TAKING VOTING LEVERAGE AND ANTI-DIRECTOR RIGHTS MORE SERIOUSLY: A CRITICAL ANALYSIS OF THE LAW AND FINANCE THEORY

Sang Yop Kang[*]

Abstract

The "Law and Finance theory"—which offers analytical frameworks to measure the protection of public investors and the quality of corporate governance—has dominated the comparative corporate governance scholarship in the last decade. So far, many proponents and critics have had debates on the relevance of the theory and the implications of the theory's empirical studies. Several important points in relation to voting leverage and shareholder protection,

[*] Sang Yop Kang is Associate Professor, Peking University School of Transnational Law; J.S.D. (Doctor of the Science of Law), Columbia University School of Law; Attorney at Law; Chartered Financial Analyst (CFA). Professor Kang thanks his mentors at Columbia Law School—Professors Merritt Fox, Jeffrey Gordon, Curtis Milhaupt, and Katharina Pistor—for their encouragement and advice when he introduced his initial ideas of this Article. Professor Kang also thanks Professors Jesse Fried at Harvard Law School and Ronald Gilson at Stanford and Columbia Law School for their insights and critical reviews of the Law and Finance theory in their seminars. Further, Professor Kang thanks Vice Chancellor Jeffrey Lehman at New York University Shanghai, and Professors Francis Snyder, Douglas Levene, Yunlong Man, and Norman Ho at Peking University School of Transnational Law, Ching-ping Shao at National Taiwan University, and Ok-Rial Song at Seoul National University, and Mr. Joon Hyug Chung at Shin & Kim, for their comments and discussions. Professor Kang's thanks go to participants of a workshop at Peking University School of Transnational Law and participants of a conference held by Korean Securities Law Association. In addition, Professor Kang thanks Dean Philip McConnaughay, Vice Dean Stephen Yandle, and his colleagues at Peking University School of Transnational Law, Chancellor Wen Hai at Peking University Shenzhen Campus, and Professors Bok Ki Hong, Sung Tae Kim, and Hyun-Yoon Shin at Yonsei University School of Law, for their advice and moral support. Also, Professor Kang thanks editors of the Columbia Journal of Asian Law for their comments, and his students, Tong Ling, Shuping Shao, Yongchen Song, Yulong Wang, Tian Xie, Xueying Zhang, Yuhui Zhao, and Xiaozhu Zhong, for their proof-reading and assistance. Last but not least, Professor Kang thanks his family for their endless support for him.

however, have been highly neglected in these debates. In particular, the significance of the one-share-one-vote (OSOV) and the one-share-multiple-vote (OSMV) has been inappropriately underestimated. In response, this Article explores (1) why OSOV (or OSMV) is a critical component of corporate governance; and (2) how OSMV makes some components of the Anti-Director Rights Index (ADRI)—perhaps, the most significant corporate governance index so far—less meaningful. In addition, this Article offers critical examinations on components of ADRI. Features of a controlling shareholder regime (including controlling minority structure) are closely examined in the context of OSOV/OSMV and the ADRI. To these ends, this Article provides examples, explanations, and evidence from China and Korea in addition to traditional U.S.-based corporate governance theories.

I. INTRODUCTION

Many institutes, relying on indices that they have defined themselves, have published reports on matters such as the "competitiveness of nations,"[1] "ranking of U.S. law schools,"[2] "corruption perception index,"[3] and even "survey of happiness across countries."[4] Likewise, a popular trend in modern social sciences is to conduct research on qualitative topics based on indexing with quantitative analysis. This academic practice makes ranking possible by using scores generated from an index. Recently, such indexing has also been

[1] *See generally* Klaus Schwab, *The Global Competitiveness Report 2013-2014*, WORLD ECON. FORUM (2013), *available at* http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2013-14.pdf; *see also* Michael Porter, *The* Competitive *Advantage of Nations*, 68 HARV. BUS. REV. 73 (1990).

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

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

[4] *See Better Life Index—Ed. 2014*, ORG. FOR ECON. COOP. & DEV., http://stats.oecd.org/Index.aspx?DataSetCode=BLI (last visited July 6, 2014).

used in comparative corporate governance scholarship. In their pioneering article of *Law and Finance* (1998),[5] four distinguished economists—La Porta, Lopez-de-Silanes, Shleifer, and Vishny (hereafter LLSV)—invented a corporate governance index to measure the level of investor protection across forty-nine countries.[6]

LLSV's framework for analyzing the quality of public investor protection in a jurisdiction[7] examines the "one-share-one-vote" (OSOV) rule and six components of the "Anti-Director Rights Index" (ADRI[8]).[9] One point is awarded to a country if it has the OSOV rule, and each component of the ADRI is worth a point as well; otherwise, zero points are awarded. It is noteworthy that the OSOV is a separate category from the six components of ADRI. Thus, the highest ADRI score for a country is six. In addition, it is of significance that OSOV and almost all the ADRI components are related to

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[5] *See generally* Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998) [hereinafter LLSV, *Law and Finance*]. The Law and Finance theory in this Article generally refers to explanations and arguments in LLSV, *Law and Finance*.

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

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

[8] The acronym of "ADRI" is used by Holger Spamann. *See* Holger Spamann, *The "Antidirector Rights Index" Revisited*, 23 REV. FIN. STUD. 467 (2010).

[9] The six components of ADRI are: (1) "Proxy by Mail Allowed"; (2) "Shares Not Blocked Before Meeting"; (3) "Cumulative Voting" (or "Proportional Representation"); (4) "Oppressed Minorities Mechanism"; (5) "Preemptive Right"; and (6) "Percentage of Share Capital to Call an Extraordinary Shareholders' Meeting." *See* LLSV, *Law and Finance*, *supra* note 5, at 1127-28.

shareholders' voting.[10] In this sense, the ADRI explores how effectively challenging shareholders can rely on voting when they disagree with directors or management.[11] Using the ADRI as their major toolkit (again, the OSOV rule is not a component of the ADRI, and OSOV score is not considered when the total score of the ADRI components are compared across countries and legal origins), LLSV's findings can be summarized as the following: (1) the quality of corporate law can be measured by six corporate law provisions as reflected in the total ADRI score;[12] and (2) public investors are protected more in common law countries than in civil law countries.[13]

The Law and Finance theory has had a huge impact on comparative corporate governance scholarship and policy-making, highlighting the importance of good corporate law that enhances shareholders' protection and capital market development.[14] Most of all, without LLSV's seminal project, it would be impractical to compare the quality of different countries' corporate governance quantitatively. Indeed, the availability of a quick indicator to measure the level of a particular jurisdiction's shareholder protection is a blessing for academia. Also, corporate governance scholarship landscape is painted more vividly with the statistical analysis of averages, standard deviations, *t*-statistics, confidence levels, and *p*-values. As a result, it is possible to understand numerically how far the quality of corporate governance in a developing country lags behind that of a developed country. Simply put, corporate governance scholarship has—at least partially—transformed from an "art" into a "science." Accordingly, economists and financial analysts as well as lawyers and legal scholars have actively

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[10] Out of the six components of ADRI, only "Oppressed Minorities Mechanism" is not directly related to shareholders' voting. *See also infra* note 92 (explaining that "Oppressed Minorities Mechanism" can be *indirectly* related to shareholders' voting).

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

[12] *See* LLSV, *Law and Finance*, *supra* note 5, at 1130-31 (table 2).

[13] *Id.* at 1116.

[14] *Id.* at 1139.

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

On the other hand, however, the Law and Finance theory has been challenged. For instance, the statement that the quality of investor protection laws determines the capital market development (and economic development)[15] has been criticized as possibly being inaccurate in its causal direction. Market development is frequently followed by legal reform, so the real direction of causation between law and market might be the opposite of what is implied by the Law and Finance theory.[16] Alternatively, it is argued that correlation between legal origins and quality of corporate law does not necessarily imply causation.[17] In addition, one study conducted by Spamann points out that LLSV's initial coding for the ADRI of countries is not very precise.[18] This study casts a great deal of doubt on the arguments and findings of the Law and Finance theory. Another weakness is that important economies in transition, such as China and Russia, are not covered in LLSV's survey.[19] Furthermore, since law-on-the-book does not necessarily guarantee efficient enforcement of such law, it is often argued that the Law and Finance scores—based on six statutory shareholder rights in corporate law—do not necessarily reflect the real level of investor protection.

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[15] *Id.* at 1152 (explaining implications of the Law and Finance theory by citing recent research). For the classic criticisms of the Law and Finance theory, see *infra* Part II.C.

[16] *Cf.* Simon Deakin et al., *An End to Consensus? The Selective Impact of Corporate Law Reform on Financial Development* 24 (Centre for Bus. Research, Univ. Cambridge, Working Paper No. 423, 2011), *available at* http://mpra.ub.uni-muenchen.de/39047/1/MPRA_paper_39047.pdf ("[L]egal reform is capable of stimulating financial growth which, in turn, intensifies the process of legal change.").

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

[18] *See* Spamann, *supra* note 8, at 469-70.

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

As a watershed topic in corporate governance scholarship, the Law and Finance theory has been extensively discussed. For example, "causation vs. correlation" and effects by legal origins are recurring issues of debate. This Article, however, does not pay attention to these popular (and already frequently studied) issues of the Law and Finance theory. Rather, aiming to propose new critical perspectives, this Article analyzes highly neglected or misunderstood factors in the article of *Law and Finance*, such as the OSOV rule and its deviation, control ownership structures, and certain characteristics of anti-director rights that could be incompatible with a fair index-score system.

To this end, this Article explores the unique legal infrastructures and market environments of Korea and China, which few studies have researched rigorously within the analytical framework of the Law and Finance theory. Regarding corporate governance issues, these two countries are of special significance: aside from the recent corporate law reforms that have occurred in these two countries, China is the second largest economy in the world, and Korea has long been the development model for emerging economies. Also, an analysis of the family-oriented corporate groups in Korea (i.e., *chaebols*) can provide a great deal of legal and economic insight into China, where controlling family shareholders have rapidly emerged. In this respect, understanding the current market and legal system in Korea is useful to predict the future of the Chinese corporate environment. In particular, features related to the prevalent controlling ownership in the two countries are to be reviewed. Against this background, this Article proposes three main points to scrutinize the Law and Finance theory. In particular, voting rights, voting leverage, the ADRI, and their interaction play a key role in the analysis.

First, this Article critically examines the OSOV principle and related issues in the context of the "controlling minority structure" (CMS),[20] where a dominant shareholder is able to inflate his voting power beyond his economic interest. As a fundamental and equal voting principle for all shareholders,

[20] For CMS, see *infra* note 90 and accompanying text and *infra* Part III.B.

OSOV should be interpreted as the principle that shareholder voting rights are to be commensurate with the amount of their equity investment. In this sense, it is more appropriate to understand OSOV as "one-dollar-one-vote" (ODOV) (or equal voting for one dollar). Under this interpretation, OSOV—and thus "one-share-multiple-vote" (OSMV), the exception of OSOV—are ill-defined in LLSV's survey, such that only a dual-class equity structure[21] is treated as an aberration of OSOV. OSMV distorts the equal voting rights in favor of a dominant shareholder; thus, for example, it is possible for one control share to have, 10 times the voting rights that an ordinary share of a minority shareholder retains, as seen in a dual-class equity structure. The problem is that the practices of stock pyramiding and cross-ownership also grant a disproportionately large amount of voting power to a dominant shareholder even if he holds a much smaller economic interest. In this respect, such schemes are *functionally equivalent* to dual-class equity structures as voting leverage devices. Therefore, all three mechanisms should have been equally categorized as corporate insiders' tools deviating from OSOV. In other words, at least in some countries, LLSV define OSOV in a broader manner (or, LLSV define OSMV in a narrower manner) than they should.

Second, this Article articulates an interlocking effect between OSMV and the ADRI not considered by LLSV. As discussed, many ADRI components are associated with shareholder voting rights.[22] Moreover, the relevance of ADRI components is implicitly based on the assumption of the OSOV principle. This is because anti-director rights—if they are closely related to non-controlling minority shareholders' voting rights—are meaningful with the notion of equal voting power for equal investment. Through voting leverage, however, OSOV—the fundamental safety valve for public investors—can be eclipsed by OSMV, which favors a controlling shareholder or other corporate insiders. With OSMV, accordingly, minority shareholders' statutory power arising from anti-director rights would be significantly lessened.

[21] For further explanation of dual-class equity structures, see *infra* Part III.B.

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

For this reason, ADRI components which are directly affected by OSOV/OSMV can be designed as dependent factors of the enforcement of OSOV, meaning that discounting the value of individual anti-director rights is necessary when OSMV is available in favor of corporate insiders.[23] Alternatively, the ideal ADRI scoring system needs to take into account OSOV/OSMV as well as individual anti-director rights. In their survey, by contrast, LLSV treat OSOV and the ADRI as two independent categories and count only the ADRI score without consideration of OSOV/OSMV. To illustrate, if Country A has 5 anti-director rights with OSMV and Country B has 3 rights with OSOV, then LLSV's ADRI scores of the two countries are 5 and 3, respectively. According to the Law and Finance theory, which is predominantly based on the ADRI, the quality of corporate governance in Country A is generally explained to be better than that in Country B. This Article argues, however, that investor protection is not necessarily better in Country A than in Country B, since OSMV (and voting leverage) would destroy the value of some voting-related ADRI components in Country A to a large extent.

Third, this Article scrutinizes whether LLSV's individual anti-director rights are truly proper indicators of investor protection. In particular, four ADRI components—"Cumulative Voting" (or "Proportional Representation"), "Preemptive Right," "Oppressed Minorities Mechanism," and "Percentage of Share Capital to Call an Extraordinary Shareholders' Meeting"—are examined in greater depth.[24] For example, as discussed later, the effectiveness of cumulative voting would be seriously lessened when the number of directors to be elected is small and a staggered board is available. Without considering such factors, LLSV mechanically award countries one point as long as cumulative voting is allowed in their corporate law.[25] In addition, the

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[23] For further explanation, see *infra* notes 139-140 and accompanying text.

[24] *See infra* Part IV.

[25] LLSV, *Law and Finance*, *supra* note 5, at 1122 (table 1). For further explanation on the variable of "Cumulative Voting" (or "Proportional Representation") and criticism, see *infra* Part IV.A.

aforementioned cascade effect of the deviation from OSOV on anti-director rights is further explored at the level of the individual ADRI components. For instance, when OSOV is circumvented, a cumulative voting system—the mechanism designed to foment public investors' *proportional* representation in a board—would be less meaningful. This is because an ingrained feature of the *disproportionate* voting scheme of OSMV (or voting leverage) already damages minorities' equal voting before minorities use cumulative voting.

The remainder of this Article proceeds as follows. Part II describes the Law and Finance theory in general and classic criticism of the index. Further criticism by the Author is proposed as well. Part III proposes the Author's perspective on LLSV's ill-defined notions of OSOV and OSMV. Subsequently, incorrect applications of such notions are discussed in greater depth. In addition, the effect of combining OSOV/OSMV and the ADRI is introduced. Part IV analyzes why individual ADRI components are incomplete and distortive, and how the ADRI could mislead policymakers who are interested in improving the corporate governance of a jurisdiction. Part IV also explores how the effectiveness of individual ADRI components could be damaged by OSMV and CMS.[26] Part V provides a summary and conclusion.

Indexing, a popular trend in many studies, is quite useful since it quantifies the quality of important information and provides a practical summary. Nonetheless, indexing is merely a means of conducting a quick litmus test. In order to properly interpret such quick tests, a careful qualitative analysis and a critical review of an index's components are essential. In this respect, this Article also provides a guideline to understand and examine index-oriented studies. For instance, law school "ranking" as well as the "independence" of central banks can be re-examined, not to mention other

[26] In terms of its impact on the quality of corporate governance, CMS is generally associated with a negative connotation. It is worth noting, however, that some jurisdictions based on CMS have possibly better corporate governance systems than we may have thought. *See generally* Sang Yop Kang, *Re-envisioning the Controlling Shareholder Regime: Why Controlling Shareholders and Minority Shareholders Often Embrace*, 16 U. PA. J. BUS. L. 843 (2014); Sang Yop Kang, *"Generous Thieves": The Puzzle of Controlling Shareholder Arrangements in Bad-Law Jurisdictions*, (Soc. Sci. Research Network, 2013), *available at* http://ssrn.com/abstract_id=2305645.

corporate governance indices (e.g., those by Gompers et al.,[27] Bebchuk et al.,[28] and Djankov et al.[29]).

II. LAW AND FINANCE

Since its publication in the late 1990s, the Law and Finance theory has perhaps been the most influential and controversial topic in the field of corporate governance. Indeed, comparative corporate governance scholarship can be divided into two eras: "before Law and Finance" and "after Law and Finance." This Part sketches the theory and core concepts of OSOV, OSMV, and the six components of the ADRI. Subsequently, this Part explains classic critical views of the theory followed by further critiques by the Author.

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

"Does being a shareholder in France give an investor the same privileges as being a shareholder in the United States, India, or Mexico?"[30] Comparative corporate governance scholars have long sought the answers to such questions. To put forward at least a partial answer, LLSV constructed an index to measure the extent to which the corporate law (or commercial code) of a jurisdiction protects public shareholders in that domain. For an international comparison of the quality of shareholder protection, LLSV first surveyed OSOV/OSMV and then the ADRI with six components across forty-nine countries.

OSOV is the rule that provides shareholders—regardless of whether they are corporate insiders or not—with voting rights proportional to the amount of their equity investment. In this sense, although OSOV literally means equal

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[27] *See generally* Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q. J. ECON. 107 (2003).

[28] *See generally* Lucian Bebchuk et al., *What Matters in Corporate Governance?*, 22 REV. FIN. STUD. 783 (2009).

[29] *See generally* Simeon Djankov et al., *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430 (2008).

[30] *See* LLSV, *Law and Finance*, *supra* note 5, at 1114.

voting rights for any "share," it should be construed as equal voting for any "dollar." In contrast, OSMV is designed to award disproportionately more voting power to a dominant shareholder or other corporate insiders. Under OSOV, an insurgent shareholder can become a dominant shareholder by either purchasing a majority of shares in the market or obtaining a majority of votes from other shareholders through a proxy fight. In contrast, under OSMV, it would be much more difficult (or simply impractical) for an insurgent to become a new dominant shareholder. Even if the insurgent holds more than 50% of cash flow rights, that does not necessarily enable the insurgent to exercise more than 50% of votes due to the voting value disparity between a challenger's shares and a controller's shares. In sum, while cash flow rights (or economic interests) and voting rights are generally aligned under OSOV,[31] they are not exactly aligned under a legal system where OSMV is allowed.

Separately from OSOV, the anti-director rights defined by LLSV—i.e., individual components of the ADRI—are a group of rights in corporate law (or a commercial code) awarded to public shareholders when opposing management and a board of directors. More specifically, they are six independent statutory rights for public shareholders: (1) whether shareholders' proxy voting by mail is legally permissible (in LLSV's terminology, "Proxy by Mail Allowed");[32] (2) whether corporate law "does not allow companies to require shareholders to deposit their shares prior to a general shareholders meeting" ("Shares Not Blocked Before Meeting");[33] (3) whether corporate law allows minority shareholders to have proportional representation in a board of directors ("Cumulative Voting" or "Proportional Representation"); [34] (4) whether public shareholders are able to bring suit against management and directors or to rely on appraisal rights under corporate law ("Oppressed

[31] *See, e.g.*, Sanford J. Grossman & Oliver D. Hart, *One Share-One Vote and the Market for Corporate Control*, 20 J. FIN. ECON. 175, 175 (1988) (". . . [A]ll securities have votes in the same proportion as their claim to income.").

[32] LLSV, *Law and Finance*, *supra* note 5, at 1122 (table 1).

[33] *Id.*

[34] *Id.*

Minorities Mechanism");[35] (5) whether corporate law grants shareholders a right to purchase newly issued shares on a proportional basis ("Preemptive Right");[36] and (6) whether less than 10% of minority shareholders are allowed to call a special shareholder meeting under corporate law ("Percentage of Share Capital to Call an Extraordinary Shareholders' Meeting").[37]

This Article calls the combination of OSOV/OSMV and the ADRI the "Macro Corporate Governance Index" (MCGI) since components of MCGI describe the quality of a country's corporate governance at the macro level. In the Law and Finance account, when a country's corporate law contains one of these "one plus six" components of the MCGI (the OSOV rule and six ADRI components), the country receives one point. Otherwise, zero points are awarded.[38] Viewed in this light, LLSV's scoring policy of OSOV and the ADRI is based on a simple binary number system of "0" or "1" (thus, a point value in between, such as 0.5, does not exist). Additionally, it is noteworthy that LLSV set the variable of OSOV (i.e., whether a country has OSOV or OSMV) aside from the six components of the ADRI, although there is little reason for such segregation.[39] Then, LLSV constructed a huge scoreboard for the ADRI of forty-nine countries, excluding scores for OSOV. Since the ADRI has six components, each country's total ADRI score can range from 0 to 6. In this respect, the core part of the Law and Finance theory is indeed the ADRI since it compares countries' ADRI scores, rather than scores of a broader index that includes the OSOV variable. For example, while the average ADRI score of forty-nine countries is 3, the score of the United States is 5.[40] The only anti-

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[35] *Id.*

[36] *Id.* at 1123 (table 1).

[37] *Id.*

[38] *Id.* at 1122-23 (table 1).

[39] For a further analysis of OSOV/OSMV and its related issues, see *infra* Part III.

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

director right that the U.S. corporate law lacks is the preemptive right.[41] Table 1 below summarizes the MCGI and describes its application in the United States under LLSV's original coding.

Table 1: MCGI (OSOV and ADRI)

<table>
<tr><th colspan="2">Macro Corporate Governance Index (MCGI)</th><th>Score of the United States</th></tr>
<tr><td colspan="2">1. One-Share-One-Vote (OSOV) Rule</td><td>0</td></tr>
<tr><td rowspan="7">2. Anti-Director Rights Index (ADRI)</td><td>(1) Proxy by Mail Allowed</td><td>1</td></tr>
<tr><td>(2) Shares Not Blocked Before Meeting</td><td>1</td></tr>
<tr><td>(3) Cumulative Voting or Proportional Representation</td><td>1</td></tr>
<tr><td>(4) Oppressed Minorities Mechanism</td><td>1</td></tr>
<tr><td>(5) Preemptive Right</td><td>0</td></tr>
<tr><td>(6) Percentage of Share Capital to Call an Extraordinary Shareholders' Meeting</td><td>1</td></tr>
<tr><td>Total Score of U.S. Anti-Director Right (Maximum 6 Points)</td><td>5</td></tr>
</table>

B. Implications of the Law and Finance Theory and Its Contributions

After surveying the ADRI of forty-nine countries, LLSV used the ADRI score—but not the OSOV score—of each country as a proxy for the country's level of corporate governance. Put differently, the quality of each of the forty-nine countries' corporate governance is roughly quantified by the individual

[41] As for preemptive right, "[t]he common law concept of preemptive rights sought to protect existing shareholders from dilution of their stock ownership through subsequent stock offerings to a few existing shareholders or to new ones." THOMAS LEE HAZEN & W. MARKHAM, CORPORATIONS AND OTHER BUSINESS ENTERPRISES: CASES AND MATERIALS 1424 (3rd ed. 2009). However, the common law rule of preemptive right could be limited by statute. "Delaware, for example, denies preemptive rights unless they are specified in the certificate of incorporation. Del. Corp. §102(b)(3)." *Id.* at 1433.

countries' aggregate ADRI scores.[42] Naturally, it is likely to conclude that, for example, a country with 5 points on the ADRI (e.g., the United States and the United Kingdom) protects public shareholders better than a country having 2 points (e.g., Ecuador, Egypt, Greece, Austria, Korea, Switzerland). [43] Accordingly, it is possible—if not sufficiently sophisticated—to rank forty-nine countries in terms of the quality of their corporate governance.

Then, LLSV sorted out the forty-nine countries according to their legal origins (based on common law vs. civil law). After classification, the number of jurisdictions with common law, French civil law, German civil law, and Scandinavian civil law were found to be 18, 21, 6, and 4, respectively. Subsequently, the average ADRI scores for each group of legal families were calculated. Since the vast majority of countries belong to either common law family or French civil law family, in practice LLSV's comparison was conducted based on the rivalry framework of "Anglo-American tradition vs. French tradition." Specifically, while the average ADRI score of countries with common law origin is 4, the average ADRI score of countries with French civil law origin is 2.33.[44] Relying on further statistical analysis (including standard deviation and t-statistics), LLSV argue that public investors in capital markets are protected the most in common law jurisdictions and the least in French civil law jurisdictions.[45] Such a difference of average scores between common law and French civil law is supported further since it is statistically significant.[46] In addition, the theory implies that the development of capital

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

[43] For the ADRI score of each country, see LLSV, *Law and Finance*, *supra* note 5, at 1130-31 (table 2).

[44] *Id.* at 1129-32.

[45] *Id.* at 1116.

[46] *Id.* at 1132. The average ADRI scores of six German civil law countries and four Scandinavian civil law countries are 2.33 and 3 points respectively.

markets as well as the quality of corporate law and governance in each jurisdiction are affected by legal origins.[47]

Since the late 1990s, the Law and Finance theory has brought revolutionary development to corporate governance scholarship as a fully interdisciplinary subject of law, economics, and finance. Based on LLSV's endeavor to pursue statistical analysis, corporate governance scholars have constructed and modified academic methodologies to evaluate the comparative advantages of one jurisdiction over another. Now, the artistic nature of corporate governance becomes more scientific because the quality of corporate governance measured by the ADRI can be quantified, compared, and ranked across countries.

Another contribution of LLSV is expanding the scope of comparative corporate governance scholarship. Before LLSV's seminal project, most corporate governance scholars—either in law or economics departments—predominantly paid attention to the United States. To a much lesser degree, the corporate governance of Japan and Germany—the second and third largest economies at the time—was studied as an alternative model. As for German corporate governance, commentators were interested in a two-tier board system, which differs from the single-tier board system of the United States.[48] As for Japanese corporate governance, a group of scholars was interested in Japan's distinctive systems (e.g., *keiretsu* corporate group system), executives' long-term view of management, lack of M&A,[49] life-long employment,[50] and corporate policies aiming at the welfare of other constituencies (e.g.,

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[47] *See* LLSV, *Law and Finance*, *supra* note 5, at 1113, 1152.

[48] Jeroen Weimer & Joost C. Pape, *A Taxonomy of Systems of Corporate Governance*, 7 CORP. GOV.: AN INT'L REV. 152, 157 (1999) ("In Germany, the board comprises a management board (*Vorstand*) and a supervisory board (*Aufsichtsrat*), which provides a complete separation between management and supervision of management.").

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

[50] *See, e.g.*, Ronald J. Gilson & Mark J. Roe, *Lifetime Employment: Labor Peace and the Evolution of Japanese Corporate Governance*, 99 COLUM. L. REV. 508 (1999) (providing general explanation on life-long employment in Japan).

employees)[51] in contrast to the American shareholder primacy norm.[52] By examining the corporate governance of forty-nine economies, including developing as well as developed countries, however, LLSV overcame this ill-balanced tendency in academia and set a new milestone in comparative corporate governance scholarship.

Furthermore, LLSV's study has fomented a trend of the "scientification of the art" in corporate governance at the firm level as well as the country level. Djankov et al. constructed the "Anti Self-Dealing Index," another macro corporate governance index measuring how well a jurisdiction protects minority shareholders from a dominant shareholder's expropriation of corporate value.[53] The World Bank conducted a "Doing Business" project[54] which assesses how friendly a jurisdiction's legal system is to business communities. In addition, Gompers et al. built a corporate governance index at the firm level.[55] Bebchuk et al. developed a management-entrenched index as well.[56]

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[51] For academic articles on Japanese corporate governance, see generally Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 YALE L.J. 871 (1993); Ronald J. Gilson & Curtis J. Milhaupt, *Choice as Regulatory Reform: The Case of Japanese Corporate Governance*, 53 AM. J. COMP. L. 343 (2005).

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

[53] *See generally* Djankov et al., *supra* note 29.

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

[55] *See generally* Gompers et al., *supra* note 27.

[56] Their entrenchment index is based on six provisions, such as staggered boards, limits to shareholder bylaw amendments, poison pills, golden parachutes, and supermajority requirements for mergers and charter amendments. *See* Bebchuk et al., *supra* note 28.

C. Criticism of the Law and Finance Theory: Overview and Further Analysis

Despite LLSV's contributions to the corporate governance scholarship, many of their key arguments have been called into question. When simplified, the key argument of the Law and Finance school is that legal origin determines the quality of corporate law, which in turn determines economic outcomes such as capital market development.[57] However, as Pistor points out, logical development of the Law and Finance theory is not fully justified.[58] This Section explains other critical views as well.

1. Correlation and Causation

Another important topic of discussion is the issue of whether LLSV's empirical study demonstrates correlation or causation. The idea behind this criticism is that correlation does not necessarily mean causation,[59] and LLSV showed merely a statistical *correlation* between legal origin, the quality of corporate law, and economic outcomes rather than links of *causation* between these variables. As for this "correlation vs. causation" debate, West conducted an intriguing and appealing project. In his paper, West points out that a country with a French civil law (English common law) system is more (less) likely to succeed in the FIFA World Cup.[60] In the last four decades, the FIFA

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

[58] *See, e.g.*, Pistor, *supra* note 57, at 1650 ("The leap from a micro-level issue—the financing of firms—to the macro-level issue—financial market development—is asserted, but not explained.").

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

[60] *See* Mark D. West, *Legal Determinant of World Cup Success* 3 (Univ. Mich. John M. Olin Center. for Law & Econ., Working Paper No. 02-009, 2002), *available at* http://ssrn.com/abstract=318940.

World Cup championship was won by Germany (1974), Argentina (1978), Italy (1982), Argentina (1986), Germany (1990), Brazil (1994), France (1998), Brazil (2002), Italy (2006), Spain (2010) and Germany (2014).[61] All of these countries, with the exception of Germany, are countries with legal origins in French civil law. More broadly, in the context of the "common law vs. civil law" debate, the performance of common law countries is much worse than that of civil law (including German civil law as well as French civil law countries). In fact, although time series data have expanded, the finding is almost the same: since the first FIFA World Cup in 1930, the only country with a common law system to win the championship was England in 1966, and this happened only once when the game took place in the United Kingdom.[62]

It is difficult, however, to say that countries with a French civil law system perform better in soccer "due to the remaining vestiges of the Napoleonic Code."[63] Put differently, legal origin—although correlated with the success of national teams in the World Cup—does not determine championship or rank in the World Cup. The logic may continue: just as the "quality of soccer playing" is not caused by legal origins, it is probable that the "quality of corporate governance" is not caused by legal origins.[64] Of course, it would be fair to say that the relationship between corporate law based on a legal origin and market development is more likely to have causality than the relationship between a legal origin and a national soccer team's performance. Thus, it seems that the soccer paradox in relation to legal origins does not necessarily fully refute LLSV's empirical study. Nonetheless, West's study is suggestive and worth noting as it raises the question of causation in LLSV's project.

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

[62] Even during the FIFA World Cup in 1966, England's score (against West Germany) during overtime was controversial.

[63] West, *supra* note 60, at 4.

[64] *Id.*

Even if a causal relationship is found in the Law and Finance theory, the direction of causation is still unclear and subject to further discussion. As Pistor explains, ". . . law typically lags market development. Thus, better investor protections tend to be a response to market."[65] That is, the extent of market development is not determined by the quality of corporate law. Rather, the direction of causality between law and market development could be reversed, as opposed to the finding of the Law and Finance account.[66] Alternatively, it is possible that there is no one-way influence and causation, so that good corporate law enhances the quality of a capital market in a certain country *and* that the more sophisticated domestic capital market further develops macro-level corporate governance and corporate law in the country.[67]

2. *Legal Origin*

The Law and Finance account is based on the notion that countries with common law differ from those with civil law in terms of the quality of their corporate governance.[68] In order to support this finding, it is necessary to first clearly distinguish between the concepts of common law and civil law. Otherwise, it would be difficult to ascribe legal origin to the different levels of investor protection. According to LLSV, common law, which is shaped by precedents from judicial decisions, is distinctive from civil law: "English law is

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[65] Pistor, *supra* note 57, at 1652; *see also* Stephen J. Choi, *Law, Finance, and Path Dependence: Developing Strong Securities Markets*, 80 TEX. L. REV. 1657, 1680 (2001) ("The LLSV and related studies demonstrate a significant relationship between stronger legal protections for minority shareholders and creditors and the size of the external capital markets, the absence of controlling shareholders, higher dividend payments, increased valuation, and reduced private benefits of control. However, what remains somewhat unclear is the causality of the relationship. For example, it may be possible that a greater level of financial development (and the corresponding larger population of investors) may actually cause the enactment of laws providing for stronger investor protections.").

[66] *See* Milhaupt, *supra* note 49, at 2122-23 (". . . the empiricists may have reversed the actual chain of causation between law and corporate governance.").

[67] *See e.g.*, Deakin et al., *supra* note 16, at 24.

[68] La Porta et al., *Legal Determinants*, *supra* note 6, at 1131.

common law, made by judges and subsequently incorporated into legislature. French, German, and Scandinavian laws, in contrast, are part of the scholar and legislator-made civil law tradition, which dates back to Roman law."[69] LLSV emphasize that, in particular, the civil law tradition "uses statutes and comprehensive codes as a primary means of ordering legal material."[70] The problem, however, is that no clear line exists between legal families. For instance, United States is a common law jurisdiction relying on corporate case law developed by Delaware courts. Nonetheless, it is often explained that the United States is also heavily dependent upon regulations and other statutory codes enacted by Congress and the SEC as well as the Securities Acts of 1933 and 1934.

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

Civil law codes also use many general terms that are not easily defined. For example, to name several, legal terms such as "fairness," "just compensation," "(utmost) good faith," "equal (or equity)," "discriminatory," "normal," "ordinary," and "public orders and good morals" usually appear in statutes. Such general terms, which often shape key issues in lawsuits, ultimately need to be interpreted by the judiciary. As a result, civil law judges

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[69] *Id.* (citation omitted).

[70] LLSV, *Law and Finance*, *supra* note 5, at 1118 (citing JOHN H. MERRYMAN, THE CIVIL LAW TRADITION: AN INTRODUCTION TO THE LEGAL SYSTEMS OF WESTERN EUROPE AND LATIN AMERICA (1st ed. 1969)).

do not mechanically, without discretionary authority, declare and apply statutory laws and rules enacted by a legislature. Indeed, the role and power of judges are significant and strong in many civil law jurisdictions. In addition, as LLSV explain, the civil law tradition often "relies heavily on legal scholars to ascertain and formulate its rules."[71] However, this is not always true. Also, since there is not one unified view among scholars in regard to complicated legal issues, it is ultimately a judge who determines which scholar's view will be applied as a legal rule in a particular case.

Whereas the classification of gender is mutually exclusive at a genetic level, there is a high chance of a hybrid classification of legal families. For example, according to LLSV's classification, the modern Japanese legal system follows German civil law tradition. More precisely, however, Japan relied on the combination of the French and German civil law systems in the 19th century (and the early 20th century).[72] After the Second World War, Japan heavily adopted legal doctrines from the United States,[73] particularly in the area of corporate law.[74] Recently, such a trend became more pronounced as Japan legally recognized the U.S.-style poison pill in hostile takeover defenses[75] and adopted a *Unocal*-based doctrine.[76]

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[71] *Id.*

[72] *See, e.g.*, J. Mark Ramseyer, *Mixing-and-Matching across (Legal) Family Lines*, 2009 BYU L. REV. 1701, 1708-11 (2009).

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

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

[75] *See generally* Jack B. Jacobs, *Implementing Japan's New Anti-Takeover Defense Guidelines—Part I: Some Lessons from Delaware's Experience in Crafting Fair Takeover Rules*, 2 N.Y.U. J. L. & BUS. 323 (2006) (explaining Japan's new approach to adopt the U.S.-style takeover doctrines).

[76] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (proposing the *Unocal* test for takeover defense cases).

Korea, another German civil law country, has also shown a trend towards Americanization. Lately, judges, prosecutors, lawyers, and scholars have tried to apply U.S. jurisprudence and doctrine, even in the fields of public law (e.g., constitution and criminal law) that are most influenced by German civil law. In regard to corporate law in particular, cases and theories in the United States play a significant role in guiding legal doctrine and practice in Korea. Also, French civil law tradition has influence on legal scholarship in Korea, at least to some extent. In short, the experiences of Japan and Korea tell us that it is difficult to use legal families as dummy variables in a straightforward manner, as was done by the Law and Finance theory.

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

3. Other Considerations

Another criticism of the Law and Finance theory is related to LLSV's limited coverage of more particularized areas of law. One important area that has been omitted is rules on M&A.[77] The United States and the United Kingdom are similar in that they share diffused shareholder ownership[78] in

[77] LLSV, *Law and Finance*, *supra* note 5, at 1120. *See also* Amir N. Licht et al., *Culture, Law, and Finance: Cultural Dimensions of Corporate Governance Laws* 21 (Law and Econ. Workshop, U.C. Berkeley, 2001) ("LLSV acknowledge some of the possible objections, including the fact that the indices do not cover merger and takeover rules, that they cover disclosure rules only partially, and that they do not cover rules made by stock exchanges or regulations of financial institutions.") (citing LLSV, *Law and Finance*, *supra* note 5), *available at* http://escholarship.org/uc/item/53p3v8k7.

[78] *See, e.g.*, 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, 641-42

public corporations and a relatively common goal of shareholder primacy.[79] They differ quite markedly, however, in their distinctive M&A rules. For instance, the mandatory bid rule, which has been the principle in the United Kingdom, is not found in Delaware. If different M&A rules were considered in LLSV's data set, the extent to which commonalities are observed between the two leading common law countries would be attenuated. Excluding M&A rules would help provide LLSV with a more robust conclusion that common law countries as a group differ from civil law countries.

Suppose that legal origin is the dispositive factor that determines the development of capital markets in countries, as the Law and Finance theory implies. Then, one intriguing interpretation among scholars is that when a certain jurisdiction was forced to adopt French civil law a few hundred years ago due to colonization[80], their economic destiny was determined to be forever hopeless in terms of investor protection and capital market development. In fact, what the Law and Finance account provides is not time series analysis but only cross-sectional analysis. If time series analysis was conducted, some fluctuation in terms of how investors have been protected in countries over the time might be observed. For instance, it is explained that the French capital market was more developed than the U.S. capital market at the start of the 20th century.[81]

Moreover, as is often discussed, it is unclear whether the six components of the ADRI that LLSV chose are representative of good corporate law. As Coffee explains, "[b]y no means is it here implied that these rights [in ADRI]

(1999) (explaining dispersed ownership, the "separation of ownership and control," and the controlling shareholder system).

[79] For more on shareholder primacy, see *supra* note 52.

[80] LLSV, *Law and Finance*, *supra* note 5, at 1126 ("Countries typically adopted their legal systems involuntarily (through conquest or colonization).").

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

are unimportant, but they seem to supply only partial and sometimes easily outflanked safeguards, which have little to do with the protection of control and the entitlement to a control premium."[82] In addition, the number of components that was chosen for the ADRI bears scrutiny. For practical purposes, it is understandable that collecting data for six components was already burdensome when LLSV examined the corporate law of forty-nine countries. Nonetheless, that does not justify the decision for the index to have six components to measure the quality of corporate governance across countries (as often criticized, for example, why not ten components?). Furthermore, it is questionable why the six components of the ADRI are equally weighted (i.e., the score of each component is always 1 point).[83] A related matter is that it is probable that a component's weights will vary from country to country. For instance, when the corporate governance role of cumulative voting in Country A is more significant than that in Country B, the weight of cumulative voting in Country A's ADRI should be larger than that in Country B.

Among the remarkable criticisms against LLSV's Law and Finance theory is Spamann's finding of the coding errors of LLSV's original ADRI. "A thorough reexamination of the legal data, however, leads to corrections for thirty-three of the forty-six countries analyzed."[84] Then, he adds, "[t]he correlation between the corrected and the original ADRI is only 0.53."[85] Indeed, such coding errors by LLSV are understandable to some extent since LLSV's work is a path-finding project and is among the first attempts to analyze and compare the corporate law of many countries. Although the enormity of LLSV's contributions should not be downplayed, Spamann's criticism is crucial. Under his corrected ADRI, three claims—upon which traditional corporate

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

[83] For example, students in my course also raise this question.

[84] Spamann, *supra* note 8, at 468.

[85] *Id.* at 470.

governance scholarship relies heavily—are not firmly supported: [86] (1) "common law countries offer greater investor protection than civil law countries"; [87] (2) "greater investor protection is associated with lower ownership concentration and larger equity markets";[88] and (3) "poor investor protection exacerbated the Asian financial crisis of 1997."[89]

III. Criticism of LLSV's Analysis of One-Share-One-Vote

OSOV is one of the most vital protective mechanisms for minority shareholders. LLSV considered it as a component of a large set of MCGI that they surveyed across forty-nine countries; however, there are several vulnerable aspects of LLSV's analysis. In particular, the failure to address CMS where a dominant shareholder exercises control via a majority of voting power while he holds only a fraction of shares is a crucial error.[90] In addition, LLSV did not include OSOV in the ADRI. Thus, the OSOV score is not counted when comparing the level of investor protection among countries or legal origins. In this respect, the significance of OSOV (or the deviation from OSOV) affecting the efficiency of ADRI components has been highly neglected in the Law and Finance theory.

[86] *Id.* at 467.

[87] *Id.* at 470.

[88] *Id.*

[89] *Id.* (citing Johnson et al, *Corporate Governance in the Asian Financial Crisis*, 58 J. FIN. ECON. 141).

[90] For CMS, see Lucian Bebchuk et al., *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash Flow Rights*, *in* CONCENTRATED CORPORATE OWNERSHIP 295, 295-96 (Randall K. Morck ed., 2000), *available at* http://www.nber.org/chapters/c9013.pdf (explaining CMS). As for the general explanation of the role of CMS in M&A defense, see Sang Yop Kang, *Transplanting a Poison Pill to Controlling Shareholder Regimes—Why It Is So Difficult*, 33 NW. J. INT'L L. & BUS. 619 (2013).

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

Voting is a common factor in five out of the six components of ADRI: (1) "Proxy Allowed by Mail"; (2) "Shares Not Blocked Before Meeting"; (3) "Cumulative Voting" or "Proportional Representation"; (5) "Preemptive Right"; and (6) "Percentage of Share Capital to Call an Extraordinary Shareholders' Meeting."[91] It is clear that (1), (2), (3), and (6) are directly concerned with voting. (5) "Preemptive Right" is also pertinent to shareholder voting rights since minority shareholders, by relying on the right, can prevent a dominant shareholder or management from diluting their voting rights. In this light, only (4) "Oppressed Minorities Mechanism" is not closely tied with minority shareholders' voting.[92]

Next, consider OSOV (and OSMV) in the context of a fundamental ideology in relation to voting. Under the OSOV principle, voting rights are proportionally given to a shareholder according to her cash flow rights (i.e., a shareholder's economic interest in a corporation). Therefore, equal voting power for an equal amount of investment is awarded to shareholders irrespective of whether they are a dominant shareholder or non-controlling minority shareholders. In this sense, OSOV is a core characteristic of corporate law that can preserve corporate democracy.[93] Accordingly, it is generally explained that under OSOV, public investors are better protected from

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[91] According to Spamann, three components of the ADRI are related to voting. "Of the six ADRI components, three are concerned with shareholder voting (voting by mail, voting without blocking of shares, and calling an extraordinary meeting), and three with minority protection (proportional board representation, preemptive rights, and judicial remedies)." (citation omitted). Spamann, *supra* note 8, at 468. From a different perspective, his view is also correct.

[92] A country's score for "Oppressed Minorities Mechanism" is one when either a derivative suit system or shareholders' appraisal right in fundamental transactions such as M&A is found in corporate law of the country. LLSV, *Law and Finance*, *supra* note 5, at 1122 (table 1). Appraisal right is given to dissenting shareholders who indicate their objection to a fundamental transaction. In this sense, it can be said that, at least in some countries, the appraisal right (and thus "Oppressed Minorities Mechanism") is indirectly related to voting as well.

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

corporate insiders' potential corporate misconduct than under OSMV.[94] In other words, under OSOV, corporate insiders are unable to use voting leverage, so it is difficult for them to make corporate strategies and transactions in favor of themselves and at the expense of minority shareholders.

In contrast, when the OSMV exception (i.e., a deviation from OSOV) is allowed, some shareholders—usually a founder and his family, executives, or a dominant shareholder—have power to leverage their voting rights, while the rest of the shareholders lack such privilege. Accordingly, OSMV distorts the fundamental principle of voting (i.e., equal treatment for shareholders with the same amount of capital investment). For instance, suppose that a controller's share can cast ten times the amount of votes that a non-controlling shareholder's share can. Then, the controller, even if he holds only a small amount of stock ownership (e.g., 10%), is able to exercise a majority of voting power. As a result, non-controlling minority shareholders, although they own the remaining 90% of the corporation's equity interests, could be effectively excluded from corporate decision-making processes even in an annual shareholder meeting. Given the OSMV rule, control is not always derived from owning a large number of shares. Rather, it stems from the power of casting a large number of votes.[95]

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

As discussed above, OSOV (and the deviation from OSOV) is a critical factor in evaluating the quality of corporate governance. Understanding the utmost significance of OSOV (or OSMV), LLSV surveyed the implementation of OSOV across forty-nine countries. Nonetheless, at least in some countries, LLSV's definition of OSOV (or OSMV) is imprecise from a *functional* perspective.

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[94] LLSV, *Law and Finance*, *supra* note 5, at 1126-27.

[95] A CMS-based ownership system is made by such discrepancy between ownership and voting rights (or control). *See generally* Bebchuk et al., *supra* note 90.

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

According to LLSV, "[the score of a country's OSOV] equals one if the company law or commercial code of the country requires that ordinary shares carry one vote per share, and zero otherwise."[96] LLSV described several cases where OSOV can be circumvented: "Companies can issue nonvoting shares, low- and high-voting shares, founders' shares with extremely high voting rights, or shares whose votes increase when they are held longer, as in France." This explanation is interesting because LLSV provided the concept of OSOV in a *negative* way by defining OSMV. LLSV clearly recognized a dual-class equity structure as an example of non-OSOV (thus OSMV), which is a correct explanation.

Now let us examine the dual-class equity structure in greater depth. Some companies use a dual-class equity structure, particularly in the media industry. For instance, in News Corporation, Rupert Murdoch's family can exercise almost 40% of the votes, but the family only owns approximately 12% of the company.[97] The New York Times, the Washington Post Co. and Dow Jones & Co. Inc. are also on the list of companies that use dual-class equity structures.[98] Warren Buffett's Berkshire Hathaway is famous for the structure as well.[99] Moreover, some companies in the internet-based industry use such structures. Examples include Google, Zynga, and Groupon.[100] Facebook also

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[96] LLSV, *Law and Finance*, *supra* note 5, at 1122 (table 1).

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

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

[99] *Id.*; *see also* Brian Womack, *Facebook Introduces Dual-Class Structure for Stock*, BLOOMBERG (Nov. 24, 2009, 18:19 EST), *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aEijG7dEtQWw&pos=6.

[100] *See supra* note 97 ("Google's IPO in 2004 involved two classes of share. LinkedIn followed suit this year [2011]. The IPO filings of Zynga and Groupon would also grant managers control over voting rights.").

instated a dual-equity structure,[101] granting Mark Zuckerberg control over the corporation. Relying on a partnership with control leverage in Alibaba (which is functionally similar to a dual-class equity structure), Jack Ma, the founder, exercised control over the company with only approximately 8.9% of ownership.[102]

Regarding OSOV, the most notable problem of the Law and Finance theory is that a dual-class equity structure is *not* the *only* voting mechanism that favors dominant shareholders (or corporate insiders). In general, corporate insiders have three ways to inflate their votes beyond their cash flow rights: (1) a dual-class equity structure; (2) stock pyramiding; and (3) cross-ownership among affiliated companies[103] (e.g., direct cross-shareholding and circular shareholding). By means of one of the above mechanisms or a combination thereof, a shareholder—even if his cash flow rights are few—could exercise control in a corporation. In this respect, stock pyramiding and cross-ownership are *functionally equivalent* to the dual-class equity structure as forms of voting leverage that create a disparity between cash flow rights and voting rights.[104] As a safety valve for non-controlling minority shareholders,

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

[102] *See, e.g.*, *Alibaba IPO Highlights Impish Founder Jack Ma's Rise to China's Entrepreneur-in-Chief*, FOX NEWS (May 7, 2014), *available at* http://www.foxnews.com/world/2014/05/07/alibaba-ipo-highlights-impish-founder-jack-ma-rise-to-china-entrepreneur-in/ (explaining Jack Ma's 8.9% of ownership in Alibaba before the initial public offering); *see also* Leslie Picker, *Alibaba Founders to Keep Control with Partnership Alternative*, BLOOMBERG (May 5, 2014, 6:01 a.m.), *available at* http://www.bloomberg.com/news/2014-05-04/alibaba-founders-to-keep-control-with-partnership-alternative.html (explaining Alibaba's partnership structure).

[103] For further discussion of these three voting leverage mechanisms, see generally Bebchuk et al., *supra* note 90.

[104] One may argue that the arrangement of common stock and non-voting preferred stock is also functionally equivalent to dual-class equity structure when common stock carries one vote and preferred stock does zero votes. In the arrangement of common stock-preferred stock, there are two classes of stocks with different voting power. However, there are not two classes of common stocks with different voting power (e.g., Class A with 10 votes and Class B with 1 vote). Also, since investors with preferred stock get paid before investors with common stock, preferred stock is characterized as a hybrid between stock and debt. In addition, if preferred stock is rarely issued (and thus, less frequently traded among investors than common stock), preferred stock cannot be

OSOV should be interpreted as a principle that protects shareholder voting rights commensurate with the amount of capital that they invest in a corporation. In the world of LLSV, however, some countries that allow cross-ownership or stock pyramiding are mis-classified as countries with OSOV, as long as they do not allow dual-class equity structures.

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

In this regard, LLSV's scoring for OSOV in Korea is exemplary.[105] According to LLSV's survey, Korea was awarded one point for OSOV. The current score of Korea, if LLSV's methodology applies, would be also one. In appearance, such scoring seems reasonable since OSOV is explicitly stipulated in the Commercial Act.[106] In addition, stock with multiple votes is not available in Korea.[107] Moreover, direct cross-shareholding between two corporations—i.e., Company A owns stock of Company B, which owns stock of Company A—in the same corporate group is prohibited in the Monopoly

a main tool for corporate insiders who wish to take advantage of differences in voting rights.

[105] This Sub-section's explanation of Korea is generally based on Nansulhun Choi & Sang Yop Kang, *Competition Law Meets Corporate Governance: Ownership Structure, Voting Leverage, and Investor Protection of Large Family Corporate Groups in Korea*, 2 PEKING U. TRANSNAT'L L. REV. 411 (2014).

[106] Sangbeob (상법) [Commercial Act], Act. No. 12397, Mar. 11, 2014, art. 369(1) (S. Kor.).

[107] More precisely, due to the recent amendment of the Commercial Act, corporations in Korea now can issue "stock without voting rights" under certain circumstances. *See id.* art. 344-3. According to the new arrangement, there can be two types of stock (including common stock): one with one vote and the other with zero votes. It is worth noting a few further points. First, the new arrangement, which allows common stock with zero votes, is different from a structure with two classes of common stock with different "positive" (rather than "zero") voting power. Thus, "stock with multiple votes" (e.g., Class A with 10 votes and Class B with 1 vote) is still prohibited. Also, the flexibility of the arrangement is limited. For instance, stock without voting rights can be issued up to 25% of the total number of shares (for listed companies, this restriction is further relaxed up to 50% under special circumstances). Thus, from a perspective of corporate insiders, the new arrangement is not an effective voting leverage device. In this respect, in Korea, it is still impractical (or very difficult) to use the traditional dual-class equity structure, which provides a corporate insider with "control without substantial ownership."

Regulation and Fair Trade Act (MRFTA).[108] If direct cross-shareholding is allowed, (1) fictitious capital would be created in two corporations;[109] (2) the principle of capital adequacy in corporations could be harmed;[110] and (3) a dominant shareholder in a corporate group would have voting rights in both corporations in exchange for fictitious capital.[111] As a result, decision-making power of the dominant shareholder is enhanced without the injection of real capital. Until 1999, stock pyramiding was effectively prohibited due to concern about the concentration of economic power among a small number of controlling shareholders in large corporate groups.[112]

By a legal loophole, however, circular shareholding is not fully prohibited.[113] Thus, it is possible that, in the simplest model of three corporations in one corporate group, Company A owns stock of Company B, which owns stock of Company C, which owns stock of Company A. In this case, fictitious capital is also made through circular shareholding, but it is permissible. In the real world, by means of more complicated cross-ownership among a large number of affiliated firms (e.g., fifty affiliated firms) in one corporate group, a dominant shareholder on top of a de facto holding company could be the controller of the entire group with only a small amount of cash flow rights.

As I explain elsewhere, Chairman Kun-Hee Lee, a dominant shareholder of Samsung Group (the largest corporate group in Korea to which the global IT giant Samsung Electronics is an affiliate) merely has 0.7% of economic

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[108] Dokjeom gyuje mit gongjeong geooraeae gwanhan beobyul (독점규제 및 공정거래에 관한 법률) [Monopoly Regulation and Fair Trade Act], Act No. 13071, Jan. 20, 2015, art.9 (S. Kor.).

[109] HYUN-YOON SHIN, ECONOMIC LAW 214 (6th ed. 2014).

[110] *Id.*

[111] *Id.*

[112] OH-SEUNG KWON, ECONOMIC LAW 234 (2014).

[113] Circular shareholding was partially regulated by the Total Equity Investment Ceiling (TEIC). For a brief explanation of the TEIC, see Choi & Kang, *supra* note 105, at 426.

interests.[114] However, he wields a significant amount (almost a majority) of voting rights in Samsung Group, which has approximately seventy subsidiary companies. This magic takes place due to the combination of complicated circular shareholding and quasi-stock pyramiding.[115] Again, it cannot be emphasized enough that corporate control ultimately means voting power rather than ownership. Decision-making power via votes substantiates corporate policies through the resolutions of directors who are in reality "chosen" (rather than "elected") by a controller. In short, LLSV's definition of the OSOV principle does not capture the deviation of such principle towards circular shareholding, thus enabling a controller to circumvent OSOV.

In China, OSOV is stipulated in the Company Law as well.[116] It is noteworthy, however, that "[a]n important feature of the Chinese system, which is also prevalent in other countries, is control through pyramidal structures."[117] A pyramiding structure is of significance, since it is a device designed to functionally weaken the effect of OSOV. Then, "[t]hrough this multi-layer structure, a parent company [or ultimately, a controlling shareholder] is able to control a large number of group affiliates in different industries or markets . . . ."[118] Via a complicated ownership structure based on stock pyramiding, Chinese business people can possibly get around the hurdle

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

[115] Note that stock pyramiding was not formally allowed until 1999, thus quasi-stock pyramiding (with a de facto holding company) in circular shareholding has been frequently used (even after 1999). For a further comparative analysis of a formal holding company system and circular shareholding with a de facto holding company, see generally Choi & Kang, *supra* note 105.

[116] Gongsi Fa (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 28, 2013, effective Mar. 1, 2014) art. 103, PUBLIC INFORMATION SERVICES, *available at* http://fdi.gov.cn/1800000121_39_4814_0_7.html.

[117] Charlie X. Cai, et al., *Do Audit Committees Reduce the Agency Costs of Ownership Structure?* 17 (Soc. Sci. Research Network, 2011), *available at* http://ssrn.com/abstract_id=1339232 (citations omitted).

[118] Yuan Lu & Jun Yao, *Impact of State Ownership and Control Mechanisms on the Performance of Group Affiliated Companies in China*, 23 ASIA PAC. J. MGMT. 485, 488 (2006).

of OSOV. Accordingly, an individual with a majority of ownership on top of a pyramid is able to exercise control over the entire group. In essence, LLSV's definition of the OSOV principle does not properly consider deviation from OSOV.

To understand the effect of voting leverage on control in a simplified manner, consider a typical stock pyramiding example in the following.[119] Suppose that a controlling shareholder owns 51% of stock in Company A, which owns 51% of Company B, which in turn owns 51% of Company C. Note that the controlling shareholder holds the equivalent of 13.26% of the economic interest of Company C.[120] Nonetheless, the controller can firmly exercise a majority of voting power (i.e., 51% voting rights) on Company C through a long control-chain connected from the controller on top of the corporate group to Company C (via Company A and B). Put differently, the controller takes advantage of CMS and a voting mechanism similar to OSMV, although a dual-class equity structure is unavailable. Even if he has no share in Company C, his one-dollar investment in Company A carries voting rights in Company C that are approximately four times more powerful than those carried by a non-controlling minority shareholder's one-dollar investment in Company C.

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

Once a dominant shareholder's voting rights slightly exceed a majority in a corporation—as does the controller of the above corporate group[121]—it is functionally equivalent to holding 100% of the votes in terms of the results of decision-making.[122] Theoretically speaking, the dominant shareholder can often ignore the opinion of the other shareholders who are holding 49% of

[119] This hypothetical example considers a pyramid structure with three layers.

[120] 51% x 51% x 51% = 13.26%. Note that this simple hypothetical example does not consider debt leverage of corporations in a pyramiding structure.

[121] *See supra* notes 119-120 and accompanying text.

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

votes. In such a scenario, the economic interests of the dominant shareholder alone and the corporation (representing all of the shareholders) are detached particularly when the dominant shareholder is a CMS controller. Accordingly, corporate strategies that are less efficient from the standpoint of the corporation could be adopted by the dominant shareholder as long as such strategies are personally beneficial to him. Furthermore, a controlling shareholder is able to transfer corporate value from a corporation that he exercises control over to himself. Such a practice is called "tunneling,"[123] a technical term broadly describing the controller's extraction of private benefits at the expense of minority shareholders.

Examine the aforementioned stock pyramiding example in the context of tunneling.[124] Suppose that Company A and Company C are in the same corporate group. They have an internal transaction, where conditions and terms are favorable for Company A. Accordingly, Company C bears a loss from the transaction. On the other hand, the controlling shareholder benefits from the transaction: he holds a larger economic interest (51%) in a beneficiary (Company A) and a smaller economic interest (13.26%) in a cost bearer (Company C). Generally, it is known that as the disparity between cash flow rights and voting rights increases (e.g., the controller holds 13.26% of ownership in Company C while he exercises a majority of voting power in the company), the problem of tunneling would worsen, since a controller does not care very much about the cost incurred to a damaged company (e.g., Company C) in which he has a lower stake in the ownership.

Arguably, tunneling has historically been prevalent among large corporate groups (not to mention small corporations) in Korea. In China, due to the lack of effective corporate governance mechanisms, protection for minority shareholders is weak,[125] so that tunneling has become a common business

[123] *See generally* Simon Johnson et al., *Tunneling*, 90 AM. ECON. REV. 22 (2000); *see also* Choi & Kang, *supra* note 105, at 427-29 (explaining tunneling).

[124] *See supra* notes 119-120 and accompanying text.

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

practice.[126] In particular, it is explained that a notable form of tunneling in China is "the use of intercorporate loans by controlling shareholders to siphon funds from publicly listed companies."[127] Although generally "the exact nature and scope of [tunneling] are difficult to pin down,"[128] it is likely that tunneling would be facilitated more within the context of a corporate group since a controlling shareholder can use OSMV (based on stock pyramiding).

As in Korea, corporate groups are the main market players in China. For instance, "[business] groups contribute close to 60% of the nation's industrial output"[129] in China and "[b]y 2006, there were 2,856 officially recognized business groups in China with 27,950 directly owned first tier subsidiaries, employing around 30 million people."[130] In Korea, a typical controlling shareholder in a large family corporate group holds a very minimal fraction of ownership (e.g., 1-2%).[131] It seems that in China, such a drastic discrepancy between a controlling shareholder's cash flow rights and voting rights currently is not common (although there is no reliable comprehensive data). Nonetheless, privately owned corporate groups in China, which have emerged at a rapid pace, are expected to prevalently adopt ownership structures that rely upon deep CMS in the near future. Accordingly, the problem of tunneling in China may worsen.

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[126] *Id.*

[127] Guohua Jiang et al., *Tunneling through Intercorporate Loans: The China Experience*, 98 J. FIN. ECON. 1, 2 (2010). *But see id.* at 17 ("We find that between 2001 and the end of 2006, numerous rulings, directives, and other edicts were issued. These efforts culminated in an eight-ministry joint statement in November 2006 which threatened personal action against the top management of controlling shareholders unless all intercorporate loans from listed companies were repatriated by December 31, 2006.").

[128] *Id.* at 1.

[129] Jia He et al., *Business Groups in China*, 22 J. CORP. FIN. 166, 167 (2013).

[130] *Id.* (citing State Statistical Bureau).

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

4. *Summary and Further Considerations*

In sum, in order to understand corporate governance problems and properly assess the level of investor protection, it is of significance to recognize OSOV more precisely from a functional perspective, taking into account not only law-on-the-book but also any possibility of circumventing OSOV in practice. For instance, OSOV is placed literally in the corporate law system in Korea and China. By relying on circular shareholding and stock pyramiding, however, market participants discover ways to circumvent OSOV in a legitimate way under existing codes and precedents.

Thus, according to a functional standard, it would be more precise to award zero points to Korea and China in terms of OSOV under the binary number system of the ADRI[132] (recall that Korea's OSOV score is one and LLSV did not survey China). As for OSOV in the United States, LLSV granted zero points. Under the LLSV's methodology, the current score of the United States would be zero as well; dual-class equity structures are permissible under U.S. corporate law.[133] Nonetheless, "dual-class share structures are rare among public companies [in the United States]."[134] Other means of voting mechanisms in favor of a controlling shareholder, such as stock pyramiding with multiple layers and partial ownership for a controller's leverage, are not common in the U.S. market. In this sense, if a value of either 1 or 0 is to be awarded to the United States for OSOV, then 1 would be more appropriate for reflecting reality.

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

Since OSOV provides a fundamental ground for shareholder voting rights, it significantly affects the allocation of voting power between a dominant

[132] It would be better to use a sliding-scale score between 0 and 1 rather than a simple binary system of 0 (nothing) or 1 (all). Technically, however, it would be extremely difficult to quantify in that way.

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

[134] *Id.* at 186.

shareholder and minority shareholders. Accordingly, a country's OSOV/OSMV most likely impacts the effectiveness of many voting-related ADRI components. Consider the cumulative voting system.[135] As LLSV explain, cumulative voting is a corporate governance tool guaranteeing proportional representation for minorities. However, cumulative voting would be rendered less useful for the protection of minority shareholders when combined with an exception of OSOV. Suppose a dominant shareholder were to take advantage of voting leverage that can make him a CMS controller. Then, it would be possible for a shareholder holding 13.26% of cash flow rights to wield 51% of voting rights, as seen in the aforementioned example.[136] Under these circumstances, cumulative voting would be a less meaningful way to achieve its ideology of proportional representation since the voting proportionality for minorities is already seriously tainted under the CMS. Thus, a country with 1 point for cumulative voting actually does not deserve 1 point if the country's corporate ownership is based on a structure associated with the deviation from OSOV.

Suppose that cumulative voting is allowed for corporations in both Country A and Country B.[137] Let us assume that OSOV is firmly established in Country A but can be legally circumvented in Country B. Under LLSV's indexing, both countries obtain 1 point for cumulative vote. Also, Country A and Country B are awarded 1 point and 0 points, respectively, for OSOV. In LLSV's research, OSOV is treated as a separate component from the ADRI. Thus, the two countries' total ADRI scores are not affected by the presence of required OSOV. This methodology of indexing has a shortcoming that can be criticized in two ways.

First, there is little reason for OSOV to be separated from the ADRI: like most ADRI components, OSOV is closely tied with voting. In fact, OSOV is perhaps the most fundamental voting-related right for public shareholders;

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

[136] *See supra* notes 119-120 and accompanying text.

[137] A country "allowing" cumulative voting is awarded 1 point. *See* LLSV, *Law and Finance*, *supra* note 5, at 1122 (table 1).

indeed, circumvention of OSOV may fundamentally disturb the foundation of non-controlling minority shareholders' voting rights. In this respect, it would be desirable to assign, for example, 2 points for OSOV (or negative 2 points for OSMV). If so, with all other things being equal, the total ADRI score of Country A, including the score of OSOV should be 2 points more than that of Country B. Of course, it is difficult to assign proper weights in a numerical way for either OSOV or any component of the ADRI.[138] What this Article seeks to emphasize, however, is that the assigned points for OSOV—which protects the fundamental voting rights—should be at least higher than those for the ADRI components.

Second, if Law and Finance theorists would like to maintain separate categories of OSOV and ADRI, then the *combined* effect of OSOV/OSMV and voting-related ADRI components should be taken into account when awarding a point for such ADRI components. To illustrate, OSOV/OSMV can be used as a multiplier: 1 if OSMV is not available, or 0.5 if it is. Thus, as for cumulative voting, OSOV points for Country A and Country B are 1 and 0.5, respectively. Again, this Article does not support the claim that the significance of OSOV in a specific jurisdiction is exactly measurable in terms of a multiplier. Rather, this Article explains that the ADRI components—if their effectiveness as minority shareholders' rights is affected by OSOV/OSMV—are *dependent* factors of OSOV/OSMV.[139] For the sake of simplicity, suppose that the multiplier (1 or 0.5) is maintained. In a case where both countries equally have three dependent ADRI components, the OSOV-ADRI combined scores of Country A and Country B are 3 (with no availability of OSMV) and 1.5 (with the availability of OSMV), respectively.[140] It is worth noting that according to

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[138] For instance, 3 points would be more proper for OSOV.

[139] Depending on specific laws and regulations in a jurisdiction, it is possible that the effectiveness of ADRI components such as "Cumulative Voting" (or "Proportional Representation"), "Preemptive Right," and "Percentage of Share Capital to Call an Extraordinary Shareholders' Meeting" is adversely affected by OSMV. For a further analysis, see *infra* Part IV.

[140] $3 \times 1 = 3$ (when OSOV is mandatory) and $3 \times 0.5 = 1.5$ (when OSMV is allowed).

the Law and Finance theory, ADRI scores of Country A and Country B are same, since they have equally three ADRI components.

It would be more precise if the average discrepancy between a typical controller's cash flow rights and his voting rights were used as a discount factor for a jurisdiction. Note that the "discrepancy discount factor" (another form of a multiplier) can be defined as "cash flow rights over voting rights."[141] When a controller's cash flow rights are low and his voting rights are high, the discrepancy discount factor decreases. To illustrate, Country X and Country Y allow OSMV and have two dependent ADRI components (whose effectiveness as public shareholders' rights is diminished by OSMV). (1) In Country X, suppose that on average a typical controller's cash flow rights and voting rights are 10% and 50%, respectively. Then, the discrepancy discount factor is 0.2 (i.e., 10% ÷ 50%). (2) In Country Y, suppose that on average a typical controller's cash flow rights and voting rights are 40% and 50%, respectively. Accordingly, the discrepancy discount factor is 0.8 (i.e., 40% ÷ 50%). As a result, the scores of dependent ADRI components for Country X and Country Y are 0.4 (i.e., 2 x 0.2) and 1.6 (i.e., 2 x 0.8), respectively. Simply put, the degree of OSMV (i.e., how much deviated from OSOV) is penalized according to a discrepancy discount factor:[142] in general, the more leveraged a controller's voting rights, the deeper the discount for the score.[143]

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[141] In order to measure the discrepancy between a controller's cash flow rights and his voting rights, in practice, two indicators—"cash flow rights over voting rights" and "voting rights minus cash flow rights"—are often used.

[142] A more complicated and comprehensive analysis of OSMV and a discrepancy discount factor is beyond the scope of this Article.

[143] In general, the voting distortion generated by OSMV is disadvantageous to public shareholders. Nonetheless, OSMV, particularly in terms of cash flow rights, is not always detrimental to public shareholders. For instance, if public shareholders have proper information about demerits of their shares in regard to OSMV, they can punish an issuer (or its controlling shareholder) by discounting the stock price when they purchase shares in the market. Put differently, if OSMV is already *expected* in the market, market participants reasonably take into account that factor when pricing. Accordingly, a country that does not allow *unexpected* change of terms of a corporation's OSMV provides better protection for public shareholders than another country that allows *unexpected* change of such terms. Another weakness of the Law and Finance theory is that the theory does not consider this key difference of two types of jurisdictions. I currently conduct independent research on these issues.

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

This Part scrutinizes whether LLSV's individual anti-director rights are proper indicators for investor protection. In particular, four ADRI components—"Cumulative Voting" (or "Proportional Representation"), "Preemptive Right," "Oppressed Minorities Mechanism," and "Percentage of Share Capital to Call an Extraordinary Shareholders' Meeting"—are examined in more detail. In addition, this Part explores in greater depth how OSMV and CMS damage the effectiveness of individual ADRI components.[144]

A. Criticism of "Cumulative Voting"

According to LLSV, if a cumulative voting system is allowed in a jurisdiction, the jurisdiction is granted one point for the protection of minority shareholders. LLSV argue that the availability of a cumulative voting system makes it easier for minority shareholders to elect their representatives in a board.[145] The advantage of cumulative voting for minorities is clear when compared with straight voting, which is the default election rule in the United States. Under straight voting, a shareholder holding 51% of shares can elect *all* directors in a board. As a result, a minority shareholder with a significant amount of shareholding (e.g., 49%) is not able to have even one director in a board no matter how many directors are to be elected. In contrast, under cumulative voting, a minority shareholder can elect one director if she has more than "T / [D + 1]" shares (where "T" stands for the total number of shares outstanding and "D" stands for the total number of directors).[146]

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

[144] Note that Part III.C explains the impact of OSMV on the effectiveness of ADRI components in general. Part IV includes an explanation and an analysis of how OSMV weakens the effectiveness of individual ADRI components.

[145] LLSV, *Law and Finance*, *supra* note 5, at 1127.

[146] For the more explanation of the formula, see CHARLES R.T. O'KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS: CASES AND MATERIALS 167 (6th ed. 2010).

According to the Company Law of China, cumulative voting can be used when electing directors and supervisors.[147] A few details are worth noting about cumulative voting in China and in LLSV's research methodology. First, before cumulative voting was introduced through the Company Law in 2005, the system was already implemented for listed companies: according to the Code of Corporate Governance for Listed Companies, cumulative voting should be adopted for "[l]isted companies that are more than 30% owned by controlling shareholders."[148] Second, under the Company Law, cumulative voting is not mandatory. Instead, in principle, corporations are able to remain outside the system.[149] Since the Law and Finance theory merely asks whether cumulative voting is allowed in a country's corporate law system,[150] China would be awarded one point for "Cumulative Voting" (or "Proportional Representation").

Consider the results of cumulative voting. Since a minority shareholder may be able to elect a director in a board, a board with cumulative voting has a high chance of being divided into two sides (the majority shareholder or corporate insiders vs. minority shareholders). Then, a fundamental point of inquiry is whether a divided board is really beneficial to enhancing the welfare of the entire group of shareholders. So far, the debate on this issue has not been definitively resolved. On the one hand, a divided board promotes a more democratic process due to participation from the minorities' side. On the other hand, it is often argued that directors from different factions are uncooperative and sometimes even hostile to each other, and accordingly,

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[147] Gongsi Fa (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 28, 2013, effective Mar. 1, 2014) art. 105, PUBLIC INFORMATION SERVICES, *available at* http://www.fdi.gov.cn/1800000121_39_4814_0_7.html.

[148] Shangshi Gongsi Zhili Zhunze (上市公司治理准则) [Code of Corporate Governance for Listed Companies in China] (promulgated by the China Sec. Reg. Comm. and State Econ. and Trade Comm., Jan. 7, 2001) art. 31, CHINA SEC. REG. COMM., *available at* http://www.ecgi.org/codes/documents/code_en.pdf.

[149] Gongsi Fa (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 28, 2013, effective Mar. 1, 2014) art. 105, PUBLIC INFORMATION SERVICES, *available at* http://www.fdi.gov.cn/1800000121_39_4814_0_7.html.

[150] *See* LLSV, *Law and Finance*, *supra* note 5, at 1122 (table 1).

efficiency in the corporate decision-making process may be sacrificed. In addition, confidential information of a corporation could possibly be leaked since a challenger-minority shareholder is sometimes related to the corporation's competitor. Thus, it would not be fully convincing to award one point to a country that allows (or mandates) cumulative voting.

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

Another criticism against cumulative voting may arise in regard to its effectiveness. In relation to the aforementioned formula[151] for a minority shareholder's minimum required shares to elect one director, it is known that a dominant shareholder or management may choose certain strategies to lessen the possibility that minority shareholders retain their representation. When "D" (i.e., the number of directorships to be elected) is lowered, the number of shares that a minority is required to hold in order to elect one director increases. Accordingly, a minority shareholder will find it more difficult to elect her representatives in a board. As a result, even in a country where cumulative voting is mandatory, a dominant shareholder or a current management team would weaken the purpose of this rule.

To illustrate, under cumulative voting a minority shareholder needs more than 10% of shares to elect one director in a nine-member board.[152] Small minority shareholders with less than 10% of shares (most minority shareholders fall into this category) are unable to elect their representative by themselves. In theory, shares can be collected via an alliance of many small shareholders. In practice, however, it would be sometimes difficult to form one group of many shareholders due to procedural issues and the collective action problem that dispersed minority shareholders face. Institutional investors are relatively large minority shareholders; thus, hardship from the collective action problem would be lessened. If, however, a capital market is

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[151] *See supra* note 146 and accompanying text.

[152] Put "T" = 100%. Then, the formula indicates 100% / [9 + 1] = 10%.

not fully developed, then it is likely that there are not many highly developed institutional investors in the market. Accordingly, cumulative voting would not be useful even if it is instated in a jurisdiction. This explanation provides an implication about the cumulative voting system in China. Indeed, stock markets in mainland China, such as the Shanghai Stock Exchange and Shenzhen Stock Exchange, have grown rapidly in terms of size. Nonetheless, their development in capital markets' intangible infrastructure has not reached a sufficiently sophisticated level. In particular, the market for institutional investors needs to be further improved.[153] As a result, the cumulative voting system is still less efficient as an investor protection device in China.

Another strategy, which is often used to defeat the minority's representation, is to set up a staggered board.[154] Suppose that a staggered board is comprised of three classes (a Delaware corporation's board can have three classes). Thus, the aforementioned formula would become "T / [(D/3) + 1]." Put differently, when a staggered board is introduced, the number of directors to be elected in a shareholder meeting is reduced to one-third. Consider again a board with 9 directors; in a staggered board, only 3 directors are to be elected in a shareholder meeting. As a result, a shareholder (or a group of shareholders) needs at least 25% of votes in order to install a director from her side (or from a group of shareholders' side).[155] In short, if a staggered board is allowed, a minority shareholder will find it more difficult to elect her director-candidate in a corporate election. In the extreme case, if a company has three seats for directors and adopts a staggered board, only one seat will be available in each shareholder meeting. As a result, cumulative voting and

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[153] For a similar view, see, for example, Benjamin L. Liebman & Curtis J. Milhaupt, *Reputational Sanctions in China's Securities Market*, 108 COLUM. L. REV. 929, 977 (2008).

[154] O'KELLEY & THOMPSON, *supra* note 146, at 169 ("For example, MBCA §8.06 allows classification of directors into two or three groups of as equal size as possible. If directors are divided into two groups, then each director serves a two-year term, and if classified into three groups, each director serves a three-year term. The terms of all directors are staggered so that the term of only one group expires each year.").

[155] Put "T" = 100%. Then, the formula indicates 100% / [(9 / 3) + 1] = 25%.

straight voting generate the functionally same result: a majority shareholder with 51% of votes is able to elect all three board members, whereas a significant minority shareholder with 49% of votes is not able to elect even one seat in the board.

Consequently, even if two countries have a cumulative voting system, the effectiveness of that system could vary widely, depending on (1) the average number of directors in a board, and (2) whether a staggered board is allowed in the jurisdiction at issue. Thus, without information on the average number of directors in a board and the availability of a staggered board in each country, LLSV's evaluation of forty-nine countries for cumulative voting is significantly incomplete. Since LLSV emphasize "proportional representation in the board" as the very goal of having a cumulative voting system,[156] it is unfair to award one point equally to a country with a cumulative voting system that does not provide sufficient guaranty for "proportional representation in the board" and to another country that does.

3. Controlling Minority Structure and Cumulative Voting

In addition, it is worth noting again that the effectiveness of the cumulative voting system should be analyzed within the context of CMS. Controlling shareholders in many countries (outside the United States and the United Kingdom) rely upon CMS where they can exercise a disproportionately large amount of voting rights, compared to their cash flow rights. Such separation of cash flow rights and voting rights can be achieved via voting leverage mechanisms. In CMS, a controller exercises a large amount of voting rights (e.g., 51%) while he holds only a small amount of shares (e.g., 10%), due to the opportunity to deviate from OSOV. This example is not unrealistic. For instance, a chairman of a large corporate group in Korea—a position usually held by a controlling shareholder—often holds less than 2% of economic

[156] In their own terminology, cumulative voting and proportional representation are considered to be within the same ADRI component. *See* LLSV, *Law and Finance*, *supra* note 5, at 1122 (table 1).

interests in a corporation.[157] As aforementioned, Jack Ma, the founder of Alibaba, the largest e-commerce company in China, controlled (and still controls) the company with only a fractional ownership.[158]

In this way, discriminatory voting is already built into a CMS, in favor of a controlling shareholder (or corporate insiders) and to the detriment of public shareholders. Thus, a corrective voting mechanism—e.g., cumulative voting—is unlikely to sufficiently redress this unfairness. Put differently, the positive effect of cumulative voting to protect minority shareholders—if any—could easily be eclipsed by a CMS. In this respect, LLSV's methodology—considering a cumulative voting system alone without taking into account CMS—is not convincing. For instance, when a controlling shareholder with 2% of cash flow rights exercises 51% of votes in a corporation, cumulative voting, even if it is firmly established, is virtually weakened and does not protect proportional voting rights of non-controlling minority shareholders who collectively hold 98% of cash flow rights.

Of course, if there is any regulation on a CMS controller's inflated voting power in the context of a corporate election, then the unfairness associated with CMS would be lessened. For instance, it would be imaginable that a CMS controller's voting power is capped or limited under corporate law, securities regulations, or exchange rules. Considering all the factors discussed above, the takeaway is that LLSV's scoring system for the cumulative voting system is too simple. Given that LLSV surveyed forty-nine countries, the need for such a simple scoring system is understandable. Indeed, LLSV's contribution is huge, and without their seminal work, the comparative study of international corporate governance would never have been developed. Nonetheless, simple application of the Law and Finance theory could be significantly misleading in terms of the extent to which minorities' proportional representation is protected.

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[157] *See supra* note 131 and accompanying text.

[158] *See supra* note 102 and accompanying text. Note that Alibaba is incorporated in the Cayman Islands and it is listed in New York Stock Exchange (NYSE). In light of this, it can be said that the company is not purely a Chinese corporation.

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

In some countries, corporations could circumvent cumulative voting through a charter or through its bylaws even when cumulative voting is available to public shareholders. The Commercial Act in Korea had no cumulative voting provision in December 1998 when LLSV's article of *Law and Finance* was published. Accordingly, Korea had zero points for its cumulative voting system. In fact, by amending the Commercial Act in December 28th 1998, Korea adopted a cumulative voting rule.[159] Thus, Korea's current score for cumulative voting would be one.[160] Nonetheless, a corporation in Korea can opt out of cumulative voting by stipulating in a charter.[161] Since CMS controllers in Korea wield a majority of voting rights, they would seek to abandon cumulative voting, which is burdensome to them. In reality, 92.1% of listed companies in Korea opted out of cumulative voting.[162] This fact indicates that LLSV's scoring system for cumulative voting is incomplete as it glances only at the cumulative voting system as law-on-the-book without considering factors that can legally incapacitate the cumulative voting system. Perhaps, it would be fair for Korea to receive, for example, 0.08 points since only about 8% of listed companies actually adopt cumulative voting.

B. Criticism of the "Preemptive Right"

Preemptive right is the right of existing shareholders to purchase shares on a pro-rata basis when a corporation issues new shares. Thus, a shareholder with 10% of shares has an option to purchase 10% of new shares issued by a

[159] As for cumulative voting in general, see Sangbeob (상법) [Commercial Act], Act. No. 12397, Mar. 11, 2014, art. 382-2 (S. Kor.). As for cumulative voting in (large) listed companies, see *id*. art. 542-7.

[160] *See* LLSV, *Law and Finance*, *supra* note 5, at 1122 (table 1).

[161] *See* Sangbeob (상법) [Commercial Act], Act. No. 12397, Mar. 11, 2014, art. 382-2(1) (S. Kor.). *See also id*. art. 542-7(3) (stipulating a special rule of the charter amendment for cumulative voting in (large) *listed* companies).

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

company. This preemptive right protects public shareholders mainly for two purposes. (1) Without this right, a corporation can issue new shares only to corporate insiders in favorable terms (at a discount), at the exclusion of non-controlling minorities. In this sense, the right protects public shareholders from dilution of their share value.[163] (2) In addition, the preemptive right protects public shareholders from dilution of their voting power since they are entitled to purchase shares proportionately to their existing portion. This is why it is important to note that preemptive right is also tied to shareholder voting rights, as this Article explains.[164] In Delaware, the preemptive right is not guaranteed for shareholders.[165] In fact, it is the only component of the ADRI that the United States lacks.[166] By contrast, as a general rule, shareholders in Korea have the preemptive right under the Commercial Act.[167] Under the Company Law of China, preemptive right applies to a limited liability company.[168]

Consider any weakness in LLSV's analysis and scoring policy of preemptive right. Importantly, what the preemptive right provides to shareholders is merely an opportunity to be asked to purchase new shares before third parties or corporate insiders are exclusively offered the chance.[169] In other words, the preemptive right does not give shareholders a gift of new shares; rather, shareholders must pay additionally in order to exercise the right. Thus, when

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

[164] *See supra* notes 91-92 and accompanying text.

[165] *See supra* note 41.

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

[167] *See* Sangbeob (상법) [Commercial Act], Act. No. 12397, Mar. 11, 2014, art. 418(1) (S. Kor.).

[168] Gongsi Fa (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 28, 2013, effective Mar. 1, 2014) art. 34, PUBLIC INFORMATION SERVICES, *available at* http://www.fdi.gov.cn/1800000121_39_4814_0_7.html.

[169] *See, e.g.*, OK-RIAL SONG, LECTURE ON COMMERCIAL LAW (5th ed. 2015), at 1093-94.

they lack sufficient capital to purchase new shares, the only alternative is to voluntarily give up the right. In this context, the preemptive right differs from other anti-director rights that are automatically granted (without any further contract consideration) to public investors once they become shareholders. For instance, when it comes to shareholders' right to call a special shareholder meeting, minority shareholders do not have to pay or give up something valuable in exchange for the right.

Second, under a corporate group setting—which is usually associated with CMS—the effectiveness of preemptive right's anti-dilution of shareholders' share value and voting power would be significantly lessened. To examine this, consider for example an affiliate of a corporate group that functions as a key hub in the CMS. Often, such a key affiliate (e.g., the de facto holding company) has shareholders who are either core insiders of the group (including executives and family members of a CMS controlling shareholder) or company-shareholders (other affiliated or related companies of the group).[170] When the affiliate issues new shares, it is possible that shareholders other than the controller may choose not to exercise their preemptive right. If so, the controller (and/or his family and third parties under the direct influence of the controller) purchases most of new shares (often on favorable terms). Also, the controller's voting rights over the key affiliate that affects the ownership structure of the corporate group are enhanced, so that his control over the entire group can be facilitated despite his small fraction of economic interests in other affiliates. In fact, it is likely that such "voluntary" renunciation of preemptive right is the result of a controller's explicit or implicit order, which is difficult for outsiders to particularize or prove.

A similar phenomenon was demonstrated in the lawsuit related to the controversial succession of control ownership in Samsung Group, from Chairman Mr. Kun-Hee Lee (the second generation of Samsung family) to his

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[170] *See, e.g.*, Won-Ik Park, *Shareholders of Lotte Holdings Sent a Confirmation Letter to Support Chairman Dong-Bin Shin*, CHOSUN BIZ (Dec. 3, 2015, 13:57), *available at* http://biz.chosun.com/site/data/html_dir/2015/12/03/2015120301623.html?right_ju (describing the shareholding structure of Lotte Group).

children (the third generation). In this case, it was alleged that newly issued securities of Everland, an amusement park company and the de facto holding company of Samsung Group at the time, were used to the benefit of the family (and to the detriment of public shareholders of Samsung Group). Through this transaction, the third generation gained a foothold for the inheritance of control over Samsung Group (currently, the number of affiliates is approximately seventy) although the family had a fraction of an economic interest in Samsung Group. It is likely that issuing new securities in favor of a controlling shareholder will be also a critical corporate governance topic in China in the near future. This is because family corporate groups have emerged in China and controlling family shareholders—who are interested in uninterrupted inheritance of their wealth and their continued capacity as controllers—would be able to find a legal loophole.

Due to other shareholders' "voluntary" renunciation of preemptive right, a controlling shareholder can purchase more shares of upstream companies in a corporate group. Then, he can make an internal transaction between an upstream company (where he has more economic stake) and a downstream company (where he has less economic stake). By setting a transfer price in favor of the upstream company, he is able to capture extra profits via self-dealing. Victims are public shareholders of downstream companies. This practice has been allegedly commonplace in Korea (particularly in the past). These tunneling cases could be also a serious socio-economic problem in China where controlling shareholders are quite strong.

In addition, although the preemptive right is in principle awarded to non-controlling public shareholders, corporate law (securities regulations and exchange rules as well) sometimes allows exceptions where a corporation can issue new shares to particular shareholders (usually corporate insiders) or third parties (who are friendly to corporate insiders) on favorable terms.[171] Once there is possibility for such a loophole, innovative lawyers can expand

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[171] In Korea, for instance, the Commercial Act stipulates possible exceptions, allowing issuance of shares to third parties for "business purposes." Sangbeob (상법) [Commercial Act], Act. No. 12397, Mar. 11, 2014, art. 418(2) (S. Kor.).

the scope of such exceptions in favor of corporate insiders, diminishing the effectiveness of the preemptive right for public investors.

In sum, this Section characterizes problems of the preemptive right in four ways: (1) it is a right that is not free; (2) the preemptive right could be merely nomenclature particularly in jurisdictions of CMS corporate groups; (3) in the context of a pyramiding structure, preemptive right can be misused as an instrument of tunneling; and (4) legally permissible exceptions may eclipse the principle, weakening the preemptive right. Under these circumstances, the preemptive right—even if stipulated in corporate law and firmly enforced by government agencies and courts—is not meaningful enough to protect public shareholders from corporate insiders. The ADRI fails to recognize this, and blindly awards one point to a country if preemptive right is written in the corporate law.

C. Criticism of the "Oppressed Minorities Mechanism"

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

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

The "Oppressed Minorities Mechanism" is a unique index component since it includes two independent rights for minority shareholders (i.e., a derivative suit system and an appraisal right). Other ADRI components are composed of only one anti-director right.[172] If the derivative suit system and appraisal right are perfectly (or substantially) substitutable for one specific purpose, LLSV's classification or definition of the "Oppressed Minorities Mechanism" would be appropriate. It is likely, however, that the derivative suit system and appraisal right are complementary (rather than substitutable)

[172] LLSV, *Law and Finance*, *supra* note 5, at 1122-23 (table 1).

since their goals, functions, and scopes of availability are different. In this respect, LLSV's classification of the "Oppressed Minorities Mechanism" would be flawed since it treats a jurisdiction having one of the two mechanisms in the same manner as another jurisdiction having both. Perhaps, it would be more relevant for the two mechanisms to be evaluated and scored separately, so that ADRI would have seven components.

Consider that one point in the binary number-based ADRI scoring system (i.e., one or zero points) amounts to 16.6% of the total score of a jurisdiction's extent of shareholder protection, since one point for a component of ADRI accounts for one-sixth of the total score. Given this scoring system, an arbitrary standard used by LLSV—namely, awarding one point to a country with either of the two mechanisms—would generate significant bias towards the total scores of the ADRI for a country (and perhaps for a legal origin as a group). In particular, this structural bias would cause a fundamental problem in relation to the reliance of LLSV's scholarly methodology upon statistical analysis. Statistical analysis based on *t*-statistics or statistical significance in the Law and Finance account is very subtle. For instance, LLSV explain that the corporate governance superiority of common law origin to that of civil law origin is supported by statistical significance at the 1% level.[173] Thus, there is 99% confidence that the statement is true in terms of quantitative analysis.[174] A key question on the methodology, however, is the following: if a 16.6% swing in the total ADRI score is determined by LLSV's discretionary standard, which is not fully convincing, then why should one care about the law and economics implications generated by a 1% margin of error?

2. <u>*Shareholders' Litigation*</u>

Regarding corporate agents' breach of fiduciary duties, it is highly unexpected that directors would bring suit against their colleagues or

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[173] *Id.* at 1131 (explaining that the *t*-value of common law vs. civil law is 5.00).

[174] *Id.* (arguing the superiority of English origin vis-à-vis French (and German) origin by explaining that the *t*-values of English vs. French origin and English vs. German origin are 4.73 and 3.59, respectively).

managers of a high position. Therefore, shareholders have the right to bring derivative suits on behalf of a corporation when alleged breaches of fiduciary duty cases take place; this is considered as a checks-and-balances system within the corporation. Despite the variance of significance across countries, certain conditions must be satisfied before shareholders bring derivative suits against corporate insiders.

Minimum shareholding requirements exist in some countries, so that only a shareholder (or a group of shareholders) holding more than a certain percentage of shares outstanding is able to bring suit. For example, in Korea by the end of the 1990s, a shareholder was required to hold 5% of shares outstanding in order to bring derivative suits.[175] After the revision in 1998, that requirement under the Commercial Act was reduced to 1%.[176] In China, shareholders' statutory derivative action right was initiated in the Company Law in 2005.[177] For example, according to the current Company Law of China, when directors and managers are in violation of law, administrative regulation, or a corporation's articles of association, shareholders who hold 1% or more of a company's stake for more than 180 consecutive days may demand a lawsuit to a supervisors' board (or supervisors).[178] When the board (or supervisors)

[175] JUNESUN CHOI, CORPORATE LAW 557 (9th ed. 2014). As to shareholders' litigation in Korea, this Sub-section mainly explains legal reforms in the Commercial Act.

[176] *See* Sangbeob (상법) [Commercial Act], Act. No. 12397, Mar. 11, 2014, art. 403(1) (S. Kor.). *See also id.* 542-6(6) (stipulating special requirements of 0.01% shareholding and the 6 month-holding period for listed companies).

[177] Hui Huang, *The Statutory Derivative Action in China: Critical Analysis and Recommendations for Reform*, 4 BERKELEY BUS. L.J. 227, 229 (2007). Some commentators claim that even before the 2005 revision, China allowed shareholders' derivative suits. *See* Hui Huang, *Shareholder Derivative Litigation in China: Empirical Findings and Comparative Analysis* 622 (Soc. Sci. Research Network, 2012), *available at* http://ssrn.com/abstract_id=2140613. However, "[a] popular view was . . . that the provision [before 2005 revision] fell short of providing a solid legal basis for derivative suits and at best offered a primitive idea of or a prelude to the statutory derivative suit introduced in the 2005 Company Law." *Id.*

[178] Gongsi Fa (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 28, 2013, effective Mar. 1, 2014) art. 151, PUBLIC INFORMATION SERVICES, *available at* http://www.fdi.gov.cn/1800000121_39_4814_0_7.html (explaining also the case where a supervisor is in violation of law, administrative regulation, or a corporation's articles of association).

refuses or fails to file an action or when it is urgent, shareholders "shall have the right to directly institute proceedings in his or their name in a people's court for the interests of the company."[179]

A primary rationale for the 1% requirement in Korea and China is to prevent frivolous suits. However, even the 1% requirement is generally a very difficult standard to pass since minority shareholders are dispersed and face a serious collective action problem. In China, without well-developed institutional investors, the collective action problem is more burdensome as there tends to be a great number of small individual minority shareholders. Accordingly, public shareholders' filing of a derivative suit would be severely discouraged. In Korea, as for listed companies, shareholders holding 0.01% for 6 months can bring a derivative suit.[180]

The United States (and particularly, Delaware) is quite different from many countries since it does not have a demanding shareholding requirement. Accordingly, it can be said that public shareholders in Delaware corporations have better access to the "Oppressed Minorities Mechanism." In this context, if different shareholding rules across countries are not carefully considered, the Law and Finance theory's simple dichotomy based on whether a derivative suit system exists in law-on-the-book is unfair and misleading. With regard to minimum shareholding, the shareholders' litigation score for the United States should be higher than that for a country with a harsh (e.g., 10%) requirement.

In addition, each jurisdiction has different shareholders' information rights (e.g., the right to demand a shareholders' list and inspect corporate books), contemporaneous ownership rules for plaintiffs, pleading requirements, evidence discovery systems, insurance/indemnification policies for accused directors and officers, and settlement systems. Indeed, such differences significantly impact the effectiveness of derivative suits. Suppose that a shareholder were prevented from inspecting information pertinent to an

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[179] *Id.* (explaining also the case where a board of directors (or executive directors) refuses or fails to file an action).

[180] *See* Sangbeob (상법) [Commercial Act], Act. No. 12397, Mar. 11, 2014, art. 542-6(6) (S. Kor.).

alleged breach of fiduciary duty by directors or executives. It would be hard for her to put forward specific allegations of directors' (or corporate officers') breach of fiduciary duties. Therefore, the effectiveness of a derivative suit system in a particular jurisdiction also depends upon supporting mechanisms, which are not covered by LLSV. In this context, the coding in the Law and Finance theory is too simple to evaluate the complicated infrastructures and functions involved in shareholders' suits.

For the foregoing reasons, it is possible that the derivative suit system in certain countries is merely a corporate law device in name only. Before the Asian financial crisis in 1997, Korea was the world's 11th largest economy. Despite the relatively large size of the Korean economy, for more than three decades since the first enactment of the derivative suit system in corporate law in the 1960s, not a single derivative suit was brought by shareholders until 1997.[181] Nonetheless, by the standard derived from the Law and Finance theory, "Korea before 1997" is deemed to be a jurisdiction providing shareholders' litigation right in its legal system. In reality, this evaluation is incorrect: if nobody uses the system for a long time (due to many official/unofficial obstacles), that would be equivalent to the system being unavailable.

China faces a similar problem: "Shareholder litigation, which in the United States serves as a crucial complement to SEC oversight, is simply not yet a viable means of investor protection in China."[182] In addition, shareholder activism—including active litigation—is generally instigated by strong minority shareholders such as institutional investors that the current Chinese market lacks. Since the Chinese economy is dominated by state-owned enterprises (SOEs), the State itself is the largest controlling shareholder in China.[183] Given this situation, minority shareholders would reasonably

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[181] The first shareholders' derivative suit was brought in the case of Korea First Bank in 1997. *See, e.g.*, *What Is Shareholders' Derivative Suit?*, HANKYUNG (July, 24, 1998, 00:00), *available at* http://www.hankyung.com/news/app/newsview.php?aid=1998072402371.

[182] Liebman & Milhaupt, *supra* note 153, at 977.

[183] *See* Li-Wen Lin & Curtis J. Milhaupt, *We Are the (National) Champions: Understanding the Mechanisms of State Capitalism in China*, 65 STAN. L. REV. 697, 697 (2013).

consider the political ramifications and implications that their complaints may generate. In other words, political cost should be taken into account as a crucial component of transaction cost associated with investors' collective action problem. Nonetheless, China would be considered a country that has an effective derivative suit system (like the United States), if China were included in LLSV's survey.

It is also noteworthy that derivative suit systems of the Commercial Act in Korea in different time periods are markedly different. As explained, there had not been a single derivative suit until 1997.[184] Due to a series of corporate law reforms and the development of market institutions after the end of 1990s, investors have recently used shareholder litigation in a relatively active way. Under the binary score system of the Law and Finance theory (i.e., "1 or 0" arrangement), however, it is unable to discern between improvement or reform of the derivative suit system and nominal shareholder litigation as a mere legal decoration.[185]

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

"Percentage of Share Capital to Call an Extraordinary Shareholders' Meeting" is the last component of the ADRI. When corporate law allows shareholders with less than 10% of shares to retain the right to call a special shareholders meeting, a jurisdiction is awarded one point. Otherwise (i.e., if shareholders have no such right or if shareholders holding more than 10% shares have such right), zero points are accorded. With the numerical cut-off of 10%, it should be noted that the standard of the scoring system for this

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[184] *See supra* note 181 and accompanying text.

[185] Another criticism of the Law and Finance theory with regard to a shareholders' litigation right is that the theory does not sufficiently discuss dark aspects of frivolous suits brought by public shareholders.

component is unique, compared to other ADRI components where the score is generally decided on the grounds of a yes or no inquiry.[186]

As LLSV precisely point out, ". . . the higher this [cut-off] percentage is, the harder it is for minority shareholders to organize a meeting to challenge or oust the management."[187] Thus, minority shareholders will find it more difficult to call a special shareholder meeting if a reference point is 10% than if the reference point were, say, 3%.[188] Nonetheless, the *same* 1 point would be given in both cases. Therefore, a natural question is why 10% should be the cut-off value for determining 1 or 0 points for each country. Since 10% could be a very high bar for dispersed minority shareholders, one may argue that a standard of 5% should be adopted. Interestingly, the criterion in the United States is 10%, so the United States barely passes the reference point and is awarded 1 point. If the reference number were lower than 10% (e.g., 5%), the U.S. score for this component would be 0. Conversely, if the reference number were higher than 10% (e.g., 20%), the U.S. score would still be 1; however, the United States would be treated in the same manner as other countries with a requirement ranging from 10% to 20%, although the U.S. standard is better for shareholders. In this regard, the 10% reference point is the most favorable standard for the United States.

To be sure, the "1 or 0" arrangement is too crude to be used for every ADRI component; however, when the standard is based on a yes or no distinction, it makes sense to some extent since the standard is at least clear. The problems stemming from the use of such a simple binary system are more pronounced in the "Percentage of Share Capital to Call an Extraordinary Shareholders'

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[186] For instance, if a preemptive right is stipulated, a country marks one point for the variable of "Preemptive Right," and if not, a country marks zero points. But, note that "Oppressed Minorities Mechanism" defines minority shareholders as "those shareholders who own 10 percent of share capital or less." LLSV, *Law and Finance*, *supra* note 5, at 1122 (table 1). In this sense, it can be explained that "Oppressed Minorities Mechanism" does not depends on entirely a yes or no standard. Rather, some features of a numerical standard are also found in "Oppressed Minorities Mechanism."

[187] *Id.* at 1128.

[188] According to *Law and Finance*, the percentage is 3% in Japan and 10% in the United States. *Id.* at 1130-31 (table 2).

Meeting," because a specific reference number (i.e., 10%) could be arbitrarily used as the dividing threshold between "good countries" and "bad countries." According to the 10% standard, a country with a 10.1% rule and another country in which shareholders have no right to call a special meeting (i.e., even a shareholder with 100% shareholding cannot call a special shareholder meeting) are treated the same: the two countries are awarded zero points. This would be unfair to the country with 10.1% rule. On the other hand, a country allowing 9.9% of shareholders to call a special shareholder meeting is granted one point. Such a drastic change from 0 to 1 due to a 0.2% difference (i.e., 9.9% vs. 10.1%) would be relatively unconvincing, compared to other ADRI components distinguishing one country from another based on a clear yes or no inquiry.

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

Another serious weakness of this ADRI component is the unfair standard that it applies when LLSV compare the United States with other jurisdictions. According to LLSV, "For the United States, our reliance on Delaware presents a problem since the state leaves up to corporations the percentage of shares needed to call an extraordinary shareholders' meeting. We use 10% for the United States because the majority of U.S. states (27) use this number."[189] In other words, LLSV first look at Delaware corporate law, and if they find no

[189] *Id.* at 1128 n.6.

positive aspect, then they look at corporate law in a majority of states. This type of cherry picking is often unavailable in other countries. As such, LLSV's stance is clearly based on a double standard. In addition, since a vast majority of large public corporations in the United States are incorporated in Delaware,[190] it would be less meaningful to pay attention to corporate law in a majority of states as LLSV do. Even if LLSV's methodology were accepted, it would be fair to award the United States 0.54 points rather than 1 point since 27 out of 50 states satisfy the 10% requirement.

To be sure, the United States is one of the best countries in terms of the quality of corporate governance; however, this is because it has the best quality of markets (i.e., both product and capital markets), legal infrastructure (e.g., an efficient enforcement mechanism and fair judiciary) and sound business culture, not due to the high score in LLSV's survey.

V. CONCLUSION

Since the end of the 1990s, the Law and Finance theory has been a central topic in the comparative corporate governance scholarship. Several important issues of the Law and Finance account, however, have been highly neglected in debates by LLSV and both their proponents and critics. This Article proposes critiques of the Law and Finance theory that have seldom been explored in the literature. In particular, features of a controlling shareholders regime (e.g., CMS and voting leverage) are scrupulously examined in the context of OSOV/OSMV and the ADRI. To this end, examples and evidence from China and Korea are used, in addition to traditional corporate governance theories based on the U.S. jurisprudence.

Above all, when it comes to protection of public shareholders' equal voting rights, OSOV should be interpreted as the principle that shareholders have voting rights commensurate with their cash flow rights. In this respect,

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

OSOV is ill-defined by LLSV since they do not consider stock pyramiding and cross-ownership. In addition, by excluding OSOV from their ADRI scoring system, LLSV underrate the importance of OSOV, voting leverage, and the CMS, all of which fundamentally affect public shareholders' voting rights. It is also noteworthy that many ADRI components that are key factors of the Law and Finance theory are related to public shareholders' voting power. Since the deviation from OSOV significantly affects the effectiveness of minority shareholders' voting power, it would be less meaningful to discuss components of ADRI on a stand-alone basis without considering the combined effect with OSOV (and CMS).

Moreover, most of the original ADRI components designed by LLSV have weaknesses as proxies to measure shareholders' protection. A cumulative voting system is subject to problems in association with a formula[191] and a staggered board. In addition, the effectiveness of cumulative voting is seriously affected by a deviation from OSOV,[192] which is not fully analyzed by LLSV. The preemptive right is not a gift for shareholders, so shareholders are not able to exercise the right for free as they do other anti-director rights.[193] In a CMS, the preemptive right could become a perfunctory right since shareholders (including company shareholders such as affiliated firms) who are under the control of a dominant shareholder are likely to give up the right.[194] In many countries, a derivative suit system is subject to burdensome requirements for plaintiff-shareholders. Thus, giving the same treatment to the United States (where a derivative suit system works well) and many other countries with ineffective systems is unfair to the United States. Minority shareholders' right to call a special shareholder meeting is another controversial ADRI component due to its numeric cut-off criteria and its double standard in favor of the United States.

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[191] *See supra* note 146 and accompanying text.

[192] *See supra* Part IV.A.3.

[193] *See supra* note 169 and its accompanying text.

[194] *See supra* Part IV.B.

Comparative corporate governance studies become more practical when their surveys are based on numbers, scores, and statistics that are ultimately reduced to an index. In fact, this Article values this trend of the "quantification of the quality" of corporate governance, as it is a useful and practical way to assess the quality of investor protection. In this sense, despite the many weaknesses of the Law and Finance theory, LLSV have undeniably made great contributions in corporate governance scholarship. Nonetheless, indexing should be used as a means of a quick litmus test and a supplementary methodology. Thus, in order to understand the quality of corporate governance across jurisdictions, a more in-depth analysis based on legal systems (not limited to a corporate law system), markets, and socio-economic infrastructures should be conducted as well, as a complement to index-oriented research.

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