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The Importance of Corporate Law: Some Thoughts on Developing Equity Markets in Developing Economies

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I. INTRODUCTION

Designing the right legal system is a fundamental challenge when attempting to promote economic growth in a developing country. Although a country's entire legal infrastructure matters, I want to reflect on this challenge in the specific context of corporate law.

In recent years, a prominent strategy offered to encourage economic development has been to shore up the rights of shareholders. Why stress shareholder rights? There are two primary links in this approach to promoting economic growth. First, as studies have confirmed, a relationship exists between thick and deep equity markets and economic growth.¹ Simply stated, business enterprises are more likely to grow and prosper if financial capital is available. The second link in the analysis is that investors will be reluctant to invest in equities if they are not adequately protected from abuse at the hands of directors and officers (i.e., insiders) and controlling shareholders. Turning this statement around, investors will be more willing to invest, and will do so at higher valuations, if they are sufficiently confident that their wealth will not be expropriated. Accordingly, for developing countries, the basic policy argument has been to adopt reforms that protect shareholders in order to foster equity markets. But what *particular* reforms are required to foster equity markets? This is the question on which I want to focus my attention. In doing so, I take for granted that equity markets stimulate economic development and that promoting equity markets is a worthwhile policy goal, as compared to, say, simply focusing on developing credit markets and a viable banking system.

The so-called "law matters thesis" captures one set of particular policy suggestions for promoting equity markets as a means of economic growth.² The work

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1. See generally Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 831-38 (2001); Stephen J. Choi, *Law, Finance, and Path Dependence: Developing Strong Securities Markets*, 80 TEX. L. REV. 1657, 1660-95 (2002); Frank B. Cross, *Law and Economic Growth*, 80 TEX. L. REV. 1737, 1769-70 (2002).

2. For some of the seminal work behind the "law matters thesis," see Rafael La Porta et al., *Agency Problems and Dividend Policies Around the World*, 55 J. FIN. 1 (2000); Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3 (2000); Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999); Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998); Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997).

that the thesis is rooted in shows a link between “more law” (i.e., stronger legal protections for shareholders) and robust equity markets (i.e., more initial public offerings (“IPOs”), higher stock market valuations, more listed companies trading on stock markets, etc.). In most cases, the reality is that directors and officers (the management team) have control over most decisions affecting the company. If a controlling shareholder exists, that shareholder may also exert a great deal of influence, and for all intents and purposes, may run the business through its chosen representatives on the board and in senior executive positions.

The “law matters thesis” responds to this form of business organization, which is characterized by a corporate structure whereby shareholders entrust their money to agents in hopes that they will put the capital to work profitably on the shareholders’ behalf. Since noncontrolling shareholders do not typically run the company day-to-day, the “law matters thesis” argues for legal protections that shield such shareholders from abusive practices at the hands of those insiders and controlling shareholders who do run the business. For example, the law may protect shareholders from the following: excessive executive compensation; insiders’ placing friends and family in high-ranking positions; self-dealing transactions involving management; theft; and shirking by executives.

Reduced to its essence, the “law matters thesis” is about strong shareholder property rights, as reflected in the control that shareholders are allocated over the enterprise and the legal limitations that constrain managerial and directorial discretion; all of which point in the direction of ensuring that shareholders do not have their wealth expropriated. As hinted at above, if shareholders do not have adequate control over the enterprise, and if managers and directors are not hemmed in when running the business, shareholders cannot rely on their financial rights bearing any fruit, even if the company is successful.

II. IMPLEMENTING THE “LAW MATTERS THESIS”

The “law matters thesis,” however, inevitably leads to a key difficulty: one cannot just call for “more law” as a policy prescription. One needs to ask, “What law?” In practice, this becomes a question of what type of corporate governance system a developing country should have to encourage investors to hold equities. Put differently, what kind of corporate governance system in a developing country is most likely to result in the kind of separation of ownership and control seen in the United States, where there is widespread external financing and widely dispersed share ownership?³

In considering the “what law?” question, it is important to note a shortcoming with many of the economic studies behind the “law matters thesis.”

3. See generally Brian R. Cheffins, *Law as Bedrock: The Foundations of an Economy Dominated by Widely Held Public Companies*, 23 OXFORD J. LEGAL STUD. 1 (2003); John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1 (2001).

Many of the factors that the “law matters” studies stress, such as whether shareholders can vote by mail, the possibility of cumulative voting, and how many shares are required to call a special shareholders meeting, do not matter much in protecting shareholders. More generally, the “law matters thesis” tends to often focus too narrowly on the formal rules of the game when there are other relevant factors beyond the formal rules. Indeed, some economic studies advancing the “law matters thesis” have broadened the focus to include factors such as enforcement, norms, culture, respect for the rule of law, and the efficiency of the judicial system that contribute to shareholder protection. When added to the law on the books, the result is a more complete measure of the extent to which the legal infrastructure shores up shareholder rights.

In thinking about which corporate law best protects shareholders, it is helpful to start by identifying two competing models of corporate law that policymakers can choose from in setting the contours of shareholder rights. The first model is part of a market-oriented approach to corporate governance. Under this approach, corporate law is enabling in that it consists largely of default rules that parties can opt out of to privately order their affairs as they see fit. In this view, corporate law plays a relatively limited role in protecting shareholders, and defers to a host of other formal and informal mechanisms to hold managers and directors accountable, such as incentive-based compensation, product-market competition, and hostile takeovers. Further, it is also expected that directors and officers will follow norms of good governance as they try to “do the right thing” even when they are not required by law to do so. The United States (or rather, Delaware, the most important state when it comes to corporate law) exemplifies this approach. The second model encompasses mandatory corporate law, in which the state, as opposed to the market, plays a central role in shoring up shareholder protections by fashioning mandatory, clear-cut rules that define shareholder rights.

Which corporate law model should developing countries follow? Asked differently, to what extent should the government displace the market with more substantive regulation of corporate governance in developing countries? Even in the aftermath of the scandals at Enron, WorldCom, Tyco, and elsewhere, the United States remains the poster child of dispersed share ownership, as characterized by the so-called “Berle and Means” firm, where ownership and control are separated. Consequently, the tendency is to look to the United States for guidance when considering the corporate law regimes of developing economies. In practice, this means that many argue for the transplantation of U.S.-style corporate law into developing countries. The rough logic is that if developing countries import U.S.-style corporate law, they will eventually end up with U.S. style equity markets.⁴

4. For more complete analyses of legal transplants, see, for example, Daniel Berkowitz et al., *Economic Development, Legality, and the Transplant Effect*, 47 EUR. ECON. REV. 1 (2003); Daniel Berkowitz et al., *The Transplant Effect*, 51 AM. J. COMP. L. 163 (2003); Jerome Frank, *Civil Law Influences on the Common Law—Some Reflections on “Comparative” and “Contrastive” Law*, 104 U. PA. L. REV. 887 (1956); Hideki Kanda &

A. *The U.S. Model of Corporate Law*

In my view, the U.S. model of corporate law (and of corporate governance in general) is the wrong approach for developing countries. Simply stated, corporate law in Delaware affords shareholders weak protections from insider and controlling shareholder abuses. It is not much of an overstatement to say that the Delaware Corporation Code is largely beside the point when it comes to protecting shareholders, and the fiduciary duties that the Delaware judiciary imposes on directors, officers, and controlling shareholders are modest, for the most part policing only egregious conduct. Even if a country wants a corporate law regime similar to that of the United States, it will miss its mark by a long shot if it simply adopts something similar to the Delaware Corporation Code. The Delaware Corporation Code does not include judge-made fiduciary standards that are primarily responsible for constraining insider and controlling shareholder behavior in the United States.

To be clear, the suggestion that corporate law does not protect shareholders much in the United States should not be taken to mean that shareholders are not protected. Moreover, there is virtue in limiting shareholder control over the firm, even if it means leaving shareholders exposed to opportunism and expropriation. That is, if there is any value in having directors and officers who manage and oversee the enterprise, then these individuals need discretion in exercising their authority to run the business without routine second-guessing or meddlesome interference by shareholders, let alone by judges or regulators.⁵

So what makes up U.S. corporate governance? U.S. corporate governance is a system with many parts that strike a unique balance between managerial discretion on the one hand, and adequate shareholder protection on the other. Time and space do not allow for explanation of all the parts of the system in detail and how they fit together. Therefore, I will briefly highlight select portions.

As noted above, the United States has adopted an enabling approach to corporate law (premised on private ordering) as opposed to a mandatory approach, and what matters most for shareholder protection is not the law on the books but the law of fiduciary duties. Indeed, the most important statutory provision in Delaware is section 141 of the Delaware Corporation Code, which allocates to the board of directors, and by extension to corporate officers, control over the corporation's business and affairs. The institution of derivative litigation, with easy access to courts and an active plaintiffs' bar, is important to provide a means for shareholders to enforce fiduciary obligations in those limited circumstances in which they are breached.

Curtis J. Milhaupt, *Re-Examining Legal Transplants: The Director's Fiduciary Duty in Japanese Corporate Law*, 51 AM. J. COMP. L. 887 (2003); Katharina Pistor et al., *The Evolution of Corporate Law*, 23 U. PA. J. INT'L ECON. L. 791 (2002); Katharina Pistor, *The Standardization of Law and Its Effects on Developing Economies*, 50 AM. J. COMP. L. 97 (2002).

5. Cf. Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003) (developing the director primacy model of corporate governance).

Markets complement the law. Product markets, the market for capital, the market for corporate control, and the market for management are said to discipline directors and officers to profitably run the business in the shareholders' interests.

Next, contracts help align directors' and officers' interests with those of shareholders. Stock options, restricted stock grants, and other forms of incentive compensation are common examples of these types of contracts. Also included in this category of governance mechanism are golden parachutes, which align the interests of managers and directors with those of shareholders in takeovers. When a target's board and senior executives will be ousted if a bid succeeds, the directors and officers might wish to defeat an unsolicited bid that the shareholders would like to accept unless these insiders receive a sizable payout when ousted.⁶

A number of market players (e.g., stock analysts, institutional investors, and hedge funds) closely follow the goings-on of companies, and in monitoring an enterprise and paying attention to company fundamentals, these players can impact how the business is run. Other important role players that keep tabs on a firm and its operations include proxy solicitation and shareholder service firms, such as Institutional Shareholder Services and Glass, Lewis & Co., and shareholder watchdog groups like The Corporate Library. Numerous blue-ribbon panels, including those organized following Enron's collapse, are also helpful watchdogs and norm entrepreneurs who shape corporate conduct simply by taking a stance on how directors and officers should behave. In addition, one cannot overlook the influence of the financial and business media. Critical coverage on CNBC or in the *Wall Street Journal* can affect a company, in part by shaming management and the board to shape up and reconsider its business plan and governance structure.⁷

Although they have received stinging criticism in the aftermath of the Enron wave of scandals, an array of important gatekeepers, including lawyers, investment bankers, accountants and auditors, and credit rating agencies fulfill a constructive governance role. At a minimum, these gatekeepers are expected to notice red flags indicating corporate malfeasance, such as fraud or looting.

Perhaps the most demanding corporate governance requirements come not from state corporate law, but from stock market listing standards. Most notably, the New York Stock Exchange ("NYSE") and NASDAQ burden their listed companies with a number of requirements. For example, a majority of the directors at a NYSE- or NASDAQ-listed company must be independent, and the company must have an audit committee, compensation committee, and nominating committee solely made up of independent directors.⁸ Of course,

6. See generally Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871, 898 (2002).

7. See David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811 (2001).

8. See Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Standards*, 30 SEC.

companies can avoid these mandates by choosing not to list on the NYSE or NASDAQ. However, the choice to remain private has its costs for a company, and is not always a viable option depending on the company's growth opportunities and capital needs.

The mandatory disclosure regime under the federal securities laws also bears mentioning. The mandatory disclosure regime helps ensure that the marketplace has the information needed to oversee the company's governance, and to evaluate whether management's business plan for the company is successful and worth pursuing.

Let me take a short step back to Delaware corporate law, as opposed to other parts of the U.S. corporate governance system, to add a few additional words that sketch how the Delaware judges work. The Delaware judges are very sophisticated, and there is a well-established shareholder primacy norm under Delaware corporate law. At the very least, shareholders know that the Delaware courts are sensitive to the interests of shareholders, as opposed to the interests of employees, creditors, or local communities. What is particularly striking about the Delaware judiciary, though, is that much of what the Delaware judges achieve in shareholder protection is through dicta and not by holding directors and officers liable. Indeed, the business judgment rule is very deferential to executives and the board. Through dicta in their opinions, as well as through their speeches and articles, the Delaware judges have honed in on the practice of articulating "aspirations" for good corporate governance—also known as best practices—which directors and officers routinely follow, even when the Delaware judges have consistently made it clear that there is no risk of legal liability for failing to do so.⁹ Put differently, the Delaware judiciary leverages the law's expressive function and the judges' authoritative standing in corporate governance matters. The Delaware judges shape corporate behavior simply by expressing how directors and officers *should* behave, even when these judicial aspirations are not backed by any serious risk of legal sanction. This approach to judicial decisionmaking is purposeful, as it allows the Delaware courts a way to afford enough protection for shareholders without the courts having to second guess management and the board in imposing legal liability.

REG. L.J. 370 (2002); William B. Chandler III & Leo E. Strine, Jr., *Views From the Bench: The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953 (2003); Troy A. Paredes, *Enron: The Board, Corporate Governance, and Some Thoughts on the Role of Congress*, in ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 495 (Nancy Rapoport & Bala Dharan eds., 2004); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 IOWA J. CORP. L. 1 (2002).

9. See, e.g., Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997); E. Norman Veasey, *What Happened in Delaware Corporate Law and Governance from 1994-2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1410-1421 (2005); see also Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735 (2001); Lynn A. Stout, *Other-Regarding Preferences and Social Norms* (Georgetown Law & Econ. Working Paper No. 265902, 2001), available at http://ssrn.com/paper.taf?abstract_id=265902.

The important point to take away from this brief tour of U.S. corporate governance is that the U.S. corporate governance system is a complex institutional mix in which corporate law takes a backseat to other features of the system in protecting shareholders. In other words, U.S. corporate law is relatively unimportant to shareholder protection, and yet, the United States has the most robust equity markets in the world.

B. A Mandatory Model of Corporate Law and Developing Countries

Where does this leave us in considering the “law matters thesis” and related corporate law reforms for promoting equity markets in developing economies? One can start to answer this question by asking whether a market-based approach to corporate governance, such as the one in the United States, is feasible for developing countries looking to develop equity markets. In my view, the answer is “no” for a number of reasons. For present purposes, it suffices simply to stress that the U.S. system presupposes the existence of markets and relies on a host of non-law market institutions to protect shareholders in place of demanding legal mandates. When a full complement of such market institutions exists, there is little need for strong laws to protect shareholders. However, developing countries do not yet have the mature market institutions that make a market-based model of governance with weak legal protections guarding shareholders feasible. Indeed, the whole endeavor is to create markets.¹⁰ A related shortcoming is that the standardized contracting and “shared mental model” of governance and business that shape parties’ reasonable expectations in developed markets are often lacking in developing economies.¹¹ These are important parts of a market-based model of corporate governance because, by getting market participants and corporate actors on the same page, standardized contracting and a shared mental model of governance and business reduce information and transaction costs as the parties’ bargain to fill the gaps in an enabling corporate law.

If not the U.S. model, what kind of corporate law regime should developing countries have? Instead of an enabling corporate law, I recommend a much more mandatory corporate law regime for developing countries that basically fills the void left by the lack of market institutions in these countries. If the law matters, it really matters in promoting equity markets in developing economies. In no particular order, the following is a list of some examples of strong legal shareholder protections worth considering:

- banning self-interested transactions;
- capping executive compensation;

10. See Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1913 (1996).

11. Cf. Douglass C. North, *Economic Performance Through Time*, 84 AM. ECON. REV. 359, 362-63 (1994).

- requiring shareholder approval for significant acquisitions;
- mandating the payment of dividends;
- granting shareholders a limited put right;
- allowing shareholders to adopt proposals binding on management;
- giving shareholders the right to nominate directors and to have a shareholder nominee elected to the board;
- allowing shareholders greater discretion in deciding whether to tender to a hostile bidder (i.e., limiting defensive tactics);
- allowing shareholders more freedom to bring suits against directors and officers (i.e., dispensing with the demand requirement);
- requiring shareholder approval to issue shares or bonds in excess of some threshold;
- adopting a strict definition of director “independence,” and requiring a majority or even a supermajority of independent directors to be on the board;
- adopting director term limits;
- limiting the number of shares insiders can buy or sell during a given period, such as every six months, and requiring that insiders disclose their planned trades before they take place; and
- requiring a certain minimum premium in a transaction whereby a controlling shareholder proposes to squeeze out the minority shareholders.

III. CONCLUSION

I have only scratched the surface in considering one aspect of economic growth—the relationship between shareholder protection and the development of equity markets. The lessons here, however, are not limited to corporate law. On a broader landscape, this is a story about institution building and the importance of having the right blend of formal and informal institutions to achieve a society’s goals. In short, a country’s overall institutional mix matters to its prosperity.¹²

It is not enough to say that institutions matter, just as it is not enough to say that law matters. The practical challenge for policymakers is to figure out which institutions matter under different circumstances. I know it sounds cliché, but one size does not fit all. As if determining the appropriate blend of legal institutions is not hard enough, a country’s legal infrastructure itself is but one part of a much

12. See generally DOUGLAS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE (1990); THE FRONTIERS OF THE NEW INSTITUTIONAL ECONOMICS (John N. Drobak & John V.C. Nye eds., 1997); Oliver E. Williamson, *The New Institutional Economics: Taking Stock, Looking Ahead*, 38 J. ECON. LIT. 595 (2000).

more complex system that includes a country's culture, history, politics, values, norms, social structure, demographics, and other factors unique to that country. Consequently, institution building requires subtlety. Whatever strategy is adopted in trying to promote economic growth, whether it is shoring up shareholder rights or some other approach, the facts have to be examined on a country-by-country basis to see what will work in a particular country at a particular time. What works in country A may fail in country B. Moreover, policymakers must avoid over-promising the benefits of reform. Economic development is tough business, and any reform agenda is risky because so many things need to go right for it to work. It is important for policymakers to avoid setting themselves up for failure by inflating expectations that then cannot be met. A dose of humility on the part of policymakers and straight shooting with the public are themselves important parts of any reform agenda.