Re-envisioning the Controlling Shareholder Regime: Why Controlling Shareholders and Minority Shareholders Embrace Each Other

Sang Yop Kang

Available at: https://works.bepress.com/sangyop_kang/4/
RE-ENVISIONING THE CONTROLLING SHAREHOLDER REGIME:
WHY CONTROLLING SHAREHOLDERS AND MINORITY SHAREHOLDERS EMBRACE EACH OTHER

Sang Yop Kang

Assistant Professor, Peking University School of Transnational Law
JSD (Doctor of Science of Law), Columbia University
Attorney at Law
CFA (Chartered Financial Analyst)

This Article is based on a chapter of J.S.D. dissertation submitted to Columbia University School of Law. Most of all, I thank my mentors at Columbia Law School—Professors Merritt Fox, Jeffrey Gordon, Curtis Milhaupt, and Katharina Pistor—for their valuable comments and advice. It was my great pleasure and honor to conduct research with these distinguished corporate law scholars. I thank Professor Ronald Gilson at Stanford and Columbia Law School for the motive of this Article and his encouragement. I started this project in order to solve a corporate governance conundrum in developing countries that Professor Gilson raised (i.e., “Gilson’ riddle”). I also thank Professor Jessie Fried at Harvard Law School for his extensive discussion, comments, and questions. I am grateful to Professor Mark Roe at Harvard Law School for his interest in an earlier version of this Article. He kindly supported me. I also thank Chancellor Jeffrey Lehman at New York University Shanghai and Professors Francis Snyder and Douglas Levene at Peking University School of Transnational Law for their great comments and advice. My thanks go to participants of a workshop at Peking University School of Transnational Law. In addition, I thank Chancellor Wen Hai at Peking University in Shenzhen, Dean Stephen Yandle and other faculty members at Peking University School of Transnational Law, Professors Bok Ki Hong, Sung Tae Kim, Hyun Yoon Shin, and Doctor Nansulhun Choi at Yonsei University School of Law, and Judge Sang-Koo Park for their advice and moral support. Last but not least, I thank my parents, brother, and wife who endlessly sacrifice themselves to support me.
ABSTRACT

According to conventional corporate governance scholarship, controlling shareholder regimes exist in jurisdictions where minority shareholders are not well protected by controlling shareholders’ expropriation. However, Professor Ronald Gilson raises a critical point against the conventional view; if laws are inefficient and do not protect investors, as the conventional view explains, why do we observe any minority shareholders at all in such “bad-law” countries? One possible reason is that in response to controlling shareholders’ expropriation, minority shareholders discount severely shares that corporations issue. Then, a related question is: if it is true, why do some controlling shareholders in bad-law countries have many minority shareholders despite such severe discount on their shares? The purpose of this Article is to offer potential answers for such conundrums, which still remain unexplored. To this end, this Article approaches in two ways: (1) why does a controlling shareholder issue equity securities even if the cost of equity is much higher than the cost of debt due to severe discount (i.e., “Gilson’s riddle”)?; (2) why do minority shareholders participate in transactions in a capital market even if they are not well protected by the legal system (i.e., the flip side of “Gilson’s riddle”)? To answer these questions, this Article proposes that a controlling shareholder and minority shareholders – as a seller and a purchaser – embrace the other party by reciprocal interactions since both can gain economic (or illusive) benefits through transactions in the capital market. Consequently, both parties accept market terms and conditions despite insufficient investor protection (which is disadvantageous to non-controlling investors) and equity discount (which is disadvantageous to a controller). As Professor Merritt Fox restates the points of this Article in a succinct way, “Two people must dance tango, not one.” A controlling shareholder and minority shareholders realize that when their interwoven relationship creates symbiosis and a mutual hostage situation, their cooperation is often compelled and strengthened, and economic development ensues. That is why some exemplary bad-law countries have functional capital markets, which is an anomaly from the standpoint of the conventional view.
TABLE OF CONTENTS

I. INTRODUCTION ................................................................................................................................. 1

II. CONTROLLING SHAREHOLDER REGIMES AND PRODUCT MARKET-BASED ACCOUNT .......... 5
   A. Controlling Shareholder Regimes – Controlled Structure (CS) and Controlling Minority Structure (CMS) ................................................................................................................................. 6
   B. Asymmetric Information and Lemon Market Problem .................................................................... 9
   C. The Product Market-Based Account
      1. Gilson’s Riddle and the Product Market-Based Account ............................................................ 12
      2. Critical Review of the Product Market-Based Account ............................................................ 14
      3. When Cash Flow Rights and Voting Rights Are Significantly Detached .............................. 18

III. WHY DOES A CONTROLLING SHAREHOLDER RELY ON EXPENSIVE EQUITY FINANCING AND HAVE MANY MINORITY SHAREHOLDERS? .................................................. 21
   A. The Additional Cost of Equity Finance Is Opportunity Cost .................................................... 22
   B. Tunneling v. Additional Cost of Equity Financing .................................................................... 22
   C. Non-Pecuniary Private Benefits of Empire-Building
      3. Empire-Building and Its Cost – If Inefficient, Who Bears the Cost and How Much? .......... 32
   D. Other Benefits of Empire-Building ............................................................................................... 34
      1. Economic Benefits of Empire-Building ................................................................................... 34
      2. “Too-Big-To-Fail” – Insurance for a Controlling Shareholder ............................................. 36
   E. Stationary Controlling Shareholders ......................................................................................... 37

IV. WHY DO MINORITY SHAREHOLDERS PARTICIPATE IN CAPITAL MARKETS DESPITE POOR PROTECTION? ........................................................................................................... 40
   A. Minority Shareholders under a Stationary Controller ............................................................. 40
   B. Imperfect Alternative Investments ........................................................................................... 41
   C. Behavioral Finance Problems That Public Investors Are Subject to ...................................... 44
   D. Minority Shareholders Are Looted, But They Buy Shares at Discount ................................... 45
   E. Foreign Minority Shareholders .................................................................................................. 47
   F. Minority Shareholders May Free-Ride When a Controlling Shareholder Expropriates
      Other Stakeholders ...................................................................................................................... 48

V. CONCLUDING REMARKS .................................................................................................................. 50
I. INTRODUCTION

“Law and finance” literature was revolutionized by four distinguished economists – La Porta, Lopez-de-Silanes, Shleifer, and Vishny (hereinafter “LLSV”) – who explain that the legal origin of a country is statistically correlated with the quality of corporate governance and patterns of share ownership. In particular, LLSV’s series of studies show that controlling shareholder regimes – economies that are dominated by controlling shareholders – exist in those jurisdictions where minority shareholders are not protected from controlling shareholders’ expropriation of corporate assets. To be sure, this view opens a new and insightful paradigm to analyze international corporate governance.

On the other hand, however, LLSV’s studies have been criticized because their conclusions and methodologies are misleading in some respects. In addition, many puzzles remain unsolved by law and finance account as well. In particular, in his Stanford Law Review article, Professor Ronald Gilson raises the critical point that neither LLSV nor the law and finance literature explain: if laws are too poor

2 LLSV write a series of articles which influence significantly on the comparative corporate governance scholarship. See e.g., La Porta, Rafael, Florencio Lopez-de-Silanes, and Andrei Shleifer, The Economic Consequences of Legal Origins, 46 J. ECON. LITERATURE, 285 (2008); La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny, Investor Protection and Corporate Governance, 58 J. FIN. ECON. 3 (2000); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny, Legal Determinants of External Finance, 52 J. FIN. 1131 (1997); La Porta et al., supra note 1.
4 Professor Coffee points out that correlation between strength of capital markets and legal protection for public investors does not mean causation. John C. Coffee Jr., Do Norms Matter? – A Cross-Country Evaluation, 149 U. PA. L. REV. 2151, 2154 (2000). Criticizing LLSV’s direction of causation, Professor Milhaupt suggests that economic structures may determine law, which is exactly opposite to law and finance theory. Milhaupt, supra note 1 at 2122-23. Professor Gilson claims that LLSV depend on a simplified syllogism that is insufficient to explain the entire controlling shareholder regimes. Ronald J. Gilson, Controlling Family Shareholders in Developing Countries: Anchoring Relational Exchange, 60 STAN. L. REV. 633, 634 (2007).
5 Id.
to protect public investors in “bad-law countries,” as LLSV explain, then why do public investors participate in such unfair capital markets? A potential answer to this question is that public investors in a country with poor investor protection would severely discount the price of shares in response to controlling shareholders’ expropriation. Accordingly, it is possible that corporations would receive less proceeds from public investors in a stock market than the intrinsic value of stocks issued. In other words, equity financing might be expensive to a corporation in a bad-law country. Then, a related puzzle in a bad-law economy (hereinafter, “Gilson’s riddle”) is: “why do companies choose to pay the very high price for equity given the bad shareholder protection discount and the availability of cheaper alternatives[?]” Or, from another perspective, why don’t controlling shareholders expropriate more in order to compensate for the expensive equity financing? And why do some of them set the limit of “tunneling” – namely, a controlling shareholder’ expropriation from minority shareholders – voluntarily even though total expropriation is not efficiently regulated by the poor legal system in a bad-law jurisdiction?

To solve this series of closely related conundrums in bad-law countries, Professor Gilson proposes an insightful hypothesis – namely, the product market-based account (PMBA). According to the PMBA, a corporation treats its minority shareholders fairly because such fair treatment could be a credible signal to trading partners in a product market that the corporation is trustworthy.

---

6 The expression of “bad-law” countries (jurisdictions) has been widely used in the literature. See generally, Gilson, supra note 3. This Article uses “developing countries,” “emerging countries,” “countries with insufficient investor protection,” “countries with inefficient legal systems,” and “bad-law countries (jurisdictions)” interchangeably.

7 See Gilson, supra note 4, at 634.

8 “Cost considerations make equity capital an even less attractive source of financing in these [bad-law] jurisdictions than in those with good shareholder protection.” Id. at 647.

9 “Gilson’s riddle” is coined by Professor Fox. Discussion with Professor Merritt Fox, Columbia Law School in N.Y.C., N.Y.

10 See Gilson, supra note 4 at 647.

11 As for “tunneling,” see generally Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, Tunneling, 90 AM. ECON. REV. 22 (2000).

12 As for this question, see generally Gilson supra note 4, at 646-651.

13 See Gilson, supra note 4 at 646-651; infra Part II C.

14 Id.
the corporation’s reputational benefits in a product market may justify expensive equity in a capital market.\textsuperscript{15} Put differently, having a large number of minority shareholders is ultimately beneficial to the controlling shareholder since minority shareholders function as proverbial canaries in the mine proving the controlling shareholders’ integrity.\textsuperscript{16} In this way, Gilson’s riddle – i.e., the puzzle as to why a controlling shareholder relies on expensive equity financing (and consequently has many minority shareholders from a public capital market) – is solved.

The purpose of this Article is to offer through a theoretical approach (rather than via case study) potential answers for Gilson’s riddle, which has long remained uncharted. Most of all, this Article reviews the PMBA,\textsuperscript{17} and then challenges its general application in controlling shareholder regimes.\textsuperscript{18} In particular, the PMBA’s implicit premise – i.e., that a controlling shareholder is concerned about a corporation’s additional cost in equity finance\textsuperscript{19} – is criticized. Instead, I argue that the controlling shareholder’s personal cost is the core determinant of his decision. In this sense, the PMBA’s premise does not hold well under the “controlling minority structure” (CMS)\textsuperscript{20} where a controlling shareholder owns only a small fraction of the economic interest of a corporation (e.g., 5%). In such a case, a CMS controlling shareholder does not consider the corporation’s cost very seriously, as opposed to a theoretical foundation of the PMBA.\textsuperscript{21}

In addition to criticisms of the PMBA, this Article proposes new accounts to answer Gilson’s riddle – why a controlling shareholder in a bad-law country needs external equity capital even if newly

\textsuperscript{15} Id.
\textsuperscript{16} Id.
\textsuperscript{17} See infra Part II C-1.
\textsuperscript{18} See infra Part II C-2.
\textsuperscript{19} See Gilson, supra note 4.
\textsuperscript{20} Despite his minority ownership, a CMS controlling shareholder can exercise control over a corporation through various voting leverages. For a more explanation of the CMS, see Bebchuk et al., infra note 34 and accompanying text.
\textsuperscript{21} See infra Part II C-3. Nonetheless, equity finance is still expensive to a CMS controlling shareholder, since he is required to spend a fraction of the corporation’s cost (e.g., 5%) anyway. Part III solves this problem.
issued stocks are costly to him.  (1) The cost of equity finance is not out-of-pocket cost but “opportunity cost,” so that a controlling shareholder is less concerned about it. (2) A controlling shareholder is able to take more private benefits if he has more public shareholders investing in new equities issued by his controlled corporation. Put differently, even if a controlling shareholder illicitly takes a small amount from each non-controlling shareholder, the sum of extractions from a large number of non-controlling shareholders would be huge. (3) Building a large business empire may bring to a controlling shareholder more “psychic utility” (or “non-pecuniary benefits”23 such as leadership, fame, and social influence)24 as well as handsome economic benefits.25 In addition, as for the question of a controlling shareholder’s voluntary limit of expropriation, this Article explains that if a controlling family shareholder rationally pursues a long-term goal of maximizing his private benefits, then it is optimal to be generous and attract more minority shareholders.

As Alfred Marshall famously said, “Supply and demand curves are like scissor blades that intersect equilibrium.” Analysis of the standpoint of a controlling shareholder would be insufficient because transactions in the stock market would not take place unless non-controlling shareholders purchased shares from a controlled corporation. In other words, both of a controlling shareholder and minority shareholders embrace the other party by accepting market terms and conditions. Then, the flip side of Gilson’s riddle is: “why do minority shareholders purchase any shares at all in the absence of an observable ceiling on private benefit extraction?”26 To answer this question, a series of unconventional explanations are put forward in this Article: (1) the “stationary controller” account; (2) limited

22 See infra Part III.
23 Gilson, supra note 3, at 1663-64.
24 Most of the extant literature on corporate governance has focused on a controlling shareholder’s pecuniary private benefits – i.e., extraction from minority shareholders such as (unfair) self-dealing. However, a controlling shareholder seeks to gain non-pecuniary private benefits from running a corporation as well. Then, a model assuming that a controlling shareholder maximizes his pecuniary benefits is not precise, although it explains very important features of a controlling shareholder regime. A more precise model is based on the notion that a controlling shareholder maximizes his “utility” arising from non-pecuniary benefits as well as pecuniary benefits. Put differently, a controlling shareholder’s utility function can be expressed as [U = U (pecuniary benefits, non-pecuniary benefits)] where “U” stands for the controlling shareholder’s utility function.
25 This question is similar to the question mentioned in supra note 7’s accompanying text.
26 Gilson, supra note 4, at 647.
opportunities of other investment account; (3) minorities’ behavioral finance account; (4) “minorities might not be damaged” account; (5) foreign minorities account; and (6) minorities’ free-ride account. Most well-functioning capital markets in less developed economies are likely to be subject to at least some of these accounts.

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

As Professor Merritt Fox comprehends my points in a succinct way, “Two people must dance tango, not one.” A message in this Article is that when both a controlling shareholder and minority shareholders realize that their interwoven relationship creates symbiosis and mutual hostage, their cooperation is often compelled and strengthened, and economic development ensues even in a bad-law country. Although the combination of well written law-on-the-book and a functional enforcement mechanism plays an important role in the development of a capital market, it is possible that a functional market can be formed and develop without sufficient formal protection of public investors by law.

II. CONTROLLING SHAREHOLDERS REGIMES AND PRODUCT MARKET-BASED ACCOUNT

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

28 However, if conditions that have persisted to date are to change in the future, it is possible that the symbiotic relationship between a controller and non-controlling shareholders would no longer exist. For example, as the process of globalization continues to gain momentum, non-controlling shareholders have more opportunities and options to diversify their assets internationally. As a result, a domestic controlling shareholder’s ability to keep public investors in his controlled corporation could be diminished. Discussion with Professor Jeffrey Gordon, Columbia Law School in N.Y.C., N.Y.
Berle and Means’ model\(^{29}\) assumes that a large number of dispersed shareholders collectively own shares of a large-scale corporation.\(^{30}\) Since there is no dominant shareholder, the corporate power belongs to management. However, the dispersed shareholder ownership in this model is limited to the United States and the United Kingdom.\(^ {31}\) In developing countries where controlling family shareholders run conglomerates and business groups,\(^{32}\) minority shareholders are poorly protected within formal legal structures, such as corporate and securities laws and judicial systems.

### A. Controlling Shareholder Regimes – Controlled Structure (CS) and Controlling Minority Structure (CMS)

Most corporate governance literature presumes that, in the controlling shareholder regime, a large block-holder controls a corporation by owning a majority of shares.\(^ {33}\) For example, when a dominant shareholder owns 51% of shares of a corporation, he exercises 51% of voting rights. In other words, voting rights and cash flow rights are generally aligned.\(^ {34}\) This type of controlling shareholder ownership is referred to as the “controlled structure” (CS).\(^ {35}\) However, there is another significant pattern of controlling shareholder ownership where a controlling shareholder wields a significant percentage of voting rights even though he holds a small percentage of equity. For example, even if a shareholder owns 10% of shares, he is able to exercise 51% of votes in a corporation via voting leverage mechanisms.

Since a controlling shareholder is also a minority shareholder in terms of the quantity of equity stake he

---

\(^{29}\) Adolf A. Berle & Gardiner C. Means, Jr., *The Modern Corporation and Private Property* (1932).


\(^{31}\) *Id.* at 642; La Porta et al., *supra* note 3 at 474 (authors find that “the Berle and Means corporation is far from universal, and is quite rare for some definitions of control”); Lucian A. Bebchuk & Mark Roe, *A Theory of Path Dependence in Corporate Ownership & Governance*, 52 STAN. L. REV. 127, 133 (1999) (authors explain that public companies in the United States and the United Kingdom are based on dispersed ownership, while public companies in the rest of the world generally are based on controlling ownership).

\(^{32}\) *La Porta et al., supra* note at 3.

\(^{33}\) *See e.g.*, Mark J. Roe, *Corporate Law’s Limit*, 31 J. LEGAL STUD. 233 (2002).


\(^{35}\) *Id.*
owns, this regime is referred to as the “controlling minority structure” (CMS). Many Chinese companies use the CMS. Similar examples are observable in Europe, South America, other Asian countries and South Africa.

Korean CMS cases are noteworthy. As of 2011, it is reported that controlling “family” shareholders of large corporate groups in Korea hold 5.04% of ownership on average. In fact, 5.04% includes controlling shareholders’ personal economic interest as well as their family members’ economic interest; when it comes to controlling shareholders’ purely *personal* economic interest, it is merely 2.62% on average. In Samsung Group (Apple’s global business rival, Samsung Electronics, is an affiliated firm), President Kun-Hee Lee holds only 0.69% of the economic interest although he is “the” controlling shareholder of the group with enormous voting rights. More strikingly, the ownership stake that President Tae-Won Choi personally holds in SK Group – which is the sixty-fifth largest corporate entity in the world – is only 0.04% (note that 0.04% is not a typo). Nonetheless, President Choi effectively holds control voting power over the entire group.

How can CMS controlling shareholders maintain their control with a small fraction of personal (or family) ownership stake? Professors Bebchuk, Kraakman and Triantis explain that such radical separation of control and cash flow rights can occur in three principal voting leverages: through (1) a

---


38 *See* Korea Exchange, *Large Shareholders’ Ownership of Stock in 10 Corporate Groups in Korea*, http://www.krx.co.kr/m10/m10_1/m10_1_3/JHPKOR10001_03_01.jsp?sch=all&noti_no=20249&cur_page=1&rn=6536&word= (published on June 24th 2011).

39 As of April 2011, among 10 largest corporate groups in Korea, while controlling shareholders *individually* hold 2.42 of economic interest of corporate groups, their families hold 2.62 % (thus, the total ownership is 5.04 %). *Id.*

40 *Id.*

41 Jong-Sung Yun, 이건희 0.69% 최태원 0.04% 쥐꼬리 지분으로 ‘그룹장악’, E-Daily (May 30, 2013), http://www.edaily.co.kr/news/NewsRead.edy?SCD=JA11&newsid=01974566602814168&DCD=A00101&OutLk Chk=Y. Including his children’s cash flow rights, Mr. Lee holds 1.27% of economic interest in Samsung Group.


43 Yun, *supra* note 41.
dual-class share structure, (2) stock pyramiding, and (3) cross-ownership ties.  

(1) In a dual-class share structure, a corporation issues “two or more classes of stock with differential voting rights.” For example, Class A stock has one-share-one-vote, while Class B stock has one-share-ten-vote. Some U.S. corporations use such a system. (2) “[Stock] pyramiding is defined as the ultimate ownership of a firm running through a chain of ownership of intermediate corporations.” In a simple model, an individual holds 51% of ownership of Company A, which subsequently owns 51% of Company B. The individual exercises full control over Company B through the chain of ownership from Company A although his economic interest in Company B is merely 26% (i.e., 51% x 51% = 26%). (3) Cross ownership is used when a corporation holds ownership stake of other affiliated firms. Suppose that there are three corporations (Company A, B, and C) in a business group: Company A holds ownership stake of Company B and C; Company B holds ownership of Company C and A; and Company C holds ownership of Company A and B. Cross ownership is useful in particular when a dual-class share structure and stock pyramiding are not allowed in a certain jurisdiction. Cross ownership would be more complicated as the number of affiliated firms in a business group grows; by means of “network effect” of such complicated ownership web among affiliated firms, a CMS controller – such as President Lee in Samsung and Choi in SK – can exercise control with a small fraction of economic interest.

In sum, holding a majority of common shares and economic interest is not a necessary condition to exercise control. Rather, when we refer to “control,” it means the status with a significant holding of “voting” rights. Indeed, it is often possible that a shareholder with less than a majority of the voting rights can wield effective control. A shareholder is able to be dominant in a corporation even if his

44 Bebchuk et al., supra note 34.
45 Id. at 3.
46 “[Stock] pyramiding is defined as the ultimate ownership of a firm running through a chain of ownership of intermediate corporations.” Stijn Claessens, Simeon Djankov, Joseph P. H. Fan, Larry H. P. Lang, Disentangling the Incentive and Entrenchment Effects of Large Shareholders, 57 J. Fin., 2741, 2743 (2002). For more explanation on stock pyramiding, see e.g., Randall Morck & Bernard Yeung, Agency Problems in Large Family Business Groups, 27 Entrepreneurship Theory and Practice 367 (2003).
47 According to the City Code in the United Kingdom, a person (or an entity) has control as long the person (or the entity) has more than 30% of voting rights. The Code (Including Downloads), THE TAKEOVER PANEL, http://www.thetakeoverpanel.org.uk/the-code/download-code.
voting power is for example 40% as long as the rest of shareholders are dispersed and are not able to form a unified insurgent group against him. In fact, many CMS controllers in Korea hold less than a majority voting rights. For the purpose of simplicity, however, Table 1 summarizes the two aforementioned patterns of controlling shareholder systems based on the notion that the control means holding more than a majority of the voting rights.

Table 1: Comparison between the CS and the CMS

<table>
<thead>
<tr>
<th></th>
<th>Controlled Structure (CS)</th>
<th>Controlling Minority Structure (CMS)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A Controlling Shareholder’s Cash Flow Rights (“α”)</td>
<td>More than 50% (0.5 ≤ α ≤ 1)</td>
<td>Less than 50% (0 ≤ α ≤ 0.5)</td>
</tr>
<tr>
<td>A Controlling Shareholder’s Voting Rights</td>
<td>More than 50%</td>
<td>More than 50%</td>
</tr>
<tr>
<td>Voting Leverage Mechanisms</td>
<td>None (for the pure CS)</td>
<td>- Stock Pyramiding - Dual-Capital Structure - Cross-Shareholding</td>
</tr>
</tbody>
</table>

B. Asymmetric Information and Lemon Market Problem

A well-performing securities market would be built on information provided by disclosure and efficient regulations. In a bad-law country, though, investors suffer from insufficient disclosure system and lack of transparency, not to mention inefficient legal infrastructure. A securities market then becomes highly vulnerable to “lemon” market problem due to the asymmetry of information between sellers (i.e., corporations or corporate insiders) and buyers (i.e., investors). In a corporation where there is the potential for a controlling shareholder to be actively involved in transactions tainted with conflict of

---


interest, the controlling shareholder knows that the fundamental value of the company has been damaged due to tunneling. Prospective investors in the securities market, however, do not know whether the firm is involved in such misconduct and, if so, to what degree. At best, information that investors can have is statistics of the market about the average quality of corporate governance of issuers.

Knowing that corporations are not distinguished in the market in terms of the quality of corporate governance, issuers with good quality (i.e., companies not associated with tunneling) have no incentive to issue, and only issuers with bad quality (i.e., companies associated with an enormous amount of tunneling) participate in the securities market. In other words, due to the asymmetric information, an adverse selection problem starts to emerge.\textsuperscript{50} Unfortunately this is not the end of the story. In turn, those investors who only know the average quality of companies discount the issuance of securities more deeply on average. and even those companies that are relatively good would feel pressure to leave the market because the price determined by the application of the deeper discount to all issuers is too cheap for them and well below the fair value of their securities. Ultimately, only companies with the worst quality (i.e., companies associated with the most egregious form of expropriation) remain in the market in the self-enforcing process of Gresham’s law – the bad drive out the good, the worse drive out the bad, and the worst drive out the worse from the market. Accordingly, the adverse selection is reinforced, which leads to market failure and the securities market may come close to collapsing if there are no measures to correct this vicious circle.\textsuperscript{51} Consequently, in theory, in a country with poor investor protection, we will not be able to observe a significant number of minority shareholders and a well developed securities market.

\textsuperscript{50} Adverse selection is a form of market failure. “Adverse selection arises when products of different qualities are sold at a single price because buyers or sellers are not sufficiently informed to determine the true quality at the time of purchase. As a result, too much of the low-quality product and too little of the high-quality product are sold in the marketplace.” ROBERT S. PINDYCK & DANIEL L. RUBINFELD, MICROECONOMICS (Pearson Prentice Hall 6\textsuperscript{th} ed. 2004) at 616. For the more law and economics explanation of adverse selection, see RICHARD A. IPPOLITO, ECONOMICS FOR LAWYERS (Princeton University Press 2005) at 299-315.

\textsuperscript{51} In extreme cases, Professors Khanna and Palepu explain that the market breaks down and no transactions occur. Tarun Khanna & Krishna Palepu, The Right Way to Restructure Conglomerates in Emerging Markets, 77 HARV. BUS. REV. 125 (1999).
This undesirable situation in a bad-law securities market would also be expected under the “pecking order theory”\(^{52}\) of corporate finance. According to the pecking order theory,\(^{53}\) given asymmetric information between corporate insiders and prospective investors, corporations have a routine order of financing: (1) first, they use internal financing when available; (2) if external financing is required, corporations choose debt over equity.\(^{54}\) As Professor Gilson explains, this phenomenon takes place because the cost of equity is highest among the financing sources, from the standpoint of corporations.\(^{55}\) In other words, prospective investors – who lack sufficient information about a corporation – are reluctant to purchase the new shares that a corporation issues, since a corporate stock is riskier than debt securities. Thus, prospective investors, if they decide to purchase new shares, require a deep discount. Accordingly, a corporation receives less than the fair amount of proceeds from selling its new shares to the capital market. Consequently, a corporation is unwilling to issue new shares, as long as it is able to rely on other types of financing. Simply put, equity financing is known as the “last resort of financing.”\(^{56}\)

The pecking order of finance could be more serious in a bad-law jurisdiction for two reasons: (1) the severe problem of a controlling shareholder’s expropriation from minority shareholders makes equity investment by public shareholders riskier; (2) since the disclosure system is underdeveloped in such a jurisdiction, the information asymmetry problem is worsened. Accordingly, equity’s status as the last resort of financing is reinforced,\(^{57}\) and equity financing is substantially more costly to a corporation than bank financing in a bad-law jurisdiction.\(^{58}\)

---

\(^{52}\) As to the pecking order theory, see generally Stewart C. Myers & Nicholas S. Majluf, *Corporate Financing and Investment decisions When Firms Have Information that Investors Do Not Have*, 13 J. FIN. ECON. 187 (1984).

\(^{53}\) In addition to the pecking order theory, the trade off theory is another competing model to explain the finance decisions of firms. Eugene F. Fama & Kenneth R. French, *Financing Decisions: Who Issue Stock?* 76 J. FIN. ECON. 549 (2005). According to the trade off theory, debt financing has trade off effect – while it has tax benefits, it increases financial distress.

\(^{54}\) Thus, according to the pecking order theory, funding through the stock market is the last resort to corporations. See generally, Richard A. Brealey, Stewart C. Myers, & Franklin Allen, *Principles of Corporate Finance* 496 (8th ed., McGraw-Hill 2008); Myers & Majluf, *supra* note 52.

\(^{55}\) Gilson, *supra* note 4.

\(^{56}\) *Brealey ET AL.*, *supra* note 54.

\(^{57}\) See Gilson, *supra* note 4, at 647.

\(^{58}\) *Id.* at 647.
C. The Product Market-Based Account

This Subpart first introduces the “product market-based account” (PMBA), then criticizes the PMBA in various aspects. In particular, this Subpart explains how the PMBA’s explanatory power would be weakened when a controlling shareholder’s economic interest in a corporation is small.

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

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

In a product market, a corporation enters into a myriad of transactions and contractual relations with its trading partners. In bad-law jurisdictions, one problem is that there is no efficient commercial law system enforcing contractual obligations in product markets. Interestingly, such contracts are often honored. As Professor Gilson explains, a primary reason for this is that reputation works as a sort of self-enforcement system, though not perfectly: if a corporation cheats its trading partners “today,” an inefficient legal system is unable to punish the corporation; however, the corporation will be punished

---

59 As for the PMBA, see generally id. at 646-651.
60 Id.
61 Id.
62 Id.
63 Id.
64 As for the structure of reputation market, see id. at 637-40.
“tomorrow” by market mechanisms since market participants would refuse to make transactions with such a dishonest corporation.

Here, Professor Gilson puts forward a brilliant explanation that logically connects across a product market as well as a capital market. According to the PMBA, if a controlling shareholder treats minority shareholders fairly in his controlled corporation, he will be deemed as trustworthy by trading partners in the *product* market as well. In this way, minority shareholders are akin to “reputational canaries” who convey to trading partners a *signal* of a controlling shareholder’s integrity. One may ask whether such a signal is credible to trading partners or merely “cheap talk.” When a controlling shareholder treats minority shareholders fairly, it means that he is required to give up at least some private benefits that he could have otherwise extracted from the corporation.

In this sense, the signal – i.e., fair treatment of minority shareholders – is *costly* to a controlling shareholder so that it is *credible*. In addition, the logic suggests, “If the family-controlled corporation does not cheat in easy ways (given poor shareholder protection) by exploiting minority shareholders, … the controlling family shareholder also will not cheat its customers.” Based on good reputation among minority shareholders and a capital market, the corporation over which the truly honest controlling shareholder exercises control would have more economic opportunities with trading partners in the product market. In sum, the PMBA posits, “The [controlling shareholder’s] decision to have minority shareholders then can be explained not by the need for *capital* …, but as a way of developing reputation that will be valuable in the *product* market …” Such reputational advantage from the product market

---

65 *Id.* at 648..

66 “… [M]inority shareholders play the role of reputational canaries, whose value is that they help credibly convey to potential traders that the corporation is an honest trading partner.” *Id.* at 648.

67 *Id.* at 648.

68 *Id.* at 648.

69 *Id.* at 648.

70 *Id.* at 648.
where a controlling shareholder participates in a “repeated game”\textsuperscript{71} may justify the more expensive equity financing in the capital market, so that Gilson’s riddle is solved.

2. Critical Review of the Product Market-Based Account

Indeed, the PMBA is a creative and path-breaking study that attempts to solve Gilson’s riddle. As with most pioneering theories, however, there are inquiries to which the PMBA might not provide clear answers in some circumstances. First of all, it seems that the way in which a controlling shareholder’s signal is sent from the capital market – by treating minority shareholders fairly – to the product market is too convoluted to be realistic. Sharing this view, Professors Gordon and Milhaupt raise a question as to the PMBA’s indirect path of a controlling shareholder’s signaling. Suppose that the reputation of the controlled corporation in the product market is the primary concern of a controlling shareholder, as Professor Gilson implies. Why then would he not show his integrity and honesty directly in the product market rather than treating minority shareholders fairly in the capital market and subsequently sending off this signal to the product market?\textsuperscript{72}

Second, I am not fully convinced by the PMBA’s explanation “… [T]he treatment of minority shareholders is visible to a company’s potential trading partners at a low cost, perhaps because such exploitation is covered by the local newspapers.”\textsuperscript{73} Jurisdictions at issue in the PMBA are bad-law countries where we are concerned about the integrity of large corporations and the efficiency of the legal systems.\textsuperscript{74} Then, how can we trust the integrity and efficiency of the “local newspapers” in the same jurisdictions? In fact, the press is often under the direct or indirect influence of large corporations in these countries. Or, a corporate group – a common business organization in many developing countries\textsuperscript{75} – that

\textsuperscript{71} Id. at 648.
\textsuperscript{72} Discussion with Professors Jeffrey N. Gordon and Curtis J. Milhaupt at Columbia Law School in N.Y.C., N.Y.
\textsuperscript{73} Gilson, supra note 4 (emphasis is added).
\textsuperscript{74} Id.
\textsuperscript{75} See e.g., Khanna & Palepu, infra note 153.
consists of more than a score of affiliated corporations may have a media corporation.\textsuperscript{76} Even if a corporate group does not have such a corporation, the group has enormous influence on the media industry by sale of advertisements to the press. Therefore, it is commonplace that local newspapers are biased towards controlling family shareholders.

In addition, contrary to the PMBA’s explanation, it might be difficult for potential trading partners in the product market to notice the corporation’s treatment of minority shareholder easily and effectively.\textsuperscript{77} Even to large institutional investors that are experts in interpreting information from public corporations, examining a particular controlling shareholder’s treatment of investors is costly. By and large, trading partners in the product market are less able to interpret capital market information efficiently than institutional investors – trading partners are experts on the product market, not on the capital market. Thus, it would be difficult that trading partners can recognize the signal at a low cost.

According to the PMBA, “If the family-controlled corporation does not cheat in easy ways (given poor shareholder protection) by exploiting minority shareholders, the reasoning goes, the controlling family shareholder also will not cheat its customers.”\textsuperscript{78} However, it is questionable whether trading partners really think of a corporation’s treatment of other parties including its minority shareholders, as a primary standard when they have transactions with the corporation. Rather, trading partners are often willing to acquiesce to a corporation’s misconduct as long as the corporation abides by contracts with trading partners. For example, even if Samsung Group has a corporate governance problem (and thus the interest of minority shareholders is arguably damaged),\textsuperscript{79} Apple – a large trading partner of Samsung Electronics – will not hesitate to purchase semiconductors from Samsung Electronics. To be sure, Apple

\textsuperscript{76} In other words, many of corporate groups have unrelated diversified business portfolio so that it is possible that, for example, a corporate group with a semi-conductor affiliate company has a newspaper subsidiary as well as a leisure business subsidiary.

\textsuperscript{77} Professors Jeffrey N. Gordon and Curtis J. Milhaupt have pointed out this question as well during the conversation with me.

\textsuperscript{78} Gilson, supra note 4, at 648.

\textsuperscript{79} As for a Samsung Group’s corporate governance problem conducted by the controlling family shareholder, Mr. Kun-Hee Lee, see Kang-II Lee, Kun-Hee Lee, Not Guilty in a Criminal Court, But Liable in a Civil Court, Hankook Daily (Aug. 22, 2012), http://news.hankooki.com/lpage/society/201208/h2012082216425322000.htm
has tried to lessen its dependence on Samsung, but this has largely been due to its hostile relationship with Samsung over intellectual property suits in many jurisdictions and its strategic efforts to diversify its suppliers. Another example can be found in the relationship between Apple and Foxconn in China. Foxconn, a major supplier of Apple, is infamous for allegedly inhumane working condition. Nonetheless, it seems that initially Apple had been apathetic to Foxcon’s mistreatment of its employees for a while. Accordingly, a corporation’s treatment of third parties, including its minority shareholders does not function as a useful indicator of a corporation’s trustworthiness to trading partners. In sum, contrary to the PMBA, it seems that the reason why a controlling shareholder voluntarily protects minority shareholders is not to attract a corporation’s trading partners in the product market.

Moreover, the PMBA is not fit for explaining an export-oriented developing economy – many successful emerging markets fall into this category – where a corporation has foreign trading partners. It might be difficult for trading partners in the “foreign product” market (in Country A) to be able to effectively observe and examine a corporation’s conduct in the “domestic capital” market (in Country B). One may argue that newspapers in developed foreign countries report about a controlling shareholder’s treatment of minority shareholders in a bad-law jurisdiction. If this is the case, then the problem of the independence of the local press is solved as well – foreign trading partners may be able to receive relevant information on a controlling shareholder’s integrity from a distinguished and independent press in a developed country in a more neutral manner. Perhaps, sophisticated business newspapers such as the Wall Street Journal or Financial Times delve into the macroeconomic environment and general characteristics of a particular country. However, it is highly unlikely that those newspapers would examine “one particular” controlling shareholder’s treatment of minority shareholders in one particular developing economy. Even if they did, the probability of these media writing a review of a particular

81 Compare with the PMBA. See Gilson, supra note 4.
82 Professor Curtis J. Milhaupt suggested this issue during the conversation.
83 As for the problem of the independence of the local press, see supra notes 73-76 and accompanying text.
controlling shareholder is so low that it would be rational for him to ignore that possibility. In addition, as seen in Samsung-Apple and Foxconn-Apple examples, foreign trading partners – even if they know a corporation’s misconduct – have little reason to raise such an issue as long as the corporation treats trading partners in a favorable way. In sum, a controlling shareholder in an export-oriented developing country hardly has reasonable grounds to send a costly signal from the “domestic capital” market to the “foreign product” markets.

Furthermore, imperfect industrial organizations in many developing countries weaken the logic of the PMBA as well. The PMBA implies that a corporation caters to trading partners in a product market. When a corporation is located in a relatively competitive market (e.g., the United States), the situation is more favorable to the trading partners of a corporation since they can use competitive pressure among corporations. However, in a market where a few large corporations form a (quasi) monopoly in almost every product market, each large corporation has powerful leverage vis-à-vis trading partners – and this is a general contour of many bad-law economies which are jurisdictions that the PMBA covers. Just as corporate law systems are ineffective, competition law systems are not effective to regulate misconduct of large corporations (and controlling shareholders) in these jurisdictions. Thus, the prevailing phenomenon in developing countries is often described as “Strong Controlling Shareholders, Weak Trading Partners.” Under these circumstances, a controlling shareholder of a large corporation does not have to send costly signals (by treating minority shareholders fairly) in order to attract trading partners.

84 Of course, it is possible that in the future Apple would use corporate governance issues of Samsung Group for its business strategy purpose.
85 For example, according to the PMBA, a corporation sends a signal of its integrity to trading partners. See Gilson supra note 4. It seems that the PMBA implies that a corporation has a weak position vis-à-vis its trading partners because it is a corporation that sends a costly and burdensome signal to trading partners in order to attract them, not the other way around.
86 In general, the U.S. market is more competitive than markets in the rest of the world. See e.g., Mark J. Roe, Corporate Law’s Limit, 31 J. LEGAL STUD. 233 (2002).
87 In other words, the correlation between the quality of corporate law and the quality of competition law is very high.
In other words, it is trading partners (rather than a controlling shareholder) that should convince the other party that they are credible, if any – which is exactly opposite to a main argument of the PMBA.

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

Depending on the reinforced pecking order theory\(^{89}\) – the cost of equity is substantially higher than the cost of debt to a corporation in a bad-law country\(^{90}\) – the PMBA concludes that a controlling shareholder’s decision to rely on the equity market is not explained through capital market-based accounts. Rather, it hypothesizes that a corporation sends off the signal of its integrity to trading partners in the product market (by showing that the corporation treats minority shareholders fairly) even if that signaling incurs financial cost (i.e., issuing stocks at the discounted price).\(^{91}\) To a corporation in a developing country, perhaps the benefit of maintaining good reputation in the product market exceeds the cost of signaling.\(^{92}\) In this Subpart, I explore the above reasoning by paying attention to the following questions: (1) when issuing stocks at the discounted price, who will ultimately bear the extra financial costs, and how much?; (2) who makes the ultimate decision on the capital structure of a corporation, and what matters most to him?

To be sure, if the cost of equity is much higher than the cost of debt, then a corporation has no good capital market justification to issue new equities. Thus, if a corporation issues new shares to the public, it may have product market rationales as the PMBA describes. However, this reasoning misses an important point as to the definition of a “corporation.” Since a corporation is a fictitious legal person,\(^{93}\) the ultimate and real cost-bearer and beneficiary of corporate transactions is not a corporation, but shareholders, natural persons. In addition, in the deep CMS where a controlling shareholder’s economic

\(^{89}\) See Gilson, \textit{supra} note 4.

\(^{90}\) \textit{Id.}

\(^{91}\) \textit{Id.}

\(^{92}\) Professor Gilson articulates the significant role of reputational mechanism in the PMBA. Gilson, \textit{supra} note 4.

\(^{93}\) See \textit{e.g.}, FRANK EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 12 (Harvard University Press 1996) (explaining “The ‘personhood’ of a corporation is a matter of convenience rather than reality.”); Gilson, \textit{supra} note 4, at 640-41 (pointing out “a corporation is just a long-lived piece of paper on which appears the corporation’s charter.”).
interest in a corporation is low, the controlling shareholder’s personal cost of equity financing could be minimal, even if the corporation’s cost is high.

Consider a controlling shareholder in a bad-law country who would like to raise external capital. Suppose that the “fundamental value” of either the debt instruments or equity securities that a corporation issues is $10 million. As the reinforced pecking order theory implies, however, the cost of equity finance is substantially higher than that of debt finance, from the perspective of the corporation. Put differently, equity issuance is subject to a deep discount in the market. Accordingly, the corporation would receive less proceeds in the equity market than in the debt market. Thus, for example, while the corporation receives $10 million through debt instruments, the corporation could receive only $8 million through equity issuance. In this sense, the additional cost of the equity that the corporation bears is $2 million.

It is noteworthy that the extra cost of $2 million when selecting equity finance will be borne by the “corporation.” It is plausible that to a controlling shareholder, the total cost of equity financing to a corporation – though it is important – is not his primary interest. Of greater significance to a controlling shareholder is his personal cost of equity finance. When a controlling shareholder holds a fractional ownership, $\alpha$ – which is between 0 (0%) and 1 (100%) – his personal extra cost in selecting equity financing over debt financing is only a fraction of a corporation’s additional cost, $\alpha \times 2\text{ million}$. The rest of the additional expense will be borne by all of the non-dominant shareholders.

---

94 Bebchuk et al., supra note 34.
95 In principle, “Fundamental value is the price that would prevail if the market consisted entirely of rational investors who possessed all available information (i.e., the price that would prevail in a truly efficient market).” Merritt B. Fox, Randall Morck, Bernard Yeung, Artyom Durnev, Law, Share Price Accuracy, and Economic Performance: The New Evidence, 102 Mich. L. Rev. 331, 349 & n.47 (2003).
96 Gilson, supra note 4.
97 For the simplicity, it is assumed that debt financing is not subject to discount in the market.
98 In this case, the additional cost of 2 million dollars is measured in terms of opportunity cost.
99 A controlling shareholder’s personal extra cost and a corporation’s cost in selecting equity finance are same only when he contributes 100% of the equity capital to the corporation (i.e., $\alpha = 1$).
According to the conventional controlled structure (CS) model, a controlling shareholder will take most benefits and costs occurring in any decision and transaction made in a controlled corporation because the controlling shareholder holds the vast majority of the cash flow rights. Here, the economic incentives of the “corporation” and the “controlling shareholder” are generally aligned. For example, when a controlling shareholder holds 90% of the economic interest of a corporation (i.e., $ is 0.9), he bears 90% of the additional cost of capital, i.e., $1.8 million in the example. Under these circumstances, if a controlling shareholder decides to choose equity financing that costs more than debt financing, then it is possible that the decision would not be made based on a capital market rationale. Instead, the PMBA’s rationale – building a reputation of integrity in the product market – may justify raising equity capital.

A limitation of the above explanation is, however, that this view is incapable of explaining another large subset of controlling shareholder regimes, the controlling minority structure (CMS). Since the cash flow rights and voting rights of controlled corporations are significantly separated in the deep CMS, the economic incentive of the “corporation” and the “controlling shareholder” can be substantially detached. In a (deep) CMS-style corporation (i.e., when $ approaches zero), a controlling shareholder’s personal burden is only a small part of a corporation’s cost. Suppose that a CMS controlling shareholder holds only 5% of cash flow rights of a business group. As explained, this example is not uncommon in countries with the CMS – for instance, controlling family shareholders of large corporate groups in Korea hold 5.04% of ownership on average. A self-interested controlling shareholder’s primary criteria for judgment when deciding the method of finance is not the corporation’s

---

100 As for the CS, see Bebchuk et al., supra note 34.
101 It is a primary reason why managerial agency problems can be rectified more as the economic interest of a controlling shareholder increases. “Large shareholders thus address the agency problem in that they have both a general interest in profit maximization, and enough control over the assets of the firm to have their interest respected.” Andrei Shleifer & Robert W. Vishny, A Survey of Corporate Governance, 52 J. Fin. 737, 754 (1997).
102 0.9 x 2 million dollars = 1.8 million dollars.
103 As for the CMS, see Bebchuk et al., supra note 34.
104 In this Article, a “business group” and a “corporate group” are used interchangeably.
105 See Korea Exchange, supra note 38.
cost ($2 million), but his personal cost (0.05 x $2 million = $100,000).\footnote{\cite{106} “Large investors may represent their own interests, which need not coincide with the interests of other investors in the firm, or with the interests of employees and managers.” Shleifer & Vishny, supra note 101 at 758.} Therefore, the fact that the cost of equity finance is much higher than that of debt finance to a corporation does not significantly constrain a CMS controlling shareholder’s desire to raise equity capital. A controlling shareholder can simply make minority shareholders pay 95% of the extra cost of equity financing.\footnote{\cite{107} Then, another derivative question is how a controlling shareholder is able to set up a corporate group and the CMS in the first place. Professor Jessie Fried at Harvard Law School also raises this question during discussion with the author. Although the question is of significance, it is beyond the scope of this Article, and should be answered in an independent project.}

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

### III. Why Does a Controlling Shareholder Rely on Expensive Equity Financing and Have Many Minority Shareholders?

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

A. The Additional Cost of Equity Finance Is Opportunity Cost

One possible answer to Gilson’s riddle is that a controlling shareholder’s additional cost of equity financing is not out-of-pocket cost but rather opportunity cost. Consider this account based on the numerical example above.\textsuperscript{108} It is noteworthy that a controlling shareholder’s “cost” of equity finance – $100,000 – incurs not because he pays $100,000 \textit{more} to public investors but because he \textit{receives} $100,000 \textit{less} from public investors. In theory, a rational economic person treats opportunity cost (“receiving less”) in the same way as out-of-pocket cost (“paying more”). From a behavioral economics perspective, however, opportunity cost tends in reality to be neglected to a greater extent than out-of-pocket cost. In addition, this tendency is reinforced as a controlling shareholder’s economic interest in a corporation becomes smaller since his personal opportunity cost to rely on equity finance becomes smaller. For example, when the cost of equity finance to a corporation is $2 million and a controlling shareholder’s economic interest in the corporation is 1%, his opportunity cost is only $20,000.\textsuperscript{109} In fact, controlling shareholders holding less than 1% of economic interest are not completely unrealistic, as seen in the aforementioned example of President Choi, who holds merely 0.04% of economic interest of SK Group.\textsuperscript{110}

B. Tunneling v. Additional Cost of Equity Financing

“Tunneling”\textsuperscript{111} – the phenomenon where a controlling shareholder siphons corporate value at the expense of minority shareholders – is rampant in bad-law countries.\textsuperscript{112} On the one hand, having more

\textsuperscript{108} As for the numerical example, see \textit{supra} notes 95-107 and accompanying text.

\textsuperscript{109} Compare with opportunity cost of $100,000 when a controlling shareholder holds 5% of economic interest in a corporation.

\textsuperscript{110} Yun, \textit{supra} note 41.

\textsuperscript{111} As for tunneling, see generally Johnson et al., \textit{supra} note 11.
public shareholders could be economically beneficial to a controlling shareholder in bad-law jurisdictions since it can enable him to take more private benefits through tunneling. On the other hand, however, since prospective investors discount the share price of a corporation in response to tunneling,\textsuperscript{113} equity financing (thus, having more minority shareholders) is costly to the controlling shareholder. Each party’s response – “tit for tat” – is dynamic and can become ongoing.\textsuperscript{114} Ultimately, whether the combination of equity financing and tunneling would create net value to a controlling shareholder depends on the relative size of both effects. Accordingly, there are three scenarios: (1) a controlling shareholder takes the exact same amount of private benefits of control via tunneling as the cost from equity finance (net value is zero); (2) he takes more private benefits of control than the equity financing cost (net value is positive); or (3) he takes less private benefits of control than the equity financing cost (net value is negative). Since a controlling shareholder knows the size of his tunneling and the extra cost of equity financing while minority shareholders do not,\textsuperscript{115} he knows which scenario he is involved in.

Consider the first scenario. A fair equilibrium between a controlling shareholder and minority shareholders is achieved by the controlling shareholder’s “disciplined” expropriation – in this respect, the controlling shareholder is “honest.”\textsuperscript{116} Interestingly, what makes the controlling shareholder fair and honest is not that he steals no corporate value but because he steals exactly the same amount of corporate assets as the cost that he loses from the discount made by public investors during the equity issuance. Gilson’s riddle is solved in this first scenario, since equity financing ultimately is not a bad or expensive choice to controlling shareholders.

\textsuperscript{112} As for insufficient investor protection in controlling shareholder regimes, see e.g., La Porta et al., supra note 1.

\textsuperscript{113} See the pecking order theory. Myers & Majluf, supra note 52; Gilson, supra note 4.

\textsuperscript{114} See Part II B.

\textsuperscript{115} It could happen because of asymmetric information between a corporate insider and public investors. As for asymmetric information, see generally Akerlof, supra note 49.

\textsuperscript{116} In a similar way, Professor Black made a bold claim “once a company has issued shares at a discounted price … the insiders may feel entitled to appropriate most of the company’s value for themselves” (emphasis is in the original text). Bernard S. Black, The Legal and Institutional Preconditions for Strong Securities Markets, 48 UCLA L. REV. 781, 807 (2000).
Gilson’s riddle from a controlling shareholder’s perspective, is solved in the second scenario as well since this type of controlling shareholders attain positive net value after the combination of equity financing and tunneling. Then, one remaining question would be: why do minority shareholders accept such unfair transactions in a capital market?\(^\text{117}\) (1) This could possibly be because imperfect market conditions make minority shareholders follow unfair market terms: (i) asymmetric information can obfuscate public investors; or, (ii) the presence of the quasi-monopolistic power of controlling shareholders as dominant market players may prevent public investors from discounting in proportion to the extent of controlling shareholders’ expropriation. (2) It could also be because minority shareholders are “rationally apathetic individualists:” perhaps, the total amount of corporate value that a controlling shareholder illicitly transfers to himself from all of the minorities might be an important issue to minority shareholders; however, rather than the collective damage of all minority shareholders as a single group, minorities are more interested in their own individual losses caused by a controller’s extraction when they invest a particular amount of money in a corporation. Thus, if the expropriation rate imposed by a controlling shareholder is low, minority shareholders are more willing to accept such “generous” stealing.

The analysis of “rationally apathetic individualists” has another important implication from the perspective of a controlling shareholder as well. Even if a controlling shareholder illicitly takes a small amount from each minority shareholder, the total amount that he steals could be huge. Accordingly, he has a strong incentive to be a “generous thief” and to be popular among public investors. In this sense, the question\(^\text{118}\) of why a controlling shareholder might voluntarily set a limit to the amount of private benefits that he takes could be solved.

In the third scenario, a controlling shareholder chooses to take less corporate assets than the cost of equity finance,\(^\text{119}\) so that Gilson’s riddle remains valid. If the controlling shareholder attains benefits from other sources related to equity financing, then Gilson’s riddle would be solved as well. The

117 As for this question (i.e., the flip side of Gilson’s riddle), see infra Part IV.
118 This question is one of questions that Professor Gilson raises. See Gilson, supra note 4.
119 Then, it is possible that minority shareholders are not financially damaged by a controlling shareholder’s expropriation. For the more related explanation of this possibility, see Part IV D.
following Subparts C and D discuss the benefits derived from business expansion by a controlling shareholder.

C. Non-Pecuniary Private Benefits of Empire-Building

“Empire-building”\textsuperscript{120} is a phenomenon wherein a top decision-maker of a corporation – either a CEO or a controlling shareholder – expands the size of the corporation for his own interest despite it being inefficient to the corporation. Although a controlling shareholder may create both pecuniary and non-pecuniary benefits by enlarging the corporation,\textsuperscript{121} this Subpart pays attention to the non-pecuniary benefits – such as social prestige, reputation, psychic utilities, and social influence – reaped by a controlling shareholder.

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

There are several significant points – which are not covered well by the extant literature – when exploring the impacts of empire-building on the corporate governance practices of developing countries. First of all, in many bad-law countries, a \textit{small} number of corporations – and as a result, a \textit{small} number of controlling shareholders – dominate the entire economy,\textsuperscript{122} which is markedly different from the

\textsuperscript{120} As to the phenomenon of empire-building, Professors Shleifer and Vishny explain that “Greater costs are incurred when managers have an interest in expanding the firm beyond what is rational, reinvesting the free cash, pursuing pet projects, and so on.” Shleifer \& Vishny, \textit{supra} note 101, at 742. In the United States, the phenomenon of empire-building has been often observed in the M&A context. “[T]he Empire Building Hypothesis suggests that the most important conflict of interests in corporate control contest may be on the bidder’s side of the transaction – between the interests of the bidder’s management and those of its own shareholders.” O’\textsc{Kelley} \& Thompson, Corporations and Other Business Associations: Cases and Materials (fifth ed., Aspen Publishers 2006) at 759..

\textsuperscript{121} Managers often desire to expand the influence of their business by managing large corporations. In particular, the empire-building account explains that managers in an acquiring corporation tend to pay a higher takeover premium to a target corporation since managing a larger corporation is more beneficial to managers. For example, according to Professors Shleifer \& Vishny, “Morck, Shleifer, and Vishny find that bidder returns tend to be the lowest when bidders diversify or when they buy rapidly growing firms.” Shleifer \& Vishny,\textit{ supra} note 101 at 746; Randall Morck, Andrei Shleifer, and Robert Vishny, \textit{Do Managerial Objectives Drive Bad Acquisitions?} 45 J. Fin. 31 (1990). As widely known, to managers, an economic rationale of managing a large corporation is that their compensation is related to the size of the corporations they manage. In addition, they can attain more psychic satisfaction by ruling a larger “empire.”

\textsuperscript{122} See e.g., Alice H. Amsden \& Takashi Hikino, Project Execution Capability, Organizational Know-How and Conglomerate Corporate Growth in Late Industrialization, 3 Industrial Corporate Change 111 (1994).
United States. For example, although Microsoft is one of the largest corporations in the United States, it is too “small” to dominate the largest market in the world. As a result, Bill Gates is only “one of many” successful business people in the economy. In contrast, although the largest corporation in a developing country is not comparable to Microsoft in terms of any economic indicator, it may account for a significant portion of a relatively small market, and so a handful of business tycoons may command the economy. Due to their unchallenged position, controlling shareholders of large corporations in less developed countries are highly respected and envied, so that they can enjoy immense reputation, social prestige and other psychic utilities (including the “jealousy of others”).

This tendency can be amplified more in countries with business “groups” because the economic power is more concentrated among fewer controlling shareholders who dictate dozens of large affiliated firms. In short, being a controlling shareholder in a large corporation or business group is psychologically rewarding – the larger a corporation (or a corporate group) is, the more non-pecuniary benefits a controlling shareholder can attain.

In addition, controlling shareholders are often treated as national leaders – the disproportionately large economic power of controlling shareholders makes it possible that, by various means, they have direct social influence and even political power among people in the street and the government. In many authoritarian regimes, which are usually developing countries, it is true that the government is

123 Media attention could be another form of non-pecuniary benefits to a controlling shareholder who would like to be famous.

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

125 In this sense, it can be said that the size of a corporation is a proxy of non-pecuniary benefits to a controlling shareholder.

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

above the business. However, if a few business people are key players in the market, they can talk directly and personally with the government as its leading partners despite the hierarchy that is generally established between the government and business. In extreme cases, business elites of large corporations could become the highest political figures in their countries. Notable examples are Thaksin in Thailand and Berlusconi in Italy – Italy is recognized by many scholars as a country with insufficient investor protection, which is a jurisdiction at issue of this Article.

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

In this respect, a top manager of a large public corporation in the United States is analogous to a “consul” in ancient Rome. Although he is influential and may be the sole decision-maker in a corporation, he has to leave the office in a fixed number of years – ultimately, Rome is not his empire but a people’s republic, even if the republic is under his dictatorship. To the contrary, a controlling shareholder in a developing country is comparable to the “emperor” (or “princeps” i.e., the first citizen like Augustus) of Rome. He can stay in office as long as he is alive, and eventually his children will succeed his throne – thus, Rome will be maintained as his “dynasty.” In that sense, a typical corporation in the United States

---

128 An example is the government-business relation in former president Park’s regime in Korea. Id.
129 Although Italy is one of G-7 economies, it has been seen as a bad-law jurisdiction. See e.g., Shleifer & Vishny, supra note 101; Gilson, supra note 3.
131 See e.g., Gilson, supra note 4.
is only “pseudo empire” to its CEO since generally the current CEO in a dispersed shareholding firm is not able to appoint his child as the next CEO.

Under these circumstances, it is obvious that building a larger empire will provide more glory (i.e., non-pecuniary private benefits) to a controlling shareholder in a controlling shareholder regime than to a top manager in the dispersed shareholder regime. In addition, it is plausible that a CEO of a widely held firm does not have sufficient incentive to expand the territory of the empire in the last period of his term since the fruits of his effort will accrue to the next “consul” to whom the current one has no biological relationship.132 In contrast, in developing countries, a controlling shareholder may have an equal incentive to pursue empire-building throughout his life since the expanded empire will ultimately belong to his children.133

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

So far, I have explained that a controlling shareholder can attain a significant part of non-pecuniary benefits by empire-building. How, then, is empire-building embodied in a concrete way, and what are the implications of empire-building in relation to equity finance? In general, “large corporations” are meant to be “corporations with large assets.”134 From an accountant’s perspective, as the size of the assets (i.e., the left side of balance sheet) increases, the sum of the debt and equity (i.e., the right side of balance sheet) should increase to the same extent since both sides of a corporation’s balance sheet are equal.135 When external capital is required by a corporation, a controlling shareholder may initially prefer to rely on debt (especially bank loans) according to the pecking order theory.136 During this period, as

---

132 Put simply, in general a CEO faces a “final period problem.”
133 In other words, in general a controlling shareholder does not face a “final period problem.” As for a controlling shareholder with an infinite tenure, see Gilson, supra note 4.
134 A large corporation might be a corporation with a large number of “employees,” large “sales” or “assets.” Nonetheless, in developing countries, the number of employees and the magnitude of sales and assets are highly correlated with each other. In that sense, the size of the assets is a good proxy for measuring how large a corporation is.
135 In short, the assets equals to the sum of liabilities and equities.
136 As for the pecking order theory, see Myers & Majluf, supra note 52.
assets increase, so does debt to the same extent, and thus the size of the equity remains. Consequently, a growth strategy that depends solely on debt financing raises the leverage ratio of a business group. As the debt-equity ratio deteriorates, however, the financial distress costs increase.\(^\text{137}\)

Perhaps, “high” leverage (e.g., 500% debt-to-equity ratio) may still be sustainable by a corporation even if it creates enormous inefficiency in the capital structure. However, at some point, a controlling shareholder’s empire-building strategy solely on debt financing is generally impractical for two reasons: (1) the financial distress costs of “extremely high” leverage (e.g., 5,000% debt-to-equity ratio) far exceed the benefits such that the corporation is unable to endure;\(^\text{138}\) and (2) the debt market would no longer make loans to the corporation due to the fear of default even if the corporation is in search of another debt. Inevitably, a “repeat controlling shareholder”\(^\text{139}\) who seeks dynastic empire-building for him and his offspring eventually “has to” turn to equity financing from outside investors in the stock market.

True, the frequency of equity issuance is rare in a controlling shareholder system\(^\text{140}\) To a dispersed shareholding firm’s CEO who can remain in that post for only several years,\(^\text{141}\) the interval between equity financing looks “long” – it is possible that a corporation is not going to issue new shares again within his tenure. The same interval between two equity issuances, however, looks “short” to a controlled firm’s dominant shareholder whose time horizon is infinite. Thus, the frequency of equity issuance is not deemed to be “rare” from the standpoint of a “repeat controlling shareholder” whose child is expected to inherit – a far-sighted controlling shareholder ought to be concerned about the next equity

\(^\text{137}\) See e.g., Brealey, Meyers, and Allen, supra note 54.

\(^\text{138}\) As for a corporation’s financial distress cost, see generally id.

\(^\text{139}\) Here, a “repeat controlling shareholder” means that a controlling shareholder is a long-term repeat player in the game theory context since he and his children will stay in a corporation for a long time (or infinitely in theory). For the explanation on game theory, see Joel Watson, STRATEGY: AN INTRODUCTION TO GAME THEORY (2nd ed. W.W. Norton & Company, 2007); Avinash K. Dixit & Barry J. Nalebuff, THINKING STRATEGICALLY: THE COMPETITIVE EDGE IN BUSINESS, POLITICS, AND EVERYDAY LIFE (W.W. Norton & Company, 1993).

\(^\text{140}\) See Gilson, supra note 4.

\(^\text{141}\) As for a typical CEO’s term in his office, see Gordon, supra note 130.
Accordingly, he has an incentive to *voluntarily* protect minority shareholders at least to some degree in order to allure public investors in the next share issuance. In this sense, the decision to have minority shareholders can be explained by the need for *capital* in the stock market (as opposed to the product market-based account), if analysis takes into consideration dynamism, such as the growth of a corporation over a long time horizon through dynastic succession.

One may argue that although the above explanation is true in some situations, a controlling shareholder will not rely on external equities when the new equity threatens his interest as a controlling shareholder. Perhaps, this argument is relevant in the controlled structure (CS) regime where a typical controlling shareholder is required to have a majority of shares to have control over a corporation. A controlling shareholder may decide to issue new shares as long as he is able to participate in this capital-raising as a dominant investor who can maintain the majority shareholder’s position after the new equity issuance. He would not let the corporation issue new shares, however, for example, if he does not have enough money to participate in the new equity issuance, since new issuance would reduce his equity holding under the critical level for control.

This concern, however, is not very meaningful to a controlling shareholder in the controlling minority structure (CMS) where a decrease in cash flow rights does not necessarily dilute a controlling shareholder’s voting rights in the same proportion. A CMS controller is effectively able to entrench his control position through voting leverage devices such as stock pyramiding. Since a CMS controller’s voting rights are *not critically* reduced by new equity issuance, equity financing is generally seen as a safe means to attain the goal of empire-building.

---

142 In sum, while a typical CEO in a dispersed-shareholding corporation is not a repeat player, a controlling family shareholder is a repeat player.

143 According to Professor Gilson’s product market-based account (PMBA), “The decision to have minority shareholders then can be explained not by the need for *capital* ..., but as a way of developing reputation that will be valuable in the product market...” (emphasis is added). Gilson, *supra* note 4, at 648.

144 For a general explanation of the controlled structure (CS), see Bebchuk et al., *supra* note 34.

145 For a general explanation of the controlling minority structure (CMS), see *id*.

146 Put differently, even if new equity issuance without a controlling shareholder’s participation reduces his cash flow rights significantly, it does not reduce his voting rights significant.

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

Table 2: Relationship between a Controlling Shareholder’s Economic Interest and the Size of a Corporate Empire

<table>
<thead>
<tr>
<th></th>
<th>Corporation 1</th>
<th>Corporation 2</th>
<th>Corporation 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount of a Controlling Shareholder’s Equity</td>
<td>$ 50 million</td>
<td>$ 50 million</td>
<td>$ 50 million</td>
</tr>
<tr>
<td>Controlling Shareholder’s Economic Interest</td>
<td>100 %</td>
<td>50%</td>
<td>5 %</td>
</tr>
<tr>
<td>Type of a Corporation’s Ownership</td>
<td>CS</td>
<td>CS / CMS</td>
<td>CMS</td>
</tr>
<tr>
<td>Total Equity of a Corporation</td>
<td>$ 50 million</td>
<td>$ 100 million</td>
<td>$ 1 billion</td>
</tr>
<tr>
<td>Total Debt of a Corporation</td>
<td>$ 200 million</td>
<td>$ 400 million</td>
<td>$ 4 billion</td>
</tr>
<tr>
<td>Total Asset Size (Asset = Equity + Debt)</td>
<td>$ 250 million</td>
<td>$ 500 million</td>
<td>$ 5 billion</td>
</tr>
</tbody>
</table>

148 In this example, for the simplicity a CS corporation is defined as a corporation where a controlling shareholder’s economic interest is more than 50%. A CMS corporation is a corporation where a controlling shareholder’s economic interest is less than 50%. Therefore, it can be said that the second controlling shareholder runs either a CS or a CMS corporation.
Although these three controllers contribute the same value of capital, the third controlling shareholder who has 95% of equity from non-dominant shareholders has an empire that is 20 times larger than that of the first who has no minorities at all. Accordingly, the third controlling shareholder attains much larger non-pecuniary benefits than the first one does since non-pecuniary benefits are positively related to the size of a corporation that a controlling shareholder exercises control over. Put differently, in consideration of non-pecuniary private benefits, the optimal choice for a controlling shareholder is to maintain the least cash flow rights in the corporation as long as his control is assured, other things being equal. In addition, although most of the assets (99%) consist of other people’s money (i.e., equity and debt) in the third corporation, the only person who is able to consume non-pecuniary benefits exclusively is the third controller.\textsuperscript{149} The lesson is clear. Having more external capital from the equity market is beneficial to a controlling shareholder in that it increases the territory (i.e., the assets) of his empire – the more equity capital a controlling shareholder has in his controlled corporation, the more debt he can bring in as well, and the larger corporation he would run, which provides more non-pecuniary benefits to him.\textsuperscript{150} Therefore, \textit{ceteris paribus}, a controlling shareholder in a developing country may have an incentive to attract more minority shareholders, despite expensive equity financing.

3. \textit{Empire-Building and Its Cost – If Inefficient, Who Bears the Cost and How Much?}

In general, empire-building is understood as the corporate insiders’ strategy of pursuing size maximization by adopting even negative NPV (net present value) projects – hence, the normative standard of the profit maximization is sacrificed.\textsuperscript{151} For example, managers in the United States in the

\textsuperscript{149} In Corporation 3, a controlling shareholder’s capital contributed is 50 million dollars and the corporation’s total assets are 5 billion dollars (equity = 1 billion dollars, debt = 4 billion dollars). Thus, a controlling shareholder’s equity is only 1% of the corporation’s total assets.

\textsuperscript{150} Equity financing is essential for attaining more debt from outside. Suppose that the debt-to-equity ratio is maintained at 400%. Then, when a corporation issues 1 million dollars of new equities, it is entitled to have additional 4 million dollars through subsequent debt financing. As the sum of equity and debt increases, the size of firm (the asset size) increases as well – through this empire-building, a controller’s non-pecuniary benefits increase. As a result, equity financing is a solid foundation for debt financing and non-pecuniary benefits.

\textsuperscript{151} Empire-building of corporations is embodied by diversification through conglomerates or business groups. The prevailing view in the economics, management, and corporate governance is that corporate diversification destroys
1960s commonly became preoccupied with “conglomeration” (i.e., empire-building). This wave of U.S. M&A is thought to have caused a significant level of inefficiency in the economy through unrelated diversification. Subsequently, the next wave of M&A in the 1980s was mainly designed to rectify the inefficiency problem by means of divestiture. Since then, it has become common sense that unrelated diversification reduces profitability—“focus” has been treated as a more reliable business norm than “diversification.” On the other hand, some of business groups – results of empire-building, such as Korean chaebols – have achieved great success in the global market. To be sure, whether empire-building is ultimately efficient or not is still a difficult question to resolve. Putting aside the complicated debate, this Article’s analyses are basically grounded on the assumption that empire-building is inefficient, so that it is costly to all shareholders, including controlling shareholders. Nonetheless, a controlling shareholder still has an incentive to keep unrelated diversification because of the disproportional features of a controlling shareholder’s personal payoff scheme.

Consider the cost-benefit analysis of a controlling shareholder in relation to empire-building. On his benefit side, virtually all non-pecuniary benefits ultimately belong to a controlling shareholder exclusively, no matter how much economic interest he has in a corporation. On the other hand, the cost of the incremental inefficiency of expanding the empire is shared among all shareholders according to their pro-rata economic interest in a corporation. As a result, a controlling shareholder may find it more attractive to pursue empire-building when his economic interest in a business group is small. In other words, when a controlling shareholder has a deep CMS by having more minority shareholders, empire-building is more advantageous to him. In this respect, Gilson’s riddle – why a controlling shareholder in

corporate value. See e.g., Morck et al., supra note 121; Larry H. P. Lang & Rene M. Stulz Tobin’s Q, Corporate Diversification, and Firm Performance, 102 J. POL. ECON. 1248 (1994).


153 For the general explanation of this Western norm, see e.g., Tarun Khanna & Krishna Palepu , Why Focused Strategies May Be Wrong for Emerging Markets, 75 HARV. BUS. REV. 41 (1997); Khanna & Palepu, supra note 51.

154 In other words, it is assumed that a controlling shareholder attains the entire non-pecuniary benefits. Whether his economic interest in a corporation is 5% or 100% does not matter under this assumption.
a developing country has so many minority shareholders despite the high expense of equity financing – is solved at least in part.

Then, why are public investors willing to absorb the inefficiency cost of empire-building by being minority shareholders? If all corporations in a domestic market are indulged in inefficient empire-building, then public investors have no other choices. In addition, while the cost that all minority shareholders should bear as a group is huge, the individual cost of each minority shareholder is not. For example, under a CMS controlling shareholder with 5% economic interest, the cost of inefficient empire-building that “one” minority shareholder should bear can be minimal since the burden is widely spread out among 95% minority shareholders.

D. Other Benefits of Empire-Building

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

1. Economic Benefits of Empire-Building

Empire-building is business expansion including vertical and horizontal integration. Then, up to some point, it is theoretically possible that empire-building can generate efficiency through synergy based on the economies of scale and scope. Another compelling defense for forming business groups is that they help to resolve the problems caused by the absence or poor functioning of institutions that managers in advanced markets take for granted. For instance, given that there is no efficient capital market in developing countries, business groups can add value by having their own “internal” capital

---

155 The examples of well functioning institutions in developed economies are an efficient capital market and an efficient labor market.
156 Khanna & Palepu, supra note 51 at 129. See also Tarun Khanna & Krishna Palepu, supra note 153.
markets. Groups can also add value by developing a common brand that is valuable in particular in export-oriented economies. In this respect, business groups which are seen as indulging in their passion for empire-building may generate some efficiency for their shareholders, although it is still uncertain whether the total effect of empire-building is efficient.

Furthermore, in a developing country, it is advantageous for a corporation to be involved in unrelated diversification since the corporation can obtain economic rent from the expansion. For example, as the size of assets increases, a corporation may have more opportunities to raise more debts at more preferential terms (e.g., cost of capital) because: (1) a corporation with large assets is able to provide more securities (collateral) for the new debts to lenders who – in a developing country – are less able to valuate borrowers’ ability to repay debts; (2) as the magnitude of debt increases, ironically a corporation may have more negotiation leverage vis-à-vis lenders; 159 (3) the government simply allocates scarce capital to only large corporations, rather than best-performing corporations, in the form of industrial policies.

A large corporation has more chances to obtain licenses to new businesses that are profitable and protected by the government. In addition, a large corporation is likely to generate excess profits via monopolistic power – wealth transfer takes place from trading partners and consumers to a large corporation. Moreover, a large corporation is at an advantage to attain subsidies or other preferential treatments from the government at the expense of general taxpayers. As long as these windfalls accrue to a large “corporation” (rather than to a controlling shareholder individually), ultimate beneficiaries are the entire shareholders. In this sense, empire-building can be “efficient” to shareholders although economic rent that makes shareholders better off is indeed detrimental to a society. This implication is of significance in two ways. First, a controlling shareholder has an incentive to rely on expensive equity financing since equity financing builds his empire and he can gain economic rent on a pro-rata basis. Second, it means that minority shareholders can free-ride on a controlling shareholder when he collects

157 Khanna & Palepu, supra note 51.
158 Id.
159 As a finance maxim goes, if you borrow $1,000, you are only a “debtor” to a creditor – however, if you borrow $1 million, you might be a “partner” to a creditor.
economic rent and share the benefits from empire-building. In turn, it can be said that public investors have incentives to be non-controlling shareholders even if there is some level of tunneling by a controller.\footnote{For more reasons why minority shareholders participate in a capital market with insufficient investor protection, \textit{see supra} Part IV.}

2. \textit{“Too-Big-To-Fail” – Insurance for a Controlling Shareholder}

Another related topic in empire-building is the principle of \textit{“too-large-to-fail.”} Even the United States (a champion of \textit{laissez-faire}) has experienced a series of bailouts for large corporations when a failure of a large corporation was likely to affect its economy. Notable examples include bailouts of Chrysler, LTCM (Long-Term Capital Management), and AIG (American International Group).\footnote{Matthew Karnitschnig, Deborah Solomon, Liam Pleven \\& Jon E. Hilsenrath, \textit{U.S. to Take Over A.I.G. in $85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up}, The Wall Street Journal (Sep. 16, 2008). This newspaper article states, “Just last weekend, the government essentially pulled the plug on Lehman Brothers Holdings Inc., allowing the big investment bank to go under instead of giving it financial support. This time, the government decided A.I.G. truly was too big to fail.”} In many developing countries, a large corporation or business group constitutes a higher percentage of the domestic economy than one in the United States. Thus, there are compelling reasons that the government in an emerging market is more afraid of the collapse of a large corporation or business group. For example, the dire consequence of a failure of Salim Group in Indonesia would be much more devastating than that of the failure of Chrysler (or perhaps even a large bank) in the United States. Aware of the government’s fear of their possibility of failing, a large corporation’s controlling shareholder may conclude that empire-building can function as effective “insurance” for its survival.

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

E. Stationary Controlling Shareholders

An important question related to Gilson’s riddle is: why would a controlling shareholder in a bad-law jurisdiction set the limit of expropriation voluntarily even though the poor legal system in the jurisdiction does not regulate his expropriation efficiently (in fact, this question is related to Gilson’s riddle – why a controlling shareholder needs many minority shareholders despite expensive equity financing). To answer to this question from another aspect, I use an analytical framework borrowed from political economics in the context of corporate governance. In explaining the evolution of government systems, Professor Mancur Olson creates the terms “roving bandits” and “stationary bandits.” “Roving bandits,” he explains, will not come to expropriate victims again. Thus, it is in their interest to take every bit of their victims’ wealth at once. In contrast, “stationary bandits” with a long time horizon have an encompassing interest in the continuing prosperity of their victims, and thus take less. As a result, people would be more willing to accept stationary bandits than roving bandits even if stationary bandits and roving bandits are essentially same bandits.

From the perspective of conventional corporate governance, a controlling shareholder regime in developing countries is systematically inferior to a dispersed shareholder regime. In particular, this view emphasizes tunneling where a controlling shareholder can illicitly transfer substantially all assets

---

162 In a previous Subpart, this question is solved in part. See supra notes 오류! 책갈피가 정의되어 있지 않습니다.-118 and accompanying text.


164 See Olson, supra note 163; see also Farzana Noshab, Book Review on “Power and Prosperity: Outgrowing Communist and Capitalist Dictatorship” by Olson (http://www.issi.org.pk/journal/2002_files/no_2/review/5r.htm).

165 See Olson, supra note 163 (both pieces of Olson); see also Noshab, supra note 164.

166 See e.g., La Porta et al., supra note 1.
from a corporation to himself if he wishes. Nonetheless, having the capacity do so does not necessarily mean using that capacity.

Suppose that a controller has a short time horizon. Then, it is in his best interest to quickly loot his controlled corporation to the fullest extent via a massive one-shot transaction. As a result, he has no reason to expropriate minority shareholders again because they do not hold any wealth in a corporation – in other words, he is a “roving controller.” While a controlling shareholder may realize a substantial amount of the pecuniary benefits at present, he would also lose future opportunities to expropriate the minority shareholders who are defrauded by his large-scale tunneling. A capital market where roving controllers constitute the majority would not be developed well since public investors would choose not to participate in the market as minorities. In contrast, a controlling shareholder with a long time horizon has an encompassing interest in the continuing prosperity of minority shareholders. Initially, a controlling shareholder may compare (1) the amount gained by a one-shot tunneling with (2) the present value of cumulative extractions in the long run and other benefits (e.g., psychic utilities). If the former is smaller than the latter, he will choose a form of theft by taking only a part of corporate value periodically – in that sense, he is a “stationary controller.” Then, he “voluntarily” abstains from siphoning off substantially all of the corporate assets to himself, even if he has the capability to do so at present; however, this is not because he is benevolent by nature but rather because he expects that being a stationary controller is ultimately more beneficial to him than being a roving controller.

167 See generally, Johnson et al., supra note 11.
170 Id.
171 For example, suppose that a controller can extract $100 million at present if he takes a one-shot transaction to the total detriment of minority shareholders – after this transaction, the corporation will be left as “shell” without any valuable assets. On the other hand, he can extract $5 million annually from the corporation by means of ongoing tunneling. Then, he will find that he is better-off being a stationary controller in 20 years (if the discount rate is assumed to be zero for the sake of simplicity). Therefore, he will choose to be a stationary controller as long as he believes that he can maintain ongoing extractions for more than 20 years. In addition, if the utility of the non-pecuniary benefits for a controller and his family is taken into consideration, he will find that looting based on a one-shot extraction is less attractive. For example, suppose that the amount of looting from a one-shot transaction is
A rational government’s tax strategy is a useful way to understand a stationary controller’s expropriation policy.\textsuperscript{172} Tax revenue is the product of a tax rate and taxable income; however, a high tax rate does not necessarily generate high tax revenue, since it gives taxpayers less incentive to work (i.e., taxable income will shrink). The same logic applies to the relationship between an extraction rate and the amount of tunneling (i.e., pecuniary benefits); the amount of tunneling is equal to the product of an extraction rate and the extractable corporate value; thus, a high extraction rate does not necessarily generate a high amount of tunneling, since that would cause non-controlling shareholders to withdraw their investments (i.e., extractable corporate value will shrink). As such, a rational stationary controller sets the optimal extraction rate carefully (generally at a moderate level) in order to maximize his “tax revenue” in the long run.\textsuperscript{173}

In other words, a repeat controlling shareholder – i.e., a stationary controller – is a “generous thief” and cares for his “continuing victims.” In this way, it is understood that a controlling shareholder sets the limit of expropriation \textit{voluntarily} even if the poor legal system in the jurisdiction does not regulate his expropriation efficiently. If he is a controlling family shareholder who expects family inheritance, by definition he is often a stationary controller who stays with victims for a long time. In addition, it is likely that he will continue to rely on equity financing with limited stealing. Then, he – or his descendants – would end up with a large number of minority shareholders, which is beneficial to him. In this respect, the stationary controller’s account also provides a useful solution to Gilson’s riddle as to why a controlling shareholder needs minority shareholders despite expensive equity finance.

\textsuperscript{172} Id.

\textsuperscript{173} For the more explanation on a rational stationary controller’s “tax policy,” see id. The presence of non-pecuniary private benefits of control may alter a controller’s tax policy to some degree.
IV. WHY DO MINORITY SHAREHOLDERS PARTICIPATE IN CAPITAL MARKETS DESPITE POOR PROTECTION?

Part III analyzes, from the standpoint of a controlling shareholder, why he has incentives to “voluntarily” – even if there is no legal requirement – accept the minimum level of minority protection and attract more minority shareholders to invest in his controlled corporation even though the cost of equity is high to a controller. Now it is fair to ask why, from the standpoint of minority shareholders, minority shareholders “voluntarily” participate in a capital market where they are expected to be expropriated by a controlling shareholder.

A. Minority Shareholders under a Stationary Controller

As aforementioned, there are at least two types of controlling shareholders in bad-law jurisdictions – roving controllers and stationary controllers. Faced with a rational stationary controller’s benevolent extraction in the long run, minority shareholders are willing to invest in a corporation run by a stationary controller as long as the return on the stock after expropriation is comparable to the return on investments in other opportunities. However, an important problem is that prospective investors do not know whether the controlling shareholder that they are dealing with is stationary or roving. Under this asymmetric information, prospective investors would hesitate to participate in the capital market even when a truly stationary controller issues new equities due to the fear of dealing with a roving bandit. Knowing this, even a sincere stationary controller might be discouraged to plan to issue new equities and have public minorities.

In this context, a controlling “family” shareholder has a comparative advantage. Since a controlling family shareholder has an infinite tenure due to family inheritance and is deemed to be a

174 See supra Part III E.

175 For the more explanation for the returns of stock and other asset classes and their impact on the investment decision by public investors, see infra Part IV B.
repeat player, prospective investors would understand that the current controlling shareholder is unlikely to kill the proverbial golden goose due to the hope that it will continue to lay eggs for him and his children eternally.\footnote{Of course, there are many circumstances that could make it difficult for a controller to be a stationary controller. In addition, I do not mean that a controlling family shareholder solves all the problems in relation to a roving control structure. For the more explanation, see Kang, supra note 169.} To be sure, it is impossible for investors to know the “intent” of a controlling shareholder whether he wishes to be roving or stationary.\footnote{Id.} By reviewing the corporate governance “structure” (e.g., how shares are spread among family members, whether children of a founder are managers or directors of a corporation), however, they can discover whether a given corporation is a “family” business.\footnote{Id.} In other words, rather than scanning the \textit{mentality} of the controller, it is more cost-efficient for investors to observe the \textit{appearance} of a corporation.\footnote{Id.} Subsequently, investors would participate in the equity market in order to gain returns. In other words, the flip side of Gilson’s riddle – why minority shareholders participate in a seemingly unfair capital market where they are not protected – is solved to some degree. The game is likely to be cooperative between minority shareholders and a family controller.

\textbf{B. Imperfect Alternative Investments}

One may argue, if prospective investors are extracted by controlling shareholders, then they may avoid investing in the stock market, and may seek investment opportunities from alternative asset classes, such as bank deposits, debt securities, and real estate. Theoretically, this phenomenon would be more apparent when investors’ risk-adjusted return of equity is lower than that of “alternative investments.”\footnote{Id.} Nonetheless, there are several perceivable reasons why prospective minority shareholders are unable to totally shun investing in the stock market.
While bank deposits are a very safe investment, they generate low returns. Although the risk-adjusted return of bank deposits is higher than that of equity investment in some cases, investing solely in bank deposits is not a workable option for investors who need to meet a certain amount of “absolute” return. As a result, at least some investors reallocate their wealth from some bank deposits to stocks, which generate higher return in absolute terms. Investment in debt securities, such as government and corporate bonds, has similar problems. This is a reason why many minority shareholders exist in a developing country despite controllers’ tunneling in corporations. In addition, in a bad-law country, if equity investment is impaired due to controllers’ extraction, it is likely that investment in other assets scathed as well. For example, when laws do not protect minority shareholders, creditors of corporations are likely to be subject to a similar risk. In that case, alternative investments would not generate higher risk-adjusted return than stocks, let alone higher absolute return.

Real estate is often seen as an attractive alternative to stock market investors as well. However, the problem is that since the value of specific real estate generally accounts for the huge portion of individuals’ wealth to many investors,\(^{181}\) they are exposed to huge idiosyncratic risk. Even worse, real estate is a very illiquid asset – thus, in an emergency, investors take risks to sell real estate at a deep discount. For these reasons, investing in real estate is not fit for many ordinary people, who are not sufficiently wealthy to deal with aforementioned difficulties. In developed economies, these problems may be well solved by the liquid and thick mortgage markets and indirect real estate investment tools such as Real Estate Investment Trusts (REITs). However, this has not been the case for many bad-law economies until the recent past.

In sum, equity is not the only imperfect asset in a country with insufficient investor protection, and investing in assets other than stocks is not always feasible to investors. Therefore, investors should choose optimal combinations among imperfect assets including stocks, even if returns from investment in stocks are impaired by controllers’ expropriation. Since an overarching principle of finance is

\(^{181}\) In general, the value of real estate is large. Thus, it is likely that the value of real estate accounts for a large part of an investor’s personal wealth. For example, if an investor’s “one” real estate constitutes 70% of his personal wealth, the adverse effect on the value of that real estate would impact the investor’s total wealth significantly.
diversification between classes of assets in order to eliminate unsystematic risks, putting equities in an investment pool is beneficial to investors even when alternative investments are sound and feasible.

One may argue, if domestic stocks are scathed by controllers, investors may shun domestic stocks and invest internationally. In addition, international investment is beneficial to investors because adding international assets enhances risk-adjusted return.\textsuperscript{182} In reality, however, many jurisdictions with poor law have established regulations on the outflows of investment by their citizens.\textsuperscript{183} More interestingly, even in countries without tight capital regulations, domestic investors would find it difficult to invest significantly in assets abroad for the following reasons. First, domestic investors do have insufficient information on potential foreign investments, and such “home bias”\textsuperscript{184} reinforces the tendency of domestic investors to invest mainly domestic assets, even though international investment provides higher risk-adjusted return. Moreover, international investment works as a supplement to domestic investments. Thus, it is more appropriate for affluent people whose wealth needs additional diversification after investing the vast majority of their assets in the domestic market. Many potential non-controlling shareholders in developing countries are middle class investors who would not have enough capital to diversify beyond domestic investments.\textsuperscript{185} Even worse, the currency risks posed by international investment could be another obstacle for small individual investors to overcome, if they do not have sources to hedge against these risks.\textsuperscript{186} These problems would be more severe when undeveloped capital

\textsuperscript{182} For the explanation on the “international diversification,” see e.g., Haim Levy & Marshall Samat, \textit{International Diversification}, 60 AM. ECON. REV. 668 (1970).
\textsuperscript{184} “Home Bias” is the phenomenon that investors tend to invest the vast majority of capital in assets in domestic countries. It is a special version of “familiarity bias” where investors tend to invest the vast majority of capital in assets that they are familiar with. As for familiarity bias, see Gur Huberman, \textit{Familiarity Breeds Investment}, 14 REV. FIN. STUD. 659 (2001).
\textsuperscript{185} To be sure, there are international diversification benefits to investors investing in equity markets abroad. As is known widely, however, the requirements of international diversification are the willingness and ability to take the greater risks that arise from international investment. Wealthy investors in \textit{developed} countries are able (and willing) to be involved in international diversification, but many minority shareholders in \textit{developing} countries are not.
\textsuperscript{186} The success of international investment has depended heavily on the performance of foreign exchange in a country wherein investors invest. Since the volatility of foreign exchange has been great, the risk associated with
market in a developing country does not provide small individual investors with efficient collective investment tools, such as funds that specialize and diversify in foreign equities. Consequently, unless controlling shareholders extract to extreme degree, potential investors have an incentive to participate in a domestic capital market as non-controlling shareholders.

C. Behavioral Finance Problems That Public Investors Are Subject to

Modern standard finance theories are built on the assumptions such as “rational investors,” “perfect information,” and “no transaction costs.” However, the real-world experiences and psychological research of human behavior has shown that these assumptions do not often hold. Realizing the limitations of modern standard finance, Daniel Kahneman and Amos Tversky open a new theory of behavioral finance. For example, they argue, cognitive biases can make individuals misestimate an asset’s value in a systematic way. Based on behavioral finance issues, in the following I explain that public investors in bad-law countries are likely to invest in domestic equity markets as non-controlling shareholders even if extraction by controller renders the shares unworthy of investment.

Most individuals have tendency of “overconfidence” – they believe that they are more competent and skillful than they actually are. Likewise, investors in a bad-law country would like to purchase stocks in order to prove their forecasting capability, even if those stocks are volatile and subject to serious tunneling risk. In addition, names of large conglomerates appear in the national media every day, and the investing in international investment has been large. Thus, international investment has required investors to have more willingness and capacity to take risks.

---


188 For example, Herbert Simon describes that individuals are “intendedly rational, but only limitedly so.” HERBERT SIMON, ADMINISTRATIVE BEHAVIOR, xxiv (2nd ed. 1957).

189 See Gilson & Kraakman, supra note 187 at 15; JUDGMENT UNDER UNCERTAINTY HEURISTICS AND BIASES (Daniel Kahneman et al. eds., 1982).

advertisements of those conglomerates repeatedly influence people in domestic markets. Then, “familiarity bias”\textsuperscript{191} holds and investors invest their wealth in shares of such conglomerates despite controlling shareholders’ exploitation. Home bias explained above is another reason why prospective investors in a bad-law country invest in the domestic capital market. Once they purchase shares, investors are often subject to “status quo bias”\textsuperscript{192} even if the performance of shares is disappointing.

Moreover, minority shareholders often play the role of “noise traders” – they make investment decisions that deviate from those that theory would predict of rational investors.\textsuperscript{193} Based on fads and sentiments, investors might invest in shares issued by large family conglomerates even if rational information indicates that domestic corporations are subject to high risk of expropriation. Besides, when “some” noise traders earn high returns, many investors might follow noise traders’ trading patterns, ignoring the fact that those successful traders took excessive risk and just were lucky.\textsuperscript{194}

Buying shares of domestic family-controlled corporation might be similar to participating in gambles. Whereas almost all participants in gambles know that they will lose on the average, most potential minority shareholders in stock market believe that their expected return is positive even if unfair games are manipulated by controllers and the risk-adjusted return is below the level where it should be. In this way, more prospective investors may enter into this gamble in the stock market casino as non-controlling shareholders.

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

So far, in Subpart A to C, I explained reasons why minority shareholders participate in the stock market even if they are subject to a controller’s expropriation risk. In this Subpart, however, I explore the possibility that minority shareholders in a bad-law jurisdiction actually might not be damaged financially.

\textsuperscript{191} As for familiarity bias, see Huberman, supra note 184.

\textsuperscript{192} “Status quo bias” is the tendency of investors to maintain their portfolio even if the performance of their portfolio is disappointing.

\textsuperscript{193} Gilson & Kraakman, supra note 187 at16.

Professor Coffee puts forward a counterintuitive but creative account: the public shareholders purchase their shares at a “bargain” price, which reflects the likelihood of future wealth expropriation by the controlling shareholder; thus, they would receive an undeserved “windfall” if legal rules were revised to entitle them to a proportionate share of corporate assets and distributions. In other words, even if the price of shares that minority shareholders hold is lower than their fundamental value due to controllers’ extraction, minority shareholders would not suffer since they purchase those shares at a depressed price for the same reason. Therefore, as Professor Coffee explains, from the perspective of “efficiency” the economy will do better if minorities are protected, but from a “normative” perspective, the respective entitlements of the majority and the minority can be debated endlessly.

Basically, I agree with this insightful opinion – however, I think that additional analysis on the impact of “volatility of expropriation” on public investors is needed for the more clarification. Suppose that there are three investors, “Investor A,” “Investor B” and “Investor C” and they buy and sell shares of Corporation “XYZ” controlled by a controlling shareholder. Initially, A holds shares (at time 1), and sells them to B (at time 2), and finally, B sells them to C (at time 3). Suppose that the controlling shareholder extracts firm value “partially” at time 1 and time 2, but he appropriates almost all of the firm value at time 3. A lenient level of extraction has been already reflected in the share price in the form of a discount when A and B purchased shares, thus A and B might not be financially damaged. However, C would be seriously injured because the extraction at the time of sale is higher than at the time of purchase (i.e., buy high and sell low). If the ex post degree of looting is far beyond the investors’ ex ante expectations, or if the controlling shareholders unexpectedly transfer corporate wealth through a one-time extraction, minority shareholders are clearly damaged, which is not explained in Coffee’s account.

In this respect, the notion of “family” (i.e., a “repeat player”) in business groups is important again. As discussed earlier, a controlling family shareholder with family inheritance exploits minority

196 Coffee, supra note 30 at 660.
197 Id. at 660.
shareholders as a stationary controller since partial extraction is more beneficial to a controller with long-term horizon than “total” extraction in terms of joint utility of pecuniary and non-pecuniary private benefits. Therefore, in this case C buys a share at the discounted price and he will sell at the similar discounted price, meaning that C is not financially damaged.

E. Foreign Minority Shareholders

Although equities in a bad-law country are scathed by poor corporate governance, a large number of foreign investors invest in such securities. A possible explanation for this phenomenon is that foreign investors are able to purchase shares at a relevant discounted price even if there are corporate governance problems. Put simply, since foreign investors buy low due to a controlling shareholder’s expropriation, they are not very concerned about the expropriation. Sometimes, foreign investors massively buy cheaper shares in an emerging country after this country experiences financial crisis, which reinforces the discount more deeply. In addition, unlike domestic minority shareholders, foreign investors are able to achieve the benefits of international diversification.

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

198 As explained earlier, domestic minority shareholders have found it difficult to participate in international investment: the circumstances in a bad-law country, including regulations, the relatively low level of wealth, and the underdevelopment of financial intermediaries like funds, impede international investment.
Thus, in the equity market of a poor law country, sometimes foreign shareholders take an important role as “minority shareholders.”

It is unlikely for foreign minority shareholders – as an organized group – to react to bad corporate governance and “directly” punish greedy controllers. However, foreign minorities can “indirectly” punish overreaching controlling shareholders. As long as foreign shareholders purchase shares of a corporation at a proper discounted price, foreign shareholders are able to endure a “partial” extraction. However, if controlling shareholders rely on “substantially all” extraction, foreign shareholders would follow the “Wall Street Rule,” i.e., selling shares. Domestic minority shareholders believe that foreign minority shareholders – sophisticated and large global financial entities – are like litmus paper and possess better information about domestic stocks and are more capable of assessing corporate value. Observing the movement of foreign shareholders, domestic minority shareholders would follow (i.e., herd) the selling trends of foreign shareholders.\(^\text{199}\) In this way, once a developing country has a significant number of foreign minorities in the stock market, it is likely that controlling shareholders in the jurisdiction will not be able to easily exacerbate the extent of tunneling.\(^\text{200}\)

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

In regard to dispersed shareholder regimes, the academic interest in corporate governance focuses on the relationship between managers and shareholders – the former exploits the latter. On the other hand, when it comes to controlling shareholder regimes, the lopsided relationship between controlling shareholders and minority shareholders has been emphasized – again, the former loots the latter. As a combination of these two views, conventional corporate governance scholarship, by and large, limits its

\(^\text{199}\) In other words, domestic minority shareholders in a developing country are under the herding effect created by foreign investors.

\(^\text{200}\) However, this does not mean that a controlling shareholder in the jurisdiction must improve corporate governance. As long as the quality of corporate governance is maintained (and does not deteriorate further), foreign minority shareholders do not lose – instead, they buy and sell stocks at the same discounted rate reflecting the same quality of corporate governance. Therefore, foreign minority shareholders do not have a strong incentive to punish controllers by following Wall Street Rule.
analytical frameworks to – what I call – the “triumvirate model,” i.e., the corporate governance model based on managers, controlling shareholders, and minority shareholders. Under this tradition, minority shareholders are (almost) always seen as the weakest in the “food chain” who are extracted either by managers\textsuperscript{201} or controlling shareholders. Accordingly, other stakeholders – employees, creditors, trading partners, consumers, and taxpayers are not treated in this model. Perhaps, in the United States, the triumvirate framework is working relatively well. Fiduciary duty is almost exclusively for shareholders since other stakeholders are seen to be protected by contracts.

In contrast, the traditional triumvirate framework is not necessarily suitable for a country with insufficient investor protection. Economic interest of other stakeholders (let alone that of minority shareholders) is damaged by corporate insiders – although the capital market is scathed by controlling shareholders’ tunneling, the capital market is not the only market that is imperfect. For example, in the imperfect labor market, employees are expropriated by a corporation as they receive less economic benefits as exchange for their labor. As a result, some of employees’ welfare is transferred to the entire body of all shareholders, i.e., the corporation – as a result, minority shareholders are benefitted as well since they share are residual claimants of the corporation.

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

\textsuperscript{201} In many cases, family members of a business group retain positions of top executives as well under controlling shareholder regimes.
Furthermore, a large corporation in a bad-law country is usually able to wield a gigantic monopoly power in each market where it plays. It is plausible that the competition law system is inefficient, if the quality of corporate law is low. Therefore, a great deal of welfare of trading partners and consumers would be transferred to a large corporation where minority shareholders participate as its partial owners. Besides, the government in a developing country sometimes provides a huge amount of subsidies to large corporations – accordingly, taxpayers’ money is transferred to all shareholders including minorities.

In sum, my point is straightforward. True, in a country with poor shareholder protection, in general minority shareholders are “victims” in the relation with the controlling shareholder who is a usual suspect of “wrongdoer”; the problem may arise when a controlling shareholder loots other stakeholders in a corporation; in this case, minority shareholders may free-ride on a controller as “shareholders” and be benefitted to the detriment of other stakeholders. In this sense, minority shareholders have incentives to participate in stock markets where they are not properly protected vis-à-vis controlling shareholders. Put simply, minority shareholders in a bad-law country, in fact, are not situated in the lowest level of the “food chain.” Indeed, it is not conclusive whether minority shareholders’ benefit from this free-riding exceeds their cost of expropriation by a controller – it depends on jurisdictions and case-by-case. Rather, my point is that minority shareholders in a bad-law country are not “unilateral victims” that is depicted by the conventional triumvirate model.

V. CONCLUDING REMARKS

Law and finance theories proposed by LLSV have made great contributions by introducing scientific methodologies to evaluate corporate governance practices in a comparative way. Nonetheless, their works have created a conundrum (i.e., Gilson’s riddle) that, so far, has not been explained well. In response to this puzzle, Professor Gilson proposes the PMBA as a possible answer. Despite pioneering contribution to pioneering this uncharted territory, the explanatory power of the PMBA is weakened, in
particular in a corporation where a controller’s cash flow rights are low. In order to rectify this problem, this Article proposes alternative explanations as to why a controlling shareholder relies on equity finance and has many public investors even though the cost of equity is substantially high. For the more relevant analysis, the incentives of public investors to participate in capital markets with poor investor protection should be analyzed as well. To this end, this Article proposes several expositions from the perspective of public investors. Based on these interactions in the capital market, as Marshall’s scissors indicate, both controlling shareholders and public investors can enjoy a surplus in the capital market. In this sense, informal (non-legal) institutions create a symbiotic relationship between two parties in a bad-law country. Since each controlling shareholder regime has its idiosyncratic forms and characteristics, it is impractical to generate “a general theory” for the controlling shareholder system. Perhaps, a large but missing part of the comparative corporate governance scholarship is an analysis based on the culture, which makes one system distinctive from the others. For example, the value of non-pecuniary benefits is very dependent on the people’s mindset and preferences shaped by their particular culture. In this context, it is worth noting the comment made by Professor Milhaupt – “It is obvious that analytical framework exploring incentives is fundamental in understanding the conducts of rational economic persons like a controller and minority shareholders. Nonetheless, I start to be convinced that we need to see through the lens of culture for the more comprehensive analysis on the corporate governance.”202 Agreeing with this insight, I look forward to seeing future works that will combine economic analysis and cultural explanations for this largely uncharted territory of comparative corporate governance.

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