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Private Firm, Public Corporation or Member`s Association – Governance Structures in European Football

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Abstract

Based on the analysis of the specific environment in which football clubs compete, this paper presents a comparative institutional analysis of three paradigmatic structures of football club governance: privately owned football firms, public football corporations (stock corporations with dispersed ownership) and members' associations with an own legal personality (Verein). Against the background that "spending power" is the main driver of competitive advantage for clubs in the overinvestment environment of European football, the governance structure of the privately owned football firm exhibits superior abilities to tap sources of funding and canalize them into playing talent. The results of the analysis are applied to current developments in German and English football and to recent initiatives of the Football Governing Bodies.

Keywords: private firm, public corporation, members' association, *Verein*, governance structure, overinvestment, European football, Bundesliga, Premier League, UEFA

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INTRODUCTION

The “peculiar” economics of sports (Neale, 1964) has always raised governance questions. It has been widely accepted that the championship race, being the joint product of the participating clubs, requires more than the degree of regulation typical for other industries (Noll, 2006). In recent years this sports governance discussion has intensified significantly with respect to European football leagues due to the general perception that they were going through a severe financial crisis. Important contributions studying the link between governance and finance have been for example made by Baroncelli and Lago (2006) for Italian football, Buraimo, Simmons, and Szymanski (2006) for English football, Gouget and Primault (2006) and Andreff (2007) for French football, and Frick and Prinz (2006) and Dietl and Franck (2007a) for German football. Typically the sports governance discussion focuses the level of the league or industry. [ii]

This paper is different because it aims to present a governance discussion, which focuses the club level instead. It abstracts from league or industry governance structures by treating them as elements of the environment, in which clubs operate. The concept of the paper is rooted in the tradition of comparative analysis of firm governance structures as pioneered by Fama and Jensen (1983a) and Fama and Jensen (1983b). According to the basic assumption of this tradition the environment, in which football clubs operate, generates specific requirements, which not all club governance structures are equally well suited to meet. In the resulting competition of governance structures those best adapted to the requirements of the environment will prevail. In the following three paradigmatic structures of football club governance will be compared:

1. Clubs governed as classical capitalistic (privately owned) firms

2. Clubs governed as public corporations (stock corporations with dispersed public ownership)
3. Clubs governed as members' associations with an own legal personality (*Verein*)

In the first step the specificities of the environment in which football clubs compete nowadays will be outlined. The second step is devoted to the comparative analysis of the three paradigmatic governance structures. In the final section, the results of the analysis will be applied to current developments in German and English football and to recent initiatives of the Football Governing Bodies.

THE ENVIRONMENT: OVERINVESTMENT AND THE RELEVANCE OF SPENDING POWER

Compared to firms in other industries professional football clubs seem to face a constantly poor business environment. Based on operating profit, which is defined as earnings **before** the deduction of interest payments and taxes, the recent Deloitte Report (Deloitte, 2009) covering the last 11 years shows a sobering picture. Only two of the "big five" European leagues have managed to deliver a moderate consolidated operating profit during this whole time span: The Premier League and the Bundesliga. The Ligue 1 broke even based on this restricted measure from time to time, whereas the Serie A was in the red almost every year. The Primera Division cannot be tracked due to missing financial information. If interest payments are included, the picture becomes darker, since even the top-performer, the Premier League, has not managed to deliver a collective pre-tax profit in any single year since its formation (Walters & Hamil, 2008). This constant poor financial performance is the more astonishing since at the same time the revenues of the "big five" have more than tripled from € 2.497 billion in 96/97 to € 7.727 billion in 07/08. We see a genuine paradox of inexistent or constantly low operating profits despite almost exploding revenues. At the same time, the football clubs have been piling up significant debt. The Premier League clubs, for example, have accumulated liabilities amounting to £ 3.1 billion in their books as of June 2009 (Conn, 2009).

The mechanisms leading to this development have been analyzed in detail elsewhere. Various authors have dealt with "overinvestment issues" based on the contest structure of sport competitions.[iii] Starting with Franck and Müller (2000), we have tried to formalize the basic trade-offs of "football overinvestment" in Dietl and Franck (2000), Dietl, Franck and Roy (2003) and Dietl, Franck and Lang (2008). The analysis shows that various factors enhance the incentives of professional football clubs to engage in a genuine arms race and "overspend" on playing talent, among them the following (see also Dietl & Franck, 2007b): A stronger correlation between talent investment and winning probability, simultaneous (as opposed to consecutive) investments, an additional exogenous prize (e.g. Champions League qualification), a system of promotion and relegation, increasing revenue differentials within a league (i.e. less revenue sharing) and increasing revenue differentials between hierarchical leagues.

It seems that overinvestment is the natural outcome of both increased commercialization and of the current format of competition in football. Various regulatory changes leading to the current format of competition in European football have intensified the incentives to overinvest. For example the practices of seeding and group stages in the Champions League all increase the discriminatory power of the contest success function because they reduce the importance of coincidence or simply luck. The incentives to invest become more high-powered, if money buys success with a higher probability. The strong growth of revenues in the UEFA Champions League and the applied distribution scheme strongly favoring sportive success increase revenue differentials between positions in the national championship races and create genuine jackpots for the winners of the qualification slots. External interventions like the Bosman ruling of the European Court of Justice have also contributed to the problem, as one obvious effect of eliminated talent market imperfections is again a stronger relationship between payrolls and sportive success.

Provided that the commercialization of professional football will continue and given that the format of the competition will not be changed by regulatory measures it is likely that football clubs will remain confronted with a typical arms race industry structure in the future. Consequently, football clubs cannot be measured against the same criteria as businesses in other industries. We know that financial profitability decides on the viability of businesses in other industries. However, financial profitability does not play the same role in football. The discussion of the constantly poor financial performance of football clubs is very often dominated by the view that unfortunately football clubs are unprofitable today, but, of course, they should and will be profitable some time in the future. This is simply not true. We should seriously consider the fact that regulation and commercialization have created an overinvestment environment in professional football.

In this specific arms race environment the competitive position of a club is not determined by its profitability, but by its spending power. The spending power of a club depends on two factors: On the ability of the club to generate funds and on the ability of the club to redirect generated funds to football. A club that can tap sources of money, which his competitors are unable to tap, will increase its competitive position in the arms race ceteris paribus. A club that succeeds to channel more of the generated funds into football instead of paying rents to different stakeholders will increase its competitive position in the arms race ceteris paribus. Compare two clubs with different spending power. The club with superior tapping and canalizing capabilities will be able to overspend his competitor while still staying within the limits of his spending power. If the competitor gambles on success and spends beyond his tapping and canalizing capabilities, he risks becoming illiquid and temporarily loosing viability.[iv] It follows that the biggest spending power is the true competitive advantage in the football industry.

Note that profit requirements turn into a genuine handicap in this specific spending power game of European football. Profit is a fraction of earnings, which cannot be canalized back into football because it will be distributed to a group of stakeholders called owners. Profit is a burden on the spending power of the club, which deteriorates its competitive advantage in the contest.

It is important to stress that this fact does not exclude capitalistic governance structures from the football industry. Only at first sight one may draw the conclusion that football clubs cannot be business enterprises, since normally a business enterprise produces a positive financial net result at the end of the year, which may be distributed to its residual claimants. If it fails to do so for a couple of years in a row it will normally go out of business, since the owners will not be able to afford or not be willing to permanently loose money and therefore look for alternative investments. However, capitalistic football club governance structures do not prohibit owners, which can afford and are willing to permanently loose money. Chelsea, for example, lost huge amounts of money every year since Roman Abramovich took over ownership in 2003 (Deloitte, 2009). In 2008 alone the loss before tax amounted to £ 84,5 million (Conn, 2009). As of June 30, 2008 the interest free loan given by Abramovich to the club to cover the losses amounted to £ 702 million (Conn, 2009). Other motivations than just to make a profit in football seem to lead the managerial decision processes at Chelsea, despite the fact that Chelsea is institutionally designed in the same way as many profit-oriented owner-dominated capitalistic firms in other industries. Chelsea FC is a PLC with the parent company Chelsea Limited. The ultimate controlling party of Chelsea Limited is Roman Abramovich. In this institutional sense Chelsea is a business enterprise, but one that obviously does not make a profit. Despite its financial unprofitability Chelsea seems to provide other rewards to its owner, which exceed his financial contributions. Otherwise he would withdraw from his football venture. Obviously, unprofitable football businesses may still be good businesses for their owners for a couple of other reasons.

Chelsea is competitive precisely because of the fact that its owner does not degrade the canalizing capacity of the club by extracting profits. On the contrary, Mr. Abramovich injects huge sums of money into the club every year. Obviously Chelsey increased its tapping capabilities without deteriorating its canalizing capabilities since Mr. Abramovich became club owner in 2003.

Many factors affect the tapping and canalizing capabilities and therefore the spending power of clubs. This paper only focuses on the influence of governance structures.

THE INFLUENCE OF CLUB GOVERNANCE STRUCTURES ON THE CAPABILITY TO CANALIZE FUNDS INTO PLAYING TALENT

Assume three clubs having exactly the same revenues and costs and therefore the same profit function. Furthermore assume that every club adopts a different governance structure. What incentives does the structure of property rights characterizing each governance structure exert on the decision of club management to spend on playing talent?

Structures of property rights result from the allocation of residual rights of control and residual claims. Having the residual rights of control with respect to an asset means having the right to make any decisions concerning the use of this asset that have not been assigned to another person or institution by contract or by law. Being the residual claimant means being entitled to whatever remains from the revenues after all debts, expenses and other contractual obligations have been paid (Milgrom & Roberts, 1992).

The Club Governed as a Classical Capitalistic (Privately Owned) Firm

The key characteristic of this governance structure is that the residual rights of control and the residual claims are allocated to the same person, the owner. Tying together residual claims and residual control has the consequence that the classical capitalistic owner of a football club bears the full financial impact of his or her decisions. This consequence of concentrated ownership is true for firm owners in all industries.

However, concentrated ownership has an additional consequence in the football industry. Because football games are entertainment products, the residual decisions taken by club owners do not only have financial consequences. In addition to that, they have a high potential to expose owners to public debate. Owner decisions can be accepted and applauded by the fans and supporters of the club as well as by local politicians, or they can be criticized. Being accepted by the community can be a source of utility for the owner and a value in itself, just as the criticisms may produce disutility for him. The important issue is that this potential source of utility or disutility for football club owners is not triggered by the level of profits but by the sportive success of the club. The utility levels of fans, supporters, local politicians etc. tend to be positively correlated with the on-pitch success of the local team. It follows that the admiration, applause or respect of fans potentially nurturing the utility of football club owners should also positively depend on the level of sportive success.

Figure 1 exemplifies the specific trade-off of a classical capitalistic club owner. It seems reasonable to assume that as the club increases its winning percentage profits rise until a certain level and then decrease and ultimately become negative. The indifference curve reflecting the utility function of the owner does not run parallel to the winning axis but instead reflects utility stemming from the public admiration coming along with winning. The owner maximizes her or his utility by trading some of the profits against the public support stemming from sportive success.

It seems likely that football club owners face a much more accentuated trade-off between profits stemming from the football business and the utility stemming from potential public acceptance than the owners of firms in most other industries. If we take a shoe manufacturer as the contrasting example then the analogy to the winning percentage of the club could be the relative quality of the produced shoes. There is less reason why the owner of the shoe factory should be able to derive substantial utility or disutility through public admiration from producing shoes of more or less quality. The profits should play a more pronounced role in his utility maximization, which means that the indifference curves should run less steeply.

The Club Governed as Public Corporation (Stock Corporation with Dispersed Ownership)

There is a broad consensus in the literature that the stockholders are not the holders of the residual rights of control in the public corporation (Milgrom & Roberts, 1992). Stockholders do have rights, for example they can elect directors, vote on the corporate charter or on "organic changes". But their voting and decision rights are exactly enumerated and delimited and therefore not residual. Stockholders have no say in investment and acquisition decisions, no influence on hiring managers and on deciding their pay, and stockholders do not vote on business strategies, product prices, firm locations etc. In contrast to the classical capitalistic owner the stockholders of the modern corporation do not run the business.[v]

However, there is a broad consensus in the literature that the stockholders are residual claimants. They receive the dividends and in case of liquidation of the firm, they appropriate the remaining profit after payment of debt and taxes (Milgrom & Roberts, 1992).[vi]

The separation of residual control and residual claims in the modern corporation allows the strong dispersion and the trading of shares on secondary markets (Fama & Jensen, 1983a, 1983b). Compared to the classical capitalist, the typical stockholder of the modern corporation holds a small share, is anonymous and assumes no other role in the firm than that of a passive investor. Being situated in the market and not in the firm he is not exposed to the typical trade-off between profits and winning. He compares alternative investments solely on the basis of shareholder value. Stocks of football clubs will be included into the portfolios of passive investors if they outperform the stocks of car manufacturers, chemical companies, banks, insurers etc in terms of risk-adjusted return.

Coming back to the graphical illustration (Figure 2) the indifference curve representing the utility function of the typical stockholder of a modern football corporation will run parallel to the winning axis. Utility is only triggered by profits, which can be seen as the long-term driver of shareholder value. Public pressure or public admiration triggered by the sportive success of the club, have no direct channel to the utility function of the anonymous shareholder managing his own diversified portfolio of investments. In sum the modern football corporation has inferior canalizing capabilities compared to the classical capitalistic firm. The anonymous modern capitalist will be less willing to waive profits and therefore channel less money into playing talent.[vii]

The Club Governed as a Members' Association with an Own Legal Personality (*Verein*)

Szymanski (2008 forthcoming) has explained in detail how a major institutional difference between English and continental European club laws came into being. As a reflection of the idea that the state should not intervene at all in the associative activities of its citizens, members' associations in England differ in one important respect from the German *Verein* and from members' associations in most continental European countries: They have no legal personality. Therefore the officers of the club are personally in charge of all the business and financial transactions and remain personally liable for debts and damages. For this reason English football clubs all became limited liability companies when the football competition started to require substantial investment in stadia and players.

Whereas British citizens had an absolute right to freedom of speech or assembly and needed no permission or license, the rules of associative activities were not perceived as lying outside the jurisdiction of the state in Germany and also in continental Europe. The necessity to obtain a license to assembly led to the development of club laws, which also included the concept of a legal personality at the club level. Therefore, in Germany the *Verein* and not his officers engages into business and financial transactions.

How are the property rights distributed in the Verein? The residual rights of control are allocated to the members, the fans, who vote on important strategic issues in the membership meeting. The residual rights of control are not transferable (there is no market on which members could sell their rights to vote in the membership meeting). Every member has one vote. The members elect representatives, who are in charge to run the daily operations of the club for the legislation period. Residual claims are inexistent. Due to the non-profit status of the *Verein*, profits cannot be distributed. This property rights structure has a variety of implications (see Dietl and Franck (2007b) for a detailed discussion). Here, we will only consider its effect on the clubs' choice between profits and winning.

The non-distribution constraint leaves no room at all for financial investors. Since nobody can extract a profit, utility can only be derived from the sportive success and fame of the club and only subjects interested in the latter have reasons to self-select as fans and become members. Coming back to the graphical illustration (Figure 3), the indifference curve of the fans as holders of residual control should run parallel to the profit axis. It seems plausible that the members of the *Verein* will induce their representatives to spend all revenues on playing strength. However, it seems unlikely that members should prefer systematic overspending in subsequent periods and therefore risk the existence of the club, to which they are attached.[viii]

Conclusion: Superior Canalizing Capabilities of the *Verein*

Remember the initial assumption of three clubs having the same revenues, costs and profit function, but different governance structures. In this artificial "ceteris paribus" setting focusing solely on the canalizing capabilities of the different governance structures, the *Verein* is able to outspend the classical capitalistic (owner-dominated) firm and field the stronger team automatically redirecting all revenues back into football (Figure 4). The structure of a public corporation would make the club the least competitive on the pitch because its owners do not even trade profits against public admiration like the classical capitalist.

THE INFLUENCE OF CLUB GOVERNANCE STRUCTURES ON THE CAPABILITY TO TAP SOURCES OF FUNDING

We will now study how club governance structures affect the abilities of clubs to tap various sources of funding and increase their spending power.

Capturing the Willingness to Pay Financial Spillovers to Other Businesses

There is a long business practice in the US to use major league sports teams as vehicles to promote other businesses that may be more valuable than the sports team itself. George Steinbrenner, the famous owner of the New York Yankees, is also an owner of a regional broadcasting network. Tom Hicks, the owner of the Texas Rangers, is engaged in real estate development and international investment. The perception of the sports team as a unit generating positive financial spillovers for parallel businesses in a conglomerate is also relevant in European football. Mohamed Al Fayed, the proprietor of Harrods and the Hotel Ritz in Paris, is the funder of Fulham, which he owns through Mafco Holdings Limited, a

Bermuda (tax heaven) company. In cases like these, the value of additional units of talent increasing the playing strength of the team is not calculated based on their contribution to the football business alone but also based on the value added to the related businesses.

Are all governance structures equally well suited to tap this additional source of funding resulting from spillovers to other businesses?

The structure of the *Verein* is clearly handicapped by the in built non-tradability of the residual rights of control. Suppose, for example, that a private regional broadcasting network in the Ruhr area in Germany, recognises that the *Verein* Schalke 04 would be a perfect promotional vehicle. One option for the broadcasting network would be to enter into a sponsoring deal with Schalke 04. However, the influence of the sponsor on the internal decision processes at Schalke and the possibilities to really manage and capture positive spillovers are rather limited, as the fans do not perceive the sponsor as the decision maker behind potential success. An additional vehicle would be for the owner of the broadcasting network to become a personal member of the *Verein* and hope to get voted into the position of a representative at the members' meeting. In the "best case" scenario the owner of the broadcasting network and sponsor of the *Verein* will become president for the legislation period and be able to influence decision processes and capture spillovers. However, the fragility of this construct is substantial, as the president can be voted down at the next members meeting. The president may try to buy votes by promising fringe benefits to certain opinion leaders among the members or even by clandestinely offering money. The crucial point is that he cannot write down an enforceable contract on the trade of a single voting right. Such contract would be illegal.

Herein lies the great difference to capitalistic governance structures. If the club was a company, the owner of the broadcasting network could legally buy its shares. Once holding the majority of shares, he would possess the rights of residual control. He would be able to make decisions in order to manage and capture spillovers and nobody would ever have the option to vote him down.

Note that this logic implies that the modern corporation too offers very limited abilities to tap the willingness to pay for financial spillovers. Suppose Schalke 04 was a modern corporation owned by dispersed anonymous shareholders. The precondition for the broadcasting network to actively manage spillovers and employ Schalke as a promotional vehicle would be to buy enough shares in order to gain residual control. This is tantamount to transforming Schalke into a classical capitalistic firm with concentrated ownership.

Summarizing the discussion, the governance structures of the *Verein* and the modern corporation are less suited to capture the financial effects of football spillovers to other related areas of business. The privately owned football firm is the superior structure for tapping the willingness to pay for spillovers to other businesses since it automatically allocates residual control to the owner. He may buy a famous player and add him to the squad because the generated interest and excitement around the deal creates value for his current real estate development around the stadium, his broadcasting network or his investment firm.

Capturing the Willingness to Pay for Social and Political Acceptance

For the owner of Fulham, Mohamed Al-Fayed, the excitement produced by the football team may generate additional customers in his other businesses, first of all at Harrods. However, these financial spillovers may be less important than something, which may be called social and political externalities. Al-Fayeds' way to wealth has not been free of critique (see BBCNEWS.com (2008a) or Guardianlies.com (1990)). For example Mohamed Al-Fayed and his brother Ali bought House of Frazer in 1985, a group that included Harrods. A Department of Trade inquiry into the deal stated that the Al-Fayed brothers had not reported the truth about their wealth and background. A competitor accused the Al-Fayed brothers of stealing millions in jewels from the Harrods safe deposit box. The dispute was settled after the competitor died with a payment to his widow. Other scandals followed, for example Mohamed Al-Fayed offered money for questions in the House of Commons to the Conservative MPs Neil Hamilton and Tim Smith, which then had to leave in disgrace. As a result of the turbulences Al-Fayed was denied British citizenship, although he sought to receive it for years. In this setting, a football club may be seen as an element in a personal holding structure, which generates what is most needed: social and political acceptance.

The case of Roman Abramovich, the owner of Chelsea, may be interpreted in a similar context. His typical Russian oligarch path to wealth is scattered with questionable practices (see e.g. Winter (2008)). Even without detailed information about the structure of businesses united in the Abramovich holding, social and political acceptance could be a desirable asset. In this context the investment in Chelsea makes Abramovich a well-known personality in England and Western Europe and generates legitimacy.[ix]

Are all governance structures discussed so far equally well suited to tap this additional source of money paid for social and political acceptance?

Obviously the *Verein* is clearly out of competition again due to its inbuilt non-tradability of the residual rights of control. Mr. Abramovich could act as a sponsor and perhaps hope to be voted as president, but he would have to live with the risk to be voted down at the next members' meeting. There is no enforceable contract guaranteeing residual control. Therefore the *Verein* does not provide a framework for **buying** social and political acceptance.

The modern corporation is out of this business segment as well. Individuals with a disputable way of wealth appropriation seeking for a vehicle to buy social and political acceptance and gain legitimacy will not be able to send any signals to the public as anonymous shareholders of a football corporation. Instead they need to be identified as individuals with the decisions of the club and as a consequence with the excitement generated by sportive success. It follows that only the governance structure of the classical capitalistic (owner-dominated) firm can tap this additional source of funding resulting from the willingness to pay for legitimacy.[x]

Capturing the Willingness to Pay for Ownership as a Consumptive Activity

In May 2007 Thaksin Shinawatra, exiled former Prime Minister of Thailand, suspended from office and found guilty for cheating the elections by the Supreme Court in 2006, posted an offer to buy Manchester City for the sum of £ 81.6 million. The shareholders accepted the offer on June 21, 2007. On the same day Mr. Shinawatra was accused for corruption in Thailand and subsequently found guilty (BBCNEWS.com, 2008b). His assets were frozen and the club had to borrow £ 25 million against the forthcoming seasons's TV money in order to continue operations. On the verge of bankruptcy Sheikh Mansour bin Zayed al Nahyan stepped in and took over 90% of the shares.

Sheikh Mansour is a member of the Royal Family of Abu Dhabi in the United Arab Emirates (see e.g. Armitstead (2008)). He is Minister of Presidential Affairs for the President, his half brother, Sheikh Khalifa bin Zayed al Nahyan. Moreover, he is the Chairman of First Gulf Bank, of the International Petroleum Investment Company (IPIC) and of the Emirates Horse Racing Authority (EHRA) among other things. His personal wealth is estimated at £ 33 billion, while the family fortune is around £ 550 billion.

It is not entirely clear but at least very unlikely that Sheikh Mansour has invested in order to generate financial spillovers to his other businesses, as the link between the excitement produced by the team on the pitch in England and the International Petroleum Investment Company or the First Gulf Bank seems rather weak. Moreover, we cannot exactly know if Sheikh Mansour is seeking social and political acceptance through his investment. However, given that there is no significant social and political pressure on the Royal Family of Abu Dhabi and that their leadership is widely accepted by the people, it seems unlikely that Sheikh Mansour bought the club in order to gain legitimacy and prepare his emigration to England.

Why did he then buy the club? Perhaps Sheikh Mansour, who also has a passion for high class race horses, bought the club for the same reason he spent money on his stud: to enjoy himself. Rosen (1981) has explained the phenomenon of imperfect substitution among quality differentiated goods. The utility derived from certain consumptive activities tends to increase more than proportionally with the quality of the consumed good or service. We prefer to listen to an excellent singer instead of listening twice to a singer with half the talent. We prefer to watch an outstanding film to watching two films of mediocre quality. Our consumption choices are, of course, restricted by budget constraints. Sheikh Mansours' budget constraints allowed him to own and "consume" a high quality team in the strongest football league of the world.

It is unclear if the example is really well-chosen. However, there is no reason a priori to exclude football clubs from the list of potential objects of consumption for affluent individuals. The type of sportsman-owner, who is not a rent-seeker but a mere consumer has a long tradition in the development of professional sports. The difference today lies in the fact that ownership of a “high quality object of consumption” in football has become very expensive due to the commercialization and economic development of the game. Sportsman-owners nowadays can only come from a restricted group of very wealthy persons. Since the rapid accumulation of wealth is only possible in environments with systematic market failures and regulatory deficits, huge wealth is probably often linked with legitimacy deficits. It goes without saying that in reality the motivations of club owners may be more complex and vary over time. Chelsea’s Roman Abramovich may be a sportsman-owner, a legitimacy-seeker and a manager promoting his other business activities at the same time.

Coming back to the question if all governance structures discussed so far are equally well suited to tap this additional source of funding paid by sportsman-owners, the assessment of the last section can simply be repeated. The *Verein* and the modern corporation do not provide a legal framework for the affluent sportsman to gain residual control over the desired object of consumption.

Capturing the Willingness to Pay for Money Laundering

The Financial Action Task Force (FATF) is an independent inter-governmental body devoted to the protection of the global financial system against money laundering and terrorist financing. Its latest report published in July 2009 deals with the topic of money laundering in the football sector (FATF, 2009). Without going into details here the report argues that football is highly vulnerable to the activities of criminals seeking new channels to launder the proceeds of their illegal activities.

Football clubs are characterized as ideal vehicles for money laundering purposes because first many high value cash transactions and second substantial cross border money flows are part of their normal business model. Money laundering practices range from the simple injection of criminal money into the business circle by buying seats at the regular games of the club to complex international player transfer deals involving investor groups constituted in tax heavens. The FATF report does not deliver any clear evidence, but instead describes as many as 17 paradigmatic cases in order to highlight the vulnerabilities of the sector and provide guidance to law enforcement agencies.

Comparing the described governance structures as potential enablers of money laundering, the *Verein* and the modern corporation are again severely "handicapped". Neither membership in a *Verein* nor shareholding in a modern corporation provide access to the internal high value cash transactions and cross border money flows of the football club. The inexistence of residual claims in combination with the non-tradability of residual control transforms the *Verein* into a local fan cooperative, which by definition cannot be constituted and managed in foreign tax havens.

It is entirely clear that ownership of football clubs by investors or investor groups constituted in tax heavens is not illegal and does not automatically imply money laundering. However, according to the FATF report it makes money laundering much easier. It is informative in this context that, according to Conn (2009), the majority of Premier League clubs are owned by individuals through trusts registered in tax heavens.

Capturing the Willingness to Pay for Gate Attendance, Broadcasting and Sponsoring

Concerning the more classical sources of club income stemming from gate attendance, broadcasting and sponsoring, the results are less obvious, when it comes to the level of earnings. However, the different governance forms should affect the structure of earnings. It goes without saying that market sizes, market structures etc. affect the revenues in every market covered by the following analysis. For example, it makes a difference for the selling of TV rights if the TV market of a country is large or small, monopolistic or competitive etc. We abstract from these differences not because they are unimportant, but because we want to isolate the (additional) effects of club governance structures.

Stigler and Becker (1977) have argued in their seminal article that the utility, which a consumer is able to derive from the present "consumption" of certain goods, depends on the "consumption capital" accumulated by this actor trough previous "consumption" of these goods. Typical "connoisseur goods", where previous experience increases enjoyment, are to be found in the areas of music, art, cuisine, literature or wine. Adler (1985) has advanced this "connoisseur theory" arguing that the utility of a connoisseur does not only depend on its own past consumption, but also on the sum of co-specific consumption capital acquired by all fellow connoisseurs, with whom he can exchange views and enjoy interaction (see Brandes, Franck and Nüesch (2008), Franck and Nüesch (2007), Franck and Nüesch (2008) for empirical applications of these theories to football). Genuine football fans following the games and activities of "their" club sometimes for their whole life are perhaps the perfect incarnation of this theory of beneficial addiction. Presumably a true fan with all the accumulated context knowledge enjoys a remarkable game of his club more than an occasional spectator coming along incidentally. Moreover, fans of the same club enjoy interacting in a group of like-minded people, for example by sharing the joy of a great performance.

The other side of the coin described as beneficial addiction is the emerging phenomenon of loyalty. Hirschman (1970) has studied phenomena of loyalty in the economic process and institutional reactions to them. In normal circumstances when an organization delivers bad performance to potential customers they will chose “exit” and switch to alternative suppliers. However, this standard market mechanism of disciplining owners and management of an underperforming organization fails when consumers are loyal. Football fans will not be able to simply walk away and support a different team if their club delivers poor quality or charges high prices. They are not able to protect their consumption capital, which can be viewed as a club-specific investment, by using the “exit mechanism”. Following Hirschman (1970) the lack of “exit” can be compensated by the introduction of “voice”. Supporters with “voice” in the decision processes of the club will be more inclined to cultivate “beneficial addiction” as they possess an instrument to safeguard their specific investments. Moreover, they have an instrument to discipline what they perceive to be poor club management by voting against undesired projects and persons.

It follows that the owner-dominated capitalistic firm, as well as the modern football corporation, can and will probably choose to have supporters’ representatives on their boards. They will do so because it is in the best interest of the owners to manage “beneficial fan addiction”. However, there is a limit on what can be managed. The limit stands out clearly when looking at the classical capitalistic firm. The Abramovich-type owner cannot credibly cede residual control to another party, unless he sells the majority of shares to this party. Fans may be invited to give their opinion, but they obviously cannot vote down projects against Roman Abramovich or even vote down Roman Abramovich. They could choose not to support the club any longer, but, as has been said, their “exit” option is severely disturbed through loyalty phenomena. The governance structure of the *Verein* stands in stark contrast here. The absence of residual claims and the definition of non-tradable residual rights of control create a perfect voice-mechanism for supporter-members. Members of the *Verein* possess an instrument to safeguard their club-specific consumption capital and to discipline management.

How do these governance differences affect the capabilities of clubs to tap earnings from gate attendance, TV broadcasting rights and sponsoring (see also Dietl & Franck, 2007b)?

It seems likely that the *Verein* will attract more supporters ceteris paribus. On the one hand fans with residual control should be more inclined to build up loyalty. On the other hand fans with residual control will probably vote for lower ticket prices. Better attended and at the same time cheaper-to-attend games do not automatically lead to higher earnings. The fan orientation of the *Verein* should at the same time be highly attractive for sponsors. The objective of sponsors is to get attention. More fans translate into more attention for the sponsor. Moreover, the non-distribution constraint of the *Verein* could be interpreted as a signal in this context: The sponsors know for sure that their contributions cannot be appropriated by any residual claimants, but instead will be invested to maximize sportive success and therefore attention.[xi]

A league with the majority of clubs organized along the *Verein* ideology will be more fan-driven and this is likely to also materialize in its TV deals. Where “football belongs to the fans" – to use the recurring slogan in Germany – public and political discussion will limit the options of the league to make an income-maximizing deal when selling TV rights. Access to football is almost viewed as a human right, with the result that the package is twisted towards a higher free TV exposure. The "bad prices" owed to this specific "football belongs to the fan" environment will be somewhat compensated by sponsorship receipts, as sponsors and commercial partners are interested in high public exposure.

The following data, which is extracted from various sources (Deloitte (2009), Bundesliga.de (2009) and Soccernet.com (2009)) is quite in line with this analysis (see Table 1). The Bundesliga continues to outperform the other "big five" leagues in terms of average match attendance with a number of 42,000 spectators per game in the season 2008/09. It is followed by the Premier League, with an average match attendance of 35,650. Despite its well-attended games, the Bundesliga "only" generated € 338 million in matchday income compared to the € 700 million of the Premier League in the season 2007/08. Only part of this effect can be attributed to the lower number of games in the 18-teams Bundesliga compared to the 20-teams Premier League. The main reason for the difference lies in the much lower admission prices in the Bundesliga, averageing € 20,79 compared to € 51 in the Premier League in the season 2008/09. The broadcasting income of the Bundesliga amounts to a disappointing € 476 million when compared to the € 1.176 billion of the Premier League in season 2007/08. However, in line with the theoretical arguments presented above, the Bundesliga is able to compensate some of the revenue disadvantages through its appeal to sponsors and commercial partners. Commercial revenue is by far the largest revenue stream of the Bundesliga amounting to € 634 million representing 43% of all revenues in 2007/08. Here, the Premier League comes second after the Bundesliga with a commercial revenue of € 565 million, amounting to 23% of all its revenues in 2007/08.

SOME CONCLUSIONS

Provided that "spending power" is the main driver of competitive advantage for clubs in the arms race environment of European football and considering the tapping and canalizing capabilities of the different club governance structures some conclusions can be drawn.

The Instability of the German Regulatory Environment

The governance structure of the *Verein* is characterized by inferior capabilities to tap sources of funding originating from wealthy individuals who are trying to capture spill-overs to other businesses, seeking social and political acceptance, laundering money, or who are interested in consumption as sportsman owners.

Moreover, the fan orientation of the "*Verein* set up" limits the possibilities to design and implement income-maximizing attendance and TV pricing schemes. Against the background that the Bundesliga operates in a potentially very attractive football market (Germany has a population of 82 million compared to the 50 million inhabitants of England; football is the number one sport in Germany with more than 6 million registered football players compared to just more than one million in England) the spending power of the Bundesliga is rather disappointing. Whereas the Premier League clubs were able to tap sources of funding totaling revenues of € 2,441 billion in the 2007/2008 season, the Bundesliga clubs only generated revenues of € 1,438 billion (Deloitte, 2009).

Consequently the German clubs are no longer competitive at the highest European level: In the period 1999-2003 4 semi-finalists in the Champions League came from Germany whereas in the period 2004-2008 this number fell to a disappointing 0. At the same time the Premier League augmented the number of semi-finalists from 3 in the period 1999-2003 to an impressing 10 in the period 2004-2008.

Why do German football clubs then not change their governance structures? Until the year 2000 the statutes of the German Federation ruled that German professional football teams must be pure members' associations. The pressure of the clubs for change led to the introduction of a new regulatory framework in the year 2000. Among other things it gave clubs the option to separate the professional football operations and spin them off into a commercial company. However, the crucial precondition for this reorganization is known as the "50%+1 vote" rule: The members' club must continue to hold at least 50% plus one of the voting rights in the commercial company, thus retaining residual control of professional football operations.

To this restriction, only two exceptions exist, VfL Wolfsburg and Bayer Leverkusen. The professional football team Bayer Leverkusen has been transformed from a *Verein* into a GmbH, a limited liability company, in 1999, and the Bayer AG (the Bayer corporation) has been granted the exception to take over 100% of the shares in the GmbH. The professional team of VfL Wolfsburg, German champion in 2009, had been transformed from a *Verein* into a GmbH in 2001 and the Volkswagen AG (the Volkswagen corporation), has been granted the exception to hold 90% of the shares in the GmbH. This means that there are two firms with a dominant owner in German football. However, this dominant owner is not an individual, but a public corporation in both cases. Apart from these two exceptions all existing German football companies are still members' clubs in essence, because they are majority-owned and controlled by their parent *Verein*. In sum the German regulatory environment has successfully blocked away private owners from football.

Today the German clubs are entirely aware of the fact that the governance reform introduced in the year 2000 did little to increase their capabilities to tap new financial sources. Complaining about the decline of the competitive position of German football in Europe, an increasing number of German football stakeholders pushes towards the abolishment of the "50%+1 vote" rule (see for example Kicker.de (2008), Goal.com (2009), and Sport1.de (2009)). It could be only a matter of time until the Bundesliga will open to the new sources of funding provided by private owners with the described complex motivations.

The Going Private Transactions in English Football

> Of almost 30 clubs in England that have at some stage been listed on a recognized stock market, only seven remain. (…) Whilst some clubs have opted for a delisting to reduce the regulatory burden and associated costs, over the past four years many of the delistings have resulted from new owners taking a club from public to private ownership (Deloitte, 2009, p. 58).

The analysis of governance structures sheds some light on this trend. Modern football corporations have inferior tapping and canalizing capabilities compared to privately owned football firms: they cannot mobilize money injections by wealthy individuals looking for spillovers to other businesses, political and social acceptance, consumptive ownership or access to cash transactions with money laundering potential. Moreover, small shareholders benchmark the performance of their football stock against alternative investments in their portfolio and deteriorate the spending power of the football club demanding a competitive profit.

Why did almost 30 clubs in England then go public in the past? One reason might be that the spending power contest was less accentuated in the past when the relationship between payrolls and field success was weaker, the revenue differentials within and between leagues were smaller etc. An additional reason could be that investors needed some time to learn that the football industry is organized as a contest with potential overinvestment in playing strength. Seen from this perspective the £ 175 million generated by English Premier League clubs through stock market listings have been an apprenticeship premium paid by investors.

The Deloitte analysis of the key trends in Premier League clubs' financing since 1992 is entirely in line with the theoretical expectations[xii]: The most important source of funding being the £ 950 million injected by "new owners" compared to 350 million attributed to securitization, 300 million originating from strategic media investment, 175 million generated through stock exchange listing and 150 million contributed by new player finance techniques. Of course, money injected for laundering purposes cannot be tracked.

The Current "Financial Doping" Debate Is Unfruitful and Should Be Reduced to an "Anti Money Laundering" Debate

In the last years the European Commission, the European Parliament, National Sports Ministers, the International Governing Bodies of Sports etc. started various initiatives like the Independent European Sports Review, the White Paper Process on Sports, the Financial

Fair Play Task Force etc., which indicate a certain level of discomfort with the current situation among important stakeholder groups of European football. The discomfort stems from different sources. One important driver of the current discussions is the perception that the money injections of new owners with "deep pockets" allow some clubs to compete without having to rely on "football-related income" in a narrow sense of the word. Issues of fairness come up because the clubs relying on owner contributions are sometimes perceived to compete outside "of their own means" and benefit from a form of "financial doping".

The "financial doping" debate is unfruitful in my opinion. The combination of residual control and residual claims characterizing concentrated ownership implies that owners are free to earn **but also to loose money**. Prohibiting owners to loose money means prohibiting private ownership of football clubs. It seems unlikely that such regulation can be imposed in countries with a tradition of football clubs operated as business firms. On the contrary, the introduction of private ownership in Germany by abolishing the "50%+1 vote" rule seems much more probable.

From an economic point of view the concept of "financial doping" is difficult to interpret because there is no simple definition of football-related income. Why, for example, should we not interpret owner contributions as a price these individuals are willing to pay for the right of residual control over the football operations? In this sense, owners pay for a certain kind of access to football, just as spectators pay for a different kind of access to football. Seen from this perspective, both payments are entirely football-related. The governance structure of the classical capitalistic firm is able to provide this special form of access to football, whereas the *Verein*, which is based on non-tradable rights of residual control, is not able to provide this kind of access. Instead of speaking of "financial doping" we should better speak of a comparative disadvantage of the *Verein*.

Owners willing to loose money in football as in any other business are not a problem, provided that the money does not originate from illegal activities and football is not used as a laundering device. The FATF report stresses the high vulnerability of football clubs as targets for individuals seeking to launder the proceeds of illegal activities. A debate "anti money laundering" would be more fruitful than the current "financial doping debate".

The "Financial Instability" Debate Will End up in "Enhanced Licensing"

Another important topic of the current discussions focuses on the arms race in European football, which is perceived as a danger for the financial stability of many clubs and seen as a systemic risk at the level of entire competitions.

Economic theory makes clear prescriptions as to how problems of overinvestment in contests could be reduced. Employing Akerlofs' metaphor of a "rat race" (Akerlof, 1976), three distinct instruments stand out:

1. Redistribute the "cheese": Implement more revenue sharing measures in order to reduce the income differentials within and between leagues.
2. Bring back "luck": Introduce k.o. instead of group stages, stop seeding etc. in order to make the outcome more a result of lucky circumstances.
3. Handicap the "rats": Design salary caps, roster restrictions etc. in order to limit the "calories" which can be invested in the race.

All these instruments imply major changes to the current format of the competition. However, the discussions, which took place in the last years in the governing bodies of European football, show that the format of the competition seems to be carved into stone.

Therefore UEFA has pursued a more moderate approach in the past. Expressed in Akerlofs' metaphor of the “rat race”, the UEFA strategy has only been to “keep the rats alive” during the “race”. The licensing system introduced by UEFA at the start of the 2004/2005 season pursues the objective that every club entering European competitions should be able to pay its bills during the contest.

It is my impression that the licensing system will remain the main instrument of UEFA to increase financial stability in European football. There is current work to improve the effectiveness and efficiency of the licensing system. One important area of innovation is how to encourage clubs to adopt more sustainable business models and more forward-looking management attitudes. Spending within the limits of “the own means” in a given season is an important goal. But, at the same time, encouraging behaviour, which does not deteriorate but instead develops future spending power, is an additional issue of the “enhanced licensing” system.

ENDNOTES

[i] Keynote Lecture given at the "First European Conference in Sports Economics", Centre d'Economie de la Sorbonne – Université Paris 1 Panthéon Sorbonne, 14th-15th September 2009.

[ii] In a very recent paper inspired by the ongoing financial crisis in football and by corporate governance reforms outside football, Walters and Hamil (2008) reassess the corporate governance of the entire English football industry and derive clear recommendations, which include the introduction of a licensing system, the application of a more rigorous fit and proper person test and stronger sporting sanctions for clubs in administration. Clearly, these measures apply at the level of the whole industry.

[iii] Important concepts in the literature are: "Hyperinvestment" in sports contests (as described by Alchian and Demsetz (1972)), "Rat race" phenomena in contests (as studied by Akerlof (1976)), or "Destructive competition" in the market for star athletes (as treated by Whitney (1993)).

[iv] Stefan Szymanski has made the good point that clubs, which are no longer able to pay their bills and go bankrupt, will hardly ever dissolve. Instead they go through administration and then reappear again in a lower league. In this sense the football system has an inbuilt mechanism to handle overinvestment without leading to ultimate failures. Therefore I speak about a temporary loss of viability in the text.

[v] To which other stakeholder of the modern corporation are the rights of residual control then assigned? At first sight the board of directors qualifies as holder of the residual rights of control since it has the legal competence to decide on the employment and remuneration of managers, the opening and closing of new lines of business, dividends etc. More recent literature (see Bebchuk and Fried (2004)) questions this view, as the board must rely on the executive officers to provide them with all the necessary information. In a more extreme interpretation termed as the "managerial power approach" the senior executives hold the residual rights of control. The senior executives set up the list of candidates on the proxy statement from which the board is elected by the shareholders, set the agenda of the board and control the information flows. We do not have to follow the discussion into further details, since the question whether the board or the executive officers have more power in the modern corporation does not dispute the fact that the stockholders are not the

holders of residual control.

vi Even the managerial power approach (Bebchuk & Fried, 2004) does not deny the role of stockholders as residual claimants but only adds the executive officers to the list of residual claimants.

vii For the sake of simplicity we have abstracted from the well-known agency problem of the modern corporation arising between shareholders holding residual claims and executives holding residual control. Executives may deviate from shareholder value maximization and pursue their own interests in case of asymmetric information. However, such discretionary behaviour is limited by various mechanisms of corporate governance and by the forces of competition (see e.g. Jensen (2000)).

viii The elected representatives of the *Verein* running the operations during the legislation period can be interpreted as the agents of the members. There are reasons to assume that their incentives to increase playing strength are even more high-powered due to their visibility at the top of the organization and due to their limited terms of office. Representatives may tend to even overstate the importance of sporting success compared to normal fans as they will personally be identified with periods of fame and glory of the club without being personally liable for financial losses. This setting may encourage a propensity to even overspend and "gamble on success" (see Dietl and Franck (2007b)).

ix The funding of Chelsea by the oligarch has been provided in the form of an interest-free loan amounting to £ 702 million in June 2008. Prior to the global economic crisis Abramovich's wealth had been estimated to be worth £ 11.7 billion. The *Forbes* magazine estimated a net worth of £ 5.247 billion, as of March 2009.

x The consequence of this analysis is straightforward. As long as football is able to produce social and political acceptance and as long as big fortunes can be earned in disputable ways the governance structure of the classical capitalistic firm can tap a source of money, which clubs governed as *Verein* or as modern corporations cannot access. The question arising in this context is whether football will be able to produce social and political acceptance in the longer run, if owners with "cleptocratic" backgrounds self-select into this industry and dominate the game.

[xi] See Hansmann (1980) for the interpretation of the non-distribution constraint as a signal that the contributions of the patrons of a non-profit organization (donators, sponsors etc.) remain committed to the pursuit of the desired goals, because they cannot be appropriated by residual claimants.

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TABLES

Table 1. Bundesliga versus Premier League

Based on Bundesliga.de (2009), Deloitte (2009), Soccernet.com (2009)

	Bundesliga	**Premier League**
Average match attendance (season 2008/09)	42,000	35,650
Matchday income (€) (season 2007/08)	338	700
Average admission price (€) (season 2008/09)	20,79	51
Broadcasting income (€) Season 2007/08)	476	1,176
Commercial revenue (€) (season 2007/08)	634	565

FIGURES

Figure 1. The classical capitalistic (privately owned) firm

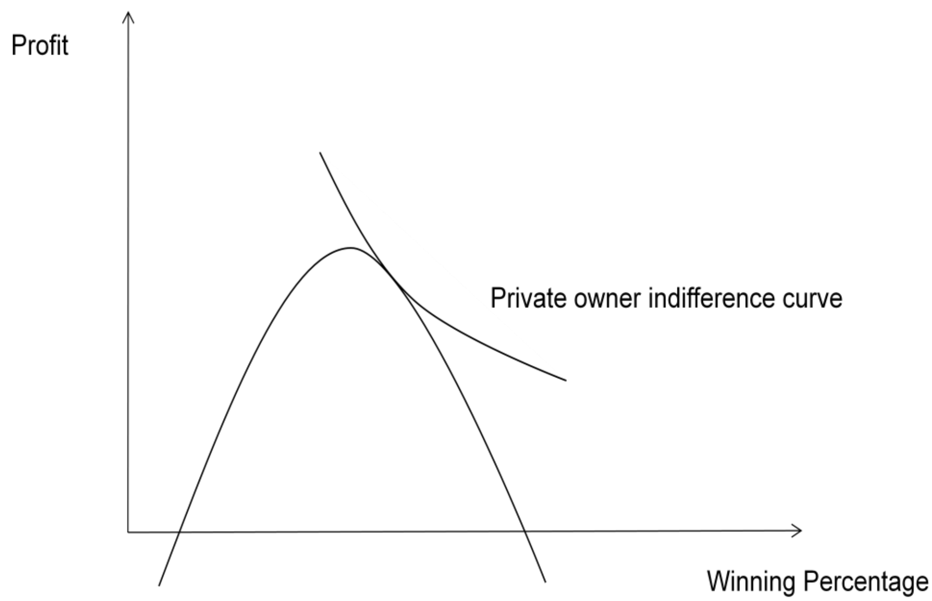

Figure 2. The modern corporation (public corporation with dispersed ownership)

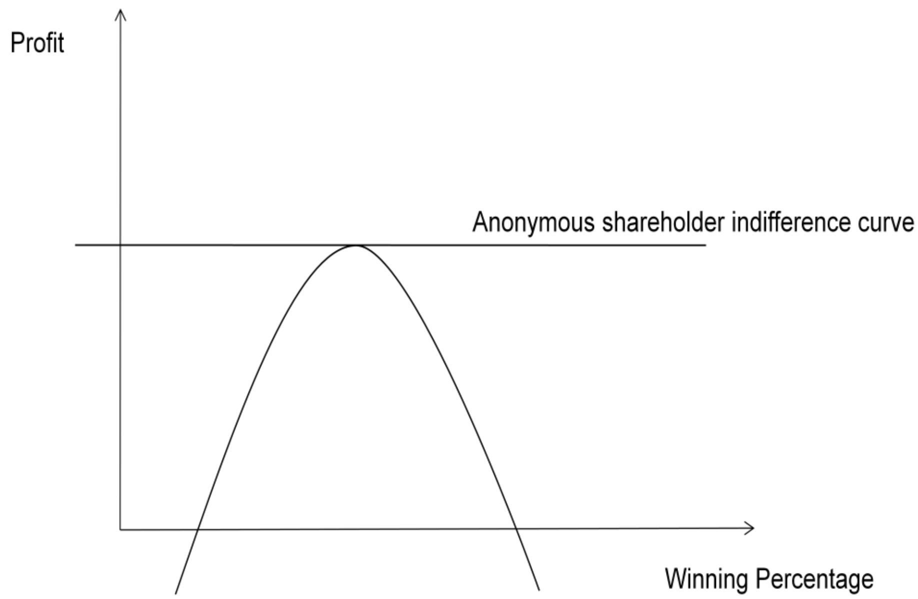

Figure 3. The *Verein*

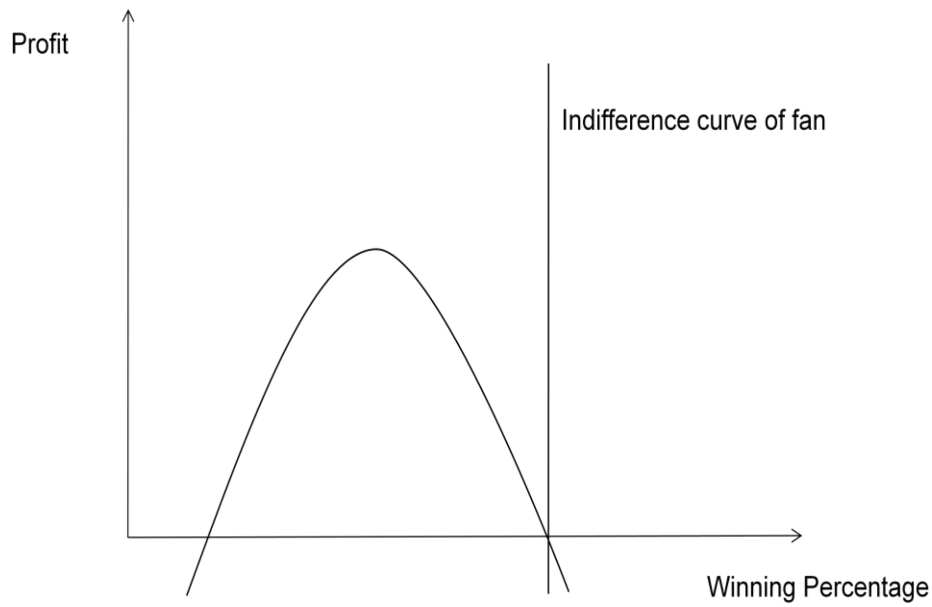

Figure 4. Comparative analysis of governance structures