print-edition/business/deutsche-bank-buys-gabriel-cerberus-shares-in-bank-leumi-1.278690 (Isr.).

exercise informal influence over corporate affairs. Controlling shareholders can exercise control and influence corporate decisions in a variety of formal and informal ways.[33] Their most dramatic means of influence is the power to summarily replace directors and officers.[34] From the government's perspective, harnessing this power to achieve regulatory goals is an attractive proposition, especially when radical intervention is necessary to terminate directors or officers.

1. The Difficulties of Regulation and Formal Intervention

Bank supervisors have a variety of formal powers at their disposal to ensure banks' stability. First, they can promulgate detailed guidelines on capital adequacy, accounting practices, corporate governance, conduct of business (customer service, customer accounts, lending activities, and credit card services), investment policies, and managing financial and operational risks. Second, banks often need regulatory consent for entering into new markets, declaring dividend distributions, offering new services, or acquiring banks or other entities. Bank supervisors can withhold their consent, qualify it, or stipulate conditions to it. Third, bank supervisors can block the appointment of bank officers and directors who fail to meet "fit and proper" standards, or demand their termination for that reason.[35]

Bank supervisors, however, may find it difficult to use their formal power, especially when their concerns relate to the performance of officers or directors at specific banks.[36] First, deploying the legal measures at their

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33 *See* Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 Harv. L. Rev. 1641, 1651 (2006) ("[A] controlling shareholder may police the management of public corporations better than the standard panoply of market-oriented techniques employed when shareholdings are widely held").

34 For example, on January 17, 1996, Sumner Redstone, the controlling shareholder and chairman of media giant Viacom Inc., walked into the office of the company's CEO, Frank Biondi, to tell him that his services were no longer needed, *see* Ehud Kamar, *The Story of Paramount Communications v. QVC Network: Everything Is Personal*, *in* Corporate Law Stories 293, 321 (J. Mark Ramseyer ed., 2009); *see also* Leo Strine, *The Inescapably Empirical Foundation of the Common Law of Corporations*, 27 Del. J. Corp. L. 499, 512 (2001) ("When an 800-pound gorilla wants the rest of the bananas, little chimpanzees, like independent directors and minority stockholders, cannot be expected to stand in the way, even if the gorilla putatively gives them veto power").

35 *See* The Banking Ordinance, 1941, IR No. 1134 p. 69, § 11A (Isr.).

36 The government can also retain golden shares with decisive voting power in privatized firms with dispersed ownership. Golden shares' likely cost is lower

disposal requires supervisors to share publicly information that, for legitimate reasons, they would rather keep confidential. One such reason, for example, is the fear that publicizing the basis for regulatory intervention might stir panic among bank clients and trigger a chain reaction that could destabilize the bank and even the market. Second, the exercise of regulatory powers requires bank supervisors to satisfy legal requirements. Banking laws and regulations define areas in which bank supervisors can act and set conditions for the exercise of their power. Among other things, these laws and regulations, as well as administrative law principles, require that bank supervisors hold formal hearings and meet certain evidentiary standards before they can impose administrative sanctions, remove an executive from office, or revoke a license. Gathering evidence that can be used in order to take regulatory steps against banks' officers and directors can be difficult and time consuming.

Consider a case in which bank supervisors conduct inspections that lead them to believe that a bank's chief executive officer (CEO) is involved in improper transactions and should therefore leave the bank. In this case, using a formal procedure to force the CEO's termination would be costly: The bank supervisors would have to disclose the information they have and make a compelling case for the CEO's removal from office. Moreover, publicizing their concerns about the bank's safety might create panic among the bank's depositors, further undermining the bank's stability. Bank supervisors would thus prefer to use an informal route to make the CEO depart.

2. Controlling Shareholders as a Safety Valve

Bank supervisors may successfully apply informal pressure on managers and directors at either widely held firms or firms with a controlling shareholder. We claim, however, that it may be easier to informally influence controlling shareholders than to informally influence managers or directors. The controlling shareholder channel may be more effective for three reasons.

First, communicating with controlling shareholders increases the likelihood that the regulatory intervention and the reasons underlying it will remain confidential. Unlike directors and officers, controlling shareholders are under

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privatization revenue due to retention of government control. Moreover, in some jurisdictions they are illegal, *see, e.g.*, Case C-543/08, Comm'n v. Portuguese Republic, O.J. C 13/3 (Jan. 15, 2011) (holding that Portugal's holding of a golden share in Energies de Portugal is contrary to European Union law); Case C-112/05, Comm'n v. Federal Republic of Germany, 2007 E.C.R I-8995 (holding that a golden share in Volkswagen is contrary to European Union law). In Israel, the government holds golden shares in at least two privatized firms: El Al Israel Airlines and Israel Chemicals.

no obligation to disclose the information they have to the companies they control or to investors. Moreover, it is easier for one person to maintain secrecy than for a group of board members. To be sure, some of the information will eventually become public if the change that supervisors demand is public. The resignation of a key director or officer, for example, is highly visible. But the precise reasons for the resignation need not be publicized. Disagreement between executives and controlling shareholders is a known phenomenon, and the market accepts the right of a controlling shareholder to choose with whom to work, so any weak business performance that may precede the regulatory pressure can suffice as the public explanation for the personnel change.

When dealing with directors and officers, in contrast, it may be difficult to keep the intervention discreet. Even informal pressure on bank management must be reported by management to the board when it concerns important issues, and the board in turn must at least consider its obligation to disclose this information to investors. Even when the board is under no legal obligation to disclose, information can leak when it is shared with a group of board members with potentially different agendas. Board leaks are particularly likely when the regulatory intervention coincides with difficulties at the bank that divide the board and alter directors' expectations that they will continue to work together in the future. This publicity may harm not only the bank, but also the market generally.

Second, controlling shareholders can make swift decisions and implement them quickly with no need for formal group deliberation. This is especially the case when the decision lies within the controlling shareholder's formal power, like the decision to terminate the chair of the board. Boards, in contrast, arrive at decisions in recorded meetings.

Third, controlling shareholders of firms in regulated industries, such as banks, typically depend on continued cooperation with regulators to preserve the value of their sizeable and often illiquid investment. This dependence motivates them to heed government demands.[37] Officers and directors also have reason to cooperate with bank regulators, but that may not suffice when bank supervisors demand the termination of these officers or directors, or their peers.

All this is not to say that pressuring controlling shareholders is always more effective than pressuring managers or using formal regulatory powers. Most controlling shareholders are not involved in the day-to-day management

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37 Since we focus on personnel changes, we assume that controlling shareholders do not have a significant economic interest in resisting the government's pressure. The analysis may be different when the dispute with supervisors touches upon issues that have a significant impact on profits.

of the bank and so they may not be the right address for influencing specific bank actions.[38] But they can be used to force the departure of directors or officers when this radical step is warranted. Their presence has a similar effect to that of the market for corporate control: Both are blunt instruments for replacing management when all else fails.[39]

B. Examples

This Section illustrates how Israeli government officials have pressured controlling shareholders into replacing management at times of internal governance failure. The first example is from a privatized bank, the second from a privatized telephone carrier, and the third from a private brokerage house. The similarities between the cases are striking.

1. Bank Hapoalim

On March 25, 2009, fourteen years after the privatization of Bank Hapoalim, Zvi Ziv, the bank's CEO, announced his resignation, reportedly under pressure from the bank's chairman, Dan Dankner. On the same day, Ziv's deputy, Zion Kenan, was appointed as the new CEO. The bank's board of directors discussed the resignation and the new appointment in a one-hour meeting.[40] The abrupt personnel change triggered swift action by bank regulators, who were said to have been dissatisfied with Danker's performance as the bank's chairman.[41]

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38 Recently, for example, the Governor of the Bank of Israel met with the managers of all Israeli banks and urged them to be conservative when extending home loans, *see* Eran Peer, *Fischer Reprimands Bank CEOs on Mortgages*, Globes, May 1, 2011, http://www.globes.co.il/serveen/globes/docview.asp?did=1000641754&fid=1124 (Isr.). The Governor supplemented his admonition with a binding instruction to banks to increase reserves for mortgage default risk, *see* Eran Peer, *BoI Orders Banks to Raise Mortgage Provisions*, Globes, May 11, 2011, http://www.globes.co.il/serveen/globes/docview.asp?did=1000644408&fid=1725 (Isr.). The banks' controlling shareholders were left out of this affair. Involving them would have been pointless as most of them are not professional bankers and would not have grasped all of the technical aspects of the matter. They would, however, likely be asked to intervene if management was unresponsive.

39 *See* Stephen Prowse, *Corporate Control in Commercial Banks*, 20 J. Fin. Res. 509 (1997) (finding that hostile takeovers of commercial banks rarely occur).

40 *See* Eran Peer, *Zvi Ziv Resigns As Bank Hapoalim CEO*, Globes, Mar. 25, 2009, http://www.globes.co.il/serveen/globes/docview.asp?did=1000437607 (Isr.).

41 In March 2007, the bank's former chairman, Shlomo Nechama, was pressured

The first regulatory response was the Supervisor of Banks' decision to suspend Kenan's appointment and demand that the board form a search committee to fill the CEO post. The second response was the launch of an inquiry into the process that led to Ziv's departure, which resulted in a report by the Supervisor of Banks that accused the board of passivity throughout the process. The third regulatory response — and the most noteworthy for our discussion — was the application of tremendous pressure on the controlling shareholder to put things back in order. Within a month of Ziv's resignation, the Governor of the Bank of Israel and the Supervisor of Banks (who reports to the Governor) met twice with the bank's controlling shareholder, Shari Arison, and demanded that Dankner resign from the board.[42] The regulators made it clear they would use their statutory power to remove Dankner from office if he did not leave.[43] On June 1, Dankner announced he was stepping down.[44]

Remarkably, at no point in the process did the regulators communicate their concerns about Dankner's performance directly to the bank's board (Shari Arison did not serve on the bank's board). Not a single representative of the bank was present at the regulators' meetings with the controlling shareholder. The board repeatedly asked to meet with the Supervisor of Banks, but was turned down and had to rely on the information that Arison relayed to it.[45] When the Supervisor of Banks finally agreed to meet with the board (a month

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to resign, and Dan Dankner was appointed as the new chairman. A month later, outside director Amir Barnea also resigned, triggering a heated dispute over the reasons for his resignation, *see* Eran Peer & Hadas Magen, *Hapoalim Admits Barnea Was Pressed to Resign*, Globes, Sept. 3, 2007, http://www.globes.co.il/serveen/globes/docview.asp?did=1000250442 (Isr.).

42 *See* Eran Peer & Stella Korin-Lieber, *Shari Arison in Stormy Meeting with Fischer, Hizkiyahu*, Globes, Apr. 21, 2009, http://www.globes.co.il/serveen/globes/docview.asp?did=1000443759 (Isr.); Sharon Shpurer & Ram Dagan, *Fischer Tells Arison: Dankner Is Responsible for Hapoalim Problems*, Haaretz, Apr. 22, 2009, http://www.haaretz.com/print-edition/business/fischer-tells-arison-dankner-is-responsible-for-hapoalim-problems-1.274581 (Isr.).

43 *See* Sharon Shpurer, *Fischer to Depose Bank Hapoalim Chairman if Shari Arison Refuses*, Haaretz, Apr. 28, 2009, http://www.haaretz.com/print-edition/business/fischer-to-depose-bank-hapoalim-chairman-if-shari-arison-refuses-1.274990 (Isr.).

44 *See* Stella Korin-Lieber & Eran Peer, *Bank Hapoalim Chairman Dankner Resigns*, Globes, June 1, 2009, http://www.globes.co.il/serveen/globes/docview.asp?did=1000454578 (Isr.).

45 *See* Eran Peer et al., *Shari Arison Set to Make Rare Appearance at Board Meeting*, Globes, May 3, 2009, http://www.globes.co.il/serveen/globes/docview.asp?did=1000446333 (Isr.).

after meeting with the controlling shareholder), he limited the discussion to his expectations regarding the search for a new CEO. He refused to discuss Dankner.[46]

Why was the board left out? After all, the same demands that were made to the controlling shareholder could have been made to the board.[47] In addition to the explicit threat of using their statutory power to remove Dankner from office, the regulators relied on the implicit threat of making life difficult for the bank whenever it needed their support.[48] Both of these threats could have just as well been directed at the board.

In fact, proper corporate governance *required* that bank regulators communicate their concerns directly to the board. Under Israeli corporate law, the board — and not the controlling shareholder — is the body authorized to manage the company's affairs.[49] Ironically, this had been the regulators' position when they criticized an earlier incident of a highly publicized termination at Bank Hapoalim, the allegedly forced resignation of outside director Amir Barnea in 2007. It was unacceptable, the regulators charged at the time, that the board was not involved and that Barnea was simply called to a meeting with the controlling shareholder's attorney in which he was asked to resign.[50]

One might be tempted to conclude that the regulators sidestepped the board in Dankner's ouster because they had lost faith in it. Their perception of the board of Bank Hapoalim as weak was the impetus for regulatory intervention,

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46 *See* Ofer Wolfson, *Hizkiyahu Nifgash im Havrey Direktorion Hapoalim* [*Hizkiyahu Meets with Members of Hapoalim Board*], News1 (May 19, 2009), http://www.news1.co.il/Archive/001-D-200924-00.html (Isr.).

47 Companies Law, 5759-1999, SH 1711 p. 189, § 94 (Isr.) authorizes the board to appoint its own chair. Section 230 authorizes the shareholders, or anyone so authorized in the bylaws, to terminate a director without cause. Section 231 requires the board to terminate a director under certain circumstances of termination for cause.

48 *See* Shpurer & Dagan, *supra* note 42:

> Arison knows that the central bank has a variety of tools at its disposal for influencing the bank's management, sources close to her said. Central bank authorization is often needed in the day-to-day operation of the bank, so that direct confrontation between the banks' watchdog and Hapoalim is likely to end in Arison's ousting Dankner.

49 *See* Companies Law, § 92.

50 *See* Eran Peer, *Hamephakeah al Habankim Hizkiyahu: "Habankim Hirvicho Beyosher et Hatadmit Halo Tova Shelahem"* [*The Supervisor of Banks: "The Banks Have Justly Earned Their Bad Image"*], Globes, Sept. 5, 2007, http://www.globes.co.il/news/article.aspx?did=1000251397 (Isr.).

so the argument might go, and therefore there was no point in talking to the board. But this explanation is not persuasive. The decision to talk solely with the controlling shareholder only further weakened the board. That is not what the regulators were trying to achieve.

The explanation lies elsewhere and reaches beyond the specifics of this case. It was articulated by the Central Bank's Governor at a hearing of the Knesset's Finance Committee on the matter: "We meant to handle the issue quietly, as it's done elsewhere in the world. We aren't the first country in which the banks supervisor decides, based on the facts, to suggest that the controlling shareholders change the top management."[51] To be sure, this time the strategy failed: The controlling shareholder's defiance dragged the bank into a standoff with the regulators. However, the alternative strategy of dealing with the entire board was even less likely to have worked because leaks from board meetings are almost inevitable.[52]

Dealing with the controlling shareholder informally also allowed bank supervisors to make less specific allegations than would have been required if they had dealt with the board using formal regulatory channels. Here, too, the strategy did not work according to plan: The controlling shareholder balked at the intervention and complained to the State Comptroller that the regulators "only provided general statements saying that they could not disclose the particulars in order to prevent instability at the bank."[53] But the complaint was in vain. The bank regulators denied the claim and the State Comptroller decided to stay out of the matter.[54]

In the ensuing months, the police investigated several suspect transactions that Dankner had approved while on the board of Bank Hapoalim. In February 2011, the police concluded that there was sufficient evidence to indict Dankner

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51 Zvi Zrahiya, *Fischer: We Meant to Handle Dan Dankner Problem Quietly*, Haaretz, May 7, 2009, http://www.haaretz.com/print-edition/business/fischer-we-meant-to-handle-dan-dankner-problem-quietly-1.275555 (Isr.).

52 On the futility of fighting board leaks, see, for example, *Tracking the H-P Controversy*, Wall St. J. Online, http://online.wsj.com/public/resources/documents/info-hptime0609.html (last visited Oct. 22, 2011) (describing the whirlwind events that followed when Hewlett Packard's chair hired private investigators to track the source of repeated leaks from the company's board meetings).

53 *See* Hadas Magen, *State Comptroller Closes Arison — Bank of Israel Case*, Globes, Nov. 1, 2009, http://www.globes.co.il/serveen/globes/docview.asp?did=1000509769 (Isr.).

54 *See* Hadas Magen, *Arison Brings Press Clippings in Complaint Against Fischer*, Globes, June 17, 2009, http://www.globes.co.il/serveen/globes/docview.asp?did=1000459363 (Isr.).

on charges of bribery, fraud, and money laundering.[55] In September 2011, the state announced it would press charges unless persuaded otherwise by Dankner.[56] As of the end of April 2012, the state has yet to file an indictment. No one knows whether this suspected wrongdoing was the reason for the Bank of Israel's demand that Dankner resign in 2009. One thing is clear: Whatever evidence exists to support these serious allegations, it was gathered only after the resignation.

2. Bezeq

In 2007, merely two years after the privatization of Bezeq — The Israel Communication Corporation, the Securities Authority demanded that Bezeq retain outside counsel to examine suspicions of improper executive pay practices and accounting irregularities. The report confirmed the suspicions.[57] However, it did not lead to criminal or civil proceedings against the company. Instead, the Chairman of the Securities Authority met with representatives of Bezeq's controlling shareholders, Saban Capital Group and Apax Partners, and demanded the departure of the main culprits — the CEO, the chairman of the board, and the general counsel — as a condition for avoiding criminal investigation.[58] Shortly thereafter, the three left Bezeq.

Ironically, as in the case of Bank Hapoalim, here too the regulators did not meet the corporate governance standards that they themselves set for the controlling shareholder. The main criticism in the outside examiner's report was that key corporate decisions had been made by the controlling shareholder

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55 *See* Chen Ma'anit, *Police Call to Indict Bank Hapoalim CEO*, Globes, Feb. 17, 2011, http://www.globes.co.il/serveen/globes/docview.asp?did=1000624397&fid=1725 (Isr.).

56 *See* Yuval Yoaz, *Former Hapoalim Chairman Dan Dankner to Be Indicted*, Globes, Sept. 5, 2011, http://www.globes.co.il/serveen/globes/docview.asp?did=1000679571&fid=1725 (Isr.).

57 *See* Bezeq — The Israel Telecommunication Corp. Ltd., Doh Bodek Hizoni [Report of Outside Examiner] (2007), *available at* http://maya.tase.co.il/bursa/report.asp?report_cd=259402&CompCd=230 (Isr.).

58 *See* Eran Gabay, *Moshe Terry Nifgash im Adam Chesnoff Mekvutzat Saban ve Stephen Grabiner me Apax ve Hivhir Lahem ki "Kol Haoptziot Ptuhot"* [*Moshe Terry Met with Adam Chesnoff of Saban Group and Stephen Grabiner of Apax and Informed Them That "All Options Are Open"*], The Marker, Apr. 11, 2007, http://www.themarker.com/hitech/1.409664 (Isr.); Hadas Magen, *Mekoravim Labdika be Bezeq: "Lo Nashlim im Matzav Shebo Weissglass ve Shloosh Yishaaru Betafkidam be Bezeq"* [*Persons Related to the Bezeq Examination: "We Will Not Accept a Situation in Which Weissglass and Shloosh Remain in Office"*], Globes, Apr. 29, 2007, http://www.globes.co.il/news/article.aspx?did=1000206233 (Isr.).

and not by the board. This criticism was the seed for subsequent legislation in 2011 that banned the usurpation of board powers and subjected anyone acting as shadow director to director fiduciary duties.[59] But regulators, it seems, do not always follow these teachings.

3. Psagot

A third illustration of the effectiveness of pressure on company owners to advance regulatory goals is provided by the case of Psagot Investment House. Psagot is not a bank, and it has always been privately owned. Nonetheless, it is a major firm in Israel's financial services industry that has received much attention from regulators and the public. In 2010, following a securities fraud investigation against Psagot, the Securities Authority and the State Prosecutor extracted an agreement from Apax Partners, a private equity fund that was set to buy Psagot, to oust the investment house's CEO after the acquisition and to pay a civil penalty of 150,000,000 NIS (about $40,000,000) in return for the firm's keeping its license and avoiding criminal charges.

The agreement was controversial because the Securities Authority and the State Prosecutor lacked statutory authority to enter into it.[60] This claim was also made in a legal challenge brought by the terminated CEO before the Supreme Court. However, the court dismissed the case, reasoning that the decision to terminate the CEO was made by the company's owner, not by government officials, and it was therefore purely a matter of contract and employment law.[61]

C. Informal Influence and Bank Privatization in Israel

That controlling shareholders *can be used* to influence banks does not mean that the government chooses to create controlling shareholders in the course of bank privatization *in order to use* them for influence. Nor does it mean that this potential use is more important than other considerations affecting the choice of privatization method. In the case of Israel, however, there are clear indications that the advantages of exercising influence over controlling

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59 *See* Companies Law (Amendment No. 16), 5771-2011, SH No. 2281 p. 390, § 10 (Isr.).

60 *See* Stella Korin-Lieber, *Everything Is Fine at Psagot but Not OK*, Globes, Oct. 31, 2010, http://www.globes.co.il/serveen/globes/docview.asp?did=1000597902&fid=4163 (Isr.).

61 The Supreme Court dismissed a claim by the terminated CEO that the agreement was invalid, *see* HCJ 8137/10 Roy Vermus v. State Prosecutor [2010] (Isr.), *available at* http://elyon1.court.gov.il/files/10/370/081/s06/10081370.s06.htm.

shareholders did play a role in bank privatizations. Thus, in explaining the government's insistence that banks have controlling shareholders, the Marani Committee stated in 2002 that "some consideration was given to the existence of a designated 'address' that [bank supervisors] could turn to in case of difficulties and concerns with the bank's performance, including the need for additional capital, etc."[62]

Moreover, the history of bank privatization in Israel demonstrates that regulators have *intended* to use controlling shareholders for informal influence over privatized banks. In 2002, after nearly two decades of failed efforts to sell the state's controlling stake in Bank Leumi, the Ministry of Finance decided to give serious consideration to the possibility of privatizing the bank through the stock market. A committee was then established to recommend statutory reforms that would enable the Bank of Israel to supervise a widely held bank. In 2004, on the basis of the committee's recommendations, the Knesset passed a statute limiting the power of shareholders to nominate directors in banks *without* controlling shareholders.[63]

After another failed attempt to sell a control block in Bank Leumi in 2005, the government decided to change gear and to plan a series of share issues that would leave all of the stock in the hands of dispersed shareholders. The Bank of Israel, however, demanded that legislation first be passed to ensure government influence over director nomination in banks without controlling shareholders. In January 2011, the government presented a bill to this effect.[64] In March 2012, the bill became law.[65]

The government's effort to increase its influence over widely held banks before it creates such a bank through privatization is telling. Even before 2004, banking regulation in Israel had required the approval of the Supervisor of Banks for acquiring ten percent of a bank and for serving on the board of a bank. Anticipating the creation of a widely held bank, the government passed legislation that lowered the ownership threshold requiring approval to five percent,[66] and, more recently, provided it with say over board nomination in widely held banks.[67] In the eyes of the bank supervisors, the absence of

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62 Marani et al., *supra* note 29, at 6.

63 *See* Banking Law (Licensing) (Amendment No. 13), 5764-2004, SH No. 1956 p. 508 (Isr.).

64 Draft Bill Amending the Banking Law (Legislative Amendments), 5771-2011, HH 360 (Isr.).

65 Banking Law (Legislative Amendments), 5772-2012, SH No. 2345 p. 206 (Isr.).

66 Banking Law (Licensing) (Amendment No. 13), 5764-2004, SH No. 1956 p. 508, § 13 (Isr.)

67 The Banking Law (Legislative Amendments), 5772-2012, SH No. 2345 p. 206 (Isr.).

a controlling shareholder who could be pressured to terminate problematic directors and officers called for a substitute.

IV. Other Motivations for Privatization Through Controlling Shareholders

Thus far, we have argued that bank supervisors' preference for dealing with controlling shareholders has played at least some role in Israel's decision to privatize its banks by selling control to dominant shareholders. In this Part, we review alternative explanations for the decision to privatize through private sales of control and highlight their incompleteness.

A. Controlling Shareholders and Bank Governance

One possible explanation for the Israeli method of bank privatization is concern for post-privatization performance. Banks are essential to economic development and financial stability. Accordingly, bank supervisors want banks to extend credit without taking excessive risks.[68] Controlling shareholders, one could argue, are vital for bank stability and performance. Written in 2002 by a committee formed to recommend how to privatize Bank Leumi, the *Marani Report* contains the clearest statement of this view:

> The requirement for a control block aimed at preventing the influence, through stock ownership, of undesirable actors on the bank's management, the risk associated with managerial control and the conflicts of interest that it produces, the risk to the bank's stability produced by frequent changes in its control and the composition of its institutions, and especially its board of directors, and fly-by-night controllers' preference for short-term profits. In addition, some consideration was given to the existence of a designated "address" that [bank supervisors] could turn to in case of difficulties and concerns with the bank's performance, including the need for additional capital.[69]

While banks around the world are generally not widely held,[70] we are unaware of similar statements of preference for concentrated ownership of financial

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68 *See* Stephen Haber, *Mexico's Experiments with Bank Privatization and Liberalization, 1991-2003*, 29 J. Banking & Fin. 2325 (2005) (arguing that the Mexico's bank privatization failed because the new owners had been reluctant to extend credit).

69 Marani et al., *supra* note 29, at 6.

70 *See generally* Caprio et al., *supra* note 8.

institutions in other countries. Below we examine in order the two parts of this statement: the claim that controlling shareholders would provide additional capital when needed, and the claim that they would prevent management from taking excessive risks.

One argument for preferring controlling shareholders is that they can provide the bank with additional capital in times of need. Policymakers in Israel have repeatedly invoked this argument in support of ensuring that banks have controlling shareholders.[71] The likely rationale was that a controlling shareholder would prefer to increase its investment in order to avert the bank's collapse and perhaps its nationalization. However, while we do not doubt the sincerity of this hope, it has no empirical or theoretical support. Controlling shareholders may face liquidity constraints in times of crisis just like the banks they control. To avoid being diluted, controlling shareholders may even prevent these banks from raising capital from the public through a rights offering, for example.

To be sure, the hope that controlling shareholders can be relied upon to provide capital in times of need may overlap with the informal influence rationale. Supervisors can thus exercise an informal pressure on controllers to provide the bank that they control with capital. One example from Israel took place in 2009, when the Supervisor of Banks urged the Bronfman family, which controls Israel Discount Bank, to inject cash into the bank. The Bronfmans, however, refused.[72]

Another argument for concentrated ownership is that banks with controlling shareholders are less inclined to take risks. Excessive risk-taking by banks can destabilize the economy. The problem is exacerbated when the government offers deposit insurance.[73] Dispersed shareholders are diversified and therefore benefit from the bank's taking risks.[74] Controlling shareholders, by contrast, invest a significant portion of their wealth in the bank's shares. They are

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71 *See, e.g.*, David Brodet, Bdikat Keda'iut ve'hitahnut Lehaf'alat Tohnit Ha'optziot Lemehirat Menayot Bank Leumi [Viability and Feasibility Examination of an Option Plan for the Privatization of Bank Leumi] (2004) (Isr.).

72 *See* Stella Korin-Lieber & Eran Peer, *Bronfman v. Bronfman (and Schron) at Discount*, Globes, Nov. 1, 2009, http://www.globes.co.il/serveen/globes/docview.asp?did=1000510067 (Isr.).

73 *See, e.g.*, Michael C. Keeley, *Deposit Insurance, Risk and Market Power in Banking*, 80 Am. Econ. Rev. 1183 (1990). There is no formal system of deposit insurance in Israel. Nevertheless, in the 1983 crisis, the government showed it would not allow a bank to collapse.

74 *See, e.g.*, Harold Demsetz & Kenneth Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 J. Pol. Econ. 1155 (1985).

therefore less inclined to risk their investment for the promise of higher returns.

The claim that concentrated ownership is better for bank governance is questionable. As a matter of theory, the fact that an investor owns a significant percentage of a company's shares does not necessarily mean that she is undiversified. Controlling shareholders can diversify their investments over several firms. Indeed, recent studies find that controlling shareholders who are diversified tend to take more risks than controlling shareholders who are undiversified.[75] Furthermore, controlling shareholders in Israel typically borrow money to acquire control. Their financial leverage further motivates them to influence the bank to take risks. This influence can be substantial because controlling shareholders are better positioned than dispersed shareholders to influence management's risk-taking activities.[76] Consequently, banks with diversified controlling shareholders may take *more* risks than widely held banks.

Empirical studies also cast doubt on the claim that banks with controlling shareholders are less prone to taking risks. Anthony Saunders and others found that stockholder-controlled banks in the United States exhibited significantly higher risk-taking behavior than managerially controlled banks during the period 1979-1982.[77] Luc Laeven and Ross Levin studied more than 250 large, privately owned banks across forty-eight countries. They found that higher cash flow rights for the bank's largest shareholder were associated with higher bank risk.[78] Their results persisted when they took into account country differences.[79]

In a study of 1100 banks in twenty-five OECD countries, Reint Gropp and Matthias Köhler found that banks with controlling shareholders had performed better on average than widely held banks before the financial crisis of 2008,

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75 *See* Mara Faccio et al., *Large Shareholder Diversification and Corporate Risk-Taking*, 24 Rev. Fin. Stud. 3601 (2011); Teodora Paligorova, *Corporate Risk Taking and Ownership Structure* (Bank of Canada, Working Paper No. 2010-3, 2010).

76 *See* Ross Levine & Luc Laeven, *Bank Governance, Regulations and Risk-Taking*, 93 J. Fin. Econ. 259, 260 (2009).

77 *See* Anthony Saunders et al., *Ownership Structure, Deregulation, and Bank Risk Taking*, 45 J. Fin. 643 (1990).

78 *See* Levine & Laeven, *supra* note 76, at 260.

79 *See* Andrea Beltratti & René M. Stulz, *The Credit Crisis Around the Globe: Why Did Some Banks Perform Better?* (Fisher College of Bus., Working Paper No. 2010-03-005, 2010) (finding that banks with more shareholder-friendly boards performed significantly worse during the 2008-2009 global crisis than other banks and were not less risky before the crisis).

but that banks with controlling shareholders experienced larger losses than widely held banks during the crisis.[80] They interpret these findings as reflecting the risks that the banks had taken. Another study, by In-Mu Haw and others, focused on banks in East Asia and Western Europe. It found that banks with controlling shareholders exhibited higher return volatility and insolvency risk than widely held banks.[81]

Finally, any analysis of the link between ownership structure and bank governance should take into account the prevalence of business groups in Israel. The government has sold controlling stakes in some of the banks to investors affiliated with business groups.[82] Bank affiliation with a business group may create risks both for the bank and for the economy as a whole due to lending by the bank primarily to firms that are part of that business group. The simultaneous failure of some of these related firms may risk the bank's stability and have ripple effects through the economy.[83]

Our analysis here casts doubt on the claim that banks with controlling shareholders are less likely to take excessive risks. Yet, as we explained earlier, we cannot rule out the possibility that this unsupported belief played a role in government officials' considerations.

B. Maximizing Privatization Revenues

Another rationale for privatizing banks by auctioning a control block is the government's interest in maximizing its revenues from privatization. On this

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80 *See* Reint Gropp & Matthias Köhler, *Bank Owners or Bank Managers: Who Is Keen on Risk? Evidence from the Financial Crisis* (Eur. Bus. School, Research Discussion Paper No. 10-02, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1555663.

81 *See* In-Mu Haw et al., *Concentrated Control, Institutions, and the Banking Sector: An International Study*, 34 J. Banking & Fin. 485 (2010). *But see* Choudhry Tanveer Shehzad, *The Impact of Bank Ownership Concentration on Impaired Loans and Capital Adequacy*, 34 J. Banking & Fin. 399 (2010) (finding that ownership concentration reduces banks' non-performing loans ratio and increases their capital adequacy when the controlling shareholder owns a majority stake).

82 *See* Kostantin Kosenko, *Evolution of Business Groups in Israel: Their Impact at the Level of the Firm and the Economy*, 5 Isr. Econ. Rev. 55, 68 (2007).

83 *See* Lucian A. Bebchuk, Control of Financial Firms in the Israeli Economy: Problems and Policies 5 (2012) (a report prepared for the Committee on Increasing Competitiveness in the Economy); Randall Morck et al., *Banking System Control, Capital Allocation, and Economy Performance*, 100 J. Fin. Econ. 264 (2011).

view, the asset sale method was chosen because it allowed the government to capture revenues that were higher than it could have obtained by distributing banks' shares through the stock market.

This claim has two prongs. First, the effect of each privatization method on the government's revenues depends on the magnitude of private benefits of control. When control is valuable, a revenue-maximizing government should favor the asset sale method of privatization because it enables the government to receive a control premium.[84] This prediction is borne out by the evidence: Asset sale privatizations are indeed more common in countries with lower shareholder protection[85] and higher private benefits of control.[86] A recent study estimates the average control premium of public companies in Israel highly, at thirty percent.[87] This suggests that selling control may have been the privatization method most likely to maximize revenues.

Second, when private benefits of control are substantial because shareholder protection is weak, dispersed ownership of public companies is unstable. Sooner or later, an investor will buy enough shares to establish control and capture the private benefits associated with this position.[88] If the emergence of a controlling shareholder after the privatization is inevitable, the government might as well choose who it will be and collect a control premium.

There are several difficulties with this explanation. To begin, the claim that selling control blocks produces high revenues is inconsistent with the history of bank privatizations in Israel. In reality, the government's search for suitable

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84 *See* Alexander Dyck, *Privatization and Corporate Governance: Principles, Evidence, and Future Challenges*, 1 World Bank Res. Observer 59 (2001); Megginson et al., *supra* note 5, at 2841.

85 *See* Bortolotti & Faccio, *supra* note 3; Megginson et al., *supra* note 5, at 2853.

86 *See* Alexander Dyck & Louigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. Fin. 537, 574-75 (2007).

87 *See* Ronen Barak & Beni Lauterbach, *Estimating the Private Benefits of Control from Partial Control Transfers: Methodology and Evidence* (Bar Ilan Working Paper, 2010) (Isr.), *available at* http://www.mba.biu.ac.il/center/data/papers/6/Block_Israel.pdf.

88 *See* Lucian A. Bebchuk & Luigi Zingales, *Corporate Ownership Structures: Private Versus Social Optimality*, *in* Concentrated Corporate Ownership 55 (Randall Morck ed., 2000); Ehud Kamar, *Beyond Competition for Incorporations*, 94 Geo. L.J. 1725, 1733 n.22 (2006) and sources cited therein (showing that some member states in the European Union improved investor protection in conjunction with large privatizations to secure a good market for the shares of privatized firms); Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. Fin. 471 (1999); Rafael La Porta et al., *Law and Finance*, 106 J. Pol. Econ. 1113 (1998).

buyers for control blocks it has offered for sale was no easy task, probably because banking regulation and supervision limit private benefits of control.[89]

Moreover, although the government is expected to care about revenues, it is not the Ministry of Finance that has favored selling control blocks. We lack information about the Ministry of Finance's position during the 1990s and early 2000s concerning the preferable method of privatization. At least in recent years, however, the Ministry of Finance has been pushing for the distribution of Bank Leumi's shares through the stock market. It is the Bank of Israel that has so far objected to this plan.

Finally, the notion that dispersed ownership of banks is unstable does not fit the legal landscape in Israel. Banking laws often constrain investors who attempt to become controlling shareholders of banks through stock acquisitions.[90] This is true also in Israel, where the law requires anyone interested in owning five percent of a bank (or ten percent before the year 2004) or in nominating a bank director to obtain permission from the Supervisor of Banks.[91] Moreover, Israel's Corporations Law requires anyone interested in owning twenty-five percent of a widely held corporation to obtain shareholder approval.[92] These requirements make it difficult to destabilize a bank's dispersed ownership and become a controlling shareholder by buying shares on the market.

C. The Experimental Nature of Dispersed Ownership

Widely held companies are quite the exception in Israel. As of 2006, only six percent of public companies in Israel were widely held.[93] The lack of significant experience with widely held firms and their governance may explain the government's preference for having controlling shareholders at

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89 Consistently, control premiums tend to be lower in banks than in other companies, *see* Gianfranco Gianfrate & Laura Zanetti, *The Voting Premium in the Banking Industry: A Cross-Country Analysis* (CAREFIN, Working Paper No. 10/10, 2010) (studying 157 bank control transfers in forty countries and finding an average control premium of 3.3%).

90 *See* Prowse, *supra* note 39 (reporting a lack of market for corporate control for commercial banks).

91 In 2004, the ownership threshold requiring permission was lowered to five percent, *see* Banking Law (Licensing) (Amendment No. 13), 5764-2004, SH No. 1956 p. 508 (Isr.); *see also supra* text accompanying note 63.

92 Companies Law, 5759-1999, SH No. 1711 p. 189, § 328 (Isr.).

93 *See* Assaf Hamdani & Yishay Yafeh, *Institutional Investors as Minority Shareholders* (ECGI Law, Working Paper No. 172/2010), *available at* http://ssrn.com/abstract=1641138.

privatized banks. The government, so the argument goes, would rather not experiment with dispersed ownership, especially in the nationally important banking sector. Government officials do not want to be blamed for a failed privatization or to undermine future privatizations.[94]

While this explanation is sensible, it should not be overstated. First, although companies with controlling shareholders are more common in Israel, some of the most successful companies are widely held. Prominent examples include Teva Pharmaceutical Industries, the largest public company in Israel, and Nice Systems, a high technology producer.[95] Second, just as there is little case law in Israel on widely held firms, there is little case law on firms with controlling shareholders. Third, there has been no shortage of share issue privatizations in other countries, which could be used as a model.

Conclusion

This Article has drawn on the experience in Israel to argue that concentrated ownership provides the government with a platform for exerting informal influence over corporate decision-making. When informal influence is important — as in the case of banks — the government may prefer firms with dominant shareholders to widely held firms. This consideration may provide the government with a reason to prefer privatizing by selling a control block to privatizing by distributing shares through the stock market.

Our analysis sheds light on the link between privatization techniques, ownership structure, government interest in retaining influence over privatized firms, and the evolution of ownership patterns around the world. We have shown that government officials may play an active role in preserving existing ownership patterns, as has been the case in the Israeli banking industry.

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94 On the importance of success of early privatizations, see Kathryn Dewenter & Paul H. Malatesta, *Public Offerings of State-Owned and Privately-Owned Enterprises: An International Comparison*, 52 J. Fin. 1659 (1997).

95 On January 3, 2000 (first date for which information is freely available) Teva's market value was 18,700,000,000 NIS, or about $4,300,000,000. This value exceeded that of Bank Hapoalim (16,600,000,000 NIS, or about $3,800,000,000) and Bank Leumi (12,400,000,000 NIS, or about $1,800,000,000).