

Does Law Matter? Private Benefits of the Controlling Shareholder Following Legal Reform

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I. Introduction

The Israeli capital market has two prominent characteristics. First, it is a market typified by concentrated ownership, in the sense that most publicly traded companies have a controlling shareholder.¹ Second, business groups control a large share of the companies traded on the Tel-Aviv Stock Exchange, as well as other closely held business enterprises. These two features combined create an increased potential for self-dealing transactions and other manifestations of conflict of interest. Indeed, in Israel this market setting served as a fertile ground for the emergence of a severe agency problem between the controlling shareholder and the minority shareholders.² Common measures for the extent of this conflict of agency problem highlighted in the past that the Israeli market suffers from a serious challenge that requires attention. In response, during the past 15 years, the Israeli system went through major legal reforms, aimed explicitly at tackling this very problem. In this study, we assess the current extent of the agency problem by measuring private benefits of control in Israel following the reform, and juxtapose it with the measures derived by previous studies. Does Law matter? Although causation is hard to prove, the preliminary results we have today are quite remarkable and telling.

II. How to Assess Private Benefits of Control?

An empirical way to assess the extent of the said agency problem is to estimate the size of the benefits that the controlling shareholder derives from his control, and which the other shareholders do not share. These benefits are termed *private benefits* of control. Private benefits are customarily divided into pecuniary benefits and nonpecuniary benefits.³ Pecuniary benefits often involve tunneling of funds from the company to the private hands of the controlling shareholder or to another entity in which he has a high capital interest. Among the nonpecuniary benefits are the prestige, status, and influence won by the controlling shareholder. The pecuniary benefits are considered especially socially undesirable, since such benefits involve allocation of assets in a non-market

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¹ ASSAF HAMDANI, CONCENTRATED OWNERSHIP AND BUSINESS GROUPS IN ISRAEL: A LEGAL ANALYSIS 10 (The Israel Democracy Institute (R. A.), 2009).

² Zohar Goshen, *The Agency Problem as a Unifying Theory for Corporate Law*, in BOOK TRIBUTE TO GUALTIERO PROCACCIA 239, 275 (Sakker Inst. of Legis. Res. and Comp. L., Hebrew U., 1997).

³ Ronen Barak & Beni Lauterbach, *Firm-Specific Factors Affecting the Private Benefits of Control in Concentrated Ownership Economies*, 15 ADVANCES IN FIN. ECON. 59, 61 (2012).

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environment. Consumption of nonpecuniary private benefits can also be harmful if such consumption involves distorted business decisions.

The tight connection between *concentrated control* and *private benefits* is also fundamental to understanding the link between law and finance. Empirical studies have demonstrated the connection between weak (strong) protection of minority rights and concentrated (dispersed) ownership,⁴ and theoretical studies explain why large benefits encourage the control-holder to maintain control.⁵ An owner that takes a corporation public may prefer a concentrated ownership structure over a dispersed one, even if the latter is less efficient,⁶ due to the distortion caused by private benefits of control.⁷

Private benefits of controlling shareholders are difficult to identify and measure. Notably, if the benefits were easy to identify, the minority would be able to demand its share of the pie – in particular where pecuniary benefits are concerned.⁸ Nonetheless, there are ways to appraise private benefits of control – the foremost being the measurement of the premium paid upon the transfer of control.

Barclay and Holderness were the first to use the sale of blocks of shares for the purpose of estimating the size of the private benefits derived by large block-holders.⁹ Their basic insight was that since the stock exchange price per share reflects the benefits derived by all shareholders pro rata to their relative share of the capital, then the difference between the price paid by the buyer of control and the market price represents private benefits of control, or at least their minimal value.¹⁰ Hence, it follows that the formula for calculating the premium on such sale of control is: the number of shares sold (in the control block) times the difference between the price paid per share by the new controlling shareholder and the price per share in the market following the announcement of the prospective transaction, divided by the market value of the firm.¹¹ In their study, which was confined to the United

⁴ Simeon Djankova, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *The Law and Economics of Self-Dealing*, 88 J. OF FIN. ECON. 430 (2008).

⁵ Lucian Arye Bebchuk, *A Rent-Protection Theory of Corporate Ownership and Control*, 7203 THE NAT'L BUREAU OF ECON. RES. 1, 29 (1999).

⁶ *See id.*

⁷ We do acknowledge, that control premium does not always reflect harmful behavior. See. e.g., Zohar Goshen & Assaf Hamdani, *Concentrated Ownership Revisited: The Idiosyncratic Value of Corporate Control*, 125 Yale Law Journal 560 (2016).

⁸ Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 2 THE J. OF FIN. 537, 537 (2004).

⁹ There is another method of estimating the size of the private benefits, based on the difference in price between two types of shares with different voting rights. For elaboration of this method, see Dyck and Zingales, *supra* note 8, at 542. For more about this method, see Ronen Barak & Beni Lauterbach, *Estimating the private benefits of control from partial control transfers: methodology and evidence*, 2 INT. J. CORP. GOV. 183, 184 (2011). The prohibition on diversified voting rights in publicly traded Israeli firms (Securities Law, 5728–1968, § 46b (Isr.)) makes this method impractical for use in Israel.

¹⁰ Michael J. Barclay & Clifford G. Holderness, *Private benefits from control of public corporations*, 25 J. OF FIN. ECON. 371, 372 (1989).

¹¹ *Id.* at 387; Dyck and Zingales, *supra* note 8, at 547.

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States alone, Barclay and Holderness found the premium on American control sale transactions to be very low.¹²

III. The Size of the Private Benefits of Control in Israel – as Measured in Previous Studies

Dyck and Zingales (2004) used Barclay and Holderness's method and published a widely influential and comprehensive study, measuring the size of private benefits in 39 countries around the world.¹³ The database included 393 transfer-of-control transactions performed between 1990 and 2000. Their findings show that whereas the average global control premium was 14%, the average control premium in Israel was 27%!¹⁴ Furthermore, Israel had the dubious honor of belonging to the select club of countries with the highest control premia in the world,¹⁵ the other members being Argentina, Austria, Colombia, Czech Republic, Italy, Mexico, Turkey, Venezuela and Brazil. At the other (and better) end of the scale were U.S., UK, Canada, Norway, Japan and Hong Kong, which all boast a control premium of 1% or lower.¹⁶

The high Israeli premium that was revealed attests to the large amount of private benefits that Israeli control-holders derive relative to their counterparts in other countries, as well as the extent of the Israeli agency problem. Dyck and Zingales also found that higher private benefits are linked to less developed capital markets.¹⁷ Contrarily, better accounting rules, better protection of minority rights, better enforcement, a more competitive market and highly diffused media were found to be associated with lower private benefits.¹⁸

In 1997 Goshen argued that the Israeli legislator must redesign its law to tackle this challenge.¹⁹ Indeed, the Israeli legislature has abandoned the Corporations Ordinance, which was rooted in the outdated English law.²⁰ In 2000, a modern Companies Law went into effect,²¹ which includes, among

¹² The two scholars analyzed 63 block trades that took place between 1978 and 1982 which included the sale of at least 5% of the common stock of NYSE or Amex corporations. Their study found that the block premium stood at 4%. See Barclay and Holderness, *supra* note 10, at 372.

¹³ Dyck and Zingales, *supra* note 8, at 538.

¹⁴ *Id.* at 551.

¹⁵ *Id.* at 550.

¹⁶ *Id.* at 551.

¹⁷ *Id.* at 590.

¹⁸ *See id.*

¹⁹ Zohar Goshen, *supra* note 2, at 239-242.

²⁰ Draft Bill for Companies Law, 5756 – 1995, HH (Gov.) No. 2432 p. 2 (Isr.).

²¹ Companies Law, 5759–1999 (Isr.) available at http://www.nevo.co.il/law_html/Law01/139_002.htm (Nevo Legal Database, by subscription, in Hebrew).

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other elements, a section dealing with the authorization of self-dealing transactions, as well as various other mechanisms that are unique to Israeli law.²²

The enactment of the Companies Law raises the question of whether the law has succeeded in its task of reducing the private benefits of control-holders and correspondingly reducing the control premium. Barak and Lauterbach (2011) conducted a study using Barclay and Holderness' familiar formula, while also presenting an advanced methodology for calculating control premium. The methodology they developed makes it possible to calculate control premia for partial transfers of control (e.g., a sale of half of a control block).²³ The study, which included such partial control transfer transactions, traced 52 Israeli transactions during the years 1993-2005. Barak and Lauterbach found that the average Israeli control premium stood at 31.5%.²⁴ They also report that using Barclay and Holderness' formula yielded nearly identical results (31.4%), although less transactions could be analyzed (34).²⁵

Even though only part of Barak and Lauterbach's database tracks transactions from the period after the enactment of the Companies Law (2000), we can cautiously say that there has been no significant improvement in the years 2000-2005. Additional evidence of the ineffectiveness of the Companies Law during this period can be found in a study by Hamdani and Yafeh, who examined the voting patterns of the institutional investors in Israel, covering 26,000 votes in the course of 2006.²⁶ One significant finding was that 97.8% of the self-dealing transactions presented for approval by the general assembly were approved.²⁷ A possible conclusion the researchers propose is that legislation that grants power to the shareholders remains ineffective as long as the potential for conflict of interest of the institutional investors remains intact.²⁸

Why then has the situation remained so unsatisfactory even after the new legislation? In the past, Bebchuk explained that reducing the control premium: "... requires not only appropriate rules but, more importantly and more costly, an elaborate and effective system of enforcement and implementation and therefore the creation of an appropriate professional and institutional infrastructure."²⁹

²² See IRIT HAVIV SEGAL, *CORPORATE LAW AFTER THE NEW COMPANIES LAW*, (El-Tech Productions Ltd., 1999); Zohar Goshen, *A Critical Look at the New Companies Law: Purpose of the Corporation, Tender Offers and the Class Action*, 32, *MISHPATIM* 381 (2002); Hamdani, *supra* note 1.

²³ Ronen Barak and Beni Lauterbach, *supra* note 9, at 185.

²⁴ *Id.* at 193.

²⁵ *See id.*

²⁶ Assaf Hamdani & Yishay Yafeh, *Institutional Investors as Minority Shareholders*, 17(2) *REV. OF FIN.* 691, 697 (2013).

²⁷ *Id.* at 702.

²⁸ *Id.* at 722.

²⁹ Bebchuk, *supra* note 5, at 31.

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IV. Legal Reform

In the decade and a half since the enactment of the Companies Law, Israel has witnessed a series of additional reforms in legislation, as well as significant steps taken to augment the enforcement and implementation of the law. A dramatic and highly influential step was the establishment of the Committee for Examining a Corporate Governance Code in Israel (the "Goshen Committee").³⁰ Its recommendations, issued in 2006, sparked a significant revolution.³¹ In the wake of the report, in 2010, another ambitious step was taken: the establishment of the economics division at the Tel Aviv District Court, the purpose of which is "to make the criminal, administrative and civil enforcement in economic affairs more efficient and sophisticated."³² And at the ceremony marking the inauguration of the new Court's Economics Division, Goshen, who was the master mind behind the establishment of the court, asserted: "The Economic Court is the most important tool for contending with the phenomenon of the concentrated control structure in Israel. The Court will give practical substance to the good faith duties of officers and directors, and to the duties and restrictions that the law imposes on controlling shareholders' ability to misuse their power at the expense of the company and its minority shareholders. The Court will set precedents that will guide the market and shape the norms of conduct in it. The efficiency of the market will rise. The control premium will become smaller and the public will profit the most."³³

Soon thereafter, in 2011, Amendment 16 of the Israeli Companies Law went into effect, which implemented many of the Goshen Committee's recommendations.³⁴ Another important step took place even before that, in 2006, when the Israeli Class Actions Law was enacted,³⁵ with its main goal to improve "enforcement of the law."³⁶ Finally, Israeli corporate case law came to life. The revolution started after the enactment of the Companies Law and erupted after the establishment of the Economics Division of the court in Tel-Aviv. Haviv-Segal finds that over the course of the first seven years since the enactment of the Companies Law, more judicial decisions have been rendered in the corporate field than were delivered in all the years between the Israeli Declaration of Independence at 1948 and 2000.³⁷ The numbers kept on rising.

³⁰ Israel Securities Authority, Committee for Examining A Corporate Governance Code (2006).

³¹ IRIT HAVIV-SEGAL, *Introduction: Between the Changeover in the Business Reality and the Revolution in Law, What Has Changed in Corporate Law?*, in CORPORATE LAW 1 (2007) (Isr.).

³² Draft Bill Amending the Law of Courts (Amendment No. 59) (Authority in Economic Matters), 5770-2010, HH (Gov.) No. 484 p. 358 (Isr.).

³³ Hila Raz, *White Collar Court: Why do we Need it?*, TheMarker Bus. Mag. (Dec. 16, 2010, 06:49 AM), <http://www.themarker.com/law/1.593295> (Isr.).

³⁴ Yosef Gross, *The Corporate Governance Revolution in Public Companies – the Wake of Amendment 16 to the Companies Law and Proposed no. 15*, 8/2 TA'AGIDIM LAW. REV. 3, (2011) (For more on Amendment 16) (Isr.).

³⁵ Class Actions Law, 5766-2006, SH No. 2054 p. 264 (Isr.).

³⁶ *See Id.* §1.

³⁷ *Supra* note 31, at 1, 5.

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The Supreme Court and District Courts' (primarily the Economics Division) contribution to constraining controlling shareholders can be divided into activity in the criminal sphere and activity in the civil sphere. In the criminal sphere, we have witnessed increased deterrence by means of imposing actual prison sentences on self-dealing transactions that involve fraud. This trend began with the Arad case,³⁸ in which the controlling shareholder was convicted and sent to jail for committing various offenses in order to circumvent the approval mechanism of a self-dealing transaction.³⁹ In the civil sphere, the courts gradually raised and perfected the standard of review for self-dealing transactions, and opened the door for private enforcement.⁴⁰

To complete the picture, we should also mention an argument raised by Bukshpan. He argues that recent years gave rise to the intensification of social and ethical responsibilities among corporations and officeholders in Israel.⁴¹ One manifestation of this phenomenon may be a reduction in the private benefits extracted by controlling shareholders at the expense of minority shareholders. We speculate that there is a close tie between the legal reforms mentioned above and this identified trend.

In summary, given all the reforms and processes that have taken place in the last decade and a half in the Israeli market, it seems that the power of the controlling shareholder, who was formerly omnipotent, has been limited significantly. In light of this water shed change, it seems especially appropriate to reexamine the scope of private benefits of control in the Israeli economy. No study has assessed the impact of the major reforms on control benefits in many years.

V. Research Objectives and Expected Significance

Our study, therefore, has two main goals: first, to provide an updated and comprehensive answer to the question concerning the current scope of the Israeli control premium; and second, to sense whether legal reforms are capable of bringing about a reduction of the control premium.

The importance of this type of research was noted by Bebchuk in his opinion to the Israeli Committee for Increasing Competitiveness in the Economy, for which he served as a professional external adviser:

³⁸ File No. 40200-99 District Court (TA), State of Israel v. Eisenberg (Sep. 26, 2003), Nevo Legal Database (by subscription, in Hebrew) (Isr.).

³⁹ See IRIT HAVIV-SEGAL, *Duty of Loyalty of Directors and Officers*, in CORPORATE LAW 491 (2007) (Isr.); Asaf Hamdani, *The Limits of a Company's Criminal Responsibility for the Control-Holder's Action*, 3/3 TA'AGIDIM LAW. REV. 30, (2006) (Isr.).

⁴⁰ File No. 26809-01-11 District Court (TA), Cahana v. Machtshim Agan Industries Ltd (May 15, 2011), Nevo Legal Database (by subscription, in Hebrew) (Isr.); File No. 2718-09 Supreme Court, "Gadish" Provident Funds Ltd. v. Elcint Ltd. (May 28, 2012), Nevo Legal Database (by subscription, in Hebrew) (Isr.).

⁴¹ For more, see Eli Bukshpan, *Integrative Corporate Governance and an Ethics Program – The Key to the Social Responsibility of the Business Corporation*, in PUBLIC RESPONSIBILITY IN ISRAEL 456 (Raphael Cohen-Almagor, Ori Arbel-Ganz & Asa Kasher ed., 2012) (Isr.).

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"The evidence that private benefits in Israel are high relative to international levels, and are higher than in other advanced OECD countries, indicates that agency problems and extraction of private benefits are especially significant in Israel. The need for measures to address such problems is, correspondingly, relatively significant in Israel. Moreover, evidence about the levels of control premium will be useful to Israeli authorities in the future as a barometer for the effectiveness of whatever reforms are adopted. As long as control premium in Israeli public firms do not substantially decline from their high levels, public officials should remain concerned about agency problems and the extraction of private benefits in such firms.⁴²

The Concentration Committee itself relied on the high figures of control premium in Israel: "These findings [by Dyck and Zingales and by Barak and Lauterbach] serve to aggravate the concern that the exploitation of minority shareholders exists."⁴³ Altogether, and considering the fact that calls for additional reforms continue to be voiced,⁴⁴ a reexamination of the current control premium is of enormous importance.

Notably, moreover, the Israeli courts rely on control premium studies. A recent example is the Livnat case, in which the Supreme Court relied on the control premium figures found in Dyck and Zingales's study.⁴⁵ Furthermore, in the same ruling, the Supreme Court referred to the preliminary findings of our study,⁴⁶ which will be detailed below. Hence, our findings are expected to be of substantial practical and theoretical value.

VI. Research Design and Preliminary Results

In order to accomplish the above-noted goals, we intend to re-measure the size of the Israeli control premium from the beginning of 2000 (when the Companies Law went into effect) through the end of 2015. We will also analyze in detail all the legal and extralegal changes that took place during this period in Israel, which may have relevancy. This analysis will help us trace the effective cause of the changes we may find in the Israeli control premium.

⁴² Lucian Arye Bebchuk, Expert Opinion, THE COMMITTEE FOR INCREASING COMPETITIVENESS IN THE ECONOMY, Part II, 16.

⁴³ GOV'T OF ISR., DRAFT RECOMMENDATIONS OF THE COMMITTEE FOR INCREASING COMPETITIVENESS IN THE ECONOMY (2011), http://mof.gov.il/Committees/CompetitivenessCommittee/TyuyatRec_Report.pdf (Isr.).

⁴⁴ For example, the proposed bill to establish a committee on behalf of the Securities Authority that would create a pool of external directors, Sharon Hannes, *Public Remuneration Decrease*, GLOBES BUS. MAG. (Apr. 8, 2013, 12:54 PM), <http://www.globes.co.il/news/article.aspx?did=1000834425> (Isr.); or the proposal to limit the pay of senior executives in public companies, Zvi Zerahiya, *Katz and Yehimovitz propose again to limit the pay of senior executive in public companies*, THE MARKER BUS. MAG. (Apr. 24, 2013, 05:02 PM), <http://www.themarker.com/news/politics/1.2003208> (Isr.).

⁴⁵ See ¶ 100 of Justice Danziger's opinion in file No. 8712-13 Supreme Court, Amir Adler v. Shai Livnat (Sep. 01, 2015), Nevo Legal Database (by subscription, in Hebrew) (Isr.).

⁴⁶ *Id.* ¶ 101.

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Notably, the idea of comparing the control premia before and after reforms has been tried in the past in other countries. For example, Dyck and Zingales examined the premium in Italy and Brazil, which underwent significant reforms in the 1990s. They found significant changes in the control premium in the wake of the reforms.⁴⁷ Furthermore, an Italian study, which examined control transfer sales between 1999 and 2007, found that the control premium in Italy plunged to a rate of 5.34% in the wake of the reform,⁴⁸ as opposed to the 37% rate during the 1990s.⁴⁹

We therefore expect to identify a drop in the average Israeli control premium between 2000 and 2015, relative to the results obtained by Dyck and Zingales in their study in the 1990s. We also expect the drop to be steeper in the years 2006-2015, due to the developments reviewed above.

For the purpose of the study we have gathered a list of all publicly traded companies on the Tel-Aviv Stock Exchange from the beginning of 2000 until the end of 2015, taking into account that this is a highly dynamic list that changes extensively over a decade and a half. For each company, we identified every control transfer transaction that occurred during these years (around 12,000 company years).⁵⁰ For each transaction we have collected, among other things, the following parameters: company name, the parties to the transaction, date of transaction, block buyer's initial holdings as a proportion of firm equity, size of the block that was purchased, price paid, whether any consideration other than cash (such as options) was offered, when the consideration is due, whether it is the largest block, the price per share on the stock market on the date of the transaction, the price per share on the stock market on the day after the transaction, and the market value (market cap) of the company.

Over the course of the research, we used the methodology used by Dyck and Zingales for two reasons: first, their methodology is simple to apply and does not require any kind of subjective discretion; second, their methodology is the most common in the literature, and using it enabled us to compare the findings we obtain to the global research they conducted and to other studies.⁵¹ Hence, for each transaction that is found suitable, we calculated the control premium according to Dyck and Zingales' (who follow Barclay and Holderness) formula presented above.

Preliminary Results

Currently we are able to report preliminary results. These results cover all the control transfer transactions in companies included in the "Tel Aviv Composite" ("Maagar") index, from the beginning of 2006 to the end of 2014. The Tel Aviv Composite index currently contains 229

⁴⁷ Dyck and Zingales, *supra* note 8, at 570-571.

⁴⁸ Carmelo Intrinsicano, *Have the Private Benefits in Italian Firms Decreased?*, 11 CHINESE BUS. REV. 911 (2012).

⁴⁹ Dyck and Zingales, *supra* note 8, at 551. Since 2007, additional significant changes were implemented in Italian law, the empirical effects of which are yet to be examined.

⁵⁰ Many of the companies were public only part of the period.

⁵¹ For instance, the Italian study: Carmelo Intrinsicano, *supra* note 48.

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companies (the sample has more companies that were in the index and later went private),⁵² as opposed to the 461 companies currently traded in total on the Tel-Aviv Stock Exchange.⁵³

We found 13 transactions that meet the rigorous threshold conditions set by Dyck and Zingales. To compare, the size of Dyck and Zingales's Israeli sample, during 1990-2000, was 9 companies, while Barak and Lauterbach's long-term sample (1993-2005) included 30 transactions using Dyck and Zingales's methodology. Notably, the preliminary results indicate an impressive shift. The average premium has plunged to a rate of only 4.6%. Furthermore, whereas in Dyck and Zingales's sample only one transaction out of the nine was conducted at a negative premium, in the current research five of the 13 transactions (over one third!) were conducted at a negative premium. Tellingly, the transaction that had the highest control premium in our study had a premium that was lower than the average premium measured in the previous studies. These are encouraging findings regarding the success of the legal reform.

Our preliminary findings were presented at many conferences, including a conference held by the Tel-Aviv Stock Exchange and the Israeli Securities Authority, and have raised quite a stir. Likewise, the results were published in *Globes* business magazine,⁵⁴ and posted on the Corporate Governance website of Tel-Aviv University.⁵⁵ As noted above, the Supreme Court also referenced these preliminary results in a recent case.⁵⁶

Additional Results

So far we have also covered around 70% of all companies that were not included in the preliminary study (i.e. the smaller companies not included in the Tel-Aviv Composite index), for the years 2006-2014. We found additional 13 transactions. These additional results shall be presented in the seminar on Wednesday.

⁵² The Tel Aviv Composite index contains shares that meet rigorous threshold conditions of market value, public holdings and tradability. For more information, see *at Index Universe*, TEL AVIV STOCK EXCHANGE (TASE), <http://www.tase.co.il/Heb/Products/Indices/IndexUniverse/Pages/IndexUniverse.aspx> (last visited October 29, 2015) (Isr.).

⁵³ As of 31.12.2014. TEL AVIV STOCK EXCHANGE (TASE), <http://www.tase.co.il/Heb/Pages/Homepage.aspx> (last visited October 29, 2015) (Isr.).

⁵⁴ Sharon Hannes & Eylon Blum, *Minimal Control Premium*, GLOBES BUS. MAG. (Mar. 2, 2015, 08:08 PM), <http://www.globes.co.il/news/article.aspx?did=1001014884> (Isr.).

⁵⁵ See Tel-Aviv University Corporate Governance Forum, <http://www7.tau.ac.il/blogs/law/2015/03/03/1559/>.

⁵⁶ See *supra* note 46.

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