UNDERSTANDING CONTROLLING SHAREHOLDER REGIMES

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

2. Controlling Shareholders – “Roving” v. “Stationary”

3. Transplanting a Poison Pill to a Controlling Shareholder Regime

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ABSTRACT

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Traditionally, the corporate governance scholarship has emphasized heavily the “dispersed shareholder regimes” in the United States and the United Kingdom, although “controlling shareholder regimes” constitute the vast majority of the world’s economy. Since there have been few systematic studies concerning controlling shareholder regimes (in particular, controlling shareholder regimes in developing countries), they have remained in a black box. With this concern in mind, in this dissertation, I proposed various analytical frameworks for understanding the corporate governance of controlling shareholder regimes that, improperly, have been overlooked for a long time. In the first chapter of my dissertation, entitled Reenvisioning the Controlling Shareholder Regime: Why Controlling Shareholders and Minority Shareholders Embrace Each Other, I proposed theories to explain why controlling shareholders and minority shareholders “voluntarily” embrace each other in an emerging capital market while the legal system in that jurisdiction does not require controllers to protect investors. In the second chapter, entitled Controlling Shareholders – “Roving” v. “Stationary,” I explored two types of controlling
shareholders (i.e., “roving” and “stationary” controllers) and delved into why an economy with stationary controllers is better in terms of corporate governance and more likely to be prosperous than an economy with roving controllers. In the third chapter, entitled *Transplanting a Poison Pill to a Controlling Shareholder Regime*, I analyzed how a poison pill would affect the market for corporate control and the corporate governance of controlling shareholder regimes. In this dissertation, I have proposed many unconventional analyses and views on controlling shareholder regimes (in some cases, the concepts may be counterintuitive from the perspective of the conventional corporate governance scholarship). I hope that my research will guide scholars in a theoretical way to understand the various aspects of law and economics related to corporate governance that mostly have not been recognized or that have been misunderstood in the standard scholarly studies of corporate governance.
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DEDICATION

TO MY FAMILY
REENVISIONING THE CONTROLLING SHAREHOLDER REGIME: 
WHY CONTROLLING SHAREHOLDERS AND MINORITY 
SHAREHOLDERS EMBRACE EACH OTHER 

*Sang Yop Kang* 

INTRODUCTION 

“Law and finance” literature, which was revolutionized by four prominent economists – La Porta, Lopez-de-Silanes, Shleifer, and Vishny (hereinafter “LLSV”) – explained that the origin of a given country’s legal system and the quality of its law enforcement are statistically correlated with patterns of share ownership, the cost of capital, and other corporate governance variables. LLSV’s series of studies showed that controlling shareholder regimes exist in those jurisdictions where the legal systems do not protect minority shareholders from dominant shareholders’ diversion
of private benefits of control. To be sure, this view opened a new and insightful paradigm to analyze international corporate governance.

On the other hand, however, LLSV’s studies have been criticized because many puzzles remain unsolved by their account, and the conclusions based on accounts by LLSV type of law and finance perspectives are misleading in some respects. For example, Professor Gilson claims that LLSV depend on a simplified syllogism that is insufficient to explain all controlling shareholder systems. In particular, he raises important questions (hereinafter “Gilson’s riddle”) that neither LLSV nor the law and finance literatures explain – if laws are too poor to protect investors, as LLSV explain, then why do we observe any minority shareholders at all in countries with poor shareholder protection; and why is the value of minority shares, as well as the number of minority shareholders, in such jurisdictions not zero?

The purpose of my Article is, in theoretical ways (rather than via case study) to offer potential answers for Gilson’s riddle, which remains unexplored. Emerging

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

3 See e.g., John C. Coffee Jr., Do Norms Matter? – A Cross-Country Evaluation, 149 U. Pa. L. Rev. 2151, 2154 (2000) (Professor Coffee suggests that although LLSV have 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. He points out “multicollinearity” problem as well); Milhaupt, supra note 1 at 2124 (Professor Milhaupt states that the (LLSV) empiricists may have reversed the actual chain of causation between law and corporate governance – in other words, law and its enforcement may not determine the structure of corporate groups; rather, important corporate and financial groups in a given society may drive the development of legal institutions and enforcement practices by affecting the demand for law, at least in part through the creation and destruction of norms).

4 Ronald J. Gilson, Controlling Family Shareholders in Developing Countries: Anchoring Relational Exchange, 60 Stan. L. Rev. 633 (2007).

5 “Gilson’s riddle” is coined by Professor Merritt B. Fox when I discussed my Article with him.

6 Gilson, supra note 4.
countries usually lack investor-friendly corporate and securities laws as well as effective court systems. In addition, these countries’ market mechanisms do not function properly – for example, the market for corporate control is practically nonexistent. Further, there are many cases of looting and “tunneling”7 by controlling shareholders in these countries, and these practices of unfair self-dealing are not thoroughly investigated or regulated by the authorities. Nonetheless, a significant amount of public shareholders participate in so-called “bad-law countries,” and some bad law countries are even exemplary in economic development. These phenomena are “anomalies” that LLSV have not acknowledged properly, and in order to explain these anomalies, we should rely on other analytical frameworks often overlooked by contemporary commentators, such as the informal (non-legal) institutions and hidden incentives of constituencies in a corporation.

With these aims, this Article proceeds as follows. Part I sets out the basic definitions of controlling shareholders regimes and the separation of ownership and control in the controlling minority structure (CMS). It briefly explains how the asymmetric information problem, coupled with controllers’ private benefits of control,8 would potentially destroy the capital market in a country with insufficient shareholder protection. Then, Professor Gilson’s “product market-based account”9 is introduced, which is the seminal work explaining Gilson’s riddle – why the capital market in a developing country has a large number of public minority shareholders.


8 In addition, I explore why diversion of corporate value to controlling families (e.g., self-dealing) is so problematic in countries with ineffective commercial laws.

9 See Gilson, *supra* note 4.
Subsequently, I raise several questions on the general application of this account and suggest the possibility that the product market-based account may lose some explanatory power when there is a large discrepancy between a controller’s cash flow rights and voting rights.

In turn, in Parts II and III, I propose two alternative hypotheses to the product market-based account, answering the conundrum of why a controller in a bad-law country needs external equity capital even if newly issued stocks are sold at a huge discount. In Part II, I argue that non-pecuniary private benefits of control (psychic utility of a controller such as leadership, fame, reputation, social and political influence), which have not been analyzed in detail by extant literature,\textsuperscript{10} may explain the riddle. To a controlling shareholder, building a large business empire is an overarching personal means to magnify her non-pecuniary benefits. I argue that, to this end, a controller inevitably has to rely on the equity issuance despite the pecking order of corporate finance. In addition, I show, empire-building based on equity capital may bring in handsome economic benefits to a controller in various ways. In that sense, reliance on the stock market is not that costly and may even be beneficial to a controller, based on her personal payoff.

\textsuperscript{10} Most of the extant literature on corporate governance has focused on a controller’s pecuniary private benefits of control – i.e., minorities’ extraction, such as (unfair) self-dealing or sale of control. However, a controller seeks to gain non-pecuniary private benefits of control from running a corporation as well. Then, a model assuming that a controller maximizes her pecuniary benefits is not precise, although it explains very important features of a controlling shareholder regime. A more precise model should be based on the notion that a controller maximizes her “utility” arising from non-pecuniary benefits – such as social prestige, reputation, psychic utilities, and social influence, including political power – as well as pecuniary benefits. Put differently, a controller’s utility function can be expressed as $[U = U (\text{pecuniary benefits, non-pecuniary benefits})]$ where “$U$” stands for the controller’s utility function.
Subsequently, in Part III, I propose that having a broad base of minority shareholders is beneficial to a controlling shareholder in efficiently expropriating pecuniary benefits. Even if the controlling shareholder takes a small amount of pecuniary benefits from each non-controlling shareholder, the sum of extraction from a large number would be huge. Therefore, despite the cost disadvantage of equity financing, the controller has reasons to rely on the stock market.\textsuperscript{11}

As discussed in Parts II and III, it is necessary to analyze the standpoint of a controlling shareholder to sell their shares to public investors. By itself, though, this would be insufficient because transactions in the stock market would not take place unless non-controlling shareholders had reasons to purchase shares from a controlled corporation.\textsuperscript{12} As Alfred Marshall famously said, “Supply and demand curves are like scissor blades that intersect equilibrium.” In the context of Gilson’s riddle, a controller and minority shareholders – as a seller and a purchaser – embrace the other party by reciprocal interactions since both can gain economic “surplus” through transactions in the capital market. Consequently, both parties accept market terms and conditions despite the insufficient investor protection (which is disadvantageous to non-controlling investors) and equity discount (which is disadvantageous to a controller).

\textsuperscript{11} On the flip side, another merit of having a large number of public shareholders is that even a large-scale “tunneling” might not aggravate the welfare of individual minorities. Why? As to “private benefits of control,” what public shareholders care about most is not the total amount of a controller’s diversion from a corporation but their individual damage. Thus, when the controller has a large number of public shareholders, she could take a great deal of pecuniary private benefits by levying a small extraction on many individual non-controlling shareholders. In that sense, it is possible that minority shareholders may prefer a controller with less cash flow rights who can “dilute” expropriation across a large number of minorities, given the insufficient protection of investors. My article will deal with this issue in depth later.

\textsuperscript{12} As far as I know, surprisingly there are very few (i.e., almost none) systematic studies explaining minority shareholders’ standpoint when a controlling shareholder offers equity issuance in a developing country.
Focused on this point (i.e., Marshall’s scissor blades), Part IV explains why minority shareholders are willing to participate in the capital market despite the ineffectiveness of the legal protection that is available. To this end, a series of unconventional explanations are put forward: (1) the “stationary controller” account; (2) limited opportunities of other investment account; (3) minorities’ behavioral finance account; (4) “minorities might not be damaged” account; (5) foreign minorities account; (6) minorities’ free-ride account; and (7) the government’s subsidy account. Most well-functioning capital markets in less developed economies are likely to be subject to at least some of these accounts discussed.

For example, as to (2) limited opportunities of other investment account, perhaps non-controlling shareholders in developing countries are not allowed to invest abroad. Even without such capital regulations, they may find it difficult to invest abroad for many reasons, including “familiarity bias,” which makes many investors have a bias towards their own domestic markets. In addition, many non-controlling shareholders are not suited for international diversification, which requires investors to bear additional risk if they do not have hedging tools. Also, until recently, access to financial intermediaries that pool funds and invest abroad on behalf of investors has not been readily available to public investors in many developing countries. Finally, Part V summarizes and concludes.

As Professor Fox precisely comprehends my points in a succinct way, “Two people must dance tango, not one.” The message in this Article is that when two parties – a controlling shareholder and minority shareholders – realize that their interwoven relationship creates symbiosis and mutual hostage, their cooperation is

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13 Discussion with Professor Merritt B. Fox.
often compelled and strengthened, and economic development ensues. That is why we can observe some exemplary economies in bad-law countries that have functional capital markets.

However, if conditions that have persisted to date are to change in the future, it is possible that the symbiotic relationship between a controller and non-controlling shareholders would no longer be stable in these countries. For example, as the process of globalization continues to gain momentum, non-controlling shareholders have more opportunities and options to diversify their assets internationally. As a result, a domestic controller’s ability to keep public investors in her controlled corporation could be diminished. This is another reason why controlling shareholders in developing countries need to “voluntarily” improve corporate governance for their own sake, although they are not legally required to do so.14

I. CONTROLLING SHAREHOLDERS REGIME

Berle and Means’ model assumes that large-scale enterprises could only raise sufficient capital to conduct their operations by attracting a large number of equity investors;15 however, contemporary empirical evidence finds, even at the level of the largest firms, that Berle and Means’ model is largely limited to the United States and

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14 Discussion with Professor Jeffrey N. Gordon.

Great Britain. In developing countries, where controlling family shareholders often run conglomerates and business groups, minority shareholders are poorly protected within formal legal structures, such as corporate and securities laws and judicial systems.

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

Most corporate governance literature presumes that, in the model controlling shareholder regime, a large block-holder controls a corporation by owning a majority of shares. In other words, voting rights and cash flow rights are generally aligned – this type of controlling shareholder ownership is referred to as the “controlled structure” (CS). Nonetheless, it is noteworthy that the CS is not the only representative form of controlling shareholder systems in the world. There is another significant pattern of controlling shareholder ownership where a controlling shareholder wields a significant percentage of voting rights even though she holds a small percentage of equity. Since a controlling shareholder is also a minority

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16 Id. at 642; La Porta et al., supra note 2 at 474 (La Porta, Lopez-de-Silanes & Shleifer find that “the Berle and Means corporation is far from universal, and is quite rare for some definitions of control”); Lucian A. Bebchuk & Mark Roe, A Theory of Path Dependence in Corporate Ownership & Governance, 52 Stan. L. Rev. 127 (1999) (authors argue at present, publicly traded companies in the United States and the United Kingdom commonly have dispersed ownership, whereas publicly traded companies in other economies generally have controlling ownership).

17 In less developed countries, controlling shareholders of large corporations are usually states or family shareholders. La Porta et al., supra note 2. Please note that in this Article, I focus on family controlling shareholders in developing countries rather than those in developed countries.

shareholder in terms of the quantity of equity stake she owns, this regime is referred to as the “controlling minority structure” (CMS).  

How is a controller able to exercise control while retaining only a small fraction of the equity claims on a company’s cash flow?  

Professors Bebchuk, Kraakman and Triantis explain that such a radical separation of control and cash flow rights can occur in three principal ways: through dual-class share structures, stock pyramids, and cross-ownership ties.  

In fact, it is not uncommon that a control family wields majority voting power although a controlling family holds less than 10 percent of the economic rights.  

In the CMS, it can be said that the control family’s voting rights are effectively *leveraged.*  

In sum, holding a majority of common shares and economic interest is not a necessary condition to exercise control, as seen in the CMS. Rather, when we refer to “control,” we mean the status with a significant holding of “voting” rights – although it is often possible that a shareholder with less than a majority of the voting rights (e.g., 40%) can wield effective control, in this Article for the purpose of simplicity, a “controller” is defined as a shareholder with more than 50 percent of the

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19 *Id.*

20 *Id.*

21 *Id.*

22 For example, many controlling shareholders in Korean *chaebols* effectively control business groups with 5 – 10% of equity ownership by means of intra cross-shareholding.

23 According to Delaware court, a U.S. controlling stockholder has the voting power to: (a) elect directors; (b) cause a break-up of the corporation; (c) merge it with another company; (d) cash-out the public stockholders; (e) amend the certificate of incorporation; (f) sell all or substantially all of the corporate assets; or (g) otherwise alter materially the nature of the corporation and the public stockholders’ interest. Paramount Communications, Inc. v. QVC Network, Inc. 637 A.2d 34 (Del. 1994).
voting rights. Table 1 summarizes the two aforementioned patterns of controlling shareholder systems in the world.

Table 1: Comparison between the Representative Forms of the Controlled Structure (CS) and the Controlling Minority Structure (CMS)

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

2. Asymmetric Information and Lemon Market Problem

A well-performing securities market would be built on information provided by disclosure\(^{24}\) and efficient regulations. In a bad-law country, though, investors suffer from insufficient disclosure system and lack of transparency, not to mention inefficient legal infrastructure. The securities market then becomes highly vulnerable to the “lemon” market problem\(^{25}\) due to the asymmetry of information between sellers (i.e., corporate insiders of issuers) and buyers (i.e., investors). In a corporation where there is the potential for a controlling shareholder to be actively involved in

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\(^{24}\) For the more explanation on the mandatory disclosure and its related discussion, see generally Merritt B. Fox, *Retaining Mandatory Securities Disclosure*, 85 Va. L. Rev. 1335 (1999).

transactions tainted with conflict of interest, the controlling shareholder knows that the fundamental value of the company has been damaged due to tunneling. Prospective investors in the securities market, however, do not know whether the firm is involved in such misconduct and, if so, to what degree. Investors can only use market statistics to judge the quality of prospective purchases. Consequently, investors discount the prices they will offer for the shares of all companies. As Professor Black explains, this ensures that investors receive a fair price, on average.

Unfortunately, this is not the end of the story. Knowing this, issuers have the incentive to issue poor-quality securities since the returns for good quality accrue mainly to the entire group whose statistics are affected rather than to the individual issuer. In response, issuers with good quality (i.e., companies not associated with tunneling) have no incentive to issue, and only issuers with bad quality (i.e., companies associated with an enormous amount of tunneling) participate in the securities market. In other words, due to the asymmetric information, an adverse selection problem starts to emerge.

So, how will those investors who only know the average quality of companies react? They discount the issuance of securities by companies more deeply on average, and even those companies that are relatively good would feel pressure to leave the market because the price determined by the application of the deeper discount to all issuers is too cheap for them and well below the fair value of their securities.

\[26\] Id.


\[28\] Akerlof, supra note 25 at 488.
Ultimately, only companies with the worst quality (i.e., companies associated with the most egregious form of expropriation) remain in the market in the self-enforcing process of Gresham’s law – the bad drive out the good, the worse drive out the bad, and the worst drive out the worse from the market. Accordingly, the adverse selection problem is reinforced, which leads to market failure and the securities market may come close to collapsing if there are no measures to correct this vicious circle. Consequently, in theory, in a country with poor investor protection, we will not be able to observe a significant number of minority shareholders and a well-developed securities market.

This undesirable situation in a developing securities market would also be expected under the “pecking order theory” of the corporate finance. According to this theory, given asymmetric information between corporate insiders and prospective investors, firms use internal financing when available and choose debt over equity when external financing is required because the cost of equity is the highest out of all of the financing sources available. In a jurisdiction where public investors are not well protected, the worsened information asymmetry reinforces equity’s

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30 As to the pecking order theory, see Stewart C. Myers & Nicholas S. Majluf, Corporate Financing and Investment decisions When Firms Have Information that Investors Do Not Have, 13 J. Fin. Econ. 187 (1984).

31 Corporate insiders will use internal funds first. When they need external funds, they choose debt over equity. Thus, funding through the stock market is the last resort to corporations. See generally, Richard A. Brealey, Stewart C. Myers, & Franklin Allen, Principles of Corporate Finance 496 (8th ed., McGraw-Hill 2008); Myers & Majluf, supra note 30.

32 Gilson, supra note 4.
placement at the bottom of the pecking order.\textsuperscript{33} Therefore, controlled corporations should pay a \textit{substantially} higher price for equity given the bad shareholder protection discount.\textsuperscript{34}

3. \textbf{Reputation and the Product Market-Based Account}

Given what the lemons and pecking order theories predict, why \textit{in reality} are corporations in bad-law countries willing to raise capital through the equity market (although the frequency is low) and have a significant number of public minority shareholders?\textsuperscript{35} To explain this phenomenon, Professor Gilson approaches from a “product market” perspective rather than from a “capital market” perspective.\textsuperscript{36} He explains that fair treatment of minority shareholders serves as evidence of a corporation’s integrity, including its commitment to performing its contractual obligations — if controlling shareholders treat minority shareholders fairly, controlling shareholders will be viewed as honest trading partners in the \textit{product} market.\textsuperscript{37} Then, “… [M]inority shareholders play the role of reputational canaries, whose value is that they help credibly convey to potential traders that the corporation

\textsuperscript{33} Id.

\textsuperscript{34} Id.

\textsuperscript{35} Id.

\textsuperscript{36} Id.

\textsuperscript{37} Since it requires that some extraction of private benefits of control must be given up, this signal is \textit{costly} and therefore \textit{credible}. Gilson, \textit{supra} note 4, at 648. Professor Gilson also says that “… [It is] not because the treatment of minority shareholders affects the controlled corporation’s ability to raise additional equity \textit{capital} but because bad behavior will degrade its \textit{reputation} in the \textit{product} market.” (emphasis is added). Gilson, \textit{supra} note 4, at 637.
is an honest trading partner."

In sum, “The decision to have minority shareholders then can be explained not by the need for capital ..., but as a way of developing reputation that will be valuable in the product market ...” Indeed, this “product market-based account” is a creative paradigm shift and a path-breaking research that attempts to solve Gilson’s riddle. As with most pioneering theories, however, there are some inquiries to which the product market-based account might not give clear answers in special circumstances.

Professors Gordon and Milhaupt raise another question that is associated with the product market-based account’s indirect path of a controller’s signaling – if the reputation of the controlled corporation in the product market is the primary concern of a controller, why would she not show her integrity and honest directly in the product market rather than treat minority shareholders fairly in the capital market and send off this signal to the product market? In addition, I am skeptical about the product market-based account’s explanation that trading partners are interested in knowing a corporation’s treatment of minority shareholders. What trading partners are concerned about is not a corporation’s treatment of minority shareholders but a

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38 Gilson, supra note 4 at 648.

39 Id. at 648. In this “repeated game”, the controlling family’s fair treatment of minority shareholders works as a credible signal of its honesty to its trading partners in “product markets.” Id. In addition, Professor Gilson explains that if the family-controlled corporation does not cheat in easy ways of exploiting shareholders, the controlling family shareholders also will not cheat its customers. Id. at 648.

40 The product market-based account is a paradigm shifting explanation since it views a controller’s willingness to issue new shares to public investors at a discounted price from the product market perspective rather than from the capital market perspective.

41 During the conversation with Professors Jeffrey N. Gordon and Curtis J. Milhaupt, they provided this view.
controller’s treatment of *trading partners*. In sum, as opposed to the product market-based account, it seems that the reason why a controlling shareholder voluntarily protects minority shareholders is not to attract a corporation’s trading partners in the product market.

According to the product market-based account, “… [T]he treatment of minority shareholders is visible to a company’s potential trading partners at a low cost, perhaps because such exploitation is covered by the local newspapers.” A related question is whether we can trust the integrity and efficiency of the “local newspapers” in developing countries where we are concerned about the integrity and efficiency of large corporations and the legal systems. In fact, the press is often under the direct or indirect influence of large corporations in these countries; a corporate group that consists of more than a score of affiliated corporations may have a media corporation; even if a corporate group does not have such a corporation, the group has enormous influence on the existing media industry by sale of advertisements to the press; therefore, it is commonplace that local newspapers are biased towards family controllers.

More generally, it might be difficult for potential trading partners in the product market to notice the corporation’s treatment of minority shareholder easily and effectively. Even to large institutional investors that are experts in interpreting

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42 A corporation’s treatment of minority shareholders might work as a (indirect) signal showing how a corporation would treat its trading partners. However, this signal is less significant compared to the corporation’s more apparent behaviors to its trading partners. If trading partners know the corporation’s trustworthiness through the past transaction records, why do they need to know whether the corporation treats its minority shareholders fairly?

43 Gilson, *supra* note 4 (emphasis is added).

44 Professors Jeffrey N. Gordon and Curtis J. Milhaupt have pointed out this question as well.
information from public corporations, examining a particular controller’s treatment of investors is costly. By and large, trading partners in the product market are less able to interpret capital market information efficiently than institutional investors – trading partners are experts on the product market, not on the capital market. How then can we expect that trading partners recognize the signal at a low cost?

Furthermore, the product market-based account is not fit for explaining an export-oriented developing economy – many successful emerging markets fall into this category – where a corporation has foreign trading partners. It might be difficult for trading partners in the “foreign product” market to be able to effectively observe and examine a corporation’s conduct in the “domestic capital” market.

One may argue that newspapers in (developed) foreign countries report about a controller’s treatment of minority shareholders in a bad-law jurisdiction. If this is the case, then the problem of the independence of the local press is solved – foreign trading partners may be able to receive relevant information on a controller’s integrity from a distinguished and independent press in a developed country in a more neutral manner.

Perhaps, sophisticated business newspapers such as the Wall Street Journal or Financial Times delve into the macroeconomic environment and general characteristics of a particular developing country; however, it is highly unlikely that those newspapers would examine “one particular” controller’s treatment of minority

45 If a corporate group has its own institutional investor as an affiliated firm, it is possible that other affiliated firms in that corporate group (which are trading partners of another corporation) have better information on another corporation. Even in this case, those trading partners (other affiliated firms in the corporate group) are not interested in another corporation’s treatment of minority shareholders in the capital market but in the corporation’s reputation and integrity in the product market.

46 Professor Curtis J. Milhaupt suggested this question during the conversation.
shareholders in one particular developing economy. Even if they did, the probability of these media writing a review of a particular controller is so low that it would be rational for her to ignore that possibility. In sum, a controller in an export-oriented developing country hardly has reasonable grounds to send a costly signal from the “domestic capital” market to the “foreign product” markets.

Moreover, imperfect industrial organizations in many developing countries matter. When a corporation is located in a competitive market, the situation is more favorable to the trading partners of a corporation since they can use competitive pressure among corporations. However, in a market where a few large corporations form a (quasi) monopoly in almost every product market, each large corporation has powerful leverage vis-à-vis trading partners – and this is a general contour of many developing economies. Just as corporate law systems are ineffective, competition law systems are not effective in these jurisdictions. Under these circumstances, a controller of a large corporation does not have to send costly signals (i.e., about the fair treatment of minority shareholders) in order to attract trading partners. Put differently, the prevailing phenomenon in developing countries is often described as “Strong Controllers, Weak Trading Partners”\(^{47}\) – it is trading partners (rather than a controlling shareholder) that should send the costly signals that they are credible, if any.

\(^{47}\) This expression is borrowed from Professor Mark J. Roe’s book. MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (Princeton University Press 1994).
4. When Cash Flow Rights and Voting Rights Are Significantly Detached

Depending on the pecking order theory\(^\text{48}\) (i.e., that the cost of equity is substantially higher than the cost of debt to a “corporation” in a developing country), the product market-based account concludes that a controller’s decision to rely on the equity market is not explained through capital market-based account.\(^\text{49}\) Rather, it hypothesizes that a corporation sends off the signal of its integrity to trading partners in the product market (by showing that the corporation treats minority shareholders fairly) even if that signaling incurs financial cost (i.e., issuing stocks at the discounted price) in the stock market. Let us explore this reasoning by paying attention to the following questions. When issuing stocks at the discounted price, who will ultimately bear the extra financial costs, and how much? Who makes the decision on the capital structure of a corporation, and what matters most to her?

To be sure, if the cost of equity is much higher than the cost of debt, then a corporation has no good reasons to issue new equities in the capital market. However, in fact, the ultimate and real cost-bearer is not a fictitious legal person i.e., a “corporation,”\(^\text{50}\) but natural persons, “shareholders” of the corporation. As a decision-maker of a corporation, it is plausible that a controlling shareholder does not

\(^{48}\) The trade off theory and the pecking order theory are two competing models to explain the finance decisions of firms. Eugene F. Fama & Kenneth R. French, Financing Decisions: Who Issue Stock? 76 J. FIN. ECON. 549 (2005). According to the trade off theory, debt financing has trade off effect – while it has tax benefits, it increases financial distress.

\(^{49}\) Professor Gilson explains that the decision of family controlled corporations to issue new equities cannot be explained by a capital market perspective but by a product market perspective. Gilson, supra note 4.

\(^{50}\) See e.g., FRANK EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 12 (Harvard University Press 1996) (explaining that “The ‘personhood’ of a corporation is a matter of convenience rather than reality); Gilson, supra note 4 (pointing out “A corporation is just a long-lived piece of paper on which appears the corporation’s charter.”)
care much about the welfare of the “corporation,” which is a collective entity consisting of all shareholders, as long as the corporation is sustainable. Rather, she takes into consideration more seriously the cost of equity financing that she has to tolerate privately, which is not so high under the (deep) CMS, where her economic interest in a corporation is low.

Let us elaborate upon a controller’s payoff in external finance. Suppose that a controlling shareholder in a developing country manages a corporation, and her economic interest in that corporation is \( \alpha \) (0 ≤ \( \alpha \) ≤ 1).\(^{51}\) She wants to raise \( X \) dollars through external funding, either debt or equity issuance. Suppose that the fundamental value\(^{52}\) of the debt and equity securities which she considers to issue is \( X \) and \( Y \) dollars, respectively. Here, \( Y \) is larger than \( X \) since the cost of equity finance is much higher than that of debt finance. In other words, even if the fundamental value of equity is \( Y \) dollars, the corporation would receive less, i.e., only \( X \) dollars – equity would be sold to the public at discounted price as the conclusion of the pecking order implies. Therefore, the additional cost of equity that the “corporation” should bear is \( (Y - X) \) if the corporation chooses to finance from the equity market. The personal cost of the “controller” in selecting the equity finance is, however, only \( \alpha \, (Y - X) \)\(^{53}\) – since \( \alpha \) is a number between 0 and 1, \( \alpha \, (Y - X) \) is less

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\(^{51}\) For example, when a controlling shareholder’s economic interest is 10, 50, 100 percent, \( \alpha \) is 0.1, 0.5, 1 respectively.

\(^{52}\) In principle, the fundamental value is the price that would prevail if the market consisted entirely of rational investors who possessed all available information (i.e., the price that would prevail in a truly efficient market). See Merritt B. Fox, Randall Morck, Bernard Yeung, Artyom Durnev, Law, Share Price Accuracy, and Economic Performance: The New Evidence, 102 Mich. L. Rev. 331, 349 & n.47 (2003).

\(^{53}\) As aforementioned, \( \alpha \) is between 0 and 1 (0 ≤ \( \alpha \) ≤ 1).
than \((Y - X)\). The rest of the additional expense, which is \((1 - \alpha) (Y - X)\), will be borne by all of the public shareholders.

According to the conventional controlled structure (CS) model, a controlling shareholder will take most benefits and costs occurring in any decision and transaction made in a controlled corporation because the controller holds the vast majority of the cash flow rights. Here, the economic incentives of the “corporation” and the “controller” are generally aligned. For example, when a controlling shareholder holds 90 percent of the economic interest of a corporation (i.e., \(\alpha\) is 0.9), she should bear 90 percent of the additional cost of capital, i.e., 0.9 \((Y - X)\). Under these circumstances, if a decision-maker of a controlled corporation (i.e., a controller) decides to choose equity financing that costs more than debt financing, then it is possible that the decision would not be made based on a capital market rationale. Instead, it is plausible that a product market rationale – for example, building a reputation of integrity in the product market – may justify raising equity capital in this more costly way.

A limitation of the above explanation is, however, that this view is incapable of explaining another subset of controlling shareholder regimes – namely, the controlling minority structure (CMS). Since the cash flow rights and voting rights of controlled corporations are significantly separated in the deep CMS, the economic incentive of the “corporation” and the “controller” can be substantially detached.

\(\alpha (Y - X)\) is equal to \((Y - X)\) only when \(\alpha\) is 1. In this case, a controlling shareholder contributes all (100 %) of the equity capital to the corporation.

Another reason that a controller may rely on equity financing, which costs more than debt financing is that the additional cost of equity financing is not out-of-pocket cost, but mostly opportunity cost. Since opportunity cost tends to be neglected to a greater extent than out-of-pocket cost, a controller is less likely to care about the additional cost of equity financing.
When a controller manages a (deep) CMS-style corporation (i.e., when $\alpha$ approaches to zero), a controller’s personal burden is only a small part of a corporation’s cost. Obviously, a self-interested controller’s criteria for judgment when deciding the method of finance is \textit{not} the corporation’s cost, $(Y - X)$, \textit{but} her personal cost, $\alpha (Y - X)$. Therefore, the fact that the cost of equity finance is much higher than that of debt finance to a corporation does not significantly constrain a CMS controller’s desire to raise equity capital.\(^{56}\) A controlling shareholder can simply make minority shareholders pay the most extra cost of equity financing.

For instance, suppose that a controlling shareholder holds only 5 percent of cash flow rights of a business group – which, in fact, is not uncommon in countries with the CMS. When a corporation raises expensive external equity financing, the cost will be shared across \textit{all} shareholders on a pro rata basis. Hence, when a new equity is issued to the public, the controlling shareholder has to bear only 5 percent of additional cost. Almost all of additional cost of equity (i.e., 95%) would be borne by minority shareholders.

In sum, the question at issue should not be why a “corporation” in a developing country has minority shareholders even if the cost of equity to a “corporation” is \textit{substantially} higher than the cost of debt by $(Y - X)$. The more precise question is why a “controller” in a developing country has so many minority shareholders even if the cost of equity to a “controller” is \textit{still} (slightly) higher than the cost of debt to her by $\alpha (Y - X)$.\(^{57}\) A controller’s choice of equity finance is not

\(^{56}\) Of course, it is true that a controlling shareholder in the CMS should bear \textit{some} personal cost, even if it is not huge compared to a controller in the CS.
very irrational even from the *capital* market perspective when a corporation’s *collective* interest and a controlling shareholder’s *private* interest are separate (i.e., when $\alpha$ is small). This implies that the product market-based account becomes less compelling as an explanation of Gilson’s riddle in deep CMS regimes.

5. Where Are We Headed?

One may argue that, to a controller, equity finance is still more expensive than debt financing, even when her economic interest in a corporation is significantly low. For instance, if a controller has 5 percent of ownership in a corporation, she has to bear 5 percent of *additional* equity cost. Even if equity financing is slightly (i.e., 5 %) more expensive than debt financing, *in theory*, an economically reasonable controller would always choose debt financing over equity financing as long as the benefits from equity or debt financing are exactly same – she does not have any reason to pay even a dime more for the same. Then, why *in reality* does a controller issue new shares in the stock market if not frequently?

One possible answer is that a controller’s additional cost of equity financing is not out-of-pocket cost but opportunity cost. Since opportunity cost tends to be neglected to a greater extent than out-of-pocket cost, a controller may have little concern about the relatively small amount of the additional cost of equity financing. Another hypothesis – which is a main argument in this Article – is that a controller would attain *personal* benefits that outweigh her *personal* costs when relying on the

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57 Please note that $\alpha (Y – X)$ is always less than $(Y – X)$ except when a controlling shareholder’s economic interest of the corporation is 100 percent ($\alpha = 1$).
new equity issuance. In short, equity financing and debt financing are not same to a controlling shareholder. The next two Parts (Parts II and III) will explore these hidden benefits that a controller can enjoy through issuing equities and having many minority shareholders.

II. WHY A CONTROLLING SHAREHOLDER NEEDS MINORITY SHAREHOLDERS: THE EMPIRE-BUILDING ACCOUNT

This Part explores the characteristics of “empire-building” 58 in developing countries and its relations with equity-financing, non-pecuniary benefits, and pecuniary benefits including economic rent. A controller has an incentive to raise capital from the stock market and have a significant number of minority shareholders because having more minority shareholders is required (see Part II Section 2) or advantageous (see Part II Section 3 & 4) to the controller.

1. Empire-Building and Non-Pecuniary Private Benefits of Control

In the most literature, a controlling shareholder is assumed to maximize her “wealth” – therefore, pecuniary private benefits of control are of primary interest to

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58 Empire-building is a phenomenon that a top decision maker of a corporation expands the size of the corporation. As to the phenomenon of empire-building, Professors Shleifer and Vishny explain that “Greater costs are incurred when managers have an interest in expanding the firm beyond what is rational, reinvesting the free cash, pursuing pet projects, and so on.” Andrei Shleifer & Robert W. Vishny A Survey of Corporate Governance, 52 J. Fin. 737 (1997).
academia. More precisely, however, a controlling shareholder’s aim is to maximize the “utility” arising from non-pecuniary benefits (e.g., social prestige, reputation, psychic utilities, and social influence including political power) as well as pecuniary benefits. Empire-building is an important source of utility since corporate insiders may create both pecuniary and non-pecuniary benefits by enlarging the size of corporations. In relation to non-pecuniary benefits in particular, there are several significant points (which are not covered well by the extant literature) when exploring the impacts of empire-building on the corporate governance practices of developing countries.

First of all, in many developing countries, a small number of corporations – and as a result, a small number of controlling shareholders – dominate the entire economy, which is markedly different from the United States. For example, although Microsoft is one of the largest corporations in the United States, it is too “small” to dominate the largest market in the world – as a result, Bill Gates is only “one of many” successful business people in the economy. In contrast, although the

59 As a proverb goes, even in the business world “Money is not everything.” Professor Gilson should be credited as one of the first scholars who seriously take into consideration the importance of non-pecuniary private benefits of control to a controller. See Gilson, supra note 2.

60 Managers often desire to expand the influence of their business by managing large corporations. In particular, the empire-building account explains that managers in an acquiring corporation tend to pay a higher takeover premium to a target corporation since managing a larger corporation is more beneficial to managers. For example, according to Professors Shleifer & Vishny, “Morck, Shleifer, and Vishny find that bidder returns tend to be the lowest when bidders diversify or when they buy rapidly growing firms.” Shleifer & Vishny, supra note 58; Randall Morck, Andrei Shleifer, and Robert Vishny, Do Managerial Objectives Drive Bad Acquisitions? 45 J. Fin. 31 (1990). As widely known, to managers, an economic rationale of managing a large corporation is that their compensation is related to the size of the corporations they manage. In addition, they can attain more psychic satisfaction by ruling a larger “empire.”

61 See e.g., Alice H. Amsden & Takashi Hikino, Project Execution Capability, Organizational Know-How and Conglomerate Corporate Growth in Late Industrialization, 3 Industrial Corporate Change 111 (1994).
largest corporation in a developing country is not comparable to Microsoft in terms of any economic indicator, it may account for a significant portion of a relatively small market, and so a handful of business tycoons may command the economy. Due to their unchallenged position, controllers of large corporations in less developed countries are highly respected and envied, so that they can enjoy immense reputation, social prestige and other psychic utilities (including the “jealousy of others”). This tendency can be amplified more in countries with business “groups” because the economic power is more concentrated among fewer controllers who dictate dozens of large affiliated firms. In short, being a controller in a large corporation or business group is psychologically rewarding – the larger a corporation (or a corporate group) is, the more non-pecuniary benefits a controller can attain.

In addition, controllers are often treated as national leaders – the disproportionately large economic power of controlling shareholders makes it possible that, by various means, they have direct social influence and even political power among people in the street and the government. In many authoritarian regimes, which are usually developing countries, it is true that the government is above the business. However, if a few business people are key players in the market, they can talk directly and personally with the government as its leading partners despite the hierarchy that is generally established between the government and business. In extreme cases, business elites of large corporations could become the

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

63 It is true that, in many developing countries, government–business relationships are vertical (with government supremacy). However, as a particular corporation’s (or a business group’s) economic importance has grown in a domestic market, the relationship has become more equal even if the
highest political figures in their countries. Notable examples are Taksin in Thailand and Berlusconi in Italy – Italy is recognized by many scholars as a country with insufficient investor protection,\textsuperscript{64} which is a jurisdiction at issue of this Article.

Moreover, the length of tenure as a corporate decision-maker makes empire-building far more attractive to controlling shareholders in developing countries than to CEOs in the United States. In the United States, in general the term of a typical top manager lasts for several years.\textsuperscript{65} In that sense, a business empire is “leased” to her for a short duration. In contrast, a controlling shareholder in a country with poor investor protection usually remains a dictator of a corporation for her entire life, if she wishes. In addition, since a controller’s children will inherit her capacity after she retires or dies, the tenure of a controlling family shareholder is practically infinite. As government’s supremacy is formally maintained. The case of Korea is noteworthy. The military government selected a handful of business people and supported them since the 1960s. It was almost unimaginable for controllers in business groups to speak out against the government until the end of the 1980s. Nonetheless, it can be said that, even during this period, business elites were influential to the government because the government needed economic development in order to compensate for the lack of political legitimacy. Thus, it may be fair to say that the relationship was a “symbiosis” despite the formal hierarchy. Since then, the government has become more captive to large business groups because their economic power has grown enormously and the government’s punishment of them could adversely affect the macro-economy, which the government has feared. In addition, democratization in Korea limited the government to using its stick (rather than carrot) against business elites. Moreover, since an incumbent president is not allowed to run for the next election under the current constitution, the power of even an incumbent president in relation to business circle has been significantly weakened. Also, since politicians are in need of campaign funds, they are not free from policy suggestions from business elites. Consequently, large business groups – more precisely, family controlling shareholders of these groups – could ultimately speak out against the government.

\textsuperscript{64} Although Italy is one of G-7 economies, it has been seen as a bad-law jurisdiction. See e.g., Shleifer & Vishny, supra note 58; Gilson, supra note 2.

\textsuperscript{65} Quoting Booze Allen Hamilton study, Professor Gordon explains that the average CEO tenure in the United States in 2001 is 7.3 years. As for the average fired CEO tenure in the same year is 4.6 years. Jeffrey N. Gordon, The Rise of Independent Directors In the United States, 1950 - 2005: Of Shareholder Value and Stock Market Price, 59 STAN. L. REV. 1465 (2007).
such, a controller is conceived as “owning” a business empire as her personal “property.”

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

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

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66 Since a controller holds only a part of shares, it is not precise that a controller “owns” the corporation (or corporate group) as her personal “property.” What I mean here is that from the “positive” standard a controller in a developing country in fact wields her decision-making power in a corporation to the fullest extent as if a corporation is her own property.

67 While a controlling family shareholder builds a “real empire,” even the most powerful CEO in a dispersed shareholding firm rules only a “pseudo empire.” If a current CEO is not able to appoint her child as the next CEO, how can we call this firm an “empire”?
shareholder may have an equal incentive to pursue empire-building throughout her life since the expanded empire will ultimately belong to her children.

2. External Equity Financing is Essential for Empire-Building

So far, I have explained that, in a developing country, a controlling shareholder can attain a significant part of non-pecuniary benefits by empire-building. How, then, is empire-building embodied in a concrete way, and what are the implications of empire-building in relation to equity finance?

(a) A Balance Sheet Analysis

In general, “large corporations” are meant to be “corporations with large assets.”68 From an accountant’s perspective, as the size of the assets (i.e., the left side of balance sheet) increases, the sum of the debt and equity (i.e., the right side of balance sheet) should increase to the same extent since both sides of a corporation’s balance sheet are equal. When external capital is required by a corporation, a controlling shareholder may initially prefer to rely on debt (especially bank loans) according to the pecking order theory. During this period, as assets increase, so does

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68 What is a “large” corporation? The definition of a large corporation may vary. A large corporation might be a corporation with a large number of “employees,” large “sales” or “assets.” Generally, in developing countries, the number of employees and the magnitude of sales and assets are highly correlated with each other. In that sense, it can be said that the size of the assets is a good proxy for measuring how large a corporation is. In this Article, therefore, when I mean by a large corporation, it is a corporation with a large size of assets.
debt to the same extent, and thus the size of the equity remains. Consequently, a growth strategy that depends solely on debt financing raises the leverage ratio of a business group. As the debt-equity ratio deteriorates, however, the financial distress costs increase.69

Perhaps, “high” leverage may still be sustainable by a corporation even if it creates enormous inefficiency in the capital structure. However, at some point, a controller’s choice to base her empire-building strategy solely on debt financing is generally impractical for two reasons: (1) the financial distress costs of “extremely high” leverage far exceed the benefits such that the corporation is unable to endure; and (2) the debt market would no longer make loans to the corporation due to the fear of default even if the corporation is in search of another debt. Inevitably, a controlling shareholder who seeks empire-building eventually “has to” turn to equity financing from outside investors in the stock market.

Under these circumstances, a “repeat controller” whose child is expected to inherit ought to be concerned about the next equity issuances – thus, she has an incentive to voluntarily protect minority shareholders at least to some degree. True, the frequency of equity issuance is rare in a controlling shareholder system.70 However, the interval between equity financing which looks “long” to a dispersed shareholding firm’s CEO who can remain in that post for only several years is actually “short” to a controlled firm’s dominant shareholder whose time horizon is infinite. In sum, the decision to have minority shareholders can be explained by the

69 According to the trade off theory of debt-equity, financial distress costs would increase as debt-equity ratio increases. See Brealey, Meyers, and Allen, supra note 31.

70 See Gilson, supra note 4.
need for *capital* in the stock market (as opposed to the product market-based account),71 if analysis takes into consideration dynamism, such as the growth of a corporation over a long (or infinite) time horizon through dynastic succession.

One may argue that although the above explanation is true in some situations, a controlling shareholder will not rely on external equities when the new equity threatens her interest as a controller; as a controller’s cash flow rights are diluted by the new equity issuance, her voting rights are injured as well, and she may eventually lose her control over the corporation. As such, a controlling shareholder would not think about the option of going to the equity market in the first place. Perhaps, this argument is relevant in the controlled structure (CS) regime where a typical controlling shareholder is required to have a majority of shares to have control over a corporation; here, a controller may decide to issue new shares as long as she is able to participate in this capital-raising as a dominant investor who can maintain the majority shareholder’s position after the new equity issuance; she would not let the corporation issue new shares, however, if she does not have enough money to participate in the new equity issuance, since new issuance would reduce her equity holding under the critical level for control.

This concern, however, is not very meaningful to a controlling shareholder in the controlling minority structure (CMS). In the CMS, a decrease in cash flow rights does not necessarily dilute a controller’s voting rights in the same proportion, since a controlling shareholder is effectively able to entrench her control position through

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71 "The decision to have minority shareholders then can be explained not by the need for *capital* …, but as a way of developing *reputation* that will be valuable in the product market…” (emphasis is added). Gilson, *supra* note 4 at 648.
voting leverage devices.\textsuperscript{72} Since a CMS controller’s voting rights are not critically reduced by new equity issuance, equity financing is generally seen as a safe means to attain the goal of empire-building.

\textit{(b) A Simple Model: A Controller’s Cash Flow Rights and Empire-Building}

To what extent, then, can a controlling shareholder enlarge her business when she raises capital from the stock market? If an algebraic relation between the size of assets and a controller’s economic interest exist, what does that tell us? For these answers, suppose that a controlling shareholder contributes money as an equity capital to her controlled corporation, where her economic interest in the corporation is denoted as $\alpha$ ($0 \leq \alpha \leq 1$). Her equity capital is worth $A$ dollars. When the total worth of equity capital in the corporation is $E$ dollars, a controller’s personal equity capital (i.e., $A$) is equal to $\alpha E$ – hence, $E$ is equal to $(A / \alpha)$. Note that the debt-to-equity ratio is expressed as $\lambda$ (for example, when the debt-to-equity ratio is 400 percent, $\lambda$ is 4); then, the size of the assets of the corporation is equal to $(1 + \lambda) (A / \alpha)$; this implies that the size of the assets (which is the proxy of the non-pecuniary benefits) and the economic interest of a controller have a \textit{reciprocal} relationship, given $\lambda$ and $A$. Table 2 summarizes above information.

\textsuperscript{72} Generally, there are three voting leverage devices – stock pyramids, dual-class share structures, and cross-ownership ties. \textit{See} Bebchuk et al., \textit{supra} note 18.
Table 2: Reciprocal Relationship between Size of Assets and Economic Interest of a Controller

- **Notations**
  - $A$: the worth of equity capital that a controller contributes to the corporation
  - $\alpha$: the economic interest of a controller
  - $E$: the total value of equity capital in the corporation
  - $\lambda$: the debt-to-equity ratio of the corporation (e.g., $\lambda = 4 \rightarrow$ debt-to-equity ratio = 400%)

- **The Size of the Assets of the Corporation**

  $A = \alpha E$  \hspace{1cm} Thus, $E = [A / \alpha]$
  
  Assets = Equity + Debt = $E + \lambda E = (1 + \lambda) E = (1 + \lambda) [A / \alpha]$

  - There is a reciprocal relationship between the size of the assets of the corporation and the economic interest of a controller, when the debt-to-equity ratio and the worth of equity capital that a controller contributes are constant.
  
  - Since the size of the assets of the corporation is a proxy for the magnitude of non-pecuniary private benefits of control, the above reciprocal relationship can be interpreted in such a way that the non-pecuniary private benefits of control increase rapidly as the economic interest of a controller decreases.

A numerical example explains the relationship between the size of assets and the economic interest of a controller in a more concrete way. Suppose that there are three corporations with three controlling shareholders who invest the same amount of money – 50 million dollars in each corporation. Three controllers hold 100 percent, 50 percent, and 5 percent of common stocks in corporations, respectively – apparently, the first controller runs a CS-style corporation, whereas the third runs a CMS-style corporation.\footnote{The second controller runs either a CS or a CMS corporation since her economic interest in a corporation is 50 percent. Remember that in this Article, a CS corporation is defined as a corporation where a controller’s economic interest is more than 50 percent. A CMS corporation is a corporation where a controller’s economic interest is less than 50 percent.} Then, the total equity of each corporation should be 50 million dollars, 100 million dollars, and 1 billion dollars, correspondingly. If each corporation is
allowed to finance debts by 400 percent equity-to-debt ratio (i.e., $\lambda = 4$), the total assets of each corporation will be 250 million dollars, 500 million dollars, and 5 billion dollars, respectively.

Although these three controllers contribute the same value of capital, the third controller attains the largest non-pecuniary benefits because she runs the largest corporation. Put differently, in consideration of non-pecuniary private benefits, the optimal choice for a controller is to maintain the least cash flow rights in the corporation as long as her control is assured, other things being equal. In addition, it is noteworthy that non-pecuniary benefits (e.g., psychic utility of a controller such as leadership, fame, reputation, social and political influence) are private benefits – although most of the assets (99%) consist of other people’s money (i.e., equity and debt) in the third corporation,74 the only person who is able to consume non-pecuniary benefits exclusively is the third controller. The lesson is clear. Having more external capital from the equity market is ultimately beneficial to a controller in that it increases the territory (i.e., the assets) of her empire – the more equity capital a controller has in her controlled corporation, the more debt she can bring in as well, and the larger corporation she would run, which provides more non-pecuniary benefits to her.75

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74 In Corporation 3, a controller’s capital contributed is 50 million dollars. Since she holds only 5% of equity, the total amount of equity in Corporation 3 is 1 billion dollars. If the corporation’s leverage level (i.e., debt-to-equity ratio) is 400%, as assumed in this example, this would mean that in addition to the 1-billion-dollar equity, there is a 4-billion-dollar debt. Thus, a controller’s equity (50 million dollars) is only 1% of the corporation’s total assets, 5 billion dollars (the sum of equity and debt).

75 Equity financing is essential for attaining more debt from outside. Suppose that the debt-to-equity ratio is maintained at 400%. Then, when a corporation issues 1 million dollars of new equities, it is entitled to have additional 4 million dollars through subsequent debt financing. As the sum of equity and debt increases, the size of firm (the asset size) increases as well – through this empire-building, a
In the numerical example, the third controller who has 95 percent of equity from minority shareholders has an empire that is 20 times larger than that of the first controller who has no minority shareholders at all – according to the aforementioned general model, the size of the assets that the first controller manages is \((1 + \lambda) \frac{A}{1}\), whereas that of the third controller is \((1 + \lambda) \frac{A}{0.05}\), which is equal to 20 \((1 + \lambda) \frac{A}{1}\). Therefore, *ceteris paribus*, a controller in a developing country may have an incentive to attract minority shareholders since her non-pecuniary benefits are a positive function of the value of equity capital she collects from public shareholders. Table 3 shows a summary of this point.

**Table 3: Relationship between a Controller’s Economic Interest in a Corporation and the Size of the Corporate Empire that She Can Control**

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

A controller in Corporation 3 can “rule” an empire 20 times larger than that of a controller in Corporation 1. Accordingly, a controller in Corporation 3 can enjoy much more non-pecuniary private benefits than a controller in Corporation 1 although they both invest the same amount of equity in the corporations.

current controller’s non-pecuniary benefits increase. As a result, equity financing is a solid foundation for debt financing and non-pecuniary benefits.

76 The assumption is that the financial leverage (debt-to-equity) ratio is 400%.
3. Empire-Building and Inefficiency

Under the ideology of the “shareholder capitalism,” the purpose of a corporation is to maximize the wealth of shareholders. Consistent with this view, Milton Friedman opined that to increase a corporation’s profit is indeed its “social responsibility.” In reality, however, we often encounter cases where corporate insiders put their interest before shareholders’ interest and deviate from the normative standard of profit maximization. In addition, according to the business judgment rule, directors/managers are required to act only reasonably (not perfectly) in the best interest of shareholders.

The conventional thought on the business economics and corporate governance views empire-building as an important example of corporate insiders’ aberration from the ideal norm of the shareholder capitalism. Since empire-building is seen as the reckless expansion of a corporation, it is understood to be the strategy of pursuing size maximization by adopting even negative NPV (net present

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77 On the other hand, according to another ideology, i.e., “stakeholder capitalism,” the purpose of a corporation is to balance welfare of all stakeholders in a corporation such as creditors, employees, suppliers, consumers, and even community.


79 The business judgment rule is “a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

80 Empire-building of corporations is embodied by diversification through conglomerates or business groups. The prevailing view in the economics, management, and corporate governance is that corporate diversification destructs corporate value. See e.g., Morck et al., supra note 60; Larry H. P. Lang & Rene M. Stulz Tobin’s Q, Corporate Diversification, and Firm Performance, 102 J. Pol. Econ. 1248 (1994).
value) projects – hence, the normative standard of the profit maximization is sacrificed. In sum, it is a common sense in advanced economies that unrelated-diversification depresses profitability.81

Managers in the United States in the 1960s were preoccupied with “conglomeration” – this third wave of M&A is thought to cause a significant level of inefficiency in the economy through unrelated-diversification. Subsequently, the fourth wave of M&A in the 1980s was mainly designed to rectify the inefficiency problem by divestiture – since then, in running business, “focus” rather than “diversification” has been established as the business norm in advanced Western countries.82

On the other hand, in most emerging countries, whether it be the grupos in Latin America, the business houses in India or the chaebol in South Korea, business groups still play a prominent role in the economy.83 According to established thought in advanced economies, these business confederations that are based on unrelated-diversification suffer great inefficiency as a result of value destruction. If this evaluation is true, all shareholders including a controller are damaged by a controller’s reckless pursuit of empire-building. Why, then, does a controller keep unrelated-diversification? The answer is related to the disproportional features of a controller’s personal payoff scheme in empire-building.


82 For the general explanation of this Western norm, see e.g., Khanna & Palepu, *Why Focused Strategies May Be Wrong for Emerging Markets*, 75 HARV. BUS. REV. 41 (1997); Khanna & Palepu, supra note 29.

83 Khanna & Palepu, supra note 82.
Let us note \textbf{NPB} as the equivalently capitalized dollar value of incremental non-pecuniary benefits from empire-building that a controller can enjoy – even if market value for non-pecuniary benefits is not set, a controller has her own reserve value for non-pecuniary benefits. It cannot be overemphasized that a controller is thought to take \textit{all NPB} no matter how much economic interest she has in a corporation. On the other hand, the dollar value of incremental inefficiency from expanding the empire is defined as \textbf{INEF}. As opposed to \textbf{NPB}, \textbf{INEF} is shared among all shareholders according to their pro-rata economic interest in a corporation. As a result, the amount of dollar value in economic inefficiency that a controlling shareholder has to bear \textit{personally} in pursuit of empire-building is \(\alpha \text{INEF}\), where \(\alpha\) is a controller’s economic interest in a corporation (0 \(\leq\) \(\alpha\) \(\leq\) 1). In sum, costs arising from empire-building are proportionally borne by all shareholders whereas all benefits accrue to a controller.

From a controller’s point of view, when \textbf{NPB} is expected to be larger than \(\alpha \text{INEF}\), seeking the expansion of business or unrelated-diversification is \textit{personally} beneficial even if the strategy of empire-building creates no value for all shareholders. As such, she would choose to enlarge the empire until the private marginal benefit (\textbf{NPB}) is equal to the private marginal cost (\(\alpha \text{INEF}\)) although it destroys the value of the corporation. Intuitively, a controller may find it more attractive to pursue unrelated-diversification or empire-building when her economic interest (\(\alpha\)) in a business group is small – then it is more likely that \textbf{NPB} is larger than \(\alpha \text{INEF}\). Accordingly, it is probable that a controller in the deep controlling minority structure
(CMS) has greater willingness to pursue the empire-building strategy than a controller in the deep controlled structure (CS).

Notwithstanding, there are some mechanisms in which a controller in the deep CMS might not pursue empire-building even if minority shareholders absorb the most inefficiency that empire-building creates. First, when huge inefficiency arising from the excessive empire-building would ultimately threaten the survival of the corporation, a controlling shareholder cannot help stopping the expansion of her business – otherwise, she would lose everything, her empire itself, and would not enjoy the private benefits any longer. For example, as a firm pursues inefficient expansion, the firm’s profit gradually decreases. Nonetheless, it could be still a sustainable empire-building for a while. When the profit of a corporate group reaches some point below zero (i.e., when total revenues are less than total costs), however, a controller should be concerned about whether she keeps to pursue inefficient unrelated-diversification. If the corporate losses accumulate continuously due to the reckless empire-building, ultimately the corporation would become unviable soon or later. Even if the incremental personal benefit of a controller from the expansion is still larger than the incremental personal cost (i.e., even if \( \text{NPB} \) is larger than \( \alpha \text{INEF} \)), she does not have a choice to keep building the costly empire.

Second, given the necessity of continuing finance from the equity market for growth, a controller with a long-term horizon has an incentive to be careful in

\[84\text{ In this sense, a corporation under a controller in the CMS system can be analyzed by the prism of the bureaucracy model in the public choice theory (e.g., Niskanen model) – rational bureaucrats have an incentive to maximize, rather than optimize, their budgets and/or the size their bureaucracy in order to enhance their power. Similarly, if a controller does not hold a significant economic interest in a corporation, she has an incentive to maximize the corporation’s budget (and/or expand the size of corporation) irrespective of efficiency.} \]
reviewing projects in the first place in order to satisfy the existing and prospective shareholders. If they are not satisfied, existing shareholders would sell their shares, and prospective shareholders would not invest their money when a corporation needs external capital. Accordingly, a chain reaction would occur: the economic interest of a controller in a corporation (α) would increase; in turn, the total amount of the equity capital of the corporation would decrease, resulting in the reduction of debt capital and, ultimately, the size of assets.

If a controller’s time horizon is relatively short, then she would have no reason to voluntarily stop pursuing inefficient empire-building as long as her personal benefit (i.e., \( \text{NPB} \)) is larger than her personal cost (i.e., \( \alpha \text{INEF} \)). Since the chain reaction aforementioned will generally take time, a short-sighted controller would not care about the end result of the chain reaction, (i.e., reduction of the size of assets) in the “future” which lies beyond her horizon. However, when a controller deems her time horizon as infinite in consideration of family inheritance, the upshot of the chain reaction is precisely inimical to the interest of a size-maximizing controller. With this fear, a controller may voluntarily stop inefficient expansion of the business at some point even if there is no other constraint in the market. In sum, to a family controller who is “immortal,” growth should be accompanied by profitability since a controller’s desire for empire-building are compromised by potential investors who pursue profits.

Indeed, any decision-maker in a corporation wants to be a captain of a “large ship.” Since a top manager in a widely held corporation in the 1960s (when conglomereration was a business trend in the United States) served for a relatively short
tenure, it is probable that she was not much concerned about how well the ship (i.e., profitability of a corporation) would fare in the future, after she retired. In contrast, since a family controller in a controlled corporation stays onboard the ship eternally, it might be plausible that she would generally have more reasons to care about the future condition of the ship – therefore, a controller has sufficient reasons to abstain from inefficient empire-building or pursue even efficient one.

Then, a more positive story may be possible for a business group in a developing economy that is built on the unrelated-diversification; in pursuing empire-building, it is plausible that family business groups with even deep CMS have reasons to search for profitability as well as growth; accordingly a far-sighted family controller would review more carefully the question of whether the expansionary project creates positive NPV; if a controller succeeds, unrelated-diversification does not incur the inefficiency cost. Thus, it is true that the performance of diversified business entities is not always poor – the experience of the value-destructive conglomeration in the United States might not apply to business groups of other countries with unrelated-diversification.85

4. Other Benefits of Empire-Building through Diversification

85 Khanna & Rivkin, supra note 81 at 45. In addition, Professors Khanna and Palepu explain “Our statistical analysis comparing groups and independent companies in India – and a similar analysis on South Korean companies that Tarun Khanna conducted with Yishay Yafeh – suggests that many groups add little or no value to their operations. The largest and most diversified groups, however, do add a good deal of value – perhaps because only these groups have the scale and scope to perform the kind of functions we have described.” Khanna & Palepu, supra note 82 at 50.
In the end of the previous Section, I suggested, it is possible that a controller may pursue efficient empire-building in some cases although empire-building tends to lead to inefficiency. Then, what is “efficiency” in empire-building? In this Article, efficient (inefficient) empire-building is defined as a business expansion that is beneficial (detrimental) to a “corporation” i.e., the entire shareholders as a group. Since the reference group when it comes to the efficiency of empire-building is a “corporation” rather than a society, it is noteworthy that efficient empire-building might be even harmful to the society.

Then, what – if any – are the benefits of conglomeration or business groups to shareholders? In other words, what are the sources of efficiency in empire-building? One of compelling defenses for forming business groups is that they help to resolve the problems caused by the absence or poor functioning of institutions that managers in advanced markets take for granted. For instance, given that there is no efficient capital market in developing countries, business groups can add value by having their own “internal” capital markets. Groups can also add value by developing a common group brand that represents world-class quality and customer service – this type of brand name is extremely valuable in export-oriented economies. In this respect, it can be said that business groups which are seen as indulging in their passion for empire-building may generate efficiency for their

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86 The examples of well functioning institutions in developed economies are an efficient capital market and an efficient labor market.

87 Khanna & Palepu, supra note 29 at 129. See also Tarun Khanna & Krishna Palepu, supra note 82.

88 Khanna & Palepu, supra note 29.

89 Id.
shareholders, as opposed to the well-established Western view that conglomeration is inefficient.

Another justification for empire-building might be that diversification at the level of the firm or the group is capable of increasing corporate value by smoothing corporate earnings over the business cycle. However, by diversifying their own investment portfolio, shareholders can smooth corporate earnings in the capital market more easily—rational investors do not put all of their eggs in one basket, or they employ experts in finance who pool money and diversify portfolios on their behalf.

In that respect, according to the conventional wisdom, unrelated-diversification loses justification in protecting shareholders and conglomeration mainly works for the benefits of only corporate insiders including a controller by stabilizing cash flow streams.

Nonetheless, I argue, there is a possibility that conglomeration may create values arising from diversification for public shareholders as well, as is counterintuitive to the firm believers of the conventional wisdom. Traditionally, it is presumed that in a controlled corporation, too much of a controller’s capital is tied to a corporation. As a result, a controlling shareholder may be reluctant to take on

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91 Id. at 446.

92 This “common sense” is less clear in developing countries’ capital markets; (1) often, individual investors do not (or cannot) use institutional investors in these underdeveloped capital markets; (2) the lack of public information in these economies could lead individual investors to less reasonable decisions in determining their portfolios. In fact, even educated individual investors in developed countries sometimes fail to diversify their investment portfolio (when they do not rely on advice of financial planners), although they know the principle and benefits of diversification.

93 “[T]here may be costs of large investors as well. The most obvious of these costs, which is also the usual argument for the benefits of dispersed ownership, is that large investors are not diversified, and
risky but profitable projects because even one mistake can financially destroy her. However, this statement is true only when two conditions are met: (1) a controller runs one corporation that is undiversified; and (2) she holds most of the cash flow rights (i.e., she runs a CS corporation). When a controller with a small percentage of cash flow rights can utilize voting leverage and set up a business group with dozens of subsidiaries (i.e., when a controller runs a CMS corporation), she is more willing to take on risky and rewarding investments because she feels secured by the cash flow stabilization arising from the group’s diversification.

Then, the logic goes on; true, the direct beneficiary of the cash flow stabilization by conglomerate is a controller; however, taking the cash flow stabilization as safety net, a controller is likely to be more entrepreneurial and adventurous as to risk-taking; as such, non-controlling shareholders also indirectly benefit from active investments. In sum, while a controller with the CS is likely to be risk-averse, a controller with the CMS is willing to take risk.

It is normatively true that a controller should take risk for the shareholders’ profit and not use shareholders as a pretext for unrelated-diversification since they can diversify unsystematic risks away by means of their own portfolio. From the positive standpoint, however, since a controller cannot be forced to take risk, a well-diversified business group can work as an incentive mechanism for her to be involved in more aggressive investments, which is eventually beneficial to minority hence bear excessive risk (see e.g., Demsetz and Lehn (1985)).” Shleifer & Vishny, supra note 58 at 758.

94 In short, the sentence means that “when a controller is able to use pyramiding scheme (including stock pyramids, dual class stock and intra-shareholding mechanisms) and set up a business group.”
shareholders as well unless the associated risks are too high for the expected return to be justified.

Furthermore, in a developing country, it is advantageous for a large corporation to enlarge the size of the business with unrelated-diversification by obtaining economic rent. For example, as the assets increases, a large corporation may have more opportunities to raise debts at more preferential terms, including cost of capital. Why? Potential reasons might be as follows: (1) a corporation with large assets is able to provide more securities (collateral) for the new debts to lenders in a less developed country, who are less able to valuate borrowers’ ability to repay debts, compared to lenders in a developed country; (2) as the magnitude of debt increases, *ironically* a corporation may have negotiation leverage vis-à-vis lenders when a debtor is large enough,95 or (3) the government simply allocates scarce financial resources to only large corporations, rather than best-performing corporations, in the form of industrial policies – when capital is insufficient (which is true in many developing countries), “can borrow” itself is a special treatment to a corporation that desperately needs external financing. Large corporations might have more chances to obtain licenses to new businesses as well – the entry barrier would be set, which would provide large corporations with another source of windfall. In addition, large corporations with monopolistic power are more likely to wield negotiation leverage vis-à-vis trading partners over the transactional terms. Moreover, large corporations are at an advantage to attain subsidies or other preferential treatments from the government.

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95 As a finance maxim goes, if you borrow 1 thousand dollars, you are only a “debtor” to a creditor – however, if you borrow 1 million dollars, you might be a “partner” to a creditor.
Let us refer to the corporation’s benefits of efficiency arising from empire-building (e.g., economic rent) as \textit{BEN}. In relation to \textit{BEN}, there are three additional implications. First, \textit{BEN} is \textit{economic} benefits as opposed to mere \textit{psychic} benefits. Please recall that a controller’s personal economic cost in issuing new equities is roughly defined as the sum of \(\alpha (Y - X)\) and \(\alpha \text{INEF}\). When \textit{BEN} is taken into account, a controller’s personal economic cost in issuing new equities, the sum of \(\alpha (Y - X)\) and \(\alpha \text{INEF}\) can be offset or even outweighed by a controller’s personal \textit{economic} benefit in issuing new equities, \(\alpha \text{BEN}\). In other words, a controller’s net “financial” payoff in empire-building is determined by \(\alpha \{\text{BEN} - [(Y - X) + \text{INEF}]\}\), and a controller can \textit{economically} benefit from having more minorities if \textit{BEN} is larger than the sum of \((Y - X)\) and \textit{INEF}.

Second, when non-pecuniary benefits from empire-building (\textit{NPB}) are taken into account as well, a controller’s payoff in empire-building is determined by \textit{NPB} + \(\alpha \{\text{BEN} - [(Y - X) + \text{INEF}]\}\). With \textit{NPB} (i.e., non-pecuniary benefits) and \(\alpha \text{BEN}\) (i.e., pecuniary benefits) which are windfalls arising from running a large corporation, a controller has the incentive to enlarge the corporation when the sum of \textit{NPB} and \(\alpha \text{BEN}\) outnumbers the sum of \(\alpha (Y - X)\) and \(\alpha \text{INEF}\). For two possible reasons, the net effect of \(\alpha \{\text{BEN} - [(Y - X) + \text{INEF}]\}\) becomes smaller as a controller pursues empire-building; (1) \textit{BEN} and the sum of \((Y - X)\) and \textit{INEF} can be offset as discussed; and (2) \(\alpha\) becomes smaller when a controller has more minorities in pursuing empire-building (thus, the net effect of \(\alpha \{\text{BEN} - [(Y - X) + \text{INEF}]\}\) can be minimal). On the other hand, \textit{NPB} becomes larger as a controller has more minorities so that the controller’s net payoff in empire-building, i.e., \textit{NPB} + \(\alpha \{\text{BEN} - [(Y - X) + \text{INEF}]\}\)
– \[(Y – X) + \text{INEF}\} \) is likely to be positive. Under these circumstances, the controller has an incentive to protect minorities to some degree in order to attract them for the purpose of building her empire and enjoying benefits even in the case where \( \text{BEN} – [(Y – X) + \text{INEF}] \) is negative.

Third, empire-building is not always detrimental to minority shareholders – it is possible that minorities can expect even some benefits from a controller’s empire-building. The conventional corporate governance scholarship has articulated that minorities in a developing country are “victims,” since a controller siphons off the corporate funds to herself at the sacrifice of minorities. It is true in itself. However, this view overlooks an important point that \((1 – a) \text{BEN} \) – economic benefits in empire-building made mainly by a controller’s effort – accrues to minorities. In other words, minority shareholders can free-ride on a controlling shareholder when she collects economic rent and share the benefits from enhanced efficiency in empire-building. In turn, it can be said that public investors have incentives to be non-controlling shareholders even if there is some level of tunneling by a controller.

Another related topic in empire-building is the principle of being “too-large-to-fail.” Even the United States (which is known as a champion of laissez-faire) has experienced a series of bailouts for large corporations when a failure of a large corporation was likely to affect its economy. Notable recent examples include bailouts of Chrysler, LTCM (Long-Term Capital Management), and AIG (American International Group).\(^96\) In many developing countries, a large corporation or business

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\(^96\) Matthew Karnitschnig, Deborah Solomon, Liam Pleven & Jon E. Hilsenrath, *U.S. to Take Over A.I.G. in $85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up*, The Wall Street Journal (September 16, 2008). This newspaper article states, “Just last weekend, the government essentially pulled the plug on Lehman Brothers Holdings Inc., allowing the big investment bank to go under
group constitutes a higher percentage of the domestic economy than one in the United States.\footnote{For example, even though Microsoft is one of largest companies in the United States, its portion of the U.S. economy is very small compared to the portion of Samsung Group in Korean economy.} Thus, there are compelling reasons that the government in an emerging market is more afraid of the collapse of a large corporation or business group. For example, the dire consequence of a failure of Salim Group\footnote{Salim Group is considered the Indonesia’s representative business group that has various affiliated firms. It was founded by Sudono Salim.} in Indonesia would be much more devastating than that of the failure of Chrysler (or perhaps even a large bank) in the United States. Aware of the government’s fear of their possibility of failing, a large corporation’s controller may conclude that empire-building can function as effective “insurance” for its survival.

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

\footnote{This time, the government decided A.I.G. truly was too big to fail.”}
III. WHY A CONTROLLING SHAREHOLDER NEEDS MINORITY SHAREHOLDERS: PECUNIARY PRIVATE BENEFITS ACCOUNT

Part II explained that having many minority shareholders is beneficial to a controlling shareholder with respect to empire-building. Through empire-building, a controlling shareholder can attain economic rent as well as non-pecuniary benefits. It partially solves the puzzle of why a controller relies on equity financing even if the cost of equity is higher than the cost of debt. In Part III, I propose that having more minority shareholders is beneficial to a controlling shareholder because it enables her to attain pecuniary private benefits more efficiently – i.e., with more equity capital, a controller can take more corporate assets illicitly without worsening – or even with improving – the welfare of individual minorities (although minorities’ welfare may be worsened collectively).

1. Minorities’ Rate of Loss and Controllers’ Rate of Return in Extraction

In a developing country, in many transactions, a controlling shareholder is dominant on both sides of transactions and, as a corporate decision-maker, she is able to determine the terms of transactions such that they are more favorable to herself at the exclusion of minority shareholders. As such, a controlling shareholder often diverts corporate assets from a corporation to herself like a parent company in the
case of *Sinclair Oil Corp. v. Levien*. Unless a controlling shareholder is found liable for the breach of fiduciary duty in her jurisdiction – which is not likely to happen in bad-law country –, she could earn undue profits from minority extraction through self-dealing. In response, although public investors understand that expropriation itself is given, it is natural that they are concerned about the extent of controllers’ expropriation.

**(a) A Simple Model on a Controller’s Extraction – Rates of Loss and Return**

What precisely is meant by the “extent” of a controller’s extraction, and how is it measured? Perhaps, the total amount of corporate value that a controller illicitly transfers to herself from all of the minorities might be an important issue to minority shareholders. However, rather than the collective damage of all minority shareholders as a single group, minorities are more interested in their own individual losses that are caused by a controller’s extraction when they invest a particular amount of money in a corporation. In that sense, each minority shareholder is concerned with what I will call the minorities’ “rate of loss in extraction,” which measures how many cents a controller extracts from an individual minority when this individual minority invests one dollar in a corporation. Against this backdrop, a simple model can be induced as follows.

A controlling shareholder has a certain portion of equities in a corporation – whether it is the majority or not – depending on the types of ownership structures. As

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99 Sinclair Oil Corp. v. Levien 280 A.2d 717 (Del. 1971).
denoted previously, the weight of her cash flow rights (i.e., a controller’s economic interest in a corporation) is $a$ ($0 \leq a \leq 1$). On the other hand, all minority shareholders hold the remaining portion of equities in a corporation – algebraically, the weight of minorities’ aggregate cash flow rights can be denoted as $(1 - a)$. Let us denote the total value of equities in the corporation as $E$. As a result, the value of equities that the controller and minorities hold is expressed as $aE$ and $(1 - a)E$, respectively. In addition, let us use $B$ to represent the amount of the pecuniary private benefits of control that the controlling shareholder extracts from the corporation at the exclusion of minority shareholders. More specifically, $B$ is equal to $\beta E$; here, $\beta$ stands for the portion of corporate value that is diverted to the controlling shareholder ($0 \leq \beta \leq 1$). For example, when a controlling shareholder transfers 10 percent of corporate value to herself, the value of $\beta$ is 0.1.

Recall that minorities’ rate of loss in extraction measures how many cents a controller extracts from an individual minority shareholder when this minority shareholder invests one dollar in a corporation. Thus, minorities’ rate of loss in extraction can be expressed as $B / [(1 - a)E]$, which is equal to $[\beta E] / [(1 - a)E]$. Ultimately, it can be reduced to $[\beta / (1 - a)]$. In order to make this notation simpler, let us refer to minorities’ rate of loss, $[\beta / (1 - a)]$ as $\delta$.

In a developing bad-law country, it is the minority shareholders’ fate that a controlling shareholder misuses corporate transactions in order to tunnel corporate value. Minority shareholders may endure a controller’s looting as long as their rate of loss in extraction is set within the acceptable range. However, if a controller overreaches and returns after a controller’s extraction (i.e., returns that minority
shareholders ultimately attain) falls too low as compensation for minorities’ equity investment, then minority shareholders would withdraw their investment from the corporation in the next stage. As such, if a controller wishes to stay in the business in the next stage, she cannot determine the rate of loss in extraction arbitrarily. Accordingly, the value of \( \delta \) (i.e., minorities’ rate of loss) is confined up to the maximum acceptable rate that minorities can tolerate.

So far, we have reviewed minorities’ loss rate in extraction. Now, let us turn to a controller’s “rate of return in extraction,” which measures how much a controller can extract from a corporation when she invests one dollar as equity in a corporation. According to this definition, a controller’s rate of return in extraction is expressed as \( \frac{B}{\alpha E} \). Since \( B \) is equal to \( \beta E \), a controller’s rate of return in extraction is the same as \( \frac{\beta E}{\alpha E} \). Again, this formula is reduced to \( \frac{\beta}{\alpha} \). Since minorities’ rate of loss in extraction, \( \left[ \frac{\beta}{1 - \alpha} \right] \), is replaced by \( \delta \) as aforementioned, \( \beta \) is equal to \( \left[ \frac{\delta (1 - \alpha)}{\alpha} \right] \). Therefore, a controller’s rate of return in extraction can be transformed into \( \left[ \frac{\delta (1 - \alpha)}{\alpha} \right] \).
What does this formula imply? For the purpose of analyzing the effect of the different economic interest (i.e., cash flow rights) of controllers under *ceteris paribus* (i.e., other conditions are equal), suppose that for some reasons, two controllers impose the *same* rate of loss in extraction from their minorities. In turn, this would mean that minority shareholders in each corporation would tolerate the *same* rate of loss in extraction and that $\delta$ is a *constant* number. Accordingly, the rate of return in extraction is a function of “one” variable, $\alpha$ (i.e., the portion of cash flow right of a controller). As a result, the formula (i.e., $[ \delta (1 - \alpha) / \alpha ]$) states that as $\alpha$ (i.e., a controller’s economic interest in a corporation) decreases, the *numerator*, $\delta (1 - \alpha)$
increases and, at the same time, the denominator, \( \alpha \) decreases. In sum, as \( \alpha \) becomes smaller, a controller’s rate of return in extraction increases geometrically. The interpretation of this phenomenon is that a controller with small economic interest may attain disproportionately more pecuniary private benefits of control than a controller with large economic interest, despite the fact that two controllers face the same degree of minority shareholders’ resistance, which is measured by \( \delta \). Therefore, a controlling shareholder has a financial advantage when she has more minority shareholders in a corporation that she controls.\(^{100}\)

\(^{100}\) One may argue that the assumption that \( \delta \) (i.e., minorities’ rate of loss in extraction) is the same in the above model is untrue. Thus, according to this logic, even if \( \alpha \) (i.e., the cash flow rights of a controller) becomes larger, a controller can maintain the previous level of the rate of return in extraction by raising \( \delta \) (i.e., minorities’ rate of loss in extraction) according to the formula – recall that the rate of return in extraction is \( \frac{\delta (1 - \alpha)}{\alpha} \). My responses are as follows. First, I do not assume that \( \delta \) is same in reality. What I merely say is that “if” \( \delta \) is same, a controller’s rate of return in extraction increases geometrically as a controller reduces \( \alpha \). In other words, I use ceteris paribus analysis by fixing \( \delta \) as the same across corporations in order to understand the effect of reduced \( \alpha \) on the controller’s rate of return.

Second, it is still theoretically possible that \( \delta \) is at least similar – if not same – across corporations which are comparable in terms of business, risk profiles, or managerial capacity in the same economy. Why? Suppose that two controlled-corporations (“Corporation AA” and “Corporation BB” respectively) are comparable except controllers’ economic interests in corporations. Then, they are likely to generate the similar “rate of return in gross terms” (i.e., the rate of return before expropriation by controllers). The rate of return that shareholders of two corporations care is not the “rate of return in gross terms” but the “rate of return after expropriation.” If the “rate of return after expropriation” of Corporation AA is lower than that of Corporation BB, shareholders of Corporation AA will move to Corporation BB. Thus, in order not to lose minority shareholders and equity capital, both corporations have incentives to maintain the “rate of return after expropriation” at the similar level. Then, please note that the “rate of return after expropriation” is approximately the “rate of return in gross terms” minus the “minorities’ rate of loss.” Therefore, if the “rate of return in gross terms” and the “rate of return after expropriation” are similar among comparable corporations, the “minorities’ rate of loss” is similar for two corporations as well. In other words, when a controller overreaches and raises \( \delta \) (i.e., minorities’ rate of loss in extraction) by large-scale looting, minorities can withdraw their equity investment from the corporation, which is ultimately harmful to a controller who wants to keep a large business empire and maximize the long-run pecuniary benefits. In this context, it can be said that a controller has less discretion (than we have thought) on raising the value of \( \delta \) above a certain critical point. Put differently, even if the value of \( \delta \) is not exactly same across corporations, it is confined within the narrow range that is tolerable to minorities.

In that sense, it is relatively relevant to assume that the rate of return in extraction is only a function of \( \alpha \) and \( \delta \) is a constant number (although in fact \( \delta \) is not exactly same across corporations). Consequently, from the perspective of a controller, raising \( \delta \) while having a high value of \( \alpha \) is not a practical way to maintain the rate of return in extraction. Moreover, even if a controller can raise the value of \( \delta \) at her full discretion, the effect of \( \delta \) on the rate of return in extraction is much smaller than that of \( \alpha \) for the following reason; as \( \alpha \) decreases, its impact on the rate of return in extraction is
When a corporation relies on equity finance, a controlling shareholder has to bear the additional cost (for example, \( \alpha (Y - X) \)). On the other hand, issuing the new equity for capital is *monetarily* (rather than psychologically) beneficial to a controlling shareholder when she is able to expropriate minorities; by having more minority shareholders, \( \alpha \) (i.e., the portion of a controller’s cash flow rights in a corporation) will be lowered; as a result of reduction in \( \alpha \), a controller’s rate of return in extraction is enhanced so that a controller is able to gain a huge amount of pecuniary benefits; moreover, it should not be overlooked that the additional cost of equity finance, \( \alpha (Y - X) \) decreases as the new shares are issued.\(^{101}\) Another beauty of lowering \( \alpha \) by raising new equities from the capital market is that a controlling shareholder can improve the rate of return in extraction “benevolently” – in other words, by having more equity capital from public shareholders (i.e., lowering \( \alpha \) by raising new equities from the capital market), a controller can collect *more pecuniary benefits without aggravating individual minorities’ welfare* \(^{102}\) (although the minorities’ *total* welfare would be aggravated by lowering \( \alpha \)). Table 4 summarizes notations, formulas and their implications.

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\(^{101}\) It is because \( \alpha \) (the economic interest of a controlling shareholder) becomes smaller when the new shares are issued.

\(^{102}\) Put differently, even if the “tax rate” on individual minorities remains constant, a controller can have more “tax payers” by issuing new shares to public investors. As a result, a controller can collect more “tax revenue” without raising the “tax rate.”
Table 4: Minority Shareholders’ Rate of Loss and a Controller’s Rate of Return in Extraction

- Minority Shareholders’ Rate of Loss in Extraction = \( \frac{B}{(1 - \alpha) E} \)

1. \( \frac{B}{(1 - \alpha) E} = \frac{\beta E}{(1 - \alpha) E} = \frac{\beta}{1 - \alpha} \)

2. Put \( \delta = \frac{\beta}{1 - \alpha} \) → \( \beta = \delta (1 - \alpha) \)

- A Controller’s Rate of Return in Extraction = \( \frac{B}{\alpha E} \)

1. \( \frac{B}{\alpha E} = \frac{\beta E}{\alpha E} = \frac{\beta}{\alpha} \)

2. Since \( \beta = \delta (1 - \alpha) \) → A Controller’s Rate of Return in Extraction = \( \frac{\delta (1 - \alpha)}{\alpha} \)

3. Therefore, as \( \alpha \) decreases, the value of \( \frac{\delta (1 - \alpha)}{\alpha} \) would rapidly decrease due to two reasons – the numerator increases and denominator decreases.

4. It can be interpreted that, as the cash flow rights of controller decrease, a controller’s rate of return in extraction increases geometrically.

Note
- \( \alpha \) : the portion of cash flow rights that the controlling shareholder holds \( (0 \leq \alpha \leq 1) \)
- \( (1 - \alpha) \) : the portion of cash flow rights that minorities hold \( (0 \leq 1 - \alpha \leq 1) \)
- \( E \) : the total value of equities of the corporation
- \( B \) : the value of private benefits of control that the controller can extract
- \( \beta \) : the portion of corporate value that is diverted to the controlling shareholder
- Thus, \( B = \beta E \)
- \( \alpha E \) : the value of equities that the controlling shareholder holds
- \( (1 - \alpha E) \) : the value of equities that minority shareholders hold

(b) A Numerical Example – Rates of Loss and Return in Extraction

A numerical example can make this explanation more concrete. Suppose that there are two corporations, “Corporation A” and “Corporation B,” which are managed by “Controller A” and “Controller B” respectively who have more than
majority voting rights in each corporation. These two corporations are comparable in terms of characteristics of business, risk profiles, managers’ capacity, and capital structure.

However, Corporation A is a deep CS-style corporation and Corporation B is a deep CMS-style corporation. More specifically, Controller A owns 75 percent of all outstanding common stocks of Corporation A of which the total equity is worth 100 million dollars – thus, her invested capital in the corporation is 75 million dollars. On the other hand, Controller B invests 75 million dollars, which is the same amount of equity investment as Controller A has. However, the cash flow rights that Controller B holds are only 5 percent due to the pyramiding mechanism. Accordingly, the total amount of equity in Corporation B is 1.5 billion dollars, which is fifteen times larger than that of Corporation A. Subsequently, suppose that these two controllers extract corporate value from both corporations and the same rate of loss in extraction ($\delta$) is levied on minorities of both corporations. If the extent of expropriation is different in the two corporations, minorities would move from the corporation with the higher rate of loss to the corporation with the lower rate of loss.

Accordingly, the rate of return in extraction of Controller A is expressed as $(0.25 \delta / 0.75)$, which is reduced to $1/3 \delta$. On the other hand, the rate of return in extraction of Controller B is calculated as $(0.95 \delta / 0.05)$, which is reduced to $19 \delta$. In sum, given the same amount of a controller’s capital contribution (i.e., 75 million dollars) and minorities’ rate of loss (i.e., $\delta$), she can attain 57 times more pecuniary private benefits of control, if a controlling shareholder is able to reduce her cash flow rights from 75 percent to 5 percent by having more minority shareholders. For
example, if minorities’ maximum acceptable rate of loss in extraction is 1 percent, while Controller A is able to annually extract 0.25 million dollars (i.e., $1/3 \times 0.01 \times 75$ million dollars) from the corporation, Controller B can extract 14.25 million dollars (i.e., $19 \times 0.01 \times 75$ million dollars). At the same time, it is noteworthy that Controller B’s rate of extraction is enhanced without worsening individual minorities’ welfare since the extraction rate that individual minorities face is the same. In this sense, the pyramiding scheme of Corporation B provides Controller B with not only voting leverage but also a leverage of pecuniary extraction.

2. A Suggestion on the Corporate Governance Scholarship

It is generally known that there is a reverse relationship between the pecuniary private benefits of control from tunneling and a controller’s cash flow rights over her corporation. Accordingly, it is often said that the controlling minority structure (CMS) is more vulnerable to controlling agency problems arising from pecuniary private benefits of control than the controlled structure (CS). As shown in the above numerical example, Controller B (a CMS controller whose $\alpha$ is 0.05) extracts an amount of pecuniary benefits from Corporation B that is 57 times larger than

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103 See generally Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, And Ownership Structure*, 3 J. FIN. ECON. 395 (1976). As to a controller’s cash flow rights, Claessens et al. explain “We find that higher cash-flow rights are associated with higher market valuation, but higher control rights are associated with lower market valuation, especially when cash-flow rights are low and control rights are high. This suggests expropriation of minority shareholders by controlling shareholders.” Stijn Claessens et al., *Expropriation of Minority Shareholders: Evidence from East Asia* World Bank Research Paper 2088 (1999). In addition, an explanation of Shleifer and Vishny is informative as well. They explain that “[L]arge investors might try to treat themselves preferentially at the expense of other investors and employees. Their ability to do so is especially great if their control rights are significantly in excess of their cash flow rights. This happens if they own equity with superior voting rights or if they control the firm through a pyramid structure, i.e., if there is a substantial departure from one-share-one-vote (Grossman and Hart (1988), Harris and Raviv (1988)).” Shleifer & Vishny, supra note 58 at 758.
Controller A (a CS controller whose $\alpha$ is 0.75) does from Corporation A. Apparently, the corporate governance of Corporation B (which has CMS) is 57 times worse than that of Controller A (which has CS), if the degree of poor corporate governance is measured by the “magnitude” of a controller’s expropriation, which is the same as the total amount of minorities’ loss.

However, this view (what I call “magnitude account”) overlooks an important point; namely, that “victims” (i.e., minority shareholders in less-developed countries) generally do not care about the total damages of the “class of victims” but rather their individual damages, which is measured by minorities’ rate of loss ($\delta$). From individual minorities’ perspective, the corporate governance of the CMS might be by far better and more constructive than expected; as shown in the example, when the total expropriation in Corporation B is 57 times larger than that in Corporation A, in fact, minorities’ rates of loss in Corporation A and B are same; then, it can be said that the quality of corporate governance in Corporation A and B is the same to individual minorities, which is striking to those who pay attention the total amount that a controller tunnel from a corporation to herself. Moreover, if Controller B siphons the corporate value less than 57 times (e.g., 50 times) than Controller A does, this means that Controller B benevolently “discount” minorities’ rate of loss in comparison with Controller A$^{104}$ – in this case, the CMS firm can be said to be better than the CS firm in terms of welfare of individual minorities.$^{105}$

$^{104}$ There are a few reasons why the rate of loss in extraction in Corporation B might be less than that in Corporation A. First, Controller B may have an incentive to charge minority shareholders a smaller rate of loss in extraction because she is 57 times more efficient at extracting pecuniary private benefits from minorities than Controller A. A reduction in rate of loss in extraction does not hurt Controller B very much. Rather, it may function as a cheap insurance premium to keep the “golden goose” (i.e., Corporation B as money machine) alive for a longer time because minority shareholders would not leave Controller B if the rate of loss in Corporation B were lower than in Corporation A. Second, the
IV. WHY DO MINORITY SHAREHOLDERS PARTICIPATE IN CAPITAL MARKETS WITH POOR PROTECTION?

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

1. Controlling Shareholders – “Stationary” or “Roving”

105 I do not say that the “magnitude account” is wrong. What I argue is that we need to see both aspects, the magnitude of tunneling by a controller and the individual loss of minority shareholders. The conventional view on the corporate governance focuses only a controller’s magnitude of tunneling (i.e., the total losses of all minority shareholders) and does not take into account an individual minority shareholder’s loss from bad corporate governance.

106 For the more explanation, see Sang Yop Kang, Controlling Shareholders – “Roving” Or “Stationary” (working paper).

large-scale stealing in a corporation with a CMS system may create public outcry and thereby pressure the government agencies or courts to take actions against the corporation and its controller. In the above example, Controller B extracts 14.25 million dollars while Controller A extracts 0.25 million. Without sophisticated information transmission mechanisms, in a less-developed economy, market participants might not recognize the 0.25 million dollar extraction in one corporation, while they can more easily recognize an extraction of 14.25 million dollars. It is true that a large corporation (in this example, Corporation B, which is 15 times larger than Corporation A) in a less-developed country is politically powerful and colludes with the government. However, when a controller in a large corporation is continuously involved in a series of large-scale thefts in terms of absolute amount (even if minorities’ rate of loss is modest), the government might be unable to simply ignore the public outcry against the controller. Therefore, in reality, it is possible that Controller B would extract less than 14.25 million dollars. As a result, it is plausible that the real minorities’ loss rate in extraction imposed by Controller B, who is a CMS controller, is less than that imposed by Controller A, who is a CS controller.
In explaining the government systems, Professor Olson created the terms “roving bandits” and “stationary bandits.” 107 “Roving bandits” expropriate everything possible from victims – because roving bandits will not come to expropriate victims again, it is their interest to take every bit of their victims’ wealth. In contrast, “stationary bandits” have an encompassing interest in the continuing prosperity of their victims and so will take less than the roving bandits. 108 As a result, people would exhibit more acceptance or tolerance for the stationary bandits than for roving bandits, irrespective of the fact that, by definition, both are essentially the same. 109

According to the conventional corporate governance view, a controlling shareholder regime in developing countries is systematically inferior to the dispersed shareholder regime. 110 In particular, this view emphasizes tunneling where a controlling shareholder can illicitly transfer substantially all assets from a corporation to herself if she wishes. 111 Nonetheless, having the capacity does not necessarily mean using that capacity. In this context, there are at least two categories of controlling shareholders in bad-law jurisdictions: (1) those who use their capacity to

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107 See e.g., MANCUR OLSON, POWER AND PROSPERITY: OUTGROWING COMMUNIST AND CAPITALIST DICTATORSHIP (Basic Book 2000); Mancur Olson, Dictatorship, Democracy, and Development, 87 AM. POL. SCI. REV. 567 (1993).

108 See Olson, supra note 107; see also Noshab, Book Review on “Power and Prosperity: Outgrowing Communist and Capitalist Dictatorship” by Olson (http://www.issi.org.pk/journal/2002_files/no_2/review/5r.htm).

109 See Olson, supra note 107 (both pieces of Olson); see also Noshab, supra note 108.

110 See e.g., La Porta et al., supra note 1.

111 See generally, Johnson et al., supra note 7.
plunder minorities (i.e., “roving controllers”); (2) and those who do not, even though they can (i.e., “stationary controllers”).

Suppose that a controller has a short time horizon. Then, it is in her best interest to loot quickly her controlled corporation to the fullest extent via a massive one-shot transaction. As a result, she does not have any reason to come to expropriate minorities again because they do not hold any wealth in a corporation – this is why she is referred to as a “roving controller.” While a controller may realize a substantial amount of the pecuniary benefits at present, she would lose future opportunities of expropriating minority shareholders who are defrauded by her large-scale tunneling. A capital market where roving controllers constitute the majority would not be developed well since public investors would not participate in the market as minorities.

In contrast, a controlling shareholder with a long time horizon has an encompassing interest in the continuing prosperity of minority shareholders. Initially, a controller may compare the present value of cumulative extractions in the long run and other benefits (e.g., psychic utilities) with the amount of a one-shot tunneling. If the former (i.e., the present value of cumulative extractions in the long run and other benefits) is larger than the latter (i.e., the amount of a one-shot tunneling), then she will choose a form of theft by taking only a part of corporate value periodically – that is why she is referred to as a “stationary controller.” Then, she “voluntarily” abstains from siphoning off substantially all of the corporate assets to herself, even if she has the capability to do so at present. However, it is not because she is benevolent by
nature, but because she expects that being a stationary controller is ultimately more beneficial to her than being a roving controller.\footnote{For example, suppose that a controller can extract 100 million dollars \textit{at present} if she takes a one-shot transaction to the total detriment of minority shareholders – after this transaction, the corporation will be left as “shell” without any valuable assets. On the other hand, she can extract 5 million dollars \textit{annually} from the corporation by means of ongoing tunneling. Then, she will find that she is better-off being a stationary controller in 20 years (if the discount rate is assumed to be zero for the sake of simplicity). Therefore, she will choose to be a stationary controller as long as she believes that she can maintain ongoing extractions for more than 20 years. For the more explanation, see Kang, supra note 106.}

For example, a stationary controller has an incentive to choose “partial” extractions in a way that optimizes the “tax revenue” (if we analogize a controller’s stealing as “taxation”) in the long run; tax revenue is the product of a tax rate and taxable income; a high tax rate does not necessarily generate high tax revenue, since tax payers have less incentive to work (i.e., taxable income will shrink). The same logic applies to the relationship between an extraction rate and the amount of tunneling (i.e., pecuniary benefits); the amount of tunneling is equal to the product of an extraction rate and the extractable corporate value; thus, a high extraction rate does not necessarily generate a high amount of tunneling, since non-controlling minority shareholders would withdraw their investments (i.e., extractable corporate value will shrink). As such, a rational stationary controller sets the optimal extraction rate carefully (generally at a moderate level) in order to maximize her “tax revenue.”\footnote{For the more explanation on a rational stationary controller’s “tax policy,” see Kang, supra note 106. The presence of non-pecuniary private benefits of control may alter a controller’s tax policy to some degree.}

Faced with a rational stationary controller’s benevolent extraction, minority
shareholders are willing to invest in a corporation run by a stationary controller as long as the return on the stock after “tax” is comparable to the return on investments in other opportunities.\textsuperscript{114}

In sum, prospective investors in the capital market prefer a stationary controller who is patient and benevolent to a roving controller who is short-sighted and ruthless.\textsuperscript{115} However, an important problem is that they do not know whether the controlling shareholder that they are dealing with is stationary or roving. Under these circumstances, prospective investors would hesitate to participate in the capital market even when a truly stationary controller issues new equities due to the fear of dealing with a roving bandit. Knowing this, even a sincere stationary controller might be discouraged to plan to issue new equities and have public minorities. Then, how can a controller make prospective investors believe that she is a stationary bandit?

In this context, a controlling “family” shareholder has an advantage. Since a controlling family shareholder has an infinite tenure and is deemed to be a repeat player, prospective investors would be more likely to trust her as a stationary controller – investors may understand that the current family controller is unlikely to kill the proverbial golden goose due to the hope that it will continue to lay eggs for her children eternally.\textsuperscript{116} To be sure, it is impossible for investors to know the

\footnote{114}{For the more explanation for the returns of stock and other asset classes and their impact on the investment decision by public investors, see \textit{infra} (Part IV Section 2).}

\footnote{115}{A stationary controller is patient and benevolent because her time horizon is long and she relies on the partial extraction from minority shareholders. In contrast, a roving controller is short-sighted and ruthless because her time horizon is very short and she depends on a large-scale one-shot tunneling from the corporation.}
“intent” of a controller whether she wishes to be roving or stationary. By reviewing the corporate governance “structure” (e.g., how shares are spread among family members, whether children of a founder are managers or directors a corporation), however, they can discover whether a given corporation is a “family” business. In other words, rather than scanning the mentality of the controller, it is more efficient for minority shareholders to observe the appearance of a corporation. When the appearance of a corporation turns out to be a family corporation, investors are more likely to be convinced that they deal with a repeat player, i.e., a stationary controller. Subsequently, investors would participate in the equity market in order to gain returns – games are likely to be cooperative between minority shareholders and a family controller.

2. Imperfect Alternative Investments

One may argue, if prospective investors are extracted by controlling shareholders, then they may avoid investing in the stock market, and may seek investment opportunities from alternative asset classes, such as bank deposits, debt securities, and real estate. Theoretically, this phenomenon would be more apparent when investors’ risk-adjusted return of equity is lower than that of alternative

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116 Of course, there are many circumstances that could make it difficult for a controller to be a “stationary controller.” In addition, I do not mean that a controlling family shareholder solves all the problems in relation to a roving control structure. For the more explanation, see Kang, supra note 106.

117 Kang, supra note 106.

118 Id.

119 In this Article, “alternative investments” mean investments in anything other than the stock.
investments. Nonetheless, there are several perceivable reasons why prospective minority shareholders are unable to totally shun investing in the stock market.

In general, while bank deposits are a very safe investment, they generate low returns. Although the risk-adjusted return of bank deposits is higher than that of equity investment in some cases, investing solely in bank deposits is not a workable option for investors who need to meet a certain amount of “absolute” return. To this end, at least some potential investors still choose equity investment that would generate higher return in absolute terms despite the fact that its “risk-adjusted return” is lower due to controllers’ tunneling. As a result, investors have to reallocate their wealth from some bank deposits to stocks. Investment in debt securities, such as government and corporate bonds, has similar problems.

In addition, if equity investment in a developing country is impaired due to controllers’ extraction, it is likely that investment in other assets is not perfect and unscathed as well in that jurisdiction. For example, when laws do not protect minority shareholders, creditors of corporations are likely to be subject to a similar risk. In that case, it is even possible that the risk-adjusted return of the alternative investments is less than that of stocks – hence, investors have good reason to participate in the stock market as minority shareholders.

Real estate is often seen as an attractive alternative to potential investors who are interested in the equity market. However, the problem is that since the value of specific real estate generally accounts for the huge portion of individuals’ wealth to many investors, they are exposed to huge idiosyncratic risk arising from real estate.

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120 In general, the value of real estate is large. Thus, it is likely that the value of real estate accounts for a large part of an investor’s personal wealth. For example, if an investor’s “one” real estate constitutes
Even worse, real estate is a very illiquid asset – thus, in an emergency, investors should take risks to sell real estate at a deep discount. For these reasons, investing in real estate is not fit for many ordinary people like most potential minority shareholders, who are not sufficiently wealthy to deal with aforementioned difficulties. In developed economies, these problems may be well solved by the liquid and thick mortgage markets and indirect real estate investment tools such as Real Estate Investment Trusts (REITs). However, this has not been the case for most developing economies until the recent past.

In sum, equity is not the only imperfect asset in a country with insufficient investor protection, and investing in assets other than stocks is not always feasible to investors. The “fruits” (i.e., investment opportunities in various assets) dangled in front of potential investors in a bad-law country do not consist of one “mediocre apple” (i.e., scathed equity securities) and the other “good orange, banana, and pineapple” (i.e., unscathed bank deposits, debt securities, real estate, etc) – rather, all fruits are mediocre (i.e., every asset class is scathed to some degree). Therefore, investors should choose some optimal combination among mediocre fruits. In that sense, even if returns from investment in stocks are impaired by controllers’ expropriation, stocks remain a viable investment option for potential investors.

An overarching principle of finance is diversification between classes of assets in order to eliminate unsystematic risks. This is another reason why putting equities in an investment pool is beneficial to investors even when alternative investments are sound and feasible. As known widely in investment community, the

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70 percent of her personal wealth, the adverse effect on the value of that real estate would impact the investor’s total wealth significantly.
investment ratio between asset classes varies according to factors that affect each individual’s willingness and capacity to take risk in investment. For example, if an investor is young, it is recommendable to take more stocks (or risky assets) because she would have other incomes (e.g., salaries) and a long time horizon to recover potential loss from relatively risky investment.\footnote{To the contrary, if an investor is old, it is more recommendable for her to take less risky fixed income securities (e.g., treasury bonds or corporate bonds with investment grades) because generally she does not have a stable income source like salaries and her horizon is too short to cover the loss arising from the failed risky investment.} As such, when a particular country has many young and active investors, it is possible that the equity market can flourish more. Moreover, stock is better protected from the adverse effects of inflation than most debt securities because the cash flows of debt securities are fixed, whereas those of stocks would increase as the general price level increases.\footnote{This is widely known among experts in the financial market.} In that sense, in a country with high inflation, stocks are likely to be more desirable than debt securities to investors.

One may argue, if domestic stocks are scathed by greedy controllers, investors may invest internationally. If it is true, investors would not have to buy domestic stocks at all. In reality, however, many jurisdictions with poor law have established regulations on the outflows of investment by their citizens.\footnote{For example, Korea and India restricted international capital flows. As it is the case for Korea, Taiwan completed the liberalization of international capital flows only at the end of the 1990s. Rui Castro, Gian Luca Clementi & Glenn MacDonald, \textit{Investor Protection, Optimal Incentives, and Economic Growth}, 119 Q. J. OF ECON. 1131 (2004).} In that case, domestic capital has been kept captive.\footnote{\textit{Id.} at 1162.} More interestingly, even in developing countries where investments in foreign assets are allowed, domestic investors would find it difficult to invest significantly in assets abroad. Why?
In principle, international investment is beneficial to investors because adding international assets enhances risk-adjusted return.\textsuperscript{125} However, since domestic investors do have insufficient information on potential foreign investments, they hesitate to invest in assets abroad. In addition, “familiarity bias”\textsuperscript{126} reinforces this tendency of domestic investors not to invest foreign assets with which they are unfamiliar, even though those assets provide higher risk-adjusted return. Moreover, since international investment works as a supplement to domestic investments, it is more appropriate for affluent people whose wealth needs additional diversification after investing the vast majority of their assets in the domestic market. Many potential non-controlling shareholders in developing countries are mostly middle class investors who would not have enough capital to diversify beyond domestic investments.\textsuperscript{127} Even worse, the currency risks posed by international investment are another obstacle for small individual investors to overcome, if they do not have sources to hedge against these risks.\textsuperscript{128}

These problems would be more severe when undeveloped capital market in a developing country does not provide small individual investors with efficient

\textsuperscript{125} For the explanation on the “international diversification,” see \textit{e.g.}, Haim Levy & Marshall Sarnat, \textit{International Diversification}, 60 AM. ECON. REV. 668 (1970).

\textsuperscript{126} “Familiarity bias” is the tendency that investors invest the vast majority of their capital in assets and securities that they are familiar with.

\textsuperscript{127} To be sure, there are international diversification benefits to investors investing in equity markets abroad. However, the requirements of international diversification are the willingness and ability to take the greater risks that arise from international investment. Wealthy investors in \textit{developed} countries are able (and willing) to be involved in international diversification, but many minority shareholders in \textit{developing} countries are not.

\textsuperscript{128} Until recently, the success of international investment has depended heavily on the performance of foreign exchange in a country wherein investors invest. Since the volatility of foreign exchange has been great, the risk associated with investing in international investment has been large. Thus, international investment has required investors to have more willingness and capacity to take risks.
collective investment tools, such as funds that specialize and diversify in foreign equities. Consequently, unless controlling shareholders extract to extreme degree (i.e., unless controllers are roving), potential investors have an incentive to participate in a domestic capital market as non-controlling shareholders.

3. Behavioral Finance Problems of Minority Shareholders

Modern standard finance theories are built on the assumptions such as “rational investors,” “perfect information,” and “no transaction costs.” However, the real-world experiences and psychological research of human behavior has shown that these assumptions do not often hold. Realizing the limitations of modern standard finance, financial economists and cognitive psychologists have proposed alternative theories of behavioral finance. As Daniel Kahneman and Amos Tversky have argued, individuals’ cognitive biases can lead them to systematically misassess an asset’s value. These new theories of behavioral finance can provide an important implication in my thesis – having been exposed to behavioral financial problems, public investors in developing countries are likely to invest in domestic

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

131 See Gilson & Kraakman, supra note 129 at 15; JUDGMENT UNDER UNCERTAINTY HEURISTICS AND BIASES (Daniel Kahneman et al. eds., 1982).
equity markets as non-controlling shareholders even if extraction by controller renders the shares unworthy of investment. Here is the further analysis.

Since most individuals believe that they are more competent and skillful than they actually are, they trade aggressively in stock markets. Due to this “overconfidence” investors in a bad-law country may purchase stocks even if those stocks are subject to tunneling risk. For example, they believe that they are able to earn extra profits through active trading by such measures as selling and buying shares in a very short period (by buying lowest and selling highest). In addition, rather than being risk-averse, investors tend to be “loss-averse,” thus they hold the losers on for too long. Furthermore, names of large conglomerates appear in the national media every day, and the advertisements of those conglomerates repeatedly influence people in domestic markets – “familiarity bias” holds. “Home bias” (which is related to familiarity bias as well) is another explanation for why investors prefer investing in large conglomerates in domestic markets rather than foreign ones or small companies that are not highly exploited by managers or controllers. Once

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133 “Overconfidence” is another behavioral phenomenon, which is against the standard finance’s assumption that an economic person is rational.


135 “Familiarity bias” is the tendency that investors invest the vast majority of their capital in assets and securities that they are familiar with.

136 “Home Bias” is the tendency that investors invest the vast majority of their capital in assets and securities in domestic countries. It is related to “familiarity bias.”
they purchase shares, investors are often subject to “status quo bias”\textsuperscript{137} even if the performance of shares is disappointing.

Moreover, minority shareholders often play the role of “noise traders” – they make investment decisions that deviate from those that theory would predict of rational investors.\textsuperscript{138} Investors might invest in shares issued by large family conglomerates based on fads and sentiments even if rational information indicates that those firms are subject to high risk of expropriation. Besides, when “some” noise traders earn high returns, many other investors might imitate them, ignoring the fact that those some successful traders took more risk and just got lucky.\textsuperscript{139} As a result, more investors may enter into this gamble in the stock market casino as non-controlling shareholders.

To minority shareholders in a country with insufficient investor protection, buying shares of domestic family-controlled corporation might be similar to buying lottery tickets, where buyers lose on average. However, as we have seen many participants in lottery, many potential investors are willing to participate in the stock market even if the risk-adjusted return is below the level where it should be. In addition, whereas all participants in lotteries know that they will lose on the average, most potential minority shareholders in stock market believe that their expected return is positive even if unfair games are manipulated by controllers. Consequently,

\textsuperscript{137} “Status quo bias” is the tendency of investors to maintain their portfolio even if the performance of their portfolio is disappointing.

\textsuperscript{138} Gilson & Kraakman, supra note 129 at16.

where the problems of behavioral finance are severe, prospective investors may have incentives to participate in domestic equity markets as minority shareholders.

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

In this Section, I explore the counterintuitive possibility that minority shareholders actually might not be damaged financially in a bad-law jurisdiction. Professor Coffee put forwards a very interesting and creative account – because the public shareholders purchased their shares at a “bargain” price, which reflected the likelihood of future wealth expropriation by the controlling shareholder, they would receive an undeserved “windfall”\(^{140}\) if legal rules were revised to entitle them to a proportionate share of corporate assets and distributions.\(^{141}\) In other words, even if the price of shares that minority shareholders hold is lower than their fundamental value due to controllers’ extraction, minority shareholders would not suffer since they bought those shares at a depressed price for the same reason. In all likelihood,

\(^{140}\) Let’s take example (from articles of Professors Coffee and Black). Once a company issues shares at a discount, the insiders may feel entitled to appropriate most of the company's value for themselves. They will resist any change in legal rules that limits this opportunity. An example can illustrate why insiders can feel this way. Assume that Company A has fifty outstanding shares worth $2 each (for a total value of $100), all held by insiders. Outside investors may be willing to pay only 50¢ per share for additional shares, both because the investors don't know the company's true value and because they expect insiders to appropriate most of whatever value exists. Suppose that Company A issues fifty additional shares at this price. Company A now has one hundred shares outstanding, fifty shares held by insiders and fifty held by outside investors, and a total value of $125. If the insiders keep only 50 percent of the company's value, they have cheated themselves. Their shares will be worth only $62.50, while the outside investors' shares will be worth $62.50--far more than the outside investors paid. The insiders' rational response is to self-deal enough to capture at least 80 percent of the firm's value--$100 out of the total value of $125. They will not feel that they have cheated anyone by doing so, and will fight legal and institutional reforms that might prevent them from taking what they see as their fair share of their company's value. This explanation is excerpted from Professor Black’s article. Bernard S. Black, The Legal and Institutional Preconditions for Strong Securities Markets, 48 UCLA L. REV. 781, 807 (2000). Also, it should be noted that this example is adapted from Professor Coffee’s explanation. Coffee, supra note 15 at 657–659.

\(^{141}\) Coffee, supra note 15 at 660.
minority shareholders would take into consideration the controllers’ appropriation as a market risk that is already reflected in determining the price of shares.

As a result, minority shareholders are not systematically damaged by the controllers. As Professor Coffee explained, from the perspective of “efficiency,” it may be clear that the economy will do better if the minority is protected, but from a “normative” perspective, the respective entitlements of the majority and the minority can be debated endlessly. In this regard, Professor Black further made a bold claim that once a company issues shares at a discount, the insiders may feel entitled to appropriate most of the company’s value for themselves.

Although I basically agree with this insightful opinion by Professor Coffee, I think that additional analyses are needed. First, if minority shareholders invest in a diversified portfolio of different stocks, the idiosyncratic appropriation risk of each company would be diversified away—only systematic appropriation risk remains, and minority shareholders are compensated for that risk through a discount. Nonetheless, it might be true as well that many small public investors in developing countries have not had diversified portfolio; perhaps, they do not know the benefits of diversification due to relatively poor education on personal finance in those jurisdictions; or, in some developing countries, there are not many institutional investors that can collect individuals’ investment and diversify on behalf of small public investors.

Second, the volatility of expropriation by a controller is important to public investors. Suppose that there are three investors, “A,” “B” and “C” and they buy and

142 Id. at 660.
143 Black, supra note 140 at 807.
sell shares of Corporation “XYZ” which is controlled by a controlling shareholder. Initially, A holds shares (at time 1), and sells them to B (at time 2), and finally, B sells them to C (at time 3). Suppose that the controlling shareholder of XYZ extracts firm value “partially” at time 1 and time 2, but she appropriates almost all of the firm value C holds the shares (at time 3). A lenient level of extraction has been already reflected in the share price in the form of a discount when A and B purchased shares, thus A and B might not be financially damaged. However, C would be seriously injured because the extraction at the time of sale is higher than at the time of purchase (i.e., buy high and sell low). If the ex post degree of looting is far beyond the investors’ ex ante expectations, or if the controlling shareholders unexpectedly transfer corporate wealth through a one-time extraction, minority shareholders are clearly damaged, as opposed to Coffee’s account.

In this respect, again, I argue that the notion of “family” (or a “repeat player”) in business groups is important. As explained, after voluntarily forfeiting excessive extraction, a family controller exploits minority shareholders based on the partial extraction since she is a stationary bandit rather than a roving bandit. “Partial” extraction is much more beneficial to a controller with long term horizon than “total” extraction in terms of joint utility of pecuniary and non-pecuniary private benefits of control as discussed earlier. In addition, if the current generation of controllers seriously takes the pecuniary and non-pecuniary utility of the next generation into account, the current generation rarely relies on a one-time extraction. Therefore, C buys a share at the discounted price and she will sell at the similar discounted price, meaning that C is not financially damaged. Consequently, Professor Coffee’s view
that minorities are not actually damaged by a controller’s expropriation is reinforced under the regime with repeat controllers even if minorities do not have fully diversified portfolio.

5. Foreign (Minority) Shareholders

We have observed that many foreign investors invest in equities in a country with bad law. It is of significance that they are another type of “minority shareholders” in that jurisdiction. Then, why do foreign investors invest in shares that are scathed by poor corporate governance? The first possible answer is that foreign investors are able to purchase shares at a relevant discounted price even if there are corporate governance problems. Sometimes, foreign investors massively buy cheaper shares in an emerging country after this country experiences financial crisis, which reinforces the discount more deeply. In addition, unlike domestic minority shareholders, foreign investors are able to achieve the benefits of international diversification. Why?

First, foreign investors from a good law country usually do not face substantial regulation of investment abroad, thus they can almost freely allot a portion

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144 Practically, “foreign investors” in this Article are mainly referred to as foreign institutional investors from developed economies. They are another type of “minority” shareholders in developing countries. Although there might be some foreign investors from other developing economies, they do not have a significant role as minority shareholders in developing countries.

145 In that sense, foreign investors are like investors A and B (and perhaps C under a stationary controller) that I explained in the previous Section.

146 As explained earlier, domestic minority shareholders have found it difficult to participate in international investment: the circumstances in a bad-law country, including regulations, the relatively low level of wealth, and the underdevelopment of financial intermediaries like funds, impede international investment.
of their money to assets outside of their country. In addition, foreign investors are usually institutional investors who are able to achieve international diversification, and institutional investors have enormous amounts of money and are capable of taking risks of international investment; investors are able to enjoy diversification effects if they invest in a significant number of securities in a domestic market; diversification benefits are more enhanced through international investment, which would generate an “international efficient frontier”; in other words, at the same level of return, international diversification produces lower risk than domestic diversification does. From the perspective of U.S. investors, the idea is that the correlation between the United States and foreign markets is so low that adding foreign investments to a domestic portfolio could result in lowering the risk. Higher returns are also expected, as many emerging markets will outperform the markets in the developed countries from time to time.

For those reasons, foreign investors are willing to take the position of minority shareholders in a developing country even when this jurisdiction provides insufficient investor protection. From the perspective of foreign investors (i.e., investors in a country with good laws, which is usually a wealth country), the amount of their investment in bad law countries is only a small portion of their overall investment. This is one of reasons why foreign investors are able to be involved in risky investments in developing countries. Nonetheless, this amount is significant from the perspective of controllers in a bad law country (i.e., a country which is less wealthy) due to the disparity between the size of the economies. Thus, in the equity market of
in a poor law country, sometimes foreign shareholders take a significant role as “minority shareholders.”

In addition, it is still unlikely for foreign minority shareholders – as an organized group – to react to bad corporate governance and “directly” punish greedy controllers. However, foreign minorities can “indirectly” punish overreaching controllers. What does it mean? Foreign shareholders are usually institutional investors in developed countries so that domestic minority shareholders believe that these sophisticated foreign investment entities possess better information about domestic stocks and are more capable of assessing corporate value. Due to this informational asymmetry among shareholders, even a fractional withdrawal of investment by foreign minority shareholders from the companies in developing countries – this withdrawal occurs when foreign minorities are disappointed by the corporate governance of a particular corporation in a developing country – would send a very strong signal about corporate governance to the domestic minority shareholders (and other foreign investors).

As long as foreign shareholders purchase shares of family business groups at a discounted price, foreign shareholders are able to endure a “partial” extraction and hold shares since the discounted price already reflects the degree of extraction. However, if controllers rely on “substantially all” extraction, then the story is different – then, foreign shareholders would follow the “Wall Street Rule”, i.e., selling shares. Observing the movement of foreign shareholders, domestic minority shareholders

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147 Under a repeat controller’s regime (i.e., a stationary controller’s regime), foreign investors are not likely to be financially damaged by unexpected one-shot tunneling. Their status is similar to that of investors A and B (and perhaps C under a stationary controller) in an example discussed earlier.
shareholders would follow (i.e., herd) the selling trends of foreign shareholders. In sum, to domestic minority shareholders, foreign shareholders are viewed as a “litmus” paper capable of assessing corporate values so that controllers’ lootings are constrained to some degree. If foreign and domestic minority shareholders (i.e., most minority shareholders) sell their shares, the controlling shareholder will be damaged as well since it is to her benefit to embrace minority shareholders. Once a developing country has a significant number of foreign minorities in the stock market, it is likely that controlling shareholders in the jurisdiction will not be able to easily exacerbate the extent of tunneling.

6. Minority Shareholders May Free-Ride When a Controller Expropriates Stakeholders

So far, I have proposed various explanations as to why domestic minority shareholders participate in a country with poor shareholder protection; (1) in some developing countries, minority shareholders understand that they luckily deal with “stationary controllers”; (2) domestic minorities might not have perfect alternatives capable of totally replacing domestic stocks (i.e., “no choice account”); (3) domestic

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

149 In previous Parts, I explained why embracing many minority shareholders is beneficial to a controlling shareholder (see Parts II and III for the detailed explanations).

150 However, this does not mean that a controlling shareholder in the jurisdiction must improve corporate governance. As long as the quality of corporate governance is maintained (and does not deteriorate further), foreign minority shareholders do not lose – instead, they buy and sell stocks at the same discounted rate reflecting the same quality of corporate governance. Therefore, foreign minority shareholders do not have a strong incentive to punish controllers by following Wall Street Rule.
investors purchase shares because they might often make unreasonable investment decisions; (4) surprisingly, minority shareholders might not be financially damaged because they purchase shares at a discounted price. From this foundation, I will further argue, which is more counterintuitive from the standpoint of the conventional thought that is sympathetic to minority shareholders in developing countries as “victims” of poor corporate governance practices. In short, my argument in the following is that minority shareholders in many bad-law jurisdictions are not likely to be unilateral “victims.” Why?

In regard to dispersed shareholder regimes, the academic interest in corporate governance focuses on the relationship between managers and shareholders – the former exploits the latter. On the other hand, when it comes to controlling shareholder regimes, the lopsided relationship between controlling shareholders and minority shareholders has been emphasized – again, the former loots the latter. As a combination of these two views, conventional corporate governance scholarship, by and large, limits its analytical frameworks to the “triumvirate” – managers, controlling shareholders, and minority shareholders. Under this tradition, minority shareholders are (almost) always seen as the ones that are extracted either by managers\textsuperscript{151} or controlling shareholders – minority shareholders are assumed to be situated in the lowest level of the “food chain.”

Then, where are other stakeholders – employees, creditors, trading partners, consumers, and taxpayers? Is it proper to omit them in the corporate governance analytical tools? Probably, in the United States, the triumvirate framework is

\textsuperscript{151} In many cases, family members of a business group retain positions of top executives as well under controlling shareholder regimes.
working relatively well. Fiduciary laws are almost exclusively for shareholders since other stakeholders are seen to be protected as fixed claimants by contracts – although *Unocal Corp. v. Mesa Petroleum Co.*\(^{152}\) opens up the possibility of fiduciary duties for other stakeholders, and former Delaware Chancellor Allen stated that, in the vicinity of bankruptcy, managers owe fiduciary duties to creditors as well (*Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*).\(^{153}\) *Revlon Inc. v MacAndrews & Forbes Holdings, Inc.*\(^{154}\) reinforces the shareholder supremacy.

In contrast, the traditional triumvirate framework is not necessarily suitable for a country with insufficient investor protection – economic interest of other stakeholders (let alone that of minority shareholders) is damaged by corporate insiders. To understand more about this situation, it is noteworthy that in a developing economy, the capital market is not the only market that is imperfect. The labor market is generally imperfect as well – and the imperfection in the labor market is *usually* advantageous to employers, i.e., (large) corporations that can set terms in labor contracts and transactions. Under these circumstances, employees are expropriated by a corporation as they receive less economic benefits as exchange for their labor. In other words, some of employees’ welfare is transferred to the entire body of *all* shareholders, i.e., the corporation – as a result, minority shareholders are benefitted as well since they share the capacity as residual claimants with a controlling shareholder.

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\(^{152}\) *Unocal Corp. v. Mesa Petroleum Co.* 493 A.2d 946 (Del. 1985).


In addition, in a country where minority shareholders are not protected well, we are not able to assume that another type of investors (i.e., creditors) is fully protected by contracts. In this jurisdiction, a corporation (a borrower) is able to take advantage of creditors by various means. For example, a corporation may take a highly risky project at the lender’s risk; if a project turns out successful, shareholders get the upside benefits as residual claimants; if it turns out dismal, the lender should bear the downside cost. In that way, “shareholders” – it is noteworthy that minority shareholders are “shareholders” as well – can transfer welfare from creditors to themselves. In a bank-finance economy, the magnitude of the wealth transfer might be huge if creditors are not properly protected.

Furthermore, the relationship between a large corporation and its trading partners (and notably consumers) makes this analysis even more complicated. A large corporation in a less developed economy is usually able to wield a gigantic monopoly power in each market where it plays. In a country with the inefficient corporate law system (law itself and its enforcement), it is plausible that the competition law system is inefficient as well because the quality of corporate and competition laws are generally correlated. Therefore, a great deal of welfare of trading partners and consumers would be transferred to a large corporation where minority shareholders participate as its partial owners. Besides, the government in a developing country sometimes provides a huge amount of subsidies to large corporations – accordingly, taxpayers’ money is transferred to all shareholders including minorities.
In sum, my point is straightforward; true, in a country with poor shareholder protection, *in general* minority shareholders are “victims” in the relation with the controlling shareholder who is a usual suspect of “wrongdoer”; the problem may arise when a controlling shareholder loots other stakeholders in a corporation; in this case, minority shareholders may free-ride on a controller as “shareholders” and be benefitted to the detriment of other stakeholders – employees, creditors, trading partners, consumers, and taxpayers. In this sense, minority shareholders have incentives to participate in stock markets where they are not properly protected vis-à-vis controlling shareholders. Put simply, minority shareholders in a country with insufficient investor protection, in fact, are not situated in the lowest level of the “food chain” – it is highly likely that there are other stakeholders below minorities.

Indeed, it is not conclusive whether the minorities’ benefit from this free-riding exceeds their cost of expropriation by a controller – it depends on jurisdictions and case-by-case. Rather, a critical point is that minority shareholders are not “unilateral victims” that is depicted by the conventional view, and we need a more expanded framework outside triumvirate model when the financial damage of minority shareholders arising from bad-law is discussed.

7. The Government’s Sponsorship of the Equity Market

For the governments of many emerging countries, having a stock market is like having a national airline – according to Professor Gilson, it is a “badge” of
modernity that often does not demand economic justification. On the other hand, more rational governments would like to have more functional stock markets in order to achieve economic development – having a stock market is even more necessary when the government is not elected democratically because the government needs to compensate for the illegitimacy of its political power. Otherwise, an undemocratic and economically failed regime would be very susceptible to any external or internal shocks that may arise from socio-political changes. To this end, the government has its own incentive to attract potential investors to its stock markets.

It is true that a government in a developing country often colludes with large business groups who care little about investor protection. Once a certain number of minority shareholders begin to participate in the stock market, however, at some point the government may not ignore totally the welfare of public shareholders. It is because existing or potential minority shareholders constitute a de-facto major political group that the government cannot overlook. Thus, while the government may turn a blind eye to a controller’s extraction of the private benefits to some degree as long as the level of extraction does not increase substantially to ignite a massive public outcry, it does not always tolerate the overt misbehaviors of a controller. Indeed, revealing corporate scandals might cause huge political cost to the government. In that respect, a particular ceiling on private benefit extraction by a controller might be set formally or informally by the government’s implicit guidelines, at least in some developing countries. Believing this, some investors participate in the capital market.

155 Gilson, supra note 4 at 651.
In addition, investors can expect the government to take a more active role as a “performance enhancer” in the stock market. The government that pursues economic development or colludes with business elites often subsidizes and treats preferentially large corporations and business groups – this practice has been justified in the name of “industrial policies.” These industrial policies benefit minority shareholders as well, as long as subsidized ones are corporations rather than controllers. Accordingly, prospective investors see merit in participating in the stock market as non-controlling shareholders although they expect some expropriation from controllers.

Furthermore, as the literature on political business cycles shows, the government has the incentives (and usually the means) to expand monetary and fiscal policy in order for the economy to look better than it actually is\(^\text{156}\) (i.e., “window dressing” by the government).\(^\text{157}\) Stimulation through financial policies in particular is largely kept in check if central banks are independent, as in the United States. However, in a country with insufficient investor protection, it is less common to see an independent central bank resist expansionary policies that result from the arbitrary decisions of politicians and bureaucrats in the government. More seriously, in addition to “indirect” stimulation through the fiscal policies aforementioned,


sometimes a government “directly” manipulates the stock market\textsuperscript{158} – i.e., the
government may use funds under its influence to purchase stocks in order to boost the
stock market.

The stimulation policies of the government might not be beneficial to the
economy from the long-term perspective and some investors who participate later
would even be damaged by the bubble that the government intentionally produces.
However, public investors have at least two incentives to participate in a stock market
manipulated by the government. First, some of public investors perceive an
expansionary policy as another chance to reap windfall even if it actually is not.\textsuperscript{159}
Second, despite the government’s manipulation, stock market investors are winners at
least vis-à-vis entire citizens (or taxpayers). Why? Although public investors in the
stock market lose from a bubble created by the government, from the standpoint of
risk-adjusted return, they lose less than average citizens (or taxpayers) who always
transfer their wealth to public investors, as seen in the United States after the recent
financial crisis.\textsuperscript{160}

\textsuperscript{158} According to a recent research, Korean government adopted stock market stimulation policies in 49
2004}, 23 S. KOREA J. FIN. MGMT. (2006) (written in Korean). The number of 49 is based on the
announcement of the government. \textit{Id}. Thus, it is probable that the government has been involved in
more stock market stimulation policies than 49, if such policies without the announcement of the
government are taken into consideration.

\textsuperscript{159} Minority shareholders often lack information and suffer behavioral finance problems – they are not
perfectly reasonable investors even if they are highly educated.

\textsuperscript{160} This view is more sensible in countries where only a small subset of citizens invests in the stock
market.
V. CONCLUDING REMARKS

One of the most appealing and attractive topics of modern corporate governance is the comparative study. Law and finance theories proposed by LLSV have made great contributions by introducing scientific methodologies to evaluate corporate governance practices in a comparative way. Nonetheless, their works have created a conundrum (i.e., Gilson’s riddle) that, so far, has not been explained well – if laws in controlling shareholder regimes within developing countries are inefficient to protect public investors, then why are there so many minority shareholders in these jurisdictions? As the trailblazing work in response to this puzzle, the product market-based account was proposed by Professor Gilson as a possible answer.

Despite pioneering contribution to pioneering this uncharted territory, the explanatory power of the product market-based account is weakened in a corporation where a controller’s cash flow rights are low, which is not uncommon in many less-developed economies. In order to rectify this problem, I propose two alternative explanations as to why a controlling shareholder needs some minority shareholders even though the cost of equity is substantially high; (1) a controller can gain a great deal of benefit from empire-building as she gains more equity capital from the stock market; and (2) having a broader base of minority shareholders is financially beneficial to a controlling shareholder since it enables her to gain more pecuniary benefits without increasing resistance from minorities. Based on the product market-based account and two alternative explanations, we may be able to see a more precise

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161 Gilson, supra note 4.
picture of why a controlling shareholder in a developing country needs external equity capital.

As the principle of demand-supply explains, for the more relevant analysis, we need to analyze the incentives of public investors (consumers in the stock market) in addition to the controlling shareholders’ (suppliers in the stock market) viewpoint – why would public investors participate in capital markets despite the ineffectiveness of the laws that protect them poorly. Surprisingly, the analysis on the incentives of minorities to participate in the stock market has been generally neglected in most existing literature. To rectify this tendency, this Article proposes several expositions from the perspective of public investors. In sum, based on these interactions, both controllers and public investors can enjoy a surplus in the capital market. In that sense, informal (non-legal) institutions create a symbiotic relationship between two parties in a country with insufficient investor protection.

In studying the controlling shareholder regime, since it has diverse and idiosyncratic forms and characteristics in each market, it is impractical to generate “a general theory” for the controlling shareholder system which is observed ubiquitously in the rest of the world. 162 Perhaps, a large but missing part of the comparative corporate governance scholarship is an analysis based on the culture, which makes

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162 The conventional theory explains that there are two ownership structures in the world – the dispersed shareholder system and the controlling shareholder system. The dispersed shareholder system is found in only two Anglo-American economies (the United States and United Kingdom) that share much commonality in history, philosophy, politics, economy, legal system, and culture. However, it is known that these two economies are distinctive in many aspects so that treating these two countries as one group is often misleading. If so, it is clear that there are huge dissimilarities among more than a hundred of controlling shareholder economies that do not often share much commonality except the ownership structure. Therefore, it is not practical and even risky to assume “the” (one) model for the controlling shareholder regime which is contrasted by the dispersed shareholder regime – every controlling shareholder system is different and the extent of the difference may be much larger than that we find between the leading two common law countries (i.e., the United States and United Kingdom).
one system distinctive from the others. For example, the value of non-pecuniary benefits is very dependent on the people’s mindset and preferences, which are shaped by their particular culture. In this context, for future research, it is worth noting the comment made by Professor Milhaupt, who is a firm believer in agency theory and economic analysis on the corporate governance – “It is obvious that analytical framework exploring incentives is fundamental in understanding the conducts of rational economic persons like a controller and minority shareholders. Nonetheless, I start to be convinced that we need to see through the lens of culture for the more comprehensive analysis on the corporate governance.”163 Agreeing with this insight, I look forward to seeing future works that will combine economic analysis and cultural explanations for this largely uncharted territory of comparative corporate governance.

163 Discussion with Professor Curtis J. Milhaupt.
INTRODUCTION

Traditionally, the world economy is divided into two groups in accordance with different ownership structures. In the “dispersed shareholder regime” (based on the Berle and Means model), stocks of a corporation are generally widely held by atomized and numerous non-controlling shareholders; 1 In contrast, in “the controlling shareholder regime,” a typical corporation is under the complete control of a dominant shareholder (or a group of a few shareholders). Interestingly, although the Berle and Means model has been a dominant theme in corporate governance scholarship, it is a localized phenomenon observed only in the United States and United Kingdom. 2 In the rest of the world, a controlled-corporation with a dominant shareholder is the standard form of business organization.


2 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, 642 (1999). La Porta, Lopez-de-Silanes & Shleifer find that “the Berle and Means corporation is far from universal, and is quite rare for some
Based on this sharp dichotomy, a traditional view has portrayed that the dispersed shareholder system is better than the controlling shareholder system in terms of investor protection and economic performance. In general, it is explained that a country with the dispersed shareholder system has “good-law” while a country with the controlling shareholder system has “bad-law.” A lot of debates have followed suit in favor of and against this view. Among others, Professor Gilson’s criticism has drawn considerable attention in academia. First, he points out that we are able to find a significant number of controlling shareholders in countries with good-law. Next, he states that academic implications drawn from a stark comparison of two ownership systems are too coarse. He argues that the controlling shareholder systems in the world can be classified into (i) good-law and (ii) bad-law jurisdictions. The controlling shareholder system with good-law, is functionally equivalent to the dispersed shareholder system in terms of investor protection.

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3 Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, Corporate Ownership around the World, 54 J. FIN. 471 (1999). Professors Bebchuk and Roe argue that at present, publicly traded companies in the United States and the United Kingdom commonly have dispersed ownership, whereas publicly traded companies in other economies generally have controlling ownership. Lucian A. Bebchuk & Mark Roe, A Theory of Path Dependence in Corporate Ownership & Governance, 52 STAN. L. REV. 127 (1999)


5 Professor Gilson stated, “The simple dichotomy between controlling shareholder systems and widely held shareholder systems that has largely dominated academic debate thus far seems to me much too coarse to allow a deeper understanding of the diversity of ownership structures in different national capital markets and of the policy implications of those structures.” Id.

6 Id.

7 Id.
Such a nuanced taxonomy based on the two-dimensional matrix of quality of law and ownership puts forward a more precise framework for comparative corporation governance than the traditional view that is based on the stark distinction between two ownership systems. Gilson’s study emphasizes primarily a detailed sub-categorization of a small number of *developed* controlling shareholder jurisdictions with *good-law*. However, controlling shareholder systems in *developing* countries with *bad-law* are still in a black box with many questions unsolved, even though this group accounts for the majority of the world. For more understanding of diversities and complicating the taxonomy among “controlling shareholder systems with bad-law,” this Article applies Professor Olson’s analytical framework of “banditry” (that was originally developed to explain the evolution of political systems throughout human history) to comparative corporate governance for this group of countries.

According to Olson, a “roving bandit” is one who will not come to expropriate victims again. As a result, he *rationally* takes *every* property possible from victims. The dominance of a roving bandit in a community creates chaos and results in *anarchy* that is further aggravated by the possibility of “uncoordinated looting” from adjacent roving bandits. In contrast, a “stationary bandit” is one who *rationally* settles down and rules his “subjects” (who used to be victims under roving bandits) in a certain domain. Using the monopolistic power to steal without interference from other bandits, a stationary bandit executes theft in the form of regular taxation rather than total looting, since he has an encompassing interest with his subjects. *Autocracy*

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*Id.*
is established when a dominant political entity is featured as stationary. Even if it is true that autocracy is less desirable than democracy, it is certainly a superior political system to anarchy, in which vandalism and disorder crowd out any possibility of prosperity and development to the full potential.

A controlling shareholder in a bad-law jurisdiction expropriates minority shareholders similarly to a powerful political entity that has physical and institutional force to exploit the subjects in its domain. In particular, extant corporate governance scholarship explains that a controller in a developing country can siphon all assets from a corporation to his own pocket at any time he wishes. Under these circumstances, the performance of the economy that is dominated by roving controllers will not be prosperous. This is the basic assumption of the conventional corporate governance view on the controlling shareholder system in bad-law countries, and I agree with this view in general.

However, many comparative studies based on this conventional view miss a material point. In these works, it is implicitly or expressly assumed that controlling shareholders in developing countries siphon all assets. Instead, the more precise assumption should be that controlling shareholders in developing countries can siphon all assets; thus, some controllers siphon all and others do not siphon all. In this regard, I hypothesize in this Article that the extent of controllers’ theft from minority shareholders varies among bad-law jurisdictions, depending on the idiosyncratic socio-political economic conditions that controllers face, as well as controllers’ personal preferences. In some countries, most controlling shareholders are characterized as roving. Therefore, they tend to take all wealth from a
corporation through an abrupt one-shot deal, which is consistent with the conventional view. As explained above, the presumption that all controllers in bad-law countries are corporate pirates, however, can be refuted in other countries where many controllers are stationary and prone to extract a part of a corporation’s assets through on-going transactions.\(^\text{11}\)

I argue that under some circumstances, being stationary and imposing less “taxes” (i.e., exploitation by controllers – please note that “taxes” are an analogy) on minorities can be optimal for long-sighted controllers. Then, even without legal enforcements, controllers reasonably and voluntarily decide to protect minority shareholders for their own benefits. In turn, this creates the minorities’ incentive to participate in the capital market that is dominated by stationary controllers. Cooperation between controllers and minorities forms repeated games in the capital market, resulting in enhanced mutual benefits. Consequently, “stationary controller” economies will be more prosperous than “roving controller” economies and sometimes even “good-law” economies. Of course, it is best for minority shareholders not to be exploited by controllers at all. Nonetheless, if the nature of bad-law is too systemic and established in a certain economy to be defeated, having stationary controllers is acceptable and desirable to investors as the second best.\(^\text{12}\)

Some may argue that public investors can invest abroad, if they do not like having bandits in a domestic market.\(^\text{13}\) However, these investors, i.e., minority

\(^{11}\) It is also plausible for “roving” and “stationary” controllers to be commingled in one jurisdiction. Professor Curtis J. Milhaupt suggested this possibility in our discussion.

\(^{12}\) In that context, while a method of transforming a bad-law country to a good-law country is important, a method of transforming a roving controller economy to a stationary controller economy is an equally significant issue in comparative corporate governance scholarship.
shareholders in (relatively poor) developing countries, are not equipped for international investment because many developing countries have implicit or explicit capital regulations. Even without such regulations, public investors are subject to “familiarity bias,” which leads them to invest a significant part of their capital in domestic markets. In addition, many non-controlling investors might have less capability for international diversification that requires additional risk unless they have hedging tools. Moreover, financial intermediaries, who pool funds and invest abroad on behalf of small investors, have not been available to many developing countries until recently.

Based on this foundation, the aim of this Article is to describe my effort to build a generalized model determining under what circumstances a controlling shareholder chooses to become roving or stationary as an optimal strategy to maximize his benefits. If a controller chooses to be stationary, he will expect two sources of continuous cash flow. One is from pro-rata economic interest and the other is from extraction of minority shareholders. The value of these two cash flow streams can be converted into the total present value of “pecuniary benefits.”¹⁴ In addition, “non-pecuniary benefits” such as fame, reputation, and social influence arising from running corporations add value for a controller as well. Thus, the total benefits that a stationary controller is able to enjoy are the sum of the present value of the “pecuniary benefits” (which are the sum of pro-rata economic interest and

¹³ This paragraph is based on Sang Yop Kang, Reenvisioning the Controlling Shareholder Regime: Why Controlling Shareholders and Minority Shareholders Embrace Each Other (working paper).

¹⁴ It is noteworthy that in this Article, while “pecuniary private benefits of control” are meant to be pecuniary benefits that exclusively and illegally belong to controllers, “pecuniary benefits” are defined more broadly – legally justified monetary benefits for controllers (such as pro-rata dividends) as well as illegal monetary benefits are included in “pecuniary benefits.”
extraction of minority shareholders) and “non-pecuniary benefits” in dollar terms. By contrast, when a controller chooses to be roving, he loots (substantially) all of the corporate assets including his own paid-in capital. Therefore, a controller may compare the total benefits as a stationary controller and as a roving controller, and ultimately chooses his position where he can receive more benefits.

Large family corporations often (but not always) function as a catalyst to make controllers more stationary. Through inheritance within a family, the length of tenure of a family controller can be extended to infinity. Then, to stay as a controller for a (potentially) eternal time horizon, a controlling family shareholder has to use less radical exploitation in its relationship with minority shareholders. In addition, imposing lenient “taxation” is in fact aligned with a controlling family shareholder’s best interest in the long run. By being stationary, he can hope that his descendants will be able to maintain a “golden goose” producing non-pecuniary as well as pecuniary benefits forever.

However, it is noteworthy that controlling family shareholders are not necessarily stationary due to the inherent problems of family. A mean-reverting problem in management skills and structural changes can adversely affect the existing repeated game set between a family controller and minority shareholders. Then a final period problem and backward induction may occur, which would destroy the concept of a family controller with infinite tenure. In addition, some family controllers are not perfectly altruistic to their following generations. Then, an incumbent controller may cause an inter-temporal problem. He will attempt to transform “future value” belonging to his descendants in the remote future to “present
value” that he can use immediately. Put differently, as he takes substantially all of
the wealth from a corporation at present, he becomes roving.

Furthermore, from any controller’s point of view (not limited to family
controllers’ view), choosing to be stationary incurs inherent risks. The expected
value that a controlling shareholder can enjoy through pecuniary and non-pecuniary
benefits in the future is not definite – it is exposed to volatilities. In contrast, by
being roving and looting at present, a controller can take a certain amount of
pecuniary benefits. Then, Carpe Diem may hold – a controlling shareholder would
choose to be roving even if the value accruing to him as a stationary controller is
expected to be larger than that as a roving controller. To many controllers, it is
absolutely valid financial advice that “a bird in hand is worth two in the bush.”

Against these backdrops, this Article proceeds as follows. Part I sketches the
development of taxonomies of the controlling shareholder regime (the traditional
view and Professor Gilson’s view). Part II introduces the analytical framework of
Olson’s banditry in order to delve into the controlling shareholder system with bad-
law. Part III proposes under what circumstances a controlling shareholder would
choose to be stationary. Various economic analyses such as “taxation” (i.e.,
extraction by a controller), valuation method, a controller’s utility function, pecuniary
and non-pecuniary benefits will be discussed. Part IV explores why a controlling
family shareholder is more likely to be stationary. In contrast, Part V examines what
factors make it difficult for a controller (in particular a family controller) to be
stationary. As the first attempt to analyze controlling shareholder systems in the
context of roving or stationary bandits, this Article emphasizes theoretical approaches
and adopts deductions based on logic. I hope to use rigorous case and empirical studies to explain theories on the controlling shareholder system in more depth in the near future.

I. TAXONOMIES OF CONTROLLING SHAREHOLDER SYSTEMS

Traditionally, comparative features of corporate economies and capital markets are viewed through the prism of corporate ownership regimes. According to this view, the world economy is divided into two ownership categories – one is the “dispersed shareholder system” and the other is the “controlling shareholder system.” In response, critics of the traditional view argue that this classification is too simple to examine “the rest of the world” outside Anglo-American economies. Based on this concern, this Part introduces Professor Gilson’s new taxonomy on controlling shareholder systems. In turn, I explain the notions of roving and stationary controlling shareholder systems.

1. Conventional Views on Comparative Ownership – The Dispersed Shareholder v. The Controlling Shareholder Systems
Since Berle and Means’ declaration on the separation of ownership and management in U.S. corporations, the “dispersed shareholder system” has been established as the norm and standard in corporate governance academia. In fact, however, the dispersed shareholder system is a parochial phenomenon that can be observed only in two Anglo American countries, i.e., the United States and United Kingdom. Rather, the alternative ownership, i.e., the “controlling shareholder system,” prevails across Europe and Asia.

In dispersed shareholder system, the combination of shareholders who are atomized and executives with powerful discretion in corporate operations inevitably creates managerial agency problems. In order to rectify (or mitigate) the imperfectness arising from the agent-principal relation, legal doctrines which are designed to punish managers’ outreaching and incentive mechanisms have been developed to align managers’ interests with a corporation. The controlling shareholder system has its own agency problem – a controller often takes corporate wealth at the sacrifice of minority shareholders via “tunneling.” Then, among two ownership systems that are subject to inherent agency problems respectively, which is better in terms of investor protection?

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15 Berle & Means, supra note 1.

16 Coffee, supra note 2 at 643.


18 See e.g., Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, Tunneling, 90 AM. ECON. REV. 22 (2000).
A decade ago, four prominent economists – La Porta, Lopez-de-Silanes, Shleifer, and Vishny (LLSV) – made attempt to solve this puzzle by presenting empirical studies on comparative corporate governance with sophisticated econometric techniques. Evaluating corporate governance of 46 countries by means of investor protection index, they conclude that the controlling shareholder system is *systematically* worse in protecting outside investors than the dispersed shareholder system, which reinforces the view of traditional corporate governance scholarship.

However, the validity of the sharp distinction between ownership systems in the conventional view is called into question in terms of comparative methodology. In fact, countries in the dispersed shareholder system are rather outliers since the United States and the United Kingdom are demonstrably the most advanced economies in the world. In addition, the sample size is too small to approve conclusions of the traditional theory – from data of two countries (i.e., the United States and United Kingdom), can we draw the meaningful *generalization* that the diffused ownership is superior to the controlling ownership and it should be a paragon of corporate economy? Or, more fundamentally, is the traditional view that divides the world economy two categories valid and useful for the comparative corporate governance scholarship?

### 2. Complicating the Taxonomy of Controlling Shareholder Ownership

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19 La Porta et al., *supra* note 3.

20 See e.g., La Porta et al., *supra* note 3; Ronald J. Gilson, *Controlling Family Shareholders in Developing Countries: Anchoring Relational Exchange*, 60 Stan. L. Rev. 633 (2007); Gilson, *supra* note 4.
Perhaps, as Professor Gilson states, “[I]t is hardly a startling intuition that a
taxonomy that divides the world into two categories – the United States and the
United Kingdom on the one hand, and everyone else on the other – does not tell us
very much about the rest of the world.”21 Rather, he proposes that the world
economy is divided into two categories in a more textured way – controlling
shareholder regimes with functionally bad-law and regimes that have functionally
good-law.22 Accordingly, Sweden and the United States both fall within the second
group, although the traditional view categorizes these two countries in different
groups.23 In contrast, Sweden and Mexico – which are included in the same group as
countries with controlling ownership by the traditional view’s standard – are not
treated as being in the same group since the former is equipped with an efficient legal
system and the latter is not.24

Gilson’s taxonomy of the world economy sets another watershed in
comparative corporate governance scholarship – this categorization of the world is
more sophisticated and informative than the conventional view based on two versus
“all minus two” (I call it the “traditional version of the rest of the world”). Gilson’s
taxonomy addresses two key points. First, controlling shareholder systems with

21 Gilson, supra note 4 at 1653.

22 Professor Gilson states that “… two more textured categories: controlling shareholder regimes with
functionally bad law and regimes that have functionally good law and support a diversity of
shareholder distributions.” Id. at 1646.

23 Professor Gilson explains “This second group includes both Sweden, which is characterized by
companies with controlling shareholders, and the United States, which is characterized by companies
with widely held shareholdings.” Id. at 1646.

24 Professor Gilson explains that “For example, both Mexico (with bad law) and Sweden (with good
law) have controlling shareholder systems.” Id. at 1650. Mexican controlling shareholders are said to
expropriate more than a third of the value of the company, while expropriation by their Swedish
counterparts is limited to 1% of company value. Id. at 1650 & n.23 (citing Tatiana Nenova, The Value
good-law and ones with bad-law should not be treated as one unified group (as seen in the comparison of Sweden and Mexico), as the conventional view has implicitly but erroneously assumed. Second, the controlling shareholder system is not necessarily inferior to widely-held shareholding (as seen in the comparison of Sweden and the United States) – efficiency of legal infrastructure is more significant in terms of investor protection than particular forms of ownership system.

3. The Need for the More Complicated Taxonomy of Controlling Shareholder Systems

Professor Gilson’s new taxonomy can be interpreted as dividing the world economy into three groups: (i) the dispersed shareholder regime (only two economies, i.e., the United States and United Kingdom); (ii) the controlling shareholder regime with good-law (some developed countries including Sweden); and (iii) the controlling shareholder regime with bad-law (some developed countries and almost all developing countries). Gilson’s contributions are to distinguish the second and third groups within the controlling shareholder system and to propose the commonalities in the first and second groups across different ownership structures. However, it is worth noting that countries with inefficient (bad-law) controlling ownership – I call this third group “Gilson’s version of the rest of the world” \(^{25}\) – are still treated as one group even though they account for a supermajority in the world economy (i.e., the

\(^{25}\) It is important to distinguish the “traditional version of the rest of the world” and Professor Gilson’s version of “the rest of the world.” While the “traditional version of the rest of the world” is composed of all countries except the United States and United Kingdom (i.e., “all minus two”), “Gilson’s version of the rest of the world” is composed of all countries except the United States, United Kingdom, and some developed countries including Sweden.
third group is composed of *all* countries except two Anglo-American countries and several developed countries). Perhaps, a reason that the third group is not sub-categorized further is that Gilson’s effort is focused on figuring out the commonalities among developed economies (i.e., the first and second groups) despite their different ownership systems.

Benefitting from Professor Gilson’s seminal work on the more nuanced taxonomy of the world economy, this Article has a motive to classify the aforementioned third group, i.e. “Gilson’s version of the rest of the world,” in more detail. To be sure, countries in this group are very diverse and heterogeneous in terms of the socio-economic and political environments that they face – even some developed countries (such as Italy, as Gilson explains\(^\text{26}\)) are included in this group, not to mention substantially all developing countries. Therefore, I believe that it is high time to sub-categorize this group that is at large deemed as having only common (inferior) features such as bad law, institutions, and enforcement.

From now on, I delve into how the concepts of “roving” and “stationary” controller systems can be distinguished (at least roughly) within the third group. For that purpose, I examine how socio-economic and political factors determine the prevalence of “roving” or “stationary” controlling systems. By doing so, I hope to answer the paradox of some bad-law countries achieving superior economic development to good-law countries as well as other bad-law countries. Table 1

\(^{26}\) In addition, Shleifer and Vishny deemed Italy as one of countries that lacks good corporate governance. “In contrast, corporate governance systems in most other countries, ranging from poor developing countries, to transition economies, to some rich European countries such as Italy, lack some essential elements of a good system,” Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. Fin. 737, 739 (1997).
summarizes the classifications of the world economy by the traditional view, Gilson, and myself respectively.

Table 1: Taxonomies of the World Economy

<table>
<thead>
<tr>
<th>I. Classification of the World by the Traditional View</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group 1, Dispersed Shareholder System: the U.S. and U.K.</td>
</tr>
<tr>
<td>Group 2, Controlling Shareholder System (i.e., the “Traditional Version of the Rest of the World”): all countries except the U.S. and U.K.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>II. Complicating Taxonomy of the World by Professor Gilson</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group 1, Dispersed Shareholder System: the U.S. and U.K.</td>
</tr>
<tr>
<td>Group 2, Controlling Shareholder System with Good-Law: some developed countries (e.g., Sweden)</td>
</tr>
<tr>
<td>Group 3, Controlling Shareholder System with Bad-Law (i.e., “Gilson’s version of the Rest of the World”): all countries except the U.S., U.K., and some developed countries – in other words, some developed countries (e.g., Italy) and all developing countries are included in Group 3</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>III. The More Complicating Taxonomy of the World by This Article</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group 1, Dispersed Shareholder System: the U.S. and U.K.</td>
</tr>
<tr>
<td>Group 2, Controlling Shareholder System with Good-Law: some developed countries (e.g., Sweden)</td>
</tr>
</tbody>
</table>

Then, Professor Gilson’s Group 3 (i.e., “Gilson’s the Rest of the World”) is divided into three sub-groups:

<table>
<thead>
<tr>
<th>Group 3-1, “Roving” Controlling Shareholder System</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group 3-2, “Stationary” Controlling Shareholder System</td>
</tr>
<tr>
<td>Group 3-3, “Commingled” Controlling Shareholder System</td>
</tr>
</tbody>
</table>

II. CONTROLLING SHAREHOLDERS AND THE ANALYSIS OF BANDITRY

Politics and corporate economics share a lot in common. In fact, corporate governance is the field that examines the political power-plays and relationships of
corporate constituencies such as directors, managers, controlling and minority shareholders. In this Part, I explain the concepts of “roving” and “stationary” controllers, which originate from the vocabulary of political economics, and explore the similarity between corporate economies and political systems.

1. Analysis of Banditry – Roving and Stationary Bandits

In his study on the evolution of governmental systems in history, Professor Olson explains that political groups with force in anarchies and autocracies are analogous to “bandits” since from the perspective of the laypeople, political groups with force exploit them by means of violence. However, every bandit is not same – according to Olson, bandits are classified into at least two groups: “roving” and “stationary” bandits.

“Roving” bandits are usually found in anarchy. As the vocabulary itself explains, they are bandits who are ready to depart from the pillaged place soon after total plundering. In anarchy where no single entity dominates the entire domain,

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27 Discussion with Professor Curtis J. Milhaupt.

28 Mancur Olson, Power and Prosperity: Outgrowing Communist and Capitalist Dictatorship (Basic Book 2000).

29 Professor Olson takes an example from the history of pre-modern China, when many warlords ruled in certain domains, independent of the central authority. “In the 1920s, China was in large part under the control of various warlords. They were men who led some armed band with which they conquered some territory and who then appointed themselves lords of that territory. They taxed the population heavily and pocketed much of the proceeds. The warlord Feng Yu-hsiang was noted for the exceptional extent to which he used his army for suppressing bandits and for his defeat of the relatively substantial army of the roving bandit, White Wolf. Apparently most people in Feng’s domain found him much preferable to the roving bandits.” Mancur Olson, Dictatorship, Democracy, and Development, 87 AM. POL. SCI. REV. 567, 568 (1993).

30 Id. at 568.
powerful groups loot a limited number of victims. Facing uncoordinated competitive theft with other groups, it is in their best interest to take every property possible from victims – if they do not loot victims’ total wealth, but leave some of it, competing bandits will take the remainder. As a result, roving bandits do not need to set a long-term goal of theft because they will not come again to expropriate victims who have nothing. Put simply, only “today” is meaningful in the minds of roving bandits.31

This tendency of a roving banditry distorts the incentive of victims. Facing and expecting cruel and short-term oriented vandalism, victims have little or no incentive to produce or accumulate anything32 since endurance of a painful “today” will not generate any fruit “tomorrow,” but will end with total plundering by roving bandits anyway. Victims make every attempt to leave the place in order to avoid the ruthlessness of roving bandits. Therefore, as roving banditry becomes more established, it becomes more difficult for roving bandits to find victims that they can loot. Consequently, the welfare of the entire society (both bandits and victims) will deteriorate as this vicious cycle is formed among roving bandits and victims.

A more desirable story may occur when a “roving” banditrationally settles down and becomes a “stationary” bandit who resides with his “subjects” (who used to be victims under roving bandits’ reign) and continuously steal from them.33 In this case, a bandit is established as a dictator and monopolizes theft from a certain domain

31 Pirates can be defined as “roving” bandits in a similar way. They do not expect to see the same victims in the future. Thus, when they have chance to plunder, it is in their best interest and the rational choice to take all wealth possible from their victims. This is why they are often ruthless.

32 Olson, supra note 29 at 568.

33 Id.
– thus, it can be said that anarchy turns into autocracy.\textsuperscript{34} In the absence of competing bandits with whom he must share trophies, a stationary bandit finds that from the long-term perspective, it is optimal for him to thieve in the form of regular taxation rather than occasional and brutal plunder.\textsuperscript{35} When only a part of their income is taken by a stationary bandit, his subjects have an economic incentive to produce, save, and invest for the future;\textsuperscript{36} in the long run, “[a rational stationary bandit] will be able to exact a larger total amount of income from his subjects if he leaves them with an incentive to generate income that he can tax.”\textsuperscript{37}

In other words, a stationary bandit has an encompassing interest in the continuing prosperity of his victims and so will take less than a roving bandit.\textsuperscript{38} Then, it can be said that the dismal inter-temporal problem under the threat of a roving banditry can be solved by the advent of a stationary bandit; in contrast to a roving bandit, a stationary bandit pursues long-term interest, and “tomorrow” as well as “today” is significant to him. Consequently, subjects under the stationary banditry are able to take the future more seriously into consideration; the economy of the domain will grow and the welfare of subjects will be improved as well.

\textsuperscript{34} Id. at 567-568.
\textsuperscript{35} Id. at 568.
\textsuperscript{36} “… the victims of the theft can expect to retain whatever capital they accumulate out of after-tax income and therefore also have an incentive to save and to invest, thereby increasing future income …,” Id. at 568.
\textsuperscript{37} Id. at 568.
\textsuperscript{38} See e.g., Noshab, Book Review on “Power and Prosperity: Outgrowing Communist and Capitalist Dictatorship” by Olson (http://www.issi.org.pk/journal/2002_files/no_2/review/5r.htm); Olson, supra note 28 (explaining that “The stationary bandit, because of his monopoly on crime and taxation, has an encompassing interest in his domain that makes him limit his predations because he bears a substantial share of the social losses resulting from these predations.”)
It is true that by basic definition, there is no fundamental difference between roving and stationary bandits as far as victims are concerned. Nonetheless, victims prefer stationary bandits to roving bandits because victims notice that under the reign of stationary banditry, victims and bandits are *sailing on the same ship* (in other words, the interests of both stationary bandits and victims are generally aligned, which is not observed under roving banditry). Through rationalizing the theft to a moderate extent and a positive process of feedback, the system based on stationary banditry is mutually beneficial to both the bandit and victims – thus, stationary banditry in relation to autocracy can generate much better economic performance than roving banditry in relation to anarchy. Democracy with political legitimacy might be the best situation for the general population in terms of political freedom and economic development. However, given the facts that lack of political legitimacy is firmly established and democracy is remote for the current generation, it is almost sure that coexistence with stationary bandits is much more desirable to victims than with roving bandits. Table 2 is the summary of the foregoing analysis.

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39 See e.g., Noshab, *supra* note 38; Olson, *supra* note 29.

40 However, there is debate whether a democracy is always better for enhancing economic development than a dictatorship. Some commentators argue that in certain cases, dictatorship achieves more economic prosperity than democracy. See generally, Ronald J. Gilson & Curtis J. Milhaupt, *Economically Benevolent Dictators: Lessons for Developing Democracies* (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1564925).
Table 2: Distinctive Features of “Roving” and “Stationary” Bandits

<table>
<thead>
<tr>
<th></th>
<th>“Roving” Bandits</th>
<th>“Stationary” Bandits</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Political System in Which They Prevail</strong></td>
<td>Anarchy</td>
<td>Autocracy</td>
</tr>
<tr>
<td><strong>“Roving” or “Stationary”</strong></td>
<td>They are “roving” in that they depart soon. Often, they will not come to expropriate victims again.</td>
<td>They are “stationary” in that they stay with victims and continuously steal for a long time period.</td>
</tr>
<tr>
<td><strong>Method of Theft</strong></td>
<td>Cruel Looting (roving bandits take all property possible)</td>
<td>Regular Taxation (stationary bandits take a part of property)</td>
</tr>
<tr>
<td><strong>Time-Horizon</strong></td>
<td>Short-term Oriented</td>
<td>Long-term Oriented</td>
</tr>
<tr>
<td><strong>Victims’ Incentive</strong></td>
<td>Victims have little incentive to produce</td>
<td>Victims have sufficient incentive to produce</td>
</tr>
</tbody>
</table>

Victims prefer a stationary bandit to a roving bandit because they can prepare for “tomorrow” only under the reign of stationary banditry.

2. “Roving” and “Stationary” Controlling Shareholders

I have reviewed political economy analysis on the evolution of government systems – especially anarchy and autocracy – by means of Professor Olson’s framework of banditry.\(^{41}\) From now on, I turn back to the subject on which I am writing, i.e. “controlling shareholder systems with bad-law,” by connecting corporate governance issues and Olson’s analytical framework of political economics. In the context of corporate governance, whoever takes corporate assets to the detriment of

\(^{41}\) Another example of stationary banditry can be found in organized crimes. Once a criminal organization establishes monopolistic dominance in a certain area, it has a long-term horizon for the exploitation of that area. Then, members of the criminal organization will soon understand that it is rational to protect their victims’ property rights to some degree and exploit them moderately for a long time. Since a moderate level of exploitation of victims will foster an economic incentive for victims to produce, the criminal organization is able to extract more wealth from victims “in the long run.”
investors (and/or other constituencies in corporations) can be named as a corporate “pirate” or “bandit.” When the corporate law is not protective in a jurisdiction, a significant issue to victims (i.e., shareholders or other constituencies) is a corporate bandit’s degree of looting a corporation – in other words, whether he is roving or stationary should be a focal point from the standpoint of victims, given the condition that looting is inevitable and law does not protect victims in a bad-law country.

In a jurisdiction where investors are well protected by corporate laws and enforcement systems, minority shareholders are at large insulated from a large scale of expropriation by corporate dictators (professional managers or controlling shareholders). For example, in the United States where a diffused shareholder ownership is the norm, statutes and common laws effectively protect public investors especially from unfair transactions arising from a conflict of interests. In fact, as Professor Fox explains, legal doctrines and jurisprudence of corporate law in the United States have been developed in order to solve problems imposed by corporate “buccaneers” (i.e., “bandits” in my analysis). In Sweden, although a limited number of wealthy families dominate the entire economy, it is well known that they do not siphon public corporations’ wealth to their own pockets.

These law-abiding economies successfully discourage “bandits” from taking wealth from victims – when a bandit appears and is recognized in the market, enforcement agencies or courts will intervene and punish him. In that sense, good-

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42 Discussion with Professor Merritt B. Fox.

43 In this sense, institutions around corporations in Sweden are functionally equivalent to those of the United States, even though the two countries differ in terms of dispersed and controlling shareholder systems. Gilson, supra note 4.

44 A notable U.S. example is punishment of Madoff for his Ponzi scheme.
law countries – whether they adopt the widely-held ownership (Gilson’s first group including the United States) or the dominant shareholder ownership (Gilson’s second group including Sweden) – can be connoted as economies with few bandits.\footnote{It is impossible to eradicate every bandit in a society. Even in a good-law country like the United States, there might be many occasions where corporate insiders take corporate assets, which are not recognized by authorities due to the relatively small magnitude of theft. Of course, there are some large-scale thefts as well (e.g., Enron and WorldCom).}

By contrast, most developing countries (and even some developed countries) in Gilson’s third group lack well-performing legal infra-structures that are designed to effectively protect investors in the capital markets. Thus, the conventional wisdom (based on law and finance literature) on the taxonomy of ownership systems presumes that the piracy of controlling shareholders in (all) developing countries is a default rule – this view treats all (developing) countries as “one” unified group that is dominated by “roving” bandits, in Olson’s terminology. However, as the notion of a “stationary” bandit shows, it is possible that some controlling shareholders in bad-law jurisdictions do not abuse their power for looting to the full extent even if they can, because paradoxically \textit{limiting theft} in each period \textit{maximizes total theft} in the long run.

With this possibility that the extent of stealing may vary, I propose dividing controlling shareholders into two categories: (i) “roving controllers” plunder corporations \textit{severely} and \textit{cruelly} (for example \textit{through a one-shot deal}); and (ii) “stationary controllers” exploit minority shareholders to a \textit{moderate} extent (for example, through \textit{continuous extractions} similar to \textit{regular taxation}). Then, the next question is – what factors make a controlling shareholder become either roving or stationary?
III. WHAT MAKES A CONTROLLER “STATIONARY”? – ECONOMIC ANALYSIS OF “STATIONARY” CONTROLLERS

It is possible that controlling shareholders in some developing countries may be more moralistic and ethical, and thus they voluntarily do not loot minority shareholders to the full extent. Although I do not entirely rule out this humane possibility, my aim in this Article is to figure out hidden socio-political economic rationalities that affect a controlling shareholder’s decision on the way of stealing – whether he should be a “roving” or “stationary” controller. Following are my analyses.

1. A Controller’s “Taxation” of Minority Shareholders – One-Shot Looting v. Ongoing Extractions

Here, let me start with a seeming digression – even if it is ultimately not – to a theory on taxation particular to Olson’s world. Tax revenue is equal to the product of the tax rate and the taxable income (i.e., tax base). Since taxpayers’ incentive to earn income is more discouraged by a higher tax rate, the trade-off relationship between
tax rate and tax base is apparent. As the tax rate increases, the size of tax revenue is dependent of the relative strengths of two competing factors, as follows.

When tax rate increases, tax revenue is initially likely to increase as well since the positive effect by increased tax rate is stronger than the negative effect by decreased tax base. When the tax rate reaches a certain point (i.e., the revenue-maximizing tax rate), however, tax revenue goes down as the tax rate continues to rise. It is because the burdensome tax rate so adversely distorts taxpayers’ incentive to earn (taxable) income in this range of tax rate – the positive effect by increased tax rate is overwhelmed by the negative effect by decreased tax base. Thus, if the government is economically rational to maximize tax revenue, it should impose the optimal tax rate rather than levy a harsh tax rate that destroys taxpayers’ willingness to work.

46 The trade-off relation between tax rates and tax revenues is named the Laffer Curve. As Laffer himself admits, however, this concept should be credited to Ibn Khaldun, a 14th century Muslim philosopher, and more recently, John Meynard Keynes. Arthur B. Laffer, The Laffer Curve: Past, Present, and Future, Heritage Foundation (2004) (also available at http://www.gates-home.com/files/Laffer%20Curve%20-%20Past%20Present%20and%20Future.pdf.). Professor Olson stated, “As Joseph Schumpeter (1991) lucidly pointed out, and Ibn Kalduhn (1967) sensed much earlier, tax receipts will (if we start with low taxation) increase as tax rates increase, but after the revenue-maximizing rate is reached, higher tax rates distort incentives and reduce income so much that tax collections fall.” Olson, supra note 8 at 569.

47 Olson, supra note 8; Laffer, supra note 46.
In Olson’s world, the method and degree of “taxation” (i.e., theft by bandits) is an important feature in distinguishing roving and stationary bandits. An (extreme) roving bandit will choose to take everything possible from victims. In other words, the imposed tax rate by the roving bandit is 100 percent in this case. Under this harsh tax rate, it is expected that victims will end up producing nothing in the next stage since they will be deprived of everything again. As a result, the tax base will shrink to zero, and in turn the tax revenue accruing to a roving bandit approaches zero soon as well.

However, when a bandit becomes stationary, a self-interested autocrat chooses a revenue-maximizing tax rate which is far less than a roving bandit’s ruthless tax
This generous tax rate imposed by a stationary bandit will foment his subjects’ incentive to produce, save, and invest for the future, which will create a larger tax base. Tax revenues will continuously accrue to a stationary bandit, and the sum of tax revenue in the long run will exceed the one-shot tax collection of a comparable roving bandit.

Now, let me turn the topic to controlling shareholders’ extractions in bad-law countries. Like bandits in Olson’s world, controlling shareholders in bad-law jurisdictions impose (illicit) “tax” on their “subjects” (i.e., minority shareholders) by tunneling corporate assets at the sacrifice of minority shareholders (please note that “tax” is analogy). If a controlling shareholder is interested in maximizing “tax revenue” (i.e., the amount of pecuniary private benefits), he should use the optimal trade-off relation between “tax rates” (i.e., the extraction rate) and “the tax base” (i.e., the corporate value).

A “roving” controller may take almost all corporate value through a one-shot transaction that is severely detrimental to minority shareholders. However, the problem for a roving controller is that when the extraction rate is prohibitively high, minority shareholders lose their incentive to invest their money in that corporation and follow the Wall Street rule in the next stage. Then corporate value, which is analogous to tax base, will drastically decrease in the subsequent period and a roving controller may not have another opportunity to accumulate his pecuniary interest in the future. A roving controller does not use the optimal extraction strategy from the perspective of the long-term horizon.

Olson, supra note 8.
In contrast, a controller with sufficient strength in the economy may rationally settle down as a “stationary” controller in the domestic capital market, and will find that it is in his best interest to extract from minority shareholders to a more benevolent extent. In other words, in order to maximize the amount of pecuniary private benefits, a stationary controller chooses the optimal extraction rate that is far less than a roving controller’s tax rate. In that sense, a stationary controller’s limited theft is not the result of his generosity, but of his carefully-calculated rationality. Paradoxically, extra-legal factors such as the self-interest of controllers may substitute for an efficient legal infrastructure in some developing countries, at least to some degree. Without strong intervention by the government and judiciary, the market performs self-regulation in a bad-law country, which is similar to Adam Smith’s explanation of the “invisible hand.”

2. When a Controlling Shareholder Rationally Chooses to be “Stationary”

According to the conventional view, it is generally (if not always) presumed that controlling shareholders in bad-law jurisdictions can take all properties of a corporation at will. In that sense, economic models have so far portrayed all controllers in bad-law countries as roving controllers who can potentially impose a nearly 100 percent tax rate on minority shareholders. Since controllers have full discretion on the extent of taxation according to these traditional accounts, there is an urgent call to protect minority shareholders from controllers’ tyranny. This view is

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49 In fact, Olson himself explains that there is an “invisible hand” behind stationary banditry. Olson, supra note 8.
correct in part and shows only the half of the picture. In contrast to this conventional view that emphasizes the concerns arising from roving bandits in bad-law countries, I propose that there is another type of controlling shareholder, i.e., stationary bandits in bad-law countries. Therefore, I request that the future economic models should take into consideration the presence of stationary controllers who levy a more generous taxation for the sake of their long-term prosperity, and inadvertently protect minority shareholders to some degree.

Then, under what conditions and circumstances, if any, does a controlling shareholder in a developing country become a stationary controller? Here, I put forward potential answers as to when a controlling shareholder becomes stationary. First, a simplified numerical example is explained, and subsequently a more generalized model is examined.50

(a) When a Controller Rationally Becomes Stationary – A Numerical Example

Due to the inefficient legal system and enforcement in a bad-law jurisdiction, a controlling shareholder is able to extract corporate value from public shareholders in a form of a one-shot deal – the extreme form of extraction by a roving controller. For example, suppose that the amount of equity in a corporation is 100 million dollars – at the outset, a controller invests 50 million dollars and public shareholders invest

50 As explained in the Introduction, my primary aim in this Article is not to work case studies from concrete examples in particular countries. Rather, it is to propose abstract theories and rationales for examining the possibility of stationary controllers’ presence, which has not been considered in traditional models of controlling shareholders.
the remaining 50 million dollars. Suddenly, the controller extracts 100 million dollars from the corporation, and it is left as a shell that does not have any meaningful assets for public shareholders.

Alternatively, a controlling shareholder may think that maintaining a corporation as a “proverbial golden goose” may be more attractive to him (and his children), if he extracts a part of the corporate value for long time. Suppose that a controller receives a stream of cash flows of 5 million dollars each year – 2.5 million dollars are from the pro-rata cash flow available to all shareholders, and the remaining 2.5 million dollars are from cash flow exclusive to him as a result of exploitation. Suppose that this amount of annual dividend and illicit exploitation is sustainable and acceptable to minority shareholders. Then, they are willing to keep investing their money in that corporation.\textsuperscript{51} For simplicity, the discount rate is assumed to be zero here. If he is patient enough with a long time horizon, in 20 years he will be better off because the total pecuniary benefit that he can gain as a stationary controller is more than 100 million dollars, which is the amount of a one-shot extraction as a roving controller.\textsuperscript{52} In sum, being a stationary controller is more beneficial to him if he is able to stay in a corporation for a long time horizon.

\textsuperscript{51} When public shareholders decide whether or not to remain in a controlled corporation, they will take into account “tax” by controllers (a controller’s exploitation is analogous to the “tax”). If the “after tax” return is satisfactory to public shareholders, they keep their investment in that corporation.

\textsuperscript{52} In other words, the strategy of a modest annual and periodic looting (i.e., “taxation”) of 2.5 million dollars is better for him than that of a drastic looting of 50 million dollars at once.
(b) When a Controller Rationally Becomes Stationary – A More Generalized Valuation Model

A generalized model for a “stationary” controller can be derived from the valuation model in financial economics. The value of an asset that generates cash flow in each period can be measured by the discounted cash flow (DCF) formula. According to the DCF formula, the present value of an asset is equal to the sum of the present values of expected cash flows with relevant discount rates. Therefore, the present value of common stocks in a firm should be the sum of all discounted dividends in the future.

In the DCF model, the life of common stocks is assumed to be infinite – barring such corporate hazards as bankruptcy or acquisition, common stocks are immortal. Thus, the price of common stocks of a firm \((P_0)\) can be expressed as the present value of a perpetual stream of cash dividends \((CF_t)\). In particular, when a company’s dividends are expected to grow at the constant rate \((g)\), the stock price \((P_0)\) is calculated by dividing the dividend of the first year \((CF_1)\) by the difference between the discount rate \((r)\) and the growth rate \((g)\) as is suggested by the constant growth model in Table 3.

53 For the more information about the valuation of shares, see BREALEY & MEYERS, PRINCIPLE OF CORPORATE FINANCE (McGraw-Hill Irwin 6th ed. 2000).

54 Id.

55 Id. at 65.

56 Id. at 66. It is written as; \( P_0 = \sum_{t=1}^{\infty} \frac{DIV_t}{(1+r)^t} \) \((P_0)\) stands for the price of common stock; \(DIV_t\) stands for dividend paid out at the end of year \(t\); \(r\) stands for the discount rate; \(\infty\) indicates infinity).

57 Id. at 67.
Table 3: The Present Value of a Common Stock (if a corporation is a perpetual entity)

- \( P_0 = \sum_{t=1}^{\infty} \frac{CF_t}{(1+r)^t} \)
- \( P_0 = \frac{CF_1}{r - g} \)

- \( P_0 \): the price of common stocks of a firm
- \( CF_t \): cash dividends that shareholders are paid at the end of year \( t \)
- \( r \): the discount rate
- \( g \): the growth rate

In a developing country with bad-law, it can be said that a (stationary) controlling shareholder receives two sources of dividends from a corporation, as shown in the numerical example above: (i) he is paid pro-rata “normal dividends” (or any form of legitimate pecuniary benefits from a corporation) that are also available to all (public) shareholders according to each shareholder’s economic interest; (ii) in addition, he is paid “special dividends” (or any form of illicit pecuniary benefits from a corporation) exclusively for himself in the form of pecuniary private benefits of control\(^{58}\) (it should be noted that in this Article, while “pecuniary private benefits of control” refers to pecuniary benefits that exclusively (and illegally) belong to controllers, “pecuniary benefits” are defined more broadly to include any justified (legal) monetary benefits for controllers, like pro-rata dividends). These (illicit) “special dividends” – i.e., pecuniary private benefits are available to a controller since he is effectively insulated from interference by government authorities and from the

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\(^{58}\) Generally, “special dividends” refer to a corporation’s payments to its shareholders. They are special because they are different from regularly recurring dividends. In this Article, however, “special dividends” are meant to be various types of illicit cash flows to a controlling shareholder. They are special because these payments are only available to a controller.
courts’ intervention, due to the inefficient legal infrastructure in a developing country. Accordingly, the present value that a (stationary) controlling shareholder expects to have in a corporation can be calculated by summing up the present value of “normal dividends” and “special dividends” accruing to a controller.

Let us first consider the present value of a stream of “special dividends” belonging to a stationary controller. The expected amount of extraction (i.e., “special dividend”) at the end of year \( t \) is notated as \( E_{xt} \). Then, the final period and discount rate are notated as \( N \) and \( r \) respectively. \( SD_0 \) is defined as the present value of perpetual extractions belonging to a controller – in the same way, \( SD_N \) is the value of perpetual extractions at the end of year \( N \). In addition, the constant growth model can be used for the valuation of the pecuniary private benefits of control to a stationary controller.

An (extreme) roving controller steals all corporate value at once. Thus, there is no “tomorrow” in the minds of him and victims – therefore, no possibility of corporate growth is expected under his reign. In contrast, since the partial taxation policy of a stationary controller encourages minority shareholders to invest in the future, a corporation will experience growth. Suppose that the value of a corporation under a stationary controller grows at the constant rate (\( g \)). Then, even if the “tax rate” (the rate of extraction from minority shareholders) is constant over each period, the dollar amount of annual extraction by a controller increases at the rate of \( g \) as well.\(^{59}\) Accordingly, the present value of extractions to a stationary controller (\( SD_0 \))

\(^{59}\) I assume here that as the value of a corporation grows at the rate of \( g \), the “tax revenue” of a stationary controller (the amount of extraction in each period) grows at the same rate, if “tax rates” (the rate of extraction from a corporation) are the same across periods. Tax revenue is equal to the product of tax rates and tax base. Accordingly, if tax rates are the same, the only factor to determine the size of
is written in two ways, as is shown in Table 4 – the two formulas are driven by the
general DCF model and the constant growth model respectively.

Table 4: The Present Value of Extractions to a Stationary Controller

<table>
<thead>
<tr>
<th>Equation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>( SD_0 = \frac{Ext_1}{1+r} + \frac{Ext_2}{(1+r)^2} + \ldots + \frac{Ext_N + SD_N}{(1+r)^N} = \sum_{t=1}^{N} \frac{Ext_t}{(1+r)^t} + \frac{SD_N}{(1+r)^N} )</td>
<td>( SD_0 ): the present value of extractions to a stationary controller</td>
</tr>
<tr>
<td>( SD_0 = \frac{Ext_1}{1+r} + \frac{Ext_1(1+g)}{(1+r)^2} + \ldots + \frac{Ext_1(1+g)^{N-1} + SD_N}{(1+r)^N} )</td>
<td>( SD_0 ): the present value of extractions to a stationary controller</td>
</tr>
</tbody>
</table>

- \( SD_0 \): the present value of extractions to a stationary controller
- \( SD_N \): the value of extractions to a stationary controller at the end of year \( N \)
- \( Ext_t \): the expected amount of extraction (i.e., “special dividend”) at the end of year \( t \)
- \( r \): the discount rate
- \( g \): the growth rate

Suppose that \( N \) is infinite – this means that a controlling shareholder’s tenure
is infinite, which is unrealistic since no human being is immortal. Since I will come
back to resolve this issue soon, let us maintain this assumption for a while. Then, the
present value of extractions to a stationary controller (\( SD_0 \)) can be reduced to the
following formula in Table 5, similarly found in valuing common stock without
maturity.

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tax revenue is the tax base. In the context of controlling shareholders’ expropriation, “tax base” is the
value of the corporation. Consequently, if the value of the corporation grows at the rate of \( g \) and the
rate of extraction from a corporation is constant over time, the amount of extraction in each period
grows at the rate of \( g \) as well.
Table 5: The Present Value of Extractions to a Stationary Controller When His Time Horizon Is Large Enough

\[
SD_0 = \frac{Ext_1}{(r-g)}
\]
- \(SD_0\) : the present value of extractions to a stationary controller
- \(Ext_1\) : the expected amount of extraction (i.e., “special dividend”) at the end of year 1
- \(r\) : the discount rate
- \(g\) : the growth rate

The present value of “normal dividends” (i.e., the present value of the pro-rata payment to every shareholder) belonging to a stationary controller, which is noted as \(ND_0\), can be calculated in the same way if the assumption of a controller’s immortality is maintained. Therefore, the present value of “normal dividends” is expressed as a pro-rata dividend in the year 1 \(Div_1\) over the difference between the discount rate \(r\) and the growth rate \(g\). Put together, the present value of total pecuniary benefits that a stationary controlling shareholder \(V_0\) has in a corporation is the sum of the present values of “normal dividends” (i.e., the present value of accumulated pro-rata dividends in the future) and “special dividends” (i.e., the present value of accumulated future extractions). Table 6 summarizes the aforementioned explanations.

\[\text{To use this formula, the discount rate } (r) \text{ should be greater than the growth rate } (g).\]
Table 6: The Present Value of Total Pecuniary Benefits to a Stationary Controlling Shareholder

- $V_0 = ND_0 + SD_0 = \frac{Div_1}{(r - g)} + \frac{Ext_1}{(r - g)}$

- $Div_1$: the amount of pro-rata dividend that a controller is paid at the end of year 1
- $Ext_1$: the amount of extraction that a controller siphons at the end of year 1
- $r$: the discount rate
- $g$: the growth rate
- $ND_0$: the present value of the sum of “normal dividends” (i.e., the present value of pro-rata dividends for a controller)
- $SD_0$: the present value of the sum of “special dividends” (i.e., the present value of extractions for a controller)
- $V_0$: the present value of the total pecuniary benefits that a stationary controlling shareholder has in a corporation = the present value of sum of pro-rata dividends and extractions = “normal dividends” plus “special dividends” = $ND_0 + SD_0$

(c) A Controller’s Rational Decision – To Be “Roving” Or “Stationary”

The above formulas explain how much pecuniary benefit – either through “normal” or “special” dividends – a controlling shareholder can expect, if he chooses to be stationary. On the other hand, a controlling shareholder may choose to be roving if he wishes. In that case, he takes all corporate wealth, including his own paid-in capital as well as the minorities’ at time 0 (now). Let us note the amount that a roving controller loots from a corporation through a one-shot transaction at time 0 as $ROV_0$. Then, as we have seen in the numerical example, a controlling shareholder will choose to be either roving or stationary.

So far, since he is assumed to be rational only in terms of wealth (I will loosen this assumption later in order to take into account non-pecuniary private benefits as well), he compares $ROV_0$ (the value that a roving controller loots from a corporation
through a one-shot transaction at time 0, i.e., now) and $V_0$ (the present value of total pecuniary benefits, consisting of normal and special dividends, to a stationary controller). The conclusion is obvious; if $ROV_0$ is larger than $V_0$, it is in his best interest to be roving; if $V_0$ is larger than $ROV_0$, a rational controller will choose to be stationary. I call it “one-factor analysis” since a controlling shareholder takes into account only the level of wealth, i.e., pecuniary benefit. One-factor analysis is summarized in Table 7.

Table 7: One-Factor Analysis – When a Controller Becomes Roving v. When He Becomes Stationary

- $ROV_0 > V_0$: a controlling shareholder chooses to be roving
- $ROV_0 < V_0$: a controlling shareholder chooses to be stationary
  - $ROV_0$: the total value that a roving controller loots from a corporation through a one-shot transaction at time 0 (now)
  - $V_0$: the present value of the total pecuniary benefit that a stationary controlling shareholder has in a corporation

$ROV_0$ and $V_0$ represent the liquidating and going concern values of private benefits of control respectively. In general, since the going concern value is larger than the liquidating value, it is likely that $V_0$ is larger than $ROV_0$ as long as a controlling shareholder is patient. This phenomenon is already shown in the aforementioned numerical example – if a controller waits for 20 years, being a stationary controller is the better choice for him than being a roving controller. In Olson’s world of political banditry, this common sense is explained in the same way – when a roving bandit settles down and rules over his subjects exclusively in a
certain domain as a stationary bandit, it is in his best interest to maximize the total value of theft in the long run.

However, it is an oversimplification to state that all controlling shareholders will choose to be stationary – there are several factors that affect the ultimate decision by a controlling shareholder. As seen in the formula, i.e., \( V_0 = \frac{[\text{Div}_1 + \text{Ext}_1]}{(r - g)} \), the amount of the total pecuniary benefits to a stationary controller \( (V_0) \) is the function of a dividend in year 1 \( (\text{DIV}_1) \), an extraction at a sustainable level in year 1 \( (\text{Ext}_1) \), the growth rate \( (g) \), and the discount rate \( (r) \). Given a dividend and a sustainable extraction level in year 1 \( (\text{DIV}_1 \text{ and Ext}_1) \), the amount of the total pecuniary benefits to a stationary controller \( (V_0) \) becomes larger: (i) when the growth rate \( (g) \) is larger, and (ii) when the discount rate \( (r) \) is smaller. Consequently, with the combination of a larger growth rate and a smaller discount rate, a controller is more likely to be a stationary controller. The reverse is true as well – with the combination of a smaller growth rate and a larger discount rate, there is more likelihood that a controller will be roving. In addition, we should bear in mind that the formula assumes that \( N \) approaches an infinite (or large) number and the “tax rate” is constant across all periods.
IV. FAMILY CORPORATIONS AND “STATIONARY” CONTROLLERS

So far, I have reviewed the foundation of economic analyses of stationary controllers. In this Part, I add the concept of “family” corporations to the analytical framework of stationary controllers, and make the generalized model more realistic. In fact, the concept of “family” corporations is very difficult to define, although it is always used colloquially. According to Professor Morck, there are at least two definitions of the “family” firm. First, broadly defined, it is used to refer to any firm with a dominant shareholder. Then Microsoft is a family firm, even though Bill Gates has given no notice of any intention to pass control to his sons or daughters. Second, if it is narrowly defined, a “family” corporation refers to a corporation where family control is expected to continue to the next generation through inheritance. This Article depends on the latter narrow definition of a “family” corporation.

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63 Morck & Yeung, supra note 61 at 3.

64 This Article uses terms such as “family business,” “family business group,” “business group,” “corporate group,” and “family corporate group” interchangeably.

65 Heirs may come to realize that professionals can run the family’s firms better than themselves and may opt to become passive investors with diversified portfolios of stock in firms they do not control. This appears to be the path chosen by numerous wealthy American heirs, including the Rockefellers (Morck & Yeung, supra note 61). However, this is not the case for some countries in East Asia. Rather than remaining wealthy but passive investors, family controllers and heirs like to control business groups even if they find more competent managers. This is because in East Asia, social
1. Length of Tenure and Controlling “Family” Shareholders

Suppose that for some reason, an absolute tyrant in a country stays on the throne for a short period. Accordingly, he does not have a long-term plan to pursue – as the final period approaches, it is in his best interest to take as much as possible as from his subjects. In this case, unfortunately, subjects are under a roving bandit and face a high risk of total plunder. As Professor Olson wisely explains, this is why the king’s subjects have more reason to be sincere when they say that “long live the king.” 66 “If the king anticipates and values dynastic succession, that further lengthens the planning horizon and is good for his subjects.” 67 With an infinite tenure through inheritance, the king is more likely to act as a stationary bandit who “benevolently” exploits people in his kingdom.

The same logic applies to the context of corporate governance in developing countries. In a bad-law jurisdiction, like a despotic kingdom, a controlling shareholder of a corporation has enormous power to extract corporate wealth at the expense of minority shareholders. Under these circumstances, the longer a controller’s tenure is, the more likely he is to be stationary, other things being equal. Since a stationary controller and minority shareholders share encompassing interests, minority shareholders wish to have a controller with a more extended horizon.

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66 Olson, supra note 8 at 571.
67 Olson, supra note 8 at 571.
Here, the notion of a “family” corporation comes into the economic analyses of stationary banditry. In the previous Part, I propose a model for calculating the present value of total pecuniary benefits to a stationary controller, which is based on the assumption that a controller’s tenure is infinite. Unlike a corporation that is an eternal entity, the life of a controlling shareholder is limited – therefore, the model is not practical. Through intra-family inheritance, however, a controlling “family” shareholder can achieve immortality (i.e., infinite tenure) as long as he treats his descendants’ utility as the equivalent of his own.\(^68\) One explanation of why a controlling “family” shareholder is altruistic for his children is that his genes will survive in his descendants as well. If genes consider a father (a today’s controller) and his children (future controllers) as the same entity, the father’s altruism is in fact, another appearance of genetic selfishness.\(^69\) Then, he is expected to keep a “golden goose” for the future rather than to kill it and take more eggs for today.

Now, by the introduction of the notion of “family,” the present value of total pecuniary benefits to a stationary controller, \(V_0 = \left[\text{Div}_1 + \text{Ext}_1\right] / (r - g)\),” which assumes an infinite time horizon \((N)\) of a controller, can be justified. The notion of “family” solves another difficult problem in a stationary controller as well. As seen in the above example of a tyrant, the final period problem may occur if his tenure is limited. In the context of corporate governance, it can be said that a controlling shareholder with absolute power is more likely to change his status from a stationary controller to a roving controller, as his final period of “reign” in a corporation becomes closer. However, family succession can reduce the likelihood of the final

\(^{68}\) Ronald J. Gilson, supra note 20 at 644.

\(^{69}\) I borrowed the terminology of the “selfish gene” from Richard Dawkins’ book “The Selfish Gene.”
period problem since the tenure is effectively extended to infinity via inheritance.70 Accordingly, a controlling “family” shareholder shares more encompassing interests with minority shareholders, and a family corporation is more likely to be prosperous and productive71 under the cooperative and repeated game between an immortal controller and public shareholders.

To be sure, it is in the best interests of minority shareholders to have good legal infrastructures and systems that protect their interests in corporations and the capital market. Nonetheless, if it is minority shareholders’ fate to stay in a bad-law jurisdiction and invest there, having a controlling “family” system may be more favorable to minority shareholders than having a corporate dictator – either a controller or professional manager – with limited tenure.

2. Non-Pecuniary Private Benefits of Control and Stationary Controllers

Extant literature predominantly emphasizes a controlling shareholder’s desire for pecuniary benefits – it is assumed that an economically rational controlling shareholder is only concerned about maximizing the level of wealth he can acquire. In reality, however, the psychological satisfaction arising from managing a corporation – for example, social prestige, reputation, and social influence72 – is an

70 See generally, Gilson, supra note 20.
71 Professor Olson said, “Given autocracy, then, dynamic succession can be socially desirable, both because it may reduce the likelihood of succession crises and because it may give monarchs more concern for the long run and the productivity of their societies.” Olson, supra note 8 at 572. This explanation can be applied to “family” controlling ownerships in many developing countries as well.
72 See e.g., Gilson, supra note 4. Running sports teams is another example for gaining the non-pecuniary benefits. Gilson, supra note 4 at 1667. For example, the Steinbrenner family, even if they
important factor as well because a controlling shareholder considers it to be another form of “compensation.” Put simply, “money is not everything,” even to business people. 73 In that sense, the utility function of a controlling shareholder is more complicated than may have been thought – it should take into consideration not only pecuniary benefits but also non-pecuniary benefits. 74 In this sense, the goal of a controlling shareholder is not to maximize his wealth, but to maximize his utility from a combined “consumption”75 of pecuniary and non-pecuniary benefits.76

73 Economics is not merely a study of “money.” Instead, it is a study of incentive, utility, and the happiness of human beings. Thus, psychological satisfaction should be included as an important factor when we analyze based on the “economics” model. For example, “Some managerial teams attempt to insulate themselves from investors’ control in order to carry out programs that they view as more important than profits. Both the New York Times and the Wall Street Journal have established structures that give their managers substantial freedom to produce news at the (potential) expense of profit.” FRANK EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 13 (Harvard University Press 1996).

74 Professor Gilson is one of the first few scholars who take into account the presence and value of non-pecuniary private benefits of control. See e.g., Gilson, supra note 20.

75 I use the word a “consumption,” because my argument here partially relies on a microeconomics theory of a consumer’s optimization.

76 Indeed, figuring out the value and utility of psychological satisfaction is not a simple job. Measuring wealth is relatively easy (in fact, it is not easy as well) because at least a dollar amount is measurable. On the other hand, measuring psychological utility is almost impossible; there is no market price for psychological pleasure that is valued objectively; psychological utility is a subjective value system by its nature. The relative price of pecuniary and non-pecuniary private benefits constantly changes depending on situations including the absolute amount of her wealth – for example, the marginal utility of non-pecuniary private benefits of control decreases as her wealth, including pecuniary benefits, accumulates; in addition, there is not even a definition of “one unit” of non-pecuniary benefits that can be converted into some amount of dollars. Probably, these are reasons why extant literature has not paid attention non-pecuniary benefits in detail – in other words, how can we add up the utility of non-pecuniary and pecuniary benefits that lack a common and justified unit? Despite these problems, however, at least a theoretical economic model on the utility function of a controlling shareholder should take into consideration the presence of non-pecuniary benefits. Without non-pecuniary benefits of control, we may not precisely understand what determines a controlling shareholder’s strategic and operational decisions in a controlled corporation. In particular, the presence of non-pecuniary benefits may be a significant factor that can alter the looting policy of a controlling shareholder – whether he would be a “roving” or “stationary” controller.
Indeed, every human being wants to show that he has achieved more than other people have done. To business people, for example, building their own business empire is a special achievement that other people may not be able to do. Now, by bequeathing his throne to his children, the founder of a family corporation can continue to impact the world even after his death – his (selfish) gene is still alive in the next generations. Keeping the family name in their empire – in itself does not generate money though – is significantly valuable to a controlling family.

(a) One-Factor Analysis v. Two-Factor Analysis

In the previous Part, I introduced “one-factor analysis” of a controller’s determining whether to be roving or stationary. When only pecuniary benefits are taken into consideration, a rational controller should compare the dollar amount of ROV (i.e., the value that a roving controller loots from a corporation through a one-shot transaction at time 0, i.e., now) and V (i.e., the present value of the total pecuniary benefit to a stationary controller): (i) when ROV is greater than V, he chooses to be a roving controller; (ii) when V is greater than ROV, he chooses to be a stationary controller.

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77 See supra note 69.

78 We have sometimes seen that dictators bequeath their position to children. A notable example is the Kim dynasty in North Korea. Kim Il-Sung observed that Khrushcheyv denounced Stalin in the Soviet Union after Khrushcheyv succeeded Stalin. Perhaps, Kim Il-Sung was deeply concerned about a possible denouncement after his death. In order to reduce this risk, Kim Il-Sung appointed his son (Kim Jung-II) as his successor (in fact, while I am writing this Article, Kim Jung-II appointed his son – i.e., Kim Il-Sung’s grandson – Kim Jung-Un as his successor as well). This example in North Korea shows how human beings care about their “name” and “reputation” even after their death. This tendency may be true for business people as well, although the extent varies in each country.
After recognition of the presence of non-pecuniary benefits, however, a controller will take into account both pecuniary and non-pecuniary benefits when determining to be roving or stationary. Thus, “two-factor analysis,” which better reflects reality, is now required. Let us note the present value of non-pecuniary benefits of control, including a controller’s descendants’, as \( \text{Alpha} \). Then, a controlling shareholder should compare \( ROV_0 \) and the sum of two factors, \( V_0 \) and \( \text{Alpha} \): (i) when \( ROV_0 \) is greater than the sum of \( V_0 \) and \( \text{Alpha} \), he chooses to be roving; (ii) on the contrary, when the case is the reverse, he chooses to be stationary.

Table 8 shows this explanation.

**Table 8: One-Factor Analysis v. Two-Factor Analysis**

- **One-Factor Analysis**
  
  (i) \( ROV_0 > V_0 \): a controlling shareholder chooses to be roving
  
  (ii) \( ROV_0 < V_0 \): a controlling shareholder chooses to be stationary

- **Two-Factor Analysis**
  
  (i) \( ROV_0 > V_0 + \text{Alpha} \): a controlling shareholder chooses to be roving
  
  (ii) \( ROV_0 < V_0 + \text{Alpha} \): a controlling shareholder chooses to be stationary

- \( ROV_0 \): the value that a roving controller loots from a corporation through a one-shot transaction at time 0, i.e., now
- \( V_0 \): the present value of the total pecuniary benefit to a stationary controller
- \( \text{Alpha} \): the present value of non-pecuniary benefits of control, including a controller’s descendants’
What is the implication of the new approach, i.e., two-factor analysis, in the context of a controlling shareholder system with bad-law? Under the two-factor analysis, even if \( ROV_0 \) is much greater than \( V_0 \), a controlling shareholder chooses to be stationary as long as \( \text{Alpha} \) compensates for the difference of two numbers \( (ROV_0 - V_0) \). For example, when \( ROV_0 \) is 100 million dollars and \( V_0 \) is only 70 million dollars, according to the one-factor analysis, a controller definitely should choose to be roving. However, under the two-factor analysis, a controller should choose to be stationary as long as the value of a family’s non-pecuniary benefits (i.e., \( \text{Alpha} \)) is more than 30 million dollars.

As such, there is more likelihood that a controlling shareholder will be found as stationary when applying the two-factor analysis (rather than the one-factor analysis) and when the value of \( \text{Alpha} \) is large. The more highly a controlling family shareholder values reputation, social prestige and family influence, the larger the value of \( \text{Alpha} \) is for him – accordingly, the more likely it is that the controller will be stationary. Since \( \text{Alpha} \) is defined as the non-pecuniary private benefits to all family members, a significant part of the value of \( \text{Alpha} \) may be reserved for a controller’s future descendants if a controlling family shareholder treats his descendants’ utility as approaching equivalence to his own. Conversely, when he does not put a high value on his descendants’ happiness, the value of \( \text{Alpha} \) will be deeply discounted. Thus, when the incumbent controller is more altruistic to his future descendants, the value of \( \text{Alpha} \) is larger.

From the perspective of minority shareholders, the presence of a large \( \text{Alpha} \) is more beneficial. Since the larger \( \text{Alpha} \) makes the controller more stationary, it is
expected that the controlling family shareholder with the larger Alpha will extract pecuniary private benefits to a more lenient degree.

(b) Interplay between Pecuniary and Non-pecuniary Benefits in Family Corporations

There is a proverb in East Asia: “The King is a ship and his subjects are water. A ship floats on the water, but the same water can overturn the ship.” In history in the East and the West, we know that harsh taxation and looting by an absolute monarch has lead to his subjects’ discontent, resistance, and ultimately to a revolution resulting in ending the dynasty – broadly defined, perhaps the Boston Tea Party is an example as well. This lesson is applicable to family shareholders managing large corporations as well, because family controllers are despotic “kings” in corporations that are their empires. In fact, it is almost impossible for minority shareholders to “overthrow” a particular controlling shareholder in active ways even if they are deeply discontented with corporate performance and governance; first, a controlling shareholder has by definition a majority of votes; and second, minority shareholders face a huge collective action problem hindering a successful insurgency. Nonetheless, minority shareholders can punish a tyrannical controlling shareholder by adopting a passive method of resistance: “voting with their feet.” When an unjustified “tax” by a controller (in the form of minority extraction) is harsh enough, minority shareholders will sell their shares (i.e., by following the Wall Street Rule) and exit a corporation, devastating the corporate dynasty.
It is noteworthy that a displeased minorities’ exit after cruel theft might not be a punishment at all to a roving controller. All a roving controller is concerned about is how to efficiently extract money from minority shareholders at the time when he loots, i.e., today. After looting, he does not care whether minorities leave a corporation, which is left as a shell. Clearly, a roving controller does not have any incentive to maintain a shell company as his empire for the future. In other words, tomorrow is not existent in a roving controller’s mind, and losing his empire by the minorities’ exit is an absent concern.

As such, minority shareholders’ collective decision to follow the Wall Street Rule\textsuperscript{79} and enact an exodus from a business empire threatens only a stationary controller. Having a large base of minority shareholders gives huge advantages to a stationary controller because it is the essence of non-pecuniary private benefits; the more minority shareholders a controlling family shareholder has, the more equity he holds in a corporation and the more debts he can borrow. As a result, he is able to control more assets, which means he is able to build a larger empire. Conversely, when a controlling family shareholder has a small base of minority shareholders, he will end up having a small empire, which reduces his (and his descendants’) non-pecuniary private benefits significantly. Consequently, minorities’ collective exit from a controller’s corporate empire works as a prime punishment to a controller.

In that sense, if non-pecuniary benefits – especially benefits arising from maintaining the control of large corporations – are highly valued in a particular culture, a controller with a long-term plan has an incentive to be recognized as a

\textsuperscript{79} Wall Street Rule is the tendency of shareholders to sell their stocks when they are disappointed by those stocks.
benevolent bandit. It is because by imposing low “taxation” on minority shareholders, a controller is able to manage a larger corporation and enjoy higher non-pecuniary benefits as a result. In other words, if a king wishes to rule over a larger empire, ultimately he should “buy” more subjects’ support (or public opinion) by reducing the tax rate. 80

The more interesting factor to consider is that the value increase of the non-pecuniary benefits to a controller might lead to the value increase of the pecuniary benefits to a controller as well. As is explained earlier, a reduction in the “tax rate” (i.e., extraction rate) sometimes increases “tax revenue” (i.e., pecuniary private benefits) due to the enlarged “tax base” (i.e., minorities’ investment in a corporation) when the current “tax rate” is above the optimal level maximizing revenue. In this case, a controlling shareholder may attain more pecuniary and non-pecuniary benefits (i.e., expansion of his empire) by lowering the “tax rate.”

It is noteworthy that, even when a reduction in the “tax rate” decreases “tax revenue” (when the current “tax rate is below the optimal level), the “tax rate” reduction is often beneficial to a controller. Why? Now, the lower “tax rate” decreases pecuniary benefits for a controller. However, it increases non-pecuniary benefits since more minority shareholders come to “reside” in his empire. Thus, as

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80 In fact, minority shareholders do not know how much a controlling shareholder extract pecuniary private benefits. However, in the capital market, they are able to know the after “tax” (extraction) return i.e., the return that they receive after a controlling shareholder extracts pecuniary benefits as “tax.” Then, it can be said that what minority shareholders care is not how much a controlling shareholder takes extraction, but how much they receive ultimately after a controller’s extraction. Public shareholders will eventually migrate to a corporation where they can receive more after “tax” return. Under these circumstances, a controlling shareholder faces two scenarios; the one is to increase the firm value more than other controllers and takes a large amount of extraction from the corporation; the other is not to take extraction from the corporation very much if he does not enhance the firm value more than other controllers. Therefore, a more efficient and competent controlling shareholder can extract more from the corporation without losing minority shareholders. However, if the efficiency of most controlling shareholders is similar, most controllers would choose to take extraction comparably with other controllers in order not to lose minority shareholders.
long as any additional non-pecuniary benefits are larger than foregone pecuniary benefits, even choosing a lower “tax rate” than the optimal point will lead to a higher utility for a controller. Again, it cannot be overemphasized that the aim of an individual human being, including a controller, is not to maximize wealth, but to maximize utility consisting of psychological satisfaction as well as wealth – therefore, a controller’s aim is not to maximize “tax revenue” but to maximize the sum of the pecuniary and non-pecuniary benefits from running his kingdom.

(c) Summary of Non-pecuniary Benefits

A roving controller takes everything from minority shareholders – it is equivalent to saying that his “tax rate” is 100 percent. In contrast, a stationary controller’s “tax rate” is much lower than that of a roving controller. However, by choosing an optimal “tax rate,” a stationary controller may maximize “tax revenue.” To a stationary controller, protecting minority shareholders by reducing the “tax rate” is in fact protecting and improving his interests.

The presence of non-pecuniary benefits can reduce a stationary controller’s “tax rate” further. “Tax revenue” accounts for a large part of the pecuniary benefits for a stationary controller. However, a controller is willing to give up some pecuniary benefits as long as the utility achieved from additional non-pecuniary benefits is larger than the utility foregone from lost pecuniary benefits. If sufficient utility from non-pecuniary benefits is attained from expanding the business empire, it is possible that a stationary controller is more benefited by reducing the “tax rate” from the
optimal point, resulting in lowering “tax revenue” and pecuniary benefits. When this is the case, minority shareholders find that having a stationary controller is more beneficial to them than having a roving controller in two ways: (i) through a controller’s reduction of the tax rate from 100 percent to the optimal tax rate; and (ii) through a controller’s additional reduction of the tax rate from the optimal tax rate to the tax rate that can maximize the sum of pecuniary and non-pecuniary benefits for a controller. In other words, when a controller takes into consideration non-pecuniary benefits of control, it is possible that the controller’s optimal tax rate is reduced further.

**Figure 2: Optimal Tax Rate 2**

X axis: “tax rate” (extraction rate) by a controller
Curve 1: “tax revenue” (pecuniary private benefits of control) by a controller
Curve 2: value of non-pecuniary benefits of control
Curve 3: Curve 1 + Curve 2

Implication: The optimal “tax rate” (max 3), where the sum of pecuniary private benefits and non-pecuniary benefits of control are maximized, is smaller than the optimal “tax rate” (max 1), where pecuniary private benefits of control are maximized.
In sum, both a controller and minority shareholders are likely to be more satisfied under a stationary controller’s reign than under a roving controller’s reign – Pareto improvement takes place in the economy of stationary controllers. A stationary controller can be praised as a “benevolent” king by minority shareholders who are pleased with the low “tax rate.” As a result, the ship can stably float on the peaceful water.

3. Reputation\textsuperscript{81} as Being (Benevolent) Stationary Controllers

So far I have dealt with the circumstances under which a controlling shareholder chooses to be stationary. After evaluating his utility by two-factor analysis, a controller will decide to be stationary if being stationary provides more utility to him than being roving. Then, minority shareholders are assumed to know with perfect certainty that a controller they encounter is stationary. Under this assumption, it is rational for minority shareholders to participate in transactions with a stationary controller in the capital market since by doing so, they are benefited as well.

As opposed to this assumption, in reality, even if a controller would like to act as a stationary controller, minority shareholders are not able to know for sure that the

\textsuperscript{81} According to Shleifer & Vishny, “Reputation building is a very common explanation for why people deliver on their agreements even if they cannot be forced to.” “[S]everal recent articles have presented reputation-building models of private financing. Diamond (1989, 1991) shows how firms establish reputations as good borrowers by repaying their short term loans, and Gomes (1996) shows how dividend payments create reputations that enable firms to raise equity.” See Shleifer & Vishny, supra note 26 at 749.
controller they deal with is truly a stationary controller – asymmetric information exists. When minority shareholders do not trust that a controller is stationary, they do not cooperate with him in the capital market. Expecting this mistrust among minority shareholders, a controller will abandon the option to be stationary in the first place, even though being stationary would generate much better utility for him than being roving. In this Section, problems associated with trust by public shareholders and the reputation of a stationary controller are analyzed more in-depth.

(a) Distrust among Potential Minority Shareholders

As we have seen previously, the going concern value of a controller’s pecuniary benefits ($V_0$) is generally larger than the liquidating value of his looting ($ROV_0$). Then, there is a fairly high possibility that the sum of the value of non-pecuniary benefits ($\text{Alpha}$) and the going concern value of pecuniary benefits ($V_0$) is larger than the liquidating value of looting ($ROV_0$). Consequently, given the assumption that a controlling family shareholder is patient and holds a long-term horizon, being a stationary controller by receiving the sum of $\text{Alpha}$ and $V_0$ is more advantageous to a family controller.

The above conclusion, however, is conditional on a controlling shareholder being able to take a series of extractions continuously from minority shareholders – a large part of $V_0$ is made by continuous extractions. In order for a controller to extract continuously from minorities, he needs to attain minorities’ “trust” that he is truly stationary. Then, what if investors in the capital market do not trust a controlling
shareholder’s integrity as a stationary controller? For example, investors may think that a controller is not patient enough to plan for the future or that his discount rates are prohibitively high – as a result, investors may conclude that a controller they face is more likely to be roving. In that case, many potential minority shareholders will not invest their money in the first place for fear of total plunder by a roving controller. Then, how can a controlling shareholder take a series of extractions continuously when he will not have sufficient minority shareholders in the next stage? In addition, if a controller’s integrity is questioned, the value of non-pecuniary benefits (Alpha) will eventually shrink to zero in the near future since the controller will manage a corporation which no longer has many minority shareholders – the fewer minority shareholders a controller retains in the corporation, the less non-pecuniary benefits there are.82

Facing the possibility of distrust among potential minority shareholders, a controlling shareholder is likely to end up with a small value of $V_0$ and $Alpha$ – now, there is substantial likelihood that the sum of $Alpha$ and $V_0$ is smaller than $ROV_0$. If so, a controlling shareholder will choose to be roving even if he initially wishes to be stationary – in this case, it is his optimal strategy to take everything from a corporation, which is detrimental to the existing minorities. Indeed, it is not primarily important whether a controller is a stationary controller. Instead, whether the market

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82 If there is not sufficient equity influx from outside minority shareholders in the next stage, a controlling shareholder will be unable to use more debts as well due to the constraint of the debt to equity ratio – the size of the total debt that a controlling shareholder can use is linked to the size of available equity. In turn, a corporation’s asset size – which is the sum of debt and equity – shrinks. Among others, non-pecuniary private benefits of control arise primarily from the asset size of a corporation that a controlling shareholder manages. Thus, if she does not find more minority shareholders in the next stage, a controller’s non-pecuniary benefits associated with empire-building are ultimately lessened significantly. Consequently, the value of $Alpha$ will approach zero.
deems a controller to be a stationary controller is more significant and determinative. Put differently, the relevant question is not who you are, but who you seem to be.

Thus, a stationary controller has to convince potential minority shareholders that he is sincerely stationary. By assuring prospective investors, a controlling shareholder can play the game repeatedly\(^{83}\) in the capital market. Since a stationary controller, by definition, is required to have continuous transactions with minority shareholders, establishing his integrity is the first thing he has to do in the market. Consequently, a stationary controller has to send off a credible signal to minority shareholders that he is really a stationary controller. Otherwise, he will end up being a roving controller against his initial will and intent.

**(b) Reputational Advantages of Family Corporations**

Indeed, a controlling shareholder finds it difficult to send a credible signal to the capital market that he is a benevolent (stationary) controller. When a capital market faces a huge problem of asymmetric information among market participants, a controller encounters a greater challenge when attempting to convince minorities that he is different from roving bandits who perhaps are prevalent in the market place.

We often observe that corporate tycoons are involved in philanthropy – for example, many of them build non-profit foundations and donate scholarships for poor but capable students. Although mostly their generosity might be sincere, they

\(^{83}\) When two parties in the market (i.e., a controlling shareholder and minority shareholders) do not make another transaction again, neither player needs to cooperate since neither is not concerned about the potential penalty imposed by the other. As such, the prisoners’ dilemma arises and the end result is that each player chooses to “defect.” However, if they are involved in repeated transactions, they will cooperate and Pareto improvement will be achieved.
sometimes use disguised altruism for image-making purposes – they would like to show to the world that they are good and trustworthy people. Put differently, such donations and other forms of philanthropy sometimes function as “advertisements” or public relations (PR) portraying that corporate tycoons are truly honest and principled and do not cheat investors and consumers.

In this sense, a “family” controller has a comparative advantage in building a reputation and convincing prospective investors of his integrity. Why? It is almost impossible for investors to know whether, in a controller’s own mind, he is roving or stationary. This is the reason that business people need to take costly measures such as sending off signals and “advertisements” to show that they are trustworthy businessmen or at least stationary bandits. In contrast, investors are able to recognize more easily that a certain corporation is a “family” corporation by reviewing the corporate governance structure (e.g., how shares are spread among family members, whether children of a founder are managers or directors of a corporation, etc.). Clearly, it is more convenient for minority shareholders to observe the appearance of a corporation than to scan the mentality of a controller.

When a sufficient number of prospective investors share the common opinion that a particular corporation is a family corporation, the market will presume that the tenure of a controller is perpetual via inheritance. Then, potential minority shareholders trust that the controller will make repeated transactions with them in the capital market for a long time. In other words, investors understand that it will likely be in a controlling family shareholder’s best interest to be stationary if he is involved

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84 This point should be credited to Professor Merritt B. Fox. When I discussed this Article with Professor Fox, he mentioned that public relations and image-making through donations and philanthropy can make business tycoons look sincere and moralistic.
in repeated transactions in the capital market. Based on this belief, market participants implicitly anticipate that the final period of transactions will not be set within the reasonably foreseeable future. As such, no backward induction will take place in these transactions, and coordination between minority shareholders and a controller is expected to continue, which results in enhanced benefits for both parties.

(c) Reputational Advantages of Family Corporate “Groups”

The comparative advantage of a family corporation in signaling a controller’s trustworthiness as a stationary controller is more apparent in a family corporate “group” context. Once a controlling family shareholder is trusted by potential minority shareholders in one subsidiary, he is able to use scale and scope economy to maintain his family’s reputation by means of a diversified corporate “group,” because a controller’s reputation need not be industry-specific. Scale and scope economy lessens the transaction costs of convincing minority shareholders as to his integrity, and he can significantly enlarge the base of minority shareholders who are induced to trust him by his already verified reputation.

Further, the presence of a corporate “group” works as a safety net for minority shareholders because in a corporate group, a controlling shareholder will not easily renge on his promise to be stationary. Why? If he deserts minority shareholders in

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85 Of course, the decision of whether or not to continue to act as a stationary controller is totally dependent on the controller’s discretion or whim. However, investors expect that if the controller is reasonable, he will not suddenly become a roving bandit unless there are revolutionary or catastrophic changes in the business environment surrounding him.

86 Gilson, supra note 20 (continuing to explain that “Once family ownership is established, the marginal cost of transmitting that fact, and thereby providing a foundation for reputation-based trading, is decreasing with scale”).
the next stage for some reason, the adverse effect of breaking “an implicit contract” – a contract to be stationary and receive investors’ money – will be amplified through scale and scope economy of the reputation built in his corporate group. The reputation of a controller’s corporate group as a whole will be tainted in the capital market, and there is substantial risk that minority shareholders will exit en masse from all subsidiaries when he does not meet investors’ expectations in even one subsidiary.

In the analysis of banditry, it is noteworthy that one of reasons roving bandits are prevalent in a particular country is that there are so many bandits who are uncoordinated with respect to theft. When “a common well” is available to many bandits, it is in their best interest to be roving – if one bandit waits to steal until tomorrow, other bandits will take everything today before he does. In contrast, if there are a small number of (gigantic) bandits who are able to monopolize theft from subjects (i.e., victims) in their own domains, they are more likely to consider long-term prosperity. Knowing this, subjects tend to believe that these powerful bandits who establish their reign to nearly the full possible extent are benevolent and stationary. In effect, under the powerful and monopolistic banditry, bandits and victims are on the same ship – cooperation is the best solution for both bandits and victims. As a result, a positive feedback loop is formed between bandits and victims and it generates mutual benefits.

The same logic can apply to the relationship between controlling shareholders and minority shareholders in a developing country. Suppose that a developing economy – which is far smaller than the economy of the United States – is
predominated by family corporate “groups” consisting of a score of subsidiaries. It means that a very small number of wealthy families dominate the entire economy of the country. Naturally, these family controllers have (quasi) monopolistic power vis-à-vis minority shareholders and there is only a low probability of a common well problem occurring. Thus, controllers in corporate groups are more likely to have long-term horizons than those in small corporations.

Consequently, in the capital market, signals of integrity from a “corporate group” are treated as being more creditworthy than those from an “individual corporation.” A controller in a corporate group and minority shareholders are more likely to be involved in coordination and a self-enforcing mechanism through repeated games in the capital market, which leads to economic development. In this sense, paradoxically there is high possibility that a developing country is better off with a (quasi) monopoly by a small number of large players (i.e., family corporate groups) in the capital market than with competition between a large number of independent corporations. In sum, in terms of extraction and stealing, a monopolized banditry is much better to investors and an economy as a whole than a competitive one.
V. WHAT MAKES IT DIFFICULT FOR A FAMILY CONTROLLER TO BE STATIONARY?

So far, I have examined why a controlling family shareholder is *more likely* to be a stationary controller. Nevertheless, it should be emphasized that I say here “more likely.” Put differently, I do not mean that every controlling family shareholder is stationary. In this Part, I will review which factors make it difficult for a family controller to be a stationary controller, by using the formulas that I already introduced *infra*. Table 9 presents a recap of the formulas.

Table 9: Recap

<table>
<thead>
<tr>
<th>The Present Value of Total Pecuniary Benefits to A Stationary Controller</th>
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<tbody>
<tr>
<td>$V_0 = ND_0 + SD_0 = \frac{Div_1}{(r - g)} + \frac{Ext_1}{(r - g)}$</td>
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Notations
- $Div_1$: the amount of pro-rata dividend that a controller is paid at the end of year 1
- $Ext_1$: the amount of extraction that a controller siphons at the end of year 1
- $r$: the discount rate
- $g$: the growth rate
- $ND_0$: the present value of the sum of “normal dividends” (i.e., the present value of pro-rata dividends for a controller)
- $SD_0$: the present value of the sum of “special dividends” (i.e., the present value of extractions for a controller)
- $V_0$: the present value of total pecuniary benefits that a stationary controlling shareholder has in a corporation = the present value of the sum of pro-rata dividends and extractions = “normal dividends” plus “special dividends” = $ND_0 + SD_0$

Two Factor Analysis
(i) $ROV_0 > V_0 + Alpha$: a controlling shareholder chooses to be roving
(ii) $ROV_0 < V_0 + Alpha$: a controlling shareholder chooses to be stationary
1. Variables in the Formulas Determining the Present Value of Extractions by a Stationary Controller

As seen in the recap, the present value of extractions by a stationary controller \( (SD_0) \) is determined by three variables – the dollar amount of an extraction in year 1 \( (Ext_1) \), the discount rate \( (r) \), and the growth rate \( (g) \). The assumptions in the formulas are: (i) the discount rate is constant; (ii) the dollar amount of an extraction will increase at a constant rate; and (iii) the length of a controller’s tenure is infinite.

\( (a) \) What If the Discount Rate Is Very High?

The discount rate \( (r) \) is very high when a corporation is subject to high risks, such as systematic macro-economic and country risk. Then, the present value of total pecuniary benefits to a stationary controller \( (V_0) \) decreases. Accordingly, since the total value that a roving controller loots from a corporation through a one-shot transaction at time 0 \( (ROV_0) \) has more chance of being larger than the sum of \( V_0 \) and Alpha, being a roving controller is increasingly attractive to a controlling shareholder. For example, suppose that a controller is concerned about the possibility of hyperinflation in the future. It will weaken the incentive of a controller to be stationary in the first place, since the inflation risk will increase the discount rate \( (r) \) and reduce the present value of total pecuniary benefits to a stationary controller \( (V_0) \).

Political risks in a specific country are a significant factor to determine the discount rate \( (r) \) as well. If the political system of a country is unstable and the
government-business relationship does not protect businesspeople in the long run, controlling shareholders are not able to set up a long-term plan, which will hamper a controlling shareholder’s desire to be stationary. For example, suppose that the government expropriates properties of businesspeople without due process and punishes them at its discretion. In other words, the government is more like a roving bandit in relation to businesspeople, who are victims in this context. As a result, businesspeople who are concerned about total expropriation by the government have a strong incentive to siphon corporate wealth as soon as possible and remit money to foreign countries. Consequently, reasonable controllers find that being roving is a better option than being stationary in the presence of a roving government. Conversely, when the government in a developing country is stationary rather than roving in relation to the business circle, the possibility that a controller will become stationary vis-à-vis minority shareholders increase.

Another important issue about the discount rate \((r)\) is how accurately and objectively it is determined. In general, the discount rate in the capital market is determined by the market consensus. There are two particular challenges to this general idea when it comes to analyzing capital markets in developing countries. First, it is uncertain whether an “objective” market consensus is existent in developing countries where capital markets are not sophisticated and “efficient.” The “objective” market consensus on the discount rate (which affects the present value of pecuniary benefits to a stationary controller) has a prerequisite that the capital market in the economy at issue is “efficient.” Since many developing countries do not have efficient capital markets, it is highly dubious that the “objective” market consensus on

87 For example, the government in a developing country may send businesspeople to prison if it wishes.
the discount rate is existent. Since there is no credible discount rate, the present value of pecuniary benefits to a stationary controller, i.e., $V_0$, also cannot be calculated in a credible way. In contrast, a roving controller knows relatively well the total value that he loots from a corporation through a one-shot transaction now, i.e., $ROV_0$, because he does not have to infer future discount rates for $ROV_0$. Under these circumstances, a controller is more inclined to choose to be roving.

Second, even if the market reaches a consensus on the discount rate, it functions only as the “objective” measurement in the market. Although it is possible that controllers may use the “objective” discount rate determined by the market, it is more likely that they will rely on their own “subjective” evaluation of risk and time preference. Under these circumstances, even if the discount rate objectively measured in the market is in fact low, the discount rate that a stationary controller perceives that he will apply in the formula can be much higher. This takes place, for example, because a controller is particularly impatient or pessimistic toward the future as opposed to the general evaluation of the market. Or, it could happen because the illiquidity of the market for corporate control in a developing country makes the discount rate higher. In sum, the “objective” discount rate functions only as a “reference” to controllers in developing countries, even if the market generally agrees on the number, which in fact is quite difficult in an inefficient capital market in a developing country. Ultimately, controllers use their subjective (rather than objective) discount rate in formulas for figuring out the present value of pecuniary benefits. When their subjective discount rate is high enough compared to the general
market evaluation, they will choose to be roving controllers rather than stationary controllers.

(b) What about the Growth Rate and Stream of Cash Flows?

According to the formula, the present value of total pecuniary benefits to a stationary controller becomes smaller as the growth rate \((g)\) decreases. Thus, when the growth rate \((g)\) is so small that \(ROV_0\) is larger than the sum of \(V_0\) and \(Alpha\), a controlling shareholder will rationally choose to become a roving controller. The growth rate is a function of many factors, such as the political stability, business-labor relations, and industries where controlling shareholders participate, and the managerial capability of a controller.

In addition, if a stream of cash flows – the sum of “normal” dividends (i.e., justified dividends) and “special” dividends (i.e., extractions through private benefits) – is uncertain and unstable from a controlling shareholder’s point of view, he is more likely to choose to be roving. Why? One of the assumptions of the formula is that both (“normal” and “special”) dividends in each period increase at the constant rate of growth rate \((g)\). Thus, for example, if the amount of extractions is highly volatile across years – for one year it increases, and for another year it decreases – the formula is not very reliable. An alternative explanation is that, in that case of volatile dividends, a controller may apply a higher discount rate for the higher risk, i.e., a higher standard deviation of dividend payments. As a result, a controller may choose
to be roving, which is the opposite phenomenon from what is expected by the original formula.

In general, keeping the “golden goose” is seen as a better idea than killing it. As long as the value from two factors (i.e., pecuniary and non-pecuniary benefits) exceeds the one-shot extraction that generates only lump sum of pecuniary benefits, it is a better choice to be stationary. However, time, as usual, is a core issue. When the breakeven point is expected to be reached in 10 years, many controllers will probably choose to be stationary. When it is in 30 years, it is obvious that fewer controllers will do so. Fewer people are sure whether the “golden goose” can still generate good-quality eggs in 30 years. Thus, it may be a better decision for him to take a certain amount of $ROV_0$ today rather than the uncertain sum of $V_0$ and Alpha, most of which will be determined in the far future. A financial epigram describes this situation well – “A bird (i.e., a certain amount of $ROV_0$) in hand is worth two (the uncertain sum of $V_0$ and Alpha) in the bush.”

(c) What If a Controlling “Family” Shareholder Does Not Treat His Descendants’ Utility as Exactly Equivalent to His Own?

So far, this Article has assumed that a controlling “family” shareholder treats his descendants’ utility as exactly equivalent to his own.88 In other words, parents are deemed to be absolutely altruistic towards their children. Of course, parental affection for their children is universal, so children’s utility is generally a part of parents’ utility as well. However, this does not necessarily mean that “one” unit of

88 See Gilson, supra note 20.
utility accruing to a controller’s children is exactly as valuable as “one” unit of utility to an incumbent controller. Thus, the extent to which the assumption holds varies across countries depending on their cultures and other socio-economic circumstances. In some countries, this assumption might be almost true. In other countries, it is far from the reality.\textsuperscript{89}

Suppose that a representative controlling shareholder in a country treats his descendants’ utility as significantly different from his own (i.e., suppose that a controller treats his defendants’ utility as \textit{less} important), which is sharply against the assumption that he considers his children as alter ego. The formula of the sum of pecuniary and non-pecuniary benefits for a stationary controller is dependent on the above assumption. If the reality is far different from the assumption, the formula should be modified accordingly as well. In the modified formula, the discount rates that apply to the future benefits of offspring should be augmented since the future benefits accruing to his descendants are \textit{less} valuable to the controller who is not perfectly altruistic to his progeny.

Under these circumstances, for example, a founding controller may have more than two stages in the discounted cash flows of his and his next generations: (i) in the first stage, when he manages a corporation, the discount rate that he faces is the same as \( r \); (ii) but, in the second stage (after he dies or retires), when his descendants manage the corporation, the discount rate that he psychologically feels is not \( r \) anymore, but \( r + \beta \) (\( \beta > 0 \)). If this is the case, the real present value of the total pecuniary benefits to a stationary controller (the real \( V_0 \)) is (much) smaller than the

\textsuperscript{89} Even if I judge on a \textit{national} or \textit{cultural} basis here, it is obvious that the relationship between a parent and children in a family corporation significantly varies on an \textit{individual} basis as well.
model-based present value of the total pecuniary benefits to a stationary controller \( (V_0) \). Then, there is more probability that a controlling shareholder would have been found as a roving controller in the first place.

\[ (d) \text{ What If the Value of Alpha (the Value of Non-Pecuniary Benefits to a Controller) Is Very Small?} \]

In the two-factor analysis, the value of \( \text{Alpha} \) (the value of non-pecuniary benefits to a controller) plays a key role in determining whether a controlling shareholder chooses to be roving or stationary. When the value of \( \text{Alpha} \) is meaningful compared to the value of pecuniary benefits, a controlling shareholder is more likely to be a stationary controller. But when its relative value is not large enough, he is more likely to be a roving controller. In that sense, it is of significance to understand the relative value of pecuniary and non-pecuniary benefits to a controlling shareholder. The relative value of pecuniary and non-pecuniary benefits is determined by many factors, such as culture, the idiosyncratic psychological standard of a particular controller, and the absolute level of wealth accumulation – among these, I pay more attention to the absolute level of wealth accumulation in the following.

The analysis of the “luxury good” in microeconomics theory is useful to explore the relationship of pecuniary and non-pecuniary benefits to a controller. For example, in New York, people may enjoy Broadway musicals \textit{only if} the level of income that people make is more than living costs – in other words, Broadway
musicals are a luxury good, while food, clothes, medical expenses, and shelter are necessities to New Yorkers. Similarly, only when the level of the wealth that a controlling shareholder accumulates exceeds some satisfactory point, does he start considering the non-pecuniary benefits. In that sense, unless a controlling shareholder is super-wealthy, he does not “demand” and cannot “consume” the non-pecuniary benefits, a luxury good. In this case, since the controlling shareholder does not enjoy many non-pecuniary benefits, the value of Alpha is not a significant number. Consequently, since the total benefits for the controller are almost all from the pecuniary benefits, it is more probable that he is going to be roving.

2. A Family Controller Managing a Small Corporation

As I explained earlier, a controller in a family corporation is more likely to be stationary compared to that of a non-family corporation because of the potentially infinite duration of a family corporation, other things being equal. In this Section, I provide the hypothesis that among family controllers, while a controller of a large family corporation is more likely to be stationary, a controller of a small family corporation is more likely to be roving for the following reasons.

First, when a corporation is small, the absolute amount of extraction is in general small. The non-pecuniary private benefits of control that a family controller can enjoy are small as well since they are a positive function of the size of a corporation. In addition, since non-pecuniary benefits are a luxury good to a controller, they are less meaningful to a controlling shareholder who manages a small
corporation and does not accumulate wealth sufficiently to consume more non-pecuniary benefits. Accordingly, since *Alpha* and as a result the sum of $V_0$ and *Alpha* (the present value of pecuniary and non-pecuniary benefits to a controller) is small, a reasonable controller is more likely to become roving. Conversely, when a controller manages a large corporation, in general he has greater opportunity to maintain a large amount of extraction from the corporation, because although his “tax rate” is the same as that of another controller running a small corporation, his “tax base” is larger. Then, he is more interested in consuming non-pecuniary benefits. Since the value of non-pecuniary benefits to a controller of a large corporation is significant, $V_0$ plus *Alpha* (the present value of pecuniary and non-pecuniary benefits to a controller) is much larger than the present value of only pecuniary benefits. Therefore, as two-factor analysis indicates, it is more likely that the controller will become stationary.

Second, the imperfection of the capital market may distort the decision of a controller in a small family corporation. Suppose that to a controller in a small corporation, the present value of pecuniary and non-pecuniary benefits to a stationary controller is larger than a one-shot extraction. Thus, it is reasonable for him to extract small but continuous pecuniary benefits from the corporation as a stationary controller. However, suppose that he needs a large amount of money all of a sudden for some reason. If the capital market is imperfect, he is not able to borrow the required money immediately. Then, the only solution for him is to become roving and attain the lump-sum pecuniary benefits at once, even though the lump-sum value is less than the present value of pecuniary and non-pecuniary benefits to a stationary controller. In contrast, even if the imperfect market problem is a barrier to a
controller of a large corporation, he is more able to manage this problem; since the allotment of pecuniary benefits in one period to a controller in a large corporation is much higher, he is less likely to face a liquidity problem; in addition, even when he encounters a liquidity problem, he is more able to borrow a large amount of money since he can provide more assets as collateral. In addition, since he runs a large corporation, his negotiation power or political influence might be large enough to borrow the money he needs.

Third, it is important to note that developing countries lack a proper disclosure system in the capital market. When an economy consists of a large number of small corporations, prospective investors in the capital market are not able to research a large number of controllers’ individual integrity given the condition of insufficient disclosure. As a result, the high degree of asymmetric information in the capital market will obstruct the building of trust between controllers and prospective investors. In other words, prospective investors are likely to treat all of controllers as roving bandits once they observe one controller’s gigantic wrongdoing, because it is difficult and costly for them to tell the better (i.e., stationary controllers) from the worse (i.e., roving controllers). Knowing that they are not deemed as stationary regardless of their sincerity and conduct, controllers in small corporations will “be compelled” to become roving by default even if being stationary would be more valuable to them – the adverse selection problem drives out stationary controllers from the capital market and only roving controllers remain.

It is true that many developing countries that are dominated by a small number of large corporations have a similar disclosure problem and asymmetric
information issue. However, at least *comparatively*, prospective investors in the capital market are more easily able to interpret a small number of large controllers’ conducts, transactions, and (relative) faithfulness through circumstantial evidence and observations. In other words, the same amount of information is concentrated on the small number of controllers. Therefore, under this system (i.e., the economy of a *small* number of *large* corporations), despite a similarly deficient disclosure system, prospective investors in the capital market are better equipped to tell – although crudely – which one is roving and which one is stationary. Therefore, at least the capital market does not bluntly treat *all* controllers in the economy as roving. Knowing this, controllers in large corporations are more able to choose to be stationary when the value of two factors is larger than the value of a one-shot looting.

Fourth, the formula’s assumption that a family controller’s tenure is infinite is less applicable to a jurisdiction with small corporations than that with large corporations or a corporate group. Why? Put simply, being a successor of a *small* corporation might be *less* attractive to a corporate founder’s children. They may be more interested in being professionals in other fields, such as medical doctors, lawyers, musicians, professors, politicians or whatever they want to be, rather than businesspeople in a large corporation, and they often (or sometimes) choose not to succeed their father. Put differently, the opportunity cost to give up the position of controlling shareholders is not so high to children of small corporations’ founders. When the assumption of infinite tenure is broken, obviously there is a greater chance that controllers will be roving.90

90 Of course, many of the next generations are still interested in succeeding to the management job of the founder. What I say is that they are *less* interested in small corporations compared to the setting of
Fifth, the fact that small corporations have small influence in the market makes controllers be more roving. In Olson’s world, a roving bandit will rationally become a stationary bandit when he is strong enough to monopolize the theft from his subjects – when the bandit’s power to steal exclusively becomes stronger and more established, it is more likely that the bandit will transform from a roving bandit to a stationary one. The same logic holds in the corporate governance issue as to controllers. Controlling shareholders in small corporations do not have monopolistic stealing power from minority shareholders in the domestic economy of a developing country. Put differently, they face “a common well” problem; if they do not exploit water from the common well immediately, somebody else will use it anyway; there is no incentive to save and there is no tomorrow. Under these circumstances, controllers are not able to have long-term plans. When they find chances of one-shot transactions to loot minorities to the full extent, it is rational for them to reap those opportunities at the time. As a result, it is difficult for controllers to evolve to stationary controllers when so many small corporations exist in a bad-law jurisdiction.\footnote{Conversely, it is \textit{likely} that a small number of large and powerful controllers become stationary. However, it does not say that a few powerful controllers of large corporations are \textit{always} stationary. Chinese history is very indicative in this sense. In ancient China, there were many independent states that waged numerous wars with each other until Qin Shi Hwang unified China in B.C. 221. In the warring period before the unification, ordinary Chinese people suffered under many competing rulers with short-sighted plans – in wartime, it was difficult to think about “tomorrow,” so most rulers could not help but be roving. Qin Shi Hwang is credited for forming “one” China and ending this chaos. Under one unified China, Qin Shi Hwang had a very good chance to be a stationary ruler because as the sole ruler in all of China, he could have considered “tomorrow” and long-term plans. However, for various reasons, disappointingly he remained a tyrant even after unification and his Qin dynasty lasted for only 15 years. In other words, although Qin Shi Hwang had strong conditions (e.g., having monopolistic power in his domain) for being stationary, he ended up as roving.}

large corporations. If this tendency is systematically accumulated nation wide, that economy is more likely to be featured as roving.
3. **Inherent Problems of “Family”**

One of the main features of “family” corporations is that a controlling shareholder can have infinite life because his genes run through generations. Thus, minority shareholders do not have the final period problem vis-à-vis a controlling shareholder in a capital market where a repeated game takes place. In this Section, I further articulate the possibility that the infinity assumption may not hold in other cases, and the potential problem that the final stage will appear when power shits from one generation to the next generation.

**(a) Inheritance – Mean-Reversion and Structural Change**

Many business gurus often say that children of Olympic gold medalists are not guaranteed to win the Olympic Games one generation later. Athletic talent of parents is not exactly inherited by their children, even though their children will often be more gifted in sports than others on average. Similarly, when corporate control passed within a family, it is likely that the heir in the second generation is less competent in management than the founder, who was a highly capable entrepreneur\(^\text{92}\) – in other words, management capacity tends to follow the principle of the mean-reversion over future generations.

What are implications of the mean-reversion of family’s managerial talents in the context of stationary (family) controllers? As we have seen, a representative

controlling family shareholder is assumed to control a corporation infinitely through inheritance. This assumption is implicitly based on the notion that the identity of the corporation and controllers is maintained eternally even if a particular family controller dies and the next one succeeds. However, the phenomenon of mean-reversion can weaken this notion; the corporation before and after inheritance is so different that it should be treated as “two” different entities rather than “one”; theories based on the concept that “one” set of human DNA controls the “same” corporation eternally through family succession have to be modified case by case.

Suppose that a son who has less managerial capability than his father succeeds in a family-controlled corporation. This means that the corporate growth rate under the son’s reign is lower than that under his father’s. Then, the successor realizes that the present value of extractions by a stationary controller becomes smaller after he inherits – thus, there is a growing likelihood that the son will at some point abandon the status of stationary controller and choose to be roving.

In addition, a less talented successor’s appearance in management will impact investors in the capital market as well. First, they will be worried that cash flows generated by the corporation from now on will be lower than those derived by the assumption that the same gene (i.e., the father’s gene) controls the same corporation forever. Therefore, investors’ confidence in the corporation will be disturbed. Second, investors will be fearful that the inheritor will raise the “tax” (i.e., extraction) rate; this is because the son may have different (i.e., more stringent) “tax policies” than his father’s, or because the “tax rate” must be higher if the successor wishes to
keep the same growth rate of extraction given the lower growth of the corporation due
to his lower management capability.

Consequently, both a new controlling shareholder and investors perceive that
the (former) corporation under the founder’s reign is different from the (new)
corporation under the successor’s reign. In fact, even a son who is comparably
capable to his father will create problems as well. Even if the managerial talent of a
father and a son is equal, their perspectives on business and philosophy might be
different, and these differences will affect employees and partners in various
transactions as well as investors in the capital market. In sum, from the investors’
standpoint, doing business with the second generation is not the same as with the
founder.

Then, a new controlling family shareholder and corporate constituencies,
minority shareholders in particular, do not share the same framework, vision, and
expectations of the corporation in the future. In other words, the environment and
rules of the game are materially modified during the course of dynastic succession: (i)
when the succeeding son is comparable to his father in terms of management talent,
the succession itself still generates significant “regime changes” to create two
different eras; (ii) when the succeeding son is subject to the problem of mean-
reversion, the succession may precipitate public concern about the future of the
corporation, (sometimes) ending up with a catastrophe.

Either way, during the power shift, corporate constituencies do not feel that
they trade with the *same* person with the *same* DNA, as the notion of the family
corporation emphasizes and assumes. Subsequently, there is substantial likelihood
that the “final stage” is set and realized by other corporate constituencies as well as a controlling family shareholder and minority shareholders. In turn, backward induction could occur, and the game between the controller and investors in the capital market might not be repeated any longer. Consequently, there is the possibility that a new controlling family shareholder would not be a stationary controller since the infinity assumption is invalid under these circumstances.

(b) King Lear Case – What If There Are Several Children?

Things will be more complicated if a founding father has multiple children – structural changes during the course of inheritance may be worse. If the oldest son succeeds to his father’s position and most of his father’s property irrespective of his ability, the mean-reversion problem may be more magnified since the oldest son is not necessarily the most capable among his siblings. The alternative solution is that all of the offspring should compete with each other for the next chairmanship. Apparently, this alternative is not fundamentally able to avoid the mean-reversion problem. In addition, it creates another problem. While many parents treat their children’s utility as nearing equivalence to their own, siblings are less likely to feel this for each other – they are rivals. The history of the West and East has observed a lot of bloodshed between siblings vying for thrones.

When there are several princes but no primogeniture system, no one is so sure about who will be the next king. Mostly, it is up to a founding father’s discretion to choose his successor. To make things worse, he is sometimes very capricious about
his decision until his death. Then, inevitably, the problem of uncertainty makes things complicated. For example, professional managers who were retainers of the last king should stake their fate on only one prince. This creates a very big problem, especially in many developing countries where labor markets are not flexible; when a talented manager chooses the wrong person as his lord, his life is permanently stagnated since he cannot easily move to other corporations after the next king takes the throne. It means that managers have to give up their successful careers in that economy when they lose in this lottery. Thus, even the most capable managers may be thrown away by a new ruler, and corporate performance may be affected adversely. In addition, more frictions can be expected in wars between princes because retainers of each prince know that they lose everything if their lord misses the chance to rule.

Accordingly, this rivalry among siblings usually creates structural changes at the time of succession and participants in the capital market (possibly the product and labor market as well) become wary about seismic alteration of a corporation including the potential for chaos and disorder. Then, the final stage problem will arise. Since the repeated game would not hold any more, the market becomes skeptical that stationary banditry is maintained. This misfortune can be further aggravated when a particular son is supported by his father, and other sons dispute with this father-son alliance in any type of corporate control contest.

So far, I have reviewed the possibility that only one child inherits his father’s entire empire through competition. However, there is also the possibility that each child succeeds to a portion of the domain – in general, this would take place in the setting of a corporate group. Suppose that a founding father with three children
manages nine subsidiaries under a corporate group, which is now about to be divided evenly. Then, rather than one large corporate empire, three independent and small corporate groups are created. The corporate group’s advantages, including building a reputation based on scale and scope economy, are now significantly lessened.  

Again, this is a structural change, and a vicious circle will follow; the final period problem arises when a corporate group is divided into three small groups because the three newly created corporate groups are clearly different partners than the previous one gigantic corporate group; then, the repeated game might no longer be expected; accordingly, controlling shareholders find it more difficult to be stationary controllers. Further, due to the “even and fair inheritance” among children, the number of controllers increases and the size of corporations decreases in an economy. Then, as explained earlier, controllers become more likely to be roving because of the small corporations’ effect.

VI. CONCLUDING REMARKS

Throughout this Article, I propose a hypothesis that the controlling shareholder systems with bad-law can be classified into at least two sub-categories: (i) the “stationary” controlling shareholder system; (ii) and the “roving” controlling shareholder system; in addition, the third possible sub-category is the “commingled” controlling shareholder system where stationary and roving controlling shareholders

93 As to a corporate group’s reputation building based on scale and scope economy, see Gilson, supra note 20.
are mixed.\textsuperscript{94} In the stationary controlling shareholder system, since a family controlling shareholder has an \textit{encompassing} interest in his controlled corporation for the \textit{long} term, it is in his best interest to voluntarily \textit{reduce} the degree of expropriation against minority shareholders.

In that sense, given the condition that the corporate law in that economy is inefficient, having “stationary” bandits is the most \textit{optimal} choice \textit{available} to minority shareholders in developing countries unless they invest abroad – however, as explained earlier, international diversification has been difficult for them. When a controlling shareholder convinces the capital market that he is a “stationary” controller, investors participate in the capital market as minority shareholders who are benefitted as well. Given bad-law in a jurisdiction, the relationship between a “stationary” controlling family and minority shareholders might be symbiotic and mutually beneficial. In that sense, although the conventional view that minority shareholders are victims is true, it can be said that minority shareholders are not that seriously injured. The relatively aligned interests of a controlling shareholder and public shareholders under the “stationary” controlling system make up partially for the deficiency in good corporate law. As a result, developing countries with “stationary” controller systems are more advantageous in terms of investor protection and economic development than those with “roving” controllers.

To be sure, controlling shareholder systems in developing countries have many weaknesses in terms of corporate governance. However, treating \textit{all} controlling shareholder systems with diversity as the \textit{same} (i.e., as roving controllers)

\textsuperscript{94} Professor Curtis J. Milhaupt suggested this “commingled” controlling system when I explained about the concepts of “stationary” and “roving” controlling systems.
is an oversimplification, and this view ignores the specificity of each sub-category of controlling shareholder systems – at least, there is the possibility of a stationary controller regime. With this concern, this Article makes attempts to develop analyses of understanding the diverse controlling shareholder systems with bad-law in a more proportional and balanced way. The final point in this Article is that the banditry in controlling shareholder systems is very dynamic – stationary controllers may be changed into roving controllers due to many external and internal conditions. In that sense, even successful stationary controlling economies should be careful and should make every attempt to enhance the general corporate governance in their jurisdictions. In addition, more globalization – which will foment more international investment by non-controlling shareholders in developing countries – may fundamentally change the corporate governance system based on banditry.
TRANSPLANTING A POISON PILL
TO A CONTROLLING SHAREHOLDER REGIME

Sang Yop Kang*

INTRODUCTION

In the history of Corporate America, the 1980s were characterized as the most vibrant decade of hostile merger and acquisition (“M&A”).¹ Most corporations were concerned about being a target by an uninvited acquirer, and heated public debates on the social implications of the market for corporate control focused on whether the dynamic hostile takeover wave was beneficial to the economy. All of a sudden, however, the mechanism of the hostile takeover was virtually crowded out with the advent of a poison pill, the most effective anti-takeover device ever invented. To make things worse (from the standpoint of critics of the pill), around the early 1990s the pill finally developed into “just say no” where a board is able to flatly refuse a bid

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¹ Professor Merritt B. Fox explains M&A is a mechanism for correcting managerial agency problem. “Managers face a number of pressures of varying intensity that help align their interests with those of shareholders: the threat of legal action for violation of fiduciary duties, the threat of hostile takeover, the managerial labor market, the evolutionary growth or decline of the firm as the result of succeeding or failing in product competition, peer review, the discipline of the outside directors, and the threat of removal by dissatisfied shareholders.” Merritt B. Fox, Insider Trading Deterrence versus Managerial Incentives: A Unified Theory of Section 16(b), 92 Mich. L. Rev 2088, 2098 (1994).
although the bid is highly attractive as well as non-coercive to shareholders. Then, did M&A activities decrease in the United States?

Interestingly, not really – in fact, the M&A wave became more powerful with the evolution of executive compensation in the 1990s. Now, managers started to accept (or acquiesce to) the change in control, since they realized that they could benefit from stock options under a high-premium bid and depart from corporations with generous severance packages. The practice of high executive compensation saved the corporate control market from the pill by transforming the nature of M&A from “hostile” to “friendly.”

Until recently, M&A had been generally deemed to be a creature of Anglo-American business culture, so that the market for corporate control was virtually nonexistent outside the United States (and United Kingdom). The corporate norm in the “rest of the world” (i.e., non-Anglo American countries) is principally built on the notion of the “controlling shareholder regime,” where dynastic succession within dominant family shareholders is well respected and established – thus, there had been few sales of control. This stereotypical M&A landscape started to change rapidly, however, around the beginning of the new millennium. Now, economies dominated by large corporations with stable control-shareholding have observed hostile bids and takeovers (although relatively few). The great tide of globalization also made M&A activities spill over internationally, as global entities are more likely to consider a cross-national acquisition as a feasible option. Then, what have reactions been to this new phenomenon in the “rest of the world?”

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M&A (in particular, a hostile takeover) raises complicated questions in a jurisdiction. Commentators are sharply divided over whether a hostile takeover is beneficial from the perspective of investors and capital market efficiency. Some argue that a hostile takeover is the best disciplinary device to enhance shareholder value by lessening of the chronic problem of managerial agency cost. In contrast, others argue that M&A (including a hostile takeover) does not create sufficient benefits, pointing out the net value-added to all shareholders (not only those of a target but also those of an acquirer) is almost nothing.3

Moreover, even if an M&A produces additional wealth for the entire group of investors in the capital market, it might generate many socio-political questions for a local government. For example, an M&A pursuing cost-reduction and synergy is often followed by a massive layoff that would create social unrest; if such loss from the employees’ side is taken into account, value-maximizing acquisition for shareholders is not necessarily beneficial to the entire society in even Kaldor-Hicks terms. In addition, when a prospective acquirer is a foreign entity, public sentiment could suddenly turn to politically flammable nationalism, which would drive policymakers into a corner. From local business people’s perspective, a seismic change arising from an unprecedented takeover wave (although weak so far) is an apparent threat to the Ancien Regime. Accordingly, authorities and the business circles in the “rest of the world” may collude and consider adopting a new defensive system to insulate a domestic economy from the active market for corporate control. As expected, the poison pill is a prominently suggested solution since it has proven to

be the most effective defense device in U.S. takeover history. In addition, the movement to enact law (either by statute or case law) permitting the poison pill is supported by a slogan of the “global standard” – “If the United States allows the pill, then why don’t we?”

To be sure, however, transplanting is more complicated than simple copying. A foreign subject that is inserted may be incompatible with other organs and cause rejection symptoms. Thus, it is of importance to analyze in advance whether the poison pill would be harmonious with an importing jurisdiction’s socio-political economy and judicial system, which are (often sharply) different from those of the United States. Most of all, the ownership structure matters when considering the pill’s side-effects. While shareholding is widely dispersed in the Anglo-American economies, the corporate norm in the rest of the world is based on the premise that a dominant family shareholder with a large fraction of voting rights runs the business. If a typical controller uses voting leverage (such as stock pyramiding, dual class common stocks, and intra-shareholding), allowing her the “just say no” pill may lead to excessive defense because the voting leverage itself is a built-in and strong anti-takeover device.

In addition, many countries in the rest of the world do not have the lynchpins that uphold the legitimacy of the pill in Delaware. For example, a typical corporation in such countries lacks the tradition of having a functional (or relatively independent) board which is designed to keep a corporate decision-maker from abusing her power – absent such a board, however, the legality of a pill is greatly weakened. Moreover,

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Unlike efficient Delaware courts, most judiciary systems in those countries are neither equipped with the expertise required to deal with cutting-edge takeover issues nor fast enough to reduce uncertainty associated with time-delay.5

Furthermore, it cannot be overemphasized that under the Delaware jurisprudence, a pill is not “absolute” 6 (thus not perfectly impenetrable)—Delaware courts rely on the proposition that ultimately shareholders have the power to replace an incumbent board with a new one to redeem a pill, if they are dissatisfied with an incumbent’s defense and continuing business model. From this perspective, a poison pill is legally upheld only when the shareholder franchise is not impeded and distorted by corporate insiders.7 Nonetheless, many countries are unlikely to have such a “ballot box safety valve.”8 In particular, when the poison pill is adopted in a jurisdiction that allows a voting leverage (such as stock pyramiding) which artificially inflates a controller’s voting power, the true will of shareholders reflecting all shareholders’ weighted cash-flow rights can be replaced with one in favor of a controller with small cash-flow rights. Under these circumstances, transplanting only the poison pill without importing complementary Delaware corporate governance

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5 The deficiency of such an important legal infrastructure would seriously discourage a prospective acquirer from submitting an uninvited bid in the first place. In addition, uncertainty associated with time-delay would make a pill more powerful than an original Delaware pill.


7 See e.g., Blasius Industries, Inc. v. Atlas Corp., 564 A.2d 651 (Del. 1988). Blasius requires management to demonstrate “compelling justification” for its defensive maneuver if the primary purpose of taking such a defensive device interferes with the shareholder franchise.

systems (such as an independent board, an efficient judicial system, and safety valves) creates an awkwardness similar to “wearing a suit jacket with pajama pants.”

As explained, U.S. market participants adapted quickly to a pill-dominated M&A climate by evolving executive compensation, aligning the interests of managers and shareholders by accepting a high-premium bid. Then, is the same (or similar) capital market accommodation expected to take place in a pill-importing jurisdiction? Maybe, in some countries. In countries where social democracy and egalitarianism is popular, however, it would be extremely difficult, if not impossible, to adopt the American-style corporate compensation system that tolerates (or even encourages) vast income disparity.

Perhaps executive compensation is not the main variable in a complicated equation with respect to a pill and M&A because in many countries, those who consider importing a pill system are generally not CEOs but dominant shareholders – thus, the driving force that encourages a dominant shareholder to sell control is the control premium that she is offered rather than a severance package available to management (or, a dominant shareholder can be paid both when she holds an executive position in a corporation). Then, as long as a controller is willing to sell control for the “appropriate” price, a pill would not preclude a friendly deal. An obstacle to a sale of control, however, is that the reserve price of many controllers is often higher than buyers’ offer price so that deals are less likely to take place⁹ – in fact, this is a reason why there was virtually no market for corporate control in the “rest of the world” in the past. Another impediment arises when the control premium

⁹ It might be (among many potential reasons) because a founding controller deems a corporation as her own avatar, thus she attaches more psychic value with the corporation than any third party.
should be equally shared with all shareholders. Under such an “equal treatment rule,” it is needless to say that a controller loses a great deal of incentive to sell control to a prospective acquirer. Even if equal treatment were not legally required, control sales would not be often made in a country with an egalitarian culture for precisely the same reason discussed regarding executive compensation. Under these circumstances, if the pill is imported, M&A activities (voluntary friendly deals as well as hostile takeovers) would be seriously weakened.

This Article is structured with the following organization. Part I sketches the evolution of the poison pill and how Delaware takeover doctrines have been developed in relation to the pill. Part II explores how the U.S. market for corporate control has survived the “just say no” pill (coupled with a staggered board). Part III describes M&A in the controlling shareholder regime, which is the corporate governance system in most countries outside the two Anglo-American economies. Part IV analyzes why transplanting the Delaware pill is difficult by demonstrating the Delaware pill’s potential incompatibility with the underlying socio-economic and legal infrastructure in an importing jurisdiction. Part V delves more into why a pill might stifle even most of voluntary friendly deals in some countries by showing that executive compensation and the sale of control are not conveniently available there. Part VI provides concluding remarks.

In sum, importing the Delaware pill blindly is risky because the pill is likely to crowd out an effective disciplining mechanism of a takeover market in an importing country. Without a takeover market, available outlets for a failing company are generally limited to bankruptcy, involuntary friendly deals (i.e., a fire sale), and a
bailout, which would affect the economy more adversely. However, it does not say that any additional defense measure is unnecessary to this jurisdiction. A pill is the most effective defense measure ever invented, so that without the pill a corporation in a controlling shareholder jurisdiction has less deterrence compared to its U.S. peers. By proposing a theoretical framework in this Article, I call for rigorous country-based studies in the near future to develop a “proportional” takeover defense system in a particular jurisdiction.

I. EVOLUTION OF THE POISON PILL AND DELAWARE DOCTRINES

Despite federalization in areas such as disclosure rules and some parts of corporate governance, U.S. corporate law remains mainly a “state creature.” Since a majority of U.S. public companies are incorporated in the state of Delaware, statutes and judge-made laws in Delaware govern a significant part of the takeover issues in the United States. Therefore, reviewing Delaware doctrines in relation to the poison pill sheds light on a controlling shareholder jurisdiction that considers adopting an American poison pill.

1. The Poison Pill in General – Its Nature and Impacts

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10 For the more explanation on the mandatory disclosure and its related discussion, see generally Merritt B. Fox, Retaining Mandatory Securities Disclosure, 85 VA. L. REV. 1335 (1999).
Traditionally, the main tool for a hostile takeover was a proxy contest\textsuperscript{11} in which an insurgent made attempts to obtain control of a target company via the support of colleague shareholders in a directors’ election. The proxy contest, however, was not an effective method for a would-be acquirer; first, the proxy machinery is procedurally advantageous to incumbents, so that gaining the endorsement of a majority of shareholders is a difficult task to an insurgent; in addition, while a hostile bidder will share the benefits from replacing a less capable management, she alone has to bear the entire costs occurring in the proxy fight and future managerial efforts.\textsuperscript{12} These difficulties were exacerbated by the SEC regulation (by 1992) that significantly regulated shareholders in terms of communication and coordination.

Realizing these disadvantages associated with a proxy contest, hostile bidders mainly used tender offers during the period between the 1960s and 1985 (before \textit{Unocal Corp. v. Mesa Petroleum Co.}\textsuperscript{13} – hereinafter “Unocal”).\textsuperscript{14} Reliance on tender offers was further strengthened by financial innovations such as a developed junk bond market, where even a bidder with limited financial resources could raise capital to purchase a large fraction of a target’s stocks. In this respect, the takeover arena was changed from an “election” to a “market,” and a would-be acquirer could bypass


\textsuperscript{12} In other words, a bidder is subject to the collective action problem.

\textsuperscript{13} Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

\textsuperscript{14} Jacobs, \textit{supra} note 11.
a target corporation’s board in an acquisition and deal directly with individual shareholders.\textsuperscript{15}

A tender offer – by itself, not in combination with other acquisition maneuvers – became powerless, however, with the advent of a “poison pill” (or in short “pill”) which is a colloquial name for various “shareholder rights plans.”\textsuperscript{16} With a pill,\textsuperscript{17} all of the target shareholders other than a (prospective) acquirer are entitled to purchase securities (of a target or an acquirer)\textsuperscript{18} at a bargain price if a specified triggering event (e.g., the acquisition of 20% of the target’s stock by a third party) takes place.\textsuperscript{19} As a result, the exercise of the pill would massively dilute an acquiring entity’s stock position so that the acquisition of the target stocks above a pre-specified level (e.g., 20%) in the market is irrational for a bidder to pursue.\textsuperscript{20} Thus, if a bidder is still interested in the acquisition of a target, she is compelled to negotiate with a target board on the terms of a bid. If consent is not reached in that negotiation, the only way for the bidder to take control of the target is to wage a

\textsuperscript{15} Discussion with Professor Jeffrey N. Gordon.


\textsuperscript{17} Adopting a poison pill can be decided solely by a target board and the approval of shareholders is not required. STEPHEN M. BAINBRIDGE, CORPORATE LAW (Foundation Press 2nd ed. 2008).

\textsuperscript{18} Depending on the types of “securities,” a poison pill is classified either as the flip-over feature (in which “securities” are a bidder company’s shares) or as the flip-in provision (in which “securities” are a target company’s shares).


\textsuperscript{20} See e.g., MELVIN A. EISENBERG, CORPORATIONS AND OTHER ORGANIZATIONS: CASES AND MATERIALS (Foundation Press 9th ed. 2005); Bebchuk, Coates & Subramanian, supra note 8; William B. Chandler III, Hostile M&A and the Poison Pill in Japan: A Judicial Perspective, 2004 Colum. Bus. L. Rev. 45 (2004). However, “All rights plans have a provision that enables the board to “redeem” the rights even after they are triggered, for a very nominal sum (say, one penny per share).” Jacobs, supra note 11.
proxy contest with the incumbent management. The advent of a pill changed the arena of a takeover once again from the “market” to the “election.”21

In terms of impacts on corporate governance brought by the poison pill, two contrasting views have competed. One is that a pill can be used to protect shareholders. As concerned the Unocal court, 22 dispersed shareholders are susceptible to the “prisoners’ dilemma”23 – in the fear of ending up with worse payoffs if they reject an initial tender offer, unorganized shareholders are stampeded to accept even an inappropriately lowball bid. With a pill, this coercion could be prevented to a large extent since the pill requires a prospective bidder to negotiate with a target board that acts as a centralized agent on behalf of shareholders. In addition, the premium from a takeover can be enhanced for the shareholders’ benefit.

On the other hand, it is argued that the pill has worsened the managerial agency problem. With the pill, a hostile bidder finds it difficult – if not impossible – to prevail in a takeover battle, although she is welcomed by most shareholders.24 To make things worse, every corporation inherently has a shareholder rights plan (although not at the time of the hostile bid) in the form of a “shadow” pill, since it takes only a few hours for a board to adopt a pill without approval from

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21 Discussion with Professor Jeffrey N. Gordon.

22 The Unocal court said, “It is now well recognized that such [two-tiered coercive] offers are a classic coercive measure designed to stampede shareholders into tendering at the first tier, even if the price is inadequate, out of fear of what they will receive at the back end of the transaction.” Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

23 It is widely known among commentators that Mesa (a hostile bidder in Unocal) designed the prisoners’ dilemma among shareholders. See e.g., Bebchuk et al., supra note 8.

shareholders.\textsuperscript{25} As Professor Grundfest stated, now the hostile takeover wars are over and management won.\textsuperscript{26} Although disgruntled shareholders (and a prospective acquirer) have an opportunity to replace the board through a proxy fight, it is an uphill battle for them since a proxy fight is cost-inefficient and time-consuming as aforementioned. As such, the poison pill works as an impermeable armor insulating incumbent management from the threat of hostile takeovers.

2. \textit{Unocal’s Proportionality Test – Intermediate Standard and Harbinger of the Pill}

By the mid-1980s, when the wave of hostile takeovers reached the peak, the Delaware court had a doctrinal dilemma in takeover cases. Under the business judgment presumption,\textsuperscript{27} the court does not second-guess the legality of a board’s decision unless a plaintiff rebuts the presumption. This highly deferential standard for a board could have over-protected directors who were inherently involved in the “omnipresent specter”\textsuperscript{28} of the agency problem, particularly in merger and acquisition cases where managers and directors lose their jobs.\textsuperscript{29} In contrast, under the entire


\textsuperscript{26} Grundfest, \textit{supra} note 24.

\textsuperscript{27} The business judgment rule is “a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

\textsuperscript{28} The \textit{Unocal} court was concerned about the “omnipresent specter that a board may be acting primarily in its own interest rather than those of the corporation and its shareholders.” See \textit{Unocal}. 

fairness review, directors and managers had to prove that the transaction was fair to the corporation in terms of the process and price as *Weinberger* stated. Under this stringent doctrine, consequently, the board would not have implemented any defensive device for the shareholders in the first place, which is harmful to shareholders who are susceptible to a coercive tender offer.

Recognizing these problems, the Delaware Supreme Court in *Unocal* put forward an “intermediate (or proportional) standard” compromising the two traditional standards of review. Now, the board must demonstrate that a takeover bid generated “reasonable grounds for believing that a danger to corporate policy and effectiveness existed” and the defensive measure adopted was “reasonable in relation to the threat posed.” After satisfying these conditions, the board’s conduct in a hostile takeover is entitled to be evaluated according to the business judgment rule.

It is noteworthy that *Unocal* in itself had nothing to do with a poison pill. A target (i.e., Unocal) implemented a self-tender as a defense tactic, excluding only Mesa Petroleum, an unwanted suitor, so that Mesa’s economic interest would be massively diluted; fearful of this economic damage, Mesa was deterred from closing

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30 *Id.*; *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).

31 Armour et al., *supra* note 29.

32 *Id.*

33 *Unocal*.

34 *Id.*

35 *See Unocal*; O’Kelly & Thomson, *supra* note 16 at 777.
in to complete a hostile takeover and finally brought a suit. The court posited that Unocal’s selective self-tender satisfied the two-pronged proportionality test, and legitimized a board’s conduct of discriminating against an insurgent shareholder in the takeover context. After Unocal, SEC promulgated Rule 14d-10, prohibiting the selective self-tender. Nonetheless, the “general principle” articulated in Unocal has been unchanged – an anti-takeover device discriminating against a hostile bidder/shareholder could be allowed (unless it is a selective self-tender) as long as the proportionality test is passed. In this light, Unocal paved the way for approving the legality of a poison pill, which is dependent on discriminatory treatment among shareholders.

3. The Evolution of the Poison Pill to the “Just Say No” Defense

In the same year of Unocal (1985) – the Delaware Supreme Court in Moran v. Household International, Inc. (“Moran”)38 upheld the legality of a (flip-over) poison pill based on the reasoning that; (i) the two-pronged proportionality test was satisfied; and (ii) a (prospective) bidder could still rely on a proxy contest through which a newly elected board could redeem the pill.39 However, it was unclear whether the existing board that placed the pill was required to redeem it, and under what circumstances.

36 See SEC Rule 14d-10; O’Kelly & Thomson, supra note 16 at 778.

37 Discussion with Professor Katharina Pistor.


39 Moran. In this sense, Moran expressed the Delaware court’s preference for the “election” over the “market” as a solution for the conflict generated in a corporate control contest.
A few years later, the Delaware Chancery Court opined in *City Capital Associates v. Interco Inc.* ("*Interco*")\(^{40}\) that a target board had to redeem a poison pill if it was used against a *non-coercive* tender offer.\(^{41}\) Accordingly, shareholders were restored the right to sell their shares without the obstacle of a continued pill, unless they were coerced by a bid. A corporate raider was another beneficiary of the case, since under *Interco* she gained a substantial chance to triumph in a hostile takeover without relying on a highly burdensome proxy contest.

The *Interco* regime, however, was struck down soon by the Delaware Supreme Court in *Paramount Communications v. Time Inc.* ("*Time*").\(^{42}\) Although Paramount announced an “all-cash 100%” non-coercive tender offer for Time at a substantial premium,\(^{43}\) Time’s board refused to redeem a pill, asserting that the price was *inadequate*. Reviewing this case, the Delaware Supreme Court stated that the “threat” examined in the *Unocal* test included shareholders’ “ignorance or mistaken belief” of the strategic benefit from a target board’s favored business combination (i.e., a Time-Warner merger).\(^{44}\)

These statements seem to be based on the notion that a target board may be smarter than the market, as the semi-strong form of efficient market hypothesis explains. Accordingly, for the sake of “foolish” shareholders, a “wise” board – that is

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\(^{40}\) *City Capital Associates v. Interco Inc.*, 551 A. 2d 787 (Del. 1988).

\(^{41}\) Bebchuk et al., *supra* note 8 at 905-906.

\(^{42}\) *Paramount Communications v. Time Inc.*, 571 A.2d 1140 (Del. 1990).

\(^{43}\) The final bid price reached at $200 per share for Time, while the stock price of Time before Paramount’s initial bid was only $126. See *Time*.

assumed to be a faithful agent who cares primarily for the principal’s interest – is paternally allowed to force them not to sell their shares to the unwanted bidder. In other words, a board can “just say no” to redeem the pill even in a non-coercive and high-premium bid.

II. HOW DEALS SURVIVE UNDER “JUST SAY NO” IN THE UNITED STATES

So far, the “just say no” pill in Time has remained valid in the Delaware takeover law. This Part first sketches the pill’s safety valves, and then explains that an effective staggered board is able to make safety valves (in particular, a ballot box safety valve) powerless. Then, this Part further explains a puzzling phenomenon in the U.S. corporate control market: M&A activities have thrived despite the highly potent defensive combination of a poison pill and a staggered board.

1. Two Safety Valves to “Just Say No”

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45 Id. Professors Bebchuk, Coates and Subramanian explain that while theoretically “Just Say No” can be defeated, there is no empirical example for that possibility. “While Delaware jurisprudence does not say that courts will never order the redemption of a poison pill, there has not been since Time a single case in which redemption of a pill was ordered by a Delaware court. Thus, as a practical matter, a bidder has had to assume in planning a bid that a target could “Just Say No” and retain a pill unless and until the bidder obtained majority control of the target’s board.” Bebchuk et al., supra note 8 at 906.

46 Bebchuk et al., supra note 8.

47 Commentators use the term “two safety valves” widely, which refer to as limitations of “just say no.” See e.g., Bebchuk et al., supra note 8.
Under the *Time* regime, the shareholders’ only recourse in the face of a board’s “just say no” pill is to replace the existing directors. In fact, this is why the pill satisfies the proportionality test and is legitimate. Although a board can refuse the acquisition by using a pill that blocks transactions between a prospective acquirer and shareholders, *ultimately* shareholders can make the final the fundamental decision on the M&A via their confidence votes for an incumbent board—a ballot box safety valve keeps the “just say no” pill in check. Thus, maintaining the shareholders’ franchise unscathed is the essential foundation for the legality of a poison pill. In this respect, *Blasius Indus. v. Atlas Corp.* ("Blasius") is of importance – in the specific context of a contested election for directors, a board has the burden of demonstrating a *compelling* justification for its defensive actions, if the *primary* purpose of such actions is to interfere with the effectiveness of shareholder franchise.

Another safety valve for the “just say no” pill available to shareholders is proposed in *Revlon, Inc. v. MacAndrews & Forbes* ("Revlon") . When a board is to abandon its independence and to enter into particular modes such as selling a company, breaking it up, or selling control (which are irreversible by shareholders), a board’s decision on the takeover defense strategy is subject to the *Revlon* standard,

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48 Gordon, supra note 44.

49 See Moran.

50 Blasius.

51 Id.; Discussion with Professor Curtis J. Milhaupt.

which is more stringent than *Unocal*\(^{53}\) – now, the board’s role is required to change from a defender of a corporate bastion to a neutral auctioneer charged with getting the best price for the shareholders.\(^{54}\) A board’s discretion in whether to take into consideration the stakeholders such as “creditors, customers, employees, and perhaps even the community generally” (which was argued under *Unocal*) no longer exists in *Revlon*, under which shareholder wealth maximization is the board’s only goal.

2. **How Safety Valves Have Been Weakened**

The Revlon duty was more developed in *Paramount Communications Inc. v. QVC Network*\(^{55}\) (“*QVC*”).\(^{56}\) Historically, nonetheless, Delaware courts have rarely recognized *Revlon* duty.\(^{57}\) In practice, the ballot box safety valve also imposes only limited constraints on management’s “just say no” defense. As discussed, since the proxy contest is far more advantageous to an incumbent, shareholder voting does not precisely reflect the true will of shareholders on the control contest issue. In addition, since shareholder meetings usually take place once a year, a prospective acquirer has to adhere to a particular timeframe in order to mount a proxy fight. Therefore, a

\(^{53}\) *Id.*

\(^{54}\) *Id.*; Marcel Kahan, *Paramount or Paradox: The Delaware Supreme Court's Takeover Jurisprudence*, 19 J. CORP. L. 583 (1994).

\(^{55}\) Paramount Communications Inc. v. QVC Network, 637 A.2d 34 (Del. 1994). In *QVC*, if the control is transferred from public dispersed shareholders (i.e., the market) to a single person, entity, or group, *Revlon*-mode is triggered and a board has to discharge its fiduciary duty to sell the company to the bidder with the highest value reasonably available.

\(^{56}\) *QVC*.

\(^{57}\) From a Professor Katharina Pistor’s lecture.
prospective acquirer may give up taking part in the corporate control contest in the first place if the timing is not favorable to her.\(^{58}\)

Above all, perhaps the most powerful device to nearly incapacitate the ballot box safety valve is a staggered board implementing a poison pill. When a board is staggered based on a charter provision, both a shareholder approval and a board resolution are necessary in order to dismantle a staggered board. Then, a hostile bidder is required to win two proxy contests in a row in order to take control of the board which will redeem a poison pill. Obviously, an incumbent has the more incentive to fight since it can successfully fend off a hostile bid by winning only one of two consecutive elections. In addition, from the perspective of a prospective acquirer, the requirement of winning two consecutive elections means that it will take more than a year for her to completely take control of a target. Since expediting a takeover process is key in business in terms of reducing uncertainty, this protracted timetable discourages a bidder from initiating a hostile takeover in the first place.\(^{59}\)

For the foregoing reasons, a staggered board – if it is not dismantled or “packed” by an insurgent within a year\(^{60}\) – is referred to as an effective staggered board (“ESB”), which makes a corporation almost invincible when it places a pill.\(^{61}\)

3. How M&A Activities Survive – Golden Parachutes and Stock Options

\(^{58}\) See Gordon, supra note 44.

\(^{59}\) Bebchuk et al., supra note 8.

\(^{60}\) Id.

\(^{61}\) Id.
A great number of U.S. corporations were exposed to the threat of hostile takeovers in the 1980s. Soon after the “just say no” defense was firmly established in Delaware jurisprudence, however, the wave of hostile takeovers ebbed. A careful board that is advised by good lawyers and investment bankers could figure out how to avoid triggering *Blasius* and *Revlon* standards under which defensive conduct is reviewed more stringently than under the deferential *Unocal* (or more watered-down *Unocal/Unitrin*\(^{62}\)) standard. Furthermore, a target became impenetrable with the combination of an ESB and the “just say no” pill. Were the M&A activities stifled? Interestingly, the market for corporate control has become even more active and flourishing. The changed landscape was that the nature of M&A has become “friendly” since the middle of the 1990s.\(^{63}\) What happened?

To corporate insiders, being acquired was a disaster – they lost jobs, high compensation and perquisites, and psychic utility from running a company. In order to avoid these losses, a target management objected to a bid although the price and terms were attractive to shareholders. The “omnipresent specter”\(^{64}\) of the agency problem weakened the mechanism of a hostile takeover, which was a major market device to discipline corporate insiders. However, the evolution of the executive compensation changed this story.

The typical executive compensation is composed of salary, bonus, stock options, and other forms of compensation. In the 1990s, the composition of the

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\(^{64}\) *Unocal*. 
executive compensation became significantly skewed towards stock options. This evolution was intended to align the interests of executives and shareholders and to redress the agency problem – the idea was, if management performed well and stock price went up, management as well as shareholders benefited from the increased stock price. Stock options based on such high-powered incentives were supported by tax and accounting rules in order to pay for the performance.

The end result was an explosive increase in a typical executive compensation package when the stock market was prosperous in the 1990s. Along with the upward trend of executive compensation in general, a “golden parachute” (i.e., a generous severance package) was developed as well. A typical golden parachute provided a departing executive the average bonus of prior years as well as three times her salary. In addition, in the case of a change in control transaction, the parachute also included the accelerated vesting of stock options that had been granted but were not yet vested. In other words, an executive in a target corporation could receive substantial gains in the event of a premium acquisition, which in fact she did not make any contribution to. As a result, management did not fiercely oppose being acquired – rather, management started to acquiesce to or welcome the deal. At the

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66 *Id.*


68 However, if high premium bid was the result of negotiation, she made contribution to a high ball bid.

same time, management may prefer using defense devices as a bargaining tool to make the terms and price of the bid more favorable for shareholders of a target corporation, which in the end is sold.\textsuperscript{70}

III. THE CONTROLLING SHAREHOLDER REGIME AND THE MARKET FOR CORPORATE CONTROL

To this point, I have analyzed Delaware doctrines and experiences as to a hostile takeover and defenses. Against this backdrop, this Part discusses the potential consequences for the M&A market if the controlling shareholder regime implements a poison pill in its corporate law system.

1. The Controlling Shareholder Regime and Takeover Defense

Based on ownership structures, the world economy is classified into two groups; (i) the dispersed shareholder regime found in the United States and United Kingdom, where the control of a public corporation is generally in the hands of public shareholders\textsuperscript{71}; and (ii) the controlling shareholder regime in which a single person (or a group of dominant shareholders) can exercise effective voting control, not

\textsuperscript{70} See Bebchuk et al., \textit{supra} note 8. However, there is possibility that management could enter into a less attractive deal from the perspective of shareholders, as long as management could leap the substantial amount of financial benefits from stock options and golden parachutes.

necessarily with corresponding equity holdings.  In fact, companies with a controlling shareholder are the dominant form among publicly traded firms in most countries outside the two Anglo-American economies. However, until recently M&A (in particular M&A initiated by a hostile bid) has been considered a phenomenon localized in the two dispersed shareholder economies.

As globalization has developed and spread, corporate insiders in “the rest of the world” (i.e., outside the two Anglo-American economies) gradually came under the pressure of the market for corporate control; Live Door (Takafumi Horie) and Steel Partners (Karl Ichan) initiated hostile takeover bids towards Fuji TV and Bulldog Sauce respectively in Japan; Vodafone (headquartered in the United Kingdom) successfully took over Mannesmann, a flagship corporation in Germany; Sovereign fund almost dismantled one of the largest conglomerates in Korea, SK Group, and took in a massive profit from the hostile attack.

Accordingly, within business circles in the rest of the world, there has been growing concern about the expansion of corporate control contests because business elites themselves will be the most apparent victims in hostile takeovers. Since the changed rules in the corporate control game may generate adverse impacts in economic and political terms (e.g., massive layoffs due to acquisitions of domestic firms), governments in such countries have become more wary about this global trend and have made attempts to redesign their countries’ anti-takeover systems and law

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72 Id. at 1643.

and financial market environments. Local business lobbies also strengthens such
government movements.

In this respect, importing the Delaware poison pill system could be an
attractive solution to relieve the fear of potential hostile takeovers, since the pill is –
from the perspective of a target management and board – the most effective and the
least costly defensive device. Above all, as proven in U.S. takeover history, a pill
makes a company almost takeover-proof. In addition, a pill does not require
shareholders’ approval – only a board’s resolution is necessary. Thus, a company
can adopt a pill very quickly, when a company notices “abnormal” movement in a
stock market via early warning systems such as 13 D filing.

Moreover, a pill does not affect any significant strategic business plans or the
financial status of a company beyond deterring a hostile takeover. Suppose that a
pill is not available in a particular jurisdiction. Facing a hostile bid, a target company
could, for example, sell an important asset to a third party in order to discourage a
hostile bidder who is interested primarily in acquiring the trophy asset; the problem,
however, is that a target corporation is harmed as well by its own decision to sell the
crown jewelry (often at the fire sale price), which would depress the firm value and
damage business opportunities in the future. Alternatively, a target could issue debt
securities or assume obligations so that the capital structure of the firm is significantly
changed; since the target is then no longer the attractive firm that the prospective

74 Kahan & Rock, supra note 2.

75 RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS
(Foundation Press 2d ed. 1995).

76 Kahan & Rock, supra note 2.
acquirer had gone after, she in the end would give up proceeding with the acquisition. Although this strategy works in terms of preserving a firm’s independence, it is injurious to the target itself as well. In contrast, the sole effect of adopting a poison pill is either to deter a hostile bid or to negotiate the terms of acquisition without damaging a target itself.

2. Dominant Shareholders – Identity and Ownership Structure

As explained, amid the changing M&A landscape, dominant shareholders in controlling shareholder regimes have made attempts to neutralize hostile bids by adopting new defensive measures in their jurisdictions. Before analyzing the anticipated consequences of adopting a poison pill in such a jurisdiction, let me start with a question – who are dominant shareholders? Basically, there are two types of dominant shareholders. One is the government. For instance, the Chinese government manages large state-owned enterprises (“SOE”) that constitute a substantial fraction of the Chinese economy in terms of assets and revenues. 77 The other is controlling family shareholders, who are ubiquitously observed in Asia, Europe, Latin America and even the United States. The subject that my Article delves into is this second group.

What ownership structures do they rely on in order to retain corporate control? For this question, it is worth noting that the primary factor that determines corporate control is not the economic stake a dominant shareholder holds in a corporation, but

77 See e.g., Donald C. Clarke, The Independent Director in Chinese Corporate Governance, 32 Del. J. Corp. L. 73 (2007).
the voting power she can exercise. Until recently, most commentators have analyzed the controlling shareholder system based on a controlled structure ("CS") model in which a large block-holder owns a majority or large plurality of a company’s shares. However, the CS model does not cover the ownership structure of all controlled companies. The other half of the picture can be explained as a controlling-minority structure ("CMS") in which a dominant shareholder is able to exercise control over a corporation while holding only a fraction of its equity – for example, while a dominant shareholder holds only 5% of cash-flow rights, she exercises effective control over a company. According to Bebchuk et al., such a radical separation of voting rights and cash-flow rights can occur in three principal ways – through dual-class share structures, stock pyramids, and cross-ownership ties.

3. Dominant Shareholders and Anti-Takeover Defenses

A dominant shareholder perhaps does not need a pill if she holds “absolute” control (i.e., more than 51% of voting rights). However, many controllers in the world do not hold absolute control – as long as the rest of all shareholders are widely dispersed, a shareholder with less than 50% of all votes can control a corporation. In this latter case, a dominant shareholder may consider a poison pill to fend off a hostile bid completely.


79 Id. at 1.

80 Id. at 1.
(a) **CMS – an “Internal Defensive Device”**

When a controller refuses a high-premium bid which will be beneficial to shareholders as a whole, a controller in a CS company has *more* legitimacy than one in a CMS company. It is because; (i) the CS controller has a significant holding of economic interest corresponding to her voting rights while a CMS controller wields the control by utilizing a voting leverage without owning corresponding economic interest; and (ii) a CS controller is the very person who will lose the most when she does not accept an attractive bid from outside, while the opportunity cost of a CMS controller is minimal since her cash-flow rights in a corporation are small. Therefore, the larger the discrepancy between economic interest and voting power, the more entrenchment effect is expected.

Now, let me explain the CMS in terms of a defense device. Suppose that the top executives in a widely-held U.S. corporation hold 5% of the corporation’s economic interest. Facing a takeover bid, they urge the board to adopt a poison pill (and suppose that the board agrees with management). Accordingly, the threat is eliminated and executives can continue to manage the corporation. On the other hand, suppose that there is a controller in a CMS company outside the United States, who holds 5% of the economic interest in the company and wields 51% of voting control. Here, the controller, as opposed to the executives aforementioned, does not need a pill to quell a hostile bid, although the controller and executives have the same amount of economic interest in each company. In this sense, the CMS itself is a strong “internal defensive device” similar to a poison pill.
In fact, this was the foundation of German opposition to the European Takeover Directive in June 2000, the goal of which was to lower the barriers to takeovers within the European Union and to establish common standards for such transactions by imposing strict neutrality on the board of a target company once a takeover bid has been made.\(^8\) Germany believed that its firms were more open to a takeover threat than were firms from France or Scandinavian member states that continued to allow multiple voting rights that constituted strong post-bid defenses.\(^2\)

\(\text{(b) }\) What If a Dominant Shareholder Does Not Have “Absolute” Control?

So far, I have assumed that a dominant shareholder holds a majority of votes irrespective of how much economic interest she has. However, she is able to “control” a corporation with less than 50% of the voting rights as long as the rest of the shareholders are widely-dispersed and do not collaborate and form one opposing group. In this respect, the Second Circuit’s opinion in *Perlman v. Feldmann*\(^3\) (“*Feldmann*”) is worth noting; Feldmann, who held 33% of Newport, was to sell all of his holding and shares held by his friends (thus, altogether 37% of the Newport stock) to a third party, Wilport, for a control premium; the court opined (seemingly in opposition to the established principle as to the sale of control in the United States) that a dominant shareholder may not sell control at a premium excluding non-


\(^{82}\) *Id.* at 81.

\(^{83}\) 219 F.2d 173 (2d Cir. 1955).
dominant shareholders from reaping the profits.\textsuperscript{84} Although it is important to analyze whether non-dominant shareholders are entitled to share control premiums, what is emphasized in this Sub-Section is the fact that the court deemed Feldmann to be a controller although he held 33\% (or 37\% including the shares of his friends) of the outstanding Newport stock, which is far less than a majority.

The Panel on Takeovers and Mergers (the “Panel”) in the United Kingdom, an independent body which supervises and regulates takeovers and other matters, has a similar position.\textsuperscript{85} According to the City Code that the Panel issues and administers, “control” is defined as an interest, or interests, in shares carrying in the aggregate 30\% or more of the voting rights of a company.\textsuperscript{86} Thus, a controller does not necessarily hold a majority of voting power.

When a dominant shareholder has less than a majority of voting rights – whether she is a CS or CMS controller – she is now exposed to the potential threat of a hostile takeover, although the possibility is low if the level of her voting rights is near 50\%. Then, a controller may be interested in a stronger anti-takeover device such as a poison pill and urge the government or the legislature (or even the judiciary) to adopt a new law that allows the implementation of a pill in a target company.

\hspace{1cm}(c) \textit{A Tale of Two Cities – Tokyo (Livedoor) And Seoul (SK Group)}

\textsuperscript{84} \textit{Id.} See also Ronald J. Gilson and Jeffrey N. Gordon, \textit{Controlling Controlling Shareholders}, 152 U. PA. L. REV. 785 (2003).

\textsuperscript{85} http://www.thetakeoverpanel.org.uk/ (last visited on Dec. 13\textsuperscript{th} in 2010).

\textsuperscript{86} The Takeover Code (explaining that “Control means an interest, or interests, in shares carrying in aggregate 30\% or more of the voting rights (as defined below) of a company, irrespective of whether such interest or interests give \textit{de facto} control.”)
In this respect, it is worthwhile to introduce two takeover attempts in Japan and Korea where business groups are dominant players in their economies and where, until recently, hostile takeovers were almost nonexistent. In February 2005, a Japanese Internet service provider Livedoor (CEO was Takafumi Horie) initiated a takeover bid against Nippon Broadcasting System, Inc. (“Nippon Broadcasting”) when Livedoor owned about 38% of Nippon Broadcasting’s stock.87 Nippon Broadcasting was a subsidiary of Fuji Television Network, Inc. (“Fuji TV”), the virtual headquarters of the Fuji Sankei media group. Interestingly, however, Nippon Broadcasting held 22.5% of Fuji TV’s shares, while Fuji TV held only 12.4% of Nippon Broadcasting’s shares.88 Therefore, Livedoor’s (or Horie’s) bid shattered the control structure of the entire Fuji Sankei Group, which was connected through intra-shareholding among affiliated firms. As a defense measure, Nippon Broadcasting considered issuing warrants to Fuji TV in order to strengthen Fuji TV’s control position and dilute Livedoor’s stake.89 Then, Livedoor sued to enjoin this defensive measure, and the courts (Tokyo District Court and the High Court) ruled in favor of Livedoor.90 As a result, Livedoor obtained a controlling interest in Nippon Broadcasting. Later, however, this battle for control was resolved peacefully –


88 Id. at 2178.

89 Id. at 2179.

90 Id. at 2179-2180.
Livedoor sold its Nippon Broadcasting shares to Fuji TV, and in return Fuji TV obtained a fractional stake in Livedoor for a capital infusion.\textsuperscript{91}

A more dynamic episode took place in Seoul, Korea. Controlling family shareholders in Korean \textit{chaebols} (business groups) use intra-shareholding for their control. In April 2003, Sovereign Asset Management Limited (“Sovereign”) acquired 14.9\% of the outstanding shares of SK Corporation (“SKC”), the largest oil refiner in Korea. SKC was important strategically because it was the \textit{de facto} holding company in SK Group and a large shareholder of SK Telecommunication (“SKT”), the largest telecommunication company in Korea. According to the Telecommunication Business Act in Korea, if Sovereign (a foreign fund) had acquired 15\% of SKC’s stock, SKC would have been deemed as a foreign entity and would have lost its voting power on SKT. Then, the entire SK Group would have been virtually collapsed because complex chains of intra-shareholding could have been destroyed between SKC and SKT. In other words, with its $140 million purchase of SK’s 14.9\% stock, Sovereign would have had the power to dismantle the entire SK Group, whose assets were worth more than $50 billion. After a series of fierce control contests, Sovereign sold its shares of SKC for a profit of roughly $900 million.

In this “tale of two cities,” Takafumi Horie, Livedoor’s CEO, was a Japanese citizen, whereas Sovereign was a foreign entity. In Japan, however, from the perspective of the traditional Japanese business community, the presence of a “maverick,” such as Horie, was deemed to be the result of globalization (more exactly, Americanization), and Japanese authorities became seriously concerned about more hostile takeover attempts from abroad. For example, \textit{Keidanren} (a powerful big

\textsuperscript{91} \textit{Id.} at 2180.
business lobby) called for developing defensive measures to prevent “foreign
predators” from taking control in Japan. In response, the Japanese government
postponed a planned corporate law amendment that would give foreign business
entities more leeway in M&A. In Korea, after SK Group’s experience, politicians
and the business community seriously discussed implementing a poison pill in its
corporate law. They argued that it was unfair that Korean corporations were exposed
to hostile takeover battles while foreign entities had full defensive measures including
the pill.

IV. A PILL – IS IT COMPATIBLE WITH AN IMPORTING JURISDICTION?

The previous Part reviews why the controlling shareholder regime considers
adopting a poison pill in its legal system by importing from Delaware jurisprudence.
One of concerns as to this legal transplantation is that a poison pill is only one
component of the entire Delaware takeover mechanism that consists of various legal
and economic infrastructures that many jurisdictions outside the United States do not
have.

1. The Composition And Nature of the Board

92 Milhaupt & Pistor, supra note 81 at 92.

93 Id. at 92.
One of the lynchpins to support the legality of a poison pill in Delaware is the existence of a board with a majority of outsiders, which can be an independent monitor in relation to management. Is there a similar board in a controlling shareholder jurisdiction, which considers importing a poison pill?

(a) Is a U.S. “Independent” Board Truly Independent?

It is argued that one of the most dramatic changes in the U.S. corporate governance since the second half of the 20th century is the emergence of a monitoring board (rather than an advisory board) with a majority of “independent” directors. The U.S. corporate law (or Delaware law and doctrines) has assumed that executives are in charge of day-to-day management. Although shareholders are residual claimants and “owners” of a corporation, on an individual basis they do not have the power or incentive to monitor executives. In response to this concern, the idea of an independent board emerged as a corporate organ monitoring executives on behalf of shareholders. Thus, a board with a majority of outside directors was designed to solve the collective action problem that dispersed shareholders’ influence as well as to lessen managerial agency costs by disciplining executives. As a result of the popularity of this notion, directors in the typical U.S. board have become less associated with corporate insiders – while most public corporations had a majority of inside directors in the 1960s, the average board consisted of nine outside and only two inside directors at around 2000.

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94 See e.g., Unocal; Moran.
95 Gordon, supra note 65.
The recurring problem, however, is that “outside” directors are not necessarily (or automatically) “independent.” Even in the United States which many commentators have lauded as the jurisdiction of the best corporate governance, an “independent” board can be easily abused as a rubber stamp for a CEO and top executives. This concern is associated with the fact that outside directors are nominated by incumbent management (even if a company has an independent nomination committee) – in fact, outside directors are often friends of a CEO or at least someone in the same social circle that the CEO belongs to.

For example, in Smith v. Van Gorkom (“Van Gorkom”) Trans Union board was found to breach the duty of care under the gross negligence standard because the board approved a CEO’s decision to sell the corporation blindly and uninformed. In fact, Van Gorkom is a very controversial case – the decision was 3-2, which was unusual to the general tendency of unanimity in Delaware Supreme Court. On the one hand, some commentators believe that the case properly emphasizes the significance of the decision-making process in a board room. On the other hand, others argue that Van Gorkom is “one of the worst decisions in the history of corporate law…” Although it is not my purpose here to participate in this debate, an intriguing feature in Van Gorkom is that four out of five “independent” directors

96 Kahan & Rock, supra note 2
97 Id.
were chief executives of major corporations\textsuperscript{100} – arguably they might have been too sympathetic to a retiring CEO and have agreed with him without reliance on enough information, skipping due process for discussing the acquisition from the standpoint of shareholder welfare. In addition, the independence of U.S. “independent” directors is sometimes doubted due to personal ties between “independent” directors and executives, although the directors by themselves are financially disinterested. This skepticism is exemplified in \textit{In Re Oracle Corp. Derivative Litigation}\textsuperscript{101} ("Oracle").\textsuperscript{102} Furthermore, it is needless to say that the economic debacles of Enron and WorldCom raised many questions on the independence of U.S. outside directors.\textsuperscript{103}

In sum, it is correct that a typical U.S. board is not independent in absolute terms. However, the board has continuously improved the quality of independence as time goes by. Then, turning towards a controlling shareholder jurisdiction which considers importing a pill system, is a typical board independent there, and to what extent is it independent, compared to its counterpart in the United States?

\textit{(b) International Comparison – Who Do Outside Directors Deal with?}

\textsuperscript{100} Among ten directors who served on the Trans Union Board, five were insiders and the other five were outsiders. “Of the outside directors, four were CEOs and one was the former Dean of the University of Chicago Business School.” Smith v. Van Gorkom, 488 A.2d. 858 (Del. 1985).

\textsuperscript{101} In Re Oracle Corp. Derivative Litigation, 824 A.2d 917 (Del. 2003).

\textsuperscript{102} In \textit{Oracle}, the Delaware Chancery Court determined the independence of the special litigation committee ("SLC") of Oracle, which was set up in response to a derivative action that alleged illegal inside trading by Oracle’s directors and officers. The court found that the members of the SLC, both of whom were professors at Stanford University, and the directors who were accused of insider trading were connected via the network of Stanford; (i) one accused director taught one of the SLC members; and (ii) two others of the accused made significant contributions and donations to Stanford. Eisenberg, \textit{supra} note 20 at 980-981.

\textsuperscript{103} Discussion with Professor Merritt B. Fox.
As opposed to the state of affairs in the United States, many boards in a controlling shareholder jurisdiction are not comprised of a majority of outside directors – sometimes, there is no outside director at all if corporate law and securities regulation do not require their presence. Even if outside directors constitute a majority, the quality of independence of a typical board in a controlling shareholder system is likely to be lower than in the United States. Why?

Most of all, outside directors are virtually nominated (and elected) by a dominant shareholder who holds voting control – in addition, since many outsiders have financial and non-financial incentives to be re-nominated (and thus reelected), they go along with a controller. It is true that in practice, many outside directors are nominated by a CEO in a typical U.S. corporation as well. Nonetheless, a board with outsiders in a controlling shareholder system is subject to more serious structural bias due to the inherent characteristics of the ownership structure.

Let us think about the nature of power-play in a U.S. widely-held company first. A typical U.S. CEO is a “consul”\textsuperscript{104} – she is the most powerful person in a company, but her tenure is limited. Under this polity, outside directors are basically a consul’s political “colleagues” (although inferior) and act in the rational anticipation that a CEO will step down at some point. It is true that in a hostile takeover situation, a board is on management’s side and rarely welcomes an \textit{external} enemy that is almost invariably a common threat to the board as well. The same board, however, is \textit{relatively} active in disciplining management as to issues that fall outside a corporate control contest. Such check and balance systems operate more often when a vast

\textsuperscript{104} See Sang Yop Kang, \textit{Reenvisioning the Controlling Shareholder Regime: Why Controlling Shareholders and Minority Shareholders Embrace Each Other} (working paper).
majority of shareholders are discontent with the ongoing projects and visions of a company, which are reflected in the stock price. Put differently, outside (and sometimes even inside) directors challenge a CEO internally and sometimes fire her when management’s performance is disappointing.

Then, what about the nature of power-play in a typical company in a controlling jurisdiction? First, it should be noted that the tenure of a dominant shareholder is deemed infinite because family dynastic succession is widely anticipated. Outside directors rationally understand that it is extremely difficult to overturn the dynasty. Accordingly, a controller wields power to the full extent, and a well-functioning system of checks and balances is virtually nonexistent. Unlike an aforementioned CEO who is “consul,” a dominant shareholder is an “emperor.”¹⁰⁵ Thus, directors are best described as “retainers” rather than political “colleagues.” Under these circumstances, an “independent” board, if any, exists in name only. Most of all, the board is not able to challenge and ultimately fire a dominant shareholder. This is obvious when we think who a dominant shareholder and a CEO are. A dominant shareholder is basically a “shareholder” with voting control; thus, her capacity as a controller has nothing to do with a board’s decision or approval; in other words, a board is not able to fire a dominant “shareholder” and a dominant shareholder can be removed only by the voluntary sale of her stock in the market. In contrast, a CEO is a corporate “officer” who is appointed by a board that has a legal power to remove her.

Of course, a controller may hold an official position such as a CEO in a corporation. In such a case, it may be legally possible that a board can fire her from a

¹⁰⁵ Id.
CEO position. But, given that a controller has the power to replace the entire board via her voting power, such a revolt is futile. Interestingly, a dominant shareholder may have incentive not to hold any official post in a corporation. Why? Having an official post such as a CEO has little to do with a controller’s power – a dominant shareholder in a controlled-corporation is powerful not because she is a CEO but because she is a controller. In contrast, when a dominant shareholder holds any official role in a company, she is more exposed to legal liabilities. A controller without an official title may lose psychic utility generated from self-esteem and social prestige. However, she can recover it by granting herself an unofficial designation such as a chairperson in a corporation (not chair of the board) which does not carry legal responsibility but satisfies a controller’s desire for honor.

Realizing this problem, authorities in Korea amended the Commercial Code to create a provision on the de facto directorship, targeting dominant shareholders who do not hold official titles but wield full control in business groups.\footnote{The Commercial Code Section 401-2} According to this provision, a person is liable for transactions if she is construed to be a de facto director who is able to instruct corporate transactions. Nonetheless, it is well known that this provision is not very practical, since a plaintiff must demonstrate that a controller is the person who directs particular orders in business transactions behind the scene, which is an extremely high bar for a plaintiff.

(c) **Reputational Constraints**

It is often argued that a U.S. outside director has reason to oversee management more actively since she cares about her reputation; when a director is
recognized in the corporate governance market as a skillful monitor, she will have more opportunities to have multi-directorships; as a result, she benefits in pecuniary terms. This hypothesis is plausible, if not perfectly convincing, in the United States and has gained some support in academia and practice. However, the extra-legal mechanism based on concern for reputation might not be successfully copied in some controlling shareholder jurisdictions.

To begin with, it is noteworthy that the mechanism of reputation – in the United States as well as in a controlling shareholder jurisdiction – constrains an outside director in two opposite directions, according to the “audiences” they face. On the one hand, a director cares about the general word-of-mouth in the capital market, and aims at public investors who seek a higher return by correcting agency problems. On the other hand, the same director is concerned about her reputation in another audience group, a business circle.

The problem is that the feedback from business elites to a director is more salient in a controlling shareholder system, in particular the CMS, than in the United States because of the very nature of ownership structure. A CMS economy is dominated by a handful of large business groups (and as a result, a handful of dominant shareholders); as a result, controllers constitute *monopsony* in the labor market for outside directors; once an outsider is stigmatized as a “maverick” who is recalcitrant toward a controller in *one* business group, her reputation would spread rapidly among other controllers and business groups; given that public investors are powerless vis-à-vis dominant shareholders, such an outside director has a high chance of being ostracized by *all* business groups, in essence, by the entire economy.
(d) Summary

The independence of U.S. outside directors is not perfect. However, a typical U.S. board is required to have relatively sound “independence.” Most of all, in the United States, the legitimacy of defensive devices including a poison pill is materially enhanced by the independent directors’ review as seen in Unocal and Moran\(^{107}\) – therefore, an independent board is nearly a necessary condition to a pill. Even Van Gorkom and Oracle, which illustrate the weakness of U.S. “independent” boards, simultaneously indicate how much the U.S. judiciary cares about the independency of boards. In addition, in Weinberger v. UOP, Inc. (“Weinberger”),\(^{108}\) the Delaware court emphasized the independence of a committee in self-dealing arrangements between a controller (a parent) and a subsidiary. Such constraint of a dominant shareholder is rarely observed in many countries outside the United States.

Further, boards of many controlling shareholder jurisdictions are subject to serious structural bias. In particular, the ownership structure itself and reputational framework in such countries compromise the board’s independence more significantly. Under these circumstances, the legitimacy of a poison pill – if it is imported – would not be well supported under Delaware jurisprudence. The Delaware court’s lenient position as to a target company’s reliance on the “just say

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\(^{107}\) For example, the Moran court stated, “In addition, the directors must show that the defensive mechanism was “reasonable in relation to the threat posed”… Moreover, that proof is materially enhanced, as we noted in Unocal, where, as here, a majority of the board favoring the proposal consisted of outside independent directors who have acted in accordance with the foregoing standards...” Moran v. Household International, Inc., 500 A.2d 1346 (Del. 1985).

no” pill is based on the court’s confidence in a board’s relative independence and the court’s ability to correct the nature of a board if it is not sufficiently independent.

2. The Judicial System in a Controlling Shareholder Regime

A controlling shareholder jurisdiction may adopt a pill, arguing that it needs an effective defensive device in order to lessen the adverse effects that hostile takeovers may bring in its economy – but those who opposed adopting a pill might be concerned with protection of the interests of shareholders and prospective acquirers. Perhaps, the adoption of the pill would not damage the interests of all relevant parties in takeover battles as long as the institutions of legal enforcement in the jurisdiction follow the general principles of Delaware takeover jurisprudence. However, this is not easily achievable in many controlling shareholder countries.

The Delaware judicial system has been touted as efficient in dealing with corporate governance matters; it has a highly regarded court which specializes in corporate cases, acting without a jury; judges are experienced and versed in business trends, substantive corporate law and litigation; courts – both the Chancery Court and Supreme Court – are expeditious in making decisions. At the same time, Delaware has enjoyed another benefit, the “network effect” – as the number of consumers increases, each consumer’s utility increases. Since Delaware

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110 Id.
111 Id.
112 See generally Michael L. Katz & Carl Shapiro, Network Externalities, Competition, and
is by far the leading state in terms of venue of choice of incorporation, its judiciary experiences a great deal of litigation among corporations, so that legal doctrines are interpreted in a more sophisticated way and results in similar cases are relatively predictable.\(^{113}\) As a result, Delaware corporations, consumers of the corporate law adjudication, are able to make their business transactions proceed in a more stable way and avoid “unfair surprises” in potential legal cases.

In contrast, it is doubtful that most controlling shareholder countries have efficient judicial systems like the Delaware courts.\(^{114}\) Most of all, since the market for corporate control has been virtually nonexistent in these countries, judiciaries do not have a network effect of their own. Alternatively, these countries may consult Delaware takeover doctrines and case laws to solve challenging legal problems associated with a poison pill. An inherent risk of this stopgap is, however, that applying Delaware doctrines without taking into consideration key differences in underlying circumstances in such countries would create incompatibility.

Judges in many countries rotate periodically and cover various legal areas (such as criminal, contract, torts, administration, and family laws) in their career because they need to have at least some knowledge of as many cases as possible to supervise their juniors when they are promoted to higher positions. Under these circumstances, having expertise in one particular subject of law (e.g., corporate law) is systematically impractical. In other words, judiciaries in many countries prefer

\(^{113}\) As to the network effect the Delaware judiciary benefits, See generally, Michael Klausner, Corporations, Corporate Law, and Networks of Contracts, 81 VA. L. REV. 757 (1995).

\(^{114}\) In this Article, for the simplicity, I rule out the possibility that courts in such countries are corrupt, although this possibility is a proper concern in some countries.
generalist judges to specialist ones. In addition, some jurisdictions do not require a judge to have any experience as a lawyer – hence, a judge can start her career in the judiciary in her mid-20s without any exposure to real business transactions. Such a system may have its own merits – however, if we limit our discussion to a court with expertise in complicated business and takeover cases, the system is not well equipped.

Moreover, timing is often of the essence in most business transactions. Thus, business people need a judiciary like the Delaware courts that expedite cases and resolve uncertainties surrounding transactions quickly. Unfortunately, courts in most countries are not fast, so parties in suits are often concerned about whether they should bring suits in the first place. For example, the Indian judiciary, which shares a common law heritage with its counterpart in the United States, is overwhelmed by delays, so that it is not uncommon for a typical dispute to be resolved in 10 or more years.\(^{115}\) With this delay, even the best statutes and case laws are not able to meaningfully protect the interests of injured parties.

3. **Does a Ballot Box Safety Valve Work in a Controlling Shareholder Regime?**

As discussed, Delaware corporate law provides a few safety valves to the pill – the protection of the shareholder franchise (*Blasius*) and a board’s duty to act as auctioneer in certain circumstances (*Revlon*).\(^{116}\) These two safety valves, in fact,


\(^{116}\) Armour et al., *supra* note 29.
support the legality of a poison pill. Are there safety valves in a controlling
shareholder regime when the poison pill is introduced in its corporate law?

(a) Delaware Does Not Allow “Just Say Never”\textsuperscript{117} 

*Time* opined that a target board can just say no to a hostile bid by refusing
*flatly* to redeem a poison pill.\textsuperscript{118} However, the shareholders have recourse in the face
of a board sitting on a pill – they are able to replace the directors in a proxy contest so
that new directors will redeem a pill.\textsuperscript{119} In this sense, even the “just say no” pill is
not really invincible from the perspectives of a prospective acquirer and shareholders,
as long as the voting mechanism is preserved to reflect the real intent of shareholders
as a whole.

However, target boards made attempts to block shareholders’ recourse to the
ballot by inventing mutants of a standard poison pill such as a “dead hand provision”
– in such a provision, only the incumbent directors or their designated successors
were entitled to redeem a pill.\textsuperscript{120} Accordingly, “…it would make little sense for
shareholders or the hostile bidder to wage a proxy contest to replace the incumbent
board,”\textsuperscript{121} since even a newly elected board in favor of the deal would be precluded
from redeeming the pill.\textsuperscript{122} Explaining that the provision effectively disenfranchised

\textsuperscript{117} “Just say never” was coined by Professor Marcel Kahan.

\textsuperscript{118} See Gordon, *supra* note 44.

\textsuperscript{119} Id.

\textsuperscript{120} Jacobs, *supra* note 11.

\textsuperscript{121} Carmody v. Toll Brothers, Inc., 723 A.2d 1180, 1187 (Del. 1998) (hereinafter “Toll Brothers”).
shareholders who wished to elect a board committed to redeeming the pill, the Delaware court invalidated the dead hand provision in *Carmody v. Toll Brothers, Inc.* In *Quickturn Design Systems, Inc. v. Mentor Graphics Corp.*, another variation of a standard pill called a “slow hand pill” – a pill that is non-redeemable for six months after a change in control of the board – was invalidated as well, although the extent of deterrence to a hostile takeover was relatively weak.

In sum, what the Delaware jurisprudence approved is the “just say no” defense, through which a board can buy time to persuade shareholders to agree on an incumbent’s business strategy. However, the board is not allowed to “just say never” which makes the “ballot box safety valve” (associated with *Blasius*) powerless by tainting the shareholder referendum on a corporate control issue.

(b) The CMS with a Pill – “Double Discrimination” against a Hostile Bidder

Does a controlling shareholder regime, the CMS in particular, preserve the ballot box safety valve? To begin with, it is noteworthy that interference with the shareholder franchise is an *innate* problem of the CMS ownership structure. Why?

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123 *Id.*

124 *Toll Brothers.*


126 Professors Kahan and Rock explained, “Thus, the ultimate effect of the pill is akin to “just say wait”: it leaves the decision on whether to accept a bid to the outside board members, but only until shareholders can replace the board, and in the meantime discourages defensive board actions.” Kahan & Rock, *supra* note 2.

127 Professor Gordon explained that “if a board can thwart a proxy fight to redeem a poison pill through a “continuing director” provision in its pill, it is ‘just say never’ defense.” Gordon, *supra* note 44.
The very definition of the CMS assumes that a dominant shareholder is able to distort the voting mechanism – in a stylized example, a dominant shareholder holds a small fraction of a corporation’s economic interest (e.g., 5%) while exercising a large stake of voting rights (e.g., 40%) through stock pyramiding, dual class common stocks, and the intra-shareholding. In the takeover context, such voting leverage mechanisms are in themselves strong defensive devices to a CMS dominant shareholder, even in the absence of a poison pill. As discussed, this is exactly the reason why Germany opposed the European Takeover Directive in June 2000. From Germany’s point of view, its companies with CS were at a greater disadvantage in terms of defense from hostile takeovers than companies from France or Scandinavian countries that continued to have the CMS ownership with multiple voting rights.\(^{128}\)

Therefore, if the “just say no” pill is allowed in a CMS jurisdiction, a dominant shareholder would be excessively protected from hostile takeovers via the mechanism of “double discrimination” among shareholders. (i) The first discrimination takes place between a dominant shareholder and the rest of all shareholders. It is based on the inflation of a dominant shareholder’s voting rights that the CMS itself legalizes. As a result, the voting power of the rest of all shareholders is diluted. (ii) The second discrimination takes place between a hostile bidder and the other shareholders, including a controller. It is based on the dilution of the hostile bidder’s economic interest and voting rights that the poison pill will generate. In the combination of these two powerful discriminatory devices, the principles of one-share-one-vote or equal treatment among shareholders are significantly tarnished. As a result of accumulating discrimination imposed by both

\(^{128}\) Milhaupt & Pistor, \textit{supra} note 81 at 81.
the CMS and a pill, a hostile bidder’s likelihood of winning in a takeover battle is substantially reduced.

(c) *Can a Prospective Acquirer Overcome a CMS with a Pill?*

In Delaware, boards are permitted to maintain the pill indefinitely to block a bid, while shareholders are protected from managerial moves to impede their voting against incumbent management. In that sense, the conflicting interests between management’s autonomy and shareholders’ fundamental right to vote are well balanced. When the Delaware pill is imported to a jurisdiction with the CMS, however, such balance is no longer maintained due to the very definition of the CMS.

Consider a numerical example. Suppose that there are two companies – one is a CMS firm (hereinafter “Company A”) and the other is a widely-held firm (hereinafter “Company B”) – and both have pills which are triggered when an uninvited bidder acquires 20% of their shares. Both a dominant shareholder in Company A and a management team in Company B hold 5% of the common stock. In terms of voting power, however, the dominant shareholder of Company A exercises 40% via voting leverage, while management in Company B holds 5% voting rights commensurate to its cash-flow rights. Suppose that a prospective acquirer considers two companies as takeover targets. At first, it seems that a prospective acquirer may purchase up to 19.9% of the shares of each company

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129 See Bebchuk et al., supra note 8 at 907.

130 In this example, for the purpose of simplification, I assume that in Company A, a CMS controller has multiple voting shares and a prospective acquirer can obtain only stock featured by one-share-one-vote. In Company B, the one-share-one-vote rule is equally preserved among all shareholders including management.
before the poison pills are triggered. In fact, however, she will realize soon that the acquisition of 19.9% of the shares of Company A is far more difficult than the acquisition of 19.9% of the shares of Company B; as to Company B’s stock, a prospective acquirer may purchase 19.9% of the shares out of the 95% free float in a widely-held company (excluding 5% that management owns); however, regarding Company A’s stock, she must buy 19.9% of all shares out of the 60% public float (excluding the 40% of votes that the controller holds).

Even if a hostile bidder is able to acquire 19.9% of the shares of each company, she needs to overcome another difficulty in a proxy contest in each company so that her director candidates will redeem the pill. Again, a prospective acquirer will realize that waging a proxy contest in Company A is far more difficult than in Company B; in Company A, in order to obtain control (i.e., 50.1%), the prospective acquirer has to have the support of 30.2% of the shares out of the remaining 40.1% – the effective percentage of votes that she needs from the rest of the shareholders is 75.3% (i.e., 30.2 / 40.1 = 75.3). In contrast, as to Company B, a prospective acquirer has to gain 30.2% of the votes from shareholders out of the remaining 75.1% – in this case, the effective percentage of additional votes that a controller needs is 40.2% (i.e., 45 / 75.1 = 40.2). Since management has the advantage in waging a proxy contest, the 40.2% hurdle is still demanding to a prospective acquirer. However, a prospective acquirer still has a chance of winning.

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131 Since the bidder currently has 19.9% of votes, she needs 30.2% more in order to gain a majority of votes.

132 100% – 19.9% (the acquirer’s fraction) – 40% (the controller’s fraction) = 40.1%

133 100% – 19.9% (the acquirer’s fraction) – 5% (management’s fraction) = 75.1%
On the other hand, the 75.3% bar is extremely high to a challenger, so that it is almost impossible for a prospective acquirer to gain control of Corporation A.

**(d) The CMS with a Pill – In Between “Just Say No” and “Just Say Never”**

Suppose that there is a straight horizontal line which describes the degree of deterrence created by a defensive device – the scale starts from the left and increases to the right.\(^{134}\) (i) On the far left side, the *Interco* pill – a board is required to redeem a pill when it faces a non-coercive bid – marks the lowest deterrence power to a hostile bid. (ii) On the far right side, the “just say never” pill such as a dead-hand provision – the redemption of a pill is not a viable option to a challenger – marks the strongest deterrence power to a takeover. (iii) The “just say no” pill upheld in *Time* is situated in the middle of those two points.

However, if a *Time* pill is coupled with another strong defensive device, the scale of such a combination moves further to the right. (iv) For example, the combination of “just say no” and an ESB carries a far stronger deterrent effect than that of the stand alone “just say no” pill. (v) Similarly, the CMS ownership with a pill increases the deterrent power of the stand alone “just say no” pill, so that it is located in the middle of “just say no” and “just say never” as well. In sum, roughly speaking, the deterrent power of each defensive measure is situated in the following

\(^{134}\) Thus, the end of left represents a defense device with the least deterrence effect, and the end of right represents a defense device with the most deterrence effect.
order (from weakest to strongest); the *Interco* pill – the *Time* pill (“just say no”) – the
*Time* pill plus either an ESB or a CMS – the *Toll Brothers* pill (“just say never”).135

(e) **The CMS with a Pill – Could It Damage Blasius?**

As Chancellor Allen famously stated in *Blasius*, “The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.”136

Therefore, even if Delaware courts are highly deferential to the board (and management) and do not second-guess business judgments made by a board, they are more intrusive when the primary purpose of a board’s conduct is to interfere with the shareholder franchise. As to the inquiry whether using a combination of a pill and an ESB amounts to undermining the shareholder franchise, reasonable minds can disagree. Nonetheless, it is true that the board with such a combination is more able to abuse its discretionary power to perpetuate itself. In that sense, a pill with an ESB is less likely to be consistent with the tenet of *Blasius*, but it is not definitely inconsistent with *Blasius*.

When a jurisdiction allows the CMS, the legal legitimacy of such an ownership system is not a question (although economic legitimacy is questionable). However, a combination of a pill and the CMS will generate consequences similar to a combination of a pill and an ESB, since the built-in nature of the CMS – which provides a controller with multiple votes – distorts the shareholder referendum. In

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135 Currently, *Interco* (which weakened a board’s discretion under the certain circumstances) and *Toll Brothers* (which practically denies the shareholder franchise) are invalid in Delaware, although it is possible that a target may voluntarily follow *Interco* by redeeming a pill in response to a non-coercive bid.

136 *Blasius*. 

principle, an original Delaware pill is legally upheld by the possibility that shareholders can indirectly (not by themselves but by electing a board) redeem it by replacing a board. Accordingly, the legal legitimacy of the combination of a pill and the CMS is questionable since the ballot box safety valve is tainted.

To make things worse, a dominant shareholder in a CMS may implement a staggered board in addition to a pill unless setting up a staggered board is not permitted. This three-headed dragon has deterrent effect as the “just say never” pill. Therefore, once a pill is allowed in this jurisdiction without careful assessment of the accumulative effect caused by the CMS and an ESB, the market for corporate control will be almost entirely stifled.

(f) Summary

Nonetheless, it does not say that any additional defensive measure is unnecessary or harmful. In other words, although adopting the Delaware’s “just say no” pill blindly leads to “too much” deterrence against hostile takeovers in a jurisdiction, the importing jurisdiction’s present defense system without the pill may generate “too little” deterrence compared to other jurisdictions that allow the pill. Thus, if the jurisdiction needs new defensive measures, it should carefully review whether the combined effect of newly-adopted and existing defensive measures should be “proportional” under the current climate and institutions. For example, as a less powerful anti-takeover device, the Interco pill may be considered.

In addition, it is worth noting that a CMS based on intra-shareholding is a relatively weak ownership structure compared to that based on either stock-
pyramiding or dual class common stocks. As seen in the Livedoor and SK Group episodes, if a hostile bidder is able to find a weak intra-shareholding chain within a business group, the entire group’s control structure could collapse. This might be another aspect that should be taken into account in determining the proportionality of an anti-takeover legal system in a jurisdiction that considers importing a defense measure.

4. Would Revlon Protect Non-controlling Shareholders in a Controlling Shareholder Regime?

In addition to the ballot box safety valve, recall that there is another safety valve to the “just say no” defense. According to Revlon, when a corporation enters into the Revlon mode – sale of a corporation, changes in long-term strategy in the face of a bid, or fundamental change of control – the board should act as a neutral auctioneer among bidders rather than as a corporate defender. Therefore, the board is not able to flatly refuse a shareholder-wealth enhancing bid. Perhaps one may argue that if a controlling shareholder jurisdiction imports the Revlon duty when it adopts the pill in its legal system, non-controlling shareholders would be more protected, at least when a controller incurs the Revlon duty. However, there are limitations of Revlon’s application to developing countries with the controlling shareholder regime.

To begin with, there are two types of controlling shareholders in developing countries. (i) On the one hand, some controlling shareholders expropriate

\[137\] Armour et al., supra note 29.
substantially all corporate value at the expense of non-controlling shareholders through a one-time transaction, just as a government can impose prohibitive taxes on its people. Accordingly, such controllers will leave corporations as shells, since the corporation has nothing left to take. I call them “roving” controllers.\textsuperscript{138} (ii) On the other hand, other controllers extract from non-controlling shareholders based on a long term plan. They transfer a fraction of corporate value through ongoing transactions periodically, just like a rational government levies sustainable taxes on its people. Accordingly, such controllers will stay within corporations for a long time (mostly, they rely on family succession). I call them “stationary” controllers.\textsuperscript{139}

A “roving” controlling regime is the worst ownership system in terms of investor protection, since inefficient enforcement allows controllers to pillage although law-on-the-books declare protection of non-controlling shareholders.\textsuperscript{140} Suppose that a jurisdiction dominated by “roving” controllers legalizes a poison pill which is subject to Revlon. Under these circumstances, dominant shareholders would do “cherry picking” in the corporate law and practice; although the Revlon duty is stipulated in law-on-the-books, controllers do not have to follow the duty because it is rarely enforceable in corporate anarchy that is dominated by roving controllers; at the same time, roving controllers will place the poison pill in corporations when they need it.

\textsuperscript{138} See Sang Yop Kang, Controlling Shareholders – Roving or Stationary (working paper). Originally, Professor Mancur Olson coined roving and stationary bandits to explain the evolution of political system. Mancur Olson, Mancur Olson, Dictatorship, Democracy, and Development, 87 AM. POL. SCI. REV. 567 (1993). I apply Olson’s logics of political economy to corporate governance scholarship.

\textsuperscript{139} Kang, supra note 138.

\textsuperscript{140} In such a jurisdiction, government agencies often collude with business tycoons, and even courts may acquiesce to or blind themselves to suspicious transactions by corporate insiders.
In a jurisdiction with a vast majority of “stationary” controllers, *Revlon* duty is also unlikely to be applicable. One reason is the combination of inefficient enforcement and the possibility of “cherry picking” as discussed above. Another reason derives from the nature of a “stationary” controller – a corporation is not likely to be put up for sale, break-up, or go through a change of control in an M&A market since a stationary controller *by definition* is going to stay in a company *infinitely* through family succession.\(^{141}\) Since *Revlon* mode would rarely be triggered, generally (if not always) the *Revlon* principle would be only a decoration in the legal system. Even in the United States, it is noteworthy that reliance on *Revlon* is not very conducive to a prospective acquirer and shareholders who oppose management’s refusal of an outside bid.

5. **Summary**

In this Part, my point is that a poison pill should not be treated as an isolated island but a part of the large continent of the Delaware takeover law system. Accordingly, the legality of a poison pill should be supported in the context of other legal and socio-economic institutions such as (i) a relatively well-functioning independent board, (ii) an efficient judiciary and enforcement mechanism, (iii) the ballot box safety valve, and (iv) investor protection. In addition, without economic incentive devices (that I will explore further in the next Part) that compensate existing corporate insiders, the poison pill is likely to be abused as an entrenchment tool as

\(^{141}\) Of course, I do not rule out every possibility that a stationary controller would put up a corporation in the market for corporate control for sale, break-up, or change of control. However, the probability seems very low to a stationary controller.
long as it is adopted in the form of “just say no.” Nonetheless, a less powerful anti-
takeover device (for example, the Interco pill) might be more suitable in a controlling
shareholder jurisdiction, depending on its socio-economic and legal infrastructure.

V. THE POISON PILL, EXECUTIVE COMPENSATION, AND THE
SALE OF CONTROL

In the United States, the evolution of executive compensation since the 1990s
has transformed the pill from an entrenchment device to a negotiation tool, at least to
some degree. This is how the market for corporate control has still survived despite
the pill’s strong deterrent effect against a hostile bid. Can we expect the same
phenomenon in a controlling shareholder jurisdiction, if the pill is incorporated in the
legal system?

1. Severance Fee And Friendly Deals

This Section explains how different severance fee practices affect corporate
insiders’ incentive and reactions toward acquisition bids from outside. On this issue,
I begin with a comparative analysis of the United States on one side and some
controlling shareholder jurisdictions on the other side. Then, I explore why a pill
would generate sharply different consequences in takeovers on either side.
(a) The Comparative Analysis on the Executive Compensation

In 1991, the average U.S. large firm CEO made 140 times what the average worker made.\textsuperscript{142} By 2003, this multiple increased to over 500 times.\textsuperscript{143} In contrast, the average CEO-rank and file employee compensation ratio is about 20:1 in many countries outside the United States. For example, Professor Eisenberg explains that the average Japanese CEO makes 16 times the pay of an average Japanese industrial worker and the average German CEO makes about 21 times the pay of the average German factory worker.\textsuperscript{144} What causes such a sharp distinction? Perhaps, one of reasons is the difference in cultural norms in each jurisdiction – in many countries which place higher value on social democracy and egalitarianism, a huge income disparity is not socially and politically tolerated.\textsuperscript{145}

Hostile deals which brought controversy and fear to Corporate America in the 1980s became suddenly quieted down, as a pill was legalized and firmly established in the Delaware takeover system. However, the evolution of U.S. executive


\textsuperscript{143} Id.

\textsuperscript{144} Eisenberg, supra note 20 at 649. Eisenberg relied on G. Crystal, In Search of Excess 27, 206-209 (1991). It is noteworthy that Crystal’s work was written in 1991. As mentioned above, the U.S. CEO-employee compensation multiple was 500 in 2003. In that sense, it would be fair to compare 2003 U.S. data and 2003 data from Germany, Japan, or other countries. At this moment, however, I do not have credible data to compare the compensation disparity in the United States and other countries in the same recent year. In addition, my point in this Article is to show that there is a huge gap between the United States and other countries in terms of executive compensation rather than to show the exact difference of each jurisdiction’s executive compensation level. For this purpose, I believe that Crystal’s 1991 work, which was quoted by Professor Eisenberg (2005), is sufficient.

\textsuperscript{145} Whether U.S. executive compensation is “exorbitant” in absolute and comparative terms is an interesting and worthwhile topic to analyze, but it is not my purpose in this Article. Rather, my focus here is how such sharp contrasts of the executive compensation level in the United States and other countries can affect incentives of corporate insiders with pills when they are approached by control-changing bids.
compensation made market participants adapt to the new takeover environment. For example, a generous severance package which corresponds with the level of a gigantic executive compensation could provide incumbent management with incentive to leave a company when an outside bid for acquisition is offered. 146 Therefore, friendly M&A activities filled the vacuum left by the hostile deals that the pill stifled. With the evolution of executive compensation, the pill was repurposed as a tool for negotiation leverage to enhance the welfare of shareholders (however, many commentators are still suspicious of its entrenchment purpose).

Now, suppose that a pill is placed in the corporate law system in a jurisdiction with a low ratio of compensation between the CEO / a rank-and-file employee. It is less likely that such a jurisdiction has a practice of generous severance packages to departing corporate insiders. Thus, corporate insiders have little reason to accept hostile bids which will deprive them of jobs, pecuniary benefits, and psychic utility without any compensation for such losses. Accordingly, they use the pill in order to quell friendly deals as well as hostile takeovers.

One may argue that such a jurisdiction is able to develop an executive compensation system just like the United States did in 1990s; the U.S. CEO-employee compensation multiple increased from 140 to 500 (i.e., 257% increase),147 and the market participants learned how to live with a pill by designing a severance package with more generous terms. 148 Of course, this argument is plausible, and some countries can dramatically change their pay tradition as a pill is instated in their

146 Kahan & Rock, supra note 2.
147 \((\frac{500}{140} - 1) \times 100\% = 257\%\)
148 Kahan & Rock, supra note 2.
takeover laws. In contrast, in many countries, the differences in culture, traditional values, political arrangements, and understanding of capitalism would make it difficult to accept the practice of Anglo-American executive compensation based on a large income disparity. Below is a detailed analysis drawn from real episodes in controlling shareholder economies.

(b) Episodes in Executive Compensation – Germany, Korea, And The United States

In 2000, Vodafone, a British telecommunication firm, acquired Mannesmann, a German conglomerate. Although the agreement was ultimately friendly, Vodafone initiated a hostile bid at first. This deal brought sensation in Europe since it was the first “hostile” takeover (in terms of the nature of the first bid) of a German firm by a foreign firm. One controversy surrounding this deal, inter alia, was associated with an “appreciation award” granted to Esser (then chief executive) and other managers of Mannesmann – in particular, Esser was granted £10 million (about €15 million). Initially Esser had fought the Vodafone bid – but suddenly he “gave up resistance against Vodafone the day he knew about his compensation package.”

149 Milhaupt & Pistor, supra note 81.


151 Id. See also Milhaupt & Pistor, supra note 81.

152 Economist, supra note 150 (quoting Martin Peltzer, a lawyer in Frankfurt).
In the United States, the question of executive compensation is left to the business judgment of the board of directors. Accordingly, even if some disgruntled shareholders bring lawsuits for monetary damage, it is difficult to imagine the executive compensation at issue being found in violation of corporate insiders’ fiduciary duty. Surprisingly to those used to the “global” executive compensation standard (which is actually the American standard), however, Esser and key players designing the appreciation award were brought to criminal trial by a prosecutor’s office on the grounds of breach of trust. The trial court acquitted the defendants. However, BGH (Bundesgerichtshof, the Federal Court of Justice in Germany which acts as a court of appeal) followed the argument of the prosecutor’s office and reversed the trial court’s decision. Finally, the retrial court terminated the criminal trial on the condition that the accused pay a total of €5.8 million to various public-interest organizations.

Another example where a top executive’s severance fee was tried in a criminal court can be drawn from Korea. During the aftermath of the Asian Financial Crisis in 1997, many Korean companies with liquidity problems were sold to foreign investors at deeply discounted prices. In 2003, Lone Star acquired a controlling stake (51%) in Korea Exchange Bank (“KEB”), which was one of the largest nationwide banks in Korea. However, the prosecutor office in Korea accused Lee Kang-Won,  

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153 Milhaupt & Pistor, supra note 81.

154 Id. In particular, Esser who had received €15 million, was required to pay €1.5 million.


then chief executive of KEB, on the grounds that he intentionally made KEB’s financial condition look worse than it actually was in order to facilitate the friendly deal. 157 Allegedly, he received $1.5 million for his future services in the bank as a consultant, which could be construed as compensation for smoothing the deal. After 5 years of hardship under criminal investigation and trial, Lee was found not-guilty of the charge of dereliction of breach by selling KEB at an intentionally low price.158 But he was sentenced to an 18 month-jail term because he was found guilty of receiving a bribe (about $50 thousand) from one of the bank’s suppliers.

Against this backdrop, it is worth comparing the occasions of Lee (and Esser) on the one side with that of Michael Ovitz, a former CEO of Disney who was a main character in one of the most important U.S. executive compensation cases. 159 The banking industry in Korea, which was the 11th largest economy in the world before the Asian Financial Crisis, is greatly concentrated, meaning that a chief executive of a large bank is a highly regarded position. Nonetheless, the absolute level of Lee’s executive compensation does not seem to be “proportional” from the U.S. industry standard. If it had been proportional, Lee would not have risked imprisonment to receive “only” $1.5 million (or $50 thousand) as “bribes” to facilitate Lone Star’s friendly acquisition of KEB (or to give favor to a supplier). People might take pity on Lee when they remember that Michael Ovitz received approximately $140 million


159 See e.g., In re the Walt Disney Company Derivative Litigation, 825 A.2d 275 (Del. 2003).
from Disney in the form of severance pay after just about one year at Disney.\footnote{Id.} Although he departed Disney due to his inability to run the business efficiently, the amount that he was granted is about 100 times the amount that Lee was offered by Lone Star.\footnote{This multiple might be higher if time value of money is taken into consideration.} Another American example from the finance industry – when Stanley O’Neal was ousted from Merrill Lynch for a disappointing performance in 2007, he departed with $161.5 million.\footnote{See e.g., Miles Weiss, *Merrill Lynch’s O’Neal Departs With $161.5 Million (Update2)*, Bloomberg, Oct. 30, 2007 (available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a52OIGkiBx0Q).}

\textbf{(c) High Compensation – Is It a Crime in Some Countries?}

Many U.S. top executives who underperform can “exit gracefully” with generous golden parachutes. They are even applauded and touted as “good men” in particular at the time of control change because they voluntarily step down from their corporate positions and accept a value-enhancing M&A. In addition, they are often able to reap a substantial profit from stock options when high-premium bids are offered. This is a quite interesting phenomenon because (i) these departing executives may be “the” reason for their companies’ depressed stock prices and (ii) high bid prices are in fact the level of prices that stocks should be worth with management of average capability. If such a pay system has been existent and well established in Korea, for example, Lee would not have considered accepting $1.5 million as “bribe” to expedite a deal, as critics describe the nature of the money Lone
Star allegedly offered to him. In this sense, a generous golden parachute in the United States can be characterized as a “legally permissible bribe.”

Of course, there is certainly “public outcry” as to the “exorbitant” level of pay for executives in the United States. In countries with a strong ethos of social democracy or egalitarianism, there would be much more serious political resistance from the public against high pay for corporate insiders (e.g., a massive street demonstration rather than only “public outcry”) although corporate insiders in such countries receive a small fraction of what their American counterparts receive. People may ask a question – how dare a CEO who underperforms and incurs the change of control receive even a $1 severance pay while most employees suffer from massive layoffs arising from the M&A?

In response, government agencies as well as the prosecutor’s office would make such “greedy” executives stand criminal trials. As Fortune vividly described in the wake of the Mannesmann case, “In Germany, High Pay Is a Crime.”\(^{163}\) Even if highly-paid corporate insiders are ultimately found not guilty, they would already have suffered from criminal trials for more than several years, when the final rulings are made by courts. In addition, their reputation will be irreversibly damaged, so that it is practically impossible for them to come back to the business world. Unless a sufficient amount of severance pay is available, top executives have virtually no reason to initiate negotiation for M&As which will take their jobs without any meaningful consideration. Consequently, the pill, when it is imported in a country with social democracy or egalitarianism, is likely to quell M&As in the domestic economy.

2. Control Premium And Friendly Deals

The previous Section focused on the role of executives’ compensation in M&A transactions. Outside the United States, although some widely-held corporations are run by professional managers, dominant shareholders are mostly key players in strategic transactions. Of course, controllers are often corporate executives as well, and executive compensation is an important issue to them. But, controllers are more interested in control premiums when they sell corporations to a prospective acquirer, since the amount of money involved in the sale of control is generally far larger than that in an executive pay. How does the control premium affect a controlling shareholder’s incentive when she considers selling control?

(a) The Components of the Control Premium

Suppose that a dominant shareholder has significant votes in a corporation which do not amount to a majority (e.g., 30% votes). She is not perfectly insulated from a threat of acquisition without a pill – a prospective acquirer has a chance (albeit a small one) to take over the corporation by purchasing shares in the market. Now suppose that her jurisdiction implements a pill in its legal system. Then, it is almost impossible for a prospective acquirer to take over a corporation in a hostile way – the only viable option is to pay the dominant shareholder for the sale of control with a “sufficient” premium (which will change the controller’s intention about remaining in control). The problem is how “sufficient” the premium should be.
In general, a controller has two sources of “utility” (or happiness) from managing a corporation – the pecuniary benefits and non-pecuniary benefits. The pecuniary benefits to a controller can be divided further into two sub-categories. (i) One is monetary benefits distributed to all shareholders according to their fraction of the cash flow – I call them “pro-rata dividends,” although these benefits are not necessarily paid in the form of dividends. For example, capital appreciation of the stock is deemed as a pro-rata dividend (in this Article) because every shareholder is equally able to reap the profits. A controller benefits in accordance with her economic stake in a corporation. (ii) The other is monetary benefits that are available *exclusively* to a controller at the expense of non-controlling shareholders – I call them “special dividends”\(^{164}\) – which a controller can take through “tunneling.”\(^{165}\) A controller takes every special dividend irrespective of her fraction of economic interest in a corporation.

It is noteworthy that the current controller is going to be paid both pro-rata and special dividends *infinitely* if she is a family controller whose heir is expected to inherit the control power of a corporation. If a controller’s pro-rata dividend and special dividend in the first year are “DIV1” and “EXT1”, then the *present value of all cumulative* pro-rata and special dividends can be expressed as “\([\text{DIV1} / (k – g)]\)” and “\([\text{EXT1} / (k – g)]\)” respectively according to a valuation model based on discounted cash flows\(^{166}\) (here, “k” is a required discount rate and “g” is the

\(^{164}\) Although I call them “special dividends,” in this Article, they are not legally allowed dividends (in that sense, they are “special.”) These payments are distributed to only a controller by mostly self-dealing transfer from a corporation to a controller.

sustainable growth rate of each dividend).  

Put together with the non-pecuniary benefits of control (“NPBC”), which is another cumulative value, the “total value of controlling a corporation” (“TV”) is the sum of \[\text{DIV1} / (k – g)\], \[\text{EXT1} / (k – g)\], and NPBC. Then, the current controller will sell control only if the payment a prospective acquirer offers is more than TV.

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\text{TV} = \left[\frac{\text{DIV1}}{k – g}\right] + \left[\frac{\text{EXT1}}{k – g}\right] + \text{NPBC}
\]

Notes
- TV: A Controller’s Total Value of Controlling a Corporation
- DIV1 / (k – g): Present Value of Cumulative Cash Flow from “Pro-rata Dividends”
- EXT1 / (k – g): Present Value of Cumulative Cash Flow from “Special Dividends”
- NPBC: Non-Pecuniary Private Benefits of Control

(b) What If a Current Controller Is Not Willing to Sell Control?

Pro-rata and special dividends are monetary benefits while the non-pecuniary benefits (“NPBC”) are not. The above formula for TV is based on the assumption that NPBC is capitalized in monetary terms. In an extreme case (but certainly, there are such cases in the real world), however, the substitutability between pecuniary and non-pecuniary benefits is near zero because the current controller values NPBC “prohibitively highly” – accordingly, the current dominant shareholder would not sell the control of a corporation irrespective of the amount of payment from a third party. For example, a controller perceives the corporation as her alter ego (which is not a negative vocabulary used in the case of piercing a corporate veil) or a cherishable

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167 For the more explanation, see Kang, supra note 138.
entity (like a child) materialized and raised by the controller’s life-long efforts. Thus, she may not even imagine selling a corporation however much a prospective acquirer offers.

Without a pill, a current controller (with 30% voting rights, for example) is exposed to the threat of any hostile takeover a prospective acquirer imposes in the market. With a pill, however, the controller does not have to worry about such a possibility, and a transaction of control does not take place. To such a controller, the only successor may be her own children who share her genes and protect her legacy.

(c) What If a Current Controller Is Willing to Sell Control? – Issues Related to the Value of Non-Pecuniary Benefits of Control

Now, suppose that a current controller is willing to sell control (therefore NPBC as well) in exchange for the corresponding premium. Nonetheless, if there is no buyer who is willing to pay such a premium, a transaction of control sale does not take place.\(^\text{168}\) As to large corporations in particular, there are several reasons why there are not many potential buyers of control. Most of all, “A typical acquirer does not (mostly is not able to) buy a large corporation like IBM, but a company with

\(^{168}\) Professor Merritt B. Fox explains a potential acquirer’s risk averseness in a takeover. “A potential acquirer, in deciding whether it is worth paying what it would need to pay to acquire a target that the acquirer feels is mismanaged, must make an assessment of what the target would be worth in the acquirer’s hands. This assessment is inherently risky and the acquirer’s management is likely to be risk averse.” Merritt B. Fox, The Securities Globalization Disclosure Debate, 78 WASH. U. L. Q. 567, 572 & n.11 (2000).
small or mid capitalization.”\(^{169}\) Or, even if an acquirer can afford it, it is reluctant to take a high risk by purchasing a large corporation with a high premium.\(^{170}\)

In addition, it is possible that the relative value of the NPBC of a large controller is higher than that of a small controller, because NPBC is deemed to be a “luxury good” that only relatively wealthy consumers – generally, controllers in larger corporations – can consume.\(^{171}\) In this sense, a “unit” value of NPBC becomes larger as the size of corporation grows, so that, for example, a large corporation that is three times larger than a small corporation gives more than three times the psychic utility to a controller than a small corporation does. This phenomenon of “NPBC synergy” makes a large corporation more expensive and less affordable to a prospective acquirer.

The high value of NPBC generates another limitation to a potential buyer. If a potential buyer’s own subjective NPBC is high as well, she may be willing to purchase control as long as she has access to sufficient financial resources. However, it is more likely that the subjective value of NPBC is higher to a current controller than to a prospective purchaser because of the “endowment effect”; to a current controller, a corporation is “her own corporation” that she has built and developed for her entire life; thus, the current controller place more subjective value on control and NPBC than a third party.

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\(^{169}\) Discussion with Professor Merritt B. Fox. When I discussed Professor Fox on my Article, he pointed out this phenomenon generally observed in the M&A market.

\(^{170}\) See e.g., Fox, supra note 168.

\(^{171}\) See generally, Kang, supra note 138.
Moreover, if a prospective acquirer is a foreign entity, the gap between the subjective value of NPBC to a seller and a buyer of control would widen – thus, it is less likely that a prospective acquirer would purchase the control of a large corporation. Suppose that a New York-based business entity considers purchasing the control of a large Philippine family corporation. First, “familiarity bias” can impede this transaction; the value of NPBC is largely dependent on the local people’s perception of how great it is to run a locally reputable corporation; thus, the subjective value of NPBC for running a large Philippine corporation is huge to a controller in Philippine, but is not to a business entity located in New York, since people in New York are not even aware of the name of a target corporation; consequently, a NY acquirer will enjoy far less NPBC if it purchases control of a Philippine corporation. Second, if a NY business entity is a widely-held corporation, it would impede the transaction further. NPBC to a controller includes accumulative psychic benefits available to her for the entire life and family lines including future descendants. Thus, the value of NPBC to a CEO in New York who has a limited tenure would be much smaller than the value of NPBC to a (family) controller in Philippine who has an infinite duration in her position through family succession.

(d) What If a Current Controller Is Willing to Sell Control? – Issues Related to Egalitarianism

The control premium is generally far higher than severance pay – for example, if Lee were a controller of KEB, he would not have considered selling control to Lone Star for only $1.5 million. When the culture and norms of a jurisdiction do not allow
a large income disparity (putting aside that a large monetary compensation is legally allowed), such a country is not likely to allow a control premium which is available only to a current controller excluding the rest of the shareholders (and other constituencies in a corporation). This view is strengthened by the fact that a large fraction of the control premium is from “special dividends” which a controller receives by illicit self-dealing; these special dividends might be socially endured as long as there is no compelling evidence for their presence; however, when the value of illicit self-dealing is capitalized in the corporate control market and paid to a current controller in the form of money, it would become a huge social and political problem in the jurisdiction. Knowing this, many controllers in large corporations would like to remain as controllers rather than sell control.

Accordingly, facing the de facto equal treatment rule (as similarly seen in Feldmann) imposed by social norms (irrespective of whether such a legal doctrine is existent in a jurisdiction), a control sale is to take place only if the control premium is equally shared with all shareholders according to their cash-flow rights. Under that condition, however, a current controller would not have much reason to sell control to a third party in the first place.

3. Does the Pill Block Sales of Control?

As seen in this Part, in a country with social democracy and egalitarianism, a likely consequence of adopting a pill system is that corporate insiders (both executives and dominant shareholders) use a pill as the tool for entrenchment and
fiercely resist any bid. In addition, those corporate insiders have social and political “justification” (which is in fact a “pretext”) to use a pill to its full extent – by resisting any bid, they are deemed as defenders of employees whose welfare would be affected adversely by an M&A. As a result, a market disciplinary device, i.e., M&A, would become figurative or meaningless.

Consequently, there are generally three alternatives when the performance of companies is disappointing; (i) management is permitted to let the performance keep deteriorated until bankruptcy, which is the worst scenario; (ii) when the situation is so serious and the public opinion ultimately accepts M&A as inevitable, management may rely on fire sales of companies at a deeply depressed price rather than high-premium sales gained in a normal M&A; or (iii) underperforming corporate insiders would seek a government bailout in which they may remain or be replaced. As seen in (ii), the pill does not block entire M&A. Perhaps, a fire sale is another form of friendly M&A, but, it is an involuntary friendly deal and may be undesirable to a domestic economy.

In a country with a weak social democracy and egalitarianism, a pill may be used as a tool for price negotiation (which only favors a controller). As discussed, however, if the discrepancy of the subjective value of NPBC to an incumbent controller and a prospective acquirer is large, it is less likely that a prospective acquirer would purchase the control of a large corporation. In this respect, the emergence of sovereign wealth funds (“SWFs”) – government-sponsored entities that invest assets such as foreign reserves in domestic and international financial
markets\textsuperscript{172} – is of importance because they may make sales of control more available.\textsuperscript{173}

Suppose that an SWF buys control from a controlling shareholder abroad by paying a high value of NPBC (thus, a high control premium), which seems to be “overpayment” from the perspective of a target’s stand-alone value. Nonetheless, as long as the purchase of a target creates positive externalities to an entire economy of the home country, an investment decision of an SWF is justified on a macro-economic basis. In other words, assets of SWFs can be used for various industrial policies of governments. In addition, it is worth noting that governments, which are shareholders of SWFs, are inherently inefficient monitors in terms of supervising economic performance, so that SWFs have more leeway to pay for the control premium. Moreover, governments and SWFs often make politically motivated deals that have no rational economic basis.\textsuperscript{174} Hence, even if a target is not worth a high price, an SWF may decide (and the government will approve) to pay an exorbitant premium for the target. Furthermore, the vast amount of foreign reserve may require SWFs to diversify their asset portfolio more broadly. In order to avoid only piling up cash (or investing in low interest-bearing treasury bonds), it may be inevitable for


\textsuperscript{173} During the discussion with Professor Curtis J. Milhaupt, he hinted that sovereign wealth funds are willing to pay high control premium for non-pecuniary benefits of control.

\textsuperscript{174} See \textit{e.g.}, Gilson & Milhaupt, \textit{supra} note 172 (quoting Sen. Chuck Schumer’s statement in Financial Times that “So the bottom line is that we don’t know if their decisions are made exclusively on an economic basis.”) James Politi, \textit{Sovereign Funds Face US Threat}, FIN. TIMES, Feb. 14, 2008.
SWFs to buy control of some targets even though SWFs know that they end up overpaying.

Another possibility that a prospective acquirer is willing to pay the high value of NPBC (thus, a high control premium) is associated with a drastic change in external environments. The aforementioned example of a Philippine family corporation and a New York-based investment entity is useful again. Suppose that the Philippines is under financial distress at the macro-level; now, from a local controller’s point of view, growth rate (g) in the future is expected to decrease significantly while the discount rate (k) soars; accordingly, her reserve price of control is accordingly lowered; therefore, purchasing control is more affordable to a prospective acquirer in New York. In addition, an exchange rate system is distorted due to national financial difficulties, so that the Philippine peso becomes drastically cheaper than the U.S. dollar. Under these circumstances, even if a huge gap of NPBC value originally existed between a seller and a buyer, a target in the Philippines becomes very attractive to a New York business entity for two reasons; (i) the depressed reserve price denominated by the Philippine peso; and (ii) the strengthened purchasing power of the U.S. dollar vis-à-vis the Philippine peso.

VI. CONCLUDING REMARKS

In the United States, “[The] “just say no” [pill] was a much more problematic defense in the corporate governance world of the 1980s than it is today, with
differently constituted boards and different incentive compensation regimes.\textsuperscript{175} If a jurisdiction outside the United States considers adopting a pill system, it should take into consideration whether its legal and socio-economic institutions are close to either the 1980s-U.S. or the post-1980s-U.S. Without developed legal and socio-economic infrastructure, the pill would remain a very “problematic defense in the corporate governance world” of such a jurisdiction. In that sense, the pill should be adopted through “bundling” (like a pair of shoes) so that when such a jurisdiction “buys” the pill (a right shoe), it should “buy” other Delaware doctrines (a left shoe) in relation to the pill.

Market adaptation via executive compensation was another important reason why the pill did not squash a material fraction of M&A activities in the United States. A similar (or the same) consequence would not be expected in a country with a strong ideology of egalitarianism – thus, even most friendly deals would be crowded out when such a country adopts a pill system. The pill may enhance a controller’s negotiation leverage, which increases her reserve price for sale of control – accordingly, a sale of control, another type of a friendly deal may be fomented as long as there is a potential buyer. In such a case, however, most shareholders are excluded from sharing the benefits of a control sale when a controller depends on the CMS ownership. This phenomenon will be precisely against the rationale of adopting the pill, i.e., protecting weak non-dominant shareholders. Furthermore, when a jurisdiction complies with the equal treatment rule (either via legal requirement or non-legal norm), thus undercutting a controller’s incentive to sell, the newly imported pill system would also suppress the sale of control although some exceptions (e.g.,

\textsuperscript{175} Kahan & Rock, \textit{supra} note 2 at 900.
SWF involved deals and fire sales incurred by idiosyncratic or macro-level systemic problems) are possible.

In sum, importing a pill would provide a jurisdiction with “too much” chilling effect towards a market for corporate control. Nonetheless, it is noteworthy as well that the defensive system without a pill may protect control of business entities “too little.” In that context, it is desirable to have an institution with expertise, impartiality, and efficiency to determine an allowable level of the pill’s deterrence on a case-by-case basis. The problem is that such a sophisticated institution is impractical to many controlling shareholder countries at this time. As an interim solution, it may be worth considering a less preclusive defensive measure such as the Interco pill (but not limited to the Interco pill). Alternatively, a new enactment, such as the Exon-Florio Act, may be useful (with/without a less powerful pill) as long as a drastic change of control in a corporation creates “national security” issues.