RE-ENVISIONING THE CONTROLLING SHAREHOLDER REGIME: WHY CONTROLLING SHAREHOLDERS AND MINORITY SHAREHOLDERS OFTEN EMBRACE

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In his article, *Controlling Family Shareholders in Developing Countries: Anchoring Relational Exchange*, Professor Ronald Gilson raises critical points against the conventional view of corporate governance in a controlling shareholder regime with poor investor protection: (1) given that equity financing is much more expensive to a corporation than debt financing due to the reinforced pecking order of corporate finance in a bad-law jurisdiction, why do some controlling shareholders nonetheless have so many minority shareholders through new equity issuances? ("Gilson's

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riddle"); and (2) if laws are inefficient and do not protect investors, as the conventional view explains, why do minority shareholders still invest their money in controlled corporations? (the "flipside of Gilson's riddle"). In order to answer these conundrums, Professor Gilson himself proposes a potential—but partial—solution namely the product market-based account (PMBA). Against this backdrop, I begin with a critical review of the PMBA. Then, I propose alternative solutions to the PMBA for corporate governance conundrums. As for Gilson's riddle, I analyze how a controlling shareholder can gain both pecuniary and non-pecuniary benefits by having more minority shareholders through equity financing (despite deep discount on equity securities). As for the flipside of Gilson's riddle, I explain why minority shareholders tolerate a controlling shareholder's expropriation, and how they can gain benefits through capital market transactions that can compensate for insufficient investor protection. Consequently, I show that both a controlling shareholder and minority shareholders—as a seller and purchasers in a capital market—accept market terms and conditions because their interwoven relationship creates symbiosis and a mutual hostage situation. In such cases, their cooperation is compelled and strengthened, and economic development ensues. That relationship explains why some bad-law countries have functional capital markets—an anomalous result from the standpoint of the conventional view.

INTRODUCTION

"Law and finance"[1] literature was revolutionized by four distinguished economists—La Porta, Lopez-de-Silanes, Shleifer, and Vishny (hereinafter "LLSV")—who explained that the legal origin of a country is statistically correlated with the quality of corporate governance and patterns of share ownership.[2] In particular, LLSV's series of studies[3] show that controlling

1. *See generally* Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Law and Finance*, 106 J. POL. ECON. 1113 (1998) (examining the origin of legal rules in forty nine countries and determining how the legal origin of those rules relates to share ownership).

2. *See* Curtis J. Milhaupt, *Creative Norm Destruction: The Evolution of Nonlegal Rules in Japanese Corporate Governance*, 149 U. PA. L. REV. 2083, 2120 (2001).

3. *See, e.g.*, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *The Economic Consequences of Legal Origins*, 46 J. ECON. LITERATURE, 285 (2008) (providing a summary of research showing the correlation between legal origin and economic outcomes, determining implications of this research, and attempting to rebut objections to this research); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, & Robert Vishny, *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3 (2000) (arguing that the legal approach provides a better understanding of corporate governance than the

shareholder regimes—economies that are dominated by controlling shareholders—exist in those jurisdictions where minority shareholders are not protected from controlling shareholders' expropriation of corporate assets.[4] This view opens a new and insightful paradigm to analyze international corporate governance.

On the other hand, LLSV's studies have been criticized because their conclusions and methodologies are misleading in some respects.[5] In addition, many puzzles remain unsolved by law and finance accounts. In particular, in his Stanford Law Review article,[6] Professor Ronald Gilson raises a critical point that neither LLSV nor the law and finance literature explain: if laws are too poor to protect public investors in "bad-law countries"[7] as LLSV explain, then why do public investors continue to participate in such unfair capital markets?[8] A potential answer to this question is that public investors in a country with poor investor protection would severely discount the price of shares in response to controlling shareholders' expropriation. Accordingly, corporations could potentially receive less proceeds from public investors in a stock market than the

difference between market-centered and bank-centered financial systems); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997) (showing that economies with poorer protection for investors have smaller capital markets); La Porta et al., *Law and Finance*, *supra* note 1 (explaining the correlation between share ownership and the origin of legal rules in many countries).

4. Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1644 (2006); Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999).

5. Professor Coffee points out that correlation between strength of capital markets and legal protection for public investors does not mean causation. John C. Coffee Jr., *Do Norms Matter? A Cross-Country Evaluation*, 149 U. PA. L. REV. 2151, 2154 (2000). Criticizing LLSV's direction of causation, Professor Milhaupt suggests that economic structures may determine law, which is exactly opposite of the law and finance theory. Milhaupt, *supra* note 2, at 2122-23. Professor Gilson claims that LLSV depend on a simplified syllogism that is insufficient to explain the entire controlling shareholder regimes. Ronald J. Gilson, *Controlling Family Shareholders in Developing Countries: Anchoring Relational Exchange*, 60 STAN. L. REV. 633, 634 (2007) [hereinafter *Controlling Family Shareholders in Developing Countries*].

6. *Id*.

7. The expression of "bad-law countries (or jurisdictions)" has been widely used in the literature. *See* Gilson, *supra* note 4 (describing bad-law countries as those with "inefficient controlling shareholder systems"); Gilson, *supra* note 5 (using "developing countries" and "emerging market countries" interchangeably to describe "bad-law countries").

8. *See* Gilson, *supra* note 5, at 634. This question is referred to as the "flipside of Gilson's riddle." On the other hand, for an explanation of "Gilson's riddle," see *infra* notes 9-11. *See also infra* note 30 (explaining how Gilson's riddle and the flipside of Gilson's riddle are related).

intrinsic value of stocks issued. In other words, as Professor Gilson expresses, equity financing might be too expensive to a corporation in a bad-law country.[9] Then, a closely related puzzle in a bad-law economy (hereinafter, "Gilson's riddle"[10]) is "why do companies choose to pay the very high price for equity given the bad shareholder protection discount and the availability of cheaper alternatives[?]"[11] Or, from another perspective, why don't controlling shareholders expropriate more in order to compensate for the expensive equity financing? And why do some of them voluntarily set the limit of "tunneling"[12]—namely, a controlling shareholder's expropriation from minority shareholders—even though total expropriation is not efficiently regulated by the poor legal system in a bad-law jurisdiction?[13]

To solve this series of closely related conundrums in bad-law countries, Professor Gilson proposes an insightful hypothesis: the product market-based account (PMBA).[14] According to the PMBA, a corporation treats its minority shareholders fairly because such fair treatment could serve as a signal of credibility and trustworthiness to trading partners in a product market.[15] In this sense, the corporation's reputational benefits in a *product* market may justify the additional cost of equity in a *capital* market.[16] Put differently, even though having a large number of minority shareholders is costly due to expensive equity financing, it is ultimately beneficial to a controlling shareholder because minority shareholders function as proverbial canaries in the coal mine proving the controlling shareholders' integrity.[17] In this way, some argue that Gilson's riddle—i.e., the puzzle as to why a controlling shareholder relies on expensive equity financing (and consequently has many minority shareholders from a public capital market)—is solved.

9. Gilson, *supra* note 5, at 647.

10. "Gilson's riddle" was coined by Professor Fox. Discussion with Merritt Fox, Professor, Columbia Law School, in N.Y.C., N.Y.

11. *See* Gilson, *supra* note 5, at 647 (explaining why equity capital is an unattractive option in jurisdictions with poor shareholder protection) (emphasis added).

12. *See generally* Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Tunneling*, 90 AM. ECON. REV. 22 (2000) (defining "tunneling" and attempting to answer many questions about tunneling and its effects on the legal treatment of minority shareholders). Tunneling refers to the "transfer of assets and profits out of firms for the benefit of those who control them," occurred especially frequently throughout the "emerging markets crisis of 1997-1998." *Id*. at 22.

13. *See generally* Gilson, *supra* note 5, at 646-51.

14. *See id*. (discussing product market influences and the role of minority shareholders); *infra* Part I.C (analyzing controlling shareholder regimes and the PMBA).

15. *See* Gilson, *supra* note 5, at 646-51.

16. *See id*.

17. *Id*. at 648.

The purpose of this Article is to offer, through a theoretical approach (rather than via case study), potential answers to the corporate governance puzzles raised by Professor Gilson, which still remained uncharted. Most of all, this Article reviews the PMBA,[18] and then challenges its general application in controlling shareholder regimes.[19] In particular, the PMBA's implicit premise—that a controlling shareholder is concerned about a *corporation's* additional cost in equity finance—is criticized.[20] Instead, I argue that the controlling shareholder's *personal* cost is the core determinant of his decision. In this sense, the PMBA's premise does not hold well under the "controlling minority structure" (CMS)[21] where a controlling shareholder owns only a small fraction of the economic interest of a corporation (e.g., 5%). In a CMS case which is not uncommon throughout the world, a controlling shareholder would not consider a corporation's costs very seriously, as opposed to the theoretical foundation of the PMBA.[22]

In addition to criticisms of the PMBA, this Article proposes new answers to Gilson's riddle—why a controlling shareholder in a bad-law country needs external equity capital even if newly issued stocks are costly to him.[23] First, the additional cost of equity finance is not out-of-pocket cost but opportunity cost so that a controlling shareholder has tendency to be less concerned about it. Second, a controlling shareholder is able to take more private benefits if he has more public shareholders investing in new equities issued by his controlled corporation. Put differently, even if a controlling shareholder illicitly takes a small amount from each non-controlling shareholder, the sum of extractions from a large number of non-controlling shareholders would be huge. Third, building a large business empire may bring a controlling shareholder more psychological utility (or non-pecuniary benefits[24] such as leadership, fame, and social influence)[25] as

18. *See infra* Part I.C.1 (discussing Gilson's riddle and the PMBA).

19. *See infra* Part I.C.2 (discussing a critical review of the PMBA).

20. *See infra* Part I.C.3 (discussing the validity of the PMBA when a controlling shareholder owns small economic interest in a corporation).

21. Despite his minority ownership, a CMS controlling shareholder can exercise control over a corporation through various voting leverages. In terms of ownership, a CMS controller is also a minority shareholder. In this Article, however, "minority shareholders" are meant to be non-controlling public shareholders. For a more explanation of the CMS, see generally Bebchuk et al., *infra* note 39 (discussing the disparity between voting rights and cash flow rights of a controlling shareholder in the CMS).

22. *See infra* Part I.C.3. Nonetheless, equity finance is still expensive to a CMS controlling shareholder, since he is required to spend a fraction of the corporation's cost (e.g., 5%) anyway. Part II solves this problem.

23. As for answers to Gilson's riddle, see *infra* Part II.

24. For an explanation of psychological benefits, see Gilson, *supra* note 4, at 1663-64.

25. Most of the extant literature on corporate governance has focused on a controlling

well as handsome economic benefits. As for the question of a controlling shareholder's voluntary limit of expropriation,[26] it can be explained that if a controlling family shareholder rationally pursues a long-term goal of maximizing his private benefits, then he ought to be generous and attract more minority shareholders.[27]

As Alfred Marshall famously said, supply and demand "curves are like scissor blades that intersect at equilibrium."[28] Analysis from the standpoint of a controlling shareholder would be insufficient because transactions in a stock market would not take place unless non-controlling shareholders purchased shares from a controlled corporation. In other words, both the controlling shareholder and minority shareholders embrace one another by accepting market terms and conditions. Then another corporate governance puzzle (hereinafter, the "flipside of Gilson's riddle")[29] can arise: "why do minority shareholders purchase any shares at all in the absence of an observable ceiling on private benefit extraction?"[30] To answer this question, this Article presents a series of unconventional

shareholder's *pecuniary* private benefits (i.e., extraction from minority shareholders such as self-dealing). However, a controlling shareholder seeks to gain *non-pecuniary* private benefits from running a corporation as well. Then, a model assuming that a controlling shareholder maximizes his pecuniary benefits is not precise, even though it explains very important features of a controlling shareholder regime. A more precise model is based on the notion that a controlling shareholder maximizes his utility arising from non-pecuniary benefits as well as pecuniary benefits. Put differently, a controlling shareholder's utility function ("U") can be expressed as [U = U (pecuniary benefits, non-pecuniary benefits)].

26. This question is related to the question mentioned in *supra* note 8's accompanying text.

27. As for an analysis of a controlling shareholder's rationally mild tunneling, see generally Sang Yop Kang, *"Generous Thieves": The Puzzle of Controlling Shareholder Arrangements in Bad-Law Jurisdictions*, DEL. J. CORP. L. (forthcoming 2014) (explaining that a self-interested controlling shareholder may impose a lenient level of expropriation from minority shareholders since the total pecuniary benefits from repeated and mild expropriations would be greater than pecuniary benefits from one-shot and severe expropriation).

28. *The Concise Library of Economics: Alfred Marshall*, ECONLIB (2008), *available at* http://www.econlib.org/library/Enc/bios/Marshall.html.

29. While Gilson's riddle approaches from the perspective of buyers (i.e., public investors) in a capital market, the flipside of Gilson's riddle approaches from the perspective of sellers (i.e., corporations or controlling shareholders) in a capital market.

30. Gilson, *supra* note 5, at 647. As for answers to the flipside of Gilson's riddle, see *infra* Part III. Professor Gilson seems to explain that Gilson's riddle and the flipside of Gilson's riddle are inherently related ("Cost considerations make equity capital an even less attractive source of financing in these jurisdictions than in those with good shareholder protection. Indeed, it is a two-sided puzzle, with the possibility of a lemons' market: why do companies choose to pay the very high price for equity given the bad shareholder protection discount and the availability of cheaper alternatives, and why do minority shareholders purchase any shares at all in the absence of an observable ceiling on private benefit extraction?" *Id.*).

explanations: (1) the "stationary controller"[31] account; (2) the "limited opportunities of other investments" account; (3) the minorities' behavioral finance account; (4) the "minorities might not be damaged" account; (5) the foreign minorities account; and (6) the minorities' free-ride account. Most well-functioning capital markets in less developed economies are likely to be subject to at least some of these accounts.

Against this backdrop, this Article proceeds according to the following structure. Part I sets out the features of controlling shareholder regimes and explains how information asymmetry, coupled with insufficient protection of public investors, would potentially destroy a capital market. Then, the PMBA is introduced and critically reviewed. Part II proposes alternatives to the PMBA, answering Gilson's riddle from the controlling shareholder's perspective. Subsequently, Part III proposes possible reasons why minority shareholders are willing to participate in a seemingly unfair capital market (i.e., the flipside of Gilson's riddle). The Article then concludes by summarizing key points.

As the saying goes, "[i]t takes *two* to tango."[32] A message in this Article is that when both a controlling shareholder and minority shareholders realize that their interwoven relationship creates symbiosis and mutual hostage, their cooperation is often compelled and strengthened. Then, economic development could ensue even in a bad-law country. Although the combination of well-written laws and efficient enforcement mechanisms plays an important role in the development of a capital market, a functional market still may form and develop without sufficient formal legal protections for public investors.[33]

I. CONTROLLING SHAREHOLDER REGIMES AND THE PRODUCT MARKET-BASED ACCOUNT

Berle and Means' model[34] of dispersed ownership assumes that a large number of dispersed shareholders collectively own shares of a large-scale

31. For a further discussion of minority shareholders' response under a stationary controller, see *infra* Part III.A.

32. Discussion with Merritt Fox, Professor, Columbia Law School, in N.Y.C., N.Y.

33. However, if the present conditions change in the future, it is possible that the symbiotic relationship between a controller and non-controlling shareholders would no longer exist. For example, as the process of globalization continues to gain momentum, non-controlling shareholders have more opportunities and options to diversify their assets internationally. As a result, a domestic controlling shareholder's ability to keep public investors in his controlled corporation could be diminished. Discussion with Jeffrey Gordon, Professor, Columbia Law School, in N.Y.C., N.Y.

34. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION & PRIVATE PROPERTY (1932).

corporation.[35] Since there is no dominant shareholder, corporate power belongs to management. However, this model is limited to the United States and the United Kingdom.[36] In many countries, controlling family shareholders run conglomerates and business groups.[37] In developing countries with a controlling shareholder regime, minority shareholders are poorly protected within formal legal structures, such as corporate and securities laws and judicial systems.

A. Controlling Shareholder Ownership: The Controlled Structure and the Controlling Minority Structure

In the controlling shareholder regime, most corporate governance literature presumes that a large block-holder controls a corporation by owning a majority of shares.[38] For example, when a dominant shareholder owns 51% of a corporation's shares, he exercises 51% of the voting rights. In this way, voting rights and cash flow rights are generally aligned.[39] This type of controlling shareholder ownership is referred to as a "controlled structure" (CS).[40] However, another significant pattern of controlling shareholder ownership occurs where a controlling shareholder wields a significant percentage of voting rights even though he holds a small percentage of equity. For example, a shareholder who owns 10% of shares may be able to exercise 51% of votes in a corporation via voting leverage mechanisms. Since a controlling shareholder is also a minority shareholder in terms of the quantity of his equity stake, this regime is referred to as the

35. John C. Coffee Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 641 (1999).

36. *Id.*; *see also* Lucian A. Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127, 133 (1999) (explaining how most public companies in the United States and the United Kingdom have dispersed ownership, while public companies in the rest of the world generally have controlling ownership); La Porta et al., *supra* note 4, at 474 (authors find that "the Berle and Means corporation is far from universal, and is quite rare for some definitions of control.").

37. *See, e.g.*, La Porta et al., *supra* note 4, at 481-83.

38. *See, e.g.*, Mark J. Roe, *Corporate Law's Limit,* 31 J. LEGAL STUD. 233, 238 (2002) (discussing how blockholders who have controlling stock attempt to maintain control by owning 51% or more of stock).

39. For a further explanation of the relationship between a controlling shareholder's voting rights and cash flow rights, see generally Lucian A. Bebchuk, Reinier Kraakman, & George Triantis, *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, (Nat'l Bureau Econ. Research, Working Paper No. 6951, 1999) (also published in CONCENTRATED CORP. OWNERSHIP (Randall K. Morck ed., 2000)), *available at* http://www.nber.org/papers/w6951.pdf?new_window=1.

40. *Id.* at 1.

"controlling minority structure" (CMS).[41] Many Chinese companies use the CMS where a pyramiding structure is used.[42] Similar examples of CMS are observable in Europe, South America, South Africa, and other Asian countries.

Korean CMS cases are noteworthy. Controlling family shareholders of large corporate groups in Korea hold, on average, 5.04% of ownership stake.[43] In fact, 5.04% includes family members' economic interest as well as controlling shareholders' personal economic interest.[44] The controlling shareholders' average personal economic interest alone is merely 2.62%.[45] For example, in Samsung Group (Apple's global business rival, Samsung Electronics, is an affiliated firm of the group), Chairman Kun-Hee Lee holds only 0.69% of the economic interest,[46] although he is undoubtedly "the" group's controlling shareholder with nearly a majority of voting rights in the group. More strikingly, the ownership stake that Chairman Tae-Won Choi personally holds in SK Group[47] is only 0.04% (note that 0.04% is *not a typo*).[48] Nonetheless, he effectively wields controlling voting power over the entire group.

How can CMS controlling shareholders maintain control with a small fraction of personal (or family) ownership stake? Professors Bebchuk, Kraakman and Triantis explain that "[s]uch a radical separation of control

41. *Id*.; Lucian A. Bebchuk & Assaf Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. Pa. L. Rev. 1263, 1313 n.161 (2009) ("The term 'controlling minority' was introduced by Bebchuk et al. . . . .").

42. For a general explanation of China's corporate pyramiding structure, see Joseph P.H. Fan, T.J. Wong & Tianyu Zhang, *The Emergence of Corporate Pyramids in China*, CHINESE UNIV. HONG KONG (May 2005), http://www.rieti.go.jp/users/peng-xu/project/asia/pdf/fan_wong_zhang.pdf.

43. *See* Press Release, Kor. Exch., Changing Status of Largest Shareholders' Ownership of Stock in Ten Conglomerates of S. Kor. (June 23, 2011) (data was collected as of 2011), *available at* http://www.krx.co.kr/m10/m10_1/m10_1_3/JHPKOR10001_03_01.jsp?sch=all&noti_no=20249&cur_page=1&rn=6536&word.

44. As of April 2011, among ten of the largest corporate groups in Korea, while controlling shareholders *individually* held 2.42% of economic interest of corporate groups, their *families* hold 2.62% (thus, the total ownership is 5.04 %). *Id*.

45. *Id*.

46. Jong-Sun Yun, *Kun-Hee Lee 0.69%, Tae-Won Choi 0.04% 'Dominate Whole Enterprise' by Holding Minimal Economic Interests,* E-DAILY NEWS (May 30, 2013), http://www.edaily.co.kr/news/NewsRead.edy?SCD=JA11&newsid=01974566602814168&DCD=A00101&OutLnkChk=Y. Including his family's cash flow rights, Mr. Lee holds 1.27% of economic interest in Samsung Group. *Id*.

47. *See Global 500—Our Annual Ranking of the World's Largest Corporations*, CNN MONEY (July 23, 2012), http://money.cnn.com/magazines/fortune/global500/2012/full_list/index.html (ranking SK Holdings as sixty-fifth in the world).

48. Yun, *supra* note 46.

and cash flow rights can occur in three principal ways: through dual-class share structures, stock pyramids, and cross-ownership ties."[49]

First, in a dual-class share structure, a corporation issues "two or more classes of stock with differential voting rights."[50] For example, Class A stock has one-share-one-vote, while Class B stock equates to one-share-ten-vote. Some U.S. corporations use such a system. Second, stock pyramiding "is defined as the ultimate ownership of a firm running through a chain of ownership of intermediate corporations."[51] In a simple model, an individual holds 51% of ownership of Company A, which subsequently owns 51% of Company B. The individual exercises full control over Company B through the chain of ownership from Company A even though his economic interest in Company B is merely 26% (i.e., 51% x 51% = 26%). Third, cross ownership is used when a corporation holds an ownership stake in other affiliated firms. Suppose that there are three corporations (Company A, B, and C) in a business group: Company A holds ownership stake of Company B and C; Company B holds ownership of Company C and A; and Company C holds ownership of Company A and B. Cross ownership is especially useful in jurisdictions where a dual-class share structure and stock pyramiding are not allowed. Cross ownership becomes more complicated as the number of affiliated firms grows within a business group.[52] Via a network effect that runs through the complicated ownership web among affiliated firms, a CMS controller—such as Chairman Lee in Samsung and Chairman Choi in SK—can exercise control with a small fraction of economic interest.

In sum, holding a majority of common shares and economic interest is *not necessary* to exercise control. Rather, one's "control" means a status with a significant holding of "voting" rights. Indeed, it is often possible that a shareholder with less than a majority of the voting rights can wield effective control.[53] For example, a shareholder may dominate a corporation

49. Bebchuk et al., *supra* note 39, at 1.

50. *Id*. at 4.

51. Stijn Claessens, Simeon Djankov, Joseph P. H. Fan, Larry H. P. Lang, *Disentangling the Incentive and Entrenchment Effects of Large Shareholders,* 57 J. FIN., 2741, 2743 n.1 (2002). For more explanation on stock pyramiding, see, e.g., Randall Morck & Bernard Yeung, *Agency Problems in Large Family Business Groups*, 27 ENTREPRENEURSHIP THEORY AND PRACTICE 367 (2003).

52. If there are "n" affiliated firms in a corporate group, then there are "n x (n – 1)" ways for intra-shareholding (through cross ownership in a matrix form) to occur among affiliated firms. For example, if there are 70 affiliated firms (which is not uncommon in Korean corporate groups), there are 4,830 possible intra-shareholdings among affiliated firms in a corporate group (70 x 69 = 4,830). If *direct* cross-shareholding (Company A owns a part of Company B, and Company B owns a part of Company A) is prohibited, the number of possible ways of intra-shareholding in a corporate group is "n x (n – 1) / 2".

53. According to the City Code in the United Kingdom, a person (or a group) has

with just 40% voting power if the rest of shareholders are dispersed and cannot form a unified insurgent group against him. For the purpose of simplicity, however, Table 1 summarizes the two aforementioned patterns of controlling shareholder systems, assuming that control means holding more than a majority of the voting rights.

TABLE 1: COMPARISON BETWEEN THE CS AND THE CMS

	CS	CMS
A Controlling Shareholder's Cash Flow Rights ("α")	More than 50% ($0.5 < \alpha \leq 1$)	Less than 50 % ($0 \leq \alpha < 0.5$)
A Controlling Shareholder's Voting Rights	More than 50%	More than 50 %
Voting Leverage Mechanisms	None (for the Pure CS)	- Stock Pyramiding - Dual-Class Share Structure - Cross-Shareholding

B. Asymmetric Information and the Lemon Market Problem

A well-performing securities market should be built upon disclosed information[54] and efficient regulations. In a bad-law country, however, investors suffer from insufficient disclosure systems and lack of transparency, not to mention inefficient legal infrastructure. A securities market then becomes highly vulnerable to the "lemon" market problem[55] due to the asymmetry of information between sellers (i.e., corporations or corporate insiders) and buyers (i.e., investors). In a corporation where a

control as long as the person (or the group) has more than 30% of voting rights. *The Takeover Code*, TAKEOVER PANEL, http://www.thetakeoverpanel.org.uk/the-code/download-code (last visited Jan. 12, 2014). *See also* Sang Yop Kang, *Transplanting a Poison Pill to Controlling Shareholder Regimes—Why It Is So Difficult*, 33 NW. J. INT'L L. & BUS. 619, 642 (2013) (explaining that a shareholder can control a corporation without a majority of voting rights).

54. For more explanation of the mandatory disclosure and its related discussion, see generally Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335 (1999) (arguing that the U.S. "should reject an issuer choice regime and retain the current [federal] mandatory system").

55. As for lemon market problem, see generally George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970).

controlling shareholder may be actively involved in transactions tainted with conflicts of interest, the controlling shareholder knows that the fundamental value of the company has been damaged due to tunneling. Conversely, prospective investors in the securities market do not know whether the firm is involved in such misconduct and, if so, to what degree. At best, investors may only have market statistics about the *average* quality of issuers' corporate governance.[56]

Knowing that corporations are not distinguished in the market based on the quality of their corporate governance, issuers with good quality (i.e., companies not associated with tunneling) have no incentive to issue, and only issuers with bad quality (i.e., companies associated with an enormous amount of tunneling) participate in the securities market.[57] Due to asymmetric information, therefore, an adverse selection problem emerges.[58] Unfortunately this is not the end of the story. In turn, because investors only know the *average* quality of companies, they *uniformly* discount the issuance of securities *more* deeply based on the statistics.[59] Then, even those relatively well-governed companies would feel pressure to leave the market because the price determined by the application of the deeper discount to *all* issuers is too cheap for them and well below the fair value of their securities.[60] Ultimately, only companies with the worst quality (i.e., companies associated with the most egregious forms of expropriation) remain in the market in the self-enforcing process of Gresham's law[61]—the bad drive out the good, the worse drive out the bad, and the worst drive out the worse from the market. Accordingly, the adverse selection is

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56. *See generally id.* (discussing the response of market participants under the asymmetric information).

57. *See* Bernard Black, *The Core Institutions that Support Strong Securities Markets*, 55 BUS. LAW. 1565, 1567-68 (2000) (explaining that investors discount all corporations' shares in a market, resulting in punishment for corporations where insiders do not siphon corporate assets).

58. Adverse selection is a form of market failure.

> Adverse selection arises when products of different qualities are sold at a single price because buyers or sellers are not sufficiently informed to determine the true quality at the time of purchase. As a result, too much of the low-quality product and too little of the high-quality product are sold in the marketplace.

ROBERT S. PINDYCK & DANIEL L. RUBINFELD, MICROECONOMICS 616 (Pearson Prentice Hall 6th ed. 2004). For a further explanation of adverse selection, see RICHARD A. IPPOLITO, ECONOMICS FOR LAWYERS (Princeton University Press, 2005) at 299-315.

59. *See* Black, *supra* note 57, at 1567.

60. *See id.* at 1568. *See also* Akerlof, *supra* note 55, at 489-92 (introducing the lemon problem in the market for used cars).

61. Gresham's law says that "bad money tends to drive good money out of circulation." Richard Dutu, Ed Nosal & Guillaume Rocheteau, *The Tale of Gresham's Law*, Federal Reserve Bank of Cleveland (2005), http://www.clevelandfed.org/research/commentary/2005/1001.pdf.

reinforced, leading to market failure and the possibility of the securities market collapsing, in the absence of adequate measures to correct this vicious circle.[62] Consequently, in a country with poor investor protections, in theory we will not be able to observe a significant number of minority shareholders and a well-developed securities market.

This undesirable situation in a bad-law securities market would also be expected under the pecking order theory[63] of corporate finance.[64] According to the theory, given asymmetric information between corporate insiders and prospective investors, corporations have a routine order of financing: (1) first, they use internal financing when available; and (2) if external financing is required, corporations choose debt over equity.[65] As Professor Gilson explains, this phenomenon takes place because the cost of equity for a corporation is highest among its financing sources.[66] Prospective investors are more reluctant to purchase newly issued shares since they lack sufficient information about a corporation's share price. Under this asymmetric information scheme, prospective investors—if they decide to purchase new shares—require a discount. Accordingly, a corporation receives less than the fair amount of proceeds from selling its new shares to a capital market. Consequently, equity financing is costly to a corporation, and thus it is unwilling to issue new shares, as long as it is able to rely on other types of financing. Simply put, equity financing is known as the last-resort financing.[67]

The pecking order of finance could have more serious implications in a bad-law jurisdiction for two reasons: (1) the severe problem of a controlling shareholder's expropriation from minority shareholders makes

62. Professors Khanna and Palepu explain that "[i]n extreme cases, the market breaks down and no transactions occur." Tarun Khanna & Krishna Palepu, *The Right Way to Restructure Conglomerates in Emerging Markets*, 77 HARV. BUS. REV. 125, 130 (1999).

63. For more information on the pecking order theory, see Stewart C. Myers & Nicholas S. Majluf, *Corporate Financing and Investment Decisions When Firms Have Information That Investors Do Not Have*, 13 J. FIN. ECON. 187 (1984).

64. In addition to the pecking order theory, the trade-off theory is an alternative model to explain corporations' finance decisions. Eugene F. Fama & Kenneth R. French, *Financing Decisions: Who Issues Stock?*, 76 J. FIN. ECON. 549, 549-50 (2005). According to the trade-off theory, debt financing has trade-off effect—while it has tax benefits, it increases financial distress. *Id.*

65. *See generally* Myers & Majluf, *supra* note 63; *see also* RICHARD A. BREALEY, STEWART C. MYERS, & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE 490-94 (McGraw-Hill 8th ed. 2006). The pecking order theory relies on an assumption that corporate insiders are not willing to issue new shares at an undervalued price in a stock market because it will dilute the share price. *Id.* at 490-92. Although the validity of the assumption in relation to agency problems is important, it is beyond the scope of this Article. Further research will be conducted in an independent project.

66. Gilson, *supra* note 5 at 647.

67. BREALEY ET AL., *supra* note 65, at 490.

equity investment by public shareholders riskier; and, (2) since the jurisdiction has an underdeveloped disclosure system, the information asymmetry problem becomes exacerbated. Consequently, equity's status as the last resort of financing is reinforced,[68] and equity financing is substantially more costly to a corporation than bank financing in a bad-law jurisdiction.[69]

C. The Product Market-Based Account

This Subpart first introduces the product market-based account (PMBA),[70] and then criticizes various aspects of the PMBA. In particular, this Subpart explains how the PMBA's explanatory power can be weakened when a controlling shareholder has only a small economic interest in a corporation.

1. Gilson's Riddle and the Product Market-Based Account

In theory, the cost of equity is so much higher for corporations in bad-law countries. Then, as Gilson's riddle suggests, why in reality are corporations in those countries willing to raise capital through an equity market (although the frequency is low) and have a significant number of public minority shareholders?[71] To answer his riddle, Professor Gilson himself proposes an insightful hypothesis—the PMBA. Gilson's riddle presents a conundrum that arises between a controlling shareholder and public shareholders. Accordingly, it seems natural to explore the puzzle from the perspective of a *capital* market where two parties engage in transactions. With the paradigm-shifting analysis, however, the PMBA approaches the puzzle from a *product* market perspective.[72]

In a product market, a corporation enters into a myriad of transactions and contractual relations with its trading partners. Bad-law jurisdictions lack an efficient commercial law system to enforce contractual obligations in product markets.[73] Interestingly, such contracts are, nonetheless, often honored. Professor Gilson primarily attributes this phenomenon to the role of reputation in a market since reputation works as a sort of self-enforcement mechanism.[74] If a corporation cheats its trading partners

68. *See* Gilson, *supra* note 5, at 647.
69. *Id*.
70. *See generally id*. at 646-651 (discussing the PMBA).
71. *Id*.
72. *Id*.
73. *Id*. at 635.
74. *See id*. at 635-36.

"today," an inefficient legal system is unable to punish the corporation. However, the corporation will be punished "tomorrow" by market mechanisms since market participants will refuse to make transactions with such a dishonest corporation.

Here, Professor Gilson puts forward a brilliant explanation that logically connects across a product market as well as a capital market. According to the PMBA, if a controlling shareholder treats minority shareholders fairly in his controlled corporation, he will be deemed as trustworthy by trading partners within a *product* market.[75] In this way, minority shareholders are akin to "reputational canaries" who convey a signal to trading partners about a controlling shareholder's integrity.[76]

One may ask whether such a signal is merely "cheap talk." When a controlling shareholder treats minority shareholders fairly, however, it means that he is required to give up at least some private benefits that he could have otherwise extracted from the corporation.[77] In this sense, according to the PMBA, the signal—i.e., fair treatment of minority shareholders—is costly to a controlling shareholder so that it is credible.[78] In addition, the logic suggests that "[i]f the family-controlled corporation does not cheat in easy ways (given poor shareholder protection) by exploiting minority shareholders, . . . the controlling family shareholder also will not cheat its customers."[79] With a good reputation among minority shareholders in a capital market, the corporation over which the truly honest controlling shareholder exercises control would have more economic opportunities with trading partners in a product market.[80]

In sum, the PMBA posits, "[t]he [controlling shareholder's] decision to have minority shareholders then can be explained not by the need for *capital* . . . , but as a way of developing reputation that will be valuable in the *product* market . . . ."[81] Such reputational advantage from the product market where a controlling shareholder participates in a repeated game[82] may justify the more expensive equity financing in a capital market, thus it is argued that Gilson's riddle is solved.

75. *Id*. at 648.
76. "[M]inority shareholders play the role of reputational canaries, whose value is that they help credibly convey to potential traders that the corporation is an honest trading partner." *Id*.
77. *Id*.
78. *Id*.
79. *Id*.
80. *See generally id*. at 646-651.
81. *Id*. at 648.
82. *See id*.

2. A Critical Review of the Product Market-Based Account

The PMBA is the first meaningful attempt to solve Gilson's riddle, yet it has remained uncharted at large. Indeed, the PMBA is a creative and path-breaking study because it analyzes the corporate governance puzzle between a controller and minority shareholders from an analytical framework in relation to a product market. As with most pioneering theories, however, the PMBA might not provide clear answers in some circumstances. First, how a controlling shareholder's signal is sent from a capital market—by treating minority shareholders fairly—to a product market may be too convoluted to be realistic. Sharing this view, Professors Gordon and Milhaupt have raised questions about the PMBA's *indirect* path of a controlling shareholder's signaling. Based on Professor Gilson's explanation, suppose that the controlling stakeholder's primary concern is the reputation of the controlled corporation within a product market. Why then would he not show his integrity and honesty *directly* in a product market rather than treating minority shareholders fairly in a capital market and subsequently sending off this signal to the product market?[83]

Second, the role of local newspapers in improving the quality of corporate governance should be closely interpreted. According to the PMBA,

> [s]uppose that the treatment of minority shareholders is *visible* to a company's potential trading partners at a *low* cost, perhaps because such exploitation is covered by the local newspapers. Fair treatment of minority shareholders then serves as evidence of the corporation's integrity, including its commitment to performing its contractual obligations . . . .[84]

This implies that local newspapers functions as a low-cost conduit for sending information from a capital market to a product market. However, it is noteworthy that jurisdictions at issue in the PMBA are bad-law countries where we are concerned about the integrity of large corporations and the efficiency of the legal systems. Therefore, it is difficult to trust the integrity and efficiency of the local newspapers in those same jurisdictions.[85]

83. Discussion with Jeffrey Gordon and Curtis Milhaupt, Professors, Columbia Law School, in N.Y.C., N.Y.

84. Gilson, *supra* note 5, at 648 (emphasis added and citation omitted).

85. Professor Gilson seems to admit this point, although he emphasizes the role of the press as an efficient corporate governance tool. "Luca Enriques has pointed out that the role of the financial press may be limited to a handful of developed countries where there is a widespread confidence in the newspapers' journalistic integrity. Absent that confidence, they cannot play the contemplated 'shaming' role." *Id.* at 648 n.37 (citing E-mail from Luca Enriques, Professor of Law, University of Bologna, and Commissioner, Commissione

More importantly, it should be noted that the integrity of local newspapers could be significantly damaged due to the very nature of corporate groups, a common business organization in many developing countries. It is not uncommon for a corporate group to consist of more than a score of affiliated corporations. Then, it is likely that the corporate group has a media corporation as well, such that the media corporation is directly under the influence of the group's controlling shareholder.[86] Even if a corporate group does not have such a corporation, the group has enormous influence on the media industry via the sale of advertisements to the press. Therefore, it is commonplace that local newspapers are biased towards controlling family shareholders. Simply put, the media is generally not a fourth branch of the government in such countries.

In addition, contrary to the PMBA's explanation, it might be difficult for potential trading partners in a product market to effectively notice a corporation's treatment of minority shareholders.[87] Even to large institutional investors, who are experts in interpreting information from public corporations in a capital market, examining a particular controlling shareholder's treatment of investors is costly. Then, by and large trading partners—experts on a product market—are less able to interpret capital market information as efficiently as institutional investors. Thus, it would be difficult for trading partners to recognize these signals at a low cost.

As aforementioned, the PMBA explains if a controlling shareholder treats minority shareholders fairly, it would be a good signal to a product market that the controller is not going to cheat his trading partners.[88] However, it is questionable whether trading partners really think of a corporation's treatment of other parties including its minority shareholders, as a primary standard when they transact with the corporation. Rather, trading partners are often willing to acquiesce to a corporation's misconduct as long as the corporation abides by contracts.

For example, although it is widely alleged that Samsung Group has serious corporate governance problems (and thus the interest of minority shareholders is arguably damaged),[89] Apple—a large trading partner of

Nazionale per le Società e la Borsa (CONSOB), to Ronald J. Gilson, Charles J. Meyers Professor of Law and Business, Stanford Law School (Nov. 24, 2006) (on file with author)).

86. In other words, many corporate groups have unrelated diversified business portfolios. Therefore, it is possible that, for example, a corporate group with a semi-conductor affiliate company has a newspaper subsidiary as well as a leisure business subsidiary.

87. Professors Jeffrey Gordon and Curtis Milhaupt have shared a similar idea with me on this question. Discussion with Jeffrey Gordon and Curtis Milhaupt, Professors, Columbia Law School, in N.Y.C., N.Y.

88. Gilson, *supra* note 5, at 648.

89. For a discussion of the corporate governance problems created by the Samsung

Samsung Electronics—has purchased important components (e.g., flash memory chips) from Samsung Electronics for its iPhone.[90] To be sure, Apple has tried to reduce its dependence on Samsung, but this has largely been due to its hostile relationship with Samsung over intellectual property issues in many jurisdictions and its strategic efforts to diversify its suppliers.[91] Another example can be found in the relationship between Apple and Foxconn in China. Foxconn, a major supplier of Apple, is infamous for allegedly inhumane working conditions.[92] Nonetheless, it initially seemed that Apple had been apathetic to Foxconn's mistreatment of its employees. These examples show how a corporation's treatment of third parties—including its minority shareholders or lay-workers—do not always function as a useful indicator of a corporation's trustworthiness to trading partners.[93]

Moreover, the PMBA is not fit for explaining an export-oriented developing economy—many successful emerging markets fall into this category—where a corporation has foreign trading partners.[94] It might be difficult for trading partners in a "foreign product" market (Country A) to be able to effectively observe and examine a corporation's conduct in a "domestic capital" market (Country B). One may argue that newspapers in developed foreign countries report about a controlling shareholder's treatment of minority shareholders in a bad-law jurisdiction. If this is the case, then the problem of local press independence is solved as well.[95]

Foreign trading partners may be able to receive relevant information on a controlling shareholder's integrity from a distinguished and

Group's controlling family shareholder, see Kang-Il Lee, *Kun-Hee Lee, Not Guilty in a Criminal Court, But Liable in a Civil Court*, HANKOOK DAILY (Aug. 22, 2012), http://news.hankooki.com/lpage/society/201208/h2012082216425322000.htm.

90. *Apple and Samsung's Symbiotic Relationship: Slicing an Apple*, ECONOMIST (Aug. 10, 2011), http://www.economist.com/blogs/dailychart/2011/08/apple-and-samsungs-symbiotic-relationship ("Together, [Samsung's products] account for 26% of the component cost of an iPhone.").

91. Jessica E. Lessin, Lorraine Luk & Juro Osawa, *Apple Finds It Difficult to Divorce Samsung*, WALL ST. J. (July 1, 2013), http://online.wsj.com/news/articles/SB10001424127887324682204578513882349940500 ("In the past year, Apple executives have expressed concern that their dependence on Samsung limits Apple's ability to control its destiny by constricting Apple's negotiating power and ability to use different technologies . . . .").

92. *See* Ulianne Pepitone, *Foxconn Workers Strike over iPhone 5 Demands, Labor Group Says*, CNN Money (Oct. 7, 2012), http://money.cnn.com/2012/10/05/technology/mobile/foxconn-iphone-5-strike/index.html.

93. Compare with the PMBA.

94. Professor Curtis Milhaupt suggested this issue. Discussion with Curtis Milhaupt, Professor, Columbia Law School, in N.Y.C., N.Y.

95. For a discussion of the local press independence problem, see *supra* notes 84-86 and accompanying text.

independent press in a developed country in a more neutral manner. Perhaps, sophisticated business newspapers such as the Wall Street Journal or Financial Times delve into the macroeconomic environment and general characteristics of a particular country. However, it is highly unlikely that those newspapers would examine "one particular" controlling shareholder's treatment of minority shareholders in a particular developing economy. Even if they did, the probability of these media sources writing a review of a particular controlling shareholder is so low that it would be rational for the controller to ignore that possibility. In addition, as seen in the Samsung-Apple and Foxconn-Apple examples, foreign trading partners—even if they know a corporation's misconduct—have little reason to raise such an issue as long as the corporation treats its trading partners in a favorable way.[96] In sum, a controlling shareholder in an export-oriented developing country hardly has reasonable grounds to send a costly signal from a "domestic capital" market to a "foreign product" markets.

Furthermore, the imperfect industrial organizations in many developing countries weaken the logic of the PMBA as well. The PMBA implies that a corporation caters to trading partners in a product market.[97] When a corporation is located in a relatively competitive market (e.g., the United States), trading partners face a more favorable situation because they can use competitive pressure among corporations.[98] However, in markets where a few large corporations form a (quasi) monopoly in almost every product market, each large corporation has powerful leverage vis-à-vis trading partners. This kind of relationship describes the general contours of the bad-law jurisdictions covered by the PMBA.

In these jurisdictions, just as corporate law systems are ineffective, competition law systems are not effective in regulating the misconduct of large corporations (and controlling shareholders).[99] Thus, the prevailing phenomenon in developing countries is often described as "Strong Controlling Shareholders, Weak Trading Partners."[100] Under these

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96. Of course, it is possible that in the future Apple could use Samsung Group's corporate governance issues for its business strategy purpose.

97. For example, according to the PMBA, a (family-controlled) corporation sends a costly signal to trading partners in order to show its integrity. *See* Gilson, *supra* note 5, at 648-49. In this sense, the PMBA seems to indicate the corporation's weak position vis-à-vis its trading partners.

98. In general, it is explained that the U.S. market is more competitive than markets in the rest of the world.

99. In other words, the correlation between the quality of corporate law and the quality of competition law is very high.

100. This expression is borrowed from the title of Professor Roe's book. MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (Princeton University Press 1994). In a bad-law jurisdiction, powerful market players are generally large family-controlled corporate groups (and their controlling

circumstances, the controlling shareholder of a large corporation does not have to send costly signals about fair dealings with minority shareholders in order to attract trading partners. In other words, it is trading partners (rather than a controlling shareholder) that should convince the other party that they are credible, which is exactly opposite of the PMBA's main argument.[101]

3. When Cash Flow Rights and Voting Rights Are Significantly Detached

Depending on the reinforced pecking order theory[102]—the cost of equity is substantially higher than the cost of debt to a corporation in a bad-law country[103]—the PMBA concludes that a controlling shareholder's decision to rely on an equity market is not explained through *capital* market-based accounts. Rather, the PMBA hypothesizes that a corporation sends off the signal of its integrity to trading partners in a *product* market (by showing that the corporation treats minority shareholders fairly), even if that signaling imposes a financial cost on the corporation (i.e., issuing stocks at a discounted price).[104] To a corporation in a developing country, perhaps the benefit of maintaining good reputation in a product market may exceed the cost of signaling.[105] In this Subpart, I explore the above reasoning by paying attention to the following questions: (1) when issuing stocks at the discounted price, who will ultimately bear the extra financial costs, and how much?; (2) who makes the ultimate decision on the capital structure of a corporation, and what matters most to him?

Indeed, if a corporation's cost of equity is much higher than the cost of debt, then the corporation has no good *capital* market justification to issue new equities. Thus, if a corporation issues new shares to the public, it *may* have *product* market rationales as the PMBA describes.[106] However, this reasoning misses an important point as to the definition of a "corporation." Since a corporation is a fictitious legal person,[107] the

shareholders). On the other hand, their trading partners are often small corporations.

101. For the comparison with the PMBA's main argument, see *supra* note 97 and accompanying text.

102. Gilson, *supra* note 5, at 647.

103. *Id*.

104. *Id*. at 647-48.

105. Professor Gilson articulates the significant role of the reputational mechanism in the PMBA. *See* Gilson, *supra* note 5, at 648.

106. However, it does not mean that there must be product market rationales.

107. *See, e.g.*, FRANK EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 12 (Harvard University Press 1996) (explaining "[t]he 'personhood' of a corporation is a matter of convenience rather than reality . . . ."); Gilson, *supra* note 5, at 640-41 ("As a formal matter, a corporation is just a long-lived piece of paper on which

ultimate and real cost-bearer and beneficiary of corporate transactions is not the corporation, but shareholders (in particular, natural persons). In addition, in the deep CMS where a controlling shareholder's economic interest in a corporation is low, the controlling shareholder's personal cost of equity financing could be minimal, even if the corporation's cost is high.

Consider a controlling shareholder in a bad-law country who would like to raise external capital. Suppose that the fundamental value[108] of either debt instruments or equity securities that a corporation issues is $10 million. As the reinforced pecking order theory in a bad-law country implies,[109] however, a corporation's cost of equity finance is substantially higher than that of debt finance.[110] Put differently, equity issuance is subject to a deep discount in a capital market due to distrust among market participants. Accordingly, the corporation would receive less proceeds in an equity market than in a debt market. Then, for example, while the corporation receives $10 million through debt instruments, the corporation could receive only $8 million through equity issuance. In this case, the additional cost of the equity that the corporation bears is $2 million.

However, it is noteworthy that the extra cost of $2 million when selecting equity finance will be borne by the "corporation." A controlling shareholder's primary interest may not be the total cost of equity financing to a corporation, even though it is important to the corporation. Of greater significance to a controlling shareholder is his *personal* cost of equity finance. When a controlling shareholder holds a fractional ownership, α—which is between 0 (i.e., 0%) and 1 (i.e., 100%)—his personal extra cost in selecting equity financing over debt financing is only a fraction of a corporation's additional cost, \$ α x 2 million.[111] The rest of the additional expense will be borne by all of the non-dominant shareholders.

According to the conventional CS model,[112] a controlling shareholder will take most of the benefits and costs occurring in any decision and transaction made in a controlled corporation because the controlling

appears the corporation's charter.").

108. In principle, "[f]undamental value is the price that would prevail if the market consisted entirely of rational investors who possessed all available information (i.e., the price that would prevail in a truly efficient market)." Merritt B. Fox, Randall Morck, Bernard Yeung & Artyom Durnev, *Law, Share Price Accuracy, and Economic Performance: The New Evidence*, 102 MICH. L. REV. 331, 349 n.47 (2003).

109. As for the reinforced pecking order theory, see *supra* notes 67-69 and accompanying text.

110. Gilson, *supra* note 5, at 647.

111. A controlling shareholder's personal extra cost and a corporation's cost in selecting equity finance are the same only when the shareholder contributes 100% of the equity capital to the corporation.

112. Recall that cash flow rights and voting rights of a CS controlling shareholder are approximately aligned.

shareholder holds the vast majority of the cash flow rights. Here, the economic incentives of the corporation and the controller are generally aligned.[113] For example, when a controlling shareholder holds 90% of the economic interest of a corporation, he bears 90% of the additional cost of capital, i.e., $1.8 million in the example.[114] Under these circumstances, if the controlling shareholder decides to choose equity financing that costs more than debt financing, the decision to issue new shares would not likely be made based on a *capital* market rationale, as the PMBA explains. Instead, it is probable that the PMBA's rationale—building a reputation of integrity in a *product* market—*may* be able to explain the controller's decision to raise equity capital.[115]

A limitation of the above explanation is, however, that this view is incapable of explaining another large subset of controlling shareholder regimes, i.e., the CMS. In a deep CMS corporation where the cash flow rights and voting rights of a controlling shareholder are significantly separated,[116] the economic incentive of the corporation and the controlling shareholder can be substantially detached. Accordingly, the controlling shareholder's personal burden in equity finance is only a small part of the corporation's cost. Suppose that a CMS controlling shareholder holds only 5% of cash flow rights of a business group.[117] This example is not uncommon in countries with the CMS. As explained, controlling family shareholders of large corporate groups in Korea hold 5.04% of ownership on average.[118] A self-interested controlling shareholder's primary criterion for judgment when deciding the method of finance is not the corporation's cost ($2 million), but his personal cost (0.05 x $2 million = $100,000).[119] Therefore, the fact that the cost of equity finance is much higher than that

113. It is a primary reason why managerial agency problems can be rectified more as the economic interest of a controlling shareholder increases. "Large shareholders thus address the agency problem in that they both have a general interest in profit maximization, and enough control over the assets of the firm to have their interest respected." Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 754 (1997).

114. 0.9 x 2 million dollars = 1.8 million dollars.

115. However, it is noteworthy that building reputation of integrity in a product market is merely a possible answer to the expensive equity financing. For a similar explanation, see also *supra* note 106 and its accompanying text.

116. As for the CMS, see *supra* note 21.

117. In this Article, a "business group" and a "corporate group" are used interchangeably.

118. *See* Korea Exchange, *supra* note 43. As discussed, on average controlling shareholders in large corporate groups in Korea *personally* hold 2.62% of economic interest in groups. Including their *family* members' economic interest, the number reaches 5.04%. *See supra* notes 43-44 and accompanying text.

119. Due to a CMS controlling shareholder's capability to separate his personal interest and a corporation's interest, it is known that a CMS corporation tends to generate serious corporate governance problems.

of debt finance to a corporation does not significantly constrain a CMS controlling shareholder's desire to raise equity capital. A controlling shareholder can simply make minority shareholders pay 95% of the extra cost of equity financing.[120]

In sum, the question at issue should not be why a "corporation" in a developing country has many minority shareholders even if the cost of equity to a "corporation" is *substantially* (e.g., $2 million) higher than the cost of debt. The theory of the PMBA is based on this incorrect question. The more precise question is why a "controlling shareholder" in a developing country has so many minority shareholders even if the cost of equity to a "controlling shareholder" is *slightly* (e.g., $100,000) higher than the cost of debt to him.[121] Under the analysis of this question, a controlling shareholder's choice of equity finance is not irrational even from the *capital* market perspective, when a corporation's collective interest and a controlling shareholder's private interest are separate. This implies that the PMBA's theory is less compelling as an explanation of Gilson's riddle in deep CMS regimes.

II. WHY DOES A CONTROLLING SHAREHOLDER RELY ON EXPENSIVE EQUITY FINANCING AND HAVE MANY MINORITY SHAREHOLDERS?

One may argue that, to a controlling shareholder, equity finance is *still* more expensive than debt financing, even when his economic interest in a corporation is significantly low. For instance, in the CMS example above, a controller has to bear $100,000. An economically reasonable controlling shareholder—even if he is in a deep CMS—would always choose debt financing over equity financing since he has no reason to pay even a penny more. The question then is: why in reality does a controller in a developing country issue new shares?

A. *The Additional Cost of Equity Finance Is Opportunity Cost*

One possible answer to Gilson's riddle is that a controlling shareholder's additional cost of equity financing is not out-of-pocket cost. Consider this account based on the numerical example above.[122] It is

120. Another derivative question is how a controlling shareholder is able to set up a corporate group and the CMS in the first place. Professor Jesse Fried at Harvard Law School also raised this question during discussion with the Author. The question of dynamic formation process of a CMS corporate group is beyond the scope of this Article, and further research will be conducted in an independent project.

121. In Part II, I examine the possibility that equity financing is not costly but beneficial to a controlling shareholder, when taking other factors into account.

122. *See supra* notes 108-120 and accompanying text for a numerical example.

noteworthy that a controlling shareholder's cost of equity finance—$100,000—incurs not because he pays $100,000 more to public investors but because he receives $100,000 less from public investors. Put differently, the controlling shareholder receives the smaller amount of proceeds from equity financing although he could have received the larger amount if he chooses debt financing. In this respect, the additional cost of equity financing is similar to opportunity cost.

In theory, a rational economic person treats opportunity cost (or "receiving less" in this example) in the same way as out-of-pocket cost (or "paying more"). In reality, however, opportunity cost tends to be neglected to a greater extent than out-of-pocket cost. This tendency could be reinforced as a controlling shareholder's economic interest in a corporation becomes smaller. For example, when the cost of equity finance to a corporation is $2 million and a controlling shareholder's economic interest in the corporation is 1%, his personal opportunity cost is only $20,000. Accordingly, it is likely that he is less concerned about the cost of equity finance. In fact, controlling shareholders holding less than 1% of economic interest are not completely unrealistic, as seen in the aforementioned example of Chairman Choi, who holds merely 0.04% of economic interest of SK Group.[123]

B. Tunneling v. Additional Cost of Equity Financing

Tunneling[124]—the phenomenon where a controlling shareholder siphons corporate value at the expense of minority shareholders—is rampant in bad-law countries.[125] Having more public shareholders could be economically beneficial to a controlling shareholder in bad-law jurisdictions since he may receive more private benefits through tunneling. However, because prospective investors discount the share price of a corporation in response to tunneling, equity financing (resulting in more minority shareholders) is costly to the controlling shareholder.[126] Each party's response is dynamic and may continue.[127] Ultimately, whether the combination of equity financing and tunneling creates net value to a controlling shareholder depends on the relative size of both effects.

123. Yun, *supra* note 46.

124. *See generally* Simeon Djankov et al., *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430 (2008) (discussing the anti-self-dealing index); Johnson et al., *supra* note 12 (describing an overview of tunneling in the controlling investor context).

125. As for insufficient investor protection in controlling shareholder regimes, see, e.g., La Porta et al., *supra* note 1.

126. Recall the pecking order theory. *See generally* Myers & Majluf, *supra* note 63; *see also* Gilson, *supra* note 5, at 647.

127. *See supra* Part I.B.

Accordingly, there are three scenarios relating to tunneling and equity financing by a controlling shareholder: (1) a controlling shareholder takes the exact same amount of private benefits of control via tunneling as the cost incurred by equity finance (net value to a controller is zero); (2) he takes more private benefits of control than the equity financing cost (net value to a controller is positive); or (3) he takes less private benefits of control than the equity financing cost (net value to a controller is negative). Since a controlling shareholder knows the size of his tunneling and the extra cost of equity financing while minority shareholders do not,[128] the controlling shareholder knows the scenario in which he is involved.

Consider the first scenario. A fair equilibrium between a controlling shareholder and minority shareholders is achieved through the controlling shareholder's "disciplined" expropriation—in this respect, the controlling shareholder is "honest." Interestingly, the controlling shareholder acts fairly and honestly in this scenario because he steals exactly the same amount of corporate assets as the cost that he loses from the discount made by public investors during the equity issuance, instead of refraining from stealing at all.[129] Because equity financing ultimately is not a bad or expensive choice to controlling shareholders, Gilson's riddle is solved in this first scenario.

Gilson's riddle is solved in the second scenario as well since a controlling shareholder attains positive net value after the combination of equity financing and tunneling. This scenario raises an additional question: why do minority shareholders accept such unfair transactions in a capital market?[130] First, this could possibly be because imperfect market conditions make minority shareholders follow unfair market terms because either: (1) asymmetric information can obfuscate public investors; or, (2) the presence of the quasi-monopolistic power of controlling shareholders as dominant market players may prevent public investors from discounting in proportion to the extent of controlling shareholders' expropriation. Second, minority shareholders may accept such transactions because they are rationally apathetic individualists.[131] Although the total amount of

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128. It could happen because of asymmetric information between a corporate insider and public investors. As for asymmetric information, see generally Akerlof, *supra* note 55 (examining deterioration in markets with asymmetric information).

129. In a similar way, Professor Black boldly claims "once a company has issued shares at a discount, the insiders may feel *entitled* to appropriate most of the company's value for themselves." Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 806 (2001).

130. As for a further discussion of this question (i.e., the flipside of Gilson's riddle), see *infra* Part III.

131. For an explanation of the rational apathy of shareholders, see Stephen M. Bainbridge, *Is 'Say on Pay' Justified?*, 32 REGULATION 42, 47 (2009) (explaining that

corporate value that a controlling shareholder illicitly transfers to himself from all of the minorities—in other words, the *collective* damage of all minorities—might be an important issue to minorities, they are more interested in their own *individual* losses caused by a controller's extraction when they invest in a corporation. Thus, as long as the expropriation rate imposed by a controlling shareholder is low, *individual* minority shareholders are likely to tolerate such "generous stealing" even though the *collective* damage is large.

The analysis has another important implication from the perspective of a controlling shareholder. Even if a controlling shareholder illicitly takes only a small amount from each minority shareholder, the aggregate amount that he steals may be huge when there are many minority shareholders (put differently, when he is a deep CMS controller). Accordingly, it would be better for him to be a "generous thief" by reducing his expropriation rate imposed on individual minorities. If almost all of controllers are thieves, a generous thief can attract more public investors, enlarging the base of his expropriation. These considerations provide an answer to why a controlling shareholder might voluntarily set a limit to the amount of private benefits he takes.[132]

In the third scenario, a controlling shareholder chooses to take less corporate assets than the cost incurred by equity finance,[133] such that Gilson's riddle remains valid. If the controlling shareholder attains benefits from other sources related to equity financing, then Gilson's riddle would be solved. The following Subparts C and D discuss the benefits derived from business expansion by a controlling shareholder.

C. Non-Pecuniary Private Benefits of Empire-Building

"Empire-building"[134] is a phenomenon wherein a top decision-maker

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rational apathy is a reasonable option to most of minority shareholders).

132. This question is raised by Professor Gilson in *Controlling Family Shareholders in Developing Countries*, *supra* note 5. Gilson's answer is based on the PMBA. "Part IV then speculates on why a controlling family shareholder might voluntarily limit the amount of private benefit extraction from minority shareholders—not because the treatment of minority shareholders affects the controlled corporation's ability to raise additional equity capital, but because bad behavior will degrade its reputation in the product market." *Id.* at 637. In contrast, my answer in this Subpart is based on notions of a controlling shareholder as a "generous thief" and minority shareholders as rationally apathetic individuals. A "stationary controller" is another form of "generous thieves." As for the theory of stationary controllers, see generally Kang, *supra* note 27; *see also infra* Part II.E and Part III.A.

133. Then, it is possible that minority shareholders are not financially damaged by a controlling shareholder's expropriation. For the more related explanation of this possibility, see *infra* Part III.D.

134. As to the phenomenon of empire-building, Professors Shleifer and Vishny explain

of a corporation—either a CEO or a controlling shareholder—expands the size of the corporation for his own interest despite it being inefficient to the corporation. A controlling shareholder may create *both* pecuniary and non-pecuniary benefits by enlarging the corporation.[135] However, this Subpart pays attention to the non-pecuniary benefits—such as social prestige, reputation, psychological benefits, and social influence—reaped by a controlling shareholder.

1. How Can Empire-Building Generate Non-Pecuniary Private Benefits?

There are several significant points—which are not covered well by the extant literature—when exploring the impacts of empire-building on the corporate governance practices of developing countries. First of all, in many bad-law countries, a *small* number of corporations—and as a result, a *small* number of controlling shareholders—dominate the entire economy, which is markedly different from the United States. For example, although Apple (or Microsoft) is one of the largest corporations in the United States, it is too small to dominate the largest market in the world—as a result, Steven Jobs (or Bill Gates) is only one of many successful business people in the economy.[136] In contrast, although the largest corporation in a developing country is not comparable to Apple (or Microsoft) in terms of any economic indicator, it may account for a significant portion of a relatively small market, and so a handful of business tycoons may command the economy. Due to their unchallenged position, controlling

that "[g]reater costs are incurred when managers have an interest in expanding the firm beyond what is rational, reinvesting the free cash, pursuing pet projects, and so on." Shleifer & Vishny, *supra* note 113, at 742. In the United States, the phenomenon of empire-building has been often observed in the M&A context. "[T]he Empire Building Hypothesis suggests that the most important conflict of interests in corporate control contest may be on the bidder's side of the transaction—between the interests of the bidder's management and those of its own shareholders." O'KELLEY & THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS: CASES AND MATERIALS 759 (Aspen Publishers 6th ed. 2006).

135. Managers often desire to expand the influence of their business by managing large corporations. In particular, the empire-building account explains that managers in an acquiring corporation tend to pay a higher takeover premium to a target corporation since managing a larger corporation is more beneficial to managers. For example, according to Professors Shleifer & Vishiny, "Morck, Shleifer, and Vishny . . . find that bidder returns tend to be the lowest when bidders diversify or when they buy rapidly growing firms." Shleifer & Vishny, *supra* note 113, at 746 (citing Randall Morck, Andrei Shleifer & Robert Vishny, *Do Managerial Objectives Drive Bad Acquisitions?*, 45 J. FIN. 31 (1990)). As is widely known, executive compensation is often positively correlated to the size of the corporations. In addition, corporate insiders can attain more psychological satisfaction by ruling a larger "empire."

136. *See, e.g.*, Gilson, *supra* note 4, at 1666.

shareholders of large corporations in less developed countries are highly respected and envied, enjoying immense reputation, social prestige, and other psychological benefits[137] (including the jealousy of others). This tendency can be amplified more in countries with business "groups" because the economic power is more concentrated among fewer controlling shareholders who dictate dozens of large affiliated firms.[138] In short, being a controlling shareholder in a large corporation or business group is psychologically rewarding, and the larger a corporation (or a corporate group) is, the more non-pecuniary benefits a controlling shareholder can attain.[139]

In addition, controlling shareholders are often treated as national leaders. The disproportionately large economic power of controlling shareholders makes it possible that, by various means, they have direct social influence and even political power among people in the street and the government.[140] In many authoritarian regimes,[141] which are usually developing countries, it is true that the government is above the business.[142] However, if a few business people are key players in the market, they can talk directly and personally with the government as its leading partners despite the hierarchy between the government and business. In extreme cases, business elites of large corporations become the highest political figures in their countries. Notable examples are Thaksin in Thailand and Berlusconi in Italy (although Italy is one of the G-7 economies, it is recognized by many scholars as a country with insufficient investor

137. As for a related view, see *id*. Media attention could be another form of non-pecuniary benefits to a controlling shareholder who would like to be famous.

138. Suppose that the size of domestic economies of countries A and B are same. There are 100 large corporations in countries A and B. Country A is dominated by corporate groups. Each corporate group has 20 corporations as affiliated firms. Corporations in country B are stand-alone corporations. Accordingly, there are 5 controlling shareholders in country A and 100 controlling shareholders in country B. Consequently, country A with the corporate group system is more concentrated than country B with the stand-alone corporation system.

139. In this sense, it can be said that the size of a corporation is a proxy of non-pecuniary benefits to a controlling shareholder. For a further discussion of the size of a corporation, see *infra* note 148.

140. To the contrary, managers in large U.S. corporations form strong lobbies as a group, such as Business Roundtable and the U.S. Chamber of Commerce, but managers are seldom influential in making policies individually.

141. For a further explanation of the relationship between an authoritarian government and businesspeople, see generally Ronald J. Gilson & Curtis J. Milhaupt, *Economically Benevolent Dictators: Lessons for Developing Democracies*, 59 AM. J. COMP. L. 227 (2011) (examining the interactions and roles of dictators and business elites in developing countries).

142. An example is the government-business relation in former president Chung-Hee Park's regime in Korea. *Id*.

protection,[143] a jurisdiction at issue in this Article).

Moreover, the length of tenure as a corporate decision-maker makes empire-building far more attractive to controlling shareholders in developing countries than to CEOs in the United States. In the United States, the term of a typical top manager generally lasts for several years.[144] In that sense, a business empire is "leased" to him for a short duration. In contrast, a controlling shareholder in a country with poor investor protection usually remains the dictator of a corporation for his entire life, if he wishes. In addition, since a controlling shareholder's children will inherit his capacity after he retires or dies, the tenure of a controlling family shareholder is practically infinite.[145] A controlling shareholder is, therefore, conceived as "owning" a business empire as his personal "property."

A top manager of a large public corporation in the United States is analogous to a consul in ancient Rome. Although he is influential and may be the sole decision-maker in a corporation, he must leave the office after a fixed number of years. Ultimately, Rome is not the consul's empire but a people's republic, even if the republic is under his dictatorship. To the contrary, a controlling shareholder in a developing country is comparable to an emperor (or princeps, i.e., the first citizen like Augustus) of Rome. He can stay in office as long as he is alive, and eventually his children will succeed his throne—thus, Rome will be maintained as his dynasty. In that context, a typical corporation in the United States is only a pseudo-empire to its CEO, because the current CEO in a dispersed shareholding firm is generally not able to appoint his child as the next CEO.

It is, therefore, clear that building a larger empire will provide more glory (i.e., non-pecuniary private benefits) to a controlling shareholder in a controlling shareholder regime than to a top manager in a dispersed shareholder regime. In addition, it is plausible that the CEO of a widely held firm does not have sufficient incentive to expand the territory of the corporate empire in the last period of his term since the fruits of his effort

143. *See, e.g.*, Shleifer & Vishny, *supra* note 113, at 739; Gilson, *supra* note 4, at 1655.

144. Quoting Booze Allen Hamilton study, Professor Gordon explains that the average CEO tenure in the United States in 2001 is 7.3 years. The average fired CEO tenure in the same year is 4.6 years. Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950 - 2005: Of Shareholder Value and Stock Market Price*, 59 STAN. L. REV. 1465, 1533 (2007).

145. For example, Gilson's PMBA in *Controlling Family Shareholders in Developing Countries* is based on a notion of a controlling family shareholder as a controller with infinite tenure. "[F]amily ownership solves the intergenerational transfer process rather elegantly. Because of intrafamily inheritance and family ties, the current generation of decision makers, at least in functional family businesses, treats the next generation's utility as the equivalent of their own, so there is no temporal distortion of incentives to invest in reputation." Gilson, *supra* note 5, at 643.

will accrue to the next "consul," to whom the current one has no biological relationship.[146] In contrast, a controlling shareholder in developing countries may have an equal incentive to pursue empire-building throughout his life since the expanded empire will ultimately belong to his children.[147]

2. External Equity Financing Is Essential for Empire-Building

So far, I have explained that a controlling shareholder can attain a significant part of non-pecuniary benefits by empire-building. How, then, is empire-building embodied in a concrete way, and what are the implications of empire-building in relation to equity finance? In general, large corporations refer to corporations with large assets.[148] From an accountant's perspective, as the size of the assets (i.e., the left side of balance sheet) increases, the sum of the debt and equity (i.e., the right side of balance sheet) should increase to the same extent.[149] According to the pecking order theory, when external capital is required by a corporation, a controlling shareholder may initially prefer to rely on debt (especially bank loans).[150] During this period, as assets increase, debt increases to the same extent, and the size of the equity remains constant. Consequently, a growth strategy that depends solely on debt financing raises the leverage ratio of a business group. As the debt-equity ratio deteriorates, however, the financial distress costs increase.[151]

A corporation could sustain "high" leverage (e.g., a 500% debt-to-equity ratio), even if it creates enormous inefficiency in the capital structure. However, at some point, a controlling shareholder's empire-building strategy financed solely by debt is impractical for two reasons: (1) the financial distress costs of "extremely high" leverage (e.g., 5,000% debt-to-equity ratio) far exceed the benefits, such that the corporation is unable to endure the burden;[152] and (2) the debt market would no longer make

146. Simply put, in general a CEO faces a final period problem when it comes to empire-building. *See also* Gilson, *supra* note 5, at 641 (but, note that Professor Gilson explains a corporate insider's final period problem in relation to the corporation's contractual obligations in a product market.).

147. In other words, in general a controlling shareholder does not face a final period problem. As for a controlling shareholder with an infinite tenure, see *supra* note 145.

148. A large corporation might be a corporation with a large number of employees, large sales or assets. Nonetheless, in developing countries, the number of employees and the magnitude of sales and assets are generally correlated with each other. In that sense, the size of the assets is a good proxy for measuring the size of the corporation.

149. In short, the assets equals to the sum of liabilities and equities.

150. As for the pecking order theory, see *supra* notes 63-67 and accompanying text.

151. *See* BREALEY ET AL., *supra* note 65, at 477.

152. *See id*.

loans to the corporation due to the fear of default even if the corporation is in search of more debt. Accordingly, a controlling shareholder who seeks dynastic empire-building for him and his offspring eventually has to turn to equity financing from outside investors in the stock market.[153]

It is true that the frequency of equity issuance *is* rare in a controlling shareholder system.[154] To a dispersed shareholding firm's CEO, who can remain in that post for only several years,[155] the interval between equity financing *looks* long. It is possible that a corporation is not going to issue new shares again within his tenure. The same interval between two equity issuances, however, *looks* short to a controlled firm's dominant shareholder whose time horizon is infinite. In other words, the frequency of equity issuance is not *deemed* to be rare from the standpoint of the controlling shareholder who (and whose children) will repeatedly participate in the stock market. A far-sighted controlling shareholder ought to be concerned about the next equity issuances.[156] Accordingly, he has an incentive to voluntarily protect minority shareholders at least to some degree to attract public investors in the subsequent share issuances. The need for *capital* in a stock market (as opposed to the PMBA)[157] explains the decision to have minority shareholders if dynamism, such as the growth of a corporation over a long time horizon through dynastic succession, is taken into account.

Although the above explanation is true in some situations, a controlling shareholder will not rely on external equities when the new equity threatens his interest as a controlling shareholder. This argument may be relevant in the CS regime where a typical controlling shareholder holds a significant amount of shares in a corporation. A controlling shareholder may decide to issue new shares as long as he is able to participate in the capital-raising as a dominant investor (who can maintain

153. This Article emphasizes a controlling shareholder's repeated participation in a capital market. *See infra* notes 154-157 and accompanying text. The controller's conduct in a capital market can be analyzed by game theory as well. For the broad explanation on game theory, see generally JOEL WATSON, STRATEGY: AN INTRODUCTION TO GAME THEORY (W.W. Norton & Co. 2nd ed. 2007) and AVINASH K. DIXIT & BARRY J. NALEBUFF, THINKING STRATEGICALLY: THE COMPETITIVE EDGE IN BUSINESS, POLITICS, AND EVERYDAY LIFE (W.W. Norton & Co. 1993).

154. Gilson, *supra* note 5, at 646.

155. As for a typical CEO's term in his office, see Gordon, *supra* note 144, at 1533.

156. Compare with Gilson, *supra* note 5 at 646 (explaining the skepticism of the controller's need "to return to the capital market to raise the capital in the future").

157. My analysis contrasts with Professor Gilson's PMBA in *Controlling Family Shareholders in Developing Countries*. The PMBA states that a controlling shareholder does not issue new shares for a capital market rationale ("The decision to have minority shareholders then can be explained not by the need for *capital* . . . , but as a way of developing *reputation* that will be valuable in the product market . . . .") (emphasis added). Gilson, *supra* note 5, at 648.

the majority shareholder's position after the new equity issuance). He would not let the corporation issue new shares, if, for example, he does not have enough money to participate in the new equity issuance, since new issuance would reduce his equity holding under the critical level for control.

This concern, however, is not very meaningful to a controlling shareholder in the CMS where a decrease in cash flow rights does not necessarily dilute a controlling shareholder's voting rights in the same proportion.[158] A CMS controller is effectively able to entrench his control position through voting leverage devices such as stock pyramiding.[159] Since new equity issuance does not critically reduce a CMS controller's voting rights, equity financing is generally seen as a safe means to attain the goal of empire-building.

To what extent, then, can a controlling shareholder enlarge his business when he raises capital from the stock market? A numerical example can explain the relationship between the size of assets and the economic interest of a controlling shareholder in a more concrete way. Suppose that there are three corporations with three controlling shareholders who invest the same amount of money, $50 million in each corporation. Three controlling shareholders hold 100%, 50%, and 5% of common stocks in corporations, respectively. Apparently, the first controlling shareholder runs a CS-style corporation, whereas the third runs a CMS-style corporation.[160] Then, the total equity of each corporation should be $50 million, $100 million, and $1 billion, correspondingly. If each corporation is allowed to finance debts by 400% equity-to-debt ratio, the total assets of each corporation will be $250 million, $500 million, and $5 billion, respectively.

158. Put differently, a controlling shareholder's cash flow rights could be less than 50% without his participation in new equity issuance. Due to the feature of one-share-multiple-vote for a CMS controller, however, he can still maintain control by holding more than 50% voting rights.

159. Bebchuk et al., *supra* note 39, at 3. For a further analysis of a CMS controller's entrenched control in M&A context, see generally Kang, *supra* note 53.

160. In this example, for the sake of simplicity a CS corporation is defined as a corporation where a controlling shareholder's economic interest is more than 50%. A CMS corporation is a corporation where a controlling shareholder's economic interest is less than 50%. Therefore, it can be said that the second controlling shareholder runs either a CS or a CMS corporation.

TABLE 2: RELATIONSHIP BETWEEN A CONTROLLING SHAREHOLDER'S ECONOMIC INTEREST AND THE SIZE OF A CORPORATE EMPIRE

	CORP. 1	CORP. 2	CORP. 3
Amount of a Controlling Shareholder's Equity	$ 50 million	$ 50 million	$ 50 million
Controlling Shareholder's Economic Interest	100%	50%	5%
Type of a Corporation's Ownership	CS	CS / CMS	CMS
Total Equity of a Corporation	$ 50 million	$ 100 million	$ 1 billion
Total Debt of a Corporation	$ 200 million	$ 400 million	$ 4 billion
Total Asset Size (Asset = Equity + Debt)	$ 250 million	$ 500 million	$ 5 billion

Although these three controllers contribute the *same* value of capital, the third controlling shareholder who has 95% of equity from non-dominant shareholders has an empire that is twenty times larger than that of the first who has no minorities at all. Accordingly, the third controlling shareholder attains much larger non-pecuniary benefits than the first, since non-pecuniary benefits are positively related to the size of a corporation over which a controlling shareholder exercises control. In consideration of non-pecuniary private benefits, the optimal choice for a controlling shareholder is to maintain the *least* cash flow rights in the corporation as long as his control is assured, other things being equal. In addition, although most of the assets (99%) consist of other people's money (i.e., equity and debt) in the third corporation, the only person who is able to consume non-pecuniary benefits exclusively is the third controller.[161] The lesson is clear. Having more external capital from an equity market

161. In Corporation 3, a controlling shareholder's capital contributed is $50 million and the corporation's total assets are $5 billion (equity = $1 billion, debt = $4 billion). Thus, a controlling shareholder's equity is only 1% of the corporation's total assets although he holds 5% of the corporation's equity.

benefits a controlling shareholder in a sense that it increases the territory (i.e., the assets) of his empire. The more equity capital a controlling shareholder has in his controlled corporation, the more debt he can bring into the corporation, and the larger corporation he would run. This provides more non-pecuniary benefits to him.[162] Therefore, *ceteris paribus*, a controlling shareholder in a developing country may have an incentive to attract more minority shareholders, despite expensive equity financing.

3. Empire-Building and Its Cost—If Inefficient, Who Bears the Cost and by How Much?

In general, empire-building is understood as the corporate insiders' strategy of pursuing size maximization by adopting even negative NPV (net present value) projects. Hence, the normative standard of the profit maximization is sacrificed.[163] For example, managers in the United States in the 1960s commonly became preoccupied with conglomeration (i.e., empire-building).[164] This wave of U.S. M&A is thought to have caused a significant level of inefficiency in the economy through unrelated diversification. The next wave of M&A in the 1980s was mainly designed to rectify the inefficiency problem by means of divestiture.[165] Since then, it has become common sense that unrelated diversification reduces profitability.[166] "Focus" has been treated as a more reliable business norm than "diversification."[167] On the other hand, some of business groups—

162. Equity financing is essential for attaining more debt from outside. Suppose that the debt-to-equity ratio is maintained at 400%. Then, when a corporation issues $1 million of new equities, practically it is entitled to have additional $4 million through subsequent debt financing. As the sum of equity and debt increases, the size of firm (the asset size) also increases. Through this empire-building, a controller's non-pecuniary benefits increase. As a result, equity financing is a solid foundation for debt financing and non-pecuniary benefits.

163. Empire-building of corporations is embodied by diversification through conglomerates or business groups. The prevailing view in economics, management, and corporate governance is that corporate diversification destructs corporate value. For this view, see generally Morck et al., *supra* note 135; Larry H. P. Lang & Rene M. Stulz, *Tobin's Q, Corporate Diversification, and Firm Performance*, 102 J. POL. ECON. 1248 (1994).

164. For a brief explanation of merger waves including the conglomerate merger wave, see Bernard S. Black, *The First International Merger Wave (and the Fifth and Last U.S. Wave)*, 54 U. MIAMI L. REV. 799, 800-01 (1999).

165. For a brief description of the merger wave in the 1980s, see *id*.

166. Tarun Khanna & Jan W. Rivkin, *Estimating the Performance Effects of Business Groups in Emerging Markets*, 22. STRAT. MGMT. J. 45, 45 (2001).

167. For an explanation of this Western norm, see generally Tarun Khanna & Krishna Palepu, *Why Focused Strategies May Be Wrong for Emerging Markets*, 75 HARV. BUS. REV. 41 (1997); Khanna & Palepu, *supra* note 62.

results of empire-building, such as Korean *chaebols*—have achieved great success in the global market. Whether empire-building is ultimately efficient or not is still a difficult question to resolve. Putting aside that complicated debate, this Article's analyses are in principle based on the assumption that empire-building is inefficient, and thus costly to all shareholders, including controlling shareholders.[168] Nonetheless, a controlling shareholder still has an incentive to continue unrelated diversification due to the disproportional features of his personal payoff scheme.

Consider a controlling shareholder's cost-benefit analysis in relation to empire-building. On the one hand, virtually all non-pecuniary benefits ultimately belong to a controlling shareholder *exclusively*, no matter his economic interest in a corporation.[169] On the other hand, the cost of the incremental inefficiency of expanding the empire is *shared* among all shareholders according to their pro-rata economic interest in a corporation. As a result, a controlling shareholder may find it more attractive to pursue empire-building when his economic interest in a business group is small. When a controlling shareholder has a deep CMS by having more minority shareholders, empire-building is more advantageous to him. In this respect, Gilson's riddle—why a controlling shareholder in a developing country has so many minority shareholders despite the high expense of equity financing—is at least partially solved.

Why then do public investors tolerate the inefficiency cost of empire-building by being minority shareholders? If all corporations in a domestic market are indulged in inefficient empire-building, then public investors have no other choices unless international investment is available to them. In addition, while the cost that all minority shareholders should bear as a *group* is *huge*, the individual cost of *each* minority shareholder is *small*. For example, under a CMS controlling shareholder with 5% economic interest, the cost of inefficient empire-building that one minority shareholder should bear can be minimal since the burden is widely spread out among the 95% minority shareholders.

D. Other Benefits of Empire-Building

In addition to non-pecuniary benefits, empire-building can provide economic benefits and insurance to a controlling shareholder. In this respect, a controlling shareholder has an incentive to rely on equity finance.

168. Nonetheless, it does not mean that every empire-building endeavor is inefficient. This controversial topic, though important, is beyond the scope of this Article.

169. It is assumed that a controlling shareholder attains the entire non-pecuniary benefits irrespective of whether his economic interest in a corporation is 5% or 100%.

1. Economic Benefits of Empire-Building

Empire-building is business expansion including vertical and horizontal integration. It is theoretically possible that up to some point vertical and horizontal integration can generate efficiency through synergy based on the economies of scale and scope. Another compelling defense for forming business groups is that they help to resolve the problems caused by the absence or poor functioning of institutions that corporate insiders in developed economies take for granted.[170] For instance, given that there is no efficient capital market in developing countries, business groups can add value by having their own internal capital markets.[171] Business groups are also useful to affiliated entities since developing a common brand is valuable in particular in export-oriented countries.[172] Business groups which are seen as indulging in their passion for empire-building may generate some efficiency for their shareholders, although it is still uncertain whether the total effect of empire-building for all of constituencies in a society is efficient.

In a developing country, it is often advantageous for a corporation to be involved in unrelated diversification since the corporation can obtain economic rent from the expansion. For example, as the size of assets increases, a corporation may have more opportunities to raise more debts at more preferential terms (e.g., cost of capital) because: (1) a corporation with large assets is able to provide more securities (collateral) for the new debts to lenders who are less able to valuate borrowers' ability to repay debts than those in a developed country; (2) as the magnitude of debt increases, ironically a corporation may have more negotiation leverage vis-à-vis lenders;[173] and (3) the government simply allocates scarce capital to only large corporations, rather than best-performing corporations, in the form of industrial policies.

A large corporation has more chances to obtain licenses to new businesses that are profitable and protected by the government. In addition, a large corporation is likely to generate excess profits via monopolistic power since wealth transfer takes place from trading partners and

170. Khanna & Palepu, *supra* note 62, at 129; *see also* Khanna & Palepu, *supra* note 167, at 41 ("Western companies take for granted a range of institutions that support their business activities, but many of these institutions are absent in other regions of the world.").

171. *See* Khanna & Palepu, *supra* note 62, at 134 (introducing an example of a business group's internal capital market in Chile); *see also* Khanna & Rivkin, *supra* note 166, at 49 (explaining that a business group can provide an internal capital market and an internal labor market).

172. Khanna & Palepu, *supra* note 62, at 129.

173. As a finance maxim goes, if you borrow $1000, you are only a debtor to a creditor. However, if you borrow $1,000,000, you might be a partner to a creditor.

consumers to a large corporation. Moreover, a large corporation is at an advantage to attain subsidies or other preferential treatments from the government at the expense of general taxpayers. As long as these windfalls accrue to a large "corporation" (rather than to a controlling shareholder individually), ultimate beneficiaries are the entire shareholders. In this sense, empire-building can be "efficient" to shareholders even though economic rent that makes shareholders better off is indeed detrimental to a society.[174]

This implication is of significance in two ways. First, a controlling shareholder has an incentive to rely on expensive equity financing since equity financing builds his empire and he can gain economic rent on a pro-rata basis. Second, it means that minority shareholders can free-ride on a controlling shareholder when he collects economic rent and share the benefits from empire-building. In turn, public investors may have incentives to be non-controlling shareholders even if there is some level of tunneling by a controller.[175]

2. Too-Big-To-Fail: Insurance for a Controlling Shareholder

Another related topic in empire-building is the principle of too-large-to-fail. Even the United States (a champion of *laissez-faire*) has experienced a series of bailouts for large corporations when a failure of a large corporation was likely to affect its economy. Notable examples include bailouts of Chrysler, LTCM (Long-Term Capital Management), and AIG (American International Group).[176] In many developing countries, a large corporation or business group constitutes a higher percentage of the domestic economy than one in the United States. Thus, there are compelling reasons that the government in an emerging market is more afraid of the collapse of a large corporation or business group. For example, the dire consequence of a failure of Salim Group,[177] a large

174. The size of a slice of a pie for shareholders increases while the size of the pie for the entire society may shrink.

175. For more reasons why minority shareholders participate in a capital market with insufficient investor protection, *see infra* Part III.

176. Matthew Karnitschnig, Deborah Solomon, Liam Pleven & Jon E. Hilsenrath, *U.S. to Take Over A.I.G. in $85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up*, WALL ST. J. (Sept. 16, 2008), http://online.wsj.com/news/articles/SB122156561931242905. "Just last weekend, the government essentially pulled the plug on Lehman Brothers Holdings Inc., allowing the big investment bank to go under instead of giving it financial support. This time, the government decided A.I.G. truly was too big to fail." *Id*.

177. For a further explanation of Salim Group and its founder, see Eric Bellman, *An Indonesian Tycoon Dies: Liem Sioe Liong, Ally of Dictator Suharto, Built Country's Biggest Conglomerate*, WALL ST. J. (June 11, 2012), http://online.wsj.com/news/articles/SB10001424052702303444204577460351515148464.

business group in Indonesia, would be much more devastating than that of the failure of Chrysler (or perhaps even a large bank) in the United States. Aware of the government's fear of their possibility of failing, a large corporation's controlling shareholder may conclude that empire-building can function as effective "insurance" for its survival.

In this context, minority shareholders may be used as "hostages" by a controlling shareholder. If a corporation has a broad base of minority shareholders, then a corporation and its controlling shareholder are more likely to be treated favorably by the government even if the government–business relationship is initially unfriendly. For example, when a corporate scandal is investigated by an honest and uncorrupt government that is not connected with the business, the corporation can convincingly argue that more investigation and punishment of the corporation and its controlling shareholder would affect the entire economy adversely. The more minority shareholders a controlling shareholder has, the more credible this threat may be. Hence, a controlling shareholder has another reason to attract minority shareholders by providing some protection to minorities.

E. Stationary Controlling Shareholders

An important question related to Gilson's riddle is: why would a controlling shareholder in a bad-law jurisdiction set the limit of expropriation voluntarily even though the poor legal system in the jurisdiction does not regulate his expropriation efficiently?[178] To answer to this question from another aspect, I use an analytical framework borrowed from political economics in the context of corporate governance.[179] In explaining the evolution of government systems, Professor Mancur Olson creates the terms "roving bandits" and "stationary bandits."[180] "Roving bandits" are bandits who depart soon and will not come to expropriate the same victims again.[181] Thus, it is in roving bandits' interest to take all of

178. In a previous Subpart, this question is solved in part. *See supra* note 132 and accompanying text.

179. This Subpart is explained based on Kang, *supra* note 27 (attempting to solve the puzzle that in jurisdictions with insufficient investor protection, some controlling shareholders voluntarily extract public shareholders less than other controlling shareholders, using the analytical framework of banditry).

180. As for "roving bandits" and "stationary bandits," see MANCUR OLSON, POWER AND PROSPERITY: OUTGROWING COMMUNIST AND CAPITALIST DICTATORSHIP 7 (2000); *see generally* Mancur Olson, *Dictatorship, Democracy, and Development*, 87 AM. POL. SCI. REV. 567 (1993) (exploring the social and economic incentives created by roving bandits who engage in total plundering under the "uncoordinated competitive theft" in anarchic conditions versus those created by stationary bandits, who rationalize theft in the form of partial and periodic taxes).

181. *See* Olson, *Dictatorship, Democracy, and Development*, *supra* note 180, at 568.

their victims' wealth at once. In contrast to short-sighted roving bandits, "stationary bandits" stay with victims for a long time and continuously expropriate victims.[182] With an encompassing interest in victims' prosperity, stationary bandits take a part of victims' wealth in the form of regular tax.[183] As a result, victims prefer stationary bandits to roving bandits although both stationary bandits and roving bandits are same in the sense that they are thieves.[184]

Consider the analytical framework of banditry in the context of corporate governance. From the perspective of conventional corporate governance scholarship, a controlling shareholder regime in developing countries is systematically inferior to a dispersed shareholder regime.[185] This view often emphasizes tunneling where a controlling shareholder can illicitly transfer substantially all assets from a corporation to himself if he wishes.[186] However, this view should be carefully interpreted in developing countries, since *having* the capacity to rely on total plundering does not necessarily mean *using* that capacity.[187] Instead, it is more precise to explain that controlling shareholders in developing countries can be categorized into at least two types.

Take into account the first type of controllers in bad-law jurisdictions. Suppose that a controller has a *short* time horizon for some reason. Then, it is often in his best interest to quickly loot his controlled corporation to the *fullest* extent via a massive *one-shot* transaction. As a result, he has no reason to expropriate minority shareholders again because they do not hold any wealth in a corporation which is entirely looted. In this respect, the controlling shareholder is a "roving controller."[188] In contrast, a controlling shareholder with a *long* time horizon has often an encompassing interest in the prosperity of minority shareholders. He stays with minority shareholders in a more constructive way and maintains control over a corporation for a long time. This type of a controlling shareholder is referred to as a "stationary controller" who chooses a form of theft by taking only *part* of corporate value *periodically*.[189] Accordingly, a stationary controller can enjoy non-pecuniary benefits—unavailable for a

182. *Id*.
183. *Id*. at 568-570.
184. *See id*. at 568.
185. *See* La Porta et al., *supra* note 1, at 1151 (concluding that the results of the authors' empirical study "support the idea that heavily concentrated ownership results from, and perhaps substitutes for, weak protection of investors in a corporate governance system").
186. *See* Johnson et al., *supra* note 12, at 22.
187. *See generally* Kang, *supra* note 27.
188. *Id*.
189. *Id*.

roving controller—as well as pecuniary benefits.[190]

Then, examine how a self-interested controlling shareholder decides to be roving or stationary. Initially, a controlling shareholder may compare (1) the amount gained by a one-shot tunneling with (2) the present value of cumulative extractions in the long run and other benefits (e.g., non-pecuniary benefits). When the latter is larger than the former, he would choose to be stationary.[191] In order to understand a stationary controller's expropriation policy, reviewing a rational government's tax policy is a useful way.[192] Tax revenue is the product of a tax rate and taxable income; however, a high tax rate does not necessarily generate high tax revenue, since it gives taxpayers less incentive to work (i.e., taxable income will shrink).[193] The same logic applies to the relationship between an extraction rate and the amount of tunneling (i.e., pecuniary benefits); the amount of tunneling is equal to the product of an extraction rate and the extractable corporate value.[194] Thus, a high extraction rate does not necessarily generate a high amount of tunneling, since that would cause non-controlling shareholders to withdraw their investments (i.e., extractable corporate value will shrink).[195] Therefore, a rational stationary controller sets the optimal extraction rate carefully (generally at a moderate level) in order to maximize his "tax revenue" (i.e., the amount of tunneling) in the long run.[196]

190. *Id.*

191. *Id.* The following explanation is based on Kang, *supra* note 27. Suppose that a controller extracts the entire corporate assets (e.g., $100 million) *immediately* if he takes a one-shot transaction to the total detriment of minority shareholders. After this transaction, the corporation will be left as a shell without any valuable assets. In this case, he is a roving controller. Alternatively, he can extract a part of corporate assets (e.g., $5 million) *annually* by means of ongoing tunneling. By doing so, he becomes a stationary controller. Under these circumstances, the controlling shareholder will choose to be stationary as long as he believes that he can maintain ongoing extractions for more than twenty years (if the discount rate is assumed to be zero for the sake of simplicity). In addition, if the utility of the non-pecuniary benefits for a controller and his family is taken into consideration, he will find that looting based on a one-shot extraction is less attractive. For example, suppose that the amount of looting from a one-shot transaction is $100 million and the present value of sum of extractions is $80 million. As long as the utility of non-pecuniary benefits is evaluated to be more than $20 million, a controller will be willing to be stationary even if being a roving controller is financially more advantageous to him.

192. *Id.*

193. *See generally* Arthur B. Laffer, *The Laffer Curve: Past, Present, and Future*, 1765 BACKGROUNDER (2004), *available at* http://www.heritage.org/research/reports/2004/06/the-laffer-curve-past-present-and-future.

194. *See* Kang, *supra* note 27.

195. *Id.*

196. For a further analysis of a rational stationary controller's "tax policy," see *id.* The presence of non-pecuniary private benefits of control may alter a controller's tax policy to some degree.

In other words, if a controlling shareholder is a repeat-player staying with minority shareholders, he is not ruthless and has a strong incentive to care for his "continuing victims." In this way, it is understood that a stationary controller sets the limit of expropriation *voluntarily* even if the poor legal system in the jurisdiction does not regulate his expropriation efficiently.[197] If a controller expects family inheritance, by definition he is often a stationary controller who stays with minority shareholders for a long time.[198] In addition, it is likely that he will continue to rely on equity financing with limited stealing. Then, he (and his descendants) would end up with a large number of minority shareholders, which would be beneficial to him (and his descendants) since minority shareholders are the foundation for the stationary controller's pecuniary and non-pecuniary benefits. In this respect, the stationary controller's account also provides a useful solution to Gilson's riddle as to why a controlling shareholder needs minority shareholders despite expensive equity finance.

III. WHY DO MINORITY SHAREHOLDERS PARTICIPATE IN CAPITAL MARKETS DESPITE POOR PROTECTION?

Part II analyzes, *from the standpoint of a controlling shareholder*, why he has incentives to "voluntarily" accept the minimum level of minority protection and attract more minority shareholders to invest in his controlled corporation even though the cost of equity is high to a controller. Transactions in a capital market are not made in a single direction by only a seller's decision. Now it is fair to ask *from the standpoint of minority shareholders*, why they "voluntarily" participate as equity buyers in a capital market where they are expected to be expropriated by a controlling shareholder.

A. Minority Shareholders under a Stationary Controller

As mentioned previously,[199] there are at least two types of controlling shareholders in bad-law jurisdictions: roving controllers and stationary controllers. Faced with a rational stationary controller's benevolent extraction in the long run, minority shareholders are willing to invest in a

197. *See id.* This explanation is also related to a potential solution for the flipside of Gilson's riddle since controllers' "generous stealing" may encourage public investors in a bad-law country to participate in a capital market. For a further discussion of a stationary controller's role in the context of the flipside of Gilson's riddle, see *infra* Part III.A.

198. Kang, *supra* note 27.

199. *See supra* Part II.E (discussing stationary controlling shareholders). The following explanation in this Subpart (Part III.A) is also based on Kang, *supra* note 27.

corporation run by a stationary controller as long as the return on the stock after expropriation is comparable to the return on investments in other opportunities.[200] However, an important problem is that prospective investors do not know whether the controlling shareholder that they are dealing with is stationary or roving. Under this asymmetric information, prospective investors would hesitate to participate in a capital market even when a truly stationary controller issues new equities due to the fear of dealing with a roving bandit. Knowing this, even a sincere stationary controller might be discouraged from issuing new equities and having public minorities.[201]

In this context, a controlling "family" shareholder has a comparative advantage.[202] Since a controlling family shareholder is a repeat-player, prospective investors would understand that the current controlling shareholder is unlikely to kill the "proverbial golden goose" due to the hope that it will continue to lay eggs for him and his children eternally.[203] To be sure, it is impossible for investors to know the intent of a controlling shareholder whether he wishes to be roving or stationary.[204] However, investors can discover whether a given corporation is a family business by reviewing the corporate governance structure (e.g., how shares are spread among family members, whether children of a founder are managers or directors of a corporation).[205] Once investors recognize the presence of a controlling family shareholder, they are likely to deem the controller to be stationary. Subsequently, investors would participate in the equity market to gain returns under a more generous stationary controller. As a result, the flipside of Gilson's riddle (why minority shareholders participate in a seemingly unfair capital market where they are not protected) is solved to some degree. In sum, the game is likely to be beneficial to both minority shareholders and a family controller.[206]

200. For the more explanation for the returns of stock and other asset classes and their impact on the investment decision by public investors, see *infra* Part III.B.

201. For this vicious circle of interaction between public investors and a controlling shareholder in a bad-law jurisdiction, see Kang, *supra* note 27.

202. *Id*.

203. Nonetheless, there are some circumstances that could make it difficult for a controlling family shareholder to be a stationary controller. For a further explanation, see generally *id*.

204. *Id*.

205. *Id*.

206. Benefits for a stationary controller (in particular a family controller) are already discussed *supra* Part II.E.

B. Imperfect Alternative Investments

Perhaps, if controlling shareholders extract investors, then prospective investors may avoid investing in the stock market, and may seek investment opportunities from alternative asset classes, such as bank deposits, debt securities, and real estate. Theoretically, this phenomenon would be more apparent when investors' risk-adjusted return of equity is lower than that of alternative investments.[207] Nonetheless, there are several perceivable reasons why prospective minority shareholders are unable to totally shun investing in the stock market.

While bank deposits are a very safe investment, they generate low returns. Although the risk-adjusted return of bank deposits is higher than that of equity investment in some cases, investing solely in bank deposits is not a workable option for investors who need to meet a certain amount of "absolute" return. As a result, at least some investors reallocate their wealth from bank deposits to stocks, which generate higher absolute returns. Investment in debt securities, such as government and corporate bonds, has similar problems. Therefore, there are many minority shareholders in developing countries despite controllers' tunneling in corporations.

In addition, in a bad-law country, if equity investment is impaired due to controllers' extraction, it is likely that investment in other assets is scathed as well. For example, when laws do not protect minority shareholders (i.e., public investors in a stock market), creditors of corporations (e.g., public investors in a bond market) are likely to be subject to a similar risk. In that case, an alternative investment in a bond market would not generate higher risk-adjusted return than stocks, let alone higher absolute return.

Investors often see real estate as an attractive alternative to a stock market as well. However, the problem is that since the value of specific real estate generally accounts for a huge portion of an individual's wealth,[208] many investors are exposed to huge idiosyncratic risk. Even worse, real estate is a very illiquid asset. Thus, investors take the risk of selling real estate at a deep discount in an emergency. For these reasons, investing in real estate is not fit for many ordinary investors, who are not sufficiently wealthy to deal with these risks. In developed economies,

207. In this Article, alternative investments are meant to be investments in any asset other than stocks. Thus, for example, an investment in bonds is treated as an alternative investment, let alone an investment in real estate.

208. Suppose that an investor's single real estate investment (e.g., a house) accounts for 70% of his personal wealth. If the value of that real estate was adversely affected by some macroeconomic problems, it would significantly affect the investor's total wealth.

these problems may be well solved by the liquid and thick mortgage markets and indirect real estate investment tools such as Real Estate Investment Trusts (REITs). However, this has not been the case for many bad-law economies until the recent past.

In sum, equity is not the only imperfect asset in a country with insufficient investor protection, and investing in assets other than stocks is not always feasible. Therefore, investors should choose optimal combinations among *imperfect* assets including stocks, even if returns from investment in stocks are impaired by controllers' expropriation. Since an overarching principle of finance is diversification between classes of assets in order to eliminate unsystematic risks, putting equities in an investment pool is beneficial to investors even when alternative investments are sound and feasible.

One may argue, if controllers scathe domestic stocks through tunneling, investors may shun domestic stocks and invest internationally. In addition, international investment is beneficial to investors because adding international assets enhances risk-adjusted return.[209] In reality, however, many jurisdictions with poor law have established regulations on the outflows of their citizen's investment.[210] Even in countries without tight capital regulations, domestic investors would find it difficult to invest significantly in assets abroad for the following reasons.

Most of all, domestic investors have insufficient information about potential foreign investments, so they are less confident in investments in foreign markets. In addition, home bias[211] reinforces the tendency of domestic investors to invest mainly in domestic assets, even if international investment can provide higher risk-adjusted return. Moreover, it is noteworthy that international investment mainly supplements domestic investments. Put differently, international investment is more appropriate for affluent people whose wealth needs additional diversification after investing the vast majority of their assets in a domestic market. In contrast, many potential non-controlling shareholders in developing countries are

209. For the explanation on the international diversification, see generally Haim Levy & Marshall Sarnat, *International Diversification*, 60 AM. ECON. REV. 668 (1970).

210. For example, Korean government restricted international capital flows before the Asian financial crisis. Taiwan restricted international capital flows and liberalized them in the end of the 1990s. Rui Castro, Gian Luca Clementi & Glenn MacDonald, *Investor Protection, Optimal Incentives, and Economic Growth*, 119 Q. J. ECON. 1131, 1156, 1156 n.18 (2004).

211. Home bias is the phenomenon that investors tend to invest the vast majority of capital in assets in domestic countries. It is a special version of familiarity bias where investors tend to invest the vast majority of capital in assets that they are familiar with. As for familiarity bias, see Gur Huberman, *Familiarity Breeds Investment*, 14 REV. FIN. STUD. 659, 659-60 (2001).

middle class investors who would be less able to invest their capital for diversification beyond domestic investments.[212] Even worse, the currency risks posed by international investment could be another obstacle for small individual investors to overcome, if they do not have sources to hedge against these risks.[213] These problems would be more severe when an undeveloped capital market in a developing country does not provide small individual investors with efficient collective investment tools, such as funds that specialize in and diversify foreign equities. Consequently, unless controlling shareholders extract to an extreme degree, potential investors have an incentive to participate in a domestic capital market as non-controlling shareholders.

C. Behavioral Finance Problems That Public Investors Are Subject to

Modern standard finance theories are built on core assumptions such as rational investors and perfect information.[214] However, the real-world experiences and psychological research of human behavior have shown that these assumptions often do not hold.[215] Realizing the limitations of modern standard finance, Daniel Kahneman and Amos Tversky pose a new theory of behavioral finance. They argue that individuals are inclined to misjudge

212. Indeed, there are international diversification benefits to investors investing in equity markets abroad. As is widely known, however, the requirements of international diversification are the willingness and ability to take the greater risks that arise from international investment. Wealthy investors in developed countries are able (and willing) to be involved in international diversification, but many minority shareholders in developing countries are not.

213. It is known that the success of international investment has depended heavily on the performance of foreign exchange in a country wherein investors invest. Since the volatility of foreign exchange has been great, the risk associated with investing in international investment has been large. Thus, in principle international investment has required investors to have more willingness and capacity to take risks.

214. Ronald J. Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias,* 28 J. CORP. L. 715, 718 (2002). Based on these assumptions, modern standard finance relies on three theoretical pillars: the Capital Asset Pricing Model ("CAPM"), the Miller-Modigliani Irrelevance Propositions, and the Efficient Market Hypothesis ("EMH"). *Id*. As to the EMH, Professor Jensen famously states, "the efficient market hypothesis is the best established fact in all of the social sciences." Andrei Shleifer & Lawrence Summers, *The Noise Trader Approach to Finance*, 4 J. ECON. PERSP. 19, 19 (1990).

215. For example, Herbert Simon describes that "human behavior is *intendedly* rational, but only *boundedly* so." HERBERT SIMON, ADMINISTRATIVE BEHAVIOR 88 (4th ed. 1997). "Behavioral models of financial markets consider not only how people should act but also how they do act. People do not always behave rationally, and although departures from rationality are sometimes random, they are often systematic." Brad M. Barber & Terrance Odean, *The Courage of Misguided Conviction*, 55 FINANCIAL ANALYSTS J. 41, 41 (1999).

an asset's value due to cognitive biases and heuristics.[216] Based on behavioral finance issues, public investors in bad-law countries are likely to invest in domestic equity markets as non-controlling shareholders even if extraction by the controller renders the shares unworthy of investment.

Most individuals have a tendency to be overconfident—they believe that they are more competent, knowledgeable and proficient than they actually are.[217] Likewise, investors in a bad-law country would like to purchase stocks since they are confident in their forecasting capability, even if those stocks are volatile and subject to serious tunneling risk. In addition, names of large conglomerates appear in the national media every day, and the advertisements of those conglomerates repeatedly influence people in domestic markets. Then, familiarity bias[218] holds, and investors invest their wealth in shares of such conglomerates despite controlling shareholders' exploitation. Home bias,[219] explained above, is another reason that prospective investors in bad-law countries invest in the domestic capital market. Once investors purchase shares, it is likely that they are also subject to status quo bias even if the shares' performance is disappointing due to corporate governance problems incurred by controllers.

Moreover, minority shareholders often play the role of noise traders.[220] Based on fads and sentiments, investors might invest in shares issued by large family conglomerates even if rational information indicates that domestic corporations are subject to a high risk of expropriation. When some noise traders earn high returns, many investors might follow those noise traders' trading patterns, ignoring the fact that those successful traders took excessive risk and were just lucky.[221] Buying shares of a

216. *See* Gilson & Kraakman, *supra* note 214, at 724; Amos Tversky & Daniel Kahneman, *Judgment under Uncertainty: Heuristics and Biases,* 185 SCI. 1124, 1124 (1974) (describing how the usage of heuristics and biases can lead to errors in judgment); *see also* Barber & Odean *supra* note 215, at 41 (explaining that people often deviate from rationality in a systematic way).

217. "Psychological studies show that most people are overconfident about their own relative abilities, and unreasonably optimistic about their futures." Colin Camerer & Dan Lovallo, *Overconfidence and Excess Entry: An Experimental Approach*, 89 AM. ECON. REV. 306, 306 (1999).

218. As for familiarity bias, see generally Huberman, *supra* note 211 (explaining home bias and familiarity bias).

219. Familiarity bias and home bias are closely related. "[R]ecent research suggests that home bias may be part of a larger phenomenon in which investors exhibit a preference for familiar companies." Mark Grinblatt & Matti Keloharju, *How Distance, Language, and Culture Influence Stockholdings and Trades*, 56 J. FIN. 1053, 1053 (2001) (citation omitted).

220. Gilson & Kraakman, *supra* note 214, at 724 (explaining that noise traders "make investment decisions that deviate from those that theory would predict of rational investors").

221. Shleifer & Summers, *supra* note 214, at 25.

family-controlled corporation in a bad-law country is often analogous to gambling.[222] Whereas almost all gamblers know that they will lose on the average, most potential minority shareholders in a stock market believe that their expected return is positive even if controllers manipulate the game and the risk-adjusted return is lower than it should be. In this way, more prospective investors gamble in the stock market casino as non-controlling shareholders.

D. Minority Shareholders Are Looted, But They Buy Shares at Discount

In Subpart A through C, I explained reasons why minority shareholders participate in a stock market even if they are subject to serious expropriation risk by a controller. In this Subpart, however, I explore the possibility that minority shareholders in bad-law jurisdictions actually might not be damaged financially. Professor Coffee puts forward a counterintuitive but creative account: the public shareholders buy their shares at a "bargain" price, which already reflects the likelihood that the controlling shareholder will expropriate wealth in the future;[223] thus, "the public shareholders would receive an undeserved 'windfall' if legal rules were revised to entitle them to a proportionate share of corporate assets and distributions."[224] In other words, even if the price of minority shares is lower than their fundamental value due to controllers' extraction, minority shareholders would not suffer since they purchase those shares at a depressed price for that same reason.[225] Therefore, as Professor Coffee explains, "[f]rom an efficiency perspective, it may be clear that the economy will do better if the minority is protected, but from a normative perspective, the respective entitlements of the majority and the minority can be debated endlessly."[226]

I essentially agree with this insightful opinion. However, I think that additional analysis of the impact of "volatility of expropriation" on public investors is needed for further clarification. Suppose that there are three investors, "Investor A," "Investor B," and "Investor C." They buy and sell

222. *See, e.g.*, ECONOMIST, *Casino Capital: China's Financial Market Are Wild—and Often Less than Wonderful* (Feb. 6, 2003), http://www.economist.com/node/1559717.

223. Coffee, *supra* note 35, at 659; *see also* Black, *supra* note 129, at 806 (using an example from Coffee, *supra* note 35, at 657-59).

224. Coffee, *supra* note 35, at 659.

225. For example, assume that the intrinsic price of a corporation's shares is $100. Suppose that the current price of shares of the corporation for minority shareholders is $70 due to the controlling shareholder's expropriation. However, it does not mean that minority shareholders lose their wealth if their purchasing price was $70.

226. Coffee, *supra* note 35, at 659.

shares of Corporation "XYZ" controlled by a controlling shareholder. Initially, A holds shares (at time 1), and sells them to B (at time 2). Finally, B sells them to C (at time 3). Suppose that the controlling shareholder partially extracts firm value at time 1 and time 2, but he appropriates almost all of the firm value at time 3. A lenient level of extraction already has been reflected in the share price in the form of a discount when A and B purchased shares, thus A and B might not be financially damaged. However, C would be seriously injured because the extraction at the time of sale is greater than at the time of purchase (i.e., buy high and sell low). If the *ex post* degree of looting is far beyond the investors' *ex ante* expectations, or if the controlling shareholders unexpectedly transfer corporate wealth through a one-time extraction, minority shareholders are clearly damaged, which is not explained in Coffee's account.[227]

In this respect, the notion of family (i.e., a repeat-player) in business groups is important again. As discussed earlier, a controlling family shareholder with inheritance usually exploits minority shareholders as a stationary controller, since *partial* extraction is more beneficial to a controller with a long term horizon than *total* extraction in terms of joint utility of pecuniary and non-pecuniary private benefits. In this case of "stable expropriation," therefore, it is likely that C buys a share at the discounted price and he will sell at the similar discounted price, meaning that C is not financially damaged.[228]

E. Foreign Minority Shareholders

Although equities in bad-law countries are scathed by poor corporate governance, a large number of foreign investors invest in such securities. A possible explanation for this phenomenon is that foreign investors are able to purchase shares at a relevant discounted price even if there are corporate governance problems. Simply put, foreign investors are not very concerned about the expropriation since expropriation is already reflected in the purchasing price. Sometimes, foreign investors massively buy cheaper shares in an emerging country after the country experiences financial crisis, which more deeply reinforces the discount. In addition,

227. In other words, when a controlling shareholder changes his status from a stationary controller to a roving controller, it is possible that minority shareholders who purchase their shares under a stationary controller and sell their shares under a roving controller are financially damaged.

228. Nonetheless, it is noteworthy that family controllers are not always stationary although they are likely to be stationary.

unlike domestic minority shareholders,[229] foreign investors are able to achieve the benefits of international diversification.

Most of all, foreign investors are usually large institutional investors in developed countries. Thus, they do not face substantial regulation of investment abroad. In addition, they are capable of taking the risks of international investment, which would enhance diversification further. From the perspective of U.S. institutional investors, the correlation between the United States and foreign markets is so low that adding foreign investments to a domestic portfolio could result in lowering the risk. Higher returns are also expected, as many emerging markets will often outperform the markets in the developed countries. Moreover, the amount of their investment in bad-law countries is only a *small* portion of their overall investment, so foreign investors can take the risky position of minority shareholders in bad-law countries. Nonetheless, the amount of investment from foreign investors is *significant* from the perspective of controllers in a bad-law country due to the disparity between the sizes of the economies. Thus, in the equity market of a poor-law country, foreign shareholders could take an important role as "minority shareholders."

It is unlikely that foreign minority shareholders react to bad corporate governance as an organized group and *directly* punish greedy controllers. However, foreign minorities can *indirectly* punish overreaching controlling shareholders. As long as foreign shareholders purchase shares of a corporation at a proper discounted price, foreign shareholders are able to endure a *partial* extraction. However, if controlling shareholders rely on *substantially all* extraction, foreign shareholders would follow the Wall Street Rule (i.e., they will sell their shares). Domestic minority shareholders believe that foreign minority shareholders—sophisticated and large global financial entities—are like a litmus paper and possess better information about domestic stocks and are more capable of assessing corporate value. Observing the movement of foreign shareholders, domestic minority shareholders would follow the selling trends of foreign shareholders.[230] In this way, once a developing country has a significant number of foreign minorities in a stock market, it is likely that controlling shareholders in the jurisdiction will not be able to easily exacerbate the extent of tunneling.[231]

229. As explained earlier, domestic minority shareholders in a bad-law country have found it difficult to participate in international investment: the circumstances in a bad-law country, including regulations, the relatively low level of wealth, and the underdevelopment of financial intermediaries like funds, impede international investment. *See supra* Part III.B.

230. In other words, domestic minority shareholders in a developing country are under the herding effect created by foreign investors.

231. However, this does not mean that a controlling shareholder in the jurisdiction must improve corporate governance. As long as the quality of corporate governance is

F. *Minority Shareholders May Free-Ride When a Controlling Shareholder Expropriates Other Stakeholders*

In regard to dispersed shareholder regimes, the academic interest in corporate governance focuses on the relationship between managers and shareholders—the former exploits the latter. On the other hand, when it comes to controlling shareholder regimes, the lopsided relationship between controlling shareholders and minority shareholders has been emphasized. Again, the former loots the latter. Combining these two views, conventional corporate governance scholarship, by and large, limits its analytical frameworks to what I call the "triumvirate model" (i.e., the corporate governance model based on managers, controlling shareholders, and minority shareholders). Under this tradition, minority shareholders are (almost) always seen as the weakest in the "food chain," extracted either by managers or controlling shareholders. Accordingly, other stakeholders—employees, creditors, trading partners, consumers, and taxpayers—are not treated in this model. Perhaps, in the United States, the triumvirate framework is working relatively well. Fiduciary duty is almost exclusively for shareholders since other stakeholders are seen as protected by contracts.

In contrast, the traditional triumvirate framework is not necessarily suitable for a bad-law country where economic interest of other stakeholders (let alone that of minority shareholders) is damaged by corporate insiders. Although controlling shareholders' tunneling scathes a capital market, the capital market is not the only market that is imperfect. For example, in an imperfect labor market, employees are expropriated by a corporation as they receive less economic benefits in exchange for their labor. As a result, some of the employees' welfare is transferred to the corporation, and the entire body of *all* shareholders including minority shareholders is benefitted as well.

In addition, in a country where minority shareholders are not protected well, it is likely that creditors are not protected by contracts either. As a borrower, a corporation is able to take advantage of creditors by various means. For example, it is widely known that a corporation may take on a highly risky project for shareholders at the lender's risk. If a project is successful, shareholders get the upside benefits as residual claimants; if it turns out dismal, the lender should bear the downside cost. In that way, shareholders including minority shareholders can transfer welfare from creditors to themselves. In a bank-finance economy, the magnitude of the

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maintained (and does not deteriorate further), foreign minority shareholders do not lose. Instead, they buy and sell stocks at the same discounted rate reflecting the same quality of corporate governance. Under these circumstances, foreign minority shareholders do not have a strong incentive to punish controllers by following the Wall Street Rule.

wealth transfer might be huge if creditors are not properly protected.

Furthermore, a large corporation in a bad-law country is usually able to wield gigantic monopoly power in each market where it plays. It is highly likely that the competition law system is inefficient, when the quality of corporate law is low.[232] Therefore, a great deal of trading partners' and consumers' welfare would be transferred to a large corporation where minority shareholders participate as its partial owners. Besides, the government in a developing country sometimes greatly subsidizes large corporations. Accordingly, taxpayers' money is transferred to all shareholders, including minorities.

In sum, my point is straightforward. True, in a country with poor shareholder protection, minority shareholders are generally "victims" in relation to the controlling shareholder who is usually suspected of being the "wrongdoer." The problem may arise when a controlling shareholder loots other stakeholders in a corporation. In this case, minority shareholders may free-ride on a controller as "shareholders" and may benefit to the detriment of other stakeholders. In this sense, minority shareholders have incentives to participate in stock markets where they are not properly protected vis-à-vis controlling shareholders. Simply put, minority shareholders in bad-law countries, in fact, are not situated at the bottom of the "food chain." Indeed, it is not conclusive whether the minority shareholders' benefit from this free-riding exceeds their cost of expropriation by a controller. It depends on jurisdictions and on a case-by-case analysis. Rather, what is emphasized here is that minority shareholders in a bad-law country are not "unilateral victims" that is depicted by the conventional triumvirate model.

CONCLUSION

Law and finance theories proposed by LLSV have greatly contributed by introducing scientific methodologies to comparatively evaluate corporate governance. Nonetheless, their works have generated conundrums (including Gilson's riddle and the flipside of Gilson's riddle) that, so far, have not been explained well. In response to these conundrums, Professor Gilson proposes the PMBA as a possible answer. To be sure, the PMBA is an insightful idea that changes an analytical framework to solve Gilson's riddle. Despite its huge contribution in pioneering this uncharted territory, however, the PMBA's explanatory power could be weakened under certain circumstances, particularly in a corporation where a controller's cash flow rights are minimal.

232. *See supra* note 99 (stating the high correlation between the quality of corporate law and competition law).

After a critical review of the PMBA, this Article proposes alternative explanations. To this end, this Article has two approaches. From the perspective of a controlling shareholder, I analyze in Part II why a controlling shareholder relies on equity finance and has so many public investors even though the cost of equity is substantially high. In addition, from the perspective of public investors, I analyze in Part III the incentives of public investors to participate in capital markets with poor investor protection. Based on these interactions in a capital market, as Marshall's scissors indicate, both controlling shareholders and public investors can enjoy surplus. In this sense, informal (non-legal) institutions create a symbiotic relationship between two parties in a bad-law country.

Since each controlling shareholder regime has its idiosyncrasies, generating a (or the) "general theory" for the controlling shareholder system is impractical. Perhaps, a large but missing part of the comparative corporate governance scholarship is an analysis based on the culture, which makes one system distinctive from the others. For example, the value of non-pecuniary benefits is very dependent on the people's mindset and preferences shaped by their particular culture. In this context, it is worth noting Professor Milhaupt's comment. "It is obvious that an analytical framework exploring incentives is fundamental in understanding the conduct of rational economic persons like a controller and minority shareholders. Nonetheless, I start to be convinced that we need to see through the lens of culture for a more comprehensive analysis of corporate governance."[233] Agreeing with this insight, I look forward to seeing future works that will combine economic analysis and cultural explanations for this largely uncharted territory of comparative corporate governance.

233. Discussion with Curtis Milhaupt, Professor, Columbia Law School, in N.Y.C., N.Y.