Puzzles in Controlling Shareholder Regimes and China: Shareholder Primacy and (Quasi) Monopoly

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Abstract

Professor Mark Roe explained that the shareholder wealth maximization norm (“the norm”) is not fit for a country with a (quasi) monopoly, because the norm encourages managers to maximize monopoly rents, to the detriment of the national economy. This Article provides new findings and counter-intuitive arguments as to the tension created by the norm and (quasi) monopoly by exploring three key corporate governance concepts that Roe did not examine—(1) “controlling minority structure” (CMS), where dominant shareholders hold a fractional ownership in their controlled-corporations, (2) “tunneling” (i.e., illicit transfer of corporate wealth to controlling shareholders), and (3) Chinese state-owned enterprises (SOEs).

First, given (quasi) monopoly, this Article considers the impact of CMS. CMS controllers, due to their fractional economic interests (e.g., 5% ownership), do not have a strong incentive to vigorously follow the norm. Their incentive is further weakened, as CMS controllers’ percentage of shareholding is lowered and/or there are other compensating sources for CMS controllers to attain pecuniary/non-pecuniary benefits. When the norm is not actively sought, public shareholders lose the opportunity to gain the maximum level of monopoly profits. A positive byproduct, however, is that the welfare of a nation is improved, since non-maximized monopoly profits do not hurt society and consumers to the fullest extent.

Second, given CMS and (quasi) monopoly, this Article analyzes the impact of tunneling. Since tunneling provides more cash flows—including illicit cash flows—to CMS controllers, it strengthens their incentive to maximize shareholder wealth. The direct effect of tunneling to public shareholders is, by definition, negative. Counter-intuitively, however, tunneling is indirectly beneficial—to some extent—to public shareholders, due to CMS controllers’ reinforced incentive to increase profits. Thus, the net effect of tunneling on public shareholders is mixed. In regard to the welfare of society in (quasi) monopoly CMS, tunneling is affected in a negative way, since it encourages CMS controllers to pursue monopoly rents in a more aggressive manner.

Third, this Article calls into question the effectiveness of the norm in a context of Chinese SOEs that do their business in domestic markets. Formally, the controlling shareholder of Chinese SOEs is the party-state. The party-state is, however, an agent of Chinese citizens, who are the ultimate shareholders (and consumers). Given (quasi) monopoly of SOEs, if the norm is imported to China, the norm will encourage SOE managers to set a monopoly-profit maximizing price in domestic markets. Such a pricing is beneficial to Chinese citizens as the ultimate shareholders. The pricing, however, damages Chinese citizens as consumers. The combined effect of the norm on ultimate shareholders—i.e., Chinese citizens—is a net loss, since a significant amount of welfare in society will disappear in the form of a dead-weight loss (DWL) in the national economy. Due to the negative
effect of the norm in China, stock options—an arrangement designed to encourage the norm—might bring undesirable consequences.

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I. INTRODUCTION

Industrial organization and corporate governance are two significant topics when corporations pursue business goals, make strategic decisions, and deal with internal affairs. Academics—both economists and legal scholars—and policy-makers tend to treat these two fields independently, except in a few cases, such as in certain M&As, which simultaneously bring issues associated with monopoly regulation and investor protection.

Generally, (quasi) monopoly—monopoly with the sole supplier\(^1\) and oligopoly, where a small number of market players wield a high level of price-setting power\(^2\)—is deemed detrimental to society. Most jurisdictions impose regulations on (quasi) monopoly via antitrust laws, competition laws, and laws against large business entities.\(^3\) A primary rationale of economics to regulate an imperfect competition market is that a (quasi) monopolist charges a higher price, while supplying a smaller quantity of a good/service than it would in a competitive market: some of the economic surplus is transferred from consumers to the monopolist;\(^4\) in addition, “monopoly produces a net loss for society,”\(^5\) namely, a deadweight loss (DWL). Aside from the efficiency loss, a variety of fairness problems will emerge, causing a great number of socio-political controversies.\(^6\)

Meanwhile, mainstream corporate governance scholarship, as exemplified by *Dodge v. Ford Motor Co.*, articulates that the primary goal of a corporation is to maximize shareholders’ wealth,\(^7\) which is usually expressed

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\(^1\) ROBERT B. COOTER JR. & THOMAS ULEN, LAW AND ECONOMICS 29 (Int’l ed., 6th ed. 2014) (“In a monopoly there is only one supplier; so, that firm and the industry are identical.”). Some scholars, practitioners, and policy-makers defend certain patterns and types of monopolies, such as natural monopolies and monopolies that enhance innovation. See, e.g., ROBERT S. PINDYCK & DANIEL L. RUBINFELD, MICROECONOMICS 388 (Global ed., 8th ed. 2015) (explaining a natural monopoly). Such topics of monopoly, though they are important, are beyond the scope of this Article. For the more explanation of economies of scale and a natural monopoly, see infra Part II.B.2.

\(^2\) In general, oligopoly is defined as “a market structure in which a small number of inter-dependent firms compete.” R. GLENN HUBBARD & ANTHONY PATRICK O’BRIEN, MICROECONOMICS 432 (3rd. ed. 2010). In this Article, oligopoly is narrowly defined as a market, where a few market players exercise dominant market power in terms of setting a price and/or the level of quantity. If a small number of suppliers fiercely compete in a market without dominant market power, such a market structure does not constitute oligopoly in this Article. In other words, when defining oligopoly, this Article focuses on individual corporations’ market power rather than simply the number of corporations in a specific market. See also infra Part II.B.


\(^4\) PAUL KRUGMAN & ROBIN WELLS, MICROECONOMICS 371 (2nd ed. 2009).

\(^5\) Id.

\(^6\) For a further explanation, see infra Part II.B.1.

as share price. This view is also supported by a Nobel laureate in economics, Milton Friedman, in his famous essay of *The Social Responsibility of Business Is to Increase Its Profits*. As the world economy has integrated, shareholder wealth maximization—in tandem with the shareholder primacy norm—has been gradually accepted as the global standard.

Professor Mark Roe at Harvard Law School, however, called into fundamental question the validity of shareholder primacy: “In nations where product markets are not strongly competitive, a strong shareholder primacy norm fits less comfortably with national wealth maximization than elsewhere because, where competition is weak, shareholder primacy induces managers to cut production and raise price more than they otherwise would.” By analyzing potentially conflicting features of shareholder primacy in a given industrial organization, Roe pioneered uncharted territory of corporate governance. Perhaps, while the shareholder wealth maximization norm is a better standard for the United States, where markets are relatively more competitive, it might not be “the global standard” particularly in developing countries with imperfect competition market tainted by monopolistic features.

Despite its huge contribution, Roe’s insightful research did not examine some key factors. Traditionally, policy-makers and corporate governance scholars have criticized institutional features in emerging markets, such as “controlling minority structure” (CMS) (i.e., the ownership, in which dominant shareholders hold a small percentage of ownership) and “tunneling” (i.e., illicit wealth transfer from a corporation to its controlling

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9 Some corporate law scholars explain that the concept of “shareholder wealth maximization” is a subset of the broadly defined concept of “shareholder primacy.” See, e.g., Stephen M. Bainbridge, *Director v. Shareholder Primacy in the Convergence Debate*, 16 TRANSNAT’L L. 45, 45-46 (2002) (“The term shareholder primacy typically connotes two distinct principles: (1) [t]he shareholder wealth maximization norm . . . [and] (2) [t]he principle of ultimate shareholder control.”). In this Article, however, the term “shareholder primacy” is narrowly defined, so that it is used interchangeably with “shareholder wealth maximization” (thus, “shareholder primacy” has nothing to do with the concept of “the principle of ultimate shareholder control”).


11 In CMS, for example, a controlling shareholder holding a 5% economic interest in a corporation can wield 51% of the voting rights. See generally Lucian A. Bebchuk et al., *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, in CONCENTRATED CORPORATE OWNERSHIP (Randall K. Morck ed., 2000), available at http://www.nber.org/chapters/c9013.pdf (explaining CMS, voting leverage devices, and agency problems of CMS); see also infra Part III.A.1 (providing a further explanation of CMS).
Also, state-owned enterprises (SOEs) in China have been considered badly inefficient, due to their low profitability. In the analytical framework of shareholder wealth maximization and (quasi) monopoly, examining Roe’s missing factors—such as CMS, tunneling, and Chinese SOEs—produces new implications in the interplay between corporate governance and industrial organization.

Recognizing the significance and complicated functions of CMS, tunneling, and Chinese SOEs, this Article explores further research questions: (1) Given (quasi) monopoly, how does CMS affect shareholder wealth maximization, investor protection, and the welfare of society?; (2) Given (quasi) monopoly and CMS, how does tunneling affect shareholder wealth maximization, investor protection, and the welfare of society?; and (3) Given the (quasi) monopolistic market power of Chinese SOEs, isn’t there a sufficient chance that the shareholder wealth maximization norm will actually lower benefits to the (ultimate) shareholders of Chinese SOEs? To these questions, as follows, this Article provides new and novel ideas and findings, some of which are counter-intuitive and contrary to the belief of the extant corporate governance scholarship.

In a country with (quasi) monopoly, as a CMS controller’s percentage of ownership decreases, ceteris paribus, three outcomes will arise (note that tunneling is not considered yet). First, the controller will have a weaker incentive to strictly follow the profit maximization norm. The weaker incentive occurs because economic interests—between a controller and the monopolist corporation—are less aligned. Second, as a result, public investors’ economic interests are likely to be damaged, since the aberration of monopoly profit maximization lowers the price. Third, however, it is likely that the total efficiency of an economy, as well as consumer surplus, will be enhanced, as the controller deviates from profit maximization for public shareholders. Note that shareholder wealth maximization is—in (quasi) monopoly—meant to be monopoly rent maximization. In essence, in terms of the level of welfare, the “square of a bad” (or, “Bad²”)—the situation where a bad ownership structure

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13 For a further analysis of this question, see infra Part III.A and B.
14 For a further analysis of this question, see infra Part III.C.
15 For a further analysis of this question, see infra Part IV.
16 See infra Part III.A and B (explaining potential outcomes of the CMS controllers’ weak incentive to follow the shareholder wealth maximization norm).
of CMS and a bad industrial organization of (quasi) monopoly are combined— is socially desirable. Due to the feature of utilizing other people’s money, CMS is also attractive to controlling family shareholders in China. Since markets in China are less competitive, the foregoing discussion—based on the combination of CMS and (quasi) monopoly—provides similar implications in the Chinese context.

When a CMS controller does not actively pursue monopoly profit maximization, all shareholders, including the controller, bear the “opportunity cost” of losing some monopoly profits that could have belonged to the shareholders. By the definition of CMS, the controller’s opportunity cost is fractional. Thus, when a CMS controller finds it personally more desirable not to seek shareholder wealth maximization, the controller is willing to assume this fractional opportunity cost. For instance, by supplying more quantity of a good/service, a CMS controller can enlarge the size of a monopoly corporation. In the form of an opportunity cost, the controller will lose some monopoly profits on a pro-rata basis. On the other hand, the controller may absorb benefits from the enlargement almost solely for her/him, since the size of a business often reflects the power of the controller, in politics as well as in a business circle. Alternatively, a CMS controller sometimes makes a personal creed into corporate policy. To illustrate, Jack Ma pledged that the goal of Alibaba was to make consumers and employees better off, which is reminiscent of Henry Ford’s philanthropy in Dodge. In the case of a CMS, while all shareholders—including the CMS controllers—bear the opportunity cost, the CMS controllers are the only ones psychologically compensated, when their own belief is realized in the corporation’s policy. In addition, their reputation—rather than the entire shareholders’—is enhanced, resulting in benefits to their future career.

Now, consider the effects of a CMS controller’s tunneling, based on a certain jurisdiction’s market structures of (quasi) monopoly and CMS. This situation is described as the “cube of a bad” (or “Bad³”), since

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17 See infra Part III.A.2.
18 Despite the positive effects of the “square of a bad,” however, other problems of (quasi) monopoly and CMS may persist. See infra Part III.D.
20 See infra Part III.B.2 (explaining Jack Ma’s CMS and his policy of “customer first, employees second, shareholders third”).
another bad feature (i.e., tunneling) is added on top of the “square of a bad.” In this situation, as the level of tunneling is higher, ceteris paribus, three outcomes will arise. First, ironically, a CMS controller will have a stronger incentive to pursue the profit maximization norm. This is because the controller’s economic interests in a corporation are strengthened by attaining additional pecuniary benefits through tunneling. Second, tunneling is—by definition and well known in extant literature—detrimental to public shareholders. On the other hand, however, due to the first outcome, tunneling will be—counter-intuitively—beneficial to public shareholders at least to some extent, since shareholder wealth maximization will be induced by tunneling. As a result, the net effect of tunneling on the welfare of public investors will depend on the relative size of the two opposing effects. Extreme tunneling, however, will take away public investors’ confidence in a corporation, so that, eventually, most of them will not invest in the next stage. Third, the welfare of a nation, as well as the level of consumer surplus, will deteriorate, as a CMS controller’s strengthened incentive to follow shareholder wealth maximization increases monopoly profits and generates larger DWL. Since the quality of corporate governance in China is still low, the aforementioned three outcomes—generated from tunneling, CMS, and (quasi) monopoly—will be likely to apply to controlling family shareholders in China.

Then, in the context of shareholder primacy, let us examine Chinese SOEs, particularly those who do their major businesses in the domestic market. Three implications are noteworthy. First, as opposed to common sense, the shareholder wealth maximization norm—if imported without reforming the established (quasi) monopoly of SOEs—would be counterproductive to China. This is because the norm will encourage the managers of SOEs in the domestic markets to reduce the quantity of a good/service, and to charge a higher price, resulting in more monopoly profits, but at the loss of the welfare of the nation. Second, for the same reasons,
similar unintended (undesirable) consequences will take place, if a stock option arrangement—designed to align the managers’ incentive with shareholder wealth\textsuperscript{25}—is widely adopted in SOEs in domestic markets. A stock option is a vehicle that incentivizes SOE managers to attempt to maximize monopoly rents, ending up with a great deal of DWL.

Third, and more strikingly, in Chinese SOEs supplying goods/services predominantly for domestic consumers, the shareholder wealth maximization norm would also be harmful to the (ultimate) shareholders. Formally, the controlling shareholder of Chinese SOEs is the party-state (or the government). However, the state is a primary agent of the Chinese citizens, who are indeed the “ultimate shareholders.”\textsuperscript{26} Meanwhile, the Chinese citizenry is—roughly speaking—the same as the consumer group of SOEs doing business in the domestic market. At a glance, it seems that a corporate policy based on the shareholder wealth maximization norm will enhance the level of profits in favor of the ultimate shareholders. Such profits are, however, transferred from the consumer group, which for a Chinese SOE is actually the group of ultimate shareholders. Thus, the transfer takes place simply from the right pocket of Chinese citizenry to the left pocket. A more systemic problem is that, during the course of the wealth transfer, a large amount of welfare will disappear in the form of DWL. Consequently, when shareholder wealth maximization applies to Chinese SOEs playing in industries for domestic demand, the level of net worth for ultimate shareholders will be lowered.

This Article is organized as follows. Part II introduces the concepts of (quasi) monopoly and shareholder wealth maximization, Roe’s insight, and the three factors (i.e., CMS, tunneling, and Chinese SOEs) that this Article emphasizes. Part III explores intricately inter-related issues—such as CMS, tunneling, a controller’s weak incentive to follow profit maximization, investor protection, and the welfare of society—in the context of the tension between monopoly and shareholder primacy. Part IV explores the relationship in China among SOEs, the government, and the Chinese citizenry. Subsequently, Part IV explains a potential risk of stock options in China. Part V summarizes and concludes.

\textsuperscript{25} However, there are many criticisms of “pay without performance” in stock option schemes. See, e.g., Lucian A. Bebchuk & Jesse M. Fried, Pay without Performance: Overview of the Issues, 30 J. CORP. L. 647 (2005).

\textsuperscript{26} See, e.g., Donald C. Clarke, Corporate Governance in China: An Overview, 14 CHINA ECON. REV. 494, 499 (explaining the citizenry of China as “the ultimate theoretical principal in the case of state ownership”).
II. TENSION BETWEEN MONOPOLY AND SHAREHOLDER WEALTH MAXIMIZATION

This Part begins with theories on shareholder wealth maximization and monopoly. Subsequently, this Part covers Roe’s insight and missing factors in his article. A fundamental tension between (quasi) monopoly and the shareholder wealth maximization norm will be emphasized.

A. Shareholder Wealth Maximization

According to U.S. corporate governance scholarship, the primary aim of a corporation is to maximize shareholders’ value. “This principle is well-established in U.S. corporate law.”27 Basically, shareholder wealth maximization is rooted in the fundamental belief that corporate agents’ fiduciary duties should be discharged for shareholders, as—for example—Aronson v. Lewis explains.28

1. Shareholder Primacy Norm in the United States

In the United States, the shareholder wealth maximization principle was pronounced in a famous, old case (1919), Dodge v. Ford Motor Company.29 Henry Ford, the majority shareholder of Ford Motor Company—a very lucrative business—retained earnings, lowered prices for consumers, and enhanced the working condition for employees.30 The Dodge brothers, minority shareholders of Ford Motor Company, brought suit and demanded that the company pay more dividends.31 Ford defended his policy of withholding profits inside the company, based on his belief of the corporation as a public good. For instance, he testified that his “ambition” was to make

27 See, e.g., Bainbridge, supra note 9, at 45.
28 Aronson v. Lewis, 473 A.2d 805 (Del. 1984) (citing Loft, Inc. v. Guth, 2 A.2d 225 (Del. Ch. 1938)).
30 See Bainbridge, supra note 29, at 574-75.
31 For the similar summary of Dodge, see, for example, Stout, supra note 29, at 164-65 (providing a further explanation of the case); see also Bainbridge, supra note 29, at 574-75.
employees better off. Also, the Michigan Supreme Court pointed out his altruism for consumers: “[Mr. Ford] thinks the Ford Motor Company . . . has had too large profits, and that, although large profits might be still earned, a sharing of them with the public, by reducing the price of the output of the company, ought to be undertaken.”

Emphasizing that the primary goal of a corporation is to make profits for stockholders, the Court articulated that “[t]he discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.” The Court ruled in favor of the Dodge brothers.

The spirit of shareholder primacy is also well preserved in the current case law in Delaware, the center of modern U.S. corporate law. For instance, Judge Strine explained that “our corporate law (and that of most of our nation) expects that the directors of a solvent firm will cause the firm to undertake economic activities that maximize the value of the firm’s cash flows primarily for the benefit of the residual risk-bearers, the owners of the firm’s equity capital.” (emphasis added). Traditionally, shareholders are considered the “owners” of a corporation. If so, the idea of maximizing net benefits for a corporation’s owners is easily justified. Even if shareholders are not precisely the “owners” of a corporation, the notion of shareholders as “residual claimants” buttresses the principle of shareholder wealth maximization, as seen in Strine’s explanation; the theory posits that shareholder wealth maximization is optimal in a corporation, since other constituencies of a corporation (such as

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33 Id. at 683-84.
34 Id. at 684 (“A business corporation is organized and carried on primarily for the profit of the stockholders.”).
35 Id. at 684.
36 See, e.g., Jonathan R. Macey & Geoffrey P. Miller, Toward an Interest-Group Theory of Delaware Corporate Law, 65 Texas L. Rev. 469, 490 (explaining how the center of the modern U.S. corporate law changed from New Jersey to Delaware).
39 But note that there are commentators who explain that shareholders are not owners of a corporation. See, e.g., Martin Lipton & William Savitt, The Many Myths of Lucian Bebchuk, 93 Va. L. Rev. 733, 754 (2007) (“Shareholders do not ‘own’ corporations. They own securities—shares of stock—which entitle them to very limited electoral rights and the right to share in the financial returns produced by the corporation’s business operations.”); see also Bainbridge, supra note 29, at 551 (introducing a similar view).
employees, suppliers, creditors, and even the government\textsuperscript{40}) already receive their cash flows, before the shareholders do;\textsuperscript{41} as a result, shareholder wealth maximization, as long as it is achieved in a proper manner with fair treatment and protection of other constituencies,\textsuperscript{42} improves Pareto efficiency without hurting the welfare of other constituencies.\textsuperscript{43}

2. \textit{Shareholder Primacy Norm as Potentially “the” Global Standard}

Outside the United States, although corporate law is not fully reformed for the sake of public shareholders’ benefits, many jurisdictions have started to accept the notion of shareholder wealth maximization. For instance, since the Asian financial crisis in 1997, Korea has made a series of corporate law reforms, and the direction of such reforms is consistent with the shareholder primacy norm.\textsuperscript{44} In Korea, shareholder derivative suits have been raised often—though the frequency is less than that of the United States, (perhaps) the most active jurisdiction in the world—since the first derivative case against the Korea First Bank in 1997.\textsuperscript{45} In China, although it did not experience a major financial crisis comparable to the Asian financial crisis in 1997, reforms have been made in

\textsuperscript{40}The government receives cash flows from a corporation in the form of corporate taxes, before shareholders receive cash flows such as dividends, share repurchase, etc.

\textsuperscript{41}Recall that shareholders are residual claimants of a corporation. But note that this argument can be weakened when other constituencies are not properly protected. \textit{See, e.g., Production Resources Group, supra} note 37, at 787 (explaining shareholder wealth maximization based on the assumption that creditors are already protected by contractual agreements, the law of fraudulent conveyance, and federal bankruptcy law).

\textsuperscript{42}\textit{See Roe, supra} note 10, at 2065 (“In the long run, the argument goes, employees and other stakeholders are overall better off with fluid and efficient capital markets, managers need a simple metric to follow, and both wealth and, in the end, fairness are maximized by shareholders being the corporation’s residual beneficiary, with the other claimants getting what they want via contract with the corporation.”).

\textsuperscript{43}\textit{Pindyck \& Rubinfeld, supra} note 1, at 598 (“In a Pareto efficient allocation of goods, no one can be made better off without making someone else worse off.”).

\textsuperscript{44}In addition to voluntary reforms inside Korea, such a significant alteration is partly because of external influence from the international community and creditor institutions. \textit{See, e.g., Hwa-Jin Kim, Living with the IMF: A New Approach to Corporate Governance and Regulation of Financial Institutions in Korea, 17 BERKELEY J. INT’L L. 61, 62 (1999)} (“The process of reform was hastened by the foreign exchange crisis of 1997 and the consequential involvement of the international lending agencies such as the International Monetary Fund (IMF) and the World Bank in the restructuring of Korean industries.”).

\textsuperscript{45}\textit{See, e.g., Bernard Black et al., Shareholder Suits and Outside Director Liability: The Case of Korea, 10 J. KOREAN L. 325 344-45 (2010)} (explaining the Korea First Bank case, the first derivative suit in Korea, which was brought in 1997).
the direction of strengthened protection for shareholders. For instance, the derivative suit system has been gradually developed, and the notion of independent directors has been emphasized in a significant manner.

In addition, shareholder activism—such as hedge funds’ aggressive investment and participation in the decision-making processes in corporations—is encouraged, in line with the shareholder wealth maximization norm. To illustrate, as I write this Article, a corporate governance dispute continues between Elliott Associates, a U.S. hedge fund, and Samsung Group, a large Korean corporate group, to which Samsung Electronics—a globally prestigious smart-phone producer—belongs. Samsung Group proceeded with a merger of Samsung C&T by Cheil Industries, a de facto holding company of the group. Arguably, the main reason for the proposed merger is to strengthen the control of the current controlling shareholder of the Lee family, since Samsung C&T is a large shareholder of Samsung Electronics, the flagship company of the group. After it purchased 7.12% of Samsung C&T’s shares, Elliott became the third largest shareholder of the company. Elliott contended that the proposed deal is “neither fair to nor in the best interests of Samsung C&T’s shareholders.” In response to this criticism, interestingly, Samsung Group also defended the deal based on the shareholder primacy norm, arguing

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47 See, e.g., Ling Zhou, The Independent Director System and Its Legal Transplant into China, 6 J. COMP. L. 262, 263 (2011) (“The ‘independent director’ is a vivid example of legal transplant into China’s post-Mao legal system.”).

48 See, e.g., Alon Brav et al., Hedge Fund Activism, Corporate Governance, and Firm Performance, 63 J. Fin. 1729, 1729 (2008) (finding that “activist hedge funds in the United States propose strategic, operational, and financial remedies and attain success or partial success in two-thirds of the cases [from 2001 to 2006].”).


50 See, e.g., Simon Mundy, Samsung’s Founding Family Strengthens Grip on Group, THE FINANCIAL TIMES (July 17, 2015, 9:15 a.m.) (explaining “Samsung C&T’s 4 per cent stake in Samsung Electronics”).


52 Id. A rumor spread that Samsung prepared the proposed merger as a way sacrificing shareholder wealth, with the sole benefits going to the controlling family of the group. See THE ECONOMIST, supra note 49.
that due to the synergy with Cheil Industry’s business portfolio, eventually the merger will create value for Samsung C&T shareholders.\(^{53}\)

The issue of which party’s argument is more convincing—though it is important and intriguing in the corporate governance scholarship—is beyond the scope of this Article.\(^{54}\) What is emphasized here is that shareholder primacy and shareholder wealth maximization are standards that the arguments of both Elliott and Samsung Group are grounded upon. Indeed, in many countries outside the United States and the United Kingdom, shareholder primacy and shareholder wealth maximization are firmly embedded as the standard to measure the quality of corporate governance.

**B. (Quasi) Monopoly**

Let us set aside the issues of shareholder wealth maximization for awhile, and consider (quasi) monopoly on a stand-alone basis. For the sake of simplicity, take an example of a product market of a good.\(^{55}\) According to microeconomics theory on producer behavior, a corporation—if it is economically rational and attempts to maximize profits—determines the level of output (hereinafter \(Q_{m}\)), where the marginal revenue (hereinafter \(MR\))—namely, the increased revenue from producing one more unit—is equal to the marginal cost (hereinafter \(MC\)) namely, the increased cost of producing one more unit.\(^{56}\)

1. **Maximizing Monopoly Profits, Consumer Surplus, Deadweight Loss, and Welfare of Society**

This general principle of profit maximization (i.e., \(MR = MC\)) also applies to a monopoly corporation, when it rationally tries to maximize monopoly profits\(^{57}\) (see the following Figure 1). At the point where \(MR\)

\(^{53}\) Id.

\(^{54}\) Currently, I conduct further research on this issue in an independent project.

\(^{55}\) Thus, a monopoly in a service market is not considered in this Section.

\(^{56}\) See Pindyck & Rubinfeld, supra note 1, at 292-93; see also Cooter & Ulen, supra note 1, at 27 (“the profit-maximizing output of the firm is shown at the point at which the marginal cost curve, labeled \(MC\), and marginal revenue curve of the firm are equal.”).

\(^{57}\) Pindyck & Rubinfeld, supra note 1, at 367-68 (explaining the output decision of a monopolist which tries to maximize profits).
equals $MC$, the monopolist determines the amount of monopoly-profit-maximizing output ($Qm$) and, based on a demand curve that consumers face, charges the monopoly-profit-maximizing price (hereinafter $Pm$).$^{58}$ $Pm$ is higher than the price determined in a competitive market (hereinafter $Pc$).$^{59}$ For this reason, it is generally explained that a monopolist has the price-setting capacity, while a supplier in a competitive market is merely a price-taker.$^{60}$ $Qm$ is lower than the output level in a competitive market ($Qc$).$^{61}$ in response to a higher price in a monopoly, consumers reduce their consumption.

Although the combination of $Pm$ and $Qm$ is optimal to the monopolist, it lowers the level of consumer surplus. Wealth transfers from the group of consumers to the monopolist (graphically, Rectangle $A$ indicates the transfer in Figure 1). Fairness issues in regard to this wealth transfer—though the issues are more like a socio-political agenda—arise. For instance, “if consumers on average are poorer than producers (more precisely, than the owners of the producers),”$^{62}$ such a transfer will deteriorate the discrepancy between the poor and the wealthy.$^{63}$ From the standpoint of efficiency, such a wealth transfer is also problematic, since DWL, a net loss in an economy, is created in the course of the transfer. Specifically, DWL can be decomposed into two parts: (1) benefits that consumers lose, since they reduce consumption at a higher monopoly price (Triangle $B$ in Figure 1);$^{64}$ (2) potential benefits that monopolist loses, since at the higher monopoly price, it is not able to sell a certain quantity of goods (Triangle $C$ in Figure 1).$^{65}$ As a result, the level of society’s welfare—the total sum of

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$^{58}$ See infra Figure 1.
$^{59}$ “In a competitive market, price equals marginal cost. Monopoly power, on the other hand, implies that price exceeds marginal cost.” PINDYCK & RUBINFELD, supra note 1, at 385. Mathematically, $Pc = MC$ and $Pm > MC$. Thus, $Pm > Pc$.
$^{60}$ Id. at 288 (explaining that “firms in perfectly competitive markets are price takers”). But, note that it does not mean that a monopolist can set any price. Id. at 366. A monopoly company, if it tries to maximize profits, can set a price within the upper limit of $Pm$. It can determine a price level, which is higher than $Pm$. In that case, however, the level of profits will be lower than that at $Pm$, since the effect from a higher price would be outweighed by the opposite effect from the reduced quantity that consumers would consume. See id. Meanwhile, $[Pm – Pc] / Pc$ is referred to as the Lerner Index. ROGER D. BLAIR & DAVID L. KASERMAN, ANTITRUST ECONOMICS 104 (2nd ed. 2009) (explaining the Lerner Index as “[t]he most commonly used measure of monopoly power”). In other words, when the difference between $Pm$ and $Pc$, if it is divided by $Pc$, is large, a monopolist has strong market power.
$^{61}$ BLAIR & KASERMAN, supra note 60, at 37.
$^{62}$ RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 285 (7th ed. 2007).
$^{63}$ This phenomenon also lowers the level of society’s utility. Id. at 285 (“because of declining marginal utility of income, a dollar is worth more to the average consumer than to the average producer . . . even if there is no effect on output and therefore no deadweight loss.”).
$^{64}$ See PINDYCK & RUBINFELD, supra note 1, at 386.
$^{65}$ Id.
consumer surplus and producer surplus—in monopoly is lower than in a competitive market by DWL, namely \( Triangle \ B \) plus \( Triangle \ C \). 66

**Figure 1: Graph of Monopoly**

2. **Other Considerations**

A few points are worth noting further. First, certain patterns of monopoly—such as a monopoly based on economies of scale67 (or scope), or a monopoly that enhances innovation—could be efficient.68 For instance, economies of scale can generate a natural monopoly, “a firm that can produce the entire output of the market at a cost that is lower than what it would be if there were several firms.”69 “[A natural monopoly] is more efficient to let it serve the entire market rather than have several firms compete.”70 This Article, however, does not focus on analyzing such features. Second, oligopoly—when only a few producers exercise dominant market power—would generate similar welfare problems (e.g., DWL), although the price-setting power of oligopolistic companies is less than that of the monopolist.71 Table 1 summarizes the general contours of monopoly, oligopoly, and a competitive market.

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66 Id.
67 See Cooter & Ulen, supra note 1, at 29 (“Economies of scale are a condition of production in which the greater the level of output, the lower the average cost of production.”) (emphasis in the original text).
68 See supra note 1 and accompanying text.
69 Pindyck & Rubinfeld, supra note 1, at 388.
70 Id.
71 Under these circumstances, an oligopoly price is generally higher than a competitive market price, but is lower than a monopoly price. Also, in general, the level of output available in oligopoly is generally higher than that in monopoly, but is
Third, oligopoly—if it is defined by a number of existing competitors—is also the most common market structure in the United States. It can be said, however, that the structure of U.S. oligopolies—for example, the markets for automobiles or smart phones—are markedly different from that of other countries: the entry barriers of U.S. markets are low, so that the U.S. product markets are quite open to domestic and foreign companies; accordingly, the extent of competition—not only from existing producers, but also from potential competitors ready to enter the U.S. markets—is high; thus, in the United States, the problem associated with exorbitant market power by a few oligopoly corporations is less serious. For these reasons, the narrowly defined oligopoly in this Article—where there are a few established market players and they exercise dominant market power without worrying very much over potential competition—is more likely to be found in less developed countries than in the United States.

**TABLE 1: PRICE AND QUANTITY OF INDUSTRIAL ORGANIZATIONS**

<table>
<thead>
<tr>
<th>Generally,</th>
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<tr>
<td>$P_m &gt; P_o &gt; P_c$</td>
</tr>
<tr>
<td>$Q_m &lt; Q_o &lt; Q_c$</td>
</tr>
<tr>
<td>$W_m &lt; W_o &lt; W_c$</td>
</tr>
</tbody>
</table>

- $P_m$: price that maximizes monopoly profits
- $Q_m$: quantity that maximizes monopoly profits
- $W_m$: welfare under monopoly
- $P_o$: price charged in an oligopoly market
- $Q_o$: quantity produced in an oligopoly market
- $W_o$: welfare under oligopoly
- $P_c$: price charged in a competitive market
- $Q_c$: quantity produced in a competitive market
- $W_c$: welfare under a competitive market

**C. Tension between (Quasi) Monopoly and Shareholder Wealth Maximization**

A corporation’s behavior in monopoly, if it maximizes monopoly profits, would create tension in relation to shareholder wealth maximization. Recently, corporate law scholars, economists, policy-makers, and judiciaries lower than that in a competitive market. An oligopoly price is not always higher than a competitive market price, however, if producers in oligopoly face fierce price competition. Nonetheless, this Article focuses only on oligopoly where established companies exercise significant market power. See supra note 2 and accompanying text.

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72 See supra note 2 and accompanying text.
outside the United States have often emphasized legal reforms based on arguments that take shareholder primacy for granted. When such jurisdictions, particularly developing countries, import the Anglo-American corporate governance ideology, a potential risk that has not been well considered is that the shareholder wealth maximization norm may be incompatible with the country’s underlying legal and market infrastructures.

In this light, Roe’s argument is of significance. In terms of the efficiency of society, Roe pointed out that shareholder primacy—though it is good for individual corporations—would create undesirable consequences. Since Roe compared the United States and Europe, his argument can be understood in the following way: in the United States where product markets were competitive, shareholder wealth maximization would be beneficial to the domestic economy; on the other hand, in Europe, where product markets were less competitive, it is possible that shareholder wealth maximization would not be beneficial to society. Roe’s analysis can be further developed and applied to emerging countries, where (quasi) monopoly is a dominant market structure. It is noteworthy, however, that Roe pointed out a potentially negative effect of shareholder primacy on welfare at a nation’s level. Roe did not refute that shareholder wealth maximization is beneficial to shareholders. In this light, an argument of this Article—explained in Part IV—is novel and intriguing: in China, there is a high chance that the shareholder wealth maximization norm will bring negative impacts on the (ultimate) shareholders, not to mention on the welfare of the nation.

In regard to the clash of the shareholder primacy norm and a (quasi) monopoly regulation, the recent case of Korea Electricity Power Corporation (KEPCO), the monopoly supplier of electricity in Korea, is exemplary. When determining a price, management of KEPCO discusses it with the Korean government, which considers the price of electricity as a factor of macro-economic policy in inflation and the general price level. Conventionally,

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73 See Roe, supra note 10, at 2063.
74 In general, even a market with a small number of competitors in the United States is exposed to the high level of competition. See supra Part II.C.2.
75 See Roe, supra note 10, at 2063; see also supra note 10.
76 In regard to Roe’s analysis, one may argue that as the European market has been further integrated, it is probable that the level of market competition in the United States and the Europe will be converged. The European market is, however, not fully integrated as one unified economy like the United States. The recent debate on possible exit of Greece and the United Kingdom from the Eurozone or the European Union (“Grexit” and “Brexit”) is evidentiary.
77 See infra Part IV.
the price of electricity has been set at a low level. Although KEPCO was discontent with the government’s low pricing policy, the government’s guidelines on pricing usually—though a little modified—prevailed. In 2011, accusing the management of KEPCO of abandoning shareholder wealth by sticking to the government’s policy, a group of minority shareholders brought a derivative suit against the then CEO, Mr. Ssang-su Kim, for damages of approximately 2.4 billion dollars.\footnote{See, e.g., KEPCO CEO Ssang-su Kim Sued for Damages of 2.8 Trillion Won, DONG-A, http://news.donga.com/3/all/20110820/39667624/1 (Aug. 20, 2011, 03:00). KEPCO minority shareholders also brought a related suit against the Korean government for its allegedly wrongful intervention when determining the price of electricity. They lost the case, however. See, e.g., Sang-Hoon Jin, KEPCO Minority Shareholders Lost the 7 Trillion-Won Case against the Government, CHOSUN BIZ, http://biz.chosun.com/site/data/html_dir/2012/10/05/2012100501200.html (Oct. 5, 2012, 11:23).} Eventually, the court opined that such a business practice—after consultation with the government, which was concerned about inflationary pressure—was lawful.\footnote{See Jin, supra note 78.} Although Mr. Kim won, according to reports, he personally had to bear a huge amount of legal cost to defend this case.\footnote{It was expected that his legal expense would be a few million dollars, which would not be covered by the corporation. See DONG-A, supra note 78.} This story indicates that the tension between monopoly/oligopoly regulation and the shareholder primacy norm is not only a potential issue, but an issue that could be realized in corporate litigation. This case gives similar implications to China in the future, if shareholder primacy is aggressively accepted and a derivative suit system is further developed.

D. Further Considerations: Factors Uncovered by Roe

Roe’s argument is insightful. Based on his seminar work, however, there are many important and timely issues that he could have explored further. For example, his analytical framework did not include CMS, where a controlling shareholder holds a minority economic interest in the controlled corporation.\footnote{CMS is one of the most significant factors in analyzing economies dominated by large corporate groups.} This seemingly odd ownership structure is, however, used in many jurisdictions—in either emerging or developed economies. Voting leverage devices—such as stock pyramiding, dual-class equity structures, and cross shareholding—make CMS available.\footnote{See generally, Bebchuk et al., supra note 11.} Due to its peculiar feature of a disproportionate relation between cash flow rights and voting rights,
CMS—when it is combined with (quasi) monopoly—potentially creates interesting phenomena in the context of shareholder wealth maximization. Part III explores the combined effects from CMS, a CMS controller’s incentive, “tunneling, monopoly/oligopoly, and shareholder primacy.

Also, Roe’s original research on shareholder primacy did not cover the Chinese economy—currently the second largest economy in the world—and Chinese SOEs, business entities with market power. A dual-role of Chinese SOEs, as public entities as well as corporations, is another critical topic in the analysis of the tension between (quasi) monopoly and shareholder wealth maximization. In addition to these topics, Part IV provides a series of novel and counter-intuitive explanations in China: the welfare of nation, consumers, and shareholders, and a stock option arrangement are extensively analyzed.

III. CONTROLLING MINORITY STRUCTURE: (QUASI) MONOPOLY, TUNNELING, AND SHAREHOLDER WEALTH MAXIMIZATION

This Part explores CMS economies in the context of (quasi) monopoly and shareholder primacy. Compared to the United States, the industrial organization of CMS-based economies tends to be more monopolistic, with economic power concentrated in large business entities. As discussed, an economically rational monopoly “corporation” is assumed to make a decision in order to maximize monopoly profits. Note, however that a corporation is an imaginary person created by law. Although it is legally assumed that business decisions are made by a “corporation” (monopolist in this Article), the decision-makers are, in reality, corporate insiders, such as a controlling shareholder.

A. Controlling Minority Structure and Shareholder Wealth Maximization

83 See supra note 57 and accompanying text.
84 A similar question, in different circumstances and for a different research question, was raised in another article. See Kang, supra note 22 (analyzing Gilson’s riddles and the pecking order theory).
85 For instance, decision-makers of a corporation in the United States are directors in a board. DEL. CODE ANN., tit. 8, §141(a) (“The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.”).
A CMS controller, by definition, has minority ownership in a corporation (e.g., 5%), while the controller yields a majority of voting rights (e.g., 51%). In CMS, as explained in this Section, a controlling shareholder has a weak incentive to choose the profit maximization point that a traditional microeconomics theory suggests.

1. CMS Controller’s Low Level of Economic Interests

CMS is commonplace in the global economy, and there are many business organizations that rely on CMS in the United States, as well as in Asia and Europe. In 2014, in four largest corporate groups in Korea, controlling shareholders and their families held, on average, 0.9% and 1.2% ownership respectively. In the same year, the internal ownership—including controlling families’ indirect ownership through affiliates as well as their direct ownership—of these corporate groups accounted for 48.3%. As a result, these families effectively exercised control over corporate groups. The Wallenberg family in Sweden is often discussed, due to a huge discrepancy between their economic interests (or cash flow rights) and voting rights: for example, “the Wallenbergs have voting control over ABB [i.e., Sweden’s fourth largest firm by market capitalization], but actually have a cash flow rights stake of only about 5 percent.”

In the United States, “[Mark] Zuckerberg owns 28.4 percent of Facebook, the largest single stake in the company, and he extended his voting power by implementing a dual-class stock structure in 2009.” Due to voting leverage such as “[his] shares with 10 times more voting power than common stock,” however, “[h]is command of the company goes beyond stock—[Zuckerberg] controls 56.9 percent of the voting power.” In China, Alibaba provides a good example of CMS. Before the initial public offering (IPO) in 2014, the largest

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87 Id. (relying on data from Korea Fair Trade Commission). The average internal ownership of the next six largest corporate groups accounted for 59.2%.
88 Randall Morck et al., Corporate Governance, Economic Entrenchment, and Growth, 43 J. Econ. Literature 657, 666-67 (2005) (citing Rafael La Porta et al., Corporate Ownership Around the World, 54 J. Fin. 471 (1999)).
90 Id.
shareholder of Alibaba was a Japanese corporation, Softbank, which owned 34.4%, followed by Yahoo which owned 22.6%. The ownership of Jack Ma was merely 8.9%. Nonetheless, Alibaba’s controlling shareholder was Jack Ma. Irrespective of economic interests, he used a partnership which had the power to nominate a majority of the members of the board. When Alibaba planned to list in a stock exchange, the Hong Kong stock exchange was a primary candidate. The Hong Kong stock exchange, however, would not allow Alibaba’s control device that was functionally equivalent to a one-share-multiple-vote mechanism. Finally, Jack Ma and his partners chose their IPO at the New York Stock Exchange (NYSE), where voting leverage was permitted.

Indeed, CMS is a useful ownership mechanism for controlling shareholders, since they can exercise control over corporations via a small fraction of their direct ownership. In this light, it is expected that controlling family shareholders of large Chinese companies (or corporate groups) will have a stronger incentive to rely on CMS and use voting leverage devices such as stock pyramiding.

2. **Renunciation of Monopoly Profit Maximization: Investors’ Loss and Consumers’ Benefit**

Since a controlling shareholder’s ownership (or cash flow rights) is small in CMS, the controller’s personal economic interest is often not aligned with the corporation. If a CMS controller owns only 5% of ownership of a corporation, without tunneling, the controller is legally entitled to benefit merely 5% of cash flow rights from dividends and market capital appreciation. Apply such a problem within the context of (quasi) monopoly. Although a CMS controller’s economic interests are fractionally associated with the corporation’s

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92 See Hodgson, *supra* note 91; see also SHENZHEN DAILY, *supra* note 91.


94 Basically, shareholders have two types of rights in a corporation, i.e., cash flow rights and voting rights. Cash flow rights are not simply the right to receive dividends. Although dividends are not paid, shareholders can realize their cash flow rights through stock price appreciation. In other words, cash flow rights are any pecuniary benefit that shareholders are entitled to attain on a pro-rata basis. Of course, in a bad-law jurisdiction, a CMS controller expropriates from a corporation (i.e., tunneling), and thus she/he takes more cash flows than her/his legally justified cash flows. As a result, in reality public shareholders are not able to enjoy some of their cash flow rights.
economic interests, monopoly profits are beneficial to a CMS controller as well. In general, thus, a decision to maximize monopoly profits is optimal to a CMS controller. Due to the small percentage of ownership, however, the CMS controller’s incentive to follow strictly the profit maximization strategy for the corporation can be weakened, if there is an internal/external factor derailing an equilibrium of profit maximization.

For instance, when a government drives monopoly regulations such as a price stabilization policy, a CMS (quasi) monopoly corporation—before it challenges the regulation in the media or the judiciary—is likely to voluntarily give up its strategy of monopoly profit maximization. In addition, if a CMS controller is able to gain other types of large, personal benefits (either pecuniary or non-pecuniary), the controller has more reason not to maximize profits for the corporation.95 Also, if a CMS controller has unique characteristics, personal creeds (e.g., a corporation as a means of philanthropy, as seen in Dodge),96 or views, which are incompatible with the maximization of monopoly profits, the controlling shareholder would not actively pursue profits for shareholders.

Other things being equal, a CMS controller’s tendency to deviate from monopoly profit maximization is further reinforced, as a CMS controller’s economic interests in a corporation decrease. In such a deep CMS, a CMS controller is likely to charge a lower price than \( P_m \) (i.e., the monopoly-profit maximizing price) and produce a larger quantity of a good than \( Q_m \) (i.e., the monopoly-profit maximizing quantity of a good produced to maximize monopoly profits). If so, public shareholders’ wealth in the corporation is not optimized.97

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95 Other benefits are either pecuniary or non-pecuniary benefits.
96 See supra Part II.A.1.
97 Most managers in a widely-held corporation in the United States have less economic interests in a corporation than a CMS controller. Then, a related question is: Do managers in a U.S. dispersed-shareholder corporation follow the shareholder primacy norm? To my knowledge, there is no convincing empirical evidence to answer this question. It is plausible, however, that the shareholder wealth maximization principle works at least better in the United States—although it does not work in a perfect manner—than other countries. This is because the United States has many corporate governance mechanisms—again, although they do not perfectly work—that rectify relatively well managers’ attempt to deviate from the shareholder wealth maximization principle. These corporate governance mechanisms include, but are not limited to, business culture to respect the shareholder primacy norm, stock option arrangements, the presence of influential institutional investors, shareholder activism, competitive and sophisticated capital and product markets, a developed disclosure system, relatively effective independent directors, and the presence of relatively active markets for corporate control. For instance, a stock option arrangement can possibly align the interest of top managers with the interest of public shareholders. See, e.g., Roe supra note 10, at 2075 (but also explaining the obstacles of implementing stock options in Europe). On the other hand, it is worthwhile to note that Bebchuk and Fried criticize a typical stock option mechanism in the United States. See generally Bebchuk & Fried, supra note 25. Also, given that the topic of this Article is related to the tension between monopoly/oligopoly, shareholder wealth maximization, and the national welfare (with consumer surplus), one more aspect
Clearly, from the perspective of corporate governance, this is a minus factor. In theory, a CMS controller’s lackluster approach with respect to shareholder primacy could amount to a breach of fiduciary duty, detrimental to shareholders. In reality, however, in most cases, the deferential business judgment rule protects the CMS controller (and managers or directors).\textsuperscript{98} This is because it would be almost impossible for public shareholders to rebut the presumption of reasonable business judgment.\textsuperscript{99} Indeed, \textit{Dodge} is an exceptional case, where a majority shareholder is held liable for a corporation’s “undesirable” dividend policy, which is almost invariably considered to be within a board’s discretion. In \textit{Dodge}, a primary reason for the Court’s ruling against the corporation’s business decision (i.e., a dividend payout policy) is that Henry Ford showed in a bold manner—rather than disguised—his intention to put public welfare (for consumers and employees) before shareholders’ economic interest.\textsuperscript{100} Other than a case of an explicit violation against the fiduciary duty to shareholders, however, there is little chance for a corporate insider to lose in a case. Accordingly, damages of public shareholders would not be recovered. In addition, even if public investors recover damages in rare cases, they are often subject to the so-called circularity problem in derivative suits: a liable corporate insider is insured by director and officer insurance, for which the corporation (and thus, eventually shareholders) pays.\textsuperscript{101}

From the perspective of the efficiency of the entire nation, however, a corporate insider’s aberration from the best interests of the shareholders is a plus factor. If monopoly profits are not maximized, the amount of consumer surplus, which is transferred to a monopoly corporation (and thus, ultimately belongs to shareholders of the corporation), will be lowered. Also, the welfare of society is improved, since the size of DWL will be also lowered. Consider both (quasi) monopoly and CMS on a stand-alone basis: (quasi) monopoly is generally considered an \textit{undesirable} industrial organization, due to the welfare loss; in addition, CMS is generally

\textsuperscript{98} See \textsc{William T. Allen et al., Commentaries and Cases on the Law of Business Organization} 228 (4th ed.) (“The core idea [of the business judgment rule] is universal: Courts should not second-guess good-faith decisions made by independent and disinterested directors.”).

\textsuperscript{99} In this sense, \textit{Dodge} is an exceptional case.

\textsuperscript{100} See supra Part II.A.1.

\textsuperscript{101} See, e.g., Ehud Kamar, \textit{Shareholder Litigation Under Indeterminate Corporate Law}, 66 U. CHI. L. REV. 887, 888 (1999) (“Arguably, there is no utility for shareholders in suing corporate fiduciaries for damages when fiduciaries pay most of these damages using funds provided by shareholders.”).
considered a \textit{problematic} ownership structure, due to a controlling shareholder’s disproportionate decision-making power. When these \textit{two negative} aspects are combined—what I call the “square of a bad” (or, “Bad\(^2\)”)—ironically, a \textit{positive} outcome, in terms of a nation’s welfare, can possibly arise.


In corporate governance scholarship, a theory of a collective action problem is often used to explain a case where non-controlling minority shareholders have difficulties, when challenging corporate insiders in a proxy fight.\(^{102}\) The key factor of the collective action problem is that—from a viewpoint of a non-controlling minority shareholder who challenges in a corporation’s election (and voting)—the costs of the challenge will be concentrated on her/him, while the benefits from the challenge will be shared with other shareholders (i.e., free-riders).\(^{103}\) In contrast to the traditional collective action problem that a \textit{non-controlling minority shareholder} faces in a proxy fight, this Subsection suggests another type of collective action problem that a \textit{CMS controller} faces, in relation to profit maximization in (quasi) monopoly.

(Quasi) monopolistic rents, enlarged by shareholder wealth maximization, are problematic to consumers, government agencies, and the general public. As an ultimate decision-maker of a corporation, thus, it is likely that a CMS controller who maximizes shareholder wealth would be \textit{personally} subject to criticism and/or even (official or unofficial) punishment. If so, on the one hand, the costs—namely, criticism and/or (official or unofficial) punishment arising from the monopoly profit maximization—fall only on the CMS controller. On the other hand, the benefits from maximizing profits in monopoly/oligopoly will be shared with non-controlling public shareholders, who hold the vast majority of the economic interests in the corporation. Again, the CMS controller’s fraction is small, proportional to her/his ownership. Taking into account such concentrated-costs-but-dispersed-benefits, the CMS controller’s incentive to maximize monopoly profits would be weakened.

\(^{102}\) See e.g., ALLEN ET AL., \textit{ supra} note 98, at 371 (explaining the concept of a collective action problem in a context of corporation).

\(^{103}\) See e.g., Bernard S. Black 39 UCLA L. REV. 811, 821 (1992) (“a shareholder proponent bears most of the cost of a proxy campaign, but receives only a pro rata share of the gains from success, while other shareholders can free ride on her efforts.”).
B. Deviation from Shareholder Wealth Maximization

So far, Section A provided general explanations for the lack of a CMS controller’s incentive to maximize monopoly profits. Now, Section B introduces—by means of more concrete accounts and examples—how a CMS controller deviates from shareholder wealth maximization. Specifically, this Section reviews a CMS controller’s preference of the size of a corporation over profitability, and her/his personal creed, which can potentially lower the profitability of a corporation. This analysis also provides a useful foundation to predict the behavior and business decisions of controlling family shareholders in China. As they use CMS more frequently in their large corporate groups, controlling family shareholders in China will pay less attention to shareholder primacy.

1. CMS Controller’s Size Preference

A CMS controller, depending on the cultural values of specific jurisdictions, may be more interested in size maximization than in profit maximization. This is partly because a CMS controller is able to enjoy non-pecuniary benefits from running a large corporation. Ruling in a corporation as king is fun and exciting. Controlling shareholders tend to expand corporate territory as much as possible, like Ghenghis Khan, raising their self-esteem, even if some level of pecuniary benefits is sacrificed. In Korea, the President sometimes has a meeting with business leaders. When they sit, the physical distance between the President and the business leaders generally depends on the asset size or sales of their corporate groups (rather than profitability). Business elites perceive the extent of the convenience to talk and take a photo with the person in power as a measurement of their success. In sum, the size of business (measured by assets or sales) is—at least sometimes—more significant than the level of profitability, since the size provides negotiating and political power.

104 See Ronald J. Gilson, Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy, 119 Harvard L. Rev. 1641, 1664 (2006) (“control of a large company in a small economy may provide a desirable social status for the controlling family”); see George W. Dent, Unprofitable Mergers: Toward a Market-Based Legal Response, 80 NW. U. L. Rev. 777, 781 (“Corporate managers may seek growth of firm size rather than maximization of share price in order to justify better compensation and perquisites, to increase prestige, to expand opportunities for promotion, and, perhaps most importantly, to protect themselves from the discipline of the market.”); see also Kang, supra note 22, at 870-73 (explaining empire-building (i.e., increasing the size of a corporation) and non-pecuniary benefits).

105 See, e.g., Yoon-Joo Lee et al., Next Seats of the President Are Determined by Ranks of the Business Circle, KYUNGHYANG (May 19, 2014, 21:22), http://bizn.khan.co.kr/khan_art_view.html?artid=201405191520161&code=920509&med=khan (explaining that the power of business entities—including banks—is generally measured by the asset size of business entities).
It is significant that while pecuniary benefits from (quasi) monopoly profits accrue to a CMS controller on a pro-rata basis (e.g., 5%), non-pecuniary benefits belong to her/him almost exclusively. Thus, the non-pecuniary benefits from managing a large business enterprise in corporate dictatorship are private benefits that only the CMS controller, despite her/his fractional ownership, can enjoy. In reality, CMS controllers do not choose entirely either the size maximization point or the profit maximization point. Rather, they compromise in between those two poles. In this case, anyhow, the profit maximization strategy is not selected.

In addition, the large size of a corporation provides the corporation with a variety of opportunities. For instance, large corporations, particularly in developing countries where capital markets are not developed, have a comparative advantage in raising capital (either equity or debt), in entering into a new regulatory industry, and in obtaining a “survival insurance” from being “too-large-to-fail.” These benefits are generally shared with—though not necessarily on a pro-rata basis—public shareholders, since benefits often go directly to corporations rather than controlling shareholders.

When a CMS controller pays attention to the size of the corporation and deviates from the pure shareholder wealth maximization norm, the controller decides to increase the quantity of a good produced by a monopoly corporation from $Q_m$ towards $Q_c$ (thus, the final quantity would be $Q$, which is situated between $Q_m$ and $Q_c$). The economic interests of public shareholders will be damaged, as monopoly profits raised by market power shrink. On the other hand, for the same reason, the amount of consumer surplus will be enlarged. The

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106 See, e.g., Kang, supra note 22, at 876 (explaining a controlling shareholder as the beneficiary of non-pecuniary benefits).

107 Id. In an example of “sitting next to the President,” supra note 105 and accompanying text, it can be said that public shareholders indirectly benefit from a controlling shareholder’s attempt to enlarge the size of a business entity. This is because media attention brought to a large business entity could strengthen confidence for the business in both a product market and a capital market.

108 Under the size maximization case, it is known that the quantity of a good is determined where the total revenue (TR) is equal to the total cost (TC). Compare with the profit maximization case, where the quantity of a good is determined where the marginal revenue (MR) is equal to the marginal cost (MC).

109 Many scholars analyze the phenomenon of “too-large-to-fail” in a context of financial institutes and corporations in product markets. See, e.g., Kang, supra note at 880-881 (explaining too-large-to-fail as insurance).

110 As explained earlier, $Q_m$ stands for the quantity produced by a monopoly corporation when it follows monopoly profits maximization. $Q_c$ stands for the quantity produced in a competitive market.

111 It is also useful to analyze this phenomenon based on supra Figure 1.
overall level of welfare for a domestic economy would be enhanced as DWL diminishes.\textsuperscript{112} As discussed in the “square of a bad” (or, “Bad\textsuperscript{2}”),\textsuperscript{113} when a CMS is combined with (quasi) monopoly, the CMS—which is generally associated with a negative connotation—might produce a better consequence for the welfare of a nation than we had thought.\textsuperscript{114}

Of course, it does not say that the “square of a bad” is optimal in absolute terms. Rather, it indicates that the situation is “better than we had thought” in relative terms. Under the “square of a bad,” for instance, the combination of a high level of output and low price will be beneficial to consumers and society. Nonetheless, given the (quasi) monopoly, the quality of a good/service will not be improved, due to the lack of meaningful competition in a market. X-inefficiency\textsuperscript{115} and other problems associated with CMS and monopoly (e.g., business-politics collusion) also should be recognized.\textsuperscript{116} This limited interpretation of the “square of a bad” is useful to examine the current and future markets in China.

2. \textit{Controlling Shareholder’s Personal Creed}

A business tycoon’s personal creed may also negatively affect shareholder wealth maximization. As discussed,\textsuperscript{117} Henry Ford’s philanthropy for the benefit of employees, consumers, and society is exemplary.\textsuperscript{118} Almost a century later, intriguingly, Alibaba’s Jack Ma showed his unique business philosophy, which was

\textsuperscript{112} See id.
\textsuperscript{113} See supra Part III.A.2 (explaining the “square of a bad” (or “Bad\textsuperscript{2}”)).
\textsuperscript{114} Note that this explanation is based on “no-tunneling.” As to a further analysis with tunneling, see infra Part III.C.
\textsuperscript{115} See infra note 151 and accompanying text.
\textsuperscript{116} See infra Part III.D.
\textsuperscript{117} See supra Part II.A.1 (explaining \textit{Dodge}).
\textsuperscript{118} Note, however, that Henry Ford’s decision not to pay a sufficient level of dividends to shareholders (particularly the Dodge brothers) can be also explained by his business strategy rather than his philanthropy. See ALLEN ET AL., supra note 98, at 271 (“In 1913, the Dodge brothers announced that they would stop building cars for Ford, and would design, build, and sell their own car. . . . In 1916, Ford announced that his company would stop paying dividends, in an attempt to cut off the cash flow that fueled his rivals’ business.”).
similar to Henry Ford’s. In his letter to employees before the Alibaba’s initial public offering (IPO) at NYSE, Jack Ma confirmed the principle of “customer first, employee second, shareholder third” in Alibaba:

In a few minutes we will officially file a listing registration statement to the U.S. Securities and Exchange Commission. This means Alibaba is about to enter a new era of challenges. . . . After the listing, we will continue to adhere to the ‘customer first, employee second, shareholder third’ principle. We will always believe that this is the best way to show our respect and protect the interests of all parties when making tough decisions, both in the past and in the future.

A few additional points are worth noting. Most of all, this letter explicitly shows Jack Ma’s belief in “consumer primacy,” as opposed to “shareholder primacy.” Given that Alibaba’s market share is almost 80% of Chinese e-commerce, the message can be read in a way that Alibaba would give up maximizing monopoly profits, which would have eventually belonged to shareholders. In that case, the price that Alibaba charges would be lower than $P_m$. Since Jack Ma’s economic interest in Alibaba was 8.9%, Jack Ma bears—if his fractional ownership is maintained—8.9% of the opportunity cost of lost monopoly profits. This opportunity cost is the price for realizing his personal belief. Although I do not downplay Jack Ma’s sincere philanthropy, given his net-worth of 24.5 billion dollars, keeping his faith in the business that he controls might be more valuable to him than additional pecuniary benefits. This is even reasonable in terms of an economic theory, as long as the

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119 Currently, I consider an independent project in relation to Alibaba and investor protection. This Section’s explanation of Alibaba is from the initial research for this project.


121 Quoted from Jack Ma’s e-mail to Alibaba’s employees. See id.

122 Alternatively, it is possible that the principle of “customer first, employee second, shareholder third” is merely Alibaba’s (or Jack Ma’s) general business slogan to declare their dedication for consumers. If so, the principle does not necessarily hurt the interest of shareholders in Alibaba, since it can be construed that the principle is merely a marketing phrase to attract consumers.


124 See supra note 91 and accompanying text.

125 See, e.g., Alibaba’s Jack Ma Dethroned as China’s Richest by Solar Magnate: Report, REUTERS (Feb. 3, 2015, 5:27 a.m. EST), http://www.reuters.com/article/2015/02/03/us-china-wealth-idUSKBN0L70WA20150203 (explaining that Jack Ma and his family’s wealth).
“marginal utility”\textsuperscript{126} of pecuniary benefits—the additional satisfaction of an additional dollar—is tiny, close to zero, at his astronomical level of wealth.

Sometimes, corporate insiders maintain a business line—which is closely related to their hobbies—as a “pet project.” This type of externalization is detrimental both to shareholders and society. Compared to dissipating resources for a “pet project,” complying with a personal belief for “consumer primacy” in Alibaba, at least from the standpoint of social welfare, seems more desirable. Nonetheless, more than 90% of the opportunity cost, in relation to the renunciation of maximized monopoly profits, will be borne by shareholders other than Jack Ma. In this light, it is theoretically possible that public shareholders—particularly from the United States—may bring a suit against Alibaba and Jack Ma, since in Alibaba, shareholder wealth is a subordinate ideology to the welfare of consumers and employees. If such a suit is indeed brought in the United States, the argument of minority shareholders would be supported by \textit{Dodge} to some extent.\textsuperscript{127}

In contrast, it is apparent that Jack Ma’s personal belief is beneficial to consumers. In addition, by the measurement of the total efficiency in the Chinese economy, this is desirable. With the market dominant power of Alibaba over China’s e-commerce, Alibaba could have charged a price close to $P_m$: but, Alibaba has not, if Jack Ma’s belief has been seriously considered.\textsuperscript{128} Then, even under the monopoly, not much consumer surplus is transferred to the monopolist (i.e., Alibaba), and the size of DWL is not very large. Thus, Jack Ma’s personal belief generates a win-win for Alibaba, consumers, and the Chinese economy in general. Again, the account of the “square of a bad” (or, “Bad\textsuperscript{2}”) holds.\textsuperscript{129}

\begin{itemize}
\item\textsuperscript{126} Marginal utility is “the additional satisfaction or benefit (utility) that a consumer derives from buying an additional unit of a commodity or service.” \textit{See BRITANNICA}, http://global.britannica.com/topic/marginal-utility (last visited Aug. 6, 2015). It is known that marginal utility diminishes. \textit{See KRUGMAN \& WELLS, supra} note 4, at 252 (“each successive clam adds less to total utility than the previous clam.”).
\item\textsuperscript{127} Alibaba may argue that its consumer-friendly policy indicates the dedication of Alibaba for its customers. The logic may continue: such a policy will be, in the long run, beneficial to shareholders. \textit{See also supra} note 122.
\item\textsuperscript{128} It might also be explained that Alibaba, which captures almost 80% of the market share in Chinese e-commerce, is not a firmly established monopolist due to the second largest competitor, Jingdong (JD), which captures most of the rest. If so, Alibaba’s “customer first” policy can be explained by the potential competition in the market, as well as by Jack Ma’s personal creed for customers (and society).
\item\textsuperscript{129} \textit{See supra} Part III.A.2.
\end{itemize}
C. Tunneling and (Quasi) Monopoly Profits

So far, Part III explores a CMS controller’s incentive issues, without considering tunneling. This Section, given (quasi) monopoly, examines the impacts of tunneling on shareholder wealth maximization, and on the welfare of shareholders, consumers, and a nation. In this analysis, three suboptimal aspects are combined: (1) bad industrial organization (i.e., monopoly); (2) bad ownership structure (i.e., CMS); and (3) bad corporate law (i.e., common practice of tunneling). I call such a combination the “cube of a bad” (or “Bad³”). The “cube of a bad” also provides implications for controlling family shareholders of large corporate groups in China, where the quality of corporate governance is low (and thus tunneling is not effectively kept in check).

In regard to the extent of tunneling, three scenarios are considered in the following Subsections; (1) Tunneling of Substantially All of Corporate Assets (e.g., tunneling of additional 85%); (2) Small-Scale Tunneling (e.g., tunneling of additional 3%); (3) Significant (But Not Substantially All) Level of Tunneling (e.g., tunneling of additional 25%). In these scenarios, to illustrate, a hypothetical CMS controller holds 5% of economic interests in a corporation. Since numerical examples of the level of tunneling (85%, 3%, and 25%) are selected merely for the simplicity purpose, a more generalized model can be further developed and suggested.¹³⁰

1. Tunneling of Substantially All of Corporate Assets (e.g., Tunneling of Additional 85%)

Suppose that a CMS controller, holding 5% of economic interests in a corporation, is able to expropriate 85% of corporate value in addition to justified 5% cash flows. Such a drastic plundering may take place in a severely tainted bad-law jurisdiction, either because corporate law in itself is imperfect, or because the enforcement system—although the law-on-the-book is perfect—is ineffective.¹³¹ Under these circumstances, the controller’s personal economic incentive—due to the combined effect of legal and illicit cash flow rights—aligns

¹³⁰ See infra Part III.D.
¹³¹ See, e.g., Ronal J. Gilson, Controlling Family Shareholders in Developing Countries: Anchoring Relational Exchange, 60 Stan. L. Rev. 633, 634 (“The law and finance literature, exemplified by a series of articles by Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, Robert Vishny and others, treats the prevalence of controlling shareholders as the result of bad law.”). However, Gilson explains that some controlling shareholder regimes are good-law countries. Gilson, supra note 104, at 1645 (explaining that Sweden—a controlling shareholder regime—is a good-law country).
almost exactly with that of the corporation, since the controller takes 90% of corporate value. Accordingly, it is highly likely that the controller will pursue monopoly profit maximization. A caveat from the CMS controller's standpoint, however, is that in the next stage, public shareholders of the pillaged corporation would be highly reluctant to invest further, and thus will leave the corporation. For that reason, the game of a CMS controller's harsh tunneling is likely a mere one-shot event with both public shareholders and consumers. A CMS controller, who wishes to remain as a repeat player—such as a controlling family shareholder who intends to stay in a corporation for a long time via inheritance—would not depend on massive tunneling.

Nevertheless, if this scenario occurs, the result will be the worst from both the aspects of shareholder primacy, and the welfare of society: (1) the financial interests of public investors will be severely damaged; (2) due to public shareholders’ distrust in their investment in corporations, further development in a capital market is unlikely; (3) a large amount of consumer surplus will be transferred to a monopoly corporation, where the CMS controller takes 90% of economic interests; and (4) a gigantic amount of DWL would be created.

2. Small-Scale Tunneling (e.g., Tunneling of Additional 3%)

Suppose that a CMS controller with 5% ownership in a monopoly corporation relies on a strategy of small-scale tunneling, taking additional 3% of corporate value on top of her/his justified 5% cash flows. This scenario of modest tunneling by a controlling shareholder is more realistic, repeated-game arrangement in a bad-law jurisdiction, if public investors and a controlling shareholder have a long time horizon. Although the 3%...
level looks low in this scenario, indeed the CMS controller’s extra return (i.e., 3% tunneling) on the initial investment (i.e., 5% cash flow rights) is huge (60%). The CMS controller with small-scale tunneling has still a weak incentive to pursue monopoly profit maximization, since the controller’s total cash flows including illicit ones are merely 8%. It is noteworthy, however, that a CMS controller with small-scale tunneling has a stronger incentive for profit maximization than a CMS controller without tunneling, whose justified cash flow rights account for 5% in a corporation. To some extent, shareholder wealth maximization ironically can be supported by tunneling.

With a CMS controller relying on tunneling, an interesting and contradictory phenomenon emerges in the context of shareholder protection. On the one hand, public shareholders are less protected, since a controller takes the public shareholders’ wealth reserved in a corporation. On the other hand, public shareholders may gain more economic benefits, due to the controller’s relatively stronger incentive to maximize monopoly profits. Thus, the impact of the modest tunneling on shareholder protection is mixed. Subsequently, consider the impact of the modest tunneling on the welfare of society, as compared to a situation with no tunneling: with tunneling—though it is modest—a CMS controller’s incentive to follow monopoly profit maximization is relatively strengthened; thus, the CMS controller will move up price towards $P_m$; as a result, consumers will be worse off and the size of DWL will be larger, ending up with the lowered level of a nation’s welfare.

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135 Note that I do not have in mind any specific controlling family shareholder who relies on 3% tunneling. It is extremely difficult to understand the extent of tunneling, which usually takes place in secretive. 3% is merely a numerical example in this hypothetical case.

136 $3\% \div 5\% = 0.6$ (which is equivalent to 60% return-on-equity). Accordingly, this situation is also attractive to the CMS controller. One may explain that it takes 29 years for a 3% annual extraction to be cumulatively larger than an 85% plundering at once (i.e., $3\% \times 29 = 87\% > 85\%$); due to a long time horizon of a 3% tunneling, a controlling shareholder is likely to choose an 85% tunneling and the example of a 3% tunneling is not practical. This explanation is, however, based on an imprecise assumption that a corporation does not grow for 29 years. Since a corporation grows, a compounding effect of growth should be considered (and thus, a break-even point is not too long like 29 years). Accordingly, the example of a 3% tunneling is feasible.

137 In this hypothetical example, a CMS controller’s legal (or justified) cash flow rights are 5%, while illicit cash flow rights are 3%. Thus, the total cash flows are 8%.

138 It is noteworthy, however, that a CMS controller in this example has only 3% more economic incentives. Accordingly, her/his incentive to follow shareholder primacy will be a little strengthened. As a result, benefits for public shareholders could be limited. Ultimately, how much public shareholders indirectly benefit from a controller’s tunneling is an empirical question.
Examine tunneling in China. Some controlling shareholders expropriate substantially all of corporate assets. For example, “in [2001], Sanjiu Pharma’s largest shareholder extracted US$ 301.9 million, 96% of the listed company’s total equity.”  As time goes by, corporate governance systems in China will be more stabilized and more controlling family shareholders—who intend to stay in their controlled corporations for a long time—will emerge as repeat players. Then, although it is difficult to rule out all tunneling cases in the future, a modest level of extraction will be dominant. If so, this Subsection will provide a useful framework to analyze the interaction of (quasi) monopoly, CMS, and modest tunneling in China.

3. **Significant (But Not Substantially All) Level of Tunneling (e.g., Tunneling of Additional 25%)**

If a CMS controller with 5% ownership in a monopoly corporation takes a significant amount, but not substantially all, of corporate value (e.g., taking 25% of corporate value more, in addition to the justified 5% cash flows), the controller has more incentive to pursue monopoly profit maximization than the controller with tunneling of 3%. As a result, price would increase further towards \( P_m \) and quantity would decrease towards \( Q_m \). Again, the effect on shareholder protection is not straightforward. On the one hand, the size of tunneling is significant, damaging public shareholders. On the other hand, since the CMS controller is likely to arduously pursue monopoly profits, public shareholders are likely to receive a significant portion of monopoly rents from consumers. In other words, public shareholders—although they do not gain such rents on a pro-rata basis—take advantage over consumers. This analysis can also apply to controlling family shareholders in China, if they use CMS in corporate groups and rely on significant (but not substantially all) level of tunneling, given (quasi) monopoly.

In light of this, due to the wealth transfer from consumers to all of the shareholders (public shareholders as well as a controller), it is difficult to label the public shareholders in a bad-law jurisdiction—though their cash

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140 See generally Kang, supra note 134.

141 Note that in this case, public shareholders own 95% of economic interests in the corporation. Also, note that in this case, public shareholders end up with 70% of monopoly rents, since 25% of profits are taken by a controller’s tunneling (i.e., 95% – 25% = 70%).
flow rights are taken by a controlling shareholder—as “unilateral victims.” If monopoly rents are generated due to an unduly high price charged by a monopoly corporation, it can be said that consumers are exploited by the corporation. Even if public investors in the monopoly corporation do not participate in an active manner in such “exploitation,” they still benefit from the wealth transfer. Put differently, public shareholders are on the same ship with the main exploiter, the monopoly corporation (or its controlling shareholder).

One may point out that public shareholders obtain only 70% of monopoly profits while they legally have 95% of cash flow rights in a corporation. The logic may continue: public shareholders lose 25% of economic benefits, and thus they are still victims by any measure. If monopoly profits are “rents” and thus consumers are victims, however, it can be said that public shareholders benefit 70% more, rather than lose 25%. In addition, from the standpoint of consumers, who are the ultimate victims in this case, the internal allocation of exploited resources within an exploiting entity—whether it is 95:5 or 70:30 between public shareholders and a controller—does not matter. As long as consumers lose their welfare, they perceive that public shareholders capture rents to the detriment of consumers, even though public shareholders with 95% ownership receive only 70% of monopoly rents, after tunneling.

4. Comparison of All Scenarios

In Scenario 3 (tunneling of 25%), the controller has a greater incentive to maximize monopoly profits than a CMS controller in Scenario 2 (tunneling of 3%), but a less incentive than a CMS controller in Scenario 1 (tunneling of 85%). Thus, the monopoly price charged in Scenario 3 is likely to be in between the price in Scenario 1 (highest) and that in Scenario 2 (lowest). Recall, however, that the price in Scenario 2 is likely to be higher than in the case where no tunneling takes place at all. Due to a CMS controller’s sufficient incentive to

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142 See Kang, supra note 22, at 894.
143 Sometimes, however, it is likely that public shareholders, as investors of a monopoly corporation, demand actively to charge the price \( P_m \) that maximizes monopoly profits.
144 See supra note 141.
145 \( 95\% - 70\% = 25\% \).
146 Monopoly rents will be distributed by the ratio of 95:5 (public shareholders v. a CMS controlling), if tunneling does not take place at all. However, rents will be distributed by the ratio of 70:30, if tunneling of 25% applies.
approach $Pm$ and $Qm$ in Scenario 3, the welfare of a general economy is damaged with a large amount of DWL:

DWL in Scenario 3 is larger than in Scenario 2, but smaller than in Scenario 1. Table 2 summarizes the three scenarios discussed in this Section.

**TABLE 2: EXTENT OF TUNNELING, MONOPOLY PROFIT MAXIMIZATION, DWL, AND WELFARE OF SOCIETY**

<table>
<thead>
<tr>
<th>CMS Controller’s Incentive to Maximize Monopoly Profits</th>
<th>SCENARIO 1 (TUNNELING OF 85%)</th>
<th>SCENARIO 2 (TUNNELING OF 3%)</th>
<th>SCENARIO 3 (TUNNELING OF 25%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price</td>
<td>Strong</td>
<td>Weak</td>
<td>Semi-Strong</td>
</tr>
<tr>
<td>Quantity</td>
<td>Small Amount</td>
<td>Large Amount</td>
<td>In-between</td>
</tr>
<tr>
<td>DWL</td>
<td>Large</td>
<td>Small</td>
<td>In-between</td>
</tr>
<tr>
<td>Welfare of Society</td>
<td>Worst</td>
<td>Best</td>
<td>In-between</td>
</tr>
</tbody>
</table>

D. **Summary and Other Considerations**

Consider a general, simple model based on variables rather than specific numerical examples. In this model, a CMS controlling shareholder’s cash flow rights (economic interests in a corporation) and the level of tunneling are denoted as “α” and “β,” respectively. For example, when a CMS controller, holding 5% economic interests of a corporation, does not rely on tunneling at all, α is 5% and β is 0%. When the CMS controller takes additional 25% of corporate value, α is 5% and β is 25%.147 A CMS controller’s total economic interests in a corporation—including illicit as well as legal cash flows—are calculated as “α plus β.” Based on this general model, the analysis of Part III can be summarized by two cases: the “case without tunneling” (i.e., β = 0, and thus the situation of good-law) and the “case with tunneling” (i.e., β > 0, and thus the situation of bad-law).

Consider the first “case without tunneling.” Since the value of β is zero, only the value of α matters. Given (quasi) monopoly of a certain jurisdiction, as an average CMS controller’s cash flow rights decrease (i.e., as the value of α becomes smaller), four outcomes are likely. (1) The profit maximization norm is less likely to be pursued, since CMS controllers have a weaker incentive to maximize profits. (2) Accordingly, public minority shareholders are likely to be worse off. (3) It is likely, however, that DWL will be reduced, since corporations move away from monopoly-profit maximizing price and quantity. As a result, the welfare of society will be

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147 See supra Part III.D.3.
improved, compared particularly to a monopoly without a CMS. (4) Also, the welfare of consumers will be enhanced, due to CMS controllers’ lukewarm incentive to maximize monopoly profits.

Due to monopoly (i.e., bad industrial organization) and deep CMS (i.e., bad ownership structure), the first case without tunneling is referred to as the “square of a bad” (or “Bad\(^2\)”). Outcomes (1) and (2)—which are related to investor protection—are easily understandable. In contrast, outcomes (3) and (4)—which are associated with efficiency and the welfare of society—are, to some extent, counter-intuitive. This is because “positive” outcomes—the welfare of consumers and the nation as a whole is enhanced—arise, when two “negatives” are combined. Sections A and B are basically explained based on the first case without tunneling.

Subsequently, examine the second “case with tunneling” where the value of $\beta$ is not zero. Given monopoly in a jurisdiction, as an average CMS controller’s tunneling becomes more serious (as the value of $\beta$ becomes larger), another four outcomes are likely. (1) The profit maximization norm is more likely to be pursued, since CMS controllers’ economic interests align with those of monopoly corporations. (2) The welfare of public shareholders is affected in a mixed manner. On the one hand, due to more serious tunneling (as the value of $\beta$ becomes larger), public shareholders are likely to be worse off. On the other hand, the larger value of $\beta$ provides CMS controllers with stronger incentive to pursue monopoly profit maximization, which ends up yielding more benefits to all of the shareholders. As a result, public shareholders are likely to be better off on a pro-rata basis. (3) DWL is likely to be larger, since the corporation is going to move towards the monopoly-profit maximizing price and quantity. Accordingly, the welfare of a nation would deteriorate. (4) In addition, the level of consumer surplus would worsen, as the price close to $P_m$ is chosen and wealth transfers from consumers to the monopoly corporation.

Due to monopoly (i.e., bad industrial organization), deep CMS (i.e., bad ownership structure), and tunneling (i.e., bad corporate governance), the second case with tunneling is referred to as “cube of a bad” (or “Bad\(^3\)”). In this case, outcomes (1) and (2) are, to some extent, counter-intuitive. In (1), interestingly,

\[ \text{See infra Part III.A.2.} \]
\[ \text{See, e.g., supra Table 2 and accompanying text.} \]
\[ \text{See, e.g., supra Table 2 and accompanying text.} \]
tunneling—despite its negative connotation in terms of investor protection—reinforces a CMS controller’s incentive to follow profit maximization, which is beneficial to public shareholders. As a result, in (2), the damage that tunneling causes to public shareholders will be mitigated by enhanced shareholder wealth maximization.

In sum, when CMS is combined with (quasi) monopoly and/or tunneling, some positive outcomes—
inadvertently—may arise. Nonetheless, it is worth noting that this Article does not disagree with the classic, critical views of (quasi) monopoly, CMS, and tunneling. Indeed, (quasi) monopoly generates many problems. For instance, when a corporation is in a (quasi) monopoly market, it does not have to improve corporate efficiency, due to the lack of competition. Thus, a monopoly corporation’s internal inefficiency, such as “X-inefficiency,” may arise. In addition, when an active market for corporate control does not exist—which is true in many jurisdictions—it is extremely difficult to rectify corporate insiders’ slack in a monopoly corporation. In other words, such a monopolist is subject to virtually no external pressure from M&A and a product market. Also, CMS generally creates bad outcomes in corporate governance. Particularly, when CMS is associated with tunneling, it has a huge negative effect on investor protection. Moreover, it is problematic that CMS controllers—usually, a small number of business tycoons in a jurisdiction—are likely to have political connections with a government, so that they (and their business associations) seek economic rents in an unfair manner.

These problems, however, are well known and already studied closely by economists, corporate law scholars, practitioners, and policy-makers. Thus, this Article—concurring with such general opinions—does not explain redundantly the same points. Rather, this Article focuses on novel findings and analyses, which are mostly uncharted. It is also noteworthy that this Article provides an analytical framework for CMS and/or tunneling, given that (quasi) monopoly is firmly established in a certain jurisdiction, and that it is impractical—at

151 Given the lack of competition, X-inefficiency is measured by “the amount of slack in the system due to individuals’ not minimizing costs or being on their production possibility frontiers.” See Oliver D. Hart, The Market Mechanism as an Incentive Scheme, 14 BELL J. ECON. 366, 366 (1983).


153 Notable examples are Chaebols (large family corporate groups) in Korea and privately owned corporations in China which have been supported by the government due to controlling shareholders’ political connections.
least in the short/medium term—to reform the jurisdiction’s imperfect industrial organization. Under these circumstances, shareholder wealth maximization may result in unintended outcomes.

IV. STATE-OWNED ENTERPRISES IN CHINA: (QUASI) MONOPOLY AND SHAREHOLDER WEALTH MAXIMIZATION

In Part III, this Article explores CMS in relation to (quasi) monopoly, and includes an analysis of tunneling. Part IV examines another topic: a potential tension that shareholder wealth maximization—if it is transplanted—may bring to Chinese economy, where SOEs are the dominant market players in domestic industries. Part IV also provides an unconventional thought on stock option arrangements in Chinese SOEs, particularly for those who supply goods/services for domestic demands.

A. Shareholder Wealth Maximization: Is It Compatible with State-Owned Enterprises in China?

Recently, the significance of Chinese SOEs in the world economy has been pronounced. “More than half of the Chinese companies in the 2012 Fortune Global 500 are SOEs supervised by an organ of the central government.”\textsuperscript{154} In many Chinese domestic markets, SOEs play as (quasi) monopolists with strong market power.\textsuperscript{155} In this respect, it is crucial to analyze this issue: What effects are expected if SOEs in domestic markets pursue the shareholder wealth maximization norm that is widely supported by economists, legal scholars, practitioners, and policy-makers in developed economies?

To answer this question, first consider who the “shareholder(s)” of SOEs is (are) in China. A quick answer is the State-Owned Assets Supervision and Administration Commission of the State Council (SASAC), an


organ of the party-state. “[The SASAC] has been described as ‘the world’s largest controlling shareholder.’”\(^{156}\) It is noteworthy, however, that the state—or, the Chinese government—is the “agent” of the entire people of China.\(^{157}\) In other words, the SASAC resembles Janus, with two-faces, one as the principal (i.e., controlling shareholder) of SOEs and the other as the agent for Chinese citizens.\(^{158}\) In principle, thus, Chinese citizens—as a group—are the “real principal” and the “ultimate shareholders”\(^{159}\) of SOEs. In this respect, in order to maximize the welfare of the ultimate shareholders, it would be—in appearance—rational for SOEs to pursue the monopoly profit maximization strategy, by charging the high monopoly price (i.e., \(Pm\)) and producing the low level of quantity (i.e., \(Qm\)).

In the above analysis, however, one important point is not taken into account. In general, consumers and shareholders are different groups, even if it is possible that a shareholder group constitutes a subset of consumers. Under this general view, a main issue in regard to (quasi) monopoly profits is the wealth transfer from a consumer group to a shareholder group. In a highly imperfect competitive market, while a consumer group is worse off, the shareholder group is better off.\(^{160}\) Under an industrial organization with monopoly/oligopoly, although the shareholder primacy norm would be counterproductive to the welfare of society as a whole, the norm is beneficial, at least, to the shareholder group. In China, however, this general analysis does not hold. In regard to SOEs playing in monopoly/oligopoly, roughly speaking, the consumers are the Chinese citizens, so that they are same as the “ultimate shareholders” of SOEs.\(^{161}\)

Under these circumstances, consider the impacts of the shareholder wealth maximization norm—if it is strictly pursued by Chinese SOE managers—on the welfare of the “ultimate shareholders” in China. The norm

\(^{156}\) See Lin & Milhaupt, \textit{supra} note 154, at 700 (citing Marcos Aguiar et al.).

\(^{157}\) See Clarke, \textit{supra} note 26, at 499.

\(^{158}\) The SASAC is the agent of the party-state, which is the agent of the Chinese citizenry. Thus, it is known that the SASAC is the agent of the agent, ultimately on behalf of the Chinese citizenry.

\(^{159}\) More precisely, Chinese citizens are not formally “shareholders” of SOEs. Instead, the official shareholder of Chinese SOEs is the SASAC. Accordingly, Chinese citizens are indeed “beneficiaries” under the SASAC. Nonetheless, this Article bases its explanations on the notion that Chinese citizens are “ultimate shareholders” of SOEs, since such an analysis is functionally correct and gives, in a more convenient manner, an opportunity to compare with the analysis of CMS economies explained earlier Parts.

\(^{160}\) See Krugman & Wells, \textit{supra} note 4, at 371.

\(^{161}\) Suppose that an SOE is run by a local government, while the SOE provides goods to the entire Chinese citizens. Then, it is possible that “ultimate shareholders” would not be same as “consumers.” This situation is not covered by this Article.
increases the profits of an SOE, for the benefit of the “ultimate shareholders,” namely Chinese citizens. On the other hand, Chinese citizens are also the consumers of a good/service that the SOE provides, so that their welfare is hurt by the monopoly-profit maximization. Technically speaking, a substantial amount of surplus is transferred from consumers to the “ultimate shareholders.” Since two groups—which are conceptually divided—are actually one group, the transfer of resources—if an analogy is used—simply takes place from a person’s right pocket to the left pocket. A critical problem is that, during the course of such a transfer, the size of DWL—visually depicted as Harberger’s triangle—is enlarged. Consequently, the shareholder wealth maximization norm in Chinese SOEs will result in a net loss to the “ultimate shareholders.”

Suppose that “consumer primacy”—rather than shareholder primacy—is pursued as the main policy of SOEs in China. On the one hand, a certain portion of profits—that an SOE could have collected, if the profit maximization strategy had been pursued—for the “ultimate shareholders” would be given up. This part is obviously a loss (or an opportunity cost) to Chinese citizens. On the other hand, as a large consumer group, the Chinese citizenry will benefit from a lower price (which is lower than \( P_m \) and approaches \( P_c \)) and a higher level of a quantity (which is higher than \( Q_m \) and approaches \( Q_c \)). The combined effect is more desirable to the Chinese citizenry. For this reason, given that the current regime of SOEs is firmly established in Chinese market and legal systems—thus, in the short run, impractical to reform on a large scale—it is preferable that the Chinese government (or the party-state) not pursue a policy that is purely in line with the shareholder wealth maximization norm.

As discussed, Roe made an argument that the shareholder wealth maximization norm is not fit for a (quasi) monopoly economy, since it reduces the welfare of a nation.\(^{162}\) I argue that the shareholder wealth maximization norm is not fit for China, since it is actually harmful to the “ultimate shareholders,” not to mention that it risks lowering the welfare of the nation. Table 3 summarizes.

\(^{162}\) See supra note 10, and accompanying text.
### Table 3: Welfare of Ultimate Shareholders of Chinese SOEs When Profits Are Maximized (Analysis Based on Figure 1)

<table>
<thead>
<tr>
<th>Wealth Transfer --- (i)</th>
<th>Benefit/Cost As Shareholders</th>
<th>Benefit/Cost As Consumers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deadweight Loss --- (ii)</td>
<td>+ A</td>
<td>− A</td>
</tr>
<tr>
<td>(i) + (ii)</td>
<td>[+ A − C]</td>
<td>[− A − B]</td>
</tr>
</tbody>
</table>

#### Total Benefit/Cost of Ultimate Shareholders [(iii) + (iv)]

\[
[A − C] + [− A − B] = [− B − C]
\]

- **Notation** (based on *supra* Figure 1 and *supra* Part II.B.1)
  - A: Rectangle A
  - B: Triangle B
  - C: Triangle C
  - +: Benefit
  - −: Cost
- **Shareholder Group = Consumer Group**

Thus, under the shareholder wealth maximization norm in a (quasi) monopoly, the total benefit/cost of ultimate shareholders is: (iii) + (iv) = [A − C] + [− A − B] = [− B − C]. Accordingly, the shareholder wealth maximization norm will result in a net loss to ultimate shareholders in Chinese SOEs.

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**B. Stock Options in China: (Speculative) Skepticism**

In China, stock options are not widely used in SOEs. This is partly because the legal system and the business culture are conservative with regard to stock options and other types of equity-based compensation. Indeed, many corporate governance scholars recommend that China adopt stock options in business associations, including SOEs: for example, “[i]t is essential to improve the compensation mechanism for directors and executives. To help attain this objective, innovative compensation mechanisms, such as stock option programs, might be made available to directors and executives in most SOE-corporatized corporations.” It is probable, however, that a stock option scheme—if it is imported, on a large scale, to managers’ compensation packages in Chinese SOEs—will bring undesirable consequences.

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163 Lin Lin, *Regulating Executive Compensation in China: Problems and Solutions*, 32 J.L. & COM. 207, 225 (2013) (“Chinese law takes a conservative view towards equity incentives. Under PRC Company Law, companies are only allowed to repurchase shares from employees for up to 5% of the issued shares in order to underwrite equity incentives for employees. For state-controlled listed companies that grant equity incentives to executives for the first time, only 1% of the total shares are permitted to issue stock option.”)

Examine a primary rationale for stock options in the context of Chinese SOEs. In advanced economies, “[stock options] were frequently justified on the grounds that they represented ‘pay-for-performance,’ that is, they base an executive’s remuneration on her company’s increase in value.” In other words, by aligning the economic interests of managers and shareholders, stock options are designed to facilitate the shareholder primacy norm. Recall that this Article analyzes SOEs, which have (quasi) monopolistic market power in each domestic industry. When encouraged by newly adopted stock option plans on a large scale, executives of Chinese SOEs are likely to make business decisions to increase monopoly profits. In other words, stock options reinforce the shareholder wealth maximization norm. Then, managers would choose a price and a quantity of a good close to $P_m$ and $Q_m$, where monopoly profits are maximized. As discussed, however, at that price and quantity level, the ultimate shareholders in Chinese SOEs will be worse off. This is because in the course of the wealth transfer from the ultimate shareholders’ right pocket to the left pocket, a huge amount of DWL—in (quasi) monopoly where SOEs play—is gone as a loss of efficiency from the national economy.

Indeed, this Article’s speculation of effects by a typical stock option mechanism in China is merely in a preliminary stage. Nonetheless, it is critical that there is a high chance that stock options in China will have inherently different problems than those in the United States, due to China’s idiosyncratic features of markets, ownership, and ultimate shareholders. Currently, I am starting to conduct another independent research project to explore corporate compensation practices in China, and the impacts of performance-based compensation arrangements such as stock options. Crucial research questions that are worth further exploration are: (1) If a wide-range of stock options on a large scale is not a solution, how can we rectify inefficiency problems of Chinese SOEs, not to mention corruption issues?; (2) Given the fact that managers in Chinese SOEs share features of both business people and government officers, what is a proper standard to measure the performance of these managers?


166 See supra note 24 and accompanying text.

167 See supra Part IV.A.
V. CONCLUDING REMARKS

Roe raised a significant and fundamental question of whether the shareholder wealth maximization norm is fit, as the global corporate governance standard, in countries dominated by (quasi) monopolies. Despite his huge contribution in this uncharted territory of the intersection between industrial organization and corporate governance, Roe did not cover, in his analytical framework, important issues such as CMS, tunneling, and the application of shareholder primacy to the Chinese economy and SOEs. Based on Roe’s missing points, this Article explores further the question, in a complicated analytical framework, of monopoly/oligopoly, investor protection, tunneling, and the welfare of a nation. Particularly, (quasi) monopoly in a CMS economy, and in China, is examined in more depth, in line with corporate governance issues such as the deviation from the shareholder wealth maximization and tunneling.168

When a CMS controller’s economic interests in a (quasi) monopoly corporation account for only a small fraction (i.e., a deep CMS), the CMS controller has a weak incentive to follow the profit maximization norm. Under these circumstances, in general, it is expected that, while public shareholders would be damaged due to the deviation from the maximized-profit point, consumers and the national economy as a whole would be inadvertently—perhaps without the CMS controller’s bona fide intent—benefited, compared to a case where the shareholder primacy norm is pursued in a strict manner.169 The lower a CMS controller’s ownership in a corporation is, the weaker the incentive to comply with shareholder wealth maximization.

Another issue, tunneling, is detrimental to public shareholders by definition. An interesting byproduct of tunneling in a (quasi) monopoly CMS corporation is that a CMS controller, ceteris paribus, has an additional incentive to consider the profit maximization strategy (due to a higher level of the CMS controller’s economic interests in the corporation), which would be potentially beneficial to public shareholders. Of course, if the negative impact of tunneling on public shareholders overwhelms the positive one, public shareholders would end

168 See supra Part III and Part IV.
169 Compare this inadvertently positive effect on the national economy with Jack Ma’s bona-fide policy of “customer first, employee second, shareholder third,” supra notes 120-121 accompanying text.
up with welfare loss. Nonetheless, the point is that commentators should recognize—at least at a conceptual level—the potentially positive corporate governance feature of tunneling. In addition, given CMS, tunneling of substantially all corporate assets is the worst scenario in terms of industrial organization, corporate governance (investor protection), and the welfare of society.170

Regarding SOEs in China, given legal and market institutions in China which are not easily reformed, the shareholder wealth maximization norm, if it is strictly transplanted, would create unintended negative effects to the economy. Specifically, the norm—which is intended to protect shareholders and make them better off—will, ironically, lower the welfare level of the ultimate shareholders in Chinese SOEs, not to mention the larger monopoly rents’ detrimental effects on the national economy.171 In addition, if stock option plans are widely adopted in Chinese SOEs on a large scale, it would also lead to an unexpected negative consequence to the macro-economy of China.172

170 See supra Part III.C.1.
171 See supra Part IV.A.
172 See supra Part IV.C.