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Optimally Restrained Tunneling: The Puzzle of Controlling Shareholders' "Generous" Exploitation in Bad-Law Jurisdictions

Law Working Paper N° 410/2018
August 2018

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This paper can be downloaded without charge from:
https://doi.org/10.67929/ecgi-law-410-2018

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ECGI Working Paper Series in Law

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Abstract

Although controlling shareholder agency problems have been well studied so far, many questions still remain unanswered. In particular, an important puzzle in "bad-law" jurisdictions is: why some controlling shareholders ("roving controllers") loot all (or substantially all) corporate assets at once, and why others ("stationary controllers") siphon a part of corporate assets on a continuous basis. To solve this conundrum, this chapter provides analytical frameworks exploring the behaviors and motivations of controlling shareholders. To begin with, I reinterpret Olson's political economy theory of "banditry" in the context of corporate governance in developing countries. Based on a new taxonomy of controlling shareholders ("roving controllers" and "stationary controllers"), I examine under what circumstances a controlling shareholder chooses to be roving or stationary, and why economically rational controlling shareholders with a long time horizon voluntarily abstain from looting minority shareholders. In addition, although I recognize family corporations' weaknesses in terms of investor protection, I explain that controlling "family" shareholders tend to be more stationary, and thus improve the quality of corporate governance. Moreover, I explain that a controlling shareholder's non-pecuniary benefits (i.e., the psychological value gained by corporate insiders when running a business) can potentially lower the level of expropriation from public shareholders.

Keywords: Corporate Governance, Controlling Shareholder, Bad-Law Jurisdiction, Roving Controller, Stationary Controller, Controlling Family Shareholder, Family Corporation, Self-Dealing, Tunneling, Pecuniary Benefits, Non-Pecuniary Benefits, Investor Protection

JEL Classifications: G30, G32, G34, K22, C70, D23

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Although controlling shareholder agency problems have been well studied so far, many questions still remain unanswered. In particular, an important puzzle in "bad-law" jurisdictions is: why some controlling shareholders ("roving controllers") loot all (or substantially all) corporate assets at once, and why others ("stationary controllers") siphon a part of corporate assets on a continuous basis. To solve this conundrum, this chapter provides analytical frameworks exploring the behaviors and motivations of controlling shareholders. To begin with, I reinterpret Olson's political economy theory of "banditry" in the context of corporate governance in developing countries. Based on a new taxonomy of controlling shareholders ("roving controllers" and "stationary controllers"), I examine under what circumstances a controlling shareholder chooses to be roving or stationary, and why economically rational controlling shareholders with a long time horizon voluntarily abstain from looting minority shareholders. In addition, although I recognize family corporations' weaknesses in terms of investor protection, I explain that controlling "family" shareholders tend to be more stationary, and thus improve the quality of corporate governance. Moreover, I explain that a controlling shareholder's non-pecuniary benefits (i.e., the psychological value gained by corporate insiders when running a business) can potentially lower the level of expropriation from public shareholders.

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I. Introduction

Unfair self-dealing and expropriation of minority shareholders by a controlling shareholder—which are generally known as "tunneling"[1]—are common business practices in many countries.[2] In this sense, these countries are labeled as "bad-law" jurisdictions.[3] In these jurisdictions, wealth-transfers from minority shareholders to a controlling shareholder often occur via outright stealing or related party transactions (RPTs). The behaviors and motivations of controlling shareholders in such jurisdictions are still in a black box with many questions unanswered. For example, (1) why don't some controlling shareholders in bad-law countries siphon all of the corporate assets for their benefit if the inefficient legal system does not regulate controlling shareholders' expropriation? And (2) if controlling shareholders in such jurisdictions are ruthless corporate pirates, why do minority shareholders have (relatively) *constructive* relationships with some controlling family shareholders over the long term?

To solve these conundrums, this chapter reinterprets Mancur Olson's theory of banditry[4]—a political economics analytical framework—in the context of corporate governance. According to Olson, a "roving bandit" is one who

1. Simon Johnson et al., *Tunneling*, 90 AM. ECON. REV. 22, 22 (2000) (explaining tunneling). *See also* Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 CALIF. L. REV. 393, 396 (2003) (explaining self-dealing); Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 787 (2003) (discussing various methods of expropriation used by controlling shareholders).
2. *See, e.g.*, La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1113 (1998) (finding negative correlation between ownership concentration and investor protections). For a critical analysis of the "law and finance" theory, see Holger Spamann, *The "Antidirector Rights Index" Revisited*, 23 REV. FIN. STUD. 467 (2010); Sang Yop Kang, *Taking Voting Leverage and Anti-Director Rights More Seriously: A Critical Analysis of the Law and Finance Theory*, 28 COLUM. J. ASIAN L. 1 (2015).
3. *See* Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1648 (2006).
4. *See generally* Mancur Olson, *Dictatorship, Democracy, and Development*, 87 AM. POL. SCI. REV. 567 (1993).

will not come to expropriate the same victims again.[5] He rationally takes every property possible from victims.[6] In contrast, a "stationary bandit" settles down and rules his subjects in a certain domain as a king.[7] Using the monopolistic power to steal without interference from other bandits, a stationary bandit executes theft in the form of regular taxation rather than total looting since he has an encompassing interest in his subjects.[8]

Based on this foundation, this chapter posits that controlling shareholders in bad-law jurisdictions expropriate minority shareholders in a manner similar to Olson's bandits. First, some controlling shareholders siphon *all* (or *substantially all*) corporate assets through an abrupt one-shot deal. I refer to this type of controlling shareholders as "roving controllers." Second, other controlling shareholders are prone to extracting *part* of a corporation's assets periodically. I refer to the second type of controlling shareholders as "stationary controllers."

In a country with insufficient investor protection, the transfer of corporate wealth by a controlling shareholder is akin to an *unavoidable* tax to public investors: this business practice is not kept in check by law enforcement due to deeply-rooted "bad-law" features. Just as a rational king imposes tolerable taxes on his subjects in order to maximize the accumulated tax revenue in the long run,[9] a far-sighted stationary controller (i.e., a "generous thief") voluntarily abstains from looting a corporation to the fullest extent possible. In turn, the stationary controller's optimally restrained tunneling creates the incentive for minority shareholders to participate in transactions with stationary controllers in the capital market.

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5. *Id.* at 568.
6. *Id.*
7. *Id*. at 571.
8. *Id.* at 568.
9. *See infra* Part II.B.

These capital market transactions form a long-term relationship between a stationary controller and minority shareholders, resulting in enhanced mutual benefits. Consequently, stationary controller economies will be more prosperous than roving controller economies and sometimes even good-law economies. Corporate autocracy is established when a dominant corporate insider is featured as stationary and becomes a "king" in his business "empire." It is best for minority shareholders not to be exploited by controlling shareholders at all. Nonetheless, stable autocracy is a superior system to anarchy, in which roving controllers' vandalism and disorder crowd out any possibility of prosperity and development. If bad-law features are too systemic in a certain economy, having stationary controllers is desirable to investors as the second-best scenario.

Then, under what circumstances, does a controlling shareholder choose to become roving or stationary? Another contribution of this chapter is to build a generalized model answering this question.[10] In this simplified model, a controlling shareholder has two options—being stationary or roving. When he considers being stationary, he expects two sources of periodic "pecuniary benefits:" one from pro-rata economic interest based on his cash flow rights; and the other from the extraction of minority shareholders' assets.[11] In addition to these pecuniary benefits, "non-pecuniary benefits"[12] such as fame, prestige, and social/political influence arising from running corporations add value for him.[13] By contrast, when he considers becoming roving, he expects to loot (substantially) all of a corporation's assets at once. However, non-pecuniary benefits would not belong to him since the corporation will

10. *See infra* Part III.C.
11. *See infra* Part III.C.1.
12. Gilson, *supra* note 3, at 1663-64 (explaining non-pecuniary benefits).
13. Thus, the total benefits that a stationary controller is able to enjoy are the sum of the present value of the pecuniary and non-pecuniary benefits. *See infra* Part IV.B.

not exist after his looting. Considering the total benefits of acting as a stationary controller and as a roving controller, he chooses the position where he can receive more benefits (including the value of non-pecuniary benefits).[14]

In addition, this chapter sheds light on the roles of large family corporations in developing countries by showing that they often—but not always—function as a catalyst to make controlling shareholders more stationary (and thus more generous).[15] To stay as a controlling shareholder for a potentially eternal time horizon (through inheritance within a family),[16] a family shareholder has to use less-radical exploitation in his relationship with minority shareholders.[17] Accordingly, a family corporate dynasty—descendants as well as a founding father—will be able to maintain a proverbial "golden goose," producing non-pecuniary as well as pecuniary benefits forever. Concomitantly, minority shareholders are better off in stable family corporations.

However, this does not mean that all controlling family shareholders are stationary. Often, *carpe diem* holds: short-sighted controlling family shareholders, who would like to enjoy pecuniary benefits at present, may choose to be roving. In addition, it is possible that at some later point stationary family controllers can transform into roving controllers.[18] A second generation's poor management skills, sibling rivalry and succession problems, unfavorable

14. *See infra* Part IV.B.1 (explaining "two-factor analysis").
15. *See infra* Part IV.
16. *See* Ronald J. Gilson, *Controlling Family Shareholders in Developing Countries: Anchoring Relational Exchange*, 60 STAN. L. REV. 633, 643 (2007) (explaining a controlling family shareholder's infinite time horizon through inheritance).
17. Gilson attempts to answer a conundrum of why some controlling shareholders in bad-law countries impose "a ceiling on private benefit extraction" (i.e., less-radical expropriation) from minority shareholders. *Id.* at 648. Gilson explains the conundrum "from a product market perspective rather than a capital market perspective." *Id.* at 648. Contrary to Gilson's product market-based account (PMBA), I propose an answer for the same conundrum by analyzing the nature of a stationary controller. A stationary controller would voluntarily impose "a ceiling on private benefit extraction" (in Gilson's vocabulary) since a series of a low rate of extraction for a long time would generate a larger total amount of extraction (and non-pecuniary benefits). *See infra* Parts III.C, IV. For a further critical review of Gilson's argument, 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).
18. There are two types of roving controllers: (1) those who are determined to be roving controllers in the first place (they initially plan to defraud public investors and they loot soon); and (2) those who start as stationary controllers but become roving under new circumstances.

macro-economic environments, or structural changes in a family business can adversely affect the existing continuous relationship between a controlling family shareholder and minority shareholders.

Against this backdrop, this chapter proceeds as follows. Part II sketches the analytical framework of Olson's banditry. Part III delves into the controlling shareholder regimes with bad-law. Subsequently, this Part puts forward a theory determining the circumstances under which a controlling shareholder would choose to be stationary. Part IV explores why a controlling family shareholder is more likely to be stationary (and thus generous). Finally, Part V summarizes and concludes.

This chapter highlights the bright side of the controlling family shareholder system through a theoretical prism. Nonetheless, it does not claim family corporations are optimized business entities. In fact, dark aspects of family corporations have been extensively studied so far. Instead of repeating established common sense, this chapter aims to explore uncharted and misunderstood corporate governance dimensions in relation to family corporations. To be sure, the grade for family corporations in developing countries is not an "A+". It is not a "C" either, however, if they are stationary: perhaps the corporate governance of stationary family corporations is better than we may have thought.

II. Analysis of Banditry

Part II starts with a seeming digression—although it is ultimately pertinent to the topic of this chapter—to Mancur Olson's political economics theory on the evolution of governmental systems in history.[19]

19. *See generally* Olson, *supra* note 4.

A. Roving Bandits and Stationary Bandits

In anarchies and autocracies, powerful political groups are analogous to "bandits," since these groups exploit laypeople by means of violence.[20] These bandits can be classified into at least two groups: less generous "roving bandits" and more generous "stationary bandits."[21]

As the vocabulary explains, roving bandits are bandits who are ready to depart from the pillaged place soon after *total* plundering.[22] In anarchy, where no single entity dominates the entire domain, powerful groups loot a limited number of victims. Facing uncoordinated competitive theft with other groups, it is in their best interest to take all property possible from their victims.[23] This problem arises since bandits "overuse" "common properties"—i.e., the properties of victims—without coordination so that common properties are depleted quickly. In other words, roving bandits face the "tragedy of the commons"[24]—if they do not loot victims' total wealth, but leave some of it, competing bandits will take the remainder. As a result, roving bandits do not set a long-term goal of theft.

After fierce competition among many roving bandits, a more powerful bandit emerges as a sole ruler in a certain domain. In the absence of competing bandits with whom he must share trophies, he resides with his subjects and monopolizes theft from them.[25] In this respect, he is referred to as a stationary bandit. Anarchy turns into stable autocracy. As a king, rather than one of many bandits, a stationary bandit finds it optimal to thieve in the form of

20. MANCUR OLSON, POWER AND PROSPERITY: OUTGROWING COMMUNIST AND CAPITALIST DICTATORSHIP 6-7 (2000).
21. *See generally* Olson, *supra* note 4.
22. *Id.* at 568.
23. *Id.*
24. *See generally* Garrett Hardin, *The Tragedy of the Commons*, 162 SCI. 1243 (1968).
25. Olson, *supra* note 4, at 568.

regular taxation with a long-term perspective rather than occasional and brutal plundering.[26] In sum, a stationary bandit enters into a "repeated game" with his subjects.

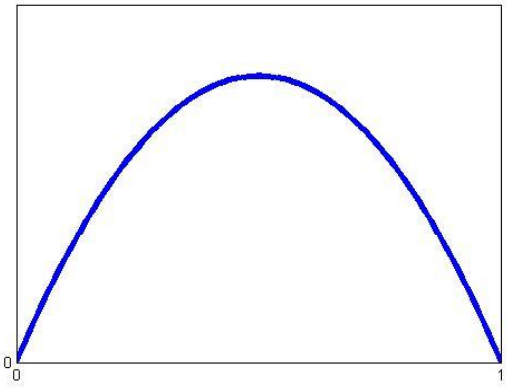
B. Bandits' Tax Policies and Impacts

Section B discusses bandits' various exploitation methods and victims' responses through the analytical framework of taxation. Tax revenue is equal to the product of a tax rate and taxable income (i.e., the tax base).[27] Since taxpayers' incentive to earn income is discouraged by a higher tax rate, the trade-off relationship between tax rate and tax base is apparent.[28] Initially, when the tax rate increases, tax revenue increases as well since the positive effect of the increased tax rate is stronger than the negative effect of the decreased tax base.[29] After the tax rate reaches the revenue-maximizing point, however, tax revenue goes down as the tax rate continues to rise (due to the distortion of taxpayers' incentive to earn income).[30] Thus, if the government is economically rational in maximizing tax revenue, it imposes the "optimal tax rate"[31] rather than a harsh tax rate that destroys the taxpayers' willingness to work.

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26. *Id.*
27. Arthur B. Laffer, *The Laffer Curve: Past, Present, and Future*, 1765 BACKGROUNDER 1, 2 (2004), http://www.heritage.org/research/reports/2004/06/the-laffer-curve-past-present-and-future.
28. *Id.* at 1-2. As Laffer himself admits, however, this concept should be credited to Ibn Khaldun and John Maynard Keynes. *Id*. at 2-3; *see also* Olson, *supra* note 4, at 569.
29. Laffer, *supra* note 27, at 2-3.
30. *Id.*
31. *Id.* In this chapter, the "optimal tax rate" is referred to as the tax rate that maximizes tax revenue for a bandit.

Figure 1: Optimal Tax Rate[32]



- X axis: tax rate ("0" equals 0% and "1" equals 100%)
- Y axis: tax revenue

In Olson's world, an (extreme) roving bandit's tax rate is 100%. This total plundering may work in the first stage. However, victims soon recognize that they will end up producing nothing from the next stage onward.[33] Accordingly, the tax base will shrink to zero, and the tax revenue accruing to a roving bandit will also approach zero.[34] Consequently, the welfare of the entire society—both bandits and victims—will deteriorate as this vicious cycle is formed.

In contrast, when a bandit becomes stationary, a self-interested bandit chooses a revenue-maximizing optimal tax rate, which is far less than a roving bandit's ruthless tax rate.[35] The sum of tax revenue accumulated over a long

32. This is a simplified graph for the revenue-maximizing tax rate. The graph is not necessarily symmetric.
33. Olson, *supra* note 4, at 568.
34. *See* Laffer, *supra* note 27, at 2; *see also* Olson, *supra* note 4, at 568.
35. Olson, *supra* note 4, at 569.

time will generally exceed the one-shot tax collection of a comparable roving bandit. Since only a *part* of their income is taken by a stationary bandit *periodically*, his subjects have an economic incentive to produce, save, and invest.[36] Accordingly, a larger tax base will be created. Through a positive process of feedback, stationary banditry is mutually beneficial to both the bandit and the victims,[37] who are sailing on the same ship.

III. Controlling Shareholders: "Roving" v. "Stationary"

In Part II, concepts of bandits in a political-economy theory and bandits' tax policies have been introduced and reviewed. In Part III, this political economy theory is reinterpreted in the context of corporate governance.

A. Agency Problems in the Controlling Shareholder Systems with Bad-Law

In a controlling shareholder system, unfair self-dealing (or tunneling[38])—a practice where a controlling shareholder transfers corporate wealth at the sacrifice of minority shareholders—is at the center of agency problems. *Sinclair Oil Corp. v. Levien*,[39] a leading U.S. case relating to a controlling shareholder's interested transactions, provides a useful definition of self-dealing: "[s]elf-dealing occurs when [a controlling shareholder], by virtue of its domination of [his controlled corporation], causes [the corporation] to act in such a way that [the controlling shareholder] receives something from the [corporation] to the exclusion of, and detriment to, the minority

36. *Id.* at 568.
37. *Id.* at 567.
38. For a further analysis of tunneling, see generally Vladimir Atanasov et al., *Unbundling and Measuring Tunneling*, 2014 U. Ill. L. Rev. 1697 (2014).
39. Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).

stockholders of [the corporation]."[40] Self-dealing often occurs in the form of RPTs (although not every RPT is necessarily unfair).[41]

A simple form of tunneling is outright theft of corporate value by a controlling shareholder.[42] Alternatively, a controlling shareholder can use more sophisticated forms of RPT by altering terms and conditions of transactions.[43] For instance, when he exercises control over both Company A (by 51% ownership) and Company B (by 10% ownership), he can transfer corporate value of Company B to Company A by manipulating transfer pricing more favorable for Company A. Victims are the non-controlling shareholders of Company B who hold the remaining 90% of economic interest.[44] Another complicated form of tunneling can take place by manipulating the price of corporate securities.[45]

One may be curious as to how the controlling shareholder can dominate Company B with only 10% ownership. In the "controlling minority structure" (CMS), although a shareholder holds a small fraction of the economic stake

40. *Id.* at 720.
41. *See generally* Sang Yop Kang, *Rethinking Self-Dealing and the Fairness Standard: A Law and Economics Framework for Internal Transactions in Corporate Groups*, 11 VA. L. & BUS. REV. 95 (2016) (explaining analytical tools of law and economics regarding self-dealing and RPTs).
42. Johnson et al., *supra* note 1, at 22-23.
43. *Id.* at 22-23; *see generally* Kang, *supra* note 41.
44. For a further explanation of self-dealing, see generally Simeon Djankov et al., *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430 (2008).
45. *See* Kee-Hong Bae et al., *Tunneling or Value Added? Evidence from Mergers by Korean Business Groups*, 57 J. FIN. 2695, 2697 (2002) (explaining the allegations related to Samsung Group).

in a corporation, he can exercise controlling power if he is able to maintain a majority of voting rights[46] through stock pyramiding,[47] dual-class equity structure,[48] and various types of cross-shareholding.[49]

B. Roving Controllers and Stationary Controllers

1. A New Typology of Controlling Shareholders

Even good-law countries are not able to perfectly prevent transactions with conflicts of interest. However, minority shareholders in such jurisdictions are generally insulated from large-scale expropriation by corporate insiders. For instance, U.S. statutes and common law effectively protect public investors, especially from unfair transactions arising from conflicts of interest. In addition to *Sinclair* which set forth the standard of intrinsic fairness,[50] *Weinberger v. UOP, Inc*. proposed an analysis based on fair price and fair dealing for evaluating whether a conflicted transaction should be permitted.[51] In Sweden, although a limited number of wealthy families dominate

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46. Lucian Arye Bebchuk et al., *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, CONCENTRATED CORPORATE OWNERSHIP 295 (Randall K. Morck ed., 2000) (explaining the CMS). *See generally* 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) (explaining a CMS controller's advantages in a hostile takeover war).
47. Bebchuk et al., *supra* note 46, at 298.
48. *Id*. at 297-98 (explaining that a company can issue two or more classes of stock with differential voting rights). For a further explanation of the dual class share structure, see generally Ronald J. Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 VA. L. REV. 807 (1987); Jeffrey N. Gordon, *Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CALIF. L. REV. 1 (1988).
49. *See* Ok-Rial Song, *The Legacy of Controlling Minority Structure: A Kaleidoscope of Corporate Governance Reform in Korea*, 34 LAW & POL'Y INT'L BUS. 183, 198 (2002) (describing the features of ownership structure and corporate governance in Korea). For a further analysis of comparative advantages and disadvantages of pure stock pyramiding (or a holding company system) and circular shareholding, see 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, 430-42 (2014).
50. Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).
51. Weinberger v. UOP, Inc. 457 A.2d 701, 711 (Del. 1983).

the entire economy, they do not siphon public corporations' wealth.[52] In these law-abiding economies, when a corporate bandit is recognized, enforcement agencies or courts will generally intervene and punish him.

By contrast, most developing countries (and even some developed countries) lack well-performing legal infrastructures that are designed to effectively protect investors.[53] The piracy of controlling shareholders is, in practice, a default rule in many bad-law countries. In other words, expropriation of minority shareholders is understood as an "unavoidable tax" imposed by corporate bandits. In this sense, the analysis of taxation in Part II.B can be used to explain the context of corporate governance in bad-law jurisdictions.

Similar to Olson's political bandits,[54] in bad-law jurisdictions there are two basic types of controlling shareholders. The first, ruthless controlling shareholders with myopia—"roving controllers"—may take almost all of the corporate value through a one-shot transaction. Put differently, roving controllers do not use the long-term "optimal tax rate"[55] strategy. Rather, they impose excessively harsh "taxation" (i.e., exploitation) on corporate constituencies (mainly minority shareholders). As a result, minority shareholders are so detrimentally impacted that they lose the incentive to invest their money in those corporations.

However, the presence of another type of controlling shareholder—"stationary controllers"—can relieve this concern to some degree. A controlling shareholder with sufficient strength in the economy rationally understands that he is not a mere "roving pirate" but a "stationary king" in his controlled corporation. It is in his best interest to impose *partial* and *periodic* taxes on minority shareholders. In order to maximize the amount of pecuniary private

52. *See, e.g.*, Gilson, *supra* note 3, at 1660.
53. *See, e.g.*, Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 739 (1997).
54. *See supra* Part II.A.
55. *See supra* note 31 (explaining the "optimal tax rate").

benefits[56]—which are analogous to "tax revenues"—a stationary controller chooses the "optimal extraction rate"[57] that is far less than a roving controller's prohibitively high expropriation rate. This optimally restrained tunneling is similar to a rational stationary bandit's strategy of imposing tax on his subjects.[58]

Indeed, the presence of a stationary controller has many implications for corporate governance. Most importantly, for the sake of long-term prosperity, a stationary controller will not abuse his power to loot to the fullest extent even if he can do so, because limiting theft in each period enhances the cumulative amount of theft in the long run. In other words, a stationary controller is a "generous thief." He also realizes that patience is gold. However, his self-control is not the result of his sincere generosity or business ethics, but of his carefully calculated rationality. In addition, irrespective of a controlling shareholder's genuine or disguised motive, minority shareholders end up being inadvertently protected to some degree. In this sense, extra-legal factors such as the self-interest of controlling shareholders can *partially* substitute for an efficient and protective legal infrastructure for public investors.

56. *See generally* Lucian Arye Bebchuk, *Efficient and Inefficient Sales of Corporate Control*, 109 Q.J. ECON. 957 (1994) (explaining pecuniary private benefits); Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537 (2004) (discussing cross-country differences in private benefits).
57. Similar to the "optimal tax rate," the "optimal extraction rate" is defined as the extraction rate which maximizes a controlling shareholder's pecuniary private benefits.
58. *See* Olson, *supra* note 4, at 568; Laffer, *supra* note 27, at 1-2.

2. Examples of Roving Controllers and Stationary Controllers

After the Soviet Union collapsed in the early 1990s, the new Russia adopted market-oriented economic policies[59] characterized by drastic and massive privatization.[60] The economic situation was chaotic, close to roving banditry. A handful of politically well-connected oligarchs purchased major companies at deeply discounted prices from the government.[61] Relying on outright theft and self-dealing, oligarchs transferred massive corporate value to the detriment of corporations.[62] Mikhail Khodorkovsky, previously the so-called "Russia's richest man," provides a good example.[63] In 1995, Khodorkovsky acquired Yukos, a major oil holding company in Russia.[64] Allegedly, Khodorkovsky extracted "over 30 cents per dollar of revenue" of the business.[65] Furthermore, in the midst of the Russian financial crisis in 1998, it was reported that he stripped the vast majority of the assets of Yukos and its subsidiaries at the sacrifice of minority shareholders.[66]

In contrast to roving banditry, stationary banditry can be found in *chaebols* (family-controlled, large corporate groups) in Korea. In general, *chaebols* were considered to be an engine for Korean economic growth. For instance, Samsung, LG, and Hyundai Motors successfully compete in the global market. On the other hand, *chaebols* had

59. *See generally* Peter Murrell, *What Is Shock Therapy? What Did It Do in Poland and Russia?*, 9 POST-SOVIET AFF. 111 (1993).
60. *See, e.g.*, Bernard S. Black & Anna S. Tarassova, *Institutional Reform in Transition: A Case Study of Russia*, 10 SUP. CT. ECON. REV. 211, 216 (2003) (describing the debate regarding the economic problems in Russia).
61. Bernard Black et al., *Russian Privatization and Corporate Governance: What Went Wrong?*, 52 STAN. L. REV. 1731, 1736 (2000).
62. *Id*. at 1736-37.
63. *See Profile: Mikhail Khodorkovsky*, BBC NEWS EUR. (Dec. 22, 2013), http://www.bbc.co.uk/news/world-europe-12082222.
64. Black et al., *supra* note 61, at 1736; *see also* BBC NEWS EUR. *supra* note 63.
65. Black et al., *supra* note 61, at 1736-37.
66. *Id*. at 1769-72.

(and still have, to some extent) serious problems with respect to protection of minority shareholders, particularly before the Asian financial crisis of 1997.[67] As some commentators explain, "[i]n addition to the consumption of perks, the chaebols' 'owners' commonly used 'tunneling' and 'asset-grabbing' schemes to transfer corporate value from their minority shareholders."[68] Indeed, it would be difficult to find *chaebols* which have not been subject to alleged tunneling by controllers. However, *chaebol* controllers' misconduct differs sharply from the sudden, massive plundering in roving banditry. In other words, they do not fatally damage their controlled corporations and minority shareholders.

C. When Does a Controlling Shareholder Rationally Choose to Be Stationary?

It is puzzling that some controlling shareholders in bad-law countries "generously" expropriate from minority shareholders. It is possible that some controlling shareholders are relatively moralistic by nature. Or, a partial expropriation would be the only viable option to some controlling shareholders, when they believe that large-scale business scandals are not condoned by the government and the judicial system. Although these possibilities are not entirely ruled out, this chapter pays attention to economic rationalities (pecuniary and non-pecuniary benefits) that affect a controlling shareholder's decision on the method of stealing.

1. When Does a Controlling Shareholder Become Stationary (or Roving)?: A Generalized Model

Perhaps, a "semi-stationary" controller may exist and the question of "roving" versus "stationary" is too simple. Nonetheless, developing a new theory based on a simplified analytical framework of two extremes might be a good

67. E. Han Kim & Woochan Kim, *Changes in Korean Corporate Governance: A Response to Crisis*, 8 J. KOR. L. 23, 27 (2008).
68. *Id.* at 23.

start. In a simplified model, I hypothesize an extreme roving controller who takes *all* corporate assets suddenly through a *one-shot* transaction (note that it is possible that roving controllers take a *substantial* amount of corporate assets through a *series* of transactions in a short time period).

To build a more generalized model to analyze controlling shareholders' conduct, the valuation model based on discounted cash flow (DCF) can be used.[69] According to the DCF formula, the present value of an asset is equal to the sum of the present values of expected cash flows with relevant discount rates.[70] Since the life of common stocks is assumed to be infinite, except in the case of bankruptcy or acquisition,[71] the price of common stocks of a firm (P_0) is expressed as the present value of a perpetual stream of cash dividends (CF_t).[72] In particular, when a company's dividends are expected to grow at the constant rate (g), the stock price (P_0) is calculated by dividing the dividend of the first year (CF_1) by the difference between the discount rate (r) and the growth rate (g),[73] as is suggested by the constant growth model in Table 1.[74]

69. *See* RICHARD A. BREALEY ET AL., PRINCIPLES OF CORPORATE FINANCE 61-63 (8th ed. 2006) (explaining valuation of common stocks based on the DCF model).
70. *Id.* at 63-64. The DCF model has been acknowledged in Delaware for the purpose of valuation. *See, e.g.*, Weinberger v. UOP, Inc. 457 A.2d 701, 712-13 (Del. 1983).
71. *See* BREALEY ET AL., *supra* note 69, at 64.
72. *Id.*
73. *Id.* at 65.
74. The formula in Table 1 is called "the Gordon model, after Myron J. Gordon, who popularized the model." ZVI BODIE ET AL., INVESTMENTS AND PORTFOLIO MANAGEMENT 769 (9th ed.) (Global ed.).

Table 1: The Present Value of Common Stock[75]

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

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

Consider how this DCF valuation model can be used to explain a controlling shareholder's choice to be stationary. In a developing country with bad-law, a stationary controlling shareholder receives two types of cash flows from a corporation. First, he is entitled to *pro-rata* "normal cash flows" (on a continuous basis). Such cash flows are *normal* because they are legitimate pecuniary benefits. Generally, these cash flows are available to all public shareholders according to each shareholder's economic interest. Thus, "normal cash flows" include cash dividends and other legitimate benefits as long as they are (potentially) distributed to all shareholders on a pro-rata basis. The total sum of all "normal cash flows" with relevant discount rates is defined as the "present value of normal cash flows" (ND_0). Second, the stationary controlling shareholder is paid "special cash flows" (on a continuous basis). Such cash flows are *special* because they are unfairly transferred pecuniary benefits from the corporation. Generally, these cash flows are exclusively for the stationary controlling shareholder in the form of

75. In this model, a corporation is assumed to be a perpetual entity. *See* BREALEY ET AL., *supra* note 69, at 64-65.

pecuniary private benefits of control through self-dealing or tunneling.[76] The total sum of all "special cash flows" with relevant discount rates is defined as the "present value of special cash flows" (SD_0). Then, the DCF model can calculate ND_0 and SD_0.

Consider SD_0 first. The special cash flow at the end of year t is notated as Ext_t. The final period and discount rate are notated as N and r, respectively. Suppose that special cash flows grow at the constant rate of g, as the corporation grows. N is infinite in the model[77]—this means that a controlling shareholder's tenure is infinite, which is unrealistic since no human being is immortal. Since I will come back to resolve this issue soon,[78] this assumption is maintained temporarily. Then, SD_0 can be reduced to a formula similarly found in valuing common stock without maturity:[79] $SD_0 = Ext_1 / (r - g)$.

Second, ND_0 can be calculated in the same way. Therefore, ND_0 is expressed as a pro-rata cash flow in year 1 (Div_1) over the difference between the discount rate (r) and the growth rate (g). Algebraically, $ND_0 = Div_1 / (r - g)$. Consequently, the "present value of total pecuniary benefits" (V_0) for a stationary controlling shareholder is the sum of ND_0 and SD_0. Thus, $V_0 = ND_0 + SD_0 = [Div_1 / (r - g)] + [Ext_1 / (r - g)] = [Div_1 + Ext_1] / (r - g)$.

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76. "Special cash flows," "pecuniary private benefits," "tunneling," and "tax (revenue)" are used interchangeably in this chapter. Generally in this chapter, while "pecuniary private benefits" refer to pecuniary benefits that exclusively (and unfairly) belong to controlling shareholders, "pecuniary benefits" are defined more broadly to include justified monetary benefits for controlling shareholders, like pro-rata dividends, as well as "pecuniary private benefits."
77. Note that the original DCF model designed to value a common stock uses infinite N as well. *See* BREALEY ET AL., *supra* note 69, at 64; *see supra* Table 1.
78. *See infra* Part IV.A (discussing the concept of a controlling family shareholder with an infinite time horizon through family inheritance).
79. *See supra* Table 1.

Table 2: The Present Value of Total Pecuniary Benefits to a Stationary Controlling Shareholder

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

- Div_1: the amount of pro-rata cash flow that a controller is paid at the end of year 1
- Ext_1: the amount of extraction that a controller siphons at the end of year 1
- r: the discount rate
- g: the growth rate
- ND_0: the present value of normal cash flows
- SD_0: the present value of special cash flows
- V_0: the present value of the total pecuniary benefits = $ND_0 + SD_0$

Alternatively, a controlling shareholder may choose to be roving if he wishes. In this simplified model, he—an extreme roving controller—takes *all* corporate wealth, ROV_0, including his own invested capital as well as that of the minorities at time 0.[80] So far, since a controlling shareholder is assumed to be rational only in terms of "wealth" (I will loosen this assumption later in order to take into account non-pecuniary private benefits as well),[81] he

80. In other words, a roving controller does not think of future cash flows at time 1, 2, 3, . . . , n, since he is not a repeat player. He takes into account only the one-shot cash flow at "time 0." Nonetheless, the roving controller does not loot *simultaneously* when public investors invest in the corporation. For instance, it is possible that "time 0" can be one year *after* public shareholders invest in the corporation. Usually, a roving controller first attracts minority shareholders and waits for a while. Then, he ultimately pillages the corporation at "time 0."

81. *See infra* Part IV.B.

compares ROV_0 (the roving controller's value) and V_0 (the stationary controller's value). If ROV_0 is larger than V_0, it is in his best interest to be roving. In contrast, if V_0 is larger than ROV_0, a rational controlling shareholder will choose to be stationary. I call this analysis "one-factor analysis" since the level of pecuniary benefits is assumed to be the only factor that a controlling shareholder is interested in.[82]

To a controlling shareholder, ROV_0 and V_0 represent the liquidation and going-concern values that he can attain in a corporation, respectively. Just as the going-concern value is generally larger than the liquidation value, it is likely that V_0 is larger than ROV_0 as long as a controlling shareholder is patient and a corporation can be maintained for a long time. In this case, being a stationary controlling shareholder is the better choice for him than being a roving controlling shareholder.

However, it is an oversimplification to state that all controlling shareholders will choose to be stationary. There are several factors that affect the ultimate decision of a controlling shareholder. As seen in the formula of Table 2, i.e., "$V_0 = [Div_1 + Ext_1] / (r - g)$," the present value of the total pecuniary benefits to a stationary controller (V_0) is the function of a pro-rata cash flow in year 1 (Div_1), an extraction at a sustainable level in year 1 (Ext_1), the growth rate (g), and the discount rate (r). Given Div_1 and Ext_1, V_0 becomes larger when g is larger and r is smaller. Consequently, with the combination of a larger growth rate and a smaller discount rate, a controlling shareholder is more likely to be stationary. The reverse is true as well: with the combination of a smaller growth rate and a larger discount rate, there is a higher likelihood that a controlling shareholder will be roving.

82. *Cf. infra* Part IV.B (describing a two-factor analysis).

2. Why Don't Investors Invest Abroad to Avoid Controlling Shareholders' Exploitation?[83]

One may argue that public investors in a bad-law country can invest abroad if they do not like bandits in their jurisdiction. In general, however, this has been impractical, if not impossible. Most of all, many developing countries have implicit or explicit capital regulations[84] that prevent public investors from investing abroad. Even without such regulations, public investors in bad-law jurisdictions have difficulties investing abroad.[85] For example, financial intermediaries, which pool funds and invest abroad on behalf of small investors, have not been well developed until recently in bad-law countries.[86] In addition, "[people] feel comfortable investing their money in a business that is visible to them."[87] Such familiarity bias takes concrete shape in the form of home bias where investors are reluctant to invest in foreign assets that they are not familiar with.[88] In less developed capital markets, another obstacle to public investors is that they have fewer hedging tools and less capacity for the additional risk of international diversification.

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83. As for the explanation in this Sub-Section, see Kang, *supra* note 17, at 887-88.
84. *See, e.g.*, Rui Castro et al., *Investor Protection, Optimal Incentives, and Economic Growth*, 119 Q.J. ECON. 1131, 1156 (2004).
85. *See* Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 MICH. L. REV. 2498, 2512-19 (1997) (describing difficulties that can be encountered when investing in foreign securities).
86. For a brief explanation of additional reasons that impede international investment, see Gur Huberman, *Familiarity Breeds Investment*, 14 REV. FIN. STUD. 659, 659 (2001) (quoting ECONOMIST).
87. *Id.*
88. For a further discussion of home bias, see Fox, *supra* note 85, at 2512-15; *see also* Huberman, *supra* note 86, at 659-65, 675-77.

IV. Family Corporations and Stationary Controllers

Based on the analytical framework for stationary controllers, this Part adds the concept of a "family" corporation and makes the generalized model in Table 2 more realistic. In this chapter a "family" corporation refers to a corporation where family control is expected to continue through the next generation via inheritance.[89]

A. Length of Tenure and Controlling "Family" Shareholders

Suppose that an absolute king in a country stays on the throne for only a short period. Accordingly, he does not have a long-term plan to pursue; as the final period approaches, it is in his best interest to take as much as possible from his subjects. In this case, unfortunately, his subjects are under a roving bandit and face a high risk of total plundering.[90] This is why the king's subjects have reason to be sincere when they say: "Long live the king."[91] "If the king anticipates and values dynastic succession, that further lengthens the planning horizon and is good for his subjects."[92] With a potentially infinite tenure through inheritance, the king, as a repeat player, is more likely to act as a stationary bandit.

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

89. *See* Randall Morck & Bernard Yeung, *Corporate Governance and Family Control*, GLOB. CORP. GOVERNANCE FORUM 3-4 (2003), http://www.ifc.org/wps/wcm/connect/06544d0048a7e568a17fe76060ad5911/DP_1_CG_Family_Control_Morck_2003.pdf?MOD=AJPERES.
90. *See supra* Part II.A.
91. Olson, *supra* note 4, at 571.
92. *Id.*

shareholder and minority shareholders share overlapping interests, minority shareholders wish to have a controlling shareholder with a more extended time horizon.

In this respect, the notion of a "family" corporation is significant in the economic analysis of stationary banditry. In Part III, I propose a model for calculating the present value of total pecuniary benefits to a stationary controlling shareholder.[93] The model is based on the assumption that a controlling shareholder's tenure is infinite.[94] Unlike a corporation that is an eternal entity, the life of a controlling shareholder is limited—therefore, in principle, the model based on perpetuity is not practical. Through intra-family inheritance, however, a controlling "family" shareholder—rather than merely a controlling shareholder—can achieve immortality as long as he treats his descendants as his alter ego.[95] Accordingly, the assumption can be justified.[96]

Like the tyrant in the above example, a controlling shareholder with absolute power—if his tenure is limited—is likely to change his status from a stationary controller to a roving controller, as his final period of reign in a corporation comes closer. However, stable family succession can reduce the likelihood of the final-period problem since the tenure is effectively extended to infinity via inheritance.[97] A controlling family shareholder shares more encompassing interests with minority shareholders, and a family corporation is more likely to be prosperous and productive under the repeated transactions between an immortal controlling shareholder and public shareholders.[98]

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93. *See supra* Table 2.
94. The DCF valuation model is based on the assumption that a corporation receives cash flows for an infinite time horizon. BREALEY ET AL., *supra* note 69, at 64.
95. *See* Gilson, *supra* note 16, at 643. But, compare with *infra* note 100 and accompanying text.
96. *See supra* notes 77-79 and accompanying text.
97. *See supra* note 95.
98. As for repeated transactions, see JOEL WATSON, STRATEGY: AN INTRODUCTION TO GAME THEORY 266 (2d ed. 2008).

For instance, this analysis explains at least partially why controlling family shareholders in large corporate groups in Korea were (are) stationary.

It would be in the best interests of minority shareholders to have good legal infrastructures and systems that protect their interests in corporations and the capital market. Nonetheless, if it is the minority shareholders' fate to stay in a bad-law jurisdiction without the opportunity for international investment, having a controlling "family" shareholder is more favorable to minority shareholders than having a corporate dictator—whether a controlling shareholder or a professional manager—with limited tenure.

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

1. One-Factor Analysis v. Two-Factor Analysis

According to the "one-factor analysis" introduced earlier:[99] (1) when ROV_0 (i.e., the value that a roving controller loots at time 0) is greater than V_0 (i.e., the present value of the total pecuniary benefits to a stationary controller), a controlling shareholder chooses to be roving; (2) when V_0 is greater than ROV_0, he chooses to be stationary. In this analysis, only pecuniary benefits are considered. However, the presence of non-pecuniary benefits—which increase a controller's utility—should be recognized as well. In this respect, the more realistic "two-factor analysis"—taking into account both the pecuniary and non-pecuniary benefits—is required to analyze a controlling shareholder's decision to be stationary or roving.

Let us denote the present value of non-pecuniary benefits of control for a controlling shareholder (and his descendants) as *Alpha*. Then, a controlling shareholder compares ROV_0 and the sum of two factors, V_0 and *Alpha*:

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99. *See supra* Part III.C.

(i) when ROV_0 is greater than the sum of V_0 and *Alpha*, he chooses to be roving; (ii) when the case is the reverse, he chooses to be stationary. Since *Alpha* reflects psychological value that a controller enjoys as a dictator of a corporate empire, an extreme roving controller who takes every corporate asset (thus dismantling a corporate empire) is not able to benefit from it. Table 3 summarizes.

Table 3: One-Factor Analysis v. Two-Factor Analysis

- One-Factor Analysis

(i) $ROV_0 > V_0$: a controlling shareholder chooses to be roving
(ii) $ROV_0 < V_0$: a controlling shareholder chooses to be stationary

- Two-Factor Analysis

(i) $ROV_0 > V_0 + Alpha$: a controlling shareholder chooses to be roving
(ii) $ROV_0 < V_0 + Alpha$: a controlling shareholder chooses to be stationary

The two-factor analysis provides important corporate governance implications. For example, when ROV_0 is $100 million and V_0 is only $70 million, according to the one-factor analysis, a controlling shareholder chooses to be roving. Under the two-factor analysis, however, he chooses to be stationary even if ROV_0 is greater than V_0, as long as *Alpha* compensates for the difference between the two numbers ($ROV_0 - V_0$). In this example, if *Alpha* is larger than $30 million, it is a controlling shareholder's rational choice to be stationary with a V_0 of $70 million. Accordingly, there is a higher likelihood that a controlling shareholder will be found to be stationary when the value of *Alpha* is large. The more a controlling family shareholder values fame, social prestige, and family influence in the society, the more beneficial it is to minority shareholders, since the controller is more likely to be stationary and

is willing to extract private pecuniary benefits to a lesser degree. In other words, the controlling family shareholder can give up some pecuniary benefits when he is able to attain non-pecuniary benefits.

Since *Alpha* is the non-pecuniary, private benefits to all family members, a part of *Alpha*'s value may be reserved for a controlling shareholder's future descendants. When an incumbent controlling shareholder is more *altruistic* to his future descendants, his discount for his descendants' non-pecuniary benefits is low. As a result, the value of *Alpha* is larger. Thus, he is more likely to be stationary, and this is more beneficial to minority shareholders for the same reason explained above. Conversely, when he does not put a high value on his descendants' happiness, his discount for his descendants' non-pecuniary benefits is high.[100] As a result, the value of *Alpha* shrinks and he is less likely to be stationary.

2. Interplay Between Pecuniary and Non-Pecuniary Benefits in Family Corporations

When an unjustified expropriation by a controlling shareholder is harsh enough, minority shareholders will exit a corporation by selling shares (i.e., the Wall Street Rule[101]). Some minority shareholders will move to another corporation in the domestic market (voting with their feet[102]). However, an exodus of displeased minorities from a business empire threatens only a stationary controller: minorities' exit is not a punishment at all to a roving

100. *Cf.* Gilson, *supra* note 16, at 643 (explaining that a controlling shareholder would think of his children's utility as equivalent to his own). In addition, it is possible that a founding father and his children fight over corporate control. *See, e.g.*, Nyshka Chandran, *Vicious South Korean Family Feud Exposes Chaebol Peril*, CNBC (Aug. 5, 2015), http://www.cnbc.com/2015/08/05/lotte-family-feud-exposes-chaebol-peril.html (describing the recent family feud in Lotte Group, one of the largest corporate groups in Korea).

101. *See, e.g.*, Robert C. Pozen, *Institutional Perspective on Shareholder Nominations of Corporate Directors*, 59 BUS. LAW. 95, 96 (2003) (discussing the Wall Street Rule, the tendency of shareholders to sell stocks when they are disappointed by those stocks).

102. Originally, the term "votes with feet" was coined to explain people's migration to another community that provides the optimal level of tax and public goods. *See generally* Charles Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956).

controller. All the roving controller is concerned about is how to efficiently extract corporate assets at the time when he loots. After looting, he does not care whether or not minority shareholders leave the corporation, which is left as a shell and which he does not have any incentive to maintain. Since "tomorrow" is nonexistent in a roving controller's mind, losing his empire by the minorities' exit is not a concern.

Generating more minority shareholders by issuing new shares to the public gives huge advantages to a stationary controller because it is the essence of non-pecuniary private benefits; the more minority shareholders a controlling family shareholder has, the more equity he holds in a corporation and the more debt he can borrow.[103] As a result, he controls more assets, which means he can build a larger empire. Conversely, when a controlling family shareholder has a small base of minority shareholders, he will end up having a small empire, which reduces his (and his descendants') non-pecuniary private benefits.

Accordingly, if non-pecuniary benefits—especially benefits arising from maintaining the control of large corporations—are highly valued in a particular culture,[104] a controlling shareholder with a long-term plan has an incentive to be recognized as a "generous thief." This is because by imposing low "taxation" on minority shareholders, a controller is able to manage a larger corporation and enjoy higher non-pecuniary benefits as a result. In other words, if a king wishes to rule over a larger empire in a stable way, ultimately he should "buy" more of his subjects' support by lenient policies. In this sense, non-pecuniary benefits and the tax rate are *negatively* correlated (other things being equal, the more generous a controller is, the larger a corporate empire is).[105]

103.*See* Kang, *supra* note 17, at 873-77 (explaining the relationship between equity financing and empire-building).
104.*See, e.g.*, Gilson, *supra* note 3, at 1673.
105.*See infra* Figure 2.

"Tax-cut" is of significance with respect to its impacts on pecuniary and non-pecuniary benefits for a controlling shareholder. First, suppose that the current "tax rate" (i.e., extraction rate) is above the "optimal tax rate" maximizing revenue. Then, a reduction in the tax rate can affect both pecuniary and non-pecuniary benefits positively:[106] (1) "tax revenue" (i.e., pecuniary private benefits) will *increase*; (2) in addition, the controlling shareholder's non-pecuniary benefits (i.e., expansion of his empire) will *increase* by lowering the "tax rate" since he attracts more minority shareholders and the corporation will be larger. Second, suppose that the current "tax rate" is below the "optimal tax rate." A reduction in the "tax rate" has conflicting effects on pecuniary and non-pecuniary benefits of a controller:[107] (1) "tax revenue" will *decrease*; (2) by contrast, non-pecuniary benefits will *increase* since more minority shareholders—attracted by a more lenient policy—come to "reside" in his empire and the controlling shareholder can control a larger corporation. Therefore, the net effect of tax reduction depends on the relative sizes of decreased "tax revenue" and increased non-pecuniary benefits.

3. Implications of Non-Pecuniary Benefits for Corporate Governance

In this respect, by *reducing* his "tax rate," a stationary controller may be able to *enhance* his utility in two ways. First, by reducing his tax rate from a roving controller's "prohibitively high tax rate" (e.g., 100%) to the "optimal tax rate" that maximizes pecuniary private benefits, a stationary controller can increase "tax revenue." Second, by reducing the tax rate further from the "optimal tax rate" to the "adjusted optimal tax rate" that maximizes the sum of pecuniary private benefits and non-pecuniary benefits, the stationary controller can attain sufficient non-

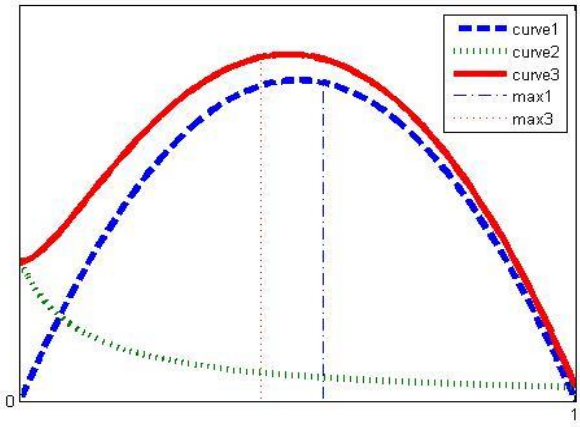
106.*See infra* Figure 2.
107.*See infra* Figure 2.

pecuniary benefits by expanding the business empire. Although reducing the "tax rate" from the optimal point results in lowered pecuniary benefits, the stationary controller can improve his total utility from pecuniary and non-pecuniary benefits.[108] Figure 2 explains that the "adjusted optimal tax rate" (max 3) is *lower* than the "(original) optimal tax rate" (max 1). Thus, from the stationary controller's perspective, being generous to minority shareholders by imposing a low tax rate (i.e., a low extracting rate) is in fact protecting and furthering his own interests.

Likewise, minority shareholders find that having a stationary controller is more beneficial to them than having a roving controller in two ways:[109] (1) through the stationary controller's reduction of the "tax rate" from a roving controller's prohibitive point to the "optimal tax rate," and (2) through the stationary controller's additional reduction of the "tax rate" from the "optimal tax rate" to the "adjusted optimal tax rate." Minority shareholders are better off under the "adjusted optimal tax rate" (max 3) than under the "(original) optimal tax rate" (max 1) since "max 3" represents a lower expropriation rate than "max 1".

108.*See infra* Figure 2.
109.*See infra* Figure 2.

Figure 2: Adjusted Optimal Tax Rate — the presence of non-pecuniary benefits of control can reduce the optimal tax rate further[110]



- X axis: a controlling shareholder's "tax rate" (extraction rate)
- curve 1: a controlling shareholder's "tax revenue" (pecuniary private benefits of control)
- curve 2: the value of non-pecuniary benefits of control
- curve 3: curve 1 + curve 2
- max 1: the maximum point of curve 1 at the "optimal tax rate"
- max 3: the maximum point of curve 3 at the "adjusted optimal tax rate"

In sum, both a controller and minority shareholders are likely to be more satisfied under a stationary controller's reign. A stationary controller can be praised as a "benevolent king" (or cynically, a "generous thief") by minority shareholders. This analysis explains (at least partially) why some controlling shareholders in bad-law

110. The analysis in Figure 2, as an extended analysis in Figure 1, focuses on the "*extra* benefits"—i.e., the sum of "special cash flows" and non-pecuniary benefits—that a stationary controller would like to attain more (thus, "normal cash flows," which *originally* belong to a controlling shareholder as benefits from his own investment, are not considered here).

jurisdictions—if they evaluate non-pecuniary benefits highly—*voluntarily* extract a small amount of corporate value from minority shareholders (i.e., optimally restrained tunneling).[111] Again, it cannot be emphasized enough that controlling shareholders' generosity is a simple reflection of their calculated self-interest. Nonetheless, it is noteworthy that minority shareholders can be protected not only by good corporate law, but also by a stationary controlling shareholder's own self-interest.

C. Reputation for Being (Benevolent) Stationary Controlling Shareholders

Minority shareholders are not able to know for sure whether the controlling shareholder they deal with is stationary or roving. This information asymmetry[112]—which impedes transactions between the two parties in the capital market—is of particular significance in bad-law countries due to the deficient disclosure system and ineffective legal mechanisms.[113] Given the fear that a controlling shareholder they will potentially deal with is a roving controller, prospective investors are reluctant to invest their money in any corporation. In this light, a controlling shareholder encounters a greater challenge when attempting to convince minorities that he is different from roving bandits who perhaps are prevalent in the market place.

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111. Thus, Gilson's question—why some controlling shareholders in bad-law jurisdictions voluntarily set the limit of extracting private benefits from minority shareholders—can be solved. *See supra* note 17 (comparing the Author's approach with Gilson's approach to a controlling shareholder's lenient expropriation).

112. *See generally* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970) (explaining asymmetric information in general); *see also* Stewart C. Myers & Nicholas S. Majluf, *Corporate Financing and Investment Decisions When Firms Have Information That Investors Do Not Have*, 13 J. FIN. ECON. 187 (1984) (providing a classic explanation of corporate finance under asymmetric information).

113. *See* Gilson, *supra* note 16, at 647. For a further explanation of mandatory disclosure, see Allen Ferrell, *The Case for Mandatory Disclosure in Securities Regulation Around the World*, 2 BROOK. J. CORP. FIN. & COM. L. 81, 81-82 (2007) (introducing the debate on the desirability of mandatory disclosure among scholars); Merritt B. Fox, *Retaining Mandatory Securities Disclosure*: *Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1337-39 (1999) (explaining a system of issuers' choice and the mandatory disclosure system).

Prospective investors are able to recognize more easily that a certain corporation is a "family" corporation because they can simply review the corporation's governance structure (e.g., whether a large number of shares are spread among family members, or whether children of a founder are executives or members of a board of directors, etc.). Clearly, it is more convenient for investors to observe the appearance of a corporation than to scan the mentality of a controlling shareholder. In the parlance of law and economics, the "transaction costs"[114] for investors to understand and trust a controlling family shareholder's intent are low. In addition, a controlling family shareholder's transaction costs to convince investors are low as well since he does not have to spend his time and resources sending off credible signals, which are costly.[115]

When a sufficient number of prospective investors share the common opinion that a particular corporation is a family corporation, the market will presume that the tenure of a controlling shareholder is (theoretically) perpetual via inheritance.[116] Then, potential minority shareholders are convinced that if a controlling family shareholder makes repeated transactions with them in the capital market for a long time, it will be in the controlling family shareholder's best interest to be stationary as well.

V. Conclusion

Based on the notion that businesspeople are self-interested and may abuse inefficiencies in their countries' legal systems, this chapter proposes that controlling shareholders in bad-law jurisdictions can be classified into at least two sub-categories: stationary controllers and roving controllers. When a controlling shareholder is a family

114.*See, e.g.,* DANIEL H. COLE & PETER Z. GROSSMAN, PRINCIPLES OF LAW AND ECONOMICS 63 (2004) (explaining the influence of the transaction costs over individuals' decisions).

115.*Cf.* Gilson, *supra* note 16, at 641-45 (explaining the importance of family from the *product* market-based perspective).

116.For an infinite time horizon of a controlling family shareholder, see *id.* at 643.

shareholder, he is more likely to be stationary and establish his own dynasty. With a long-term interest in his controlled corporation, it is in the controlling family shareholder's best interest to *voluntarily* reduce the degree of expropriation from minority shareholders. Given the condition that the corporate law in a developing country is inefficient at protecting investors, having a stationary family controller might be the optimal choice available to public investors. The relatively aligned interests of a stationary family controller and public shareholders make up partially for the lack of good corporate law.

Controlling family shareholders, however, are not necessarily stationary in the first place. It is also possible that at some point stationary family controllers transform into roving controllers due to major factors in family businesses (e.g., a second generation's poor management or sibling rivalry) or significant external variables. In this respect, it is noteworthy that this chapter is not intended to defend and justify family business. Rather, this chapter argues that despite many weaknesses, family-controlled corporations might be better than we have thought. Last but not least, more globalization in the future will foment international investment by non-controlling shareholders in bad-law countries,[117] and it may significantly change the corporate governance system based on local banditry.

117.*Cf. supra* Part III.C.2.

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