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**Background Paper: Corporate Governance, the Equity Contract and the Cost of Capital: Incremental  
and Accretive Reform Strategies**

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## **Corporate Governance, the Equity Contract and the Cost of Capital: Incremental and Accretive Reform Strategies**

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Corporate governance constitutes the firm's equity contract; that is, the terms under which an equity investor commits funds to the corporation. To understand the link between the terms of the equity contract and the corporation's cost of capital and, therefore, the direction in which corporate governance reform should take to allow companies to reduce that cost, it is helpful to compare the equity contract with the standard debt contract – the rules governing the provision of a corporation's other source of external capital.<sup>1</sup>

The debt contract is "hard."<sup>2</sup> If the debtor violates specific obligations – for example, to pay interest, to maintain financial covenants, or to repay principal – the creditor can take immediate legal action to collect the debt, including forcing the debtor into bankruptcy. The equity contract, in contrast, is "soft."<sup>3</sup> Because common stock holds the residual claim on the corporation's income stream, its returns are contingent on the corporation's strategy, both with respect to its business and with respect to future financing decisions. As a result, corporate governance standards do not contain specific rules that specify the amount or timing of distributions to common shareholders. The difference between a debt holder's remedy when the corporation fails to make an interest payment on outstanding debt on the one hand, and a common shareholder's remedy when the corporation determines not to pay a dividend on the other, illustrates the point. The debt holder has an immediate cause of action for behavior that breaches an enforceable contract. The shareholder has no cause of action for failure to pay a dividend; he is relegated either to seek a change in the corporation's strategy by changing its management, or to pursue a broader claim of breach of fiduciary duty. In short, the equity contract substitutes processes and general standards of behavior for the specific and directly enforceable obligations of the debt contract.

This difference between the character of the debt contract and that of the equity contract should not obscure the link between the rules that govern the two forms of external capital and the price the corporation has to pay for that capital. Suppose a proposed debt contract gives a creditor little protection, either because the debt has low priority or because the relevant jurisdiction does not provide effective enforcement of

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<sup>1</sup> While corporations frequently will have multiple classes of equity and multiple layers of debt, for present purposes the distinction between common equity and standard debt is sufficient.

<sup>2</sup> See Michael Jensen, *The Eclipse of the Public Corporation*, *Harv. Bus. Rev.* 61 (Sept.-Oct. 1989); G. Bennett Stewart III and David M. Glassman, *The Motives and Methods of Corporate Restructuring: Part II*, *J. Applied Corp. Fin.*, Summer 1988, at 81.

<sup>3</sup> *Id.*

breaches by the debtor. If the risk of nonpayment of the debt increases for these reasons, the interest rate demanded by lenders will increase correspondingly. Now suppose that the equity contract – the corporate governance regime in the relevant jurisdiction – provides poor protection to the equity investor. Just as with the debt contract, increased risk associated with common shareholders getting the expected return will result both in a correspondingly lower stock price and the reciprocal, a higher cost of equity capital.

Evaluation of a country's corporate governance structure and the relation between the quality of governance and the cost of equity capital then turns on the extent to which the governance structure protects against risks that prospective equity investors assess in valuing a corporation's stock. For this purpose, it is important to recognize that this is an assessment of function, not form. Every corporate governance system must address a core set of functions that respond to the risks of holding equity. However, this response may take different forms depending on a particular country's unique history and politics.<sup>4</sup>

In this paper, I focus on corporate governance in a setting where public corporations typically have a controlling shareholder, as is the case in Asia. In particular, I stress two themes. First, I distinguish between efficient and inefficient controlling shareholder regimes; that is, between jurisdictions in which there are effective constraints on the amount of private benefits of control that the controlling shareholder can extract, and jurisdictions where there are not. This distinction, different from the more familiar distinction between controlling shareholder jurisdictions and jurisdictions in which most public corporations have widely distributed shareholdings, has important implications for understanding corporate governance in controlling shareholder jurisdictions. Second, I assess strategies for reform of inefficient controlling shareholder systems, with particular emphasis on strategies that are incremental and accretive, as opposed to systemic reform of the formal structures of the corporate governance system.

## **I. The Taxonomy of Corporate Governance: The Risks and the Distribution of Shareholders**

Corporate governance is a matter of concern only when the corporation relies upon external equity; that is, equity provided by parties who will not be actively involved in the corporation's management. As a result, external equity investors always confront a separation of ownership and control; from their perspective someone else will be making the decisions that determine the corporation's success. Whether the actual decision maker is a controlling shareholder or management in the case of corporations without a controlling shareholder, there is an agency problem resulting from this delegation at the core of the corporate governance of public corporations.

For our purposes, and consistent with both the academic literature and the general content of corporate law, this agency problem manifests itself in two ways. The decision makers may manage poorly, reducing the returns to outside shareholders through poor strategy and execution. I will refer to behavior of this sort as breaching the decision makers' "duty of care." As well, the decision makers may favor themselves at the expense of external shareholders by making decisions with their own interests in mind, rather than

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<sup>4</sup> See Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Function or Form?*, 49 *Am. J. Comp. L.* 329 (2001).

those of the shareholders. I will refer to behavior of this sort as breaching the decision makers' "duty of loyalty."<sup>5</sup>

The role of controlling shareholders lies at the intersection of these two elements of the public corporation agency problem.<sup>6</sup> It is also central to analysis of corporate governance in East Asia, where a controlling shareholder is present in virtually all publicly held corporations.<sup>7</sup> To see this, it is helpful to start with the more familiar (though globally much less common) public corporation that has widely distributed shareholdings – the Berle-Means style corporation that has dominated much of academic and policy debate over the last twenty years.<sup>8</sup>

For these companies without a controlling shareholder, which dominate the corporate landscape in the United States and the United Kingdom, the agency problems of lack of care and disloyalty are attacked through internal governance techniques like a board of directors dominated by independent directors without financial or other close ties to the management or the corporation, and through external market devices like hostile takeovers. While both are effective techniques, each has significant limitations. It is hard to get the incentives of independent directors right: fees high enough to secure their full attention may be inconsistent with their independence. Takeovers, in turn, can be blunt instruments. They are an effective response to only some kinds of performance problems,<sup>9</sup> and the large premiums necessary for their success makes them appropriate only for very large problems.

From this perspective, a controlling shareholder may better police both the care and the loyalty of the management of a public corporation than the panoply of market-oriented techniques employed when shareholdings are widely-held. Because of a large equity stake, a controlling shareholder is more likely to have the incentive either to effectively monitor managers or to manage the company itself. The controlling shareholder is in this view an alternative to the frictions associated with the techniques used to ameliorate the agency problem in companies with widely-held shareholdings.<sup>10</sup>

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<sup>5</sup> It is important to keep in mind from the outset that these two categories of misbehavior, although analytically distinct, in practice have a tendency to appear together. In the recent Parmalat scandal for example, the controlling shareholder is said to have diverted some 1 billion euros to himself and his family, while losing in excess of eight times that much through poor management. When a manager's focus is on diverting resources to himself, facilitating that transfer may warp strategic choices as well as divert attention from maximizing the value of the corporation.

<sup>6</sup> This discussion draws on Ronald J. Gilson & Jeffrey Gordon, *Controlling Controlling Shareholders*, 152 *U. Penn. L. Rev.* 785 (2003).

<sup>7</sup> Classens, Djankov and Lang report a single controlling shareholder at more than two-thirds of listed East Asian companies. Stilin Classens, Simeon Djankov & Larry H.P. Lang, *The Separation of Ownership and Control in East Asian Corporations*, 58 *J. Fin. Econ.* 81 (2000). The OECD White Paper on Corporate Governance in Asia notes that, because the Classens et. al. study excludes companies whose ownership cannot be traced because of nominee holdings, "the actual degree of family control may be substantially higher than two-thirds." OECD, *White Paper on Corporate Governance in Asia* 1n.6 (2003).

<sup>8</sup> See Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Taxonomy* (working paper, Oct. 2004).

<sup>9</sup> For example, hostile takeovers may be effective at breaking up inefficient conglomerates, which requires little internal information to sell of unrelated businesses, while fixing the operating problems of a single business may require deep local knowledge of the business that may not be available to an outsider.

<sup>10</sup> This is consistent with empirical findings that firm value increase in the level of inside ownership. See, e.g., Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, *Investor Protection*

Controlling shareholder monitoring as a means to ameliorate managerial agency problems, however, comes with its own set of frictions. Here the conflict is one of loyalty: between a controlling shareholder and public shareholders over the potential for the controlling shareholder to extract private benefits of control – benefits to the controlling shareholder not provided to the public shareholders. Conditional on maintaining control, the smaller the controlling shareholder's equity stake, the greater his incentive to use control to extract private benefits.<sup>11</sup>

At least conceptually, there is an equilibrium between these two opposing characteristics of controlling shareholder governance structures. Because a controlling shareholder must bear liquidity and non-diversification costs from holding a concentrated position as well as the direct costs of focused monitoring or direct management, some private benefits of control are necessary to induce a party to play that role. Thus, from the public shareholders viewpoint, the two elements of the corporate agency problem present a tradeoff. Public shareholders will prefer a controlling shareholder as long as the benefits from reduction in managerial agency costs exceed the private benefits that the controlling shareholder will extract.

Framing the controlling shareholder structure as an alternative to governance techniques associated with the United States-United Kingdom's widely distributed pattern of share ownership, and particularly as an alternative structure whose attraction depends on a trade off between increased monitoring and increased private benefit extraction, provides a prism that improves our understanding of the role of legal rules and corporate governance in controlling shareholder systems like those in Asia. Different corporate governance rules and different legal rules may result in different controlling shareholder systems having very different costs and benefits and thus very different tradeoffs. The platform for legal and governance reform and the direction that reform might take grows out of understanding the differences.

## **II. Inefficient and Efficient Controlling Shareholder Regimes and the Role of Law and Corporate Governance**

A large and influential body of recent "law and finance" scholarship has sought to reveal empirical links between measures of the quality of a jurisdiction's legal and corporate governance rules and the prevalence of controlling shareholders in public corporations. For present purposes, a particular claim of this literature is central: that a capital market characterized by controlling shareholders in public corporations is

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and Corporate Valuation, 57 *J.Fin.* 1147 (2002); John McConnell & Henri Servaes, Additional Evidence on Equity Ownership and Corporate Value, 27 *J.Fin. Econ.* 595 (1990); Randall Morck, Andrei Shleifer & Robert Vishny, Management Ownership and Market Valuation, 20 *J.Fin. Econ.* 293 (1988).

<sup>11</sup> This is consistent with empirical findings that firm value decreases in the difference between equity ownership and voting control. See Stijin Classens, Simeon Djankov & Larry H.P. Lang, The Separation of Ownership and Control in East Asian Corporations, 58 *J.Fin. Econ.* 81 (2000); Karl V. Lins, Equity Ownership and Firm Value in Emerging Markets, 38 *J.Fin. & Quant. Anal.* 159 (2003); Paul Gompers, Joy Ishii & Andrew Metrick, Incentives vs. Control: An Analysis of U.S. Dual Class Companies, NBER Working Paper 24 (Jan. 2004).

associated with bad law and bad corporate governance.<sup>12</sup> Where minority shareholders are not protected from controlling shareholders extracting large private benefits of control, the argument runs, entrepreneurs will not part with control through public offerings because they then would risk their own subsequent exploitation by someone who assembles control through the market and whose extraction of private benefits would be unchecked by the legal system. Under this analysis, controlling shareholder systems will be characterized by weak equity markets – too much liquidity tied up in control blocks – and by large differences in the value of controlling and minority blocks as a result of private benefit extraction.

For my purposes here, a difficulty with this literature is that it treats all controlling shareholder regimes as if they were alike. The analysis in Part I suggested that one might encounter two different types of controlling shareholder regimes: jurisdictions characterized by *inefficient* controlling shareholders who extract more in private benefits of control than the benefits from their focused monitoring; and jurisdictions characterized by *efficient* controlling shareholders who create more value from focused monitoring than the cost of their private benefit extraction.<sup>13</sup> This more complex taxonomy of controlling shareholder systems provides a context in which to better understand the role of legal rules and corporate governance in supporting a particular pattern of shareholder ownership.

Recall that the initial claim made by the law and finance literature was that controlling shareholder systems are associated with bad law: entrepreneurs retain control to protect themselves against private benefit extraction by someone who might subsequently assemble control if the existing controller gave it up. Having retained control, the entrepreneur then exploits it by extracting private benefits of control. This framework has three clear empirical implications. In inefficient controlling shareholder systems, where legal and corporate governance rules do not effectively constrain the size of private benefits, one should find that (1) the value of controlling shares will be dramatically larger than minority shares; and (2) the extent of private benefits will decrease in the amount of the controlling shareholders' equity holdings and increase in the difference between percentage of control and percentage of equity. In contrast, efficient controlling shareholder systems will be characterized by good law; that is, law that limits private benefit extraction to an amount necessary to compensate a controlling shareholder for the costs of focused monitoring and which is less than the benefit from focused monitoring. Thus, in efficient controlling shareholder systems (3) the value of controlling shares will exceed that of minority shares by a much smaller amount than in inefficient controlling shareholder systems.

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<sup>12</sup> See, e.g., Rafael LaPorta, Florencio Lopez-de-Silanes & Andrei Shleifer, Corporate Ownership Around the World, 54 J.Fin. 471 (1999); Rafael LaPorta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, Legal Determinants of Outside Finance, 52 J. Fin. 1131 (1997); Rafael LaPorta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, Law and Finance, 106 J.Pol. Econ. 113 (1998); Rafael LaPorta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, Investor Protection and Corporate Ownership, 58 J. Fin. Econ 3 (2000). Charles P. Himmelberg, R. Glenn Hubbard & Inessa Love, Investor Protection, Ownership, and Investment: Some Cross-Country Evidence (working paper, Sept. 2000), reaches a similar result using different econometric techniques.

<sup>13</sup> See Gilson, supra note 8.

Recent empirical studies support all three predictions that derive from drawing a distinction between inefficient and efficient controlling shareholder systems. The level of private benefit extraction should be reflected in the difference in value between controlling and minority shares; only the value of controlling shares includes the net present value of expected private benefits of control. As shown in Table 1, the level of private benefit extraction in bad law regimes is large whether measured by the difference between the market price of high voting and low voting shares,<sup>14</sup> or by the size of the premium paid for a controlling block.<sup>15</sup> Measured by differential market price, control represents approximately 36 percent of firm value in Mexico, 29 percent in Italy, and only 1 percent in Sweden.<sup>16</sup> Mexico and Italy are typically characterized as bad law states and Sweden as a good law state. Measured by the size of block premium to the value of firm equity, control represents 34 percent of firm value in Mexico, 37 percent in Italy, and 7 percent in Sweden.<sup>17</sup> Both studies report that differences in the quality of law account for a large portion of the difference between countries.

*Table 1*  
*Value differential between controlling and minority shares in CS systems depends on the quality of law*

	Mexico	Italy	Sweden
●PBC measured by difference in market price	36%	29%	1%
●PBC measured by control block premium	34%	37%	7%

Source: Nenova (2003); Dyck & Zingales (2002)

A recent study of East Asian countries, also characterized by the authors as having bad law, provides empirical support for the relationship between the size of equity holdings by controlling shareholders and the extent of private benefit extraction, and for that between the size of the difference between equity ownership and control on the one hand and private benefit extraction on the other. In systems that are dominated by controlling shareholders, firm value increases in the equity share of the largest shareholder, and decreases with the size of the difference between control rights and equity holdings.<sup>18</sup>

<sup>14</sup> See Tattiana Nenova, *The Value of Corporate Voting Rights and Control: A Cross-Country Analysis*, 68 *J.Fin. Econ.* 325 (2003).

<sup>15</sup> Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, working paper (Dec. 2002)(forthcoming, *Journal of Finance*).

<sup>16</sup> Nenova, *supra* note 14, at Table 3, p. 334.

<sup>17</sup> Dyck & Zingales, *supra* note 15, at Table II.

<sup>18</sup> Claessens, Djankov, Fan & Lang, *supra* note 13.

Finally, the link between the level of private benefits extraction and the quality of law appears from the results of another empirical strategy. A recent study of large publicly traded companies in South Korea, a jurisdiction characterized by a controlling shareholder system, tracked the impact of a legal reform that mandated a majority of independent directors; i.e., the reform added a component of good law. Controlling for measures of productivity and all other governance characteristics, Black, Jang and Kim find that large firms with 50 percent outside directors, required by a recent change in South Korean law, experienced a 40 percent increase in stock price.<sup>19</sup> Of particular significance, the increase in stock price did not result from increased firm productivity; companies did not become more productive because of a majority of independent directors. Rather, the presence of a majority of outside directors caused the market to value more highly the company's existing cash flow. The authors interpret their results as showing the importance of outside directors – i.e. good law -- in controlling private benefit extraction by controlling shareholders: "The most likely reason why outside directors add value is that they may control self-dealing by controlling shareholders."<sup>20</sup>

In short, then, the controlling shareholder tradeoff framework implies a different relationship between the quality of law and controlling shareholder regimes. Good law supports efficient controlling shareholder systems; bad law supports inefficient controlling shareholder systems.

### **III. Governance Implications of Distinguishing Between Inefficient and Efficient Controlling Shareholder Systems**

The distinction between inefficient and efficient controlling shareholder systems has implications for the design of corporate governance systems. In an efficient controlling shareholder system, concentration of control operates as a cost effective response to the managerial agency cost problem. It is observed when the benefits of more focused monitoring exceed the limited extraction of private benefits of control allowed in a country with good law. This represents a form of functional convergence – within limits, different corporate governance systems may solve the same monitoring problem through different institutions.<sup>21</sup>

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<sup>19</sup> See Bernard S. Black, Hasung Jang & Woonchan Kim, Does Corporate Governance Predict Firms' Market Value? Evidence from Korea (July 2003), Stanford Law & Economics Working Paper No. 237, <http://ssrn.com/abstracts=311275>.

<sup>20</sup> *Id.* at 48. Making the same point a little differently, the authors state: "We do not find strong evidence that better governed firms are more profitable or pay higher dividends. We do find that investors value the same earnings or the same dividends more highly for better governed firms." *Id.* at 6. A similar result emerges in a recent study of market valuation of research and development investments in Europe. Hall and Oriani report that research and development investments by publicly traded Italian firms are not as highly valued by the market as similar investments by German and French firms. The authors attribute the difference to the potential for Italian controlling shareholders to appropriate the returns on the research and development investments. The authors report that they "found a positive relationship between R&D and market value only after controlling for the eventual control by the major shareholder." Bronwyn H. Hall & Raffaele Oriani, Does the Market Value R&D Investment by European Firms: Evidence from a Panel of Manufacturing Firms in France, Germany, and Italy 24 (working paper, 2004).

<sup>21</sup> See Ronald J. Gilson, Globalizing Corporate Governance: Convergence of Form or Function, 49 *Am. J. Comp. L.* 329, 332-33 (2001); Ronald J. Gilson, Corporate Governance and Economic Efficiency, 74



One significant implication of distinguishing between inefficient and efficient controlling shareholder systems concerns the extent of diversity of shareholdings within each type of system. We can expect diversity – different firm level ownership patterns – within a single efficient controlling shareholder system. Put simply, the distribution of shareholdings in a particular corporation should be driven by considerations of efficiency: As Demsetz argued some time ago, a corporation's organizational structure should be dictated by the nature of its business and competitive conditions in the industry in which it operates.<sup>22</sup> The advantages of a controlling shareholder in a system with good law that minimizes the potential for private benefit extraction depends on the value gain that results from more focused monitoring of management performance than possible only with market-based techniques like independent directors and the market for corporate control.<sup>23</sup> The size of this value gain, in turn, should be sensitive to differences in industry, companies, and controlling shareholders. For example, focused monitoring by a controlling shareholder may have no comparative advantage over market-based monitoring when competition in the product market is sufficiently intense.<sup>24</sup> And so, not surprisingly, in high technology industries characterized by rapid technological change, we may observe companies with widely distributed shareholdings even in an efficient controlling shareholder system. These alternative monitoring techniques – product market competition and technology races – make unnecessary even limited private benefit extraction to pay for more focused monitoring. In contrast, a controlling shareholder may be efficient even in a good law jurisdiction when the capital market is not sufficiently developed to provide the informational efficiency necessary to the external monitoring mechanisms associated with monitoring by widely-held shareholders.

Diversity also may result from differences between particular controlling shareholders with respect to their taste for or skill at focused monitoring, which may tip the balance in a particular company between the continued presence of a controlling shareholder and movement to a widely-held shareholder distribution, so that some diversity of shareholder distribution may exist in an efficient controlling shareholder system even within the same industry. Thus, the controlling shareholder tradeoff framework predicts diversity of ownership structures within an efficient controlling shareholder system. We should see companies with both controlling shareholders and widely-held shares.

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Wash. U.L.Q. 327, 332-33 (1996). For example, the extraction of private benefits of control by a controlling shareholder can be constrained by rules against self-dealing, or by a mandatory bid rule that forces the controlling shareholder to increase its equity ownership. Gilson, *Globalizing Corporate Governance*, at 336-37.

<sup>22</sup> Harold Demsetz, *The Structure of Ownership and Control and the Theory of the Firm*, 26 *J. L. & Econ.* 375 (1983); Harold Demsetz & Kenneth Lane, *The Structure of Corporate Ownership: Causes and Consequences*, 93 *J. Pol. Econ.* 1155 (1985).

<sup>23</sup> The focus on the benefits of monitoring performance rather than merely private benefit extraction distinguishes this discussion from that of Mike Burkhart, Fausto Panunzi & Andrei Shleifer, *Family Firms*, NBER Working Paper 8776 (Feb. 2002), which treats monitoring as extending principally to the consumption of private benefits by a non-owner manager.

<sup>24</sup> For discussion of product market competition as a monitoring mechanism, see Mark Roe, *Rents and Their Corporate Law Consequences*, 53 *Stan. L.Rev.* 1463 (2001); Dyck & Zingales, *supra* note 15.

In contrast, we should see much less diversity of ownership structures within an inefficient controlling shareholder system. As stressed in the Law and Finance literature, the absence of constraints on private benefit extraction by a subsequent acquirer of control prevents an existing controlling shareholder from parting with control. And since here the concern is not monitoring performance, but monitoring self-dealing or tunneling, alternative techniques are far less likely to be available. To be sure, this analysis does not rule out the presence of any widely-held companies in an inefficient controlling shareholder regime. For example, companies that begin as widely-held, perhaps through privatization, may survive especially if formal or informal restrictions on control positions exist. Nonetheless, we would expect there to be less diversity of shareholder distribution in an inefficient controlling shareholder system than in an efficient controlling shareholder system.

The available data appear to support this prediction. Table 2 shows the percentage of widely-held and family controlled public corporations in Sweden, an efficient controlling shareholder system, and in Italy, an inefficient controlling shareholder system. While Sweden has rough parity between publicly traded

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*Table 2*  
*Distribution of Controlling Shareholder and Widely-held*  
*Companies in Sweden and Italy*

	Controlling Shareholder (family)	Widely-held
Sweden	46.94 %	39.18 %
Italy	59.61 %	12.98 %

Source: Mara Faccio & Larry H.P. Lang, The Ultimate Ownership of Western European Corporations Table 3 (working paper,2003)

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companies with controlling shareholder structures and those with widely-held shareholder structures, Italy has close to 5 times more companies with controlling shareholders than companies whose shares are widely-held. A similar result appears in East Asia. As interpreted by the OECD, the data presented by Classens and his co-authors suggests that well in excess of two-thirds of East Asian publicly traded companies have a controlling shareholder; diversity in shareholder distribution is not apparent.<sup>25</sup>

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<sup>25</sup> See note 7 supra.

The absence of diversity in shareholdings in inefficient controlling shareholder systems has a range of implications for the macroeconomic efficiency of these jurisdictions. First, because bad law prevents a company from adopting the most efficient organizational form, it can be expected to be less productive and at a disadvantage in competing with companies from countries whose law supports selection of the most efficient organizational form.

Second, the absence of good law that supports diversity of shareholder distribution makes impossible an important form of market monitoring that has been very effective in good law systems. Originating in the United States, but now prevalent in the U.K. and Europe, private equity investors acquire control of underperforming companies, typically through a leveraged buyout, and then restructure the company's incentive and monitoring systems to improve performance. In the U.S., the vehicle for such leveraged buyouts is commonly a limited partnership, funded in large measure by institutional investors. To assure investors of liquidity, the limited partnership has a ten year term, which makes it very likely that a company whose performance has been improved through a leveraged buyout will go public again within the investor partnership's lifespan. In an inefficient controlling shareholder system, the inability to provide liquidity to investors makes such a transaction pattern at best more difficult and at worst impossible; institutional investors require an exit in order to fund their own obligations. The result is to make an important monitoring cycle unavailable in inefficient controlling shareholder systems.

#### **IV. The Importance and Structure of Good Law: Thoughts About Reform**

The goal of the previous discussion was to make a simple point. The problem is not with controlling shareholder systems. It is with *inefficient* controlling shareholder systems. And it is reasonably easy to identify which systems fall within each category. Given that economic theory persuasively predicts diversity of shareholdings in efficient systems, systems that support only controlling shareholder distributions are likely candidates for law reform to improve minority shareholder protection. The point is not to tilt the balance against controlling shareholders, but to lower the cost of equity capital by making the full range of organizational forms available to the capital market.

The next step is to consider briefly what one might mean by the term "good law." It is easy to exhort jurisdictions to have good law; it is more difficult to provide a road map of what needs to be done. My ambition here is not to provide that road map. The components of effective minority protection have been addressed in a range of governance codes and statements of best practices; in particular, the circumstances of Asian corporate governance have been addressed specifically by the OECD White Paper on Corporate Governance in Asia. Rather, I want to stress a limited number of points dealing with good law in controlling shareholder systems that are highlighted by my analysis and which have not been featured prominently in the existing debate.

For my purposes, good law requires three components: (1) a well framed statement of the standards that make significant pecuniary private benefits of control unlawful; (2) a disclosure process that allows pecuniary private benefits of control to be observed by those who have the power to enforce the legal standard; and (3) the available

public and private enforcement mechanisms available. Evaluating these components, however, requires that we take a rather expansive view of law. I have in mind not just formal legal rules imposed by legislatures and courts, but also soft law – listing requirements and self regulation – that may effectively constrain misbehavior. I also have in mind social structures that are not law, hard or soft, but which support or in some cases substitute for more formal institutions. The role of an effective business press in providing effective disclosure independent of legal requirements is a good example.<sup>26</sup>

As described in the OECD White Paper, the problem in inefficient Asian controlling shareholder regimes is not the formal statement of the standards of behavior that govern controlling shareholders. All systems prohibit self-dealing.<sup>27</sup> Rather, the problems arise in connection with disclosure and enforcement. In many countries, a corporation is not required to disclose transactions with a controlling shareholder or his affiliates, including other companies in a controlled pyramid. Nor is disclosure required concerning the identity of a controlling shareholder's affiliates. In turn, significant gaps remain in enforcement. In some countries, effective shareholder remedies – whether direct or derivative – do not exist. Even when formal remedies do exist, the right incentives to initiate the litigation may not exist, or the court system may not provide prompt and predictable enforcement. Finally, in jurisdictions whose enforcement strategy relies on regulatory activity rather than private litigation, there may be shortages of resources or will.<sup>28</sup> In these circumstances, the constraints on self dealing necessary to support an efficient controlling shareholder regime will not be present regardless of the statement of formal standards.

It is easy enough and plainly correct to counsel that formal laws should make private enforcement more effective, that courts' speed and performance should be improved, and that regulatory resources and commitment should be increased. However, these tasks are neither easy nor quick to implement. For practical purposes – and effective corporate governance is pragmatic, a matter of function not form – reform will also need to be incremental and accretive; overtime, small steps add up to large improvements. What can be done in the meantime?

I offer for consideration a few preliminary thoughts. First, I want to return to the idea of a mandatory majority of independent directors in corporations with a controlling shareholder. The most common response to an emphasis on independent directors in a controlling shareholder regime has been pessimistic: the combination of the fact that the controlling shareholder effectively selects the independent directors and that actively independent directors are said to be inconsistent with Asian corporate culture underlie the claim that independent directors will prove ineffectual at altering self-dealing by the controlling shareholder.<sup>29</sup> However, clear public expectations about the obligations of

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<sup>26</sup> See Dyck & Zingales, *supra* note 15.

<sup>27</sup> OECD White Paper, ¶ 120.

<sup>28</sup> *Id.*

<sup>29</sup> A public debate on this point is said to now exist in SK Corp., a Korean corporation, over pressure by public directors to remove the company's chairman and founder following his completing a seven month criminal sentence for participating in securities fraud at an SK affiliate. An outside director responded to the effort by stating that "'Anglo-Saxon' governance standards disregarded South Korea's corporate culture." Francesco Guerrera & Anna Fifield, *SK Director Hits out at Calls for Reform*, FT, Nov. 12, 2004, p.21.

independent directors coupled with increased transparency concerning their work and conflicts of interest in the corporation's business, might well work a substantial and reasonably prompt change in the corporate governance culture of a jurisdiction that decides to access the international market for external equity capital even in the absence of effective formal enforcement techniques. Korea is a case in point both with respect to the process and the problem. I discussed earlier the positive empirical results associated with Korean reform of its board composition;<sup>30</sup> the fact that the behavior of independent directors has become a matter of current coverage in the *Financial Times*, and that external shareholders have been "putting pressure on management to improve governance and close the 'Korean discount' – the low valuation of domestic companies compared with international rivals"<sup>31</sup> demonstrates that incremental reform can improve the equity contract and, by reducing the "discount," reduce the cost of external equity capital. One may anticipate that this process also will be accretive. A corps of independent directors may itself create a demand for further reform.

To be sure, such improvement cannot happen entirely on its own. As the OECD White Paper stresses,<sup>32</sup> heightened disclosure standards must accompany a requirement of a majority of independent directors. Some patterns of corporate culture simply may not be sustainable when they are subject to review and comment by the international business press. Making public self-dealing that is brought to the board can facilitate the public response that serves as an important enforcement process even without effective formal enforcement techniques.

Additionally, an emphasis on the role of independent directors, especially if it leans against previous patterns, will benefit greatly from the kinds of director education recommended in the OECD White Paper.<sup>33</sup> A requirement, perhaps imposed through the listing requirements of national stock exchanges, that independent directors attend educational sessions offered by leading universities would help to give independent directors the skills necessary to their office and to socialize a clear understanding of the independent directors' role in a company with a controlling shareholder.

The point is that with only minimal formal reform, independent outside directors can serve to reduce private benefits of control even in a formally inefficient controlling shareholder jurisdiction, a kind of incremental, accretive strategy that can operate while more far reaching reform is pending and may even prove to be accretive by increasing the likelihood of such reform occurring.

A second incremental approach to restricting the extent of private benefits of control in an inefficient controlling shareholder regime while more far reaching reform is implemented is structural. Extracting significant private benefits requires a mechanism to transfer large amounts of funds. Short of pure theft, this is typically accomplished through transfer pricing schemes in dealings with affiliates of the controlling shareholder – the terms of trade are skewed in favor of the affiliates. Because policing transfer pricing is a difficult even for the tax authorities of leading industrial countries, the better strategy may be simply to prohibit certain kinds of interested transactions, as

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<sup>30</sup> See text at note 19 *supra*.

<sup>31</sup> Guerrero & Fifield, *supra* note 29.

<sup>32</sup> OECD White Paper ¶¶112-116.

<sup>33</sup> OECD White Paper ¶¶275-289.

recommended by the OECD White Paper.<sup>34</sup> For example, pyramidal organization presents a special problem; empirical studies show that the level of private benefits of control increases in the difference between the controlling shareholders' percentage control and its equity holding.<sup>35</sup> While it is plausible that transfer pricing and investment allocations can be policed in a country with effective public and private enforcement techniques, in the period before the development of those institutions prohibition may be a necessary first stage.<sup>36</sup>

In short, a requirement of a majority of independent directors, coupled with disclosure rules and efforts to shape the directors perception of their job to correspond to international standards, may have a significant effect on limiting private benefits of control even before formal enforcement rules can sustain that burden themselves. Prohibitions of transactions that are particularly susceptible to abuse may have the same effect. Incremental and accretive corporate governance strategies thus can play an important role in improving capital markets during the critical period when formal institutions are developing the capacity to deal directly with excessive private benefits of control.

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<sup>34</sup> OECD White Paper ¶134.

<sup>35</sup> See Classens, Djankov & Lang, *supra* note 7.

<sup>36</sup> For example, U.S. corporate law prohibited any interested transactions in the early years of U.S. corporate law. The prohibition later gave way to judicial review for fairness as the passage of time allowed for the improvement of enforcement techniques. See Harold Marsh, *Are Directors Trustees?*, 22 *Bus. Law.* 35 (1966).