

The Effect of Minority Veto Rights on Controller Tunneling

Law Working Paper N° 385/2018

May 2019

Jesse M. Fried
Harvard University and ECGI

Ehud Kamar
Tel Aviv University and ECGI

Yishay Yafeh
The Hebrew University of Jerusalem, CEPR and
ECGI

© Jesse M. Fried, Ehud Kamar and Yishay Yafeh 2019. All rights reserved. Short sections of text, not to exceed two paragraphs, may be quoted without explicit permission provided that full credit, including © notice, is given to the source.

This paper can be downloaded without charge from:
http://ssrn.com/abstract_id=3119426

www.ecgi.global/content/working-papers

ECGI Working Paper Series in Law

The Effect of Minority Veto Rights on Controller Tunneling

Working Paper N° 385/2018

May 2019

Jesse M. Fried
Ehud Kamar
Yishay Yafeh

This project received support from the Binational Science Foundation (Grant No. 2012/071) and the Raymond Ackerman Family Chair in Israeli Corporate Governance. Yafeh acknowledges financial support from the Krueger Center at the Jerusalem School of Business Administration. We thank Menachem Abudy, Benjamin Alarie, John Armour, Nikolaos Artavanis, Bernard Black, Stijn Claessens, Oded Cohen, Jean-Gabriel Cousin, Luca Enriques, Zohar Goshen, Yaniv Grinstein, Assaf Hamdani, Sharon Hannes, Beni Lauterbach, Amir Licht, Yu-Hsin Lin, Anthony Niblett, Konrad Raff, Edward Rock, Marco Venturuzzo, seminar participants at Bar Ilan University, Bocconi University, University of Hamburg, the Hebrew University, University of Lille, Oxford University, Tel Aviv University, University of Vienna and University of Zurich, as well as conference participants at the NYU–Tel Aviv University Corporate Law Conference, the University of Siena–University of Toronto–Tel Aviv University Law and Economics Workshop, the American Law and Economics Association 2018 Annual Meeting, the Rotterdam Executive Compensation 2018 Workshop, the Corporate Governance in Emerging Markets 2018 Workshop, the Empirical Legal Studies 2018 Conference, the Empirical Legal Studies in Europe 2018 Conference, and the Journal of Law, Finance and Accounting 2018 Conference for helpful comments and suggestions. Kobi Avramov of the Tel Aviv Stock Exchange kindly assisted us with data queries. We are also grateful to Shai Ashri, Peleg Davidovitz, Dana Gorfine, David Harar, Nufar Kotler, Michal Lavi, Alon Luxemburg, Naama Mond, Oriya Peretz, Itamar Rahabi, Dorin Rottenshtreich, Barak Steinmetz, Hadas Studnik, Tomer Yafeh, and Nadav Yafit for outstanding research assistance.

© Jesse M. Fried, Ehud Kamar and Yishay Yafeh 2019. All rights reserved. Short sections of text, not to exceed two paragraphs, may be quoted without explicit permission provided that full credit, including © notice, is given to the source.

Abstract

A central challenge in the regulation of controlled firms is curbing controller tunneling. As independent directors and fiduciary duties are widely seen as not up to the task, a number of jurisdictions have given minority shareholders veto rights over these transactions. To assess these rights' efficacy, we exploit a 2011 regulatory reform in Israel that gave the minority the ability to veto pay packages of controllers and their relatives ("controller executives"). We find that the reform curbed the pay of controller executives and led some controller executives to quit their jobs or work without pay in circumstances suggesting their pay would not have received approval. These findings suggest that minority veto rights can be an effective corporate governance tool.

Keywords: controlling shareholders, corporate governance, executive compensation, minority shareholders, related-party transactions, shareholder voting, tunneling

JEL Classifications: G18, G34, G38, J33, J38, K22, L20, M12, M52

Jesse M. Fried*

Dane Professor of Law
Harvard University, Harvard School of Law
1563 Massachusetts Ave
Cambridge, MA 02138, United States
phone: +1 617 384 8158
e-mail: jfried@law.harvard.edu

Ehud Kamar

Professor of Law
Tel Aviv University, The Buchmann Faculty of Law
Ramat Aviv
Tel Aviv 6997801, Israel
phone: +972 3640 7301
e-mail: kamar@tau.ac.il

Yishay Yafeh

Professor
The Hebrew University of Jerusalem, School of Business Administration
Mount Scopus
Jerusalem 91905, Israel
phone: +972 2588 3081
e-mail: yishay.yafeh@huji.ac.il

*Corresponding Author

The Effect of Minority Veto Rights on Controller Tunneling

Jesse M. Fried, Ehud Kamar, and Yishay Yafeh*

March 2019

Abstract

A central challenge in the regulation of controlled firms is curbing controller tunneling. As independent directors and fiduciary duties are widely seen as not up to the task, a number of jurisdictions have given minority shareholders veto rights over these transactions. To assess these rights' efficacy, we exploit a 2011 regulatory reform in Israel that gave the minority the ability to veto pay packages of controllers and their relatives ("controller executives"). We find that the reform curbed the pay of controller executives and led some controller executives to quit their jobs or work without pay in circumstances suggesting their pay would not have received approval. These findings suggest that minority veto rights can be an effective corporate governance tool.

JEL classification: G18, G34, G38, J33, J38, K22, L20, M12, M52

Keywords: controlling shareholders, corporate governance, executive compensation, minority shareholders, related-party transactions, shareholder voting, tunneling

* Fried is at Harvard Law School and ECGI (jfried@law.harvard.edu). Kamar is at the Tel Aviv University Buchmann Faculty of Law and ECGI (kamar@tau.ac.il). Yafeh is at the Hebrew University School of Business Administration, CEPR, and ECGI (yishay.yafeh@huji.ac.il). This project received support from the Binational Science Foundation (Grant No. 2012/071) and the Raymond Ackerman Family Chair in Israeli Corporate Governance. Yafeh acknowledges financial support from the Krueger Center at the Jerusalem School of Business Administration. We thank Menachem Abudy, Benjamin Alarie, John Armour, Nikolaos Artavanis, Bernard Black, Stijn Claessens, Oded Cohen, Jean-Gabriel Cousin, Luca Enriques, Zohar Goshen, Yaniv Grinstein, Assaf Hamdani, Sharon Hannes, Beni Lauterbach, Amir Licht, Yu-Hsin Lin, Anthony Niblett, Konrad Raff, Edward Rock, Marco Ventoruzzo, seminar participants at Bar Ilan University, Bocconi University, University of Hamburg, the Hebrew University, University of Lille, Oxford University, Tel Aviv University, University of Vienna and University of Zurich, as well as conference participants at the NYU–Tel Aviv University Corporate Law Conference, the University of Siena–University of Toronto–Tel Aviv University Law and Economics Workshop, the American Law and Economics Association 2018 Annual Meeting, the Rotterdam Executive Compensation 2018 Workshop, the Corporate Governance in Emerging Markets 2018 Workshop, the Empirical Legal Studies 2018 Conference, the Empirical Legal Studies in Europe 2018 Conference, and the Journal of Law, Finance and Accounting 2018 Conference for helpful comments and suggestions. Kobi Avramov of the Tel Aviv Stock Exchange kindly assisted us with data queries. We are also grateful to Shai Ashri, Peleg Davidovitz, Dana Gorfine, David Harar, Nufar Kotler, Michal Lavi, Alon Luxemburg, Naama Mond, Oriya Peretz, Itamar Rahabi, Dorin Rottenshtreich, Barak Steinmetz, Hadas Studnik, Tomer Yafeh, and Nadav Yafit for outstanding research assistance.

1. Introduction

Most publicly traded firms around the world have a controlling shareholder, also known as a controller (Claessens, Djankov and Lang, 2000; Faccio and Lang, 2002; Khanna and Yafeh, 2007; Holderness, 2009; Gutiérrez and Sáez Lacave, 2018). In these firms, a key objective of corporate governance is protecting minority shareholders from tunneling via related-party transactions (Shleifer and Vishny, 1997; Gilson and Gordon, 2003; Enriques and Volpin, 2007; Djankov et al., 2008; Jackson and Roe, 2009).

The standard tools for constraining controllers—the use of independent directors and the duty of loyalty—are often insufficient. Independent directors are typically appointed and terminated by the controller, making them at least somewhat loyal to her (Bebchuk and Hamdani, 2017; Enriques et al., 2017). And procedural impediments to shareholder litigation and controller-friendly substantive law can vitiate the legal system’s potential deterrent effect (Enriques et al., 2017).

A potentially more powerful protective tool is subjecting related-party transactions to advance minority approval (Goshen, 2003; Djankov et al., 2008). This approach, now favored by the OECD (2012), has become the law in Israel, the major Canadian provinces,¹ Australia, Hong Kong, India, Indonesia, Mexico, Russia, and other former members of the Soviet Union.² The European Union has also recently considered it.³ Delaware has adopted a softer version of this approach, which rewards a controller who voluntarily conditions a related-party transaction on minority approval by granting the transaction more deferential

¹ Canadian Securities Administrators (2017).

² OECD (2012), Black and Kraakman (1996), Enriques and Tröger (2018), Li (2018).

³ The European Union considered requiring minority veto rights for conflict transactions, in the end leaving this decision to member states. *Compare* Article 9c of the Proposal for a Directive of the European Parliament and of the Council Amending Directive 2007/36/EC as Regards the Encouragement of Long-Term Shareholder Engagement and Directive 2013/34/EU as Regards Certain Elements of the Corporate Governance Statement (April 9, 2014) *with* Article 9c of the Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 Amending Directive 2007/36/EC as Regards the Encouragement of Long-Term Shareholder Engagement, 2017 O.J. L 132/1.

judicial review.⁴ Similarly, in the United Kingdom, controlled firms with premium listing on the stock exchange can be required to obtain minority approval for transactions with the controller.⁵

However, there is scant empirical evidence on whether minority veto rights work. While Delaware has long rewarded controllers for obtaining minority approval, it does not require this approval. A Delaware controller can choose whether to grant the minority a veto right over a transaction, raising significant identification concerns. Even in regimes that require minority approval, substantial empirical challenges remain. First, the controller chooses whether to propose the transaction, creating endogeneity problems. Second, it is difficult to find comparable transactions not subject to minority veto rights. Third, mandatory minority veto rights are a recent regulatory innovation, limiting the size of potential samples.

A 2011 regulatory reform in Israel offers a unique setting for testing the efficacy of minority veto rights. A key element of this reform, known as Amendment No. 16 to the Israeli Companies Law of 1999,⁶ was to give minority shareholders of controlled firms veto rights over proposed related-party transactions, including the proposed pay of controllers and their relatives serving as officers or directors (“controller executives”). In particular, their pay packages require approval by a majority of the minority votes cast in a shareholder meeting (“MoM approval”) within three years of the last approval. Absent MoM approval, a controller executive can continue to work, but only without pay. Until 2011, pay packages of controller executives had required the approval of only a third of the minority (“ToM approval”) and this approval was valid indefinitely, so that a controller executive could continue to draw the same

⁴ Kahn v. M&F Worldwide Corp., 88 A.3d 635 (Del. 2014).

⁵ Davies (2018); Listing Rules, Section 11.1.1. To avoid a minority vote, the firm must have an agreement with the controller containing certain independence provisions, including the requirement that related-party transactions be conducted at arm’s length and on normal commercial terms and that there be no circumvention of the listing rules. See Listing Rules, Section 6.1.4D R.

⁶ Companies Law (Amendment No. 16), 5771–2011, Section 34, which amends Companies Law, 5759–1999, Section 275.

amount of pay even if the minority came to believe that this amount had become excessive. The reform did not alter the approval mechanisms for the pay of executives unrelated to controllers (“non-controller executives”), creating a viable control group.⁷

Contemporaneous anecdotal accounts suggest that the reform had real bite. For example, Rami Levy, the controller and CEO of an eponymous supermarket chain, had to cut his bonus in half to secure minority support for his pay contract (Calcalist, October 16, 2011). According to our calculations, his post-approval package was 26% lower than the previous one. Ilan Ben Dov, the controller of cellular holding company Suny Electronics, forfeited most of his compensation as board chair to win minority shareholder approval of his compensation package (Calcalist, October 16, 2011; Globes, November 14, 2011). According to our calculations, this led to a pay drop of 83%. Other controllers and their relatives left their executive positions or continued to work without pay due to inability to reach an agreement with the minority on their compensation. At wireless technology firm MTI, the threat of minority veto felled a father-and-son team: MTI’s controller and board chair (Zvi Borovitz) and CEO (Zvi’s son, Moshe Borovitz) both announced their departure (Globes, December 7, 2011).

We use the reform to determine whether giving the minority veto rights had a systematic effect on the pay of controller executives by hand-collecting and analyzing data on hundreds of firms and thousands of executives, some related to controllers and others not, over an eight-year period around the reform.

We find that the grant of minority veto rights constrained the pay of controller executives. In particular, controlling for other factors, the full-sample results suggest that the reform is associated with an average decline of 13%–17% in controller-executive pay relative to the expected pay of the same executive based on firm size, profitability and other factors. We also find that this decline is due at least in part to a substantial increase in the frequency of pay cuts for controller executives. Minority shareholders appear to be selective in wielding

⁷ Below we discuss the possibility that the reform affected non-controller-executive pay indirectly.

their veto power, forcing some controller executives to accept massive pay cuts, but not others.

We also examine the reform's effect on the rate at which controller executives disappear from a firm's list of highest paid executives. Such a disappearance means that the controller executive either stops working at the firm or continues working for limited or no pay. We find that the likelihood of controller executives disappearing increased by over 50% after the reform, often in circumstances indicating that the controller executives might have had their pay package vetoed. Managers unrelated to the controller replaced about 10% of the disappearing controller executives, suggesting that the reform affected corporate management. Our direct estimates of the effect of minority veto rights on controller-executive pay are therefore probably downward-biased.⁸

Our study does not assess the desirability of the reform because minority veto rights can also thwart value-increasing transactions (Enriques, 2015; Rock, 2018). In addition, to the extent private benefits motivate controllers to generate value (Burkart et al., 1997; Gilson and Schwartz, 2015), curbing these benefits can be harmful. Furthermore, impeding controller tunneling through a particular type of related-party transaction can induce controllers to use costlier forms of tunneling. That said, we do not observe a post-reform increase in related-party transactions or a change in dividend policies.⁹

Also worth noting is that controller-executive pay may be different from other related-party transactions, making it hard to generalize. Specifically, the cost to the minority of mistakenly vetoing a desirable controller-executive pay arrangement will generally be low because a controller has other incentives to run the firm well. By contrast, the cost to the minority of mistakenly vetoing a

⁸ The average decline in controller-executive pay understates the effect of the reform also because many MoM approvals were due only in 2012 or 2013 (for pay contracts last approved in 2009 or 2010). Much of the controller-executive pay observed in the initial post-reform years thus reflects the lingering effect of pre-reform pay arrangements.

⁹ We cannot rule out the possibility of an increase in other forms of tunneling, including indirect tunneling that do not involve a related-party transaction (Bebchuk and Hamdani, 2018). For example, a controller of several firms may impose the costs of a joint investment on one of the controlled firms (where she has low cash-flow rights), while the benefits accrue primarily to other controlled firms (where she has high cash-flow rights).

desirable commercial or financial arrangement with the controller can be high. The minority may accordingly be more reluctant to veto non-pay related-party transactions, reducing the utility of minority veto rights in non-pay contexts. Despite our inability to assess the overall welfare implications of the reform, our results demonstrate that granting the minority veto rights over a particular transaction makes it more difficult for controllers to extract value through that channel.

Our findings relate to four corporate governance questions.

First, we shed light on the potential use of minority veto rights to constrain tunneling through related-party transactions. Because the requirement of minority approval in related-party transactions is relatively recent, almost all prior work relating to minority veto rights concerns controllers who voluntarily grant the minority veto rights in Delaware freezeouts to reduce judicial scrutiny of the transaction (Subramanian, 2007; Restrepo, 2013; Restrepo and Subramanian, 2015). However, it is impossible to determine empirically the effect of minority veto rights in this setting, as both the timing of the freezeout proposal and the decision to grant the minority veto rights are endogenous, and the grant of minority veto rights changes the legal treatment of the transaction. The advantage of our study is that it examines a largely exogenous event: we study mandatory minority approval of existing related-party transactions by a state-imposed deadline. In addition, the availability of pay data for non-controller executives, combined with executive fixed effects, enables us to construct robust controls. In contemporaneous work, Li (2018) finds that minority-shareholder veto rights on related-party transactions in India reduce minority shareholder expropriation.¹⁰ Consistently, Lin (2018) reports that activist shareholders use minority veto rights to leverage their positions in Hong Kong controlled firms.

¹⁰ Chen et al. (2013) study the effect of a Chinese regulation requiring advance minority approval for stock issuances, transactions that often facilitate tunneling (Fried, 2018; Fried and Spamann, 2018). Chen et al. (2013) find that mean cumulative abnormal stock returns associated with stock issuances are negative before and positive after the regulation, suggesting that minority veto rights improve the quality of stock issuances. Their study does not include controls in the form of stock issuances unaffected by the reform.

Second, our findings contribute to the literature on the effectiveness of shareholder voting generally, including in widely held firms. Shareholders typically have veto rights over fundamental corporate actions like charter amendments and mergers. In addition, depending on the jurisdiction and the firm, shareholders may have veto rights over corporate actions like equity issuances (Yermack, 2010; Holderness, 2018), acquisitions (Kamar, 2006; Becht et al., 2016), equity compensation plans (Armstrong et al., 2013), or extraordinary transactions involving directors (Enriques et al., 2017).

The protection that these veto rights afford is difficult to measure because—outside the say-on-pay (SoP) context, where periodic votes are mandated—firms typically put proposals to shareholder vote only when expecting approval, possibly after negotiating with institutional investors (Carleton, Nelson, and Weisbach, 1998). This endogeneity makes it difficult to infer from voting outcomes whether a shareholder vote affects transaction outcomes, as the outcome that would occur absent a vote is unknown. By contrast, our setting features largely exogenously timed votes, permitting us to test whether shareholders use their voting power to constrain insiders.

Third, we contribute to the line of research investigating tunneling through pay. While pay is not the most lucrative channel for tunneling, as it is salient and often small relative to firm value, pay is readily accessible because controllers and their relatives often work for the firm and it is accepted that they should be paid. Prior work has therefore sought to determine whether pay tunneling occurs by comparing the pay of controller executives to that of non-controller executives. This work has found pay tunneling in some jurisdictions—including Italy (Bozzi et al., 2017), Chile (Urzua, 2009), and Israel (Barak et al., 2011)—but not in others—including Germany (Elston and Goldberg, 2003) and Continental Europe generally (Crocì et al., 2012).

Our setting enables us to test for the presence of pay tunneling more directly by examining the effect on pay of a reform that, in midstream, introduced arm’s-length bargaining between the minority and the controller. Even before the reform, there was a constraint on pay tunneling, as controller executives needed ToM approval to obtain pay increases. However, the reform substantially tightened the constraint, as all controller-executive pay arrangements now needed MoM approval every three years. Our findings, that the reform increased

the likelihood of pay reductions for controller executives, constrained controller-executive pay, and caused some controller executives to quit, suggest that the minority perceived some controller executives as overpaid—although it is possible that the minority penalized these controller executives for reasons unconnected to tunneling.

Finally, our findings contribute to the extensive literature on the effect of SoP votes on executive pay levels and structure. In the United Kingdom, nonbinding SoP has caused certain shareholder-favored changes in the structure of executive pay (Ferri and Maber, 2013; Gregory-Smith et al., 2014). By contrast, in the United States, nonbinding SoP has had little effect on pay (Ertimur et al., 2011; Brunarski et al., 2015; Cuñat et al., 2016; Iliev and Vitanova, 2018).¹¹ Using a large multi-jurisdiction sample of firms, Correa and Lel (2016) find that SoP restrains the growth of executive pay and increases the sensitivity of pay to performance, primarily in regimes with nonbinding SoP. However, in all jurisdictions studied to date, SoP requires a simple majority, guaranteeing approval in controlled firms. Our study is the first to examine the effect of binding SoP requiring MoM support, and shows that binding SoP can not only restrain executive pay but also cause executives to step down or work without pay.

The remainder of the article is as follows. Section 2 presents the data and our empirical approach. Section 3 describes our main empirical results. Section 4 presents several extensions and robustness tests and Section 5 concludes.

2. Methodology and data

Our analysis focuses on a 2011 Israeli reform of the regulation of public firms. Prior to 2011, related-party transactions—including pay packages of controller executives—had to receive approval by a third of the minority (ToM) once for the

¹¹ Other work related to SoP in the United States examines the effects on stock prices of nonbinding shareholder proposals to adopt nonbinding SoP (before the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 mandated nonbinding SoP) and the adoption of regulation increasing shareholder influence over pay (Cai and Walking, 2011; Larcker et al., 2013).

duration of the transaction.¹² The reform raised the threshold to a majority of the minority (MoM) and, importantly, required long-term transactions to receive new approval every three years. The reform thus gave the minority real veto rights: the ability to deny a controller executive any pay going forward.

We study the effect of these veto rights on the pay of controller executives using hand-collected data on executive compensation for firms listed on the Tel Aviv Stock Exchange in the years 2008–2015. We exclude financial firms (for which measures of performance are different), dual-listed firms (which did not report individual executive compensation until 2014), firms with public debt but no public equity (which are not subject to minority veto rights) and exchange-listed oil explorations partnerships. Our sample, an unbalanced panel described in Panel A of Table 1, consists of 554 firms, of which 30% are in manufacturing, 27% are in services and 23% are in real estate.

Like Delaware law, Israeli law defines a shareholder (or a group of affiliated shareholders) as a controller if she can direct the firm's actions. For purposes of the requirement to obtain minority shareholder approval of controller transactions, including executive pay, Israeli law presumes that a 25% shareholder is a controller unless another shareholder holds 50% of the shares. Virtually all firms in our sample have a controller.

Panel A of Table 1 also presents accounting data on firm size and profitability obtained from the commercial provider A-Online. Firm size, measured by total assets, varies considerably across firms, with a mean that is much higher than the median. Accordingly, we control for the natural logarithm of total assets. As is standard in the executive compensation literature (for example, Bebchuk and Grinstein 2005), operating profitability is measured by return on assets (ROA).¹³ In our sample, ROA averages about zero, with a median of 2.5%, indicating the presence of many poorly performing firms. In fact, ROA is negative in about 30%

¹² Hamdani and Yafeh (2013) describe the voting rules and practices before the reform.

¹³ In many specifications, we use ROA together with individual or firm fixed effects, capturing changes in profitability relative to the firm-specific mean ROA over time. The results reported below remain qualitatively unchanged in unreported regressions using lagged profitability and market-to-book ratio instead of ROA.

of the observations. Accordingly, we control for ROA and in some specifications also use a dummy variable to denote negative profitability.

Israel requires the types of firms in our sample to disclose the compensation of individual executives (like the United States in its regulation of domestic public firms). In particular, these firms must report the individual annual compensation of the five highest paid executives in the firm and its subsidiaries, each of the three highest paid executives in the firm itself, and any holder of at least 5% of the shares (if paid by the firm). The precise definition of covered executives and the possibility of mid-year turnover mean that firms sometimes report the pay of fewer or more than five executives. For each firm, we obtain from annual reports and proxy statements the names, positions, compensation packages, and pay approvals of reported executives, typically including both controller executives and non-controller executives.¹⁴

In our sample, the median number of reported executives is five (the mean is slightly higher; Panel A of Table 1). More than 40% of all firms report the compensation of exactly five executives, making five the modal number of reported executives. Another 30% of the firms report the compensation of six or seven executives, 10% of the firms report the compensation of eight to ten executives, and another 10% report the compensation of three to four executives.

While virtually all firms in the sample have a controller, only about 60% of the firms report at least one controller executive. The median and mode of the number of controller executives per firm is one, and the mean is 1.3 (Panel A of Table 1), with 63% of controller executives serving as board chair or CEO. In one of the robustness tests described below, we exclude firms with no reported controller executives, obtaining similar results to those of the main specifications.

Panel B of Table 1 presents the executive compensation data, consisting of about 16,880 observations of about 4,900 executives during the period 2008–2015. Controller executives comprise about a fifth of the executives in the

¹⁴ We classify executives as controller executives according to the type of pay approval they obtain and verify the classification using the executive roster in the annual report.

sample. However, because their turnover is lower than that of other executives, they comprise about a quarter of the observations.

The average level of total compensation of an executive in the sample is about NIS 1.38 million (about \$345,000) and the median is about NIS 850,000 (approximately \$215,000), with controller executives earning on average about NIS 1.6 million—15% above the full sample average. Some controller executives are relatives of the controller who occupy less senior positions and bring down the average.

As expected, equity compensation is more common in compensation packages of non-controller executives. Non-equity compensation (total compensation minus equity-based pay) accounts, on average, for 88% of total compensation in the full sample and for 95% of total compensation of controller executives. Although controller executives are less likely to receive equity-based pay, they typically hold much larger equity stakes than non-controller executives: 23% on average (with a median of 15%), compared to 0.4% on average (with a median of 0%) for non-controller executives. Here too, some of the controller executives are relatives of the controller, bringing down the group average.¹⁵

Panel C of Table 1 presents compensation approvals by type and year. There are 310 pre-reform ToM approvals and 773 post-reform MoM approvals. MoM approvals appear to occur in two rounds. The first round starts in 2011, when the new law became effective. The second round starts in 2014, when the MoM approvals obtained in 2011 expired. In an extension of our analysis, we distinguish between the two MoM approval rounds.

Panel C of Table 1 also presents the distribution over time of compensation approvals for non-controller executives. These approvals include board approvals for the compensation of officers and shareholder approvals by a simple

¹⁵ A recent Bank of Israel internal memorandum reports very similar figures for the entire population of listed firms in Israel around the same period. Within the controller group (controller plus related parties), the average blockholder holds 23.3% of the equity; firms have 2.74 blockholders, on average, holding together about 64% of the equity. Because our focus in the present study is on the effect of the 2011 reform on the compensation of controller executives, where equity-based pay is not a major feature, we do not examine further the structure of compensation contracts.

majority for the compensation of board members.¹⁶ Both allow a controller to increase the pay of non-controller executives even if the minority objects. We use this information to compare the effect of different approval types on the likelihood of a compensation reduction.

Finally, Panel D of Table 1 reports the numbers of controller- and non-controller executives disappearing from their firm's list of highest paid executives each year. Casual observation suggests that the number of disappearing controller executives is higher in the post-reform period. We examine these data in more detail below.

We divide our main empirical tests into three parts. In the first part of our analysis, we use a difference-in-difference model to estimate the post-reform change in the compensation levels of controller executives. In essence, we compare the post-reform change in compensation of controller executives, whom the reform affected directly, with the post-reform change in compensation of non-controller executives in the same firm, whom the reform did not affect directly. For example, this can be a comparison between the change in compensation of a controller who serves as board chair and the change in compensation of a hired CEO at the same firm.

Ideally, the control group in an analysis of this type should be entirely unaffected by the reform. In our setting, this assumption may be violated if the compensation of non-controller executives is linked to that of the most senior executive in the firm—and that senior executive is a controller executive.¹⁷ However, if such linkage exists between the compensation of non-controller executives and the compensation of controller executives, it would only bias our estimates *against* finding pay differences post-reform between controller

¹⁶ Starting in 2013, new pay contracts of non-controller executives required MoM approval in certain circumstances. Our findings do not materially change when excluding these approvals.

¹⁷ Dittmann et al. (2018) show that, while CEO compensation only modestly affects employee compensation in Germany, the compensation of top executives tends to move together more closely.

executives and non-controller executives.¹⁸ Our estimates would then be conservative.

In the second part of the analysis, we explore one mechanism by which the reform affected controller-executive pay levels: the minority shareholders' use of their veto right to force controller executives to take pay cuts.¹⁹

In the third part of the analysis, we examine the extent to which the reform caused controller executives to disappear from the firm's list of highest paid employees and the likelihood that a hired professional manager replace a disappearing controller executive.

Finally, towards the end of the paper, we extend the core three parts of the analysis and present a variety of additional results and robustness tests.

3. Main results

3.1. The reform's effect on controller-executive pay level

We begin by examining whether the reform affected the pay levels of controller executives. We use a standard difference-in-differences specification:

$$\text{Log}(\text{Total Compensation})_{ijt} = \alpha + \beta * \text{Controller Executive}_{ijt} * \text{Post Reform} \\ + \text{Firm-Level Controls}_{jt} + \text{Executive Fixed Effects} + \text{Year Fixed Effects} + \varepsilon_{jt}, \quad (1)$$

where i , j and t denote the individual executive, the firm and the year, respectively. *Controller Executive*Post Reform* is a dummy for a controller executive (the treated group) in the year 2011 or later; the dummy for a

¹⁸ Our estimates would have a downward bias also if controller executives anticipated the reform and rushed to obtain ToM approvals ahead of the change, spurring pay increases pre-reform and postponing pay reductions by three years post-reform. However, Panel C of Table 1 does not reveal such a rush. This stands to reason. First, controller executives who could obtain pay increase before the reform would have presumably done so independent of the reform. Second, while a possible reform had been in discussion for several years, its timing and content evolved over a lengthy legislation process.

¹⁹ Minority veto rights can also keep pay from increasing.

controller executive prior to the reform is subsumed by individual executive fixed effects.²⁰ Executive fixed effects capture (among other things) each executive's average level of compensation over time. Firm-level controls and year fixed effects capture other determinants of pay.

Our main dependent variable in this part of the analysis is the natural logarithm of total compensation of an individual executive i in the year t , a variable commonly used in the executive compensation literature (for example, Bertrand and Mullainathan, 2001; Bebchuk and Grinstein, 2005). For accounting reasons, firms may report equity-based pay after the grant year, potentially distorting our pay measure. To address this, some specifications use total compensation minus equity-based pay. We also examine an alternative regression specification in which the dependent variable is the ratio of each executive's pay to the reported aggregate pay to all of the firm's top executives. Following Bebchuk et al. (2011), we refer to this measure of relative pay as the "pay slice".

Table 2 presents the results for the full sample, except for Columns 2 and 6, which present results for a more homogenous subsample of the two highest paid executives in each firm and year. In Columns 1, 2, 5, and 6, the dependent variable is the natural logarithm of total compensation. In Columns 3 and 7, the dependent variable is the natural logarithm of non-equity compensation; and in Columns 4 and 8 the dependent variable is the "pay slice". In Columns 1 through 4 we control only for executive- and year fixed effects. Columns 4 through 8 include, in addition, commonly used controls for firm size and ROA. We also control for whether the firm employs the executive for less than a full year or only part-time (*Partial Employment*).²¹ We cluster standard errors by firm and year.

²⁰ If we included a dummy variable for controller executives, as in a standard difference-in-differences specification, its coefficient would merely reflect the few executives whose relation to the controller varied over time (and so the executive fixed effect would not capture it), or who serve in two firms and are related to the controller only in one. In unreported regressions that include this variable, we find that its coefficient is positive and that the remaining coefficients are similar to those in Table 2.

²¹ The inclusion of executive fixed effects requires that we use only time-varying controls. The variable *Partial Employment* equals one in a year in which an executive works less than 12

The coefficients of the interaction term *Controller Executive*Post Reform* in Table 2 indicate the existence of a negative effect of the reform on the compensation of the treated group—controller executives. Although absolute compensation levels for executives in aggregate do not materially change during the sample period, the effect of the post-reform period on controller-executive pay levels implies that controller executives earn 13%–17% less in 2011–2015 than they would have earned absent the reform.²² Importantly, this is an *average* effect. Many controller executives (including the ones named in the Introduction) saw their pay fall by substantial amounts, with some experiencing pay cuts of over 50%. Conditional on pay reduction, nearly a quarter of controller executives saw their pay fall by at least 30%. Consistent with the previous results, Columns 4 and 8 show that the pay slice of controller executives (averaging about 19% in the years 2008–2010) declines by about one percentage point (about 5%) in the years 2011–2015. This decline is statistically significant.

3.2. The reform's effect on the likelihood of pay reductions

We study the mechanism by which the reform may have affected the pay of controller executives by examining the likelihood of pay reductions. Table 3 presents several regression specifications in which the dependent variable indicates whether total compensation or non-equity compensation is lower than in the preceding year. We use logit and linear probability models with and without executive fixed effects for the full sample and for a subsample of the two

months or less than full time. This variable, which equals one in about 25% of the observations, varies over time for some executives and thus can be included in the regressions. In robustness regressions reported below, we exclude executives working part time and obtain similar results. While our sample does not contain other executive-specific variables (such as age or education), the individual fixed effects largely capture their effects.

²² The estimates are smaller in magnitude and less statistically significant when the sample is restricted to the two highest paid executives. The results in the main specification of Column 5 are unchanged when we replace the post-reform dummy, which takes the value one starting in 2011 for all executives, by an individual post-reform dummy, which takes the value one after the MoM deadline of each controller executive. The results remain qualitatively unchanged also when we use other measures of firm performance, such as market-to-book ratio or lagged ROA. Note that the regressions include of (thousands of) executive-specific fixed effects results in high values of R-squared.

highest paid executives. The results are consistent across the various specifications.

In general, approvals of pay packages are associated with compensation increases across executives: the coefficient of *Any Approval* is negative and statistically significant (that is, negatively correlated with the probability of a compensation reduction). This is not surprising. First, over half of all approvals in our sample involve pay packages of non-controller executives. These pay packages are not subject to minority approval and thus depend solely on the controller. A controller or a board carrying out a controller's will and wishing to retain an executive is more likely to raise pay than to cut it. Second, many of the remaining approvals are pre-reform ToM approvals of controller executives' pay packages. A controller is likely to seek these approvals only when planning to raise the pay and expecting to obtain approval. Accordingly, the coefficient of *ToM Approval* is not statistically different from that of *Any Approval*.

MoM approvals are economically and statistically different from all other approvals in not being associated with compensation increases: the sum of the coefficients of *Any Approval* and *MoM Approval* is close to zero. This is because many MoM approvals are associated with compensation reductions. Specifically, of the 773 MoM approvals in our sample, 280 (36%) are associated with a reduction in total pay; the comparable figure for other approval types is nearly 50% smaller. Similarly, 36% of MoM approvals are associated with a reduction in non-equity compensation, compared to 17% of other approvals. Figure 1 shows that MoM approvals are far more likely to result in reductions of non-equity pay than other approval types. The same holds for reductions in total compensation.

We seek to explore why the reform affected certain controller executives more than others. In all specifications in Table 3 but one, we observe a negative and statistically significant relation between ROA and the likelihood of pay reduction. In unreported regressions, we find an even stronger negative relation between ROA and the likelihood of pay reduction of at least 25%.²³ However,

²³ The results in Table 3 remain qualitatively unchanged when we use other measures of firm performance, such as lagged ROA or market-to-book ratio. In unreported regressions, we also define dummy variables corresponding to ROA levels: one for negative ROA, another for positive-but-below-median ROA, and a third for above-median ROA. We find that negative ROA and

unlike Fisch et al. (2018), we do not find that the effect of MoM approval on the likelihood of pay reduction varies with firm performance or excess pay, defined as the residual from a regression of pay on firm size, industry and profitability. This suggests that minority shareholders use other indicators to determine whether a controller executive's pay is excessive.

We conclude that the requirement of MoM approval has real bite. Before their introduction in 2011, the alternative to seeking ToM approval for a raise was to keep a controller-executive's compensation unchanged. Starting in 2011, the option of continuing at the existing level of pay indefinitely is no longer available. The firm now has to seek MoM approval within three years of the previous approval, which can result in a pay cut if the minority perceives the controller executive as overpaid.

3.3. The reform's effect on controller-executive disappearances

As discussed above, contemporaneous anecdotal accounts indicate that, after the reform, certain controller executives quit or remained in office with no pay when they were unable to obtain MoM approval. These effects do not show up in our measure of controller-executive pay, which we based on the reported pay of executives who continue to appear on the list of the firm's highest paid employees, causing any observed decline to understate the reform's true impact on controller-executive pay levels and firm governance generally.

To investigate this effect, we identify all executives whose pay no longer appears in the firm's annual report, even though the firm remains in the sample and continues to report the pay of other executives. These executives disappear from their firm's list of highest paid executives because they no longer hold a senior position in the firm or because they continue to hold the same or other position but at a low pay or no pay at all.

positive-but-below-median ROA correlate with pay reductions more than the benchmark of above-median ROA.

Consistent with contemporaneous media reports, we find that the reform sharply increased the disappearance rate for controller executives. We also find that this effect correlates with failure to obtain MoM approval.

We begin by observing that controller executives are less likely to disappear than are non-controller executives during the entire sample period. While controller executives constitute about 25% of our sample, they constitute only 12% of disappearances. However, the disappearance rate for controller executives increases significantly after the reform. Between 2008 and 2009 and between 2009 and 2010, about 6% of controller executives disappeared each year. In the post-reform period, the corresponding annual figures are 9% to 12%, an increase of about 50%. There is no similar trend for non-controller executives. Figure 2 presents this change: the disappearance rate of controller executives increases in the post-reform period, whereas that of non-controller executives does not (upper panel). As a result, the frequency controller executive disappearance increases relative to the frequency of disappearance of non-controller executives (lower panel).

In Columns 1 and 2 of Table 4, we corroborate this result by running logit regressions estimating the coefficients of several determinants of the probability of disappearance. We find that this probability increases for controller executives after the reform. Moreover, Column 3 of Table 4 shows that the likelihood of controller executive disappearance increases after a MoM approval deadline. In particular, it is failure to meet the deadline that correlates with disappearance: Column 4 indicates that the likelihood of disappearance falls after obtaining MoM approval.²⁴

We read corporate filings to examine if hired professionals replaced disappearing controller executives. Before the reform, this was virtually unheard of. After the reform, it occurred in about 10% of controller-executive disappearances (roughly 30 out of about 300).²⁵ This appears to be a real, if

²⁴ This result holds also when using a linear probability regression.

²⁵ The figures are approximate because the fate of some disappearing controller executives is unclear. It appears that around 30 controller executives ceased to hold their positions for reasons unrelated to control changes and the person who replaced them was unrelated to the controller.

modest, effect of the reform on corporate management (we examine additional effects in Section 4). In addition, after the reform, about 50 controller executives remained in office but were no longer on the list of top paid executives because they worked for little or no pay.²⁶

In sum, the reform not only restrained the pay of controller executives whose pay continued to be reported, but also drove the pay of other controller executives below reported levels, often to zero. It also prompted a modest shift in the staffing of management positions, from controllers to hired professionals. Our estimates of the reform's effect on controller-executive pay therefore understate the reform's full effect on firms.²⁷

4. Extensions and Robustness Tests

4.1. Results for sub-periods: first-round vs. second-round MoM approvals

The reform required controller executives to obtain MoM approval for their pay within three years of the last approval. The first approval deadline thus took place in the period 2011–2013, depending on the executive's last pay approval date, with over half of controller executives in office in 2011 having their initial MoM deadline in 2011. The second MoM approval deadline came three years later, in the period 2014–2016.

To examine the long-term effects of the reform, we distinguish in Table 5 between the first round of MoM approvals, in 2011–2013 (63% of the sample), and the second round of MoM approvals, in 2014–2015 (37% of the sample). It appears that second-round MoM approvals are less likely to be associated with

²⁶ Here too the figures are approximate. Other reasons for controller-executive disappearance include replacement by different controller executives, control changes, and court ordered receivership.

²⁷ Ra and Kim (2018) discuss a related phenomenon in Korea, where a mandatory pay disclosure rule applies to board members whose compensation levels exceed a certain level. They report that board members attempt to evade the rules and disappear through pay cuts or by relinquishing their formal positions.

compensation reductions than first-round MoM approvals, although this difference is not statistically significant.²⁸

One interpretation of the lower likelihood of pay reductions in second-round MoM approvals is that the first round of MoM approvals adjusted the pay of controller executives as much as minority shareholders wanted, allowing firms to revert to normal raises at the time of second-round MoM approvals. Another interpretation is that firms had more time to prepare for the second round of MoM approvals and chose opportune moments to hold them.²⁹

4.2. Results for subsamples

In Table 6, we repeat the benchmark regression specification from Column 5 of Table 2 for several subsamples.

In Column 1, we exclude firms without controller executives on the list of highest paid executives. These firms help us to estimate the effects of the control variables more precisely, but do not contribute to the estimation of the post-reform change in controller-executive pay. These firms may also be different from firms with controller executives on the list of highest paid executives. The results are similar to those in Column 5 of Table 2.

In Column 2, we include only firms with a controller executive whose MoM approval deadline is in 2011 to estimate the effect of the reform on controller executives that could not plan for it. In this, much smaller subsample, the effect

²⁸ While the difference between the coefficient of first-round approvals and the coefficient of second-round approvals is not statistically significant in any regression, in all regressions the coefficient of first-round approvals is larger and more statistically significant. However, the coefficients on first-round approvals are not larger than the coefficients on second-round approvals in logit regressions with no executive fixed effects; therefore, our conclusions in this section remain tentative.

²⁹ In unreported regressions, we distinguish between MoM approvals obtained at a date before the calendar year of the deadline stipulated by law and MoM approvals obtained in the calendar year of the legal deadline or later. We examine if controller executives facing an approval deadline (perhaps because they did not expect to win approval earlier in the cycle) are more likely to take a pay cut than controller executives who seek approval earlier in the cycle. The differences, however, are economically and statistically insignificant.

of the reform on the compensation of controller executives is much larger than in the full sample: about –20% versus about –13% in Column 5 of Table 2.³⁰

In Column 3, we exclude executives who disappear from the sample before its last year. In Column 4, we also exclude executives who appear in the sample only after its initial year. In Column 5, we exclude executives employed part-time. In these three specifications, the effect of the post-reform years on the compensation of controller executives remains.

In unreported regressions, we exclude parents and their subsidiaries from the sample. The reason is that compensation figures in the reports of parents include compensation paid by subsidiaries, even if the subsidiaries are public and report it in their own filings. This can distort our analysis of the relation between compensation, approvals, and performance. The results of Table 2 remain unchanged in this subsample.

4.3. Additional effects of the reform on firm behavior

We explore possible effects of the reform on other aspects of corporate behavior.

First, we examine if other types of related-party transactions replaced executive pay as a way for controllers to extract rent. We do not believe such a shift is likely because the reform subjected all related-party transactions not in the ordinary course of business to the same MoM approval requirement as executive pay. After the reform, the value of non-pay related-party transactions normalized by firm assets declines for the 108 firms in our sample with available data (non-financial firms among the largest 150 firms on Tel Aviv Stock Exchange) by slightly more than 50%. The decline is similar (slightly less than 50%) for firms in which a controller executive experienced a pay decrease post-reform. It is possible that controller-executive pay and non-pay related-party transactions are complements, rather than substitutes, but the available data are not enough to draw firm conclusions.

³⁰ It is also possible to run the pay slice regressions of Table 2 for this subsample. The results hold.

Second, we examine if an increase in dividend payout replaces executive pay as a way of controllers to benefit from the firm. Such a shift is also unlikely because, contrary to executive compensation, dividends are payable to all shareholders and are thus costly to controllers. Accordingly, in unreported regressions we find that the ratio of dividends to profits (or other measures of dividends normalized by firm size) remains roughly constant post-reform and that firms with controller-executive pay reductions are not different from other firms.

Finally, we also do not detect significant changes in Tobin's Q following the reform or following compensation reductions. This is perhaps not surprising given the modest magnitude of compensation reductions and the fact that the managerial incentives of controller executives are due primarily to their shareholdings.

4. Conclusion

To protect minority shareholders from tunneling by controllers, a number of jurisdictions have introduced reforms designed to give the minority veto rights over related-party transactions. We test the effect of this right by exploiting a 2011 Israeli reform that gave minority shareholders, in midstream, the ability to veto the pay of controller executives.

We find that this veto right constrains the pay of controller executives, in part by increasing the frequency of pay reductions. The threat of minority veto also induces some controller executives to relinquish their positions or continue to work without pay. Following the reform, the rate at which controller executives disappear from their firm's highest paid executives list increases by about 50%. The estimated effect of the reform on controller-executive pay thus understates its actual effect.

Our work contributes to a better understanding of controller-pay tunneling. We find that the grant of a minority veto constrains controller-executive pay levels, leads to more pay reductions and to the disappearance of certain controller executives from the firm's list of highest paid executives, suggesting that pre-reform minority shareholders considered some controller executives to be overpaid.

This paper also provides a unique setting for identifying the power of minority veto rights for policing related-party transactions more generally. Unlike other settings, where the controller chooses whether to give the minority a veto right (as in Delaware) or the veto right is mandatory but the controller can choose whether and when to propose a transaction (as in Canada), our setting raises minimal endogeneity concerns. The reason is that the Israeli reform makes the veto right mandatory and sets forth an exogenous deadline for obtaining minority approval.

Our work also contributes to the literature on SoP by showing that a mandatory vote can have an effect both on the level of executive pay and on whether executives remain in their jobs. This may be relevant to policymakers in many jurisdictions given the ubiquity of shareholder voting schemes around the world.

References

Armstrong, C., Gow, I., Larcker, D., 2013. The efficacy of shareholder voting: Evidence from equity compensation plans. *Journal of Accounting Research* 51, 909–950.

Barak, R., Cohen, S., Lauterbach, B., 2011. The effect of CEO pay on firm valuation in closely held firms. *Advances in Financial Economics: International Corporate Governance* 14, 19–42.

Bozzi, S., Barontini, R., Miroshnychenko, I., 2017. Investor protection and CEO compensation in family firms. *Corporate Ownership and Control* 14, 17–29.

Bebchuk, L., Cremers, K., Peyer, U., 2011. The CEO pay slice. *Journal of Financial Economics* 102, 199–221.

Bebchuk, L., Grinstein, Y., 2005. The growth of executive pay. *Oxford Review of Economic Policy* 21, 283–303.

Bebchuk, L., Hamdani, A., 2017. Independent directors and controlling shareholders. *University of Pennsylvania Law Review* 165, 1271–1315.

Bebchuk, L., Hamdani, A., 2018. The agency costs of controlling shareholders. Unpublished working paper, Harvard Law School and Tel Aviv University.

Becht, M., Polo, A., Rossi, S., 2016. Does mandatory shareholder voting prevent bad acquisitions? *Review of Financial Studies* 29, 3035–3067.

Bertrand, M., Mullainathan, S., 2001. Are CEOs rewarded for luck? The ones without principals are. *Quarterly Journal of Economics* 116, 901–929.

Black, B., Kraakman, R., 1996. A self-enforcing model of corporate law. *Harvard Law Review* 109, 1911–1982.

Brunarski, K., Campbell, C., Harman, Y., 2015. Evidence on the outcome of say on pay votes: How managers, directors, and shareholders respond. *Journal of Corporate Finance* 30, 132–149.

Burkart, M., Gromb, D., Panunzi, F., 1997. Large shareholder monitoring and the value of the firm. *Quarterly Journal of Economics* 112, 693–728.

Cai, J., Walking, R., 2011. Shareholders' say on pay: Does it create value? *Journal of Financial and Quantitative Analysis* 46, 299–339.

Canadian Securities Administrators, 2017. Multilateral CSA notice of adoption of multilateral instrument 61–101: Protection of minority security holders in special transactions.

Carleton, W., Nelson, J., Weisbach, M., 1998. The influence of institutions on corporate governance through private negotiations: Evidence from TIAA–CREF. *Journal of Finance* 53, 1335–1362.

Chen, Z., Bin, K., Yang, Z., 2013. Minority shareholders' control rights and the quality of corporate decisions in weak investor protection countries: A natural experiment from China. *Accounting Review* 88, 1211–1238.

Claessens, S., Djankov, S., Lang, L., 2000. The separation of ownership and control in East Asian corporations. *Journal of Financial Economics* 58, 81–112.

Correa, R., Lel, U., 2016. Say on pay laws, executive compensation, CEO pay slice, and firm value around the world. *Journal of Financial Economics* 122, 500–520.

Croci, E., Gonenc, H., Ozkan, N., 2012. CEO compensation, family control, and institutional investors in Continental Europe. *Journal of Banking and Finance* 36, 3318–3335.

Cuñat, V., Giné, M., Guadalupe, M., 2016. Say pays! Shareholder voice and firm performance. *Review of Finance* 20, 1799–1834.

Davies, P., 2018. Related party transactions: UK model. ECGI Law Working Paper No. 387/2018.

Dittmann, D., Schneider, C., Zhu, Y., 2018. The real cost of CEO compensation: The effect of behindness aversion of employees. ECGI Finance Working Paper No. 559/2018.

Djankov, S., La Porta, R., Lopez de Silanes, F., Shleifer, A., 2008. The law and economics of self-dealing. *Journal of Financial Economics* 88, 430–465.

Elston, J., Goldberg, L.A., 2003. Executive compensation and agency costs in Germany. *Journal of Banking and Finance* 27, 1391–1410.

Enriques, L., 2015. Related-party transactions: Policy options and real-world challenges, *European Business Organization Law Review* 16, 1–37.

Enriques, L., Hertig, G., Kanda, H., Pargendler, M., 2017. Related party transactions. In: R. Kraakman et al. (Eds.), *The Anatomy of Corporate Law*, Oxford University Press, 3d Edition, pp. 145–169.

Enriques, L., Tröger, T., 2018. The law and (some) finance of related party transactions: An introduction. In: Enriques, L., Tröger, T. (Eds.), *The Law and Finance of Related Party Transactions*, Cambridge University Press, forthcoming.

Enriques, L., Volpin, P., 2007. Corporate governance reforms in Continental Europe. *Journal of Economic Perspectives* 21, 117–140.

Ertimur, Y., Ferri, F., Muslu, V. 2012. Shareholder activism and CEO pay. *Review of Financial Studies* 24, 535–592.

Faccio, M., Lang, L., 2002. The ultimate control of Western European corporations. *Journal of Financial Economics* 65, 365–395.

Ferri, F., Maber, D., 2013. Say on pay votes and CEO compensation: Evidence from the United Kingdom. *Review of Finance* 17, 527–563.

Fisch, J., Palia, D., Davidoff Solomon, S., 2018. Is say on pay all about pay? The impact of firm performance. *Harvard Business Law Review* 8, 101–129.

Fried, J., 2019. Powering preemptive rights with presubscription disclosure. In: Enriques, L., Tröger, T. (Eds.), *The Law and Finance of Related Party Transactions*, Cambridge University Press, forthcoming.

Fried, J., Spamann, H., 2018. Cheap-stock tunneling around preemptive rights. ECGI Law Working Paper No. 408/2018.

Gilson, R., Gordon, J., 2003. Controlling controlling shareholders. *University of Pennsylvania Law Review* 152, 785–843.

Gilson, R., Schwartz, A., 2015. Corporate control and credible commitment. *International Review of Law and Economics* 43, 119–130.

Goshen, Z., 2003. The efficiency of controlling corporate self-dealing: Theory meets reality. *California Law Review* 91, 393–438.

Gregory-Smith, I., Thompson, P., Wright, P., 2013. CEO pay and voting dissent before and after the crisis. *Economic Journal* 124, F22–F39.

Gutiérrez, M., Sáez Lacave, M., 2018. Strong shareholders, weak outside investors. *Journal of Corporate Law Studies* 18, 277–309.

Hamdani, A., Yafeh, Y., 2013. Institutional investors as minority shareholders. *Review of Finance* 17, 691–725.

Holderness, C., 2009. The myth of diffuse ownership in the United States. *Review of Financial Studies* 22, 1377–1408.

Holderness, C., 2018. Equity issuances and agency costs: The telling story of shareholder approval around the world. *Journal of Financial Economics* 129, 415–439.

Iliev, P., Vitanova, S., 2019. The effect of the say-on-pay vote in the U.S. *Management Science*, forthcoming.

Jackson, H., Roe, M., 2009. Public and private enforcement of securities laws: Resource-based evidence. *Journal of Financial Economics* 93, 207–238.

Kamar, E., 2006. Does shareholder voting on acquisitions matter? American Law and Economics Association Annual Meeting.

Khanna, T., Yafeh, Y., 2007. Business groups in emerging markets: Paragons or parasites? *Journal of Economic Literature* 45, 331–373.

Larcker, D., Ormazabal, G., Taylor, D., 2013. The market reaction to corporate governance regulation. *Journal of Financial Economics* 101, 431–448.

Li, N., 2018. Do greater shareholder voting rights reduce expropriation? Evidence from related party transactions. Columbia Business School Research Paper No. 18–26.

Lin, Y., 2019. When activists meet controlling shareholders in the shadow of the law: A case study of Hong Kong, *Asian Journal of Comparative Law* 14, forthcoming.

OECD, 2012. Related Party Transactions and Minority Shareholder Rights. OECD Publishing.

Ra, J., Kim, W., 2018, Perils of limiting the coverage of mandatory pay disclosure: The Korean experience, ECGI Law Working Paper No. 572/2018

Restrepo, F., 2013. Do different standards of judicial review affect the gains of minority shareholders in freeze-out transactions? A re-examination of Siliconix. *Harvard Business Law Review* 3, 321–359.

Restrepo, F., Subramanian, G., 2015. The effect of Delaware doctrine on freezeout structure and outcomes: Evidence on the unified approach. *Harvard Business Law Review* 5, 205–236.

Rock, E., 2019. MOM approval in a world of active shareholders. In: Enriques, L., Tröger, T. (Eds.), *The Law and Finance of Related Party Transactions*, Cambridge University Press, forthcoming.

Shleifer, A., Vishny, R., 1997. A survey of corporate governance. *Journal of Finance* 52, 737–783.

Subramanian, G., 2007. Post-Siliconix freeze-outs: Theory and evidence. *Journal of Legal Studies* 26, 1–26.

Urzua, F., 2009. Too few dividends? Groups' tunneling through chair and board compensation. *Journal of Corporate Finance* 15, 245–256.

Yermack, D., 2010. Shareholder voting and corporate governance. *Annual Review of Financial Economics* 2, 103–125.

Figure 1: Percent of Approvals Ending in Non-Equity Pay Reduction by Approval Type

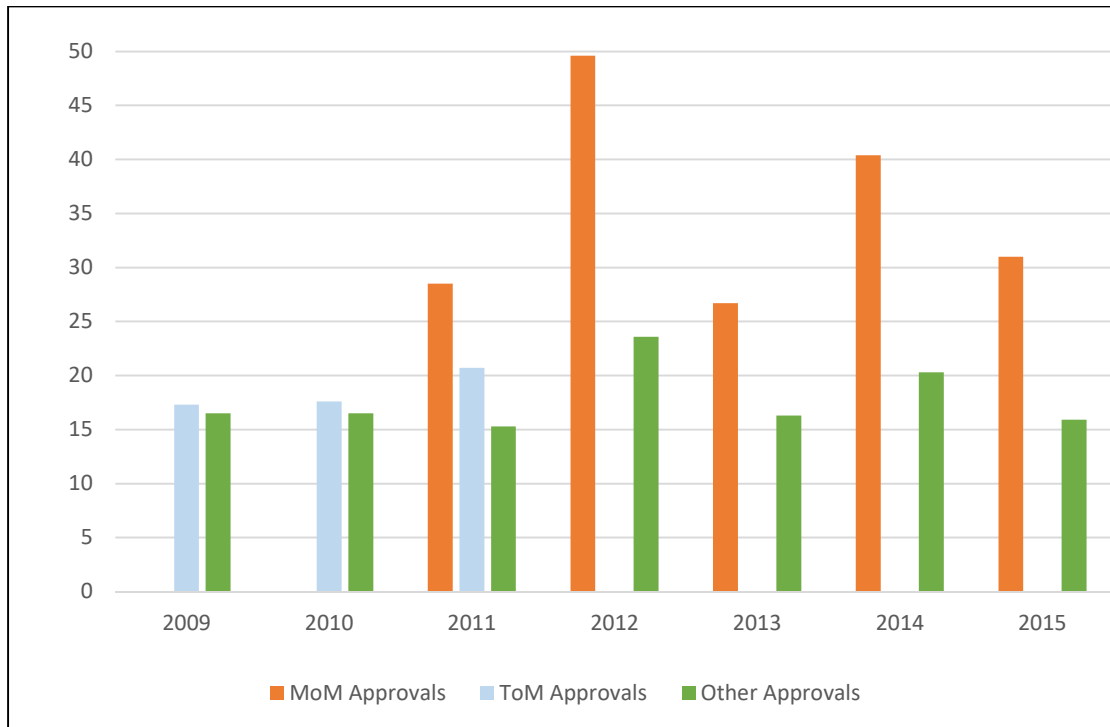


Figure 2: Disappearance Rates of Controller- and Non-Controller Executives

A disappearing executive is an executive who no longer appears on the firm's list of highest paid executives after the current year. The last year in the sample appears on the horizontal axis. The disappearance rate is the likelihood that a particular type of executive (controller or non-controller) will disappear. The top figure compares the disappearance rate each year with the pre-reform disappearance rate (the average of the 2008 and 2009 disappearance rates, normalized at 100). The bottom figure compares the disappearance rates of controller- and non-controller executives.

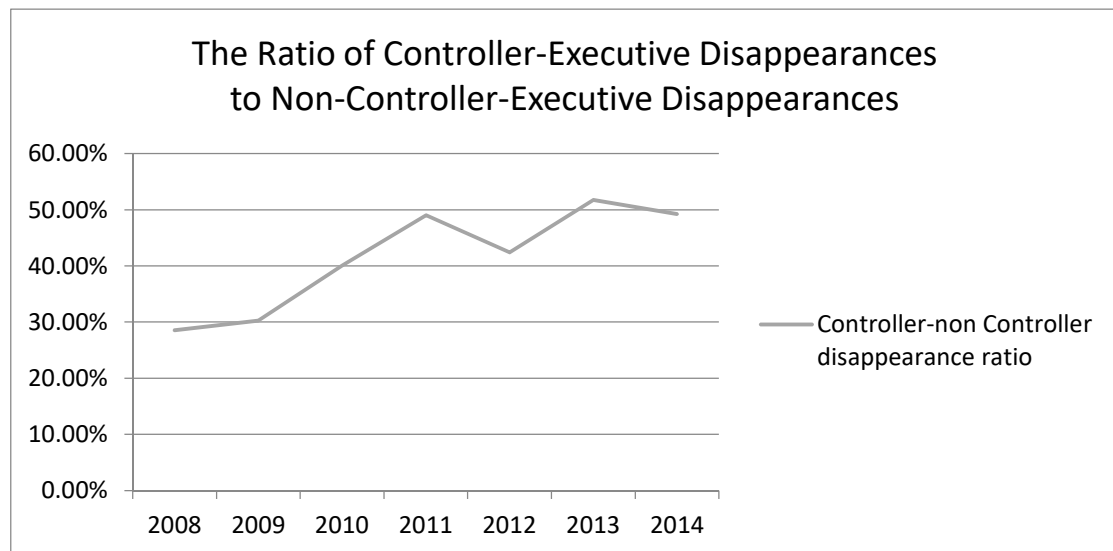
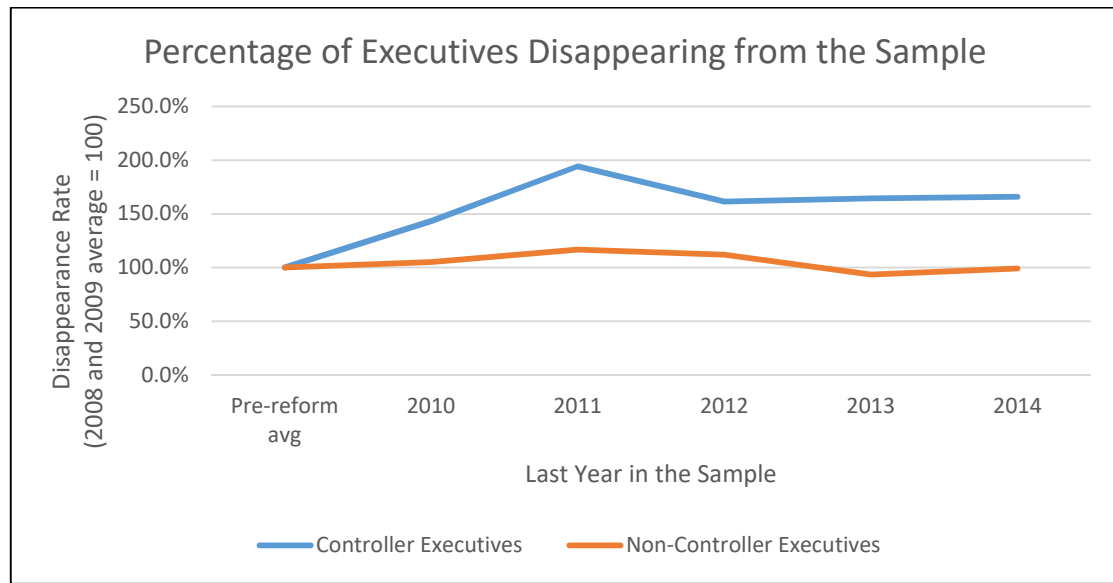


Table 1, Panel A: Firm-Level Data

The sample is an unbalanced panel of 4,922 executives from 554 Israeli public firms in the years 2008–2015. Panel A reports annual firm-level data. Firm-level financial variables are from commercial provider A-Online. Other data come directly from firms’ annual reports. All monetary values are in New Israeli Shekels (about 4 NIS per 1 USD).

Definition	Units	Mean	Std.	25%	50%	75%
Total Assets	Millions of NIS	3,616	13,600	116	376	1,284
ROA	Annual operating profits to assets, in percent	0.0	16.0	–1.2	2.5	6.8
Number of Reported Executives		5.8	1.9	5	5	6
Number of Reported Controller Executives		1.27	1.38	0	1	2

Table 1, Panel B: Executive-Level Pay Data

The sample is an unbalanced panel of 4,922 executives from 554 Israeli public firms in the years 2008–2015. Panel B reports the annual compensation of each executive based on annual reports. All financial values are in NIS (about 4 NIS per 1 USD).

Definition	Units	Mean	Std.	25%	50%	75%	Obs.
Total Compensation (reported value of all compensation components)	Thousands of NIS	1,378	1,992	462	849	1,520	16,880
Total Compensation of Controller Executives	Thousands of NIS	1,585	2,369	522	11,015	1,840	4,141
Non-Equity Compensation (Total Compensation excluding equity-based components)	Thousands of NIS	1,212	1,575	446	817	1,422	16,880
Non-Equity Compensation of Controller Executives	Thousands of NIS	1,493	2,097	510	995	1,795	4,141
Equity Held by Individual Controller Executives	In percent	23	25	0	15	39	4,126
Partial Employment	Equals one if an executive is employed for less than a full year or less than full-time	24.8%					16,880

Table 1, Panel C: Pay Approvals

The sample is an unbalanced panel of 4,922 executives from 554 Israeli public firms in the years 2008–2015. Panel C reports, for each of those years, pay approvals for controller and non-controller executives in our sample. All variables are from annual reports and proxy statements. We did not collect data on Other Approvals for the year 2008.

Approval Type	Definition	2008	2009	2010	2011	2012	2013	2014	2015	Total
MoM Approval	Majority of the minority approval of a controller executive's pay (after mid-2011)	N/A	N/A	N/A	210	143	117	209	94	773
ToM Approval	Third of the minority approval of a controller executive's pay (before mid-2011)	91	75	117	27	N/A	N/A	N/A	N/A	310
Other Approvals	Various approvals by the board or shareholders of the pay of non-controller executives (all years)		220	335	278	258	238	181	167	1677

Table 1, Panel D: Executive Disappearances by Last Year of Appearance

The sample is an unbalanced panel of 4,922 executives from 554 Israeli public firms in the years 2008–2015. Panel D reports the number (percent) of disappearing executives (executives whose pay no longer appears after the current year in firm’s that continues to report the pay of other executives). All variables are from annual reports and proxy statements.

Definition	2008	2009	2010	2011	2012	2013	2014	2015	Total
Number of controller- executives (percent of all controller- executives) whose pay is not reported in the following year	28 (5.7)	33 (6.7)	56 (8.8)	71 (12.0)	52 (9.9)	46 (10.1)	45 (10.2)	N/A	331 (8.0)
Number of non-controller executives (percent of all non-controller executives) whose pay is not reported in the following year	316 (19.8)	345 (22.0)	415 (22.0)	437 (24.4)	370 (23.4)	283 (19.5)	295 (20.7)	N/A	2,461 (19.3)

Table 2: Pay Before and After the Reform

The sample is an unbalanced panel of 4,922 executives from 554 Israeli public firms in the years 2008–2015. In Columns 1, 2, 5, and 6, the dependent variable is the natural logarithm of annual total compensation. In Columns 3 and 7, the dependent variable is the natural logarithm of non-equity compensation (omitting observations in which the entire compensation package is equity based). In Columns 4 and 8, the dependent variable is the “pay slice” (the share of the executive’s total pay to that of all reported executives in the firm/year), omitting the lowest paid executive reported in each firm/year so that the slices do not add up to one. All specifications include executive- and year fixed effects. All columns report results for the full sample, except Columns 2 and 6, which report the results for a subsample of the two highest paid executives in each firm. *Controller Executive*Post Reform* equals one for controller executives starting in 2011 and zero otherwise. *Partial Employment* equals one for executives employed less than a full year or less than full time and zero otherwise. We multiply the coefficient of ROA by 100. All control variables are from the same year as the dependent variable. Robust standard errors, clustered by firm and year, are in parentheses. ***, ** and * denote statistical significance at the 1%, 5% and 10% levels respectively.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Controller Executive*Post Reform	-0.16** (0.03)	-0.08*** (0.03)	-0.17*** (0.03)	-0.01** (0.005)	-0.13*** (0.03)	-0.05 (0.03)	-0.15*** (0.03)	-0.01** (0.005)
Partial Employment					-0.31*** (0.03)	-0.16*** (0.04)	-0.30*** (0.03)	-0.02*** (0.004)
Log (Total Assets, in thousands of NIS)					0.22*** (0.02)	0.22*** (0.02)	0.20*** (0.02)	-0.03*** (0.003)
ROA					-0.02 (0.09)	0.18* (0.11)	0.03 (0.09)	0.03** (0.01)
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Executive Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	16,880	6,352	16,826	13,624	16,880	6,352	16,826	13,624
R-Squared	0.86	0.90	0.87	0.77	0.87	0.90	0.87	0.78

Table 3: The Determinants of Pay Reduction

The sample is an unbalanced panel of 4,922 executives from 554 Israeli public firms in the years 2008–2015. Using a truncated sample starting in 2009 (compensation changes relative to 2008) this table presents logit and linear probability regressions where the dependent variable is compensation reduction. Column 1 presents a logit regression with a dummy for controller executives and no executive fixed effects. The dependent variable is a dummy that equals one if total compensation declines relative to the previous year and zero otherwise. Column 2 presents results of a linear probability regression with executive fixed effects (and hence no dummy for controller executives) for the same dependent variable. Columns 3 and 4 present similar specifications for a subsample of the two highest paid executives. Columns 5 and 6 present similar specifications using reduction in non-equity compensation as the dependent variable. *Any Approval* is a dummy variable that equals one if there was a pay approval in the year, and zero otherwise. *MoM Approval* and *ToM Approval* are similarly defined dummy variables that equal one if a MoM approval or a ToM approval, respectively, took place in the current year and zero otherwise. *Log (Total Assets)* is the natural logarithm of total assets in NIS. We multiply the coefficient of *ROA* by 100. *Negative ROA* and *Partial Employment* are dummy variables denoting negative ROA and partial employment (less than a full-year or less than full-time). All control variables are from the same year as the dependent variable. Robust standard errors, clustered by executive in the logit regressions and by firm and year in the LPM regressions, are in parentheses. ***, ** and * denote statistical significance at 1%, 5% and 10% respectively.

	(1) Logit	(2) LPM	(3) Logit	(4) LPM	(5) Logit	(6) LPM
Any Approval	-0.63*** (0.07)	-0.13*** (0.02)	-0.55*** (0.10)	-0.15*** (0.03)	-0.61*** (0.07)	-0.10*** (0.02)
MoM Approval	0.45*** (0.11)	0.08*** (0.03)	0.44** (0.15)	0.10** (0.05)	0.47*** (0.11)	0.07** (0.03)
ToM Approval	-0.13 (0.21)	0.01 (0.04)	-0.01 (0.26)	0.04 (0.06)	0.07 (0.26)	0.00 (0.04)
Log (Total Assets in Thousands of NIS)	0.04*** (0.01)	-0.01 (0.01)	0.04** (0.02)	-0.01 (0.02)	0.00 (0.01)	-0.01 (0.01)
ROA	-0.42*** (0.14)	-0.13* (0.07)	-0.42* (0.22)	-0.19* (0.11)	-0.15 (0.15)	-0.16** (0.07)
Negative ROA	0.13** (0.05)	0.03 (0.02)	0.10 (0.08)	0.04 (0.03)	0.05 (0.05)	0.01 (0.02)
Partial Employment	0.05 (0.04)	0.07*** (0.02)	-0.03 (0.07)	0.05 (0.04)	0.04 (0.04)	0.07*** (0.02)
Controller Executive	0.36*** (0.05)	N/A	0.18*** (0.07)	N/A	0.42*** (0.05)	N/A
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Executive Fixed Effects	No	Yes	No	Yes	No	Yes
Observations	14,790	14,790	5,552	5,552	14,790	14,790
R-Squared	N/A	0.30	N/A	0.35	N/A	0.29

Table 4: Executive Disappearance Before and After the Reform

The full sample is an unbalanced panel of 4,922 executives from 554 Israeli public firms in the years 2008–2015. Using a truncated sample ending in 2014, this table presents the results of logit regressions in which the dependent variable is a dummy that equals one if the firm reports the pay of an executive in a given year but not thereafter while the firm continues to report the pay of other executives, and zero otherwise. *Controller Executive*Post Reform* equals one for controller executives starting in 2011 (controller executives whose last year in the sample is 2010) and zero otherwise. *MoM Approval Due* equals one if there is a MoM approval deadline in the current year, and zero otherwise. *MoM Approval* equals one if a MoM approval occurs in the year and zero otherwise. *Partial Employment* equals one for executives employed less than a full year or full time, and zero otherwise. We multiply the coefficient of ROA by 100. All control variables are from the same year as the dependent variable. Robust standard errors, clustered by executive, are in parentheses. ***, ** and * denote statistical significance at the 1%, 5% and 10% respectively.

	(1)	(2)	(3)	(4)
Controller Executive	-1.39*** (0.14)	-1.41*** (0.14)	-1.68*** (0.09)	-1.00*** (0.07)
Controller Executive *Post Reform	0.45* (0.15)	0.43*** (0.16)		
MoM Approval Due			0.79*** (0.15)	
MoM Approval Obtained				-0.48*** (0.17)
Partial Employment		0.57*** (0.05)	0.56*** (0.06)	0.57*** (0.05)
Log (Total Assets in thousands of NIS)		0.03** (0.01)	0.03* (0.01)	0.03** (0.01)
ROA		-1.11*** (0.13)	-1.05*** (0.13)	-1.10*** (0.13)
Year Fixed Effects	Yes	Yes	Yes	Yes
Executive Fixed Effects	No	No	No	No
Observations	14,998	14,998	14,614	14,998

Table 5: Pay Reductions by MoM Approval Round

The sample is an unbalanced panel of 4,922 executives from 554 Israeli public firms in the years 2008–2015. Using a truncated sample starting in 2009 (compensation changes relative to 2008), this table presents linear probability regressions with executive fixed effects where the dependent variable is a dummy that equals one if compensation declines relative to the previous year, and zero otherwise. Column 1 presents results for the entire truncated sample. Column 2 presents results for a subsample of the two highest paid executives. Column 3 presents full-sample results of a regression in which the dependent variable is a dummy that equals one if non-equity pay declines relative to the previous year, and zero otherwise. *MoM Approval*2011–2013* and *MoM Approval*2014–2015* equal one if a MoM approval occurs in the year and the year is in 2011–2013 or 2014–2015, respectively, and zero otherwise. *Any Approval* is a dummy variable that equals one if there is any pay approval for the executive in the year, and zero otherwise. *ToM Approval* is a similarly defined dummy variable that equals one if a ToM approval occurs in the year, and zero otherwise. *Log (Total Assets)* is the natural logarithm of total assets in NIS. We multiply the coefficient of *ROA* by 100. *Negative ROA* and *Partial Employment* are dummy variables denoting negative ROA and partial employment (less than full-time or less than a full year). All control variables are from the same year as the dependent variable. Robust standard errors, clustered by firm and year, are in parentheses. ***, ** and * denote statistical significance at the 1%, 5% and 10% respectively.

	(1) LPM	(2) LPM	(3) LPM
Any Approval	–0.13*** (0.02)	–0.14*** (0.03)	–0.10*** (0.02)
MoM Approval*2011–2013	0.09** (0.04)	0.13** (0.05)	0.08** (0.04)
MoM Approval*2014–2015	0.06 (0.05)	0.04 (0.07)	0.05 (0.05)
ToM Approval	0.01 (0.04)	0.04 (0.06)	0.00 (0.04)
Log (Total Assets in thousands of NIS)	–0.01 (0.01)	–0.01 (0.02)	–0.01 (0.01)
ROA	–0.13* (0.07)	–0.19* (0.11)	–0.16** (0.07)
Negative ROA	0.03 (0.02)	0.04 (0.03)	0.01 (0.02)
Partial Employment	0.07*** (0.02)	0.05 (0.04)	0.07*** (0.02)
Year Fixed Effects	Yes	Yes	Yes
Executive Fixed Effects	Yes	Yes	Yes
Observations	14,790	5,552	14,790
R-Squared	0.30	0.35	0.29

Table 6: Pay Before and After the Reform by Subsamples

This table repeats the benchmark regressions from Column 4 of Table 2 for several subsamples. In all regressions, the dependent variable is the natural logarithm of total compensation. In Column 1, we include only firms with at least one controller executive on the list of highest paid executives. In Column 2, we include only firms with controller executives whose MoM approval deadline is in 2011. In Column 3, we include only executives who remain in office until the end of the sample period. In Column 4, we include only executives who are in office for the entire sample period. In Column 5, we exclude executives with *Partial Employment*. *Controller Executive*Post Reform* equals one for controller executives starting in 2011, and zero otherwise. *Partial Employment* equals one for executives employed less than a full year or less than full time, and zero otherwise. We multiply the coefficient of ROA by 100. All control variables are from the same year as the dependent variable. Robust standard errors, clustered by firm and year, are in parentheses. ***, ** and * denote statistical significance at the 1%, 5% and 10% levels respectively.

	(1)	(2)	(3)	(4)	(5)
Controller Executive *Post Reform	-0.12*** (0.03)	-0.20*** (0.04)	-0.11*** (0.03)	-0.14*** (0.03)	-0.12*** (0.03)
Partial Employment	-0.30*** (0.03)	-0.28*** (0.05)	-0.26*** (0.04)	-0.24*** (0.06)	N/A
Log (Total Assets in Thousands of NIS)	0.23*** (0.04)	0.19*** (0.05)	0.26*** (0.04)	0.28*** (0.04)	0.14*** (0.02)
ROA	0.23 (0.15)	0.60** (0.29)	0.13 (0.10)	0.46*** (0.15)	0.09 (0.10)
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes
Executive Fixed Effects	Yes	Yes	Yes	Yes	Yes
Observations	10,554	5,793	8,486	3,796	12,694
R-Squared	0.88	0.91	0.86	0.84	0.88

about ECGI

The European Corporate Governance Institute has been established to improve *corporate governance through fostering independent scientific research and related activities*.

The ECGI will produce and disseminate high quality research while remaining close to the concerns and interests of corporate, financial and public policy makers. It will draw on the expertise of scholars from numerous countries and bring together a critical mass of expertise and interest to bear on this important subject.

The views expressed in this working paper are those of the authors, not those of the ECGI or its members.

ECGI Working Paper Series in Law

Editorial Board

Editor	Amir Licht, Professor of Law, Radzyner Law School, Interdisciplinary Center Herzliya
Consulting Editors	John Coates, John F. Cogan, Jr. Professor of Law and Economics, Harvard Law School Horst Eidenmüller, Freshfields Professor of Commercial Law, University of Oxford Curtis Milhaupt, Professor of Law, Stanford Law School Niamh Moloney, Professor of Law, Department of Law, London School of Economics and Political Science
Editorial Assistants	Tamas Barko , University of Mannheim Vanessa Wang, University of Mannheim

Electronic Access to the Working Paper Series

The full set of ECGI working papers can be accessed through the Institute's Web-site (www.ecgi.global/content/working-papers) or SSRN:

Finance Paper Series	http://www.ssrn.com/link/ECGI-Fin.html
-----------------------------	---

Law Paper Series	http://www.ssrn.com/link/ECGI-Law.html
-------------------------	---