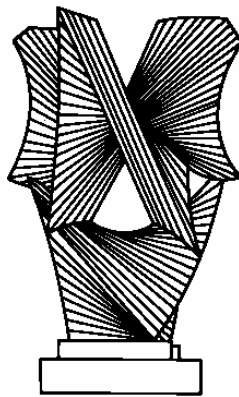


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EQUITY MARKETS, THE CORPORATION AND ECONOMIC DEVELOPMENT

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Modern economies are heavily dependent on the corporate form of doing business. The sheer scale of modern commercial activity, once it goes beyond the individual store and workshop, increasingly demands capital beyond the resources of most individual entrepreneurs. Although the capital needs could in some cases be met by partnership, the partnership form has proved rather inflexible and is utilized primarily for very small enterprises and for the professions. Some professional organizations using the partnership form—such as accounting and law firms—have taken advantage in the United States of various special statutory entity forms, such as limited liability partnerships and limited liability corporations, that grant limited liability but cannot be easily used as a source of large-scale capital from public investors.¹

The use of companies to pool large sums of capital and therefore to raise capital for large new commercial ventures has been increasingly common since the Dutch and English East India companies were organized at the beginning of the seventeenth century.² By the twentieth century corporations became the dominant organizational vehicle for commercial ventures almost without exception throughout the world.

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¹ Allen (2003, p. 76–79); Hansmann, Kraakman and Squire (2006, p. 53–54). The choice of these organizational forms is often dictated, of course, by tax considerations.

² See East India Company and Dutch East India Company, Encyclopedia Britannica Online. There were English precedents for the English East India Company, of which the first was perhaps the Russia Company of 1553. Scott (1912, p. 18).

The Corporation in Historical Perspective

The corporation was an institution that helped to solve the long distance trade problem of early Europe, just as were the various enforcement institutions that helped to bridge the separation of the quid and the quo.³ At least in England the corporation was much more important in long-distance trade than it was in domestic commerce. The English East India Company received a charter from the Crown in 1600.⁴ But companies had existed for centuries before they were used for economic ends. Previously they had been, in England, “regulated companies” limited to non-profit purposes.⁵ Only after regulated companies began to be chartered by the English crown for trading purposes were they gradually superseded for such purposes by joint stock companies.⁶ These joint stock companies were not chartered by the state but rather represented a private sector contractual arrangement.⁷ Over time transferable shares of joint stock companies became common *de facto* if not *de jure*,⁸ and only later did limited liability become common. That shareholders could not be held liable for the debts of the company was not fully established until the enactment by Parliament of the 1855 and 1856 limited liability acts.⁹

Even in the early days of the trading company these predecessors of the modern corporation provided a vehicle for assembling capital from a large number of merchants sufficient to finance not just the especially large ships that, sailing beyond the protection of the Royal Navy, had to be armed, but also the capital involved in the crew and provisioning costs for the two to three years involved in sailing to the Indian subcontinent and beyond to the Spice Islands and Java and returning with valuable and

³ Kindleberger (1984, p. 196). See on the separation of the quid and the quo, Kenneth W. Dam, *Institutions, History, and Economic Development* (2006), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract_id=875026], and sources cited therein.

⁴ An historical issue is whether the English or the Dutch East India Company were the first to be created. It appears that the Dutch were the first to send regular sea voyages to East Asia but the English were the first to charter a company, with the Dutch East India Company (VOC) having received a charter only in 1602. Harris (2005).

⁵ See Davis (1905) for a survey of the use of corporations and stressing their use for ecclesiastical, municipal, gild, educational, and eleemosynary purposes in feudal and early modern Europe. Davis' second volume continues the survey, including a discussion of the transition to the use of regulated companies and then joint stock companies.

⁶ See generally Evans (1908, p. 339–45).

⁷ Hansmann, Kraakman and Squire (2006, p. 45).

⁸ Scott (1912, p. 442) states that “from an early period in England, shares were bought and sold with a considerable degree of freedom.” Scott refers to a sixteenth century example—that is, before the East India Company was organized. Scott (1912, p. 443). See Harris (2000, p. 114–27).

⁹ See discussion in Harris (2000, p. 127–32) and in Blumberg (1986 p. 177–586).

exotic cargo.¹⁰ To undertake such ventures through partnerships would have had a number of disadvantages. With several hundred partners, the legal mechanics would have been unwieldy.¹¹ Partnership law would probably have required a new partnership agreement each time a particular partner died; one or more of the London-based merchants backing the voyage almost certainly would have died during the lengthy voyages requiring a new partnership agreement. Kuran has made a powerful case that the failure of Islamic law to permit business in corporate form was a major impediment to economic development, especially in Arab countries, at least until under the influence of colonial powers the corporate form was added to those countries' menu of legal choices.¹²

In the case of the East India company ventures, the pattern of creating a separate company for each voyage or group of voyages developed,¹³ thereby adding to the economic advantages not just the assembly of capital and avoidance of the pitfalls of partnership, but also the diversification of risk across multiple ventures; after all, sailing to and from Asia was risky at the beginning of the seventeenth century and even in the early years not all safely completed voyages, it appears, yielded net profits.¹⁴ The East India Company was an early example of drawing capital not just from entrepreneurs themselves (and their families), but also from passive investors.¹⁵ Although at first the East India entrepreneurs used the regulated company form with separate accounts for each voyage,¹⁶ they later turned to separate joint stock companies that apparently did not have either a royal or a parliamentary charter; their legal characteristics were murky.¹⁷ Later, however, the East India Company itself was given a longer-term monopoly of England-India trade and with it a charter, by this time however as a permanent joint stock company.¹⁸

¹⁰ Harris (2004, p. 10–11).

¹¹ Harris (2000, p. 21).

¹² Kuran (2004) and Kuran (2003).

¹³ Baskin and Miranti (1997, p. 64) and Chaudhuri (1965, p. 208–9).

¹⁴ Chaudhuri (1965, p. 212) and Baskin and Miranti (1997, p. 72).

¹⁵ Chaudhuri (1965, p. 33).

¹⁶ Harris (2004, p. 31).

¹⁷ Evans (1908, p. 349–50).

¹⁸ Evans (1908, p. 350). The sequence of the different forms in which the East Indian enterprise functioned in the early years is not entirely clear. See, in addition to Evans (1908), Scott (1912, p. 150–65) and Chandhuri (1965).

Parliament later became the source of the privilege of incorporation in England, and later the legislatures of the several states of the United States began to grant corporate charters. Inevitably the practice of granting individual charters led to a merger of politics and business. The problem was not so much that a businessman might bribe politicians to obtain a charter, but that politics would drive business activity to the advantage of particular politicians. In other words, “venal corruption” was not the problem but rather, in the useful dichotomy of Wallis, “systematic corruption.” The latter term, according to Wallis, embodies “the idea that political actors manipulated the economic system to create economic rents that politicians could use to secure control of the government.”¹⁹ This merger of politics and business thus created a serious Rule of Law problem from both the political and the economic perspectives. Consequently, the move to free incorporation in England in 1844, under general incorporation statutes calling for articles of incorporation to be issued under administrative procedures to all entrepreneurs meeting statutorily prescribed standards, was a major step toward a Rule of Law.²⁰

Even though the joint stock company was the predecessor of the modern corporation, it did not acquire all at once the hallmarks of the modern corporation, such as limited liability, legal personality and transferable shares.²¹ As in so many aspects of economic development, the legal framework evolved. As previously noted, limited liability became available in England for all corporate entities as a result of legislation in 1855 and 1856; prior to that time limited liability required an Act of Parliament and was used only for large-scale undertakings such as canals and railroads.²² In the United States limited liability had become available slightly earlier, in the 1830s, in some leading commercial states.²³ Limited liability in its entirety did not reach California until 1931.²⁴

Whatever the validity of the LLSV Legal Origins hypothesis in the contemporary world, it does not mean that common law countries were more progressive in this legal evolution than continental countries, especially France. For example, today most American lawyers and businessmen strongly approve of the concept of limited

¹⁹ Wallis (2004, Abstract).

²⁰ On free incorporation, see Lamoreaux and Rosenthal (2005) and Harris (2000, p. 282–86).

²¹ See discussion of these three key concepts below.

²² Blumberg (1986, p. 583–85).

²³ Baskin and Miranti (1997, p. 141–42).

²⁴ Blumberg (1986, p. 597–99).

partnerships (in which some partners invest but, not being managers, are not responsible for the partnership's debts beyond the value of their investment). Napoleon introduced limited partnerships in 1807 in his Commercial Code, but the English judiciary held that limited partnerships could not be recognized without a Parliamentary statute. The reason is interesting in view of the widespread idea that the common law is more flexible and more keyed to commercial needs than continental code writing. The reason for refusal of English courts to recognize limited partnerships was the simple-minded notion that such partnerships had always been contrary to the common law!²⁵ (Harris observes that British judges were from the tight-knit rank of barristers, who were overwhelmingly from the landed classes and had few acquaintances among the merchant class and even dealt with their merchant clients through intermediary solicitors; his observation suggests that the common law of the time was truly autonomous and that any flexibility of the common law at that time was strictly intellectual, not a response to economic changes.²⁶) In any case, the French economy benefited from limited partnerships for half a century before England even got around to confirming the availability of limited liability for corporations in 1856 and for a century before Parliament passed the Limited Partnership Act of 1907.²⁷

Turning from legal rules to financial development, a problem with the Legal Origins hypothesis is that it appears to apply among developed countries only to the post-World War II world. Rajan and Zingales find that “financial markets in countries with a Civil Law system were not less developed than those in countries with Common Law in 1913 and in 1929 but only after World War II.”²⁸ Their data shows that France had 13.29 listed companies per million people in 1913 whereas the United States had only 4.75. As late as 1960 France had twice as many listed companies per million people as the United States. The United States surpassed France only during the 1970s,²⁹ long after—it might be noted—nearly all French law countries in today's developing world had become independent. Similarly, in 1913 the percentage of gross fixed capital raised in public equity offers was roughly the same in France and Britain and more than three times

²⁵ Harris(2000, p. 30), See Lamereaux and Rosenthal (2005, p. 33).

²⁶ Harris (2000, p. 230–249, especially p. 231–32).

²⁷ Harris (2000, p. 30).

²⁸ Rajan and Zingales (2003b, p. 42).

²⁹ Rajan and Zingales (2003b, p. 17, Table 5).

greater than in the United States.³⁰ Thus, the notion that French law condemned French law countries to inferior equity markets seems poorly supported historically within the developed world.

Advantages of the Corporation Today

One of the reasons for the spread of the corporate form was that it has several advantages beyond the pooling of capital. One, as previously noted, is limited liability of the shareholders, which simply means that the corporation is liable for its debts but its shareholders are not; shareholders are liable only for their own debts and therefore can lose only what they have already invested in the corporation. Limited liability tends to promote risk-taking (though founders of new enterprises find that they may have to guarantee the corporation's debts to induce creditors to provide loans).

Another advantage is that the corporation has a legal personality, meaning that it can enter into contracts without requiring the signature of its shareholder owners or indeed without even consulting them, at least for contracts in the ordinary course of business. But legal personality also has advantages from the standpoint of property rights and liability. The protection of the corporation's assets from the creditors of the shareholders has been called "entity shielding" (or alternatively "affirmative asset partitioning") because it permits a corporation to own assets and thereby to borrow on the strength of its asset position or even to pledge the assets directly as collateral.³¹ Limited liability and entity shielding are thus mutually reinforcing effects from the standpoint of the economy for they create "a default regime whereby a shareholder's personal assets are pledged as security to his personal creditors, while corporation assets are reserved for corporation creditors"³²:

In an enterprise of any substantial magnitude, this allocation generally increases the value of both types of assets as security for debt. It permits creditors of the corporation to have first claim on the corporation's assets, which those creditors have a comparative advantage in evaluating and monitoring. Conversely, it permits an individual's personal creditors to have first claim on personal assets, which those creditors are in a good position to evaluate and monitor and which creditors of the corporation, conversely, are not in a good

³⁰ Rajan and Zingales (2003b, p. 16, Table 4).

³¹ Hansman, Kraakmann and Squire (2006).

³² Hansmann and Kraakman (2004a, p. 9).

position to check. As a consequence, legal personality and limited liability together can reduce the overall cost of capital to the firm and its owners.³³

Although this explanation may appear rather abstract, it makes especially good sense when one is speaking of large corporations with widely diversified ownership with many individual equity investors. In these circumstances, the sources of credit for the corporation are likely to be completely different financial institutions from those that finance the individual investors. Whether those advantages of the corporate form are as great in developing countries may depend on the development and diversity of finance-providing institutions.

These advantages of the corporate form are intimately tied up with a legal characteristic that puts the individual shareholder in a different situation from an individual creditor and therefore is at the root of the difference between equity and debt as a source of capital for the corporation. The corporation is in principle perpetual and therefore the shareholder cannot demand that the corporation cash out his shares. A share of stock does not mature and become payable (though it is true that so-called preferred shares are sometimes callable by the corporation).³⁴ A creditor, whether bondholder or ordinary creditor, is of course tied up for the agreed term of the bond or debt. But a creditor, unlike a shareholder, can agree on a short term or the debt may even be agreed to be payable on demand by the creditor. This lock-in effect is satisfactory to large numbers of shareholders, of course, only in conjunction with the development of the transferable share, which is usually considered a further advantage of the corporation.³⁵ But the key is the lock-in effect because it means that the corporation is not dissolved, as in the case of a partnership, when one of the owners dies or simply wants out.

The transferability of corporate shares, in contrast to contractual rights in a partnership, underpins the perpetual life characteristic of corporations and is thus another advantage of the corporate form. Transferability also provides liquidity to shareholders. Finally, it supports savings and investment by individuals by providing opportunities, through investment in many companies, to build a diversified portfolio, thereby reducing risk.³⁶

³³ Hansmann and Kraakman (2004a, p. 9).

³⁴ For a general discussion of “lock-in,” see Stout (2004). See also Blair (2003).

³⁵ Hansmann and Kraakman (2001, p. 439–40).

³⁶ Hansmann and Kraakman (2001, p. 453).

Finally, in the twentieth century the advantage of the corporation in the hiring of professional management began to be important in many developed countries, though even in publicly held corporations dominant shareholders still often hold management positions, especially in the developing world.³⁷

All of these advantages of the corporation add up to a great strength for an economy. A prime function of a financial system being to channel funds from the ultimate savers in a society to enterprises that will invest those funds in productive uses, the corporation has proved to be efficient for gathering funds for such uses. Although the corporation can borrow, it is particularly attractive for those investors who are willing to be last in priority in the case of corporate insolvency in order to be entitled to a potentially greater return in the event of corporate profitability—which is from the investor’s point of view the fundamental distinction between equity and debt.

Legal Origin Analysis of Equity Markets

The characteristics of the corporation and the status of shareholders are defined by law. Some of the underlying rules of corporate law have proved better for economic development than others. But as in many other legal fields, the greater difference among countries lies in the enforcement of the rules rather than in their exact content. Nonetheless, the Legal Origin literature places great emphasis on the substantive rules of corporate law.

A close look at the methodology of the LLSV study on “Law and Finance” shows how the Legal Origin approach works in practice.³⁸ The six substantive law rules that were characterized by LLSV as “anti-director rights” were: (1) “proxy by mail allowed,” which makes it possible for shareholders to vote without physically showing up at shareholder meetings; (2) “shares not blocked before meeting,” which precludes companies from requiring deposit of shares as a prerequisite to shareholder voting and thereby limiting sales and purchases for a period before and even after shareholder meetings; (3) “cumulative voting” or “proportional representation,” which allows a minority to obtain representation on the board; (4) “oppressed minorities mechanism,” which allows minority shareholders one or more of several remedies in the case of

³⁷ Hansmann and Kraakman (2001, p. 450–51).

fundamental transactions such as mergers; (5) “preemptive rights,” which make it more difficult for controlling shareholders to dilute the voting power and/or value of minority shareholders’ interests; and (6) “percentage of share capital to call an extraordinary shareholder meeting,” which if kept low gives minority shareholders the power to appeal to shareholders as a group.³⁹

With respect to the first five “anti-director rights,” which have a binary character, each of the countries in the Law and Finance survey were given a 1, if the right was accorded by substantive law, and a zero if the right was not accorded. The sixth anti-director right, not being binary, was scaled to give a 1 where the percentage was at or below the world median of 10 percent and a zero otherwise. The sums of these scores were then added, with the possible anti-director rights score ranging from zero to six. (Other substantive law provisions that might bear on shareholder rights included “one-share, one-vote,” which preclude dual class shares, and “mandatory dividend,” were also scored, but can be ignored for present purposes because they played little role in subsequent Legal Origin analyses.)

The country scores were averaged across legal family (English, French, German and Scandinavian origin) to give a score for each legal origin. The higher the score, the greater the protection to minority shareholders the legal family was credited with giving. In racing terms, one can observe from these averages that English-origin came in far ahead with 4.00 compared with French-origin and German-origin in a dead-heat for last at 2.33 and Scandinavian-origin in between at 3.00. Statistical tests showed that differences between English-origin and the three civil law origins were significant, indeed significant at a high level (the one-percent level) for the difference between common law and French/German law.

These kinds of cross-country statistical tests often evoke quite different responses from economists and lawyers. For most economists and many social scientists such statistical analyses are necessary to come up with valid general propositions that are more than impressions. For many lawyers, on the other hand, general propositions are inherently suspect, especially if they are based on giving legal rules ones and zeros or otherwise simplifying the richness of detail that one finds in any legal field. In large part

³⁸ Rafael LaPorta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny (1998). “LLSV” refers hereafter to the joint work of these four authors.

this difference lies in the training and perspective of economists and lawyers; economists are trained to find general principles that lie beneath the churning and discontinuous surface of life while lawyers are trained to distinguish factually between cases that for most people seem to be much the same.

Even from a lawyer's perspective, the results in the Legal Origin literature are rather powerful. But on further examination, some anomalies can be perceived in the investor protection results. In the first place, one can question the choice of anti-director rights. Preemptive rights, for example, have long since virtually disappeared from the scene in the United States.⁴⁰ And they have disappeared for the good reason that they have costs to the corporation and to the economy:

[Preemptive rights] delay new issues of shares by forcing companies to solicit their own shareholders before turning to the market. They also limit management's ability to issue blocks of shares with significant voting power. Both constraints reduce a company's ability to raise equity capital, which may explain why the EU's Second Company Directive permits those Member states that allow authorized but unissued shares to also allow shareholders to waive pre-emption rights. These constraints may also explain why both Japan and the U.S. states have abandoned preemptive rights as the statutory default, and why Japanese and U.S. shareholders almost never attempt to override this default by writing preemptive rights into their corporate charters.⁴¹

All U.S. states now make preemptive rights, under which existing shareholders have the right to participate in any new issuance of equity by subscribing to the offer, only an optional term in corporate charters.⁴² This is in fact one of the examples of the movement of American corporate law toward a default term concept of corporate law, which allows shareholders either to opt-in or to opt-out of certain terms. The default term usually chosen is the term that parties forming corporations would normally choose. Thus, in most if not all states of the United States preemptive rights do not apply unless they are chosen in the articles of incorporation; in other words, they are opt-in rather than opt-out provisions (that is, preemptive rights are permissible but not mandatory and they

³⁹ LLSV (1998, p. 1122–25, Table 6 and 1126–28).

⁴⁰ William T. Allen and Reinier Kraakman, *Commentary and Cases on the Law of Business Organizations* 367 (2003).

⁴¹ Rock et al. (2004, p. 148).

⁴² Cox et al. (1997, p. 474).

must be affirmatively chosen to be applicable).⁴³ In Delaware, which is the state LLSV chose to represent all U.S. corporate law,⁴⁴ preemptive rights are opt-in provisions. It is, to say the least, rather odd that the LLSV test of preemptive rights accords a zero where preemptive rights are available only on an opt-in basis when they chose a different approach for proportional representation, according one point where proportional representation is allowed, though not required.⁴⁵

Whatever the pros and cons of the default term approach, it seems obvious that preemptive rights have a smaller role in countries where there is a vigorous market for new stock issues among widely dispersed shareholders (as illustrated by the atrophying of preemptive rights in the United States), as compared with countries with primarily concentrated share ownership. In the absence of a vigorous market for new issues, preemptive rights are a reflection in part of an assumption that new equity capital for an existing corporation will most usually have to come from existing shareholders. Preemptive rights also are a recognition that where share ownership is concentrated, the relative position of such owners is a major issue. In the absence of preemptive rights, a controlling shareholder could, for example, gradually squeeze out or otherwise disadvantage existing minority shareholders, including those who had major stakes but who, in the absence of a liquid stock market for the company, had little prospect of selling those stakes to anyone other than the controlling shareholder. Thus, the use of preemptive rights is a sign of a weak, not a strong, market for corporate equities.

Some important protections for minority shareholders do not find themselves on LLSV's list. At least in the United States, the concept of directors' fiduciary obligations, particularly the duty of loyalty, is generally regarded as the most important safeguard for minority shareholders.⁴⁶ Yet it finds no place in the LLSV list of "anti-director" investor protection provisions.

An important perspective into the LLSV approach is gained by observing that the

⁴³ The dominant theory of American corporate law that has emerged in recent decades is that a corporation is essentially a contractual arrangement in the sense that a corporation is a bundle of rights. See Easterbrook and Fischel (1991). In this vision of the corporation, corporate law is to a substantial degree a set of default rules; these default rules can be varied if the shareholders agree. See Ayres and Gertner (1989).

⁴⁴ LLSV (1998, p. 1128 n. 6).

⁴⁵ LLSV (1998, p. 1122). In a December 2005 working paper, Djankov and three of the LLSV authors proposed dealing with the opt-in, opt-out inconsistency by revising the anti-director index. Djankov et al. (2005).

adoption of the LLSV anti-director rights is not systematic across legal families. Cumulative voting (or proportional representation) is possible in only 5 of the 18 common law countries (and then, with respect to the United States, only in some states), whereas it is found in roughly the same proportion of French law countries. More important, preemptive rights are required in only 44 percent of common law countries in contrast to 62 per cent of French law countries (thereby suggesting that, at least if one takes the LLSV view of preemptive rights, French law origin is in this respect more protective, not less protective, of minority shareholders than common law origin). The comparisons suggest that the relative scores for legal families may be more a construct of the choice of rights deemed to protect minority shareholders than a systematic difference in shareholder protection among legal families.

Third, because LLSV looked at statutory law and apparently failed to consider case law, they have scored certain Continental countries too low, according to commentators from civil law countries. This is certainly an oddity in view of declarations in LLSV articles about the supposed superiority of judge-made law (that is, of the common law method).⁴⁷ According to Cools, LLSV failed to look at functional equivalents of substantive rules they scored.⁴⁸ Taking these two and related points together, Cools claims that LLSV got their conclusions backward: France, according to Cools, should have gotten a 4 or 5 (or, accounting for recent changes in French law, a 5 or 6) rather than a 3, Belgium a 4 rather than a zero, and the United States should have received only a 4 rather than 5.⁴⁹ In other words, according to Cools, French and French-origin law is at least equal to English-origin law, particularly of the U.S. variety.

Similarly, Berndt has criticized as inconsistent the scores with regard to Germany compared with the United Kingdom with respect to preemptive rights.⁵⁰

Vagts in turn came, through a detailed analysis of the actual state of corporate law and practice with regard to the LLSV “anti-director rights” in Germany, to the conclusion that the difference in national scores between Germany and common law countries “is not such as to concern an internationally sophisticated lawyer advising a client where to

⁴⁶ Hertig and Kanda (2004, p. 114–18).

⁴⁷ For a review of the LLSV articles on this point, see Beck and Levine (2003).

⁴⁸ Cools (2005).

⁴⁹ Cools (2005, p. 734–35). See LLSV (1998, p. 1130, Table 2).

⁵⁰ Berndt (2002, p. 17–18).

invest.”⁵¹ In his view, “It is hard to agree with LLS & V that ‘the evidence points to a relatively stronger stance favoring all investors in common-law countries.”⁵²

In sum, the LLSV method of selecting certain statutory rights and scoring them, sometimes on an opt-in basis and sometimes on an opt-out basis, is deficient—according to some critics—because LLSV have the wrong values for the variables, in part by ignoring what courts actually do (as opposed to only what statutes explicitly provide) and in part by ignoring functional substitutes. These shortcomings lead to the observation that the devil in the LLSV method is definitely in the details. Econometrics unquestionably has the virtue that it helps to abstract from details in order to highlight regularities. But one cannot ignore the obvious fact that a failure to use the right values for the variables or to use consistent methods of assigning those values can produce misleading, even erroneous, conclusions.

Fourth, even if the variables—that is, the chosen anti-director rights—are roughly the right ones, the variance among countries within any legal family is remarkably high if indeed the origin of a country’s law makes a decisive difference, especially for economic growth in developing countries. Pakistan and India rank at the top of the list in total anti-director rights with a score of 5 out of 6 (along with the United States, Canada and the United Kingdom) but others like Thailand and Sri Lanka receive only a 2 and a 3, respectively.⁵³ And in the French law family, Chile achieves a 5 out of 6 whereas many French law countries receive only a 1 out of 6. Most striking of all, Germany ranks lowest of all among German law families with a 1 out of 6, whereas Japan—a German-law country—achieves a 4 out of 6.⁵⁴ Perhaps this oddity can be traced to Japan’s corporate law being based, thanks to the post-World War II occupation under General MacArthur, on Illinois law, not German law⁵⁵; Mattei observes that “Japanese law ... is as much influenced by American legal culture as by German or French.... In corporation law American legal culture has the lead.”⁵⁶ Still, a poll of international corporate lawyers

⁵¹ Vagts (2002, p. 595, 606).

⁵² Vagts (2002, p. 602).

⁵³ The reader should be aware that the LLSV classification of Thailand as a common law country is not free from doubt.

⁵⁴ LLSV (1998, p. 1130–31, Table 2).

⁵⁵ West (2001, p. 529).

⁵⁶ Mattei (1997, p. 128).

might easily come to the conclusion that minority shareholders are at least as well protected *de facto* in Germany as in Japan.

In considering the utility of the LLSV-preferred corporate law rules, one conclusion would be that if the purpose is to look for policy implications and to give advice to developing countries, one should focus on the pros and cons of particular shareholder rights, given the nature of particular country's economies and existing equity markets and the social norms and other informal constraints that exist in that country. In that light, the LLSV studies are merely an introduction to a series of issues that each developing country needs to resolve against this local background. Even though the influence of legal history and path dependence may be great in many fields of law, it is likely to be less of a constraint with regard to legal provisions applying to publicly held corporations and particularly rules governing the issuance and trading of securities. Reform, especially in the securities field, occurs frequently even in developed countries. Here the dead hand of the past is less likely to be a constraint than in more traditional fields.

Several other considerations bear on the proper evaluation of the LLSV anti-director rights approach. First, the authors in the same Law and Finance article claim that enforcement of corporate law works better in common law than in French law countries.⁵⁷ Their conclusion raises the immediate question of whether enforcement is not a dominant consideration, a point that is of particular relevance to issues of corporate governance, at least in a country such as the United States recognizing fiduciary duties of directors and officers and holding them responsible for violations of such duties.⁵⁸

The Japanese adoption of Illinois corporate law illustrates the critical role of enforcement in determining the workability of transplanted law. When Japan adopted a U.S.-style fiduciary "duty of loyalty" as a substantive standard, it failed to provide a U.S.-style remedy in the form of disgorgement of profits derived by the officer or director. The oversight is understandable; whereas common law judiciaries are accustomed to fashioning remedies to effectuate the policy behind a substantive rule,

⁵⁷ LLSV (1998, p. 1140–43, including Table 5).

⁵⁸ See generally Hansmann and Kraakman (2004b). Financial responsibility of directors and officers for breach of fiduciary duty has been greatly tempered in the United States by the corporate use of insurance to cover this risk. Indeed, at least until very recently, officers and directors were rarely forced to pay out of their own pocket damages to investors for violation of their fiduciary duties, but the recent Sarbanes-Oxley statute may lead to a change in this respect.

Japanese courts are not comfortable in giving any remedy not specified by statute. Hence, a rule that works in one legal system may not fit the legal infrastructure and culture of another system.⁵⁹ As a review of countries in transition from communism to capitalism (especially Russia) shows, a country can enact a modern world-class corporate law without enjoying the expected benefits if the country fails to consider the enforcement infrastructure.⁶⁰

Fiduciary duties, such as the duty of loyalty, are examples of standards. “*Rules ... require or prohibit specific behaviors, [but] standards ... leave the precise determination of compliance to adjudicators after the fact.*”⁶¹ In contrast to well-defined “bright-line” rules (which call on the judge to make a binary decision—yes or no—whether the rule has been violated), legal standards require a judge to use mature and trained judgment to determine whether the standard has been met, taking into account all of the factual circumstances of the case (often in complicated factual situations, say under the “duty of loyalty” in a corporate self-dealing case). Common examples of corporate law rules, which can be thought of as *ex ante* prohibitions or prescriptions, are “dividend restrictions, minimum capitalization requirements, or capital maintenance requirements.”⁶² Those requirements and restrictions are either met or not, and the kinds of fact-weighting judgments required for standards are usually not necessary for rules.

The economic development issue is whether standards, which are a key to corporate governance litigation in the United States, make sense for a developing country. Richard Posner, one of the most respected U.S. Federal appellate judges, thinks not:

The relative simplicity of rules has two consequences for the kind of weak judiciary one is apt to find in a poor country. The first is that the application of rules places fewer demands on the time and the competence of the judges and is therefore both cheaper and more likely to be accurate. The accuracy is a little illusory, because it is a property of governance by rules that they never quite fit the complex reality that they govern. But this observation is consistent with their being more efficient than standards if administered by a judiciary that has a limited capability for the kind of nuanced and flexible decisionmaking that standards require. Second, rules facilitate monitoring of

⁵⁹ Kanda and Milhaupt (2003).

⁶⁰ Black and Tarassova (2002, p. 253–261). See Berglöf and Claessens (2004).

⁶¹ Hansmann and Kraakman (2004b, p. 23).

⁶² Hansmann and Kraakman (2004b, p. 24).

the judges and so reduce the likelihood of bribery and the influence of politics in the judicial process. The less discretion a judge has in making decisions, the easier it will be to determine whether a case has been decided contrary to law or whether there is a pattern of favoring one class or group of litigants over another.⁶³

Standards are, of course, not at all unknown to the civil law. But though concepts such as “good faith” are common in the German Civil Code,⁶⁴ it is also true that standards are less used in corporate law in civil law countries than in common law countries, at least the United States.⁶⁵ It is curious that the opposite is true in corporate accounting, where the United States relies on a rulebook, U.S. Generally Accepted Accounting Standards (USGAPP), whereas Britain and continental countries rely more on “principles based” accounting.⁶⁶ It was precisely the tendency of U.S. companies to use a “check the box” approach to the rules of USGAPP that led to some of the corporate scandals in the early 2000s. As we turn to corporate governance issues, it will become clear that bright line rules are unlikely to be able to deal effectively with self-dealing by controlling shareholders, and yet standards will be difficult for developing country judiciaries to apply effectively.

Corporate governance

Despite the great benefits the corporate form brings to an economy, it also produces Rule of Law problems. A useful perspective on these problems that may be particularly relevant in developing countries due to the prevalence of concentrated share ownership in those countries is based on the concept of agency.⁶⁷ As noted above, agency exists whenever one person acts on behalf of another. It is a ubiquitous phenomenon in the modern economy; common examples would be a stockbroker buying or selling securities for a customer and a lawyer acting for a client. The customer and client are the principals, and the stockbroker and lawyer are agents. The general shape of the legal problem in any agency relationship is to assure that the agent acts in the interest of the principal rather than in his own interest or, failing that, to assure that the principal will be

⁶³ Posner (1998, p. 5).

⁶⁴ See the discussion of Section 242 of the German Civil Code in Zweigert and Kötz (1998, p. 150).

⁶⁵ See the discussion of the “standards strategy” and the “trusteeship strategy” in Hansmann and Kraakman (2004c).

⁶⁶ Benston et al. (2006).

⁶⁷ See generally Hansmann and Kraakman (2004b).

able to remove the agent and select a new agent.

In the corporate context, because of the relationship between shareholders, directors, and management, it is not an exaggeration to say that, at base, corporate governance is fundamentally about agency. The directors and management (in American parlance, the “officers”) act for the owners, namely the stockholders. It is true that in some countries (but a much lesser extent in the United States), there is legal support for the notion that directors and management are to act for other stakeholders (the community, labor, the environment, and so on) and not just for the shareholders. These communitarian notions all too often allow directors and management (who in some countries tend to be the same people) to act in their own interest by purporting to act for a constituent of convenience of the moment. All too often, this ambiguity as to the responsibility of the owner’s agents creates its own Rule of Law problems.

In addition, a second agency problem arises when a controlling shareholder or shareholder block takes action to the detriment of minority shareholders, say by self-dealing. Hansmann and Kraakman explain:

The second agency problem involves the conflict between, on the one hand, owners who possess the majority or controlling interest in the firm and, on the other hand, the minority or noncontrolling owners. Here the noncontrolling owners are the principals and the controlling owners are the agents, and the difficulty lies in assuring that the former are not expropriated by the latter.⁶⁸

The resulting corporate governance problem is exacerbated by the permanence of a corporation, which is a prime characteristic from which many of its economic advantages flows. As noted above, an individual shareholder cannot ask for his money back, and under most corporate charters it takes more than a simple majority of shares to dissolve the corporation. But therein lies one of the great issues of corporate law and some of the major choices that countries must make in creating and regulating a corporate sector. These issues are commonly referred to under the heading of corporate governance, which recent events have proved to be of the greatest importance not just for developing countries but also for the most developed countries.

The permanence of a corporation creates a central dilemma for legal policy. If the

⁶⁸ Hansmann and Kraakman (2004b, p.22). A third agency problem in the corporation lies in its relations with third parties, especially creditors.

shareholder cannot get his money back, then why should he invest in the first place? Of course, where there is an efficient secondary market for stock, the shareholder can always simply sell when dissatisfied in view of the transferability characteristic of corporate shares. But that is not much of an answer for the poorer developing countries, because an adequate secondary market may itself be difficult to develop. And even in a developed country, the sale option for individual shareholders does not work well for corporations that have not “gone public.” Thus, the fact that the management controls the assets of the corporation and the shareholders have at most whatever residual rights over the corporation that corporate law and the corporate charter give them leads to the much-discussed problem of the separation of management and control—or to put it differently the relative absence of the ultimate owners’ control over management.

The essence of the corporate governance issue in most developing countries, in contrast, arises from the fact that the great majority of even the largest corporations do not have widely diversified shareholdings but rather are controlled by a single shareholder or by a family or other block. On the positive side, this means that controlling shareholders are in a far better position to monitor management than is the case for widely diversified shareholders. But when there is concentration of ownership, the risk is that a minority shareholder may find himself at the mercy of a controlling shareholder who may seek to transfer the value of the minority shareholding to himself by some form of self-dealing. Of course, sometimes control is in a group or in a family, but the problem is the same.

The means of making this transfer takes many forms, sometimes by outright self-dealing, sometimes by seizing an opportunity that belongs to the corporation, and sometimes by high salaries, extravagant expenses and other techniques for private enjoyment of corporate assets. Other means involve transactions between the controlled public corporation and a company solely owned by the control person or group; in such a situation, a below arms-length price of a sale of corporate assets to the latter (or an above arms-length price of a purchase) will suffice. In short, the ability of the control person or group to select transfer prices on transactions with (in effect) themselves is the key. These methods are often referred to, depending on the context, in pejorative terms

ranging from the private benefits of control to expropriation of minority shareholding interests.⁶⁹

The failure to solve the private benefits/expropriation problem adequately inevitably leads to scandals and setbacks that are a threat to public and corporate confidence and therefore may impede economic development. One could say that that failure is one of the reasons that the dominance of dispersed shareholding free of control by a single shareholder or group is by and large a phenomenon limited to the United States and the United Kingdom.⁷⁰ Elsewhere in the world, even though stock markets may exist, a substantial proportion (often a majority) of listed corporations is controlled by a single shareholder or group of shareholders. Indeed, even in the United States several hundred publicly traded firms have one shareholder with more than 50 percent of the shares.⁷¹ Obviously in an otherwise widely held corporation, ownership of 20 or even 10 percent of the shares may be enough for *de facto* control, enabling a *de facto* controlling shareholder to select directors and thereby indirectly determine corporate policy. Most countries have a much higher percentage of concentrated ownership in their publicly held corporations than the United States and the United Kingdom. The controlling shareholders often also manage the corporation (which is of course a solution, though less than an adequate solution, to the much-discussed separation of management and control); indeed, this pattern of owner-managers is often found in family companies—that is, companies where the controlling owners are members of the same family.

The pattern of concentrated ownership, often family ownership, is widespread in continental Europe. A recent study of the French corporate world characterized the ownership structure as having three salient features: “(1) concentration of ownership; (2) extensive family ownership; and (3) the role of holding companies.”⁷² In Germany as late as “the mid-1990s two-thirds of all listed companies ... had one blockholder with a stake exceeding 25 per cent.”⁷³ In Italy a history of inter-war nationalizations and subsequent

⁶⁹ Although corporate governance issues in the United States are normally discussed in the light of the prevailing pattern of widely held publicly traded corporations, it is usefully to note that U.S. law is less demanding in small, family-owned corporation situation where there are no public shareholders (referred to as “close corporations”), which is the usual situation in many developing countries.

⁷⁰ La Porta, Lopez-de-Silanes and Shleifer [hereafter “LLS”] (1999).

⁷¹ Holderness and Sheehan (1988).

⁷² Murphy (2004, p. 5).

⁷³ Schmidt (2004, p. 394).

partial privatizations, coupled with a number of large family controlled companies, initially led in the post-war period to the dominance of concentrated ownership; nevertheless, a series of legal changes in the 1990s led to a somewhat more diversified ownership structure.⁷⁴

Concentrated ownership is no doubt even more common in some countries, particularly in the developing world. In a survey of the 20 largest publicly held corporations in 27 countries, La Porta, López-de-Silanes, and Shleifer found that only about one-third were widely held. In their survey “widely held” was narrowly construed to mean that no person or family held directly or indirectly more than 20 percent of the shares. Among a sample of medium-sized corporations, the proportion of widely held was less than one-quarter.⁷⁵

From the standpoint of economic development, what is striking about this research can be deduced from the few developing countries found among the 27 countries examined in the survey (Argentina, Mexico, South Korea and Israel). All of those developing countries were middle income countries, and the percentage of concentrated ownership (at the 20 percent control level) among the 20 largest and the sample of medium-sized corporations within those countries was well above average for the 27 countries as a whole. Of these middle income developing countries Argentina and Mexico had no widely held companies among either the top 20 largest or the medium-sized corporations. South Korea, however, counted 55 percent widely held in the first category and 30 percent in the second category, and hence is more like Continental Europe than other developing countries in the survey or the United States. Israel’s numbers were closer to Argentina and Mexico than South Korea.⁷⁶

This survey of corporate ownership developed some further data that point to the fact that in many countries over one-third of large publicly held corporations were family controlled (at the 20 percent share level), as were almost one-half of the sample of medium-size publicly traded companies.⁷⁷ Many of these family controlled corporations account for a large percentage of publicly traded corporations within their countries: over

⁷⁴ Rajan and Zingales (2003a, p. 212–16).

⁷⁵ LLS (1999, p. 492–95, Tables II and III).

⁷⁶ LLS (1999, p. 492–95, Tables II and III). An earlier study by LLSV suggests that countries less developed than the four just listed show results not sharply different from Argentina and Mexico. LLSV (1998, p. 1147–48, Table 7).

⁷⁷ LLS (1999, p. 492–95, Tables II and III).

one-quarter on average of the 20 largest firms in the study's 27 countries, over one-half in Argentina, and 100 percent in Mexico.

Perhaps the most important point about family control is that "(at least) 69 percent of the time, families that control firms also participate in management."⁷⁸ This figure was 95 percent in Mexico, 75 percent in South Korea, and 62 percent in Argentina. Further, participation in management was given a narrow definition to assure that the participation was at the top of the company. The significance of family control with management participation is apparent when one considers minority shareholders who run the risk of expropriation both by controlling shareholders and by management separately. The experience in Russia was that the combined efforts of controlling shareholders and of management were devastating for minority shareholders.⁷⁹

Dual Class Shares and Pyramids

Controlling shareholders are perhaps a fact of life, but corporate law itself in most countries permits controlling shareholders to magnify their ability to control a corporation. Among the legal means at their disposal are two widely used techniques. One is to create two (or more) classes of shares, one without voting rights and the other with voting rights, the latter issued to the controlling shareholder (or the controlling group of shareholders). A second technique involves pyramiding, in which control is magnified by holding shares through a series of controlled corporations. To take one simple albeit atypical example of pyramiding, an individual or a family might hold 20 percent of an otherwise widely held corporation, which in turn held 20 percent of the target, also an otherwise widely held corporation. In effect, the ultimate shareholder could achieve *de facto* control with only 4 percent of the total investment (or put differently, with only 20 percent of what would be required to achieve *de facto* control by direct ownership of shares in the target). In this light, the purpose of pyramiding can be seen to be primarily control of the corporation with a lesser investment. This achievement of *de facto* control in turn facilitates self-dealing by the controlling group.

The use of dual class shares is tailor-made for self-dealing. A cross-country study by Nenova involving all dual class firms in the 18 countries (among the 20 largest

⁷⁸ LLS (1999, p. 500).

⁷⁹ Black et al. (2000) and Goldman (2003, p. 210–211, 240–244).

national capital markets) that allow dual classes of shares differing in voting rights found substantial private benefits of control. Under the methodology used and assuming that the two classes of stock have similar attributes (for example, the same dividend rates) other than the right to vote, the private benefits of control can be measured by the difference between the market value of the voteless shares and the price commanded by the voting shares in a sale of control. The private benefits of control in the dual class share situation can be interpreted as the percentage of the value of the firm that controlling shareholders can expropriate from minority shareholders. Remarkably the potential expropriation ranged as high as 28 percent of the value of the firm in South Korea and 36 percent in Mexico.⁸⁰ The most important factor in determining the extent of expropriation, however, was not the nature of substantive legal protections or of takeover rules, but rather the quality of enforcement—showing again the crucial role of an independent and effective judiciary.⁸¹

To see, however, the point about the control of the corporation's cash flow, an example involving the practice of pyramiding is useful. Let us assume the ultimate shareholder owns 50 percent of a first-tier public company that in turn owns 50 percent of another public company—the second tier company—so that control is not at risk in either tier. Then, with only a 25 percent indirect ownership (50 percent of 50 percent), the ultimate shareholder can easily direct speculation in new ventures by the second-tier company. Take speculation in high-risk ventures (by definition, ventures that involve a small chance of a big payoff and a large chance of loss): The ultimate shareholder's proportion of wins versus losses does not change, but he is able to control the decisions with a much smaller personal investment. This kind of pyramiding is sometimes used, for example, in the domestic U.S. real estate industry to allow promoters to diversify their investment across more real estate ventures than their personal funds would otherwise permit. Pyramids, however, also allow the ultimate shareholder to engage in self-dealing by transactions between himself (or a corporation he controls) and a company in the pyramid that he controls only by reason of the pyramid. From this possibility arises the corporate governance challenge of pyramiding.

⁸⁰ Nenova (2003, p. 334, Table 3).

⁸¹ These types of measures of the extent of expropriation may underestimate the loss attributable to self-dealing because they arguably fail to account for the loss in revenues due to waste and mismanagement

An alternative explanation, raising further corporate governance issues, is that pyramiding allows controlling shareholders to economize on capital transactions involving assets they own outright, thereby facilitating the transfer of wealth out of publicly held companies to themselves.

The corporate ownership research previously analyzed gives some examples of pyramiding from Canada, Hong Kong, Japan, and Korea. The Hong Kong example involves its most prominent company, Hutchison Whampoa, where the Li family held 35 percent of Cheung Kong Holdings, which in turn owned 43.9 percent of Hutchison Whampoa. The authors also give a more dramatic example in the South Korean firm, Samsung Electronics, whose chairman controlled Samsung with only a 14.1 percent ownership of two companies that in turn held Samsung stock.⁸²

The Blockholder Phenomenon

Much scholarly literature concludes that well-dispersed shareholding can only be expected to develop in countries where corporate law reaches adequate solutions to the corporate governance problem. Put differently, concentration of ownership—at least to the extent of a group of so-called “blockholders” being able to act on behalf of the shareholders as a group—is an inevitable consequence of inadequate corporate governance rules. The blockholders can, acting together, control the management. Of course, in many cases—especially with family firms—the blockholders are the management, and in those cases minority shareholders are potentially doubly vulnerable. In short, concentrated ownership involving control by a few individuals, especially by a family, may turn out to be desirable for minority shareholders insofar as the controlling owner can monitor the management and keep it focused on the success of the company (as opposed to the managers’ own perquisites and incomes). Consider, for example, the outstanding stock market performance of the family-controlled Wal-Mart over recent decades in the United States. But concentrated ownership coupled with deficient legal protections for minority shareholders can be another matter entirely.

Consequently, even where there are neither dual class shares nor pyramidal arrangements, controlling shareholders can be in a position in some countries to take

where controlling shareholders devote their energy to diverting resources from minority shareholders rather than to managing the enterprise.

pecuniary advantage of minority shareholders. Dyck and Zingales found that control premiums (the excess of the price per share when control was sold over the price in ordinary share trading) ranged on average as high as 27 percent in Argentina, 65 percent in Brazil, 37 percent in Turkey, and 58 percent in the Czech Republic.⁸³

Legal institutions thus play a vital role in the development of equity capital markets. In a prior chapter, a central problem of governance of countries was addressed—namely, the difficulty of constructing a political and legal system strong enough to guarantee citizens that a predatory ruler would not expropriate their property. The issue of corporate governance is a close analogue. As the foregoing discussion makes clear, corporate governance problems come in two parts in many developing countries. First, if shareholders, certainly small shareholders, cannot control the management, how can they be protected against expropriation of the value of their economic interest by management? Second, in the case of the blockholder solution to the first problem (a solution to the extent that the blockholders, at least collectively, can discharge the management), the minority shareholders find themselves at risk of being expropriated by the blockholders. This second version of the expropriation issue is especially severe when the blockholders and the management are the same people, because then the first and second problems merge to the disadvantage of minority shareholders. And where the two problems merge, it is likely to be very difficult to raise money from small shareholders; the economy therefore has a more difficult challenge in channeling savings from ultimate savers to productive uses. This set of challenges has proved a particular problem in transition countries such as Russia and in developing countries—especially East Asia—where so-called relationship capitalism is dominant.

Legal Protection

In the context of legal protection of minority investors, three kinds of protection should be distinguished: corporate law, securities law, and stock exchange listing requirements. Most of the focus in the development literature has been on corporate law. Thus, the original article by LLSV addressed, as we have seen, substantive rules of corporate law. The Legal Origins approach was partially validated in the Nenova study of

⁸² LLS (1999, 482–483, and 485, Figure 5).

expropriation potential, reviewed above, with the median value of control-block votes highest in French civil law countries (22.6 percent), followed by German civil law countries (11.0 percent), and then by common law and Scandinavian civil law countries (only 1.6 percent and 0.5 percent, respectively).⁸⁴ Dyck and Zingales found, however, that any supposed advantage of common law over French law with regard to control premiums disappeared once certain non-legal factors such as newspaper circulation and tax compliance were included in their regressions.⁸⁵

An approach to economic development in the equity capital area that would be primarily focused on bringing best practice to developing countries through the process of legal transplantation would run into several kinds of hurdles—the nature of the substantive rules and the ways in which the courts deal with those rules. Even accepting that the LLSV list of corporate law provisions was not optimum and that a better set of rules could be devised, the nature of the enforcement of the rules must be taken into account.

The lack of enforcement led to serious problems in Russia and in other transition countries in the early days in the 1990s after the demise of the Soviet Union,⁸⁶ and can be seen more recently in several recent Latin American cases involving abuse by controlling shareholders. The first became public only because the firm and people involved were charged by the U.S. Securities and Exchange Commission with U.S. securities violations involving concealing a scheme involving a major Mexican entrepreneur, Ricardo Salinas Pliego, in which Salinas Pliego personally profited by \$109 million.⁸⁷ Salinas Pliego is alleged to have used his control of the holding company of TV Azteca, a major Mexican television chain, to enter into a complex transaction involving two related companies. The purchase of the debt of one related company for one-third of its face value was followed by the payment by that company of the debt at the full face value to net a profit of more than \$200 million for insiders. In this Mexican corporate governance debacle enforcement was in the hands of the U.S. Securities and Exchange Commission because

⁸³ Dyck and Zingales (2004, 551 (Table II)). Some of the countries, such as Brazil, allowed dual class shares.

⁸⁴ Nenova (2003, p. 334–35, Table 3).

⁸⁵ Dyck and Zingales (2004, p. 588–589 (Table XI, Panels A and B)).

⁸⁶ Pistor et al. (2000).

⁸⁷ Securities and Exchange Commission. SEC Charges TV Azteca and Its Chairman—Ricardo Pliego—with Fraudulent Scheme To Conceal Salinas' \$109 Million Windfall Through Related Party Transaction. Press Release 2005-1 (January 4, 2005).

of an SEC filing by TV Azteca.⁸⁸

The second such case involved the CEO and six executives of a Chilean electricity utility. After the privatization of the formerly state-owned company, a Spanish utility holding company acquired stock in Chilean holding companies that in turn held stock in the Chilean utility. These Chilean holding companies had two classes of stock, Class A which held most of the equity of the Chilean utility but no voting rights and Class B with little equity but majority voting power. Class A shares were held by small shareholders and pension funds, and Class B shares by the executives. The price paid to the executives, whose class B shares controlled the utility, was 1000 percent greater than the price paid for the Class A shares of the small shareholders and the pension funds. While the case may illustrate the value of control, the case also shows a great corporate governance problem that became a scandal in Chile. In this Chilean case the problems seems to have arisen because of deficient substantive law and the absence of any effective enforcement mechanism.⁸⁹

Securities Laws

A second reason why legal differences play a large role in the corporate area has to do with the securities laws. With widely dispersed shareholders, the availability of remedies with regard to disclosure of information to such shareholders is particularly important. As Black has observed, it is hard to envision strong securities markets without a strong legal foundation:

Creating strong public securities markets is hard. That securities markets exist at all is magical, in a way. Investors pay enormous amounts of money to strangers for completely intangible rights, whose value depends entirely on the quality of information that the investors receive and on the sellers' honesty.⁹⁰

In a 2006 study La Porta, Lopez-de-Silanes and Shleifer found, using their cross-country regression methodology, that securities laws are particularly important to the development of a strong financial sector and especially to achieving a large stock market

⁸⁸ *Ibid.* See also Dempsey (2005).

⁸⁹ Clarke (2003, p. 40).

⁹⁰ Black (2001, p. 782).

capitalization as a percentage of GDP.⁹¹ Indeed, they found that their measure of corporate law effectiveness loses most of its explanatory power for stock market development when securities law variables concerning disclosure and standard of liability for failure to disclose adequately are included in their regressions.⁹² In short, corporate law may be primarily important for protection of minority shareholders in closely held corporations, where stock is not sold to the public, but stock market development depends considerably more on the quality of securities laws than on the quality of corporate law, at least as the original Legal Origin articles measure corporate law quality.

What is particularly striking about the 2006 study is the finding that the existence of securities laws mattered but that the most important factor was private enforcement allowing financial recovery by injured investors for securities law violations. In contrast, they found that enforcement by a government agency was of relatively little importance. Specifically, they found that public enforcement plays a modest role at best in the development of the stock market. On the other hand, mandatory disclosure was important, in part because it made it easier for investors to recover damages in private litigation.⁹³ These findings suggest that good substantive law and a competent independent judiciary go hand in hand in this legal area as well as others.

These findings are especially interesting because unlike traditional legal institutions, securities regulation is a recent phenomenon. It first came to England at the end of the 1920s and to the United States with the Securities Act of 1933. Both were the result of legislation, not the common law nor general corporate law. This necessarily raises some doubts about what it means to say that legal origin has much to do with the efficacy of securities laws in different countries. Moreover, the rules on securities regulation are almost entirely statutory and regulatory even in common law countries. Yet the emphasis on the importance of investor recovery of damages for losses would seem to depend on a greater willingness of common law countries to rely on an independent judiciary to enforce even highly technical statutory and regulatory law. Once again, enforcement is at least as important as the content of substantive law.

The importance of enforcement, including public enforcement, to the

⁹¹ LLS (2006).

⁹² LLS (2006).

success of securities regulation was brought home with force in the development of stock markets in the transition countries of Eastern Europe. Glaeser, Johnson, and Shleifer studied the experiences of Poland and the Czech Republic. They found that Poland “created an independent and highly motivated regulator to enforce the rules” but that the Czech Republic, in contrast, left enforcement to “an unmotivated office in the finance ministry.”⁹⁴ The result in Poland was “rapid development of securities markets” enabling “a number of firms to raise external funds,” but the Czech securities scene was characterized by “delistings and a notable absence of equity finance through a public market by either new or existing firms.”⁹⁵ Thus, where private litigation is not available as an enforcement tool, vigorous public enforcement is especially important.

The difference in the size of the equity markets in the two countries shows the significance of the difference in enforcement. Though the Czech stock market was twice as big as the Polish stock market in 1995 -- \$9.2 billion to \$4.6 billion – the situation was more than reversed by 2001, with the Czech market size essentially unchanged and the Polish market having increased over fivefold to \$26 billion.⁹⁶

⁹³ LLS (2006, p. 14, 20).

⁹⁴ Glaeser et al. (2001, p. 855).

⁹⁵ Glaeser et al. (2001, p. 855–856).

⁹⁶ Berglöf and Pajuste (2003).

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