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Re-envisioning Investors' Anti-Director Rights Index: Theory, Criticism, and Implications

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RE-ENVISIONING INVESTORS' ANTI-DIRECTOR RIGHTS INDEX: THEORY, CRITICISM, AND IMPLICATIONS

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Abstract

'Law and Finance' theory – which offers analytical frameworks to measure the protection of public investors and the quality of corporate governance – has dominated the comparative corporate governance scholarship in the last decade. So far, many proponents and critics have had debates on the relevance of the theory and the implications of the theory's empirical studies. Several important points in relation to shareholder protection, however, have been highly neglected in these debates. In particular, the significance of one-share-one-vote (OSOV) rule has been inappropriately underestimated. In response, this Article explores (1) why OSOV is an utmost critical component in corporate governance; and (2) how OSOV (or an exception of OSOV) makes some components of Anti-Director Rights Index (ADRI) – perhaps, the most significant corporate governance index so far – less meaningful. In addition, this Article offers critical examinations on components of ADRI. Features of a controlling shareholder regime (including CMS) are closely examined in the context of OSOV and ADRI. Moreover, this Article introduces possible structural biases as well. To these ends, examples, explanations, and evidence from China and Korea are used, in addition to traditional corporate governance theories based on the US jurisprudence.

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I. INTRODUCTION

Many institutes, relying on indices they define, have published reports on matters such as the 'competitiveness of nations,'[1] 'ranking of US law schools,'[2] 'corruption perception index,'[3] and even 'survey of happiness across countries.'[4] Likewise, a popular trend in modern social sciences is to conduct research on qualitative topics based on indexing with quantitative analysis. By means of scores generated from an index, this academic tendency makes ranking possible. Recently, such indexing has also been used by comparative corporate governance scholarship. In their pioneering article in *Law and Finance*[5], four distinguished economists from Harvard University and University of Chicago – La Porta, Lopez-de-Silanes, Shleifer, and Vishny (hereinafter LLSV) – invented a corporate governance index to measure the level of investor protections across 49 countries.[6]

LLSV's key framework for analyzing the quality of public investor protection in a jurisdiction[7] depends on the 'one-share-one-vote' (OSOV) rule and 'Anti-Director Rights Index' (ADRI)[8] with six components.[9] One point is awarded to a country if the country has the OSOV rule and any component of ADRI. Otherwise, zero points are awarded. It is noteworthy that the category of OSOV is separated from the six components of ADRI.

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[1] As for global competitiveness, see, e.g., Klaus Schwab, The Global Competitiveness Report 2013-2014, World Economic Forum (2013) at 15 (table 3) (available at http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2013-14.pdf); *see* also Michael Porter, *The Competitive Advantage of Nations*, 68 Harv. Bus. Rev. 73 (1990).

[2] *See, e.g.*, US News and Report, Best Law School: Ranked in 2014 (available at http://grad-schools.usnews.rankingsandreviews.com/best-graduate-schools/top-law-schools/law-rankings) (last visited July 6, 2014).

[3] *See* Corruption Perception Index 2013, available at http://www.transparency.org/cpi2013/results (last visited July 7, 2014).

[4] For example, Organization for Economic Co-operation and Development (OECD) publishes 'Better Life Index,' available at http://stats.oecd.org/Index.aspx?DataSetCode=BLI (last visited July 6, 2014).

[5] *See generally* Rafael La Porta et al., *Law and Finance*, 106 J. Pol. Econ. 1113, 1139 (1998) [hereinafter LLSV, *Law and Finance*]. In this Article, I refer to 'Law and Finance' as LLSV's theory and *'Law and Finance'* as LLSV's article.

[6] LLSV (or some of them) wrote a series of articles that are closely related to Law and Finance. *See e.g.*, La Porta et al., *The Economic Consequences of Legal Origins*, 46 J. ECON. LITERATURE, 285 (2008); La Porta et al., *What Works in Securities Laws?,* 61 J. Fin. 1 (2006); La Porta et al., *Investor Protection and Corporate Governance,* 58 J. FIN. ECON. 3 (2000); La Porta et al., *The Quality of Government*, 15 J. L. Econ. & Org. 222 (1999); Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997).

[7] As for ranking of countries' corporate governance quality and its availability, see e.g., Michael Graff, *Law and Finance: Common Law and Civil Law Countries Compared – An Empirical Critique,* 75 Economica 60, 64 (2008) ("Therefore, given adequate cross-country data, the proposed ranking of countries from different legal origins in terms of investor protection forms a testable hypothesis.").

[8] The acronym of 'ADRI' is used by Holger Spamann, *The "Antidirector Rights Index" Revisited,* 23 Rev. Fin. Stud. 468 (2010).

[9] Six components of ADRI are: (1) 'Proxy by Mail Allowed'; (2) 'Shares Not Blocked before Meeting'; (3) 'Cumulative Voting'; (4) 'Oppressed Minorities Mechanism'; (5) 'Preemptive Rights'; and (6) 'Percentage of Share Capital to Call an Extraordinary Shareholders' Meeting.' *See* LLSV, *supra* note 5. For the more explanation, see *infra* Part II.

Thus, the highest ADRI score for a country is six. In addition, it is of significance that almost all of ADRI components are related to shareholders' *voting*.[10] In this sense, ADRI explores into how effectively challenging shareholders can rely on their voting when they disagree with directors or management.[11] With ADRI (which does not include OSOV) as the major toolkit, LLSV's findings can be summarized as follows: (1) the quality of corporate law can be measured by six corporate law provisions which are reduced to the total score of ADRI[12]; and (2) public investors are protected more in common law countries than in civil law countries[13] (and such a difference of protection across legal origins is statistically significant).[14]

Law and Finance theory has had a huge impact on the comparative corporate governance scholarship and policy-making, highlighting the importance that 'good corporate law' enhances shareholders' protection and capital market development.[15] Most of all, without LLSV's seminal project, it would be impractical to compare the *quality* of different countries' corporate governance in a numerical way. Indeed, the availability of a *quick* indicator to measure the level of a particular jurisdiction's shareholder protection is a blessing for academia. Also, corporate governance scholarship becomes more vivid with statistical analysis of averages, standard deviations, *t* statistics, confidence levels, and *p*-values. As a result, it is understandable, by numbers, *how far* the quality of corporate governance in a developing country lags behind that in a developed country. Simply put, corporate governance scholarship has – at least partially – transformed from an 'art' into a 'science.'[16] Accordingly, economists and financial analysts as well as lawyers and legal scholars have actively participated in debates on

[10] OSOV is directly related to shareholders' voting since it is a principle that guarantees minority shareholders to cast their voting rights in proportion to their shareholding. Out of six components of ADRI, Only 'Oppressed Minorities Mechanisms' is not directly related to shareholders' voting. It is noteworthy, however, that 'Oppressed Minorities Mechanisms' is also partially related to voting. *See infra* note 96.

[11] As for the importance of shareholders' voting, it is noteworthy to quote Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988) ("The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.")..

[12] *See* LLSV, *supra* note 5. Although LLSV awards '1 or 0' point for OSOV, OSOV is not a component of ADRI and the score of OSOV is not considered when the total score of ADRI is compared across countries and legal origins. For the more explanation and criticisms of LLSV's analysis as to OSOV and deviation from OSOV, see *infra* Part III.

[13] *See* LLSV, *supra* note 5.

[14] Particularly, investors in French civil law countries are sheltered the least.

[15] *See* LLSV, *supra* note 5, at 1139.

[16] For instance, influenced by LLSV's approach, the World Bank has implemented 'Doing Business Project' (http://rru.worldbank.org/Documents/DoingBusiness/2004/DB2004 -full- report.pdf). For another example, Nenova uses ADRI when control premium is analyzed. *See* Tatiana Nenova, *The Value of Corporate Voting Rights and Control: A Cross-Country Analysis*, 68 J. Fin. Econ. 325 (2003).

corporate governance. In addition, transplantation of corporate law from developed countries has been popularly pursued as it is widely believed that the more investor-protection mechanisms (e.g., anti-director rights) exist in corporate law, the better the quality of corporate governance is.

On the other hand, however, Law and Finance theory has been challenged as well. LLSV's statement that the quality of law for investor protection determines the quality of the capital market has been criticized as possibly being inaccurate in its causal direction.[17] Market development is frequently followed by legal reform, so that the real direction of causation between law and market might be opposite to that suggested by LLSV.[18] Or, it is argued that a *correlation* between legal origins and the quality of corporate law does not necessarily mean *causation*.[19] In addition, one study conducted by Professor Spamann points out that LLSV's initial coding for the ADRI of 49 countries is not very precise.[20] As such, this study casts a great deal of doubt on the arguments and findings of Law and Finance theory. Another weakness is that important transition economies such as China and Russia are not covered in LLSV's survey.[21] Furthermore, since law-on-the-book does not guarantee efficient enforcement of such law, it is criticized that Law and Finance scores – based on six statutory shareholder rights in corporate law – do not necessarily reflect the real level of investor protection.

Likewise, Law and Finance theory has been extensively discussed, supported and criticized as a watershed topic in corporate governance scholarship. In particular, issues such as 'causation vs. correlation' and effects by legal origins are popular topics of debate. To be sure, these research issues are still worth further analysis. This Article, however, does not primarily pay attention to such recurring topics; rather, it aims to propose new critical perspectives that extant literature has seldom covered. In particular, highly neglected or misunderstood but significant debate topics – such as the OSOV rule and its deviation, impacts of control

[17] For the classic criticisms of LLSV and Law and Finance, see *infra* Part II.C.

[18] *See, e.g.*, Simon Deakin et al., *An End to Consensus? The Selective Impact of Corporate Law Reform on Financial Development*, 24 CENTRE FOR BUSINESS RESEARCH, UNIVERSITY OF CAMBRIDGE (June 2011), available at http://mpra.ub.uni-muenchen.de/39047/1/MPRA_paper_39047.pdf ("[L]egal reform is capable of stimulating financial growth which, in turn, intensifies the process of legal change.").

[19] *See infra* Part II.C.

[20] *See generally* Spamann, *supra* note 8.

[21] LLSV, *supra* note 5, at 1117 ("The sample covers 49 countries from Europe, North and South America, Africa, Asia, and Australia. There are no socialist or ''transition'' economies in the sample.").

ownership, and certain characteristics of anti-director rights that could be incompatible with a fair index-score system – are to be analyzed.

To this end, this Article explores in depth unique legal infrastructures and market environments in China and Korea which few studies have conducted rigorous research within the analytical framework of Law and Finance. Regarding corporate governance issues, these two countries are of significance since China is the second largest economy and Korea has long been the development model for emerging economies, not to mention the recent corporate law reforms in these two countries. Also, an analysis of evolved family-oriented corporate groups in Korea (i.e., *chaebols*) can provide scholars and policymakers with a great deal of legal and economic implications and lessons in China since controlling family shareholders have rapidly emerged and developed in China. In this respect, understanding the current market in Korea is useful to predict the future of the Chinese corporate environment. In particular, features related to the prevalent controlling ownership in the two countries – dominated by either State or elite family business tycoons – are to be reviewed in the context of OSOV and ADRI. The 'controlling minority structure' (CMS),[22] where a dominant shareholder is able to inflate his voting power beyond his economic interest, is discussed as well in conjunction with one-share-multiple-vote (OSMV), the antonym of OSOV. Against this background, this Article proposes three main points through scrutiny of Law and Finance theory.

First, this Article critically examines the OSOV principle and related issues in the context of CMS in particular. Most of all, OSOV – and thus OSMV, the exception of OSOV – are ill-defined in LLSV's survey, such that only the dual-class equity structure[23] is treated as an aberration of OSOV. OSMV distorts the equal voting rights in favor of a dominant shareholder; thus, it is possible that one control-share has, for example, 10 times the voting rights that an ordinary share of a minority shareholder retains, as seen in a dual-class equity structure. The problem is that stock pyramiding and intra-shareholding also grant a disproportionately large amount of voting power to a dominant shareholder. In this respect, such schemes are *functionally equivalent* to

[22] As for CMS, see *infra* note 94 and accompanying text and Part III.B.

[23] In a dual-class equity structure, for example, a share in Class A has 1 vote whereas a share in Class B has 20 votes. For the further explanation of dual-class equity structure, see *infra* note 101 and accompanying text and Part III.B.

dual-class equity structure as voting leverages. Therefore, all three mechanisms should be equally categorized as a controller's tools deviating from OSOV. In other words, LLSV define OSOV (OSMV) in a broader (narrower) manner than they should; thus, countries with voting privilege for dominant shareholders are *incorrectly* awarded generous scores for OSOV.

Second, this Article articulates a cascade effect – OSMV brings on ADRI – not considered by LLSV. Voting is the 'greatest common denominator' in ADRI since 5 out of 6 anti-director rights are related to minority shareholders' voting.[24] Thus, the relevance of ADRI as a corporate governance index is based on the implicit assumption of OSOV as a foundation for ADRI, since anti-director rights associated with *voting* should be supported by equal *voting* power for minority shareholders. Via voting leverages, however, OSOV – the fundamental safety valve for public investors – can be eclipsed by OSMV. With OSMV, accordingly, minorities' statutory power arising from anti-director rights would be significantly lessened.

For this reason, ADRI components should be designed as 'dependent variables' of the enforcement of OSOV, meaning that discounting the value of individual anti-director rights is necessary when OSMV is available in favor of corporate insiders. Alternatively, the ideal scoring system needs to construct a combination of OSOV/OSMV *and* individual anti-director rights. In the real survey, by contrast, LLSV separate ADRI from OSOV as two *independent* categories and count only the ADRI score without consideration of OSOV/OSMV. To illustrate, if Country A has 5 anti-director rights with OSMV and Country B has 3 rights with OSOV, LLSV's ADRI scores of the two countries are 5 and 3, respectively. However, I argue that investor protection is not necessarily better in Country A than in Country B, since OSMV destroys the value of voting-related ADRI components to a great extent.

Third, this Article scrutinizes whether LLSV's individual anti-director rights are really proper indicators for investor protection. In particular, four ADRI components – 'Cumulative Voting,' 'Preemptive Right,' 'Oppressed Minorities Mechanism,' and 'Percentage of Share Capital to Call an Extraordinary Shareholders' Meeting' – are examined in more depth.[25] For example, the effectiveness of cumulative voting would be seriously

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[24] *See supra* note 10 and accompanying text.

[25] *See infra* Part IV.

lessened when the number of directors to be elected is small and a staggered board is available. Without considering such factors, LLSV mechanically award countries one point as long as cumulative voting is 'allowed' in their corporate law.[26] In addition, the aforementioned cascading effect of the deviation from OSOV on anti-director rights is further explored at the level of individual ADRI components. For instance, when OSOV is circumvented, it is possible that a cumulative voting system – the mechanism designed to foment public investors' *proportional* representation in a board – would be entirely meaningless. This is because an ingrained feature of *disproportionate* voting scheme of OSMV already damages minorities' equal voting before minorities use cumulative voting.

In addition to these three main points, this Article puts forward possible 'structural biases' that many index-based studies (including Law and Finance theory) may be subject to.[27] Specifically, by taking an example of an alternative corporate governance index ('Pro-Director Right Index'), this Article elaborates the potential problem of constructing an index picked by researchers' discretion: even a seemingly reasonable index can generate a misleading implication.[28] Subsequently, this Article introduces an overview of other structural or systematic drawbacks of index-oriented studies, which the Author currently conducts research on in an independent project.[29] In particular, synergistic and overlapping effects of multiple components of an index and an interpretation problem of coding are briefly reviewed.

The remainder of this Article proceeds as follows. Part II describes Law and Finance theory in general and classic criticism on the index. Further criticism by the Author is proposed as well. Part III puts forward the Author's criticism as to LLSV's ill-defined notions of OSOV and OSMV. Subsequently, incorrect applications of such notions are to be discussed in greater depth. In addition, the effect of combining OSMV and ADRI is explored at the macro level (i.e., impacts on ADRI as a whole). Part IV analyzes why individual ADRI components are incomplete and distortive, and how ADRI could mislead policymakers who are interested in

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[26] LLSV, *supra* note 5, at 1122. For a further explanation of the variable of 'Cumulative Voting' and criticisms, see *infra* Part IV.A.

[27] *See infra* Part V.

[28] *See infra* Part V.A.

[29] *See infra* Part V.B.

improving the corporate governance of a jurisdiction. This Part also explores how the effectiveness of each ADRI component could be damaged by OSMV at the micro level (i.e., impacts on individual ADRI components). Part V sketches structural biases that LLSV and index-based studies may have. Part VI provides summary and conclusion.

The academic fashion of indexing is popular in many studies that *numerically* measure *qualitative* matters. Indeed, an index is quite useful, since it quantifies the quality and provides practical summary information. Nonetheless, indexing is merely a means of a 'quick litmus test.' In order to interpret the quick test in a proper manner, a careful qualitative analysis and a critical review of index components are essential. In this respect, this Article also provides a guideline to understand and examine index-oriented studies: based on a similar analytical framework, for instance, law school 'ranking' as well as 'independence' of central banks can be re-examined, not to mention other corporate governance indices (e.g., Gompers et al.'s,[30] Bebchuk et al.'s,[31] and Djankov et al.'s[32] indices).

II. LAW AND FINANCE

Since its publication in the late 1990s, Law and Finance theory has perhaps been the most influential and controversial corporate governance topic in contemporary scholarship. In particular, comparative corporate governance scholarship can be divided into two eras – 'before Law and Finance' and 'after Law and Finance.' This Part sketches the theory and core concepts of 'one-share-one-vote' (OSOV), 'one-share-multiple-vote' (OSMV), and the six components of Anti-Director Rights Index (ADRI). Subsequently, this Part explains classic critical views of the theory followed by further critiques by the Author.

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[30] *See* Gompers et al., *infra* note 59.

[31] See Bebchuk et al., infra note 60.

[32] *See* Djankov et al., *infra* note 57.

A. The One-Share-One-Vote Principle and Anti-Director Rights Index

"Does being a shareholder in France give an investor the same privileges as being a shareholder in the United States, India, or Mexico?"[33] Comparative corporate governance scholars have long sought the answers to such questions. To put forward at least a partial answer, LLSV construct an index to measure the extent to which corporate law (or commercial code) of a jurisdiction protects public shareholders in that domain. For an international comparison of the quality of shareholder protection, LLSV survey first OSOV/OSMV and then ADRI with six components across 49 countries.[34]

OSOV is the rule that requires every share to carry *equal* voting right.[35] As such, OSOV grants public shareholders a level playing field when challenging a dominant shareholder or the current management. In contrast, OSMV – the antonym of OSOV – is designed to award disproportionately more voting power to a dominant shareholder or the current management. Under OSOV, an insurgent shareholder can become a dominant shareholder by either purchasing a majority of shares in the market or obtaining a majority of votes from colleague shareholders through a proxy fight. In contrast, under OSMV, it would be much more difficult (or simply impractical) for an insurgent to become a new dominant shareholder. In other words, even if the insurgent hold more than 50% of cash flow rights, it does not necessarily lead to exercising more than 50% of votes due to the voting value disparity between a challenger's shares and a controller's shares. In sum, while 'cash flow rights' (or economic interests) and 'voting rights' are generally aligned under OSOV, they are not exactly associated under the legal system where OSMV is allowed. In this respect, OSOV/OSMV makes fundamental difference in shareholders' voting mechanisms.

Separately from OSOV, anti-director rights defined by LLSV – i.e., individual components of ADRI – are a group of rights in corporate law (or commercial code) awarded to public shareholders when opposing management and a board of directors. More specifically, they are six independent statutory rights for public

[33] *See* LLSV, *supra* note 5, at 1114.

[34] *See supra* note 21 and accompanying text.

[35] OSOV is explained in the following way as well. "… all securities have votes in the same proportion as their claim to income." Sanford J. Grossman & Oliver D. Hart, *One Share-One Vote and the Market for Corporate Control*, 20 J. Fin. Econ. 175, 175 (1988). As for the OSOV principle and deviations from the principle, the following explanation is worth noting.

shareholders: (1) whether shareholders' proxy voting by mail is legally permissible (in LLSV's terminology, the right is referred to as 'Proxy by Mail Allowed');[36] (2) whether corporate law "does not allow companies to require shareholders to deposit their shares prior to a general shareholders meeting" ('Shares Not Blocked before Meeting');[37] (3) whether corporate law allows minority shareholders to have proportional representation in a board of directors ('Cumulative Voting or Proportional Representation');[38] (4) whether public shareholders are able to bring suit against management and directors or to rely on appraisal rights under corporate law ('Oppressed Minorities Mechanism');[39] (5) whether corporate law grants shareholders a right to purchase newly issued shares on a proportional basis ('Preemptive Rights');[40] and (6) whether less than 10% of minority shareholders are allowed to call a special shareholder meeting under corporate law ('Percentage of Share Capital to Call an Extraordinary Shareholders' Meeting').[41]

I call the combination of OSOV/OSMV and ADRI 'Macro Corporate Governance Index' (MCGI) since components of MCGI describe the quality of corporate governance of countries at the macro level. In Law and Finance account, when a country's corporate law contains one of these 'one plus six' components of MCGI (the OSOV rule and six ADRI components), the country receives one point – otherwise, zero points are given to the country.[42] Viewed in this light, LLSV's scoring policy of OSOV and ADRI is based on a simple binary number system of '0' or '1.' Thus, a point value in between such as 0.5 does not exist. In addition, it is noteworthy that LLSV set the variable of OSOV (whether a country has OSOV or OSMV) aside from the six components of ADRI, although there is little reason to support such segregation.[43] Then, LLSV construct a huge scoreboard of ADRI for 49 countries, excluding scores for OSOV. Since ADRI has six components, each country's total ADRI score can range from 0 to 6. In this respect, the core part of Law and Finance theory is indeed ADRI since scores

[36] LLSV, *supra* note 5, at 1122 (table 1).
[37] *Id*.
[38] *Id*.
[39] *Id*.
[40] *Id*.
[41] *Id*.
[42] LLSV, *supra* note 5, at 1122-23 (table 1).
[43] *See infra* Part III.

of ADRI among countries – rather than scores of a broader index including the variable of OSOV – are compared. For example, while the average ADRI score of 49 countries is 3, the score of the United States is 5.[44] The only anti-director right that the US corporate law lacks is (5) 'Preemptive Right.'[45] Table 1 below summarizes MCGI as being comprised of OSOV and ADRI, and describes its application in the United States under LLSV's original coding.

Table 1: MCGI (OSOV and ADRI)

Public Shareholder Protection Index		**US Score**
1. One-Share-One-Vote (OSOV) Rule		0
2. Anti-Director Rights Index (ADRI)	(1) Proxy by Mail Allowed	1
	(2) Shares Not Blocked before Meeting	1
	(3) Cumulative Voting or Proportional Representation	1
	(4) Oppressed Minorities Mechanism	1
	(5) Preemptive Rights	0
	(6) Percentage of Share Capital Needed Call an Extraordinary Shareholders' Meeting	1
	Total Score of US Anti-Director Right (Maximum 6 Points)	**5**

B. Implications of Law and Finance Theory and Its Contributions

After surveying the ADRI of 49 countries, LLSV use the ADRI score – but not the OSOV score – of each country as a proxy for the level of corporate governance in the country. Put differently, the *quality* of 49 countries' corporate governance is roughly *quantified* by individual countries' aggregate ADRI scores.[46] Naturally it is likely – although it is not necessarily true all the time – that, for example, a country with 5 points of

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[44] However, Spamann points out that LLSV's coding is seriously flawed, and the 'corrected ADRI' score of the United States is 2. Spamann, *supra* note 8, at 474.

[45] As for preemptive right, "The common law concept of preemptive rights sought to protect existing shareholders from dilution of their stock ownership through subsequent stock offerings to a few existing shareholders or to new ones." Thomas Lee Hazen & W. Markham, Corporations and Other Business Enterprises: Cases and Materials (3rd ed. West 2009) at 1424. However, the common law rule of preemptive right could be limited by statute. "Delaware, for example, denies preemptive rights unless they are specified in the certificate of incorporation. Del. Corp. 102(b)(3)." *Id.* at 1433.

[46] Although scores of countries are calculated and revealed, the main point of Law and Finance theory is the superiority of common law jurisdictions over civil law jurisdictions in terms of the level of investor protection. In other words, it seems that comparison among 'groups of countries' – rather than among 'countries' – is emphasized in the theory.

ADRI (e.g., the United States and the United Kingdom) protects public shareholders better than a country having 2 points (e.g., Ecuador, Egypt, Greece, Austria, Korea, and Switzerland).[47] Accordingly, it is possible – if not sufficiently sophisticated – to rank 49 countries in terms of the quality of corporate governance.

Then, LLSV sort out 49 countries according to their 'legal origins' (based on common law vs. civil law). After classification, the numbers of jurisdictions with common law, French civil law, German civil law, and Scandinavian civil law are found to be 18, 22, 6, and 4 respectively. Subsequently, the average scores of ADRI for each group of legal families are calculated. Since the vast majority of countries belong to either common law family or French civil law family, in practice LLSV's comparison is conducted based on the rivalry framework of 'Anglo-American tradition vs. French tradition.' Specifically, while the average ADRI score of countries with common law origin is 4, the average ADRI score of countries with French civil law origin is 2.33.[48] Relying on further statistical analysis (including standard deviation and *t*-statistics), LLSV argue that public investors in capital markets are protected the most in common law jurisdictions and the least in French civil law jurisdictions.[49] Such a difference of average scores between common law and French civil law is supported further since it is *statistically significant*.[50] In addition, the theory implies that the quality of corporate law and governance in each jurisdiction and the development of capital markets are affected by legal origins.[51] In essence, LLSV put forward "law matters" in terms of investor protection and capital market development.

Since the late 1990s, Law and Finance theory has brought revolutionary development to the corporate governance scholarship as a fully interdisciplinary subject of law, economics, and finance. Through their endeavor to pursue statistical analysis, LLSV construct academic methodologies to evaluate comparative advantages of one jurisdiction over another jurisdiction in terms of the quality of corporate governance. Now, the

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[47] As for ADRI score of each country, see LLSV, *supra* note 5, at 1131 (table 2).

[48] LLSV, *supra* note 5, at 1131-32.

[49] LLSV, *supra* note 5, at 1116.

[50] LLSV, *supra* note 5, at 1132. The average ADRI scores of 6 German civil law countries and 4 Scandinavian civil law Countries are 2.33 and 3 points respectively. Countries with Scandinavian civil law and with German civil law are situated in between two contrasting legal origins of common law countries and French civil law countries.

[51] LLSV, *supra* note 5.

'artistic' nature of corporate governance becomes more 'scientific' as the quality of corporate governance of countries measured by ADRI can be quantified, compared, and ranked across countries.

Another contribution of LLSV is to expand the scope of the comparative corporate governance scholarship. Before LLSV's seminal project of Law and Finance, most of corporate governance scholars – either in law departments or economics departments – predominantly paid attention to the United States. To a much lesser degree, the corporate governance of Japan and Germany – the second and third largest economies at the time – was studied as an alternative model to that of the United States. As for German corporate governance, commentators were interested in a two-tier board system, which differs from the single-tier board system of the United States.[52] In addition, a group of scholars were interested in Japanese corporate governance with its distinctive systems (e.g., *keiretsu* corporate group system), executives' long-term view of management, lack of M&A,[53] life-long employment,[54] and corporate policies aiming at the welfare of 'other constituencies'[55] rather than the US-styled 'shareholder primacy norm.'[56] Examining corporate governance of 49 economies including *developing countries* as well as developed countries, however, LLSV overcome such ill-balanced tendency in academia and set a new milestone in the comparative corporate governance scholarship.

Furthermore, LLSV's study foments a trend of the 'scientification of the art' in corporate governance at the firm level as well as the country level. Djankov, La Porta, Lopez-de-Silanes, and Shleifer (Djankov and LLS) construct the 'Anti Self-Dealing Index,' another country-level macro corporate governance index measuring how

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[52] "In contrast to the USA and the UK, Germany and the Netherlands have a two-tier boar system. In Germany, the board comprises a management board (*Vorstand*) and a supervisory board (*Aufsichtsrat*), which provides a complete separation between management and supervision of management." Jeroen Weimer & Joost C. Pape, *A Taxonomy of Systems of Corporate Governance*, 7 Corporate Governance: An International Review 152, 157 (1999)

[53] For the more explanation of lack of M&A in Japan, see generally Curtis J. Milhaupt, *Creative Norm Destruction: The Evolution of Nonlegal Rules in Japanese Corporate Governance,* 149 U. PA. L. REV. 2083 (2001).

[54] For the general explanation of life-long employment in Japan, see Ronald J. Gilson & Mark J. Roe, *Lifetime Employment: Labor Peace and the Evolution of Japanese Corporate Governance*, 99 Colum. L. Rev. 508 (1999).

[55] As for academic articles on general Japanese corporate governance, see Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps between Corporate Governance and Industrial Organization,* Yale L. J. 871 (1993); Ronald J. Gilson & Curtis J. Milhaupt, *Choice as Regulatory Reform: The Case of Japanese Corporate Governance*, 53 Am. J. Comp. L. *343* (2005).

[56] 'Shareholder primacy' refers to the principle that shareholders' interest should be placed as the most significant issue in corporations. For example, directors and officers of a corporation are required to discharge duty of loyalty to shareholders (not another constituency of a corporation such as creditors and employees). As for a leading corporate law case of shareholder primacy principle, see Dodge v. Ford Motor Co. 204 Mich. 459, 170 N.W. 668 (1919). As for a critical review of this case, see Lynn A. Stout, *Why We Should Stop Teaching Dodge v. Ford*, 3 Va. L. & Bus. Rev. 163 (2008).

well a jurisdiction protects minority shareholders from a dominant shareholder's expropriation of corporate value.[57] Stimulated by LLSV's series of articles, World Bank has conducted a project called 'Doing Business,'[58] which assesses how much friendly a jurisdiction's legal system is to business communities. On the other hand, Gompers, Ishii, and Metrick (GIM) build a corporate governance index at the firm level.[59] Bebchuk, Cohen, and Ferrell further develop a management-entrenched index at the firm level as well.[60] Accordingly, investors – particularly large institutional investors – are able to diversify their capital in international markets as well as firms in a domestic market by means of quantified evaluation of corporate governance in both particular countries and particular companies in a country.

C. Criticism of Law and Finance: Overview and Further Analyses

Despite LLSV's contributions to the corporate governance scholarship, many of their key arguments have been called into question. When simplified, the key argument of Law and Finance school is that legal origin determines the quality of corporate law, which in turn determines economic outcomes such as capital market

[57] *See* Simeon Djankov et al., *The Law and Economics of Self-Dealing*, 88 J. Fin. Econ. 430, 431 (2008) ("Initial research in this area argues theoretically and shows empirically that differences in legal investor protection across countries shape the ability of insiders to expropriate outsiders, and thus determine investor confidence in markets and consequently market development (Shleifer and Vishny, 1997; La Porta, Lopez-de-Silanes, Shleifer, and Vishny, 1997, 1998; Shleifer and Wolfenzon, 2002). Yet while this research presents several empirical measures of investor protection that predict financial outcomes, it does not explicitly focus on self-dealing.").

[58] "Based in significant part on LLSV's methodology for quantifying law, one strand of rule of law projects that is still emerging is the World Bank's Doing Business Initiative, begun in 2004." Ruth V. Aguilera & Cynthia A. Williams, *"Law and Finance": Inaccurate, Incomplete, and Important*, BYU L. Rev. 1413, 1426 (2009) (two authors rely on Kevin E. Davis & Michael B. Kruse, *Taking the Measure of Law: The Case of the Doing Business Project,* 32 L. & SOC. Inquiry 1095 (2007).).

[59] As for their 'Governance Index,' see generally Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q. J. Econ. 107 (2003).

[60] Their entrenchment index is based on six provisions such as staggered boards, limits to shareholder bylaw amendments, poison pills, golden parachutes, and supermajority requirements for mergers and charter amendments. *See* Lucian Bebchuk et al., *What Matters in Corporate Governance?*, 22 Rev. Fin. Stud. 783, 783 (2009).

development.[61] However, as Professor Pistor points out, logical development based on the second 'stepping stone' – namely, that the quality of corporate law determines economic outcome – is not fully justified.[62]

Another important topic of discussion is the issue of whether LLSV's empirical study demonstrates correlation or causation. The idea behind this criticism is that correlation does not necessarily mean causation,[63] and LLSV show merely a statistical *correlation* between legal origin, the quality of corporate law, and economic outcomes rather than links of *causation* between these variables. As for this 'correlation vs. causation' debate, Professor West conducts an intriguing and appealing work. He suggests that a country with a French civil law (English common law) system is more (less) likely to succeed in the FIFA World Cup.[64] For the recent four decades, the FIFA World Cup championship was won by Germany (1974), Argentina (1978), Italy (1982), Argentina again (1986), Germany again (1990), Brazil (1994), France (1998), Brazil again (2002), Italy (2006), Spain (2010) and Germany again (2014).[65] All of these countries – with the exception of Germany – are countries with legal origins of French civil law. More broadly in the context of 'common law vs. civil law,' the performance of common law countries is much worse than that of civil law – including German civil law as well as French civil law – countries. In fact, even if time series data are expanded, the finding is almost the same – since the first FIFA World Cup in 1930, the only country with a common law system that has won the championship was England in 1966 when the games took place in the United Kingdom.[66]

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[61] LLSV, *supra* note 5. As for LLSV's key argument, see Katharina Pistor, *Rethinking the Law and Finance Paradigm* BYU L. Rev. 1647, 1656 (2009) ("In their anniversary paper, LLS depict the relation between origin, legal rules, and economic outcomes in a flow chart that leads from 'Legal Origin' to 'Legal Institutions' to economic 'Outcomes.'")

[62] *See, e.g.*, *id*. at 1650 ("The leap from a micro-level issue-the financing of firms-to the macro-level issue-financial market development-is asserted, but not explained.").

[63] *See, e.g.*, John Coffee, *Do Norms Matter? – A Cross-Country Evaluation*, 149 U. PA. L. REV. 2151, 2154 (2000) ("Yet, although LLS&V have unquestionably shown a statistically significant correlation between strong capital markets and certain specific legal protections that tend to characterize common law legal systems, correlation does not prove causation.").

[64] *See* Mark West, *Legal Determinant of World Cup Success*, UNIVERSITY OF MICHIGAN JOHN M. OLIN CENTER FOR LAW AND ECONOMICS, Paper #02-009.

[65] Originally, West conducts his research based on countries' ranking in International Federation of Association Football (FIFA). *See id.* at 1 ("In my regressions, I focus on soccer, using as the dependent variable the number of points each country has in the FIFA/Coca-Cola World Ranking as of May 2002."). In this Section, however, I use data of championship in FIFA World Cup.

[66] Even England's championship in 1960 World Cup is controversial since allegedly an England's score (against West Germany) in overtime is not legitimate.

It is difficult, however, to say that countries with French civil law system perform better in soccer "due to the remaining vestiges of Napoleon Code."[67] Put differently, legal origin – although it is *correlated* with the success of national teams in the FIFA World Cup – does not *determine* championship or rank in FIFA World Cup. The logic may continue: just as the 'quality of soccer playing' is not *caused* by legal origins, it is probable that the 'quality of corporate governance' is not *caused* by legal origins.[68] Of course, it would be fair to say that the relationship between corporate law based on a legal origin and market development is more likely to have causality than the relationship between a legal origin and a national soccer team's performance. Thus, it seems that the soccer paradox in relation to legal origins does not necessarily fully refute LLSV's empirical study. Nonetheless, West's study is suggestive and worth noting as it raises the question of causation in LLSV's project.

Even if a causal relationship is found in Law and Finance theory, the direction of causation is still unclear and subject to further discussion. As Professor Pistor explains, "law typically lags market development."[69] That is, the extent of market development is not determined by the quality of corporate law. Rather, the direction of causality between law and market development could be reversed,[70] as opposed to the finding of Law and Finance.[71] Alternatively, it is possible that there is no 'one-way' influence and causation, so that good corporate

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[67] West, *supra* note 64, at 4.

[68] *Id*. ("Perhaps teams from countries with systems based on the French model (such as 1998 champion France and 2002 champion Brazil) perform well due to the remaining vestiges of the Napoleonic Code that somehow remove discretion from coaches and managers in the same manner that that civil law system curtails judicial activism. Or maybe –just maybe –some other forces are at work.").

[69] Pistor, *supra* note 61, at 1652 ("one would expect that LLS et al. run the basic test whether countries with better legal protection do indeed have better financial systems. However, this would raise problems of reverse causality. It may well be, and indeed has been documented, that law typically lags market development. Thus, better investor protections tend to be a response to market."). *Id.* Stephen Choi also points the same problem. Stephen J. Choi, *Law, Finance, and Path Dependence: Developing Strong Securities Markets,* 80 Tex. L. Rev. 1657, 1680 (2001-02) ("The LLSV and related studies demonstrate a significant relationship between stronger legal protections for minority shareholders and creditors and the size of the external capital markets, the absence of controlling shareholders, higher dividend payments, increased valuation, and reduced private benefits of control. However, what remains somewhat unclear is the causality of the relationship. For example, it may be possible that a greater level of financial development (and the corresponding larger population of investors) may actually cause the enactment of laws providing for stronger investor protections.").

[70] As for reverse causality issue, see generally Katharina Pistor et al., *The Evolution of Corporate Law: A Cross-Country Comparison,* 23 U. Pa. J. Int'l Econ. L. 791 (2002).

[71] In addition, Professor Milhaupt explains, "… the empiricists may have reversed the actual chain of causation between law and corporate governance." Curtis Milhaupt, *Creative Norm Destruction: The Evolution of Nonlegal Rules in Japanese Corporate Governance*, 149 U. PA. L. REV. 2083, 2122-23 (2001).

law enhances the quality of corporate governance in a certain country *and* good macro-level corporate governance in the country further develops the domestic capital market.

Then, consider legal origin in more depth. The Law and Finance account is based on the notion that countries with common law *differ* from countries with civil law in terms of the quality of their corporate governance.[72] In order to support this finding, it would be better that the concepts of common law and civil law are clearly distinguished. Otherwise, it would be difficult to ascribe legal origin to the different level of investor protection. According to LLSV, common law is shaped by precedents from judicial decisions, which is a distinctive feature from civil law: "English law is common law, made by judges and subsequently incorporated into legislature. French, German, and Scandinavian laws, in contrast, are part of the scholar and legislator-made civil law tradition, which dates back to Roman law."[73] LLSV emphasize that particularly, civil law tradition "uses statutes and comprehensive codes as a primary means of ordering legal material."[74] The problem is, however, there is no clear fault line between legal families, despite LLSV's classification. The United States, for example, is a common law jurisdiction that relies on the case corporate law developed by Delaware courts. Nonetheless, it is often explained that in order to regulate corporate insiders' breach of duty, the United States is also heavily dependent upon the Securities Acts of 33 and 34 and regulations, which are statutory codes enacted by Congress and the SEC.

Similarly, in a country of civil law origin, the role of courts to interpret law and regulation is more significant than may have been generally thought. In such a country, it is true that written law is passed by legislature and rules are enacted by government agencies. Accordingly, the judiciary is not a main player during the initial law-making process. However, such statutory codes are usually condensed. This is done partially because law makers are unable to expect and write every detail of potential issues in the laws and regulations. In addition, a legislature often leaves statutes and rules 'open' (incomplete) on purpose in order to accommodate the

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72 Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. Fin. 1131, 1131 (1997).

73 *Id*. (internal citation omitted).

74 LLSV, *supra* note 5, at 1118 (citing JOHN H. MERRYMAN, THE CIVIL LAW TRADITION: AN INTRODUCTION TO THE LEGAL SYSTEMS OF WESTERN EUROPE AND LATIN AMERICA. Stanford, Calif.: Stanford Univ. Press, 1969).

evolution of society. Functionally, in this sense, the judiciary should be involved in the law-making process by clarifying law and rules in concrete cases.

Furthermore, there are many 'general legal terms' that cannot be easily defined. For example, to name several, legal terms such as 'fairness,' 'just compensation,' 'the principle of (utmost) good faith,' 'equal (or equity),' 'discriminatory' 'normal,' 'ordinary,' and 'public orders and good morals' often appear in statutes. Such general terms – that often shape key issues in law suits – ultimately need to be interpreted by the judiciary. As a result, civil law judges are not mere 'machines' that declare and apply statutory laws and rules that are enacted by a legislature. In addition, it is often true that civil law tradition "relies heavily on legal scholars to ascertain and formulate its rules"[75] as LLSV explain. However, such trend is not always true. Also, since there is no 'one unified' view from scholars as for complicated legal issues, ultimately it is a judge who finally approves which scholar's view should be applied as a legal rule in a particular case.

The categories of women and men are *mutually exclusive* at the *absolute* level. Inherently, however, the distinction between civil law and common law (not to mention the distinction between French civil law and German civil law) is not clear. As for legal families, indeed, there is a high chance of a hybrid. Japan – which is classified by LLSV as a country with a German civil law tradition – is a good example. It is generally true that the modern Japanese legal system was heavily influenced by German civil law. More precisely, however, Japan swung to adopt the French and German civil law systems in the 19th century.[76] After the Second World War, Japan heavily adopted legal doctrines from the United States,[77] (particularly corporate law).[78] Recently, such a trend is more pronounced as Japan legally recognizes the US-styled poison pill in hostile takeover defense[79] and

[75] Id. (citing Merryman, *supra* note 74).

[76] *See e.g.*, J. Mark Ramseyer, *Mixing-and-Matching across (Legal) Family Lines*, BYU L. Rev. 1701 (2009).

[77] *Id*. at 1708 (citing Curtis J. Milhaupt, *Historical Pathways of Reform: Foreign Law Transplants and Japanese Corporate Governance, in* CORPORATE GOVERNANCE IN CONTEXT: CORPORATIONS, STATES, AND MARKETS IN EUROPE, JAPAN, AND THE US 53, 55 (Klaus J. Hopt et al. eds., 2005).

[78] Hideki Kanda & Curtis J. Milhaupt, *Re-examining Legal Transplants: The Director's Fiduciary Duty in Japanese Corporate Law,* 51 Am. J. Comp. L 887, 887 (2003). ("Japan imported its original Commercial Code (including legal rules on business corporations) from Germany in 1898 as part of a fundamental reform of its legal system, and made large-scale amendments to the corporate law in the immediate post-war period by importing many specific legal rules from the United States.").

[79] For a more explanation of Japan's new approach to adopt the US-styled takeover doctrines, see generally Jack B. Jacobs, *Implementing Japan's New Anti-Takeover Defense Guidelines—Part 1: Some Lessons from Delaware's Experience in*

adopts *Unocal*-based doctrine.[80] Korea, another German civil law country, has lately shown a trend similar to 'Americanization.' In Korea, for example, judges, prosecutors, lawyers, and scholars frequently apply US jurisprudence even in public law fields (e.g., constitution and criminal law) that are heavily influenced by German civil law. In regard to corporate law in particular, cases and theories in the United States play a significant role by directly guiding legal doctrines and practice in Korea. Also, it is noteworthy that French civil law tradition has influenced administrative law scholarship in Korea.

Given this possibility of a complex hybrid, it would be fair to say that Japan and Korea are characterized by X% German civil law, Y% French civil law, and Z% common law, as opposed to the simple dichotomy proposed by LLSV. Of course, problems when acknowledging a hybrid of legal origins include the following: (1) it is impractical to recognize the precise fraction of X, Y, and Z; (2) even if X, Y, and Z are recognized, they differ in different fields of law (thus, legal origins' influence on corporate law could be different from those on other laws); (3) even worse, X, Y and Z may change over time. As a result, it is impractical to use legal families, as dummy variables as Law and Finance theory does.

Another criticism against Law and Finance theory is related to LLSV's limited coverage of law. One important area that has been omitted is rules on merger and takeover (M&A).[81] The United States and the United Kingdom are similar in that they share diffused shareholder ownership[82] in public corporations and a relatively common goal of 'shareholder primacy.'[83] However, they differ quite markedly from each other in that they have distinctive M&A rules. For instance, the mandatory bid rule, which has been the principle in the United Kingdom, is not found in Delaware. If different M&A rules were considered in the data set of LLSV, the extent of commonalities between two leading common law countries would be attenuated. Excluding M&A rules would

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Crafting Fair Takeover Rules, 2 N.Y.U. J. L. & BUS. 323 (2006).

[80] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

[81] LLSV, *supra* note 5, at1120. *See* also Amir N. Licht et al., *Culture, Law, and Finance: Cultural Dimensions of Corporate Governance Laws,* Law and Economics Workshop, BERKELEY PROGRAM IN LAW AND ECONOMICS, UC BERKELEY (2001) at 21 ("LLSV acknowledge some of the possible objections, including the fact that the indices do not cover merger and takeover rules, that they cover disclosure rules only partially, and that they do not cover rules made by stock exchanges or regulations of financial institutions" (citing LLSV, *supra* note 5)), available at http://escholarship.org/uc/item/53p3v8k7.

[82] For the more explanation of a diffused shareholder system, see generally John C. Coffee Jr. *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641 (1999).

[83] As for 'shareholder primacy,' see *supra* note 56.

help provide LLSV with a more robust conclusion that common law countries as a group differ from civil law countries.

Suppose that a legal origin is the dispositive factor that determines the development of capital markets in the countries, as LLSV suggest. Then, one possible interpretation is that when a certain jurisdiction was 'forced'[84] to adopt French civil law a few hundred years ago due to colonization, their economic destiny was determined to be forever 'hopeless' in terms of investor protection and capital market development. In fact, what Law and Finance provides is not 'time series' analysis but only 'cross sectional' analysis. If time series analysis is conducted, there might be fluctuation in terms of how investors have been relatively protected in countries over the time, as opposed to the implications of Law and Finance. For instance, it is explained that the French capital market was more developed than the US capital market at the start of the 20th century.[85]

Moreover, as is often discussed, it is unclear whether the 6 components of ADRI that LLSV choose are *representative* of 'good corporate law.' As Professor Coffee explains, "[b]y no means is it here implied that these [ADRI] rights are unimportant, but they seem to supply only partial and sometimes easily outflanked safeguards, which have little to do with the protection of control and the entitlement to a control premium."[86] In addition, it is questionable as to the number of components in ADRI. For practical purposes, it is understandable that collecting data for 6 components was already burdensome when LLSV examined the corporate law of 49 countries. Nonetheless, that does not justify why the index should have 6 components – rather than 10 or 20 – to measure the quality of corporate governance across countries. Or, as many who read and study Law and Finance for the first time comment, it is questionable why the 6 components of ADRI are *equally* weighted (the score of each component is always 1 point).[87] Also, it is probable that a component's weights in different countries may be

[84] Many of French civil law countries involuntarily adopted their legal origin when they were colonized.

[85] *See e.g.*, Raghuram G. Rajan & Luigi Zingales, *The Great Reversals: The Politics of Financial Development in the Twentieth Century*, 69 J. Fin. Econ. 5, 7 (2003) ("In 1913, France's stock market capitalization (as a fraction of GDP) was almost twice that of the United States (0.78 vs. 0.39) even though the French Civil Code has never been friendly to investors (La Porta et al., 1998). By 1980, roles had reversed dramatically. France's capitalization was now barely one-fourth the capitalization in the United States (0.09 vs. 0.46). And in 1999, the two countries seem to be converging (1.17 vs. 1.52).").

[86] John C. Coffee, *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 Yale L. J. 1, 4 (FN 6) (2001).

[87] In my course 'Corporate Governance from the Global Perspective,' Law and Finance was covered and many of my students raised this question as well.

different. For instance, when the corporate governance role of cumulative voting in Country A is more significant than that in Country B, the weight of cumulative voting in Country A's ADRI is larger than that in Country B.

Among the remarkable criticisms against LLSV's Law and Finance theory is Professor Spamann's finding of the coding errors of LLSV's original ADRI. "A thorough reexamination of the legal data, however, leads to corrections for thirty-three of the forty-six countries analyzed."[88] Then, "[t]he correlation between the corrected and the original ADRI is only 0.53."[89] Indeed, such coding errors by LLSV are understandable to some extent since LLSV's work is a path-finding project that nearly first attempts to analyze and compare corporate law of 49 countries. Although LLSV's huge contributions should not be downplayed, Spamann's criticism is crucial. Under his corrected ADRI, three widely held claims from LLSV's project – upon which traditional corporate governance scholarship relies heavily – are not firmly supported:[90] (1) "common law countries offer greater investor protection than civil law countries";[91] (2) "greater investor protection is associated with lower ownership concentration and larger equity markets";[92] and (3) "poor investor protection exacerbated the Asian financial crisis of 1997."[93]

III. CRITICISM OF LLSV'S ANALYSIS OF ONE-SHARE-ONE-VOTE

OSOV is one of the most vital protective mechanisms for minority shareholders. LLSV consider it as a component of a large set of MCGI that they survey across 49 countries. There are, however, several vulnerable aspects of LLSV's analysis. In particular, the failure to address 'controlling minority structure' (CMS) – where a dominant shareholder exercises control power via a majority of voting power while he holds only a fraction of shares[94] – is a crucial error. In addition, LLSV do not include OSOV in ADRI; thus, the score for OSOV is not

[88] Spamann, *supra* note 8, at 468.
[89] *Id*. at 470.
[90] *Id*. at 467.
[91] *Id*. at 470.
[92] *Id*.
[93] *Id*.
[94] *See generally* Lucian Bebchuk et al., *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash Flow Rights* 1 (NAT'L BUREAU OF ECON. RESEARCH, Working Paper No.6951, 1999). As for the general explanation of the role of CMS in M&A defense, see Sang Yop Kang, *Transplanting a Poison Pill*

counted when comparing the level of investor protection among countries or legal origins. In this respect, the significance of OSOV (or the deviation from OSOV) affecting the efficiency of ADRI components has been highly neglected in Law and Finance theory. A more desirable index – which is able to better reflect the quality of corporate governance – should take into account the huge dependence of ADRI components on the enforcement of OSOV.

A. The Importance of the One-Share-One-Vote Principle

It is of significance that voting is a 'common factor' in five out of the six components of ADRI: (1) 'Proxy Allowed by Mail'; (2) 'Shares Not Blocked before a Shareholders' Meeting'; (3) 'Cumulative Voting or Proportional Representation'; (5) 'Preemptive Right'; and (6) 'Percentage of Share Capital to Call an Extraordinary Shareholders' Meeting.'[95] It is clear that (1), (2), (3), and (6) are concerned with voting. (5) 'Preemptive Right' is also pertinent to shareholders' voting rights since by relying on the right, a minority shareholder can prevent a dominant shareholder or management from diluting her voting rights. In this light, only (4) 'Oppressed Minorities Mechanism' is not directly tied with minority shareholders' voting.[96]

Against this background, consider OSOV and OSMV. Under the OSOV principle, 'voting rights' are *proportionally* given to a shareholder according to her 'cash flow rights' (i.e., a shareholder's economic interest in a corporation). Therefore, *equal* voting right is given to each share irrespective of whether that share belongs to a dominant or a minority shareholder. In this sense, OSOV is a core characteristic of corporate law that can

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to Controlling Shareholder Regimes-Why It Is So Difficult, 33 NW. J. Int'l L. & Bus. 619 (2013).

[95] Compare with Spamann. According to Spamann, three components of ADRI are related to voting. "Of the six ADRI components, three are concerned with shareholder voting (voting by mail, voting without blocking of shares, and calling an extraordinary meeting), and three with minority protection (proportional board representation, preemptive rights, and judicial remedies)." (internal citation omitted). Spamann, *supra* note 8, at 468.

[96] A country's score for 'Oppressed Minorities Mechanism' is one, when *either* a derivative suit or shareholders' appraisal right in fundamental transactions such as M&A is found in corporate law of the country. LLSV, *supra* note 5. Basically, derivative suit system is a judicial remedy that is not closely related with voting. Also, a derivative suit could be brought against a corporation even when a shareholder does not have significant holding and voting. For example, a single shareholder with a single share can bring derivative suit in Delaware. In that case, derivative suit system is far from the issue associated with voting. On the other hand, appraisal right is given to only dissenting shareholders who cast their votes against M&A proposed by a board of director. DGCL 262. Thus, it could be explained that appraisal right is a back-up remedy for shareholders who already indicate their objection in voting. In this sense, it can be said that appraisal right is *indirectly* related to voting as well at least in some countries.

preserve 'corporate democracy.'[97] Accordingly, it is generally explained that under OSOV, public investors are better protected from corporate insiders' potential corporate misconduct than under OSMV.[98] In other words, under OSOV a dominant shareholder (or management) is unable to use a voting leverage, so that it is difficult for him to make corporate strategies and transactions in favor of himself at the expense of minority shareholders.

In contrast, when the OSMV exception (i.e., a deviation from OSOV) is allowed, some shareholders – usually a founder and his family, executives, or a dominant shareholder – have power to leverage their voting rights, while the rest of the shareholders have only one vote per share. Accordingly, OSMV distorts the fundamental principle of voting (i.e., equal treatment for any shareholder). For instance, suppose that a controller's share can cast ten times the amount of votes that a non-controlling shareholders' share can. Then, the controller – even if he holds only a small amount of stock ownership (e.g., 10%) – is able to exercise nearly a majority of voting power. As a result, non-controlling minority shareholders – although they "own" more than a majority of the equity interests of a corporation – could be effectively excluded from any corporate decision-making process in even an annual shareholder meeting. Indeed, due to the presence of the OSMV rule, it is true that control power is not always derived from 'owning' a large number of 'shares' but from the power of 'casting' a large number of 'votes.'[99]

B. Inaccurate Definition of One-Share-One-Vote

As discussed, OSOV (and the deviation from OSOV) is a critical factor when evaluating the quality of corporate governance. Without the firm establishment of OSOV – thus, when OSMV is allowed – minority shareholders' other anti-director rights that are tied to voting could be damaged. Despite the utmost significance of OSOV (or OSMV), however, LLSV's definition of OSOV (or OSMV) is imprecise from the practical perspective. To put it concretely, OSOV (or OSMV) in Law and Finance theory is *over-inclusive* (or *under-*

[97] Compare with 'political democracy' characterized as 'one-person-one-vote.' *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (Harvard Univ. Press 1996) at 72-73.

[98] LLSV, *supra* note 5, at 1126-27.

[99] A CMS-based ownership system is made by such discrepancy between 'ownership' and 'voting rights' (or control). For the more general explanation of such discrepancy and the CMS, see Bebchuk et al., 94.

inclusive). Consequently, some patterns of OSMV – deviations from OSOV – are mistakenly treated as categories of OSOV in LLSV's classification.

1. <u>One-Share-One-Vote and One-Share-Multiple-Vote</u>

"[The score of a country's OSOV] equals one if the company law or commercial code of the country requires that ordinary shares carry one vote per share, and zero otherwise."[100] LLSV continue to describe several cases where OSOV can be *circumvented*: "Companies can issue nonvoting shares, low- and high-voting shares, founders' shares with extremely high voting rights, or shares whose votes increase when they are held longer, as in France." This explanation is interesting because LLSV describe the concept of OSOV in a *negative* way by defining OSMV, which is the antonym of OSOV. Anyhow, LLSV clearly recognize a dual-class equity structure[101] as an example of non-OSOV (thus OSMV), which is a correct explanation.

Examine dual-class equity structure in more depth. Dual-class equity structures are used in some companies in particular in media industry. For instance, in News Corporation, Rupert Murdoch family can exercise almost 40% of the votes whereas the family owns about 12% of the company.[102] The New York Times, the Washington Post Co. and Dow Jones & Co. Inc. are also in the list.[103] Warren Buffett's Berkshire Hathaway relies on the structure as well: "The Class B stock is worth 1/30th of the Class A stock. But the Class B shares have 1/200th of the voting rights of the Class A version, according to a 2003 memo from Buffett."[104] Moreover, some companies in the Internet-based industry use the structures. "Google's IPO in 2004 involved two classes of share. LinkedIn followed suit this year [2011]. The IPO filings of Zynga and Groupon would also grant

[100] LLSV, *supra* note 5, at 1122 (table 1).

[101] As for dual-class equity structure, see Bebchuk et al., *supra* note 94, at 3 ("A planner can simply attach all voting rights to the fraction α of shares that are assigned to the controller, while attaching no voting rights to the remaining shares that are distributed to the public or other shareholders.").

[102] *Dual-Class Share Structures: The Cost of Control*, THE ECONOMIST (July 21, 2011), available at http://www.economist.com/node/18988938.

[103] Alistair Barr, *Buffett Defends Newspapers' Dual-class Shares*, MARKETWATCH (May 5, 2007, 5:15 p.m.), http://www.marketwatch.com/story/buffett-defends-dual-class-shares-for-newspapers.

[104] *Id*.

managers control over voting rights."[105] Another example is Facebook where Class A shares carry one vote and Class B shares have 10 votes.[106] As a result, Mark Zuckerberg can control with a fraction of ownership interests. Alibaba, the largest E-Commerce giant in China, uses a control leverage similar to a dual-class equity structure, so that Jack Ma, the founder of Alibaba, is able to control the company with only approximately 8.9% of ownership.[107]

Now consider weaknesses of Law and Finance theory in relation to OSOV. The most notable problem is that a dual-class equity structure is *not* the *only* voting mechanism in favor of a dominant shareholder (or corporate insiders) with a small amount of shares. In general, corporate insiders can use three ways to inflate their votes beyond their cash flow rights and bypass OSOV: (1) a dual-class equity structure; (2) stock pyramiding; and (3) intra-shareholding[108] (either through cross-shareholding or through circular ownership). By means of one of the above voting leverage mechanisms or a combination thereof, a shareholder – even if his cash flow rights are small – could exercise control in a CMS where he is a 'minority' in terms of 'equity holding' but a 'controller' in terms of 'decision-making power.' Accordingly, it can be explained that stock pyramiding and intra-shareholding are *functionally equivalent* to dual-class equity structure as voting leverages that render disparity between cash flow rights and voting rights. Since OSOV in Law and Finance theory is not defined narrowly enough, a country where intra-shareholding (or stock pyramiding) is used could be treated as a country with OSOV, as long as the country does not allow dual-class equity structure.

2. *How to Circumvent One-Share-One-Vote without Dual-Class Equity Structure*

In this respect, LLSV's scoring for OSOV in Korea is exemplary. According to LLSV's survey, Korea is awarded one point for OSOV. In appearance, such scoring seems reasonable since OSOV is explicitly stipulated

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[105] *Supra* note 102.

[106] Brad Stone, *Facebook Will Form 2 Classes of Stock*, THE NY TIMES (Nov. 24, 2009), available at http://www.nytimes.com/2009/11/25/technology/internet/25facebook.html?_r=0.

[107] *See, e.g.*, *Alibaba IPO Highlights Impish Founder Jack Ma's Rise to China's Entrepreneur-in-Chief*, FOX NEWS (May 7, 2014), http://www.foxnews.com/world/2014/05/07/alibaba-ipo-highlights-impish-founder-jack-ma-rise-to-china-entrepreneur-in/; *see* also Leslie Picker, *Alibaba Founders to Keep Control with Partnership Alternative*, BLOOMBERG (May 5, 2014, 6:01 a.m.), http://www.bloomberg.com/news/2014-05-04/alibaba-founders-to-keep-control-with-partnership-alternative.html.

[108] For the further discussion of these three voting leverages, see generally Bebchuk et al., *supra* note 94.

in Commercial Code in Korea.[109] In addition, dual-class equity structure is not allowed in Korea, thus a controller in a corporate group is not able to have common stock with multiple votes.[110] Moreover, in Korea, 'direct cross-ownership' between two corporations – i.e., Company A owns stock of Company B, which owns stock of Company A – in the same corporate group is prohibited in Monopoly Regulation and Fair Trade Act (MRFTA).[111] If direct cross-ownership is allowed, (1) fictitious capital would be made in two corporations;[112] (2) the principle of capital adequacy in corporations could be harmed;[113] (3) in addition, a controller in a corporate group would have voting rights in *both* corporations in exchange for *fictitious* capital.[114] As a result, voting rights of the controller are enhanced without the injection of real capital. Stock pyramiding had been effectively prohibited until approximately 2000 due to the concern about the concentration of economic power among a small number of controlling shareholders in large corporate groups.[115]

There is a legal loophole, however: circular shareholding is not fully prohibited.[116] Thus, it is possible that – in the simplest model of three corporations in one corporate group – Company A owns stock of Company B which owns stock of Company C which owns stock of Company A. In this case, fictitious capital is also made as in direct cross-ownership, but it is permissible in circular shareholding among three companies. In the real world, by means of more complicated intra-shareholding among a large number of affiliated firms (e.g., 50 affiliated firms) in one corporate group, a dominant shareholder on top of a *de facto* holding company could be a controller of the entire group with only a small amount of cash flow rights.

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[109] Art. 369, Commercial Code.

[110] Traditionally, different classes of common stocks that carry different voting power are not allowed in Commercial Code. It is noteworthy, however, that common stocks and preferred stocks are distinguished. Common stocks carry one vote, while preferred stocks do not. Thus, if more delicately explained, it can be said that there are two kinds of stocks that have different voting power although there are not different classes of common stocks. In this respect, issues surrounding OSOV/OSMV are very much complicated.

[111] Art. 9, MRFTA.

[112] HYUNG-YOON SHIN, ECONOMIC LAW 211-12 (5th ed. Bummunsa 2012). Consider that 'Corporation A' invests capital to 'Corporation B' which in turn invests capital back to 'Corporation A.' The same amount of capital is swapped between two corporations, leaving capital recorded in *both* corporations' balance sheet. In this sense, such capital is *fictitious*.

[113] *Id*. at 212.

[114] *Id*.

[115] OH-SEUNG KWON, ECONOMIC LAW (10th ed. Bummunsa 2013).

[116] More precisely, circular ownership has been 'regulated' by 'Total Equity Investment Ceiling (TEIC)' in MRFTA although it is allowed. However, TEIC has not sufficiently discouraged and deterred circular ownership.

For instance, Chairman Kun-Hee Lee, a dominant shareholder of Samsung Group – the largest corporate group in Korea to which a global IT giant Samsung Electronics belongs as an affiliated firm – has merely 0.7% of economic interests.[117] However, he wields a significant amount (almost a majority) of voting rights in Samsung Group as a whole with approximately 80 subsidiary companies. This magic takes place due to the combination of complicated circular shareholding and quasi stock pyramiding.[118] Again, it cannot be emphasized enough that corporate 'control' ultimately means voting power rather than ownership. Decision-making power via votes substantiates corporate policies through resolutions of directors who are in reality 'chosen' (rather than 'elected') by a controller. In short, LLSV's definition of the OSOV principle does not capture deviation of such principle towards circular shareholding, enabling a controller to circumvent OSOV.

In China, OSOV is stipulated in Company Law as well.[119] It is worth noting, however, that a pyramiding structure is often observed in business groups in China.[120] Fosun Group provides an interesting example.[121] Four individuals own Fosun International (58%, 22%, 10%, and 10% respectively). Fosun International owns 100% of Fosun Holdings, which owns 80% of Fosun International Limited, which owns 100% of Fosun High-Tech (Group) Limited. From then on, the ownership structure becomes more complicated. Fosun High-Tech (Group) Limited has ownership stake in four affiliated companies, Fosun Pharma, Forte, Industrial Investment, and Nanjing United Steel (49.0%, 47.1%, 100%, and 30% respectively). Fosun Phama holds 10.6% of ownership in Forte. Industrial Investment has ownership stake in Nanjing United Steel, Tebon Securities, Yuyuan, Jianlong Group, Zhaojin Mining, and Huaxia Mining (30.0%, 19.7%, 18.2%, 26.7%, 14.5%, and 20.0% respectively).

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[117] *Chairmen of 10 Largest Corporate Groups Control Corporate Groups with Less than 1% Economic Interests*, CHOSUN BIZ (July 10, 2014 12:00), available at http://biz.chosun.com/site/data/html_dir/2014/07/10/2014071001680.html (relying on data from Fair Trade Commission in Korea).

[118] Note that pure stock pyramiding was not allowed until around 2000, thus quasi stock pyramiding has been frequently used so far.

[119] Art. 103, Company Law.

[120] *See, e.g.*, Yuan Lu & Jun Yao, *Impact of State Ownership and Control Mechanisms on the Performance of Group Affiliated Companies in China*, 23 ASIA PACIFIC J. MGMT. 485, 488 (2006) ("Through this multi-layer structure, a parent company is able to control a large number of group affiliates in different industries or markets and therefore diversification becomes a popular strategy for business groups to achieve a rapid growth."). *See* also Charlie X. Cai, et al., *Do Audit Committees Reduce the Agency Costs of Ownership Structure?* (May 2011) at 17, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1339232 ("An important feature of the Chinese system, which is also prevalent in other countries, is control through pyramidal structures.") (citations omitted).

[121] As for the explanation of the ownership structure in Fosun Group, see Jia He et al., *Business Groups in China*, 22 J. CORP. FIN. 166, 169 Fig. 1 (citing Company History and Reorganization of Fosun Group).

Then, Nanjing United Steel has ownership stake in Nanjing Iron & Steel and Ningbo Steel (71.8% and 20.0%). Also, Yuyuan has ownership stake of Tebon Securities and Zhaojin Mining (32.7% and 15.2%), and Jianlong Group holds 20% of ownership in Ningbo Steel. Via this complicated ownership structure based on stock pyramiding (which enables OSMV), the individual with 58% of ownership in Fosun International is able to exercise control over almost the entire group. Again, this example illustrates that LLSV's definition of the OSOV principle (solely based on dual-class equity structures) does not capture deviation from OSOV.

To understand the effect of a voting leverage on control in a simplified manner, consider a hypothetical example in the following.[122] Suppose that a controlling shareholder – either the State or a family shareholder – owns 51% of stock in Company A, which owns 51% of Company B, which in turn owns 51% of Company C. Note that the controlling shareholder holds the equivalent of 13.26% of the economic interest of Company C.[123] Nonetheless, the controller can firmly exercise a majority of voting power on Company C through a long control-chain connected from the controller on top of the corporate group to Company C (via Company A and B). Simply put, the controller takes advantage of OSMV and a CMS.

3. *One-Share-Multiple-Vote and Tunneling*

Once a dominant shareholder's voting rights slightly exceed a majority in a corporation – as does the controller of the above corporate group[124] – it is functionally equivalent that he holds 100% votes in terms of the result of decision-making.[125] As a result, the dominant shareholder is able to do whatever he wants in the corporation even if the rest of the shareholders (holding 49% of votes) object. In this case, economic interests of the dominant shareholder alone and the 'corporation' – representing *all* shareholders – are detached in particular when the dominant shareholder is a CMS controller. Accordingly, less efficient corporate strategies from the standpoint of the 'corporation' could be adopted by the dominant shareholder as long as such strategies are

[122] In this hypothetical example, a pure pyramiding structure with three layers is considered.

[123] 51% x 51% x 51% = 13.26%.

[124] *See supra* notes 122-123 and accompanying text.

[125] It is assumed that shareholders can make decisions with a majority of votes. In the case of super-majority requirement, however, this assumption is not valid.

personally beneficial to him. Even worse, a controlling shareholder is able to transfer corporate value from a corporation that he exercises control over to himself. Such a practice is called 'tunneling,'[126] the technical term broadly describing the controller's extracting private benefits at the sacrifice of minority shareholders.

Examine the aforementioned hypothetical example in the context of tunneling.[127] Suppose that Company A and Company C have a transaction, where conditions and terms are favorable for Company A.[128] Thus, at the *legal entities'* level, the transaction is profitable to Company A, while it is costly to Company C. Then, consider the *controller's* personal payoff derived from two legal entities' cost-benefit. Since the controller holds 51% of economic interest over Company A, 51% of profit of Company A will privately belong to the controller. Likewise, since the controller is exposed to 13.26% of economic interest over Company C, 13.26% of Company C's cost will ultimately accrue to the controller through the control-chain within the corporate group. Given the fact that the amounts of Company A's profit and Company C's cost are exactly the same (only signs are opposite), the controller's 'personal *net* profit,' after taking into account personal benefit and cost from the internal transaction – is positive. This is because 51% (profit) is larger than 13.26% (cost). Likewise, as the disparity between cash flow rights and voting rights increases (for example, the controller holds 13.26% of ownership in Company C while he exercises a majority of voting power in the company), the problem of tunneling would deteriorate, since a controller does not care very much the cost occurred in a damaged company (e.g., Company C) where he has a low level of ownership stake.

Arguably, tunneling has been historically prevalent among large corporate groups (not to mention small corporations) in Korea. In China, due to the lack of effective corporate governance, protection for minority shareholders is still weak,[129] meaning that tunneling is a common business practice.[130] In particular, a notable form of tunneling in China is "the use of intercorporate loans by controlling shareholders to siphon funds from

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[126] 'Tunneling' is a phenomenon where a controlling shareholder takes corporate value at the sacrifice of minority shareholders. As for tunneling, see generally Simon Johnson et al, *Tunneling*, 90 AM. ECON. REV. 22 (2000). Djankov et al. construct a corporate governance index in relation to tunneling. Djankov et al., *supra* note 57.

[127] As for the numerical example, see *supra* notes 122-123 and accompanying text.

[128] The Author conducts an independent project which analyzes self-dealing and criticizes the conventional wisdom.

[129] Kun Wang & Xing Xiao, *Controlling Shareholders' Tunneling and Executive Compensation: Evidence from China*, 30 J. ACCT. & PUB. POL'Y 89, 90 (2011).

[130] *Id*.

publicly listed companies."[131] Although generally "the exact nature and scope of [tunneling] are difficult to pin down,"[132] it is likely that tunneling would be more facilitated within the context of a corporate group since a controlling shareholder is able to use OSMV (based on stock pyramiding and intra-shareholding) and CMS where the disparity between a controller's cash flow rights and voting rights is large. Like in Korea, corporate groups are main market players in China. For instance, some commentators explain "[business] groups contribute close to 60% of the nation's industrial output"[133] in China and "[b]y 2006, there were 2856 officially recognized business groups in China with 27,950 directly owned first tier subsidiaries, employing around 30 million people."[134] Accordingly, it is possible that the problem of tunneling in China would worsen as corporate groups develop more complicated ownership structures in the near future.

4. Summary

In sum, in order to understand corporate governance problems and properly assess the level of investor protection, it is of utmost significance to recognize OSOV more precisely, taking into account not only law-on-the-book but also any possibility of circumventing OSOV. It is worth noting that abuse of voting leverages in Korea and China is not caused by an 'inefficient enforcement' problem of the government or courts illegally allowing corporate groups to avoid OSOV.[135] Rather, market participants discover ways to circumvent OSOV *legally* under the existing codes and precedents.

Thus, it would be more precise to award zero points to Korea in terms of OSOV under the binary number system of ADRI[136] (recall that LLSV award one point to Korea). Similarly, it is expected that zero points would be assigned for China if the OSOV principle is surveyed according to Law and Finance theory. As for OSOV in the United States, LLSV grant zero points. It seems that LLSV take it seriously that dual-class equity structure is

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[131] Guohua Jiang et al., *Tunneling through Intercorporate Loans: The China Experience*, 98 J. FIN. ECON. 1, 2 (2010).
[132] *Id*. at 1.
[133] He et al., *supra* note 121, at 167.
[134] *Id*.
[135] Regulations on stock pyramiding, dual-class equity structures, and cross-ownership are relatively well enforced in Korea.
[136] Of course, it would be better to use a sliding-scale score between 0 and 1 rather than a simple binary system of 0 (nothing) or 1 (all). Technically, however, it would be extremely difficult to quantify in that way.

permissible under the US corporate law.[137] It is important to note, however, that "dual-class share structures are rare among public companies [in the United States]." Other means of voting leverages, such as stock pyramiding, are rarely found in the US market as well. In this sense, if a value of either 1 or 0 is to be awarded to the United States for OSOV, then 1 would be more appropriate, if the reality is appropriately reflected.

C. One-Share-One-Vote as a Foundation of Anti-Director Rights

As explained above, whether OSOV is mandatory in a jurisdiction is a fundamental factor that affects allocation of voting power between a dominant shareholder (or management) and minority shareholders. Accordingly, a country's OSOV score affects five voting-related components of ADRI. Consider the cumulative voting system.[138] As LLSV explain, cumulative voting is a corporate governance tool guaranteeing proportional representation for minorities. However, cumulative voting would be rendered less useful for the protection of minority shareholders when it is combined with an exception of OSOV. Suppose a dominant shareholder takes advantage of a voting leverage that can make him a CMS controller. Then, it is possible that a shareholder holding 13.26% cash flow rights could wield 51% of voting rights,[139] as seen in the aforementioned example.[140] Under these circumstances, cumulative voting would be a less meaningful way to achieve its ideology of 'proportional representation' since the voting proportionality for minorities is already seriously tainted under the CMS. Thus, a country with 1 point for cumulative voting actually does not deserve 1 point if corporate ownership of the country is based on the CMS, which is an ownership structure associated with the deviation from OSOV.

Consider an example where cumulative voting is allowed for corporations in both Country A and Country B to adopt.[141] In addition, suppose that OSOV is firmly established in Country A, but can be legally

[137] "American corporate law does not require all shares to have voting rights, nor does it require all voting shares to have equal voting rights." WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION (4th ed. Aspen, 2012) at 185.

[138] For a further analysis of cumulative voting, see *infra* Part IV.A.

[139] In other words, a CMS controller is able to inflate voting power by means of dual-class equity structures, stock pyramiding, or intra-shareholding.

[140] *See supra* notes 120-123 and accompanying text.

[141] It is noteworthy that a country 'allowing' – rather than 'requiring' – cumulative voting is awarded 1 point. *See* LLSV, *supra* note 5, at 1122 (table 1).

circumvented in Country B. Under LLSV's indexing, both countries obtain 1 point for cumulative vote. Also, Country A and B are awarded 1 point and 0 points, respectively, for OSOV. It is noteworthy that OSOV is treated as a separate component from ADRI in LLSV's research. Thus, the two countries' total ADRI scores are not affected by the presence of required OSOV. This methodology of indexing has a fatal shortcoming that can be criticized in two ways.

First, there is little reason for OSOV to be separated from ADRI. As discussed, OSOV is a key safety valve – perhaps the most important one – to protect minorities' voting power. Like most of ADRI components OSOV is closely tied with voting. Thus, it is more natural for OSOV to be included in ADRI as the seventh component. But, note that circumvention of OSOV may *fundamentally* disturb the foundation of minority shareholders' voting rights. In this respect, it would be desirable to assign, say, 2 points for OSOV (or at least negative 2 points for OSMV). If so, the total ADRI score of Country A including the score of OSOV should be 2 points more than that of Country B, other things being equal. One may argue that it is difficult to assign proper weights in a numerical way for either OSOV or any component of ADRI. I fully agree: for instance, 3 points are more proper: alternatively, 'properly' enhanced OSOV scores – compared to ADRI components – may vary widely across countries. What I emphasize here is, however, that the assigned points for OSOV should be *at least* higher than those for ADRI components. In this respect, LLSV make a fundamental error in their scoring system.

Second, if Law and Finance theorists would like to maintain the separation between OSOV and ADRI, then the combined effect of OSOV/OSMV and voting-related ADRI components should be taken into account when awarding a point for such ADRI components. To illustrate, OSOV/OSMV can be used as a *multiplier*; 1 if OSMV is not available, or 0.5 if it is. Thus, as for cumulative voting, OSOV points for Country A and Country B are 1 and 0.5 respectively. Again, I do not support the idea that the significance of OSOV is 'measurable' in terms of a multiplier such as '1' or '0.5.' Even if it is measurable, it does not say that the significance of OSOV is the same across countries. My point is, *if* a scoring system is used, the fundamental significance of OSOV/OSMV should be recognized because OSOV/OSMV affect the effectiveness of voting-related ADRI components. Put differently, ADRI components associated with public shareholders' voting power are *dependent* variables of OSOV/OSMV. If both countries equally have 3 voting-related ADRI components, the OSOV-ADRI combined scores of Country A and Country B should be 3 (with no availability of OSMV) and 1.5 (with the availability of OSMV), respectively.[142]

More precisely, it would be better that the average discrepancy between a typical controller's cash flow rights and his voting rights can be used as a discount factor in a jurisdiction. Note that the 'discrepancy discount factor' (another form of a multiplier) can be defined as 'cash flow rights over voting rights.' When a controller's cash flow rights are low and his voting rights are high, the discrepancy discount factor decreases. It means that the controller uses a more favorable voting leverage. To illustrate, two countries, Country X and Y allow OSMV and have 3 voting-related ADRI components. (1) In Country X, suppose that on average, a typical controller's cash flow rights and voting rights are 10% and 50% respectively. Then, the discrepancy discount factor is 0.2 (i.e., 10% ÷ 50% = 0.2). (2) In Country Y, suppose that on average, a typical controller's cash flow rights and voting rights are 40% and 50% respectively. Accordingly, the discrepancy discount factor is 0.8 (i.e., 40% ÷ 50% = 0.8). As a result, the total ADRI scores for Country X and Y are 0.6 (i.e., 3 ADRI components x 0.2) and 2.4 (i.e., 3 ADRI components x 0.8) respectively. Simply put, the extent of OSMV (i.e., how much deviated from OSOV) is penalized according to a discrepancy discount factor: the more leveraged a controller's voting rights are, the deeper the discount for the score is.[143]

IV. CRITICISM OF INDIVIDUAL COMPONENTS IN ANTI-DIRECTOR RIGHTS INDEX

This Part scrutinizes whether LLSV's individual anti-director rights are really proper indicators for investor protection. In particular, four ADRI components – 'Cumulative Voting,' 'Preemptive Right,' 'Oppressed Minorities Mechanism,' and 'Percentage of Share Capital to Call an Extraordinary Shareholders' Meeting' – are examined in more depth in this Article. In addition, this Part explores how OSMV and CMS damage the effectiveness of ADRI components.

[142] 3 x 1 = 3 (when OSOV is mandatory) and 3 x 0.5 = 1.5 (when OSMV is allowed).

[143] Despite the voting distortion generated by OSMV, OSMV is not always bad in the context of corporate governance. This complicated issue is, however, beyond the scope of this Article. I currently conduct another project to explore OSMV in more depth.

A. Criticism of 'Cumulative Voting'

According to LLSV, if a cumulative voting system is allowed in a jurisdiction, the jurisdiction is granted one point for the protection of minority shareholders. LLSV argue that the availability of a cumulative voting system makes it easier for minority shareholders to elect their representatives in a board.[144] The advantage of cumulative voting for minorities is clear when compared with straight voting, which is the default election rule in the United States. Under straight voting, a shareholder holding 51% of shares can elect *all* directors in a board. As a result, even a minority shareholder with a significant amount of shareholding (e.g., 49%) is not able to have even *one* director in a board no matter how many directors are to be elected. In contrast, under cumulative voting, a minority shareholder can elect one director if she has 'T / [D + 1]' shares ('T' stands for the total number of shares outstanding, and 'D' stands for the total number of directors).[145]

1. *Cumulative Voting in Law and Finance Theory and a Divided Board*

According to Company Law of China, cumulative voting could be used when electing directors and supervisors.[146] As for cumulative voting in China and LLSV's research methodology, a few details are worth noting. First, before cumulative voting was introduced in Company Law in 2005, the system was already implemented for listed companies under Code of Corporate Governance for Listed Companies in China[147] Second, under Company Law, cumulative voting is not mandatory. Instead, corporations are able to remain outside the system.[148] In contrast, cumulative voting is mandatory in Taiwan, for example. Nonetheless, China would be awarded one point for 'Cumulative Voting,' if LLSV's methodology is applied. This is because Law and Finance theory merely asks whether cumulative voting is 'allowed' in a country's legal system.[149]

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[144] LLSV, *supra* note 5.

[145] For the more explanation of the formula, see O'KELLEY & THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS: CASES AND MATERIALS (5th ed., Aspen Publishers 2006).

[146] Art. 105, Company Law in 2013.

[147] Code of Corporate Governance for Listed Companies in China, http://www.ecgi.org/codes/documents/code_en.pdf.

[148] Art. 105, Company Law in 2013.

[149] *See* LLSV, *supra* note 5, at 1122 (table 1).

Consider which result cumulative voting produces. Since a minority shareholder may be able to elect a director in a board, a board with cumulative voting has a high chance of being divided by two sides (the majority shareholder or management vs. a minority shareholder). Then, a fundamental point of inquiry is whether a divided board is really beneficial to enhancing the welfare of the entire group of shareholders. So far, the debate on this issue has not been definitively resolved: on the one hand, a divided board promotes a more democratic board due to participation from the minorities' side; on the other hand, it is often argued that directors from different factions are not cooperative and are sometimes even hostile to each other (accordingly, efficiency in the corporate decision-making process may be sacrificed). In addition, confidential information of a corporation could possibly be leaked since a challenger-minority shareholder is often an insider of the corporation's competitor. Then, it would be not perfectly convincing to award one point to a country that allows cumulative voting.

2. *Law and Finance Theory Does Not Consider 'Weak' Proportional Representation*

Another criticism against cumulative voting may arise when it comes to effectiveness. In relation to the aforementioned formula[150] for a minority shareholder's minimum required shares to elect one director, a dominant shareholder or management may choose certain strategies to lessen the possibility that minority shareholders retain their representation. When 'D' (the number of directorships to be elected) is *lowered*, the number of shares that a minority is required to hold in order to elect one director *increases*. Accordingly, a minority shareholder will find it more difficult to elect her representatives in a board. As a result, even in a country where cumulative voting is mandatory, a dominant shareholder or a current management team would defeat the purpose of this rule.

To illustrate, a minority shareholder needs more than 10% of shares to elect one director in a nine-member board.[151] Small minority shareholders with less than 10% of shares – actually most minorities fall into this category – are not able to elect their representative by themselves. In theory, shares can be collected via an alliance of many small shareholders. In practice, though, it would be very difficult to form one group of many

[150] *See supra* note 145 and accompanying text.

[151] Put 'T' = 100%. Then, the formula indicates 100% / [9 + 1] = 10%.

shareholders due to procedural issues and the collective action problem that dispersed minority shareholders face. Institutional investors are relatively large minority shareholders; thus hardship from the collective action problem would be lessened. However, if a capital market is not fully developed, it is likely that there is not a sufficient number of institutional investors. Accordingly, cumulative voting would not be useful even if it is instated in a jurisdiction. It provides an implication in understanding the cumulative voting system in China as follows. Indeed, stock markets in mainland China such as Shanghai Stock Exchange and Shenzhen Stock Exchange have grown rapidly in terms of size. Nonetheless, their development in capital markets' intangible infrastructure does not reach a sufficiently sophisticated level. In particular, the market for institutional investors should be more enhanced. As a result, the cumulative voting system in China would be less meaningful.

In addition, another strategy similar to defeating the minority's representation would be to set up a staggered board.[152] A staggered board in Delaware – the center of US corporate law – can be comprised of up to three classes. Thus, the aforementioned formula would become 'T / [(D/3) + 1].' Put differently, when a staggered board is introduced, the number of directors to be elected in a shareholder meeting is reduced to one-third. Consider again a board with 9 directors; in a *staggered* board only 3 directors are to be elected in a shareholder meeting. As a result, a shareholder (or a group of shareholders) needs at least 25% of votes in order to install a director from his side (or from a group of shareholders' side).[153] In short, if a staggered board is allowed, then a minority shareholder will find it more difficult to elect her director-candidate in a corporate election. In the extreme case, if a company has three seats for directors and adopts a staggered board, only one seat will be available in each shareholder meeting under corporate law similar to that of Delaware. As a result, cumulative voting and straight voting generate the functionally same result – a majority shareholder with 51% of votes is able to elect all three board members, whereas a significant minority shareholder with 49% of votes is not able to elect even one seat in the board.

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[152] "For example, MBCA 8.06 allows classification of directors into two or three groups of as equal size as possible. If directors are divided into two groups, then each director serves a two-year term, and if classified into three groups, each director serves a three-year term. The terms of all directors are staggered so that the term of only one group expires each year." O'KELLEY & THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS: CASES AND MATERIALS (5^{th} ed., Aspen Publishers 2006) at 156.

[153] Put 'T' = 100%. Then, the formula indicates 100% / [(9 / 3) + 1] = 25%.

Consequently, even if two countries have the cumulative voting system, the effectiveness of that system could vary widely, depending on (1) the average number of directors in a board and (2) whether a staggered board is allowed in a jurisdiction at issue.[154] Thus, without information on the average number of directors in a board and the availability of a staggered board in each country, LLSV's evaluation of 49 countries for cumulative voting is significantly incomplete. Since LLSV emphasize 'proportional representation on the board' as the very goal of having a cumulative voting system,[155] it is unfair to award one point equally to a country with a cumulative voting system that does not provide sufficient guaranty for 'proportional representation on the board' and another country that does. In this respect, LLSV's simple dichotomy – whether a country allows cumulative voting or not – would actually be inconsistent with their own philosophy.

3. *Controlling Minority Structure and Cumulative Voting*[156]

In addition, it is worth noting again that the effectiveness of the cumulative voting system should be analyzed within the context of CMS. As discussed, controlling shareholders in many countries (outside the United States and the United Kingdom) rely upon CMS where they can exercise a disproportionately large amount of voting rights, compared to their cash flow rights. Such separation of cash flow rights and voting rights can be achieved via voting leverages. In CMS, a controller exercises a large amount of voting rights (e.g., 50.1%) while he holds only a small amount of shares (e.g., 10%), due to the opportunity to deviate from OSOV. This example is not unrealistic. For instance, the chairman of a large corporate group in Korea – a position usually held by a controlling shareholder – often holds less than 2% of economic interests in a corporation.[157] As

[154] Some countries including the United States allow staggered board system, which weakens minority shareholders' capacity to elect a director in a board.

[155] In their own terminology, 'cumulative voting' and 'proportional representation' are considered to be within the same ADRI component. *See* LLSV, *supra* note 5, at 1122 (table 1) (explaining LLSV's variable of 'cumulative voting or proportional representation').

[156] This Subsection is based on Sang Yop Kang's article, tentatively titled, *Cumulative Voting in a Controlling Shareholder Regime: Theory from the United States, Lessons from Korea, and Implications for China* (unpublished draft).

[157] Ownership of Large Corporate Group in 2014, FAIR TRADE COMMISSION IN KOREA, at 2, available at http://www.ftc.go.kr/news/ftc/reportView.jsp?report_data_no=5722 (explaining that the average ownership of controlling shareholders in 40 largest corporate groups in Korea is 2.0% as of April 1, 2014). The average ownership of controlling families as well as controllers is 4.2%. *Id*.

aforementioned, Jack Ma, the founder of Alibaba, the largest online commerce company in China, controlled (and still controls) the company with only 8.9% ownership.[158]

Based on this theoretical background of CMS, consider the following two cases. Begin with **Case 1**. Suppose that everyone relies on OSOV in Company A and there is no controlling shareholder. In other words, CMS does not apply to Company A (nobody is able to use a voting leverage). Under these circumstances, the total number of votes cast by all of shareholders in Company A is equal to the number of shares that all shareholders in the corporation own. For instance, if there are 1,000 shares outstanding, the number of votes is 1,000 as well. Accordingly, a minority shareholder with 5% shares – say 'Shareholder A' – holds exactly 5% of voting power. Thus, she can cast 50 votes.

Then, consider **Case 2**. Suppose that in Company B, there is a controlling shareholder who wields a majority of voting rights but holds only 5% of the economic stakes. He uses dual-class equity structure, and his shares have multiple votes per share. In other words, CMS applies to this case. Such prerogative, however, is not available to the rest of shareholders, including a non-controlling shareholder – say, 'Shareholder B' – who holds 5% of shares in Company B. The focal point in Case 2 is that the controlling shareholder holds the *same* percentage of shares outstanding as Shareholder B does, although they have *different* voting rights. Think about the total number of 'votes' in Company B where the controlling shareholder has a voting advantage of OSMV. If there are 1,000 shares outstanding in Company B, the number of votes is '1,000 + *Alpha*' (where *Alpha*, a positive number, represents the enhanced voting power of the controlling shareholder). When the controller has 20 votes per share, he has 1,000 votes and *Alpha* is 950.[159] Accordingly, the total number of 'votes' that can be cast in Company B is *larger* than the total number in Company A. Nonetheless, Shareholder B can cast only 50 votes, the same number of votes that Shareholder A can cast.

Then, consider the 'percentage' of votes that the two non-controlling shareholders hold. Recall that in Company A where CMS – thus, OSMV – is not used, Shareholder A has 5% votes (50 out of 1,000 votes). The case of Shareholder B in Company B, where CMS and OSMV are available, is a little complicated. Similarly to

[158] *See supra* note 107 and accompanying text.

[159] The controller's enhanced voting power is shown as 19 votes per share. Thus, 19 (votes) x 50 (shares) = 950.

Shareholder A, Shareholder B has 5% of shares (50 out of 1,000 shares). Shareholder B can cast one vote per share (thus, 50 votes). To Shareholder B, the difference is that the total number of votes within Company B is not 1,000 but '1,000 + *Alpha*' due to the dual-class equity structure. When the total number of votes in the corporation becomes *larger* as the number of her own votes is *not changed*, Shareholder B ends up with *less* than 5% of voting rights in Company B. Simply put, the percentage of her voting power is not '50/1,000' (i.e., 5%) but '50/(1,000 + *Alpha*).' When the controlling shareholder has 20 votes per share, Shareholder B retains merely 2.56% of voting power in Company B. As a result, from the standpoint of Shareholder B (a minority shareholder who owns 5% of shares), under a cumulative voting system it is more difficult to occupy one seat in a board than for a similarly situated minority shareholder in a corporation without CMS (e.g., Shareholder A). Table 2 summarizes.

Table 2: The Effect of a Dual-Class Equity Structure on Cumulative Voting

		Company A	**Company B**
CMS		N/A	Dual-Class Equity Structure
Controlling Shareholder		N/A	5% Ownership Majority Voting Power
Minority Shareholders		A	B
OSOV/OSMV		OSOV	OSMV for the Controller (One-Share-Twenty-Vote)
Ownership	Total Number of Shares Outstanding	1,000	1,000
	Number of Shares the Controller Owns	N/A	50
	Number of Shares Minority Shareholders (A and B) Own	50	50
	Ownership of Minority Shareholders (A and B) (%)	5%	5%
Voting	Total Number of Votes[160]	1,000	1,950
	Number of Votes the Controller Can Cast	N/A	1,000
	Number of Votes Minority Shareholders (A and B)	50	50
	Voting Power of Minority Shareholders (A and B) (%)	5%	2.56%
Effect of Cumulative Voting (from the Perspective of a Minority)		More Proportional	Less Proportional

[160] In Company B, the total number of votes is 1950, since 5% of shares (50 shares) have 20 votes and 95% of shares (950 shares) have 1 vote (i.e., 50 x 20 + 950 x 1 = 1950).

Under cumulative voting, let us continue to discuss the minimum number of directors to be elected in a shareholder meeting. In the case for Shareholder A, she would get one directorship when the total number of directors to be elected is at least 19, as the formula indicates.[161] On the other hand, when Shareholder B needs one seat in the board of Company B, the minimum number of directors in the board to be elected should be definitely *more* than 19, which is the cut-off number for the non-controlling shareholder with 5% shares in Company A. Put differently, this explanation confirms the above conclusion; a dual-class equity structure, a voting leverage that renders CMS available, creates a great deal of difficulty for a minority shareholder who is interest in making her voice heard in a board.

Next, consider the controlling shareholder in Company B in the context of a corporate election under cumulative voting. Since he wields a majority of votes, the controller would always take more than a *majority* of directors in a board *irrespective* of the number of directors in a board. This is a point of critical contrast when two facts are considered: (1) in Company B, both the controlling shareholder and Shareholder B hold the same amount of economic stakes; (2) nonetheless, Shareholder B has an opportunity to elect *one* director *only when* there are 'many' – far more than 19, as discussed – directors to be elected. How 'many' directors must be elected depends upon the value of *Alpha*; the larger *Alpha* is, the more directors must be elected in a shareholder meeting, in order for Shareholder B to have her own representation in the board.

Note, however, that the above discussion is based on the assumption that cumulative voting is used with a non-staggered board. As already seen, the availability of a staggered board would exacerbate the chance of the minority's representation. This is because the number of directors to be elected is reduced to one-third of the total number of directors. Now, let us begin analysis of the case of Company A where dual-class equity structure is not used. Under cumulative voting, Shareholder A can elect her director in the board when the number of directors to be elected in an annual shareholder meeting is 19. This means that under a staggered board, Company A should have at least 57 directors since only one-third of the board members are changed in an annual shareholder meeting (19 is one-third of 57). In Company B, of course, the total number of directors that makes an opportunity for

[161] Put 'T' = 100%. 5% = 100% / [D + 1]. If the equation is solved for 'D,' D = 19.

Shareholder B to elect one director from her side is more than the total number of directors in Company A. This is because Company B is a CMS corporation with dual-class equity structure, which is a more burdensome condition for Shareholder B when electing a director.

In sum, in a CMS where discriminatory voting is built in, a corrective voting mechanism – e.g., cumulative voting – is unable to sufficiently redress unfairness. Put simply, the positive effect of cumulative voting to protect minority shareholders – if any – could easily be eclipsed by a CMS. Of course, if there is any regulation on a CMS controller's inflated voting power in the context of a corporate election, then the unfairness associated with CMS would be lessened. For instance, it would be imaginable that a CMS controller's voting power is capped or limited under corporate law, securities regulations, or exchange rules. Considering all the factors discussed above, my point is that LLSV's scoring system for the cumulative voting system is too simple. Given that LLSV surveyed 49 countries, the need for such a simple scoring system is understandable. Indeed, LLSV's contribution is huge, and without their seminal work of Law and Finance, the comparative study of international corporate governance would never have been born. Nonetheless, simple application of Law and Finance theory could be significantly misleading in terms of the extent to which minorities' proportional representation is protected.

4. *Availability of 'Opt-out' and Its Consequence: The Case of Korea*

In some countries, corporations could circumvent cumulative voting through a charter or a bylaw although cumulative voting is a default rule. Commercial Code in Korea had no cumulative voting provision in December 1998 when *Law and Finance* was published. Accordingly, Korea gets zero points for its cumulative voting system in LLSV's survey. In fact, by amending Commercial Code in December 1998, Korea adopted a *de facto* mandatory cumulative voting rule.[162] Thus, Korea's current score of for cumulative voting would be one.[163] Nonetheless, a corporation can opt out of cumulative voting by stipulating in a charter, which could be made by a

[162] Art. 382-2, Commercial Code.

[163] In *Law and Finance*, if cumulative voting is 'allowed' (not 'mandatory') in a country, the country is awarded 1 point. LLSV, *supra* note 5.

shareholders' resolution.[164] Consider who are dominant shareholders in Korea in terms of *voting* power, particularly in large corporate groups – namely, CMS controllers. On average, they hold only 2% of cash flow rights (including their families' ownership, the number is 4.2%).[165] As such, CMS controllers would seek to abandon cumulative voting. In reality, 92.1% of listed companies in Korea opt out cumulative voting.[166] This fact indicates that LLSV's scoring system for cumulative voting is very incomplete as it takes glance only at the cumulative voting system in law-on-the-book without considering factors (such as a CMS or OSMV) that affect the system seriously. Perhaps, it is fair that Korea gets, for example, 0.08 point since only about 8% of listed companies in fact adopt cumulative voting.

B. Criticism of 'Preemptive Right'

Preemptive right is the right of existing shareholders to purchase shares on a *pro-rata* basis when a corporation issues new shares. Thus a shareholder with 10% of shares has an option to purchase 10% of new shares issued by a company. Preemptive right protects public shareholders mainly for two purposes. (1) Without this right, a corporation can issue new shares only to corporate insiders in favorable terms (at a discount), at the exclusion of non-controlling minorities. In this sense, the right protects public shareholders from dilution of their share *value*.[167] (2) In addition, preemptive right protects public shareholders from dilution of their *voting* power since they are entitled to purchase shares proportionately to their existing portion. This is why it is important to note that preemptive right is also tied to shareholders' voting rights, as this Article explains.[168] In Delaware, preemptive right is not guaranteed for shareholders.[169] In fact, it is the only component of ADRI that the United

[164] Art. 382-2, Commercial Code.

[165] *See supra* note 157.

[166] *Cumulative Voting as a Titular System*, Asia Business Daily (Mar. 13, 2014, 16:10), available at http://view.asiae.co.kr/news/view.htm?idxno=2014031314070790126 (stating that 665 out of 722 listed companies in Korea opt out cumulative voting in 2013, according to Financial Supervisory Service).

[167] "This [preemptive] right is intended to protect shareholders from dilution, whereby shares are issued to favored investors at below-market prices." LLSV, *supra* note 5, at 1128.

[168] *See supra* notes 95-96 and accompanying text.

[169] *See supra* note 45.

States lacks.[170] By contrast, as a general rule, shareholders in Korea have preemptive right under Commercial Law.[171] Similarly, shareholders in China are in principle awarded preemptive right under Company Law.[172] Thus, if LLSV's scoring methodology is applied, Korea and China are to be awarded 1 point for the right, while the United States is awarded 0 points.

Then, consider any weakness of LLSV's analysis and scoring policy of preemptive right. Most of all, preemptive right has a fundamental limit that mitigates LLSV's 'positive' view of the right. What the preemptive right provides to shareholders is merely an opportunity to be asked to purchase new shares before third parties or corporate insiders are exclusively offered the chance.[173] In short, preemptive right does not give shareholders gifts of new shares; thus, shareholders *pay additionally* in order to exercise the right. Thus, when they lack sufficient capital to purchase new shares, the only alternative is to voluntarily give up the right. In this context, preemptive right markedly differs from the other five anti-director rights that are automatically granted to public investors *without* any further contract *consideration* once they become shareholders. For instance, when it comes to shareholders' right to call a special shareholder meeting, minority shareholders do not have to pay or give up something valuable in exchange for the right.

Second, as analyzed in cumulative voting, under a CMS the effectiveness of preemptive right's anti-dilution of shareholders' share value and voting power would be significantly lessened. To understand this, consider a (de facto) holding company of a corporate group that is built by a CMS voting leverage, which is a common phenomenon in the world economy.[174] Often, a (de facto) holding company has a small number of shareholders in order to give powerful voting leverage ultimately to a dominant shareholder. Accordingly, shareholders of a (de facto) holding company are either core insiders of the group (including executives and family members of a CMS controlling shareholder) or company-shareholders (affiliated or related firms of the

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[170] LLSV, *supra* note 5, at 1130 (table 2). *See* also *id.*, at 1129 ("The only dimension on which common-law countries are not especially protective is the preemptive right to new share issues (44 percent).").

[171] Art. 418 (1), Commercial Law.

[172] Art. 34, Company Law in 2013.

[173] *See e.g.*, OK-RIAL SONG, LECTURE ON COMMERCIAL LAW (3rd ed. Hongmunsa 2013), at 1086-87.

[174] For the CMS system in the world, see generally Andrei Shleifer & Robert Vishny, *A Survey of Corporate Governance*, 52 J. Fin. 737 (1997); Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999).

group).[175] When a (de facto) holding company issues new shares, it is possible that all shareholders other than the controller may choose not to exercise their preemptive right. Consequently, only the controller (and/or his family and third parties under the direct influence of the controller) purchases new shares in favorable terms. Actually, such 'voluntary' renunciation of preemptive right is the result of a controller's explicit or implicit pressure, which is difficult for outsiders to particularize or prove.

This sort of phenomenon was vividly observed in the law suit case in relation to arguably 'unjustified' succession of control ownership in Samsung Group, from Chairman Mr. Kun-Hee Lee (the second generation of Samsung family) to his children (the third generation). In this case, it is alleged that new securities of Everland, a theme park company but the *de facto* holding company of Samsung Group, were used in favor of the family. Ultimately, the second and third generations were able to firmly control the entire group consisting of about 80 affiliated corporations. Also, it is noteworthy that similar patterns of preemptive right abuse would happen in China in the near future. This is because family corporate groups have gradually emerged in China and controlling family shareholders – who are interested in uninterrupted inheritance of their wealth and capacity as controllers – would be able to find a legal loophole in preemptive right.

In addition, as more shares of upper-stream companies in a corporate group are purchased by a controller, he is able to capture extra-profits by manipulating the terms and conditions of an internal transaction between an upper-stream company (where he has more economic stake) and a down-stream company (where he has less economic stake). More specifically, by setting an unjustified transfer price between two companies in favor of the upper-stream company, he can easily transfer corporate value of affiliated down-stream companies to upper-stream companies via self-dealing.[176] Accordingly, since the controlling shareholder has more economic interests in the upper-stream company than in the down-stream company, illicit profits ultimately flow into the controlling shareholder's pocket. Apparent victims are public shareholders of down-stream companies. This practice has been allegedly commonplace in large corporate groups in Korea and China. In particular in China, since

[175] *Id*.

[176] *See* the example in *supra* notes 120-129 and accompanying text. Sinclair Oil Corp. v. Levien 280 A.2d 717 (Del. 1971) is a leading case for self-dealing.

controlling shareholders and holding companies (natural people and government entities) are quite strong, these tunneling cases would become a serious socio-economic problem.

In sum, this Section characterizes problems of preemptive right in three ways: (1) it is a right that is not free; (2) preemptive right at least in a (de facto) holding company could be merely *nomenclature* in particular in jurisdictions of the CMS; and (3) in the context of a pyramiding structure, preemptive right can be misused as an instrument of tunneling. Under these circumstances, preemptive right – even if stipulated in corporate law and firmly enforced by government agencies and courts – is not meaningful enough to protect public shareholders from corporate insiders, particular controlling shareholders. ADRI fails to recognize this and blindly awards one point to a country if preemptive right is written in the corporate law.

C. Criticism of 'Oppressed Minorities Mechanism'

According to LLSV, when legal recourses are available to shareholders who are oppressed by a board, a jurisdiction is granted one point. Shareholders' 'Oppressed Minorities Mechanism' is composed of derivative suit system and appraisal right.

1. Oppressed Minorities Mechanism: Two Rights in One ADRI Component

Oppressed Minorities Mechanism' is a unique index component since it includes two *independent* rights for minority shareholders (i.e., derivative suit system and appraisal right). Other ADRI components are composed of only one anti-director right respectively.[177] If derivative suit system and appraisal right are perfectly (or substantially) 'substitutable' to each other for one specific purpose, LLSV's classification or definition of 'Oppressed Minorities Mechanism' would be reasonable. However, It is likely that derivative suit system and appraisal right are 'complementary' (rather than 'substitutable') since their goals, functions, and scopes of availability are different. In this respect, LLSV's classification of 'Oppressed Minorities Mechanism' would be flawed since it treats a jurisdiction having one of the two mechanisms the same as it treats another jurisdiction

[177] LLSV, *supra* note 5, at 1122 (table 1).

with both. Perhaps, it would be more reasonable for the two mechanisms to be evaluated and scored *separately*, so that ADRI would have seven components.

Consider that one point in the *binary* number-based ADRI scoring system (i.e., one or zero points) amounts to 16.6% of the total score of a jurisdiction's extent of shareholder protection, since one point for a component of ADRI accounts for one-sixth of the total score. Given this scoring system, an arbitrary standard used by LLSV – namely, awarding one point to a country with *either* of two mechanisms – would generate significant bias towards the total scores of ADRI for a country (and perhaps for a legal origin as a group). In particular, this structural bias would cause a fundamental problem in relation to the reliance of LLSV's scholarly methodology upon 'statistical analysis.' Statistical analysis based on *t*-statistics or statistical significance in Law and Finance account is so subtle. For instance, LLSV explain that the corporate governance superiority of common law origin to that of civil law origin is supported by 'statistical significance at the 1% level.'[178] Thus, it is 99% confident that the statement is true in terms of quantitative analysis.[179] A key question on the methodology, however, is as follows: if a 16.6% swing in the total score of ADRI is determined by LLSV's discretionary standard, which is not fully convincing, why do we have to care about law and economics implications generated by 1% margin of error?

2. *Shareholders' Derivative Suit*

Aside from such a quantitative issue, examine shareholders' derivative suit in more detail. A corporation, as an independent legal entity, can bring suit against its agents, such as directors and officers; however, a dilemma arises in that a corporation – a fictitious person – is in fact managed by directors and officers, and they do not bring suit against themselves or their colleagues. As a sort of checks-and-balances system in a corporation, accordingly, it is necessary that shareholders have the right to bring derivative suits on behalf of a corporation

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[178] LLSV, *supra* note 5, at 1131 (explaining *t*-value of common law vs. civil law is 5.00).

[179] The superiority of English origin vis-à-vis French (and German) origin is statistically confirmed as well. *Id*. (explaining *t*-values of English vs. French origin and English vs. German origin are 4.73 and 3.59 respectively).

when alleged breaches of fiduciary duty cases take place. Despite the variance of significance across countries, certain conditions must be satisfied before shareholders bring derivative suits against corporate insiders.

Most of all, standing requirements for plaintiffs exist in some countries, so that only a shareholder (or a group of shareholders) holding more than a certain percentage of shares outstanding is able to bring suit. For example, in Korea by the end of 1990s, a shareholder was required to hold 5% of shares outstanding in order to use derivative suits. After the revision of Commercial Law in 1998, the requirement was reduced to 1%.[180] In China, shareholders' statutory derivative action right was initiated in Company Law in 2005.[181] Similarly to Korean law, Company Law of China stipulates that shareholders who hold 1% or more of a company's total shares for more than 180 consecutive days may demand a law suit when directors and managers are in violation of law, regulation, or bylaw.[182] A primary rationale for such requirement in Korea and China is to prevent frivolous suits. However, even a 1% requirement is a very stringent standard to pass since minority shareholders are dispersed and face a serious collective action problem. Accordingly, public shareholders' filing of a derivative suit would be severely discouraged. With this concern, the requirement in Korea was further relaxed by the revision in 2009; as for listed companies, shareholders holding 0.01% for 6 months can bring a derivative suit.[183]

In this sense, the United States (particularly, Delaware) is quite different from many countries that have harsh standing requirements since, in principle, a *single* shareholder with *one* share is allowed to bring a derivative suit. Thus, shareholders in Delaware corporations have better access to 'Oppressed Minorities Mechanism.' In fact, there is a demanding voice from corporate law academia in Korea that since a 0.01% holding requirement is still cumbersome to minority shareholders, a single shareholder standing rule should be implemented. In this context, a simple dichotomy based on whether a derivative suit system exists in law-on-the-

[180] Art. 403 (1), Commercial Law.

[181] Hui Huang, *The Statutory Derivative Action in China: Critical Analysis and Recommendations for Reform*, 4 Berkeley Bus. L.J. 227, 229 (2007). Some commentators claim that even before the 2005 revision, China allowed shareholders' derivative suits. *See* Hui Huang, *Shareholder Derivative Litigation in China: Empirical Findings and Comparative Analysis*, at 622, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2140613 (however, "[a] popular view was … that the provision [before 2005 revision] fell short of providing a solid legal basis for derivative suits and at best offered a primitive idea of or a prelude to the statutory derivative suit introduced in the 2005 Company Law."). *Id.*

[182] Art. 151, Company Law in 2013.

[183] Art. 542-6 (6), Commercial Law.

book is unfair and misleading. Simply put, the score for the United States should be higher than that for Korea (in particular, Korea before 2009).

In addition, each jurisdiction has different shareholders' information rights (e.g., the right to demand shareholders' list and inspect corporate books), pleading requirements, and evidence discovery systems. Indeed, such differences significantly affect the effectiveness of derivative suits. Suppose that a shareholder were prevented from inspecting information pertinent to an alleged breach of fiduciary duty by directors or executives – it would be hard for her to put forward specific allegations of directors' (or corporate officers') breach of fiduciary duties. Therefore, the effectiveness of a derivative suit system in a particular jurisdiction is dependent upon supporting mechanisms including procedural rule and law, which is not covered by LLSV. In this context, the coding in *Law and Finance* is too simple to consider a complicated function of infrastructure for shareholders' suits.

Moreover, in order to examine the effectiveness of a derivative suit system, the analysis of the collective action problem[184] faced by average shareholders – which LLSV overlooks in their original survey – should be included.[185] When a shareholder brings suit against corporate insiders who allegedly are liable for breach of fiduciary duties, *all* the cost associated with legal procedure – including financial cost, time value, efforts, and any opportunity cost – would be borne by her. On the other hand, when she wins a case, monetary damages that corporate insiders are required to pay would belong to a 'corporation' (thus, to all shareholders) rather than to her exclusively. Hence, a shareholder who actually brings suit benefits from the case merely on a pro-rata basis. Knowing this, a shareholder loses economic incentive to bring suit in the first place, even if corporate law (including the enforcement system and other legal infrastructures) fully supports a derivative suit system for challenger-shareholders.

The collective action problem could potentially be more complicated in China for the following reasons. (1) Domestic capital markets in China are not sophisticated, and institutional investors do not play a significant

[184] "Where all investors hold small stakes in the enterprise, no single investor has a strong incentive to invest time and money in monitoring management." ALLEN ET AL., *supra* note 137, at 371.

[185] For the more explanation of a minority shareholder's difficulties to challenge management (including collective action problem), see generally Lucian A. Bebchuk, *The Myth of Shareholder Franchise*, 93 VA. L. REV. 675 (2007).

role in capital markets, compared to other major economies.[186] Without well-developed institutional investors, the collective action problem is more burdensome to a great number of small individual minority shareholders. (2) The Chinese economy is dominated by state-owned enterprises (SOEs). Thus, the State by itself is the largest controlling shareholder in China. Under these circumstances, economic (or managerial) issues could be interpreted within the context of political issues. Given this situation, minority shareholders – even if large institutional investors exist – would reasonably consider the political ramifications and implications that their suits may generate. In other words, 'political cost' should be taken into account as a crucial part of transaction cost associated with minority shareholders' collective action problem.

Despite the aggravated collective action in China, however, it is noteworthy that China would receive one point for the derivative suit system, if a Law and Finance survey were conducted. Thus, the simple dichotomy used by LLSV to describe whether a derivative suit system exists (1 point) or not (0 points) in a particular country, is so crude that it generates a misleading perception of the quality of minority protection.

In this respect, the level of lawyers' compensation is a critical factor to be considered with respect to the effectiveness of derivative suits. In the United States, contingency fee arrangement enables a plaintiff's lawyer to collect roughly one-third of monetary damage or the amount of settlement granted by defendants to a corporation. Given that it is not uncommon for the amount of alleged damage to be more than $100 million in the United States, lawyers are strongly incentivized to convince shareholders to bring suit against corporate insiders.[187] Accordingly, collective action problem could be mitigated; however, note that US-style contingency fee arrangement is rather 'abnormally' in favor of lawyers based on the global comparison. Indeed, the collective action problem is very difficult to overcome or alleviate in most countries.

For all of the above-mentioned reasons, it is possible that the derivative suit system in certain countries is merely a 'dead corporate law textbook example.' Before the Asian financial crisis in 1997, Korea was the world's 11th largest economy. Despite the relatively large size of Korean economy, for more than three decades since the

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[186] For a similar view, see e.g., Benjamin L. Liebman & Curtis J. Milhaupt, *Reputational Sanctions in China's Securities Market*, 108 Colum. L. Rev. 929, 977 (2008).

[187] In fact, another US corporate governance concern is high chance of frivolous suits without merit due to lawyers' economic incentive from contingency fee in a derivative suit.

first enactment of the derivative suit system in corporate law in the 1960s, *not a single* derivative suit was brought by shareholders until 1999.[188] Nonetheless, *Law and Finance* in 1998 awarded 'Korea before 1999' one point for 'Oppressed Minorities Mechanism.' In this light, LLSV's evaluation of Korea as deserving one point for its derivative suit system is in reality incorrect – if nobody uses the system for a long time, it is equivalent to the system being 'unavailable.' China faces a similar problem. "Shareholder litigation, which in the United States serves as a crucial complement to SEC oversight, is simply not yet a viable means of investor protection in China."[189] In addition, it is noteworthy that shareholder activism – including active litigation – would be fomented with strong minority shareholders such as institutional investors. In China, however, recall that institutional investors have not yet played a main role in capital markets, compared to Western developed economies.[190] Nonetheless, China would be awarded one point for derivative suit, if China is included in LLSV's survey.

In sum, LLSV's principle that any country with a derivative suit system should be awarded one point based on law-on-the-book unfairly renders the United States – the jurisdiction that guarantees a derivative suit system in substance – at a disadvantage. Also, note that derivative suit systems of Commercial Law in Korea in different time periods (e.g., before 1998 and after 2009) are markedly different. Due to a series of corporate law reforms and the development of market institutions, investors have recently used shareholder litigation in a relatively active way. In contrast, as explained before, there was no single derivative suit by the end of 1990s.[191] Nonetheless, two corporate laws in Korea – Commercial Law before 1998 and after 2009 – would be equally awarded one point under LLSV's research. This indicates that Law and Finance theory is unable to discern the improvement or reforms of derivative suit system from merely nominal shareholder litigation as a 'legal decoration.'

[188] The first shareholders' derivative suit was brought in the case of Korean First Bank in 1999, right after the Asian financial crisis.

[189] Liebman & Milhaupt, *supra* note 186, at 977.

[190] *See supra* note 186 and accompanying text.

[191] *See supra* note 188 and accompanying text.

The last but not the least point is that notwithstanding the positive factors that shareholder litigation provides, a fundamental question – which could disturb the basis of shareholder litigation as a protective legal mechanism for investors – still remains: is a stronger derivative suit system always more desirable for investors and market players? Active shareholder litigation may bring with the risk of frivolous suits against corporations as well; thus, the welfare of shareholders, who are so-called owners of corporations, could be damaged if a shareholder litigation system is unbridled. In sum, the simple binary scoring system of Law and Finance account does not take into account this complicated issue.

D. Criticism of 'Percentage of Share Capital to Call an Extraordinary Shareholders' Meeting'

'Percentage of Share Capital to Call an Extraordinary Shareholders' Meeting' is the last component of ADRI. When corporate law allows shareholders with less than 10% of shares to retain the right to call a special shareholders meeting, a jurisdiction is awarded one point. Otherwise (if shareholders have no such right or if shareholders holding more than 10% shares have such right), zero points are accorded. From such a *numerical* 'cut-off' of 10%, it should be noted that the standard of the scoring system for this component is unique, compared to other ADRI components where the score is generally decided on the grounds of a 'yes/no' inquiry.[192]

As LLSV precisely point out, "… the higher this [cut-off] percentage is, the harder it is for minority shareholders to organize a meeting to challenge or oust the management." Thus, minority shareholders will find it more difficult to call a special shareholder meeting if a reference point is 10% than if the reference point were, say, 0.1%. Nonetheless, the *same* 1 point would be given in both cases. Then, a natural question is why 10% should be the cut-off value for determining 1 or 0 points for each country. Indeed, there is little reason. Since 10% could be a very high bar for dispersed minority shareholders, one may argue that 5% standard should be adopted. Interestingly, the criteria in the United States is 10%, so that the United States barely passes the reference point and is awarded 1 point. Two possible reference points can be considered. (1) If the reference number were lower

[192] For instance, if preemptive right is stipulated, a country marks one point for the variable of 'Preemptive Right,' and if not, a country marks zero points. But, note that 'Oppressed Minorities Mechanisms' defines minority shareholders as "those shareholders who own 10 percent of share capital or less." LLSV, *Law and Finance*, at 1122 (table 1). In this sense, it can be explained that 'Oppressed Minorities Mechanism' does not depends on entirely a 'yes/no' standard.

than 10% (e.g., 5%), the US score for this component would be 0. (2) Conversely, if the reference number were higher than 10% (e.g., 20%), the US score would still be 1; but the United States would be treated the same as other countries with a requirement ranging from 10% to 20%, although the US standard is better for shareholders. In this respect, 10% reference point, which is determined by LLSV's discretion, is the best for the United States.

To be sure, the '1 or 0' arrangement is too crude to be used for every ADRI component. However, if the standard is based on 'yes/no,' it makes sense at least to some extent. In this respect, the problems stemming from the use of such a simple binary system are more pronounced in 'Percentage of Share Capital to Call an Extraordinary Shareholders' Meeting,' because a specific reference number (i.e., 10%) – rather than a 'yes/no' standard – could be arbitrarily used as the dividing threshold between 'good countries' and 'bad countries.' According to the 10% standard, a country with 10.01% rule and another country where shareholders have no right to call a special meeting (i.e., even a shareholder with 100% shareholding cannot to call a special shareholder meeting) are treated same (i.e., zero points). This would be unfair to the country with 10.01% rule. On the other hand, a country allowing 9.99% of shareholders to call a special shareholder meeting is granted one point. Such a drastic change from 0 to 1 due to a 0.02% difference (i.e., 9.99% vs. 10.01%) would be less convincing, compared to other ADRI components distinguishing one country from another based on a clear 'yes/no' inquiry.

In this respect, a decimal point system (rather than the binary system of '1 or 0') would be most desirable for 'Percentage of Share Capital to Call an Extraordinary Shareholders' Meeting' since the variable relies on a 'percentage.' For instance, if a country has a 10% requirement, the decimal point system can award the country the basic marks of 0.5. As a required percentage decreases from 10% to 0%, the score could *gradually* and *continuously* increase from 0.5 to 1, generating the scoring system with a *linear* relation between a required percentage and a decimal point score. Of course, a problem remains unanswered: why do we have to use a 10% standard (rather than a 5% standard or a 20% standard)? This sort of problem is quite common in any index that uses a specific number as a cut-off standard.

Another serious weakness of this ADRI component is the unfair standard that it applies when LLSV compare the United States with other jurisdictions. According to LLSV, "For the United States, our reliance on Delaware presents a problem since the state leaves up to corporations the percentage of shares needed to call an extraordinary shareholder meeting. We use 10% for the United States because the majority of US states (27) use this number."[193] In other words, LLSV first look at Delaware corporate law, and if they do not find a 'positive' aspect for one point, then they look at corporate law in a majority of states. Such 'cherry picking' is not available in many countries other than the United States. In this light, LLSV's stance is clearly based on 'double standards.' Since a vast majority of large public corporations in the United States are incorporated in Delaware,[194] it would be less meaningful to pay attention to corporate law in 'a majority of states' as LLSV do. Even if LLSV's methodology were correct, it would be fair to award the United States 0.54 points rather than 1 point since 27 out of 50 states satisfy the 10% requirement. To be sure, the United States is one of the best countries in terms of the quality of corporate governance. However, this is because it has the best-quality of markets (i.e., both product and capital markets), legal infrastructure (e.g., an efficient enforcement mechanism and the fair judiciary) and sound business culture, not because of the high score in LLSV's survey.

V. STRUCTURAL BIASES OF ANTI-DIRECTOR RIGHTS INDEX

In Part IV, I have reviewed the drawbacks of ADRI at the *individual* components' level. In Part V, I put forward 'structural biases' or 'systematic weaknesses' that ADRI has as a *group* of components. I first provide an analysis of 'Pro-Director Right Index' (PDRI), an alternative index that I construct. PDRI shows how an arbitrarily designed index can generate misleading implications. Subsequently, I introduce the overview of an independent project that I am currently pursuing regarding other structural or systematic drawbacks of ADRI.

A. Alternative Index: Pro-Director Right Index

Indeed, all six components of LLSV's ADRI are important to measure the extent of protections for minority shareholders. As discussed, it is not convincing, however, to claim that *only* these six components

[193] LLSV, *supra* note 5, 1128 FN 6.

[194] For a further explanation of how Delaware became a center of incorporation in the United States, see generally Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679 (2002).

are important. In other words, the components of ADRI are criticized as being utilized on an *ad hoc* basis.[195] Instead of LLSV's ADRI, consider another possible combination of important legal mechanisms to protect minority shareholders. In ADRI, each country gets '+1' (positive one) point in 6 categories if it has anti-director rights in corporate law or commercial code. Instead of giving '+1' point for each component of ADRI, it would be possible to give "−1" (negative one) point for any component of 'Pro-Director Right Index' (PDRI). Note that the total ADRI score of the United States is 5, according to LLSV's survey.[196]

For instance, PDRI may consist of: (1) 'Staggered Board Allowed'; (2) 'Dual-Class Common Stock Allowed'; (3) 'Cash-out Merger Allowed'; (4) 'Poison Pill Allowed'; (5) 'Statutory Exculpatory Provisions for Breaches of Fiduciary Duty (e.g., DGCL Section 102 b (7)) Allowed'; and (6) 'Self-dealing Allowed.' Under the new index of PDRI, the United States' corporate governance score would be '− 5.' The United States lacks only one negative component ('Self-dealing Allowed'). What is more, different weights could be allocated for different components of PDRI. For example, it would be unfair to treat a poison pill[197] as equal to the others. Probably, allowing a poison pill in corporate law is worth '–5' points or lower rather than merely '–1' point, since it is the most effective takeover defensive tactic invented ever.[198] In addition, when (effective) staggered board[199] and poison pill are combined and used against an outsider challenger in a hostile takeover, it would be almost impossible for an outsider to take over a corporation's control through a

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[195] *See, e.g.*, Djankov et al., *supra* note 57, at 432.

[196] *See supra* Table 1.

[197] For a general explanation of the legality of a poison pill in the US corporate law, see Moran v. Household International, Inc. 500 A.2d 1346 (Del. 1985). For a general explanation of 'just say no' pill upheld in Delaware, see generally Paramount Commc'n v. Time, Inc., 571 A.2d 1140 (Del. 1989).

[198] *See e.g.*, Robert W. Hamilton, *Corporate Governance in America 1950–2000: Major Changes But Uncertain Benefits*, 25 J. CORP. L. 349, 358 (2000).

[199] A staggered board is an effective staggered board (ESB), if it is not dismantled or "packed" by a challenger-shareholder in a year. *See* Lucian A. Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887 (2002).

proxy fight.[200] Thus, such a combinational case – which sometimes takes place in the United States – should receive another negative 5 points. Then, the total PDRI score for the United States would be negative 14.[201]

According to PDRI, thus, it could be concluded that the quality of the US corporate governance is below average (or one of the worst in the world), *which is absolutely not true*. What it indicates is that the scores and ranks of countries for their level of protections for public shareholders would be determined by which provisions in corporate law are selected as components of an index. This criticism can be applied to any index designed to measure the quality of corporate governance at the firm level. Again, the reason that the quality of the US corporate governance is so high is not because it has more shareholders' rights in ADRI, but because a positive synergy effect is created by its good corporate law (including case law), an effective enforcement mechanism, an efficient judicial system, and business-friendly culture.

B. Other Structural Biases

In this Section, I merely introduce and sketch the overview of structural or systematic drawbacks of ADRI that I am currently pursuing to research on in an independent project. Further analyses on these weaknesses – which have been at large overlooked in extant literature – will be developed in more depth in the project. In the following, the synergistic effect, the overlapping effect, interpretation problems, and other issues are briefly discussed.

In Law and Finance theory, if there are two ADRI components in a country, the total ADRI score of the country is two. However, inter-related factors such as the 'synergistic effect' and the 'overlapping effect' should be considered as follows. (1) The synergistic effect: if these two components create synergy, the total ADRI score should be higher than two; this is because what the total ADRI score indicates is not simply the number of investor rights in a particular country but the quality of investor protection in the country. (2) The

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[200] For a more explanation of the combined effect of (efficient) staggered boards and poison pills, see generally *id*.

[201] The United States would have five components of PDRI. Four of them except a poison pill have negative 1 point, so that the total score of four components is negative 4. In addition, a poison pill provides the United States with negative 5 points. Another negative 5 points would be awarded to the United States for the combined effect of a poison pill and an (effective) staggered board. In total, the United States would receive negative 14 points.

overlapping effect: to the contrary, if there is overlapping effect – for instance, two components protect investors in a *similar* and *redundant* way – the total ADRI score should be lower than two; this is because the effect of two ADRI components to protect investors is duplicated to some extent.

In particular, the overlapping effect can be further explained by set theory. Suppose that there are two sets, A and B, which have 100 elements respectively. Then, the total number of elements in these two sets is not 200 (which is the result of the simple summation of '100 + 100'). Rather, the correct number is; $N(A \cup B)$) = $\{N(A) + N(B)\} - N(A \cap B) = 100 + 100 - N(A \cap B)$, as Table 3 indicates. Likewise, when considering two ADRI components, the total score should not be calculated based on a simple summation of '1 + 1.' Rather, the 'intersection' of two ADRI components should be deducted in order to avoid double-counting the extent to which investors are protected by two ADRI components.

Table 3: The Overlapping Effect and Set Theory

- $N(A \cup B) = \{N(A) + N(B)\} - N(A \cap B)$
- N(X) means the number of elements in Set X.

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After taking into both the synergistic effect and the overlapping effect, the 'effective total score' (or the 'corrected total score') of two ADRI components could vary. For instance, in the case of the overlapping effect, the effective total score could be 1.1. On the other hand, in the case of synergistic effect, the effective total score could be 2.9. Thus, even if the two countries have equally two ADRI components, the gap of investor protection quality between two countries could be huge (indicated by the difference of 1.8). One may argue that this sort of subtlety is improper in a simple model like ADRI. This opinion is reasonable to some extent. Nonetheless, since LLSV use a very subtle analysis under 1% margin of error or 1% significance level when analyzing ADRI,[202] it is not convincing to ignore another type of subtlety that could generate actually the large difference of 1.8 points.

[202] *See supra* notes 178-179 and accompanying text.

Also, interpretation problems in relation to issues around in default rules should be discussed in more depth. For instance, according to the usual legislative technique, "AAA (i.e., a legal mechanism for public investors) is required … unless …." Often, 'unless …' is treated as a legal expression to explain an exception. Accordingly, it is usually construed that 'AAA' is guaranteed for public shareholders *in principle*, and a country with the above statute is awarded 1 point for AAA under LLSV's survey (if AAA is one of ADRI components). However, consider what 'in principle' really means in any law or regulation: (1) 'in principle' does not necessarily mean 'in the vast majority of cases'; (2) in addition, as long as the condition of 'unless …' is achieved, corporate insiders obtain a legal right to circumvent the 'principle'; (3) moreover, 'unless …' sometimes constitutes a principle, depending on statutes and circumstances. Consequently, under LLSV-type indexing, a high risk of arbitrarily determining one-or-zero point system can be generated.

In addition, it is probable that a corporate law mechanism that is not recognized as a component of ADRI could provide investors with similar protection as an ADRI component does. For example, although derivative suit system is not practically available in many countries, it is possible that suits based on administrative law or criminal law can substitute for derivative suit, and solve corporate law issues such as tunneling. Then, it might be unfair that a country is mechanically awarded zero point for not having derivative suit. An analogy may be useful: average people in many countries use 'chopsticks' rather than a 'fork.' When a scoring system as to 'food culture' across countries – if any – does not recognize such substitutability and awards 1 point only to countries with a 'fork,' the scoring system would not reflect the reality.

VI. CONCLUSION

For the past fifteen years since its inception, Law and Finance theory has been a central topic in the comparative corporate governance scholarship. Several important issues of Law and Finance, however, have been highly neglected in debates by LLSV and their proponents (and even critics). This Article proposes critiques of Law and Finance theory that have been seldom explored in extant literature. In particular, features of a controlling shareholders regime (including CMS) are heavily examined in the context of OSOV and ADRI. To this end, examples and evidence from China and Korea are used, in addition to traditional corporate governance theories based on the US jurisprudence.

Above all, OSOV is ill-defined by LLSV. In addition, LLSV have underrated the importance of OSOV, voting leverages, and CMS. Most of ADRI components that are a key factor of Law and Finance theory are directly related to public shareholders' voting power. Since the deviation from OSOV significantly affects the effectiveness of minority shareholders' voting power, it would be less meaningful to discuss components of ADRI on the stand-alone basis without considering the combined effect with OSOV. Thus, OSOV should be seriously taken into account as a foundational aspect when examining ADRI.

Most of original ADRI components designed by LLSV have weaknesses as proxies to measure shareholders' protection. A cumulative voting system is subject to problems in association with a formula[203] and a staggered board. In addition, the effectiveness of cumulative voting is seriously affected by a deviation from OSOV,[204] which is not fully analyzed by LLSV. Preemptive right is not a gift for shareholders, so that shareholders are not able to exercise the right for free as they do for the other five anti-director rights.[205] In a CMS, preemptive right could become a perfunctory right since shareholders who are under control by a dominant shareholder are likely to voluntarily give up the right.[206] In many countries, a derivative suit system is subject to collective action problem and burdensome requirements for plaintiff-shareholders. Thus, treating the United States (where a derivative suit system works well) and many other countries with ineffective systems as the same is unfair to the United States. Minority shareholders' right to call a special shareholder meeting is another controversial ADRI component due to its numeric cut-off criteria and its double standards in favor of the United States.

Moreover, this Article suggests that index-based studies (including LLSV's project) may have structural biases in their scoring systems. In particular, this Article offers problems associated with an alternative index

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[203] *See supra* note 145 and its accompanying text.

[204] *See* Part IV.A.3.

[205] *See supra* note 173 and its accompanying text.

[206] *See* generally Part IV.B.

(PDRI),[207] which looks reasonable but generates a biased conclusion. This indicates the risk of inventing an index on an *ad hoc* basis. Other structural biases that could be commonly found in many index based studies – such as synergistic and overlapping effects of multiple components of an index, interpretation problems when translating corporate law – are briefly introduced. I currently pursue a further analysis of these structural biases in an independent project.

Comparative corporate governance studies become more practical when their surveys are based on numbers, scores, and statistics that are ultimately reduced to an index. In fact, I value this trend of the 'quantification of the quality' of corporate governance, as indexing is a very useful methodology to show and compare the quality of investor protection in a scientific way. In this respect, despite the many weaknesses of Law and Finance theory, it is undeniable that LLSV have made great contributions in corporate governance scholarship. What I emphasize is that although an index is useful, it should be used as a means of a 'quick litmus test.' Thus, a more in-depth analyses based on legal systems (not limited to a corporate law system), markets, and socio-economic infrastructures should be conducted as well, on top of index-oriented research that is limited by its reliance upon simplified numbers and statistics.

[207] *See* generally Part V.A.