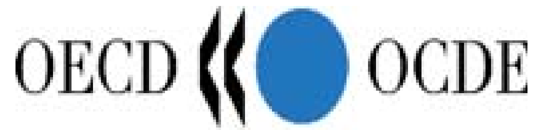

The Fourth Asian Roundtable on Corporate Governance

Shareholder Rights and the Equitable Treatment of Shareholders

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PROTECTING MINORITY SHAREHOLDERS FROM IMPROPER DILUTION

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Expropriation

Literally, expropriation is defined as "the act of taking from the owner". The risk of expropriation is one of the most important principal-agent problems for listed companies. An agency relationship is initiated when the shareholders of a joint-stock firm, as ***principals***, hire professional managers as ***agents*** to run the firm for them. In this relationship, the shareholders are risk bearing specialists whilst the managers are decision-making specialists.

An agency problem occurs when the desires or goals of the principal and agent conflict, and it is difficult or expensive for the principal to verify that the agent has behaved improperly. For example, in a firm with dispersed ***ownership*** *(cash flow rights)* and ***control*** *(voting rights)*, managers may over-diversify to reduce their employment risk and increase compensation. However, owners can mitigate such indirect expropriation by instituting an effective and responsible board of directors as a monitoring mechanism and by entering into incentive-based performance contracts with the managers.

However, the agency problems tend to be far more complicated when control of a firm is concentrated in the hands of a single shareholder (individual, family, or business group). The threat of expropriation is further exacerbated when such large shareholders manage to gain *control* disproportionately higher to their *ownership*. Control in excess of ownership can be achieved with the help of cross holdings between companies, through pyramidal holding structures, or by issuing more than one class of shares with differential voting rights.

In such firms, since the managers are effectively appointed by the controlling shareholders, they owe their allegiance to the latter rather than the body of shareholders as a whole. Consequently, the classic principal-agent problem degenerates into a more complex conflict between the controlling shareholders and managers ***(insiders)*** and the non-controlling owners of a firm ***(outsiders)***. Thus, in the corporate context, expropriation can be more narrowly defined as the improper extraction of economic benefits from the outsiders by the insiders.

Common Modes of Expropriation

Expropriation of non-controlling shareholders can take several forms. Expropriation can be categorized into three broad groups based on whether it impacts the *income statement*, or the *balance sheet* on the *net assets* (assets – liabilities) side or the *owners' equity* side. The three modes are defined as – (i) *profit expropriation*, (ii) *tunnelling of assets*, and (iii) *improper dilution of ownership*.

i. **Profit expropriation:** Improper transfer pricing between *affiliated companies* (companies controlled by a common shareholding group) is perhaps the most common way to expropriate profits. Goods or services can be transacted at non-market rates with a group affiliate, thus transferring profits out of the listed company into the other company.

   Another instance could be the selection of a group affiliate as a supplier despite better terms or quality being offered by a competing vendor. This could potentially compromise the revenues and/or the reputation of the listed company. In cases where the listed company shares common resources or services with other group affiliates, the shared costs or revenues may be disproportionately allocated to the listed company, to the detriment of its profits. Finally, there could be instances of outright theft or fraud by the managers on their own, or at the behest of the controlling shareholders.

ii. **Tunnelling of Assets:** This category comprises expropriations of the net assets (assets – liabilities) on the balance sheet. The term "*tunnelling*" was coined originally to

characterize the expropriation of minority shareholders in the Czech Republic (as in removing assets through an underground tunnel).

In the most direct form, controlling shareholders' may transfer assets out of a listed company at sub-market prices. Alternatively, a listed company may be used to bail group affiliates out through value-destroying acquisitions and investments, or even extend off-balance sheet loan guarantees on their behalf. In a more subtle form, the controlling shareholder may force a listed company to forego an economic opportunity in favor of a group affiliate.

iii. **Improper Dilution:** This mode of expropriation relates to the equity side of the balance sheet, and refers to the dilution of non-controlling shareholders' ownership of a firm. In the most blatant form, controlling shareholders may exploit the absence of statutory pre-emptive rights to dilute the other shareholders. A pre-emptive right is the right of an existing shareholder to purchase securities before they are offered to anyone else, and at terms at least as favorable.

In markets where the prevailing laws do not provide for pre-emptive rights, a listed company can easily issue fresh equity or convertible instruments to the controlling shareholders or their friends and associates, at a discount to market price. However, even in markets where shareholders have pre-emptive rights, tactics like a rights issue priced at a deep discount to the market price can be used to dilute the shareholders that do not participate in the issuance.

Very commonly, foreign investors are at the receiving end of such tactics. Because foreign investors often comprise one of the largest groups of minority shareholders in major emerging market companies, rules or practices limiting foreign ownership rights have, at times, been thinly disguised avenues of expropriation for the domestic controlling interests (IIF Equity Advisory Group, 2002).

In instances similar to the tunnelling examples cited in (ii) above, the controlling shareholders may use a firm's stock to pay for the acquisition of an unlisted group affiliate at inflated valuations. Non-controlling shareholders' are also diluted for no fault of theirs when a firm suffers financial distress due to inappropriate policies designed to further the interests of the controlling shareholders. Similarly, managers can pay themselves excessive compensation in the form of stock at no or low cost, diluting the other risk-taking owners of a firm in the process.

Improper Dilution: A Few Case Studies

I have used a few examples encountered in the Emerging Asian Markets in the post-1997 financial crisis period to illustrate improper dilution of non-controlling shareholders. All the information and data used in the following examples is gathered from public sources.

1. **Absence of Pre-emptive Rights – *Shinsegae Department Stores, Korea*:** Korean law does not offer statutory pre-emptive rights to shareholders, a fact which allows controlling groups to issue securities to related parties at diluting discounts. Shinsegae Department Stores, a leading retailer in Korea, had enjoyed a strong, secular run in its stock price in 2001, with both its common and convertible preferred shares more than tripling in value through the year. The improvement in company fundamentals on account of its success in the discount-stores format had made the stock very popular with foreign investors too, with the cumulative foreign shareholding in the company exceeding 50% by the year-end. Given its popularity with investors at the time, Shinsegae could have easily raised capital by issuing common shares or GDRs/ADRs at a premium to the local price.

   However, on December 17, 2001, the company announced the issuance of one million preferred shares convertible 1-for-1 into its common shares, three years from the effective

date of December 31, 2001. Shinsegae already had similar convertible preferred shares listed on the Korea Stock Exchange, that were trading at a 40% discount to the common shares.

The new series of preferred shares was privately placed with a select group of investors, without offering existing shareholders the first right of refusal. The issue price of KrW65,000 per new share reflected a 14% discount to the closing price of the old shares on the announcement date, despite the new shares carrying a higher dividend rate (15%) than the existing shares (10%).

The official stance of the management was that the issuance was necessary for meeting capital needs. However, the choice of instrument (dividend-yielding convertibles at a steep discount to the common shares), and the manner of placement, led to serious market speculation that the issuance was intended to shore up the controlling shareholders' stake in the firm at a relatively lower cost.

2. **Deep Discounted Rights Issue – *Thai Farmers Bank, Thailand*:** Existing shareholders can be diluted even if they have pre-emptive rights. For example, it can be easily proven mathematically that the issue price in a rights issue does not affect the shareholders' wealth, and is thus irrelevant under normal circumstances. However, if the rights issue is priced at a discount to the prevailing market price of a company's common shares, the *ex-rights* price is very likely to be lower than the *rights-on* price. Thus, existing shareholders that renounce their rights entitlement will almost certainly suffer a reduction in their market wealth. Higher the discount on the rights offering, greater is the dilution for the renouncing shareholders.

   Following severe asset quality deterioration in the 1997-98 Asian Financial Crisis, Thai Farmers Bank (TFB) raised US$800mn at a price of Bt88 per share to re-capitalize its balance sheet. At the time of the 1998 issuance, it confidently assured investors that no further capital raising was necessary. However, just a year later, TFB announced a 1-for-1 rights issue at Bt20 per share, a steep discount to the prevailing market price of about Bt70.

   As explained earlier, the pricing of a rights issue should not matter in most cases. But in this instance, minority shareholders faced a Hobson's Choice of either investing more money to maintain their stake, or getting massively diluted, since the ex-rights market price was bound to be significantly lower. Several minority shareholders, whose trust in the TFB management and the handling of the financial system in Thailand had been eroded, did not want to invest more money in the company. Worse still, several others were not able to participate since the particular rights offering did not meet all the requirements under the US securities laws.

3. **Over-payment for an Unlisted Acquisition – *Hyundai Mobis, Korea*:** This case study illustrates an important avenue for improper dilution that is also very difficult to challenge. But the more important reason why I mention it here is that it signified a relatively uncommon case in emerging markets when the controlling shareholder not only sought feedback from institutional investors on the proposed transaction, but on receiving negative inputs, also withdrew the proposal.

   Hyundai Mobis is part of the Hyundai Motors Group, which is a carve-out from the erstwhile Hyundai Group, one of the five largest Korean business conglomerates in the 1990s. Mobis provides after-sales service and supplies auto-parts to its group affiliates, Hyundai Motors and Kia Motors. The proposal in question involved the acquisition of Bontec Co., an unlisted electronic auto-parts manufacturer by Mobis.

   The family of Mobis' controlling shareholder, M K Chung, had directly as well as through a holding company purchased more than 50% of Bontec in Oct-2001 at a price of W13,000 per share. Though the formal proposal presented to investors had underplayed the valuation angle, the market expectation was for a price of about W60,000 per share of

Bontec. Hyundai Mobis was planning to pay for the acquisition with its own shares. Thus, M K Chung's family would potentially have increased its stake in Mobis at a very low cost, thanks to the 300%+ implicit capital gains on their Bontec investment in less than nine months.

Moreover, Mobis was planning to acquire Bontec using a "simplified merger method" under the Korean Company Law, which neither requires approval by the general body of share-holders nor allows dissenters to claim repurchase of their shares by the company.

As mentioned above, it is very difficult to argue, much less prove anything, against the rationale or valuation of such transactions. But the equity market responded very negatively when the news of this proposal first broke in the media, prompting the management to seek investor feedback, and subsequently drop the transaction.

4. **Employee Bonus Share Issue – *Mediatek, Taiwan*:** This is an excellent example of managers exploiting specific loopholes in accounting practices to expropriate shareholders. I have used Mediatek's case to illustrate the practice since they took it to an extreme, and were probably responsible for focussing the market's attention on the issue earlier this year. However, almost all listed high-tech companies in Taiwan have been similarly diluting the non-management shareholders over the past several years in varying degrees.

   Employee bonus shares *per se* are not unique to Taiwan, but what is distinctive is that the Taiwanese GAAP (Generally Accepted Accounting Practices) requires companies to expense only the par value (usually NT$10) of such shares in the income statement. This allows companies to significantly mask the dilution and overstate accounting earnings.

   In April 2002, the Mediatek management announced that it would be granting 18 million shares (4.1% of total outstanding shares) to employees at the par value of NT$10 apiece as bonus for the past year. This price reflected a 98% discount to the prevailing market price of NT$447 (NT$626 adjusted for a 40% stock-dividend announced simultaneously). The NT$8.1bn imputed value of the employee bonus shares was 1.25x the entire net profit of NT$6.7bn earned by the company in FY2001, however only NT$180 million (18 million * NT$10) requires to be expensed. Before the October 2001 listing of Mediatek, employees had already been granted 12.3mn shares in 2000 and 12.5mn shares in 1999.

   The employee bonus shares do not entail a lock-in period and are subject to virtually no capital gains taxation. So the employees can (and probably most of them do) sell these shares soon after they receive them, pocketing the difference between the market price and par value. Thus, effectively the managers dilute the owners every year to pay executive compensation, the excessiveness of which is highlighted by the high market value of the compensation relative to the profit-after-tax for the company.

5. **Financial Distress Leading to Massive Dilution – *Hanvit Bank, Korea*:** Separation of ownership and control also encourages controlling shareholders' to increase financial risk levels in a firm. A controlling shareholder group may force a listed firm to undertake riskier projects so as to maximize the value or benefits to the group rather than the firm.

   In a difficult external environment, the higher risk levels may lead to financial distress or bankruptcy for the listed firm, resulting in significant dilution or complete loss of ownership for the non-controlling shareholders. On the other hand, the controlling shareholders most often manage to extract value at the group level even if an individual firm fails. Moreover, they may continue to reap private benefits from the control over the assets left in the firm long after the diminution of the cash flow benefits.

   I have picked a government-controlled bank in Korea to illustrate this category, with the intention to highlight that expropriation is not limited to private controlling shareholders. Often times, governments, with an eye on the broader social or economic agenda, end up compromising the interests of the non-controlling shareholders. In so many cases, risks or

concerns are downplayed and verbal, non-contractual assurances to investors reneged upon, as government-appointed management teams over-promise and under-deliver.

Following the Asian Financial Crisis in 1997-98, Hanvit Bank was created in a government-dictated merger between Commercial Bank of Korea and Hanil Bank in January 1999. Hanvit Bank became the largest domestic bank in the country after the merger. The government then sought to re-capitalize the bank in August 1999 with a US$1 billion offering to international investors in the form of GDRs. Brave claims and assurances by the management on the quality and thoroughness of clean up of Hanvit's balance sheet ensured that the GDR issue was successfully completed. Foreign shareholders owned about 12% of the company at the end of the first quarter of 2000.

However, following an unabated deterioration in asset quality and increase in loan losses, Hanvit Bank's entire capital was wiped out by year-end 2000. After formally effecting a 100% capital reduction and de-listing the stock, the government re-capitalized the bank with a W2.8bn injection of public funds.

Equity Market Response to Improper Dilution

Claessens et al. (2000) present evidence that group-affiliated firms whose ultimate owners have voting rights exceeding cash flow rights are on average valued lower than independent firms. The finding is consistent with the view that the anticipation of expropriation associated with group affiliation more than offsets any possible benefits of group membership.

Improper dilution can be regarded as the most severe of the three modes of expropriation, as it attacks on the very core of the relationship between a firm and its shareholders. In the first two modes – profit expropriation and tunnelling of assets – the expropriator deprives the non-controlling shareholder of economic benefits. However, by improper dilution, the expropriated shareholder not only loses economic benefits but more importantly, other ownership rights such as voting are also watered down even further.

Empirical evidence also suggests that a period of sustained stock price under-performance follows an incidence of improper dilution. In fact, the ensuing erosion in a firm's market value may significantly exceed the immediate dilution in economic benefits. This comes about as the market tries to price in the increased probability of future recurrence of such actions by the controlling shareholders.

Thus, in the equation $P = P/E * EPS$ (where P is stock price, P/E is the price to earnings ratio, and EPS is the earnings per share), not only does the EPS suffer an erosion, but the market also "de-rates" the P/E ratio attributed to the company.

Viewed differently, the market raises the implicit cost of equity financing for the firm, to account for the heightened risk of expropriation. Thus, future cash flows to equity investors are now discounted at a higher discount rate, resulting in lower present market value for the firm.

At the country or market level, when attributed to lacunae in the company or stock exchange laws or accounting standards, such instances tend to highlight the lack of protection for non-controlling shareholders. Thus, they may not only raise the cost of equity for a particular firm (in other words, de-rate its earnings multiple) but also do that for the country or market as a whole.

For example in Taiwan, the Mediatek employee share bonus issue brought to everyone's attention a practice that had long existed across the whole breadth of the local electronics sector. The investment community, particularly the foreign institutional investors and brokers, began focussing on the practice very closely, generating a slew of analyses on its dilutive

impact. It is difficult to attribute the specific quantum of the Taiwan market's sharp decline from April to September 2002 to this factor, given that the period also coincided with a global weakness in the technology sector. However, it clearly had an impact on the Taiwan market's rating, with the theme constantly coming up as a key concern about the market in recent months.

Usually, the market functions very effectively as a *post-facto* signaling mechanism. However, beyond that, the market can neither redress the affected non-controlling shareholders nor help prevent recurrence of such behavior on its own. Despite a previous history of expropriation, investors often return to a market or firm after the initial shock of expropriation has faded, driven by benchmark or risk-control constraints, lack of options in the local context, or simply a herd mentality. Cases abound when an upturn in the business cycle or improvement in operational fundamentals has led minority investors to ignore a prior history of expropriation to re-invest in a firm. Shinsegae Department Stores, one of the companies mentioned above, highlights an extreme case, where despite the improper dilution in Dec-01, the stock price continued to rise in the following months, peaking at a level 80% higher than that on the announcement date.

Extra-Legal Mitigation for Improper Dilution

Is legal armoring the only way to prevent such expropriation, or could any other factor(s) or force(s) be considered strong enough to dissuade the controlling shareholders?

A. Self-Regulation: The proponents of this school of thought argue that firms need repetitive access to capital markets and therefore realize the necessity to build a reputation for good corporate governance with investors. Thus, firms may try to reassure investors in several diverse ways that range from regularly interacting with minority investors and maintaining a good dividend policy, to listing ADRs to demonstrate their commitment to greater disclosure.

In a highly laudable but equally rare instance, a firm may voluntarily adopt a clause in its articles of association requiring approval by a majority of its shareholders for major strategic decisions including those relating to capital raising or other forms of dilution.

B. Influence by Large Non-Management Shareholders: It is quite common to see one or more foreign or domestic institutional investors holding a sizable chunk of a firm's equity alongside the controlling shareholder. Such investors are *passive* in most cases, meaning that they do not participate in the company's executive management or the board either voluntarily or are statutorily restricted from doing so. Similarly, vendors, customers, or overseas technology and marketing partners may also hold a stake in a firm.

Such institutional or strategic investors may have the ability to advise or influence the controlling shareholders against anti-minority actions, including expropriation. Following the Asian financial crisis in 1997-98, there have been several instances in the region where institutional investors have collaborated to challenge the controlling shareholder against actions detrimental to the firm's larger interests. The most obvious example would be Korea, where People's Solidarity for Participatory Democracy (PSPD), a not-for-profit organization, rallied minority shareholders against the excesses of the *chaebols* (large business groups, in Korean). Most foreign institutional investors, including Alliance Capital Management, the author's employer, lent their support to the minority shareholders' movement in Korea, voting against the management-sponsored resolutions in shareholder meetings.

C. Extra-Legal Suasion by the Government: Capital markets usually do not view direct government intervention in business very favorably. However, there may be special instances when blatant or significant expropriation threatens to hurt the reputation of the

whole market and the non-controlling shareholders have no recourse whatsoever. Thus, in an extreme situation, the government may step in directly to deter the errant management by threatening withdrawal of tax incentives or operating licenses.

Are such extra-legal measures effective under all conditions? Do they withstand conditions of stress, when the non-controlling shareholders' incentive to expropriate is the highest? Can they substitute legal and statutory protection for non-controlling shareholders?

The answer to the above questions is, unfortunately, a negative one, with powerful arguments that expose the weakness and limitations of extra-legal measures.

La Porta, Lopez-de-Silanes, Shleifer & Vishny (1998) emphasize the higher risk to non-controlling shareholders amongst all stakeholders of a firm. They point out that the outside investors are more vulnerable to expropriation, and more dependent on the law than either employees or suppliers, who remain continually useful to the firm.

Johnson & Shleifer (1998) argue against the ***efficacy of self-regulation*** that if a firm in a weak legal system promises to treat investors well but then suffers an adverse shock, the manager who controls the firm has an incentive to renege on this promise. They conclude that ultimately, the only way to enforce a contract between managers and shareholders is through legal action of some kind. For example, they make the point that ADRs may help companies opt into a regimen of greater disclosure, but they do not stop expropriation as long as it is disclosed.

In the absence of a strong legal framework, the continued ***effectiveness of large non-controlling shareholders in preventing expropriation*** is also highly questionable. If the law is weak, it is very likely that expropriation will be widespread across a particular market. Equally, without legal support, the financial, resource and opportunity costs of each campaign against the controlling shareholders are likely to be significantly higher. Even in Korea, which has one of the most successful records of minority shareholder activism in recent history, the role of new minority-friendly laws and regulations instituted after the 1997-98 financial crisis cannot be understated.

Finally, ***direct government intervention*** in private business is never a very desirable situation. Moreover, the temptation to repeat the one positive action can easily cross the thin dividing line to become repetitive interference. Johnson & Shleifer further underscore the risk by pointing out that governments may say that that they want to protect investors, but in a sharp downturn find that they would rather protect entrepreneurs as was the case in Malaysia.

Legal Approach Against Expropriation

As discussed above, negative equity market response is, by definition, a *post-facto reaction* to expropriation, doing little to forestall its occurrence or provide relief to the aggrieved investors. Similarly, extra-legal measures suffer from serious limitations in restricting and combating expropriation.

On the other hand, there exists substantial intuitive and empirical support for the legal approach against expropriation. The cornerstone of this approach is the existence of an effective legal and regulatory framework, comprising appropriate and clearly defined regulations and laws. This is a necessary but not a sufficient condition, though. Strong institutional support in the form of an impartial judiciary, a tough and fair capital market regulator, and alert stock exchanges is equally important, so that enforcement is at reasonable cost and within an acceptable time frame.

After studying a sample of 49 countries, La Porta and Lopez-de-Silanes (1998) conclude that in the absence of a good legal environment, countries cannot protect financiers against expropriation by controlling shareholders. Financiers are then reluctant to surrender funds in exchange for securities, and hence the scope for capital markets is limited. They emphasize their argument with evidence that bad legal institutions result in high levels of ownership concentration, low availability of external equity financing, narrow equity markets, and small debt markets.

In a more recent study using a sample of 539 firms in 27 wealthy economies, La Porta et al (2001) find evidence that poor shareholder protection is penalized with lower firm valuations, supporting the importance of expropriation of minority shareholders and the role of law in limiting such occurrences. This evidence is also consistent with the findings of a similar study conducted by Claessens et al (1999) on a sample of 2,980 large publicly listed firms in nine East Asian countries.

An effective legal system – comprising laws and enforcement – works both as a redress mechanism and a deterrent to expropriation in the long-term. This point is illustrated by La Porta, et al (2000), who argue that legal protection considerably reduces the efficiency of the expropriation technology. At the extreme of no investor protection, the insiders can steal a firm's profits perfectly efficiently. Without a strong reputation, no rational outsider would finance such a firm. As investor protection improves, the insiders must engage in more distorted and wasteful diversion practices such as setting up intermediary companies into which they channel profits. When investor protection is very good, the most the insiders can do is overpay themselves, put relatives in management, and undertake some wasteful projects. After a point, it may be better just to pay dividends. As the diversion technology becomes less efficient the insiders expropriate less, and their private benefits of control diminish.

Top-Down Approach to Prevent Improper Dilution

Corporate governance, to a large extent, is a set of mechanisms through which outside investors protects themselves against expropriation by insiders (La Porta et al). Thus, elements to prevent expropriation, and by extension, improper dilution, are integral to a broader legal and regulatory structure for good corporate governance.

The most important anti-expropriation tenet is the ***alignment of ownership and control***. Bebchuk et al. (1998) demonstrate that expropriation by controlling shareholders who have a small minority of the cash flow rights in their companies can be an order of magnitude larger than by controlling shareholders who hold a majority of the cash flow rights. All else being equal, the incentive to expropriate increases exponentially as the fraction of equity cash flow rights held by controlling shareholders decreases.

On the other hand, when control is proportionate to ownership, it becomes significantly more expensive for the largest shareholder to acquire and retain control of a firm. Not only that, the market-value-at-risk for the controlling shareholder also becomes much higher in the face of a negative equity market response to expropriation. Thus, there is a far greater incentive for the controlling shareholder to pay dividends than expropriate in such a situation.

The common arrangements used for separating control from cash flow rights include pyramidal holding structures, cross-ownership, and issuance of dual-class equity.

- A pyramidal holding structure is constructed with a controlling stake in a holding company that, in turn, holds a controlling stake in an operating company either directly or through one or more tiers of similar holding companies. Pyramids are the most commonly used mechanism for concentrating control.

- A cross-ownership structure is created when two or more companies with a common largest shareholder also own shares in one another, thus reinforcing the control of the central shareholder. The popularity of cross-ownership structures in emerging markets is largely attributable to their ability to make the control structure much less transparent.

  The strongest argument in support of the pyramidal and cross-ownership structures is that they help establish *internal capital markets* within business groups to allocate scarce capital in less-developed financial markets. Such internal markets can overcome informational asymmetries involved in the selection of valuable new projects more easily than external markets. However, Claessens et al. (1999) argue that because investment projects funded by internal markets are subject to much less external monitoring, firms or groups may use them to fund high-risk activities that are more difficult to finance independently. Their findings suggest that such structures lead to lower profit margins and lower valuation for firms in less-developed countries, which is exacerbated during periods of economic downturn.

- Issuance of two (or more) classes of shares with differential voting rights is the simplest way to separate ownership and control and the only one where creation of multiple firms is not required (Bebchuk et al., 1998). Despite its simplicity, dual-class equity issuance is popular mostly in Latin America. A major reason is that the corporate law in many countries restricts both the voting ratio and the numerical ratio between the different classes of shares. In most other markets, as foreign ownership restrictions get relaxed with time, a key reason behind the existence of multiple-class shares is losing its relevance.

To sum up the debate, continuing academic investigations in the past decade have presented strong evidence that separation of ownership and control creates significant incentives for expropriation without any meaningful offsetting efficiencies. Thus, there seems to be increasing pressure worldwide to dismantle such arrangements.

In Asia, one of the key corporate law reforms in Korea following the 1997-98 financial crisis was the elimination of cross-ownership between *chaebol* companies. Similarly, the company law in India was changed to prohibit holding companies from being subsidiaries. In Taiwan, cross-holding and pyramid linkages are allowed but now require mandatory disclosure. Clearly, these are only small victories, and leave plenty of scope for follow-up measures like an outright ban on pyramid structures or an indirect deterrent like inter-corporate taxation to discourage pyramids and cross-ownership.

A ***strong, independent board of directors*** is another key pre-requisite for prevention and redress of expropriation and other agency problems. The OECD Principles of Corporate Governance (1999) carry a comprehensive list of the functions and responsibilities of the board.

However, the credibility of the board may be compromised if its composition does not adequately reflect minority interests. In the absence of *cumulative voting*, each board member is appointed by a separate majority vote of all shareholders, resulting in the controlling shareholder effectively deciding on all appointments to the board.

Thus, in several cases the "independence" of even the independent, non-executive directors may be questionable. This has important implications for monitoring and preventing expropriation, as mechanisms such as an audit committee set up to review related party transactions are rendered meaningless if the spirit of independence is not followed.

Finally, ***timely and accurate disclosure*** on all material matters is also critical in forestalling expropriation. Again, the OECD document has a fairly exhaustive list, but from an expropriation standpoint, regulations should be in place to ensure disclosures on (i)

transactions with related parties, (ii) off-balance sheet liabilities, commitments and transactions, (iii) cross-ownership and pyramid relationships, (iv) board and executive remuneration, particularly stock bonus and options, and (v) material financial, operational, and regulatory risk factors. Clearly, fair, timely and cost-efficient dissemination is as important as the information content itself.

Specific Anti-Improper Dilution Measures

In the previous section, I have highlighted the elements in a comprehensive super-structure of good corporate governance that are directly relevant to improper dilution of non-controlling shareholders. To recapitulate, ownership and control rights in a firm need to be aligned by abolition of cross-ownership, pyramidal and dual-class share arrangements. A cumulative voting system should be adopted to ensure fair representation for minority shareholders on the board, thereby strengthening the board's strength and independence. Timely and accurate disclosure on all material issues should be made mandatory so as to help reduce the unfair informational advantage of the insiders.

In addition, the following specific measures are also very important in curbing improper dilution:

- **Pre-emptive Rights:** Shareholders should have pre-emptive rights by law. This simply means that existing shareholders should have the first opportunity to purchase securities, including common shares, convertible securities, warrants, and voting preferred stock, before they are offered to anyone else and at terms at least as favorable. These rights should be in proportion to their percentage of ownership, and must be transferable. The pre-emptive rights do not apply to issues of stock to employees or to treasury stock held for subsequent resale.

- **Accounting Practices:** It is very important that local accounting practices measure up to international standards and enable an accurate reflection of the financial status of firms. The Mediatek example in an earlier section highlights that the accounting practices in Taiwan are probably more to blame for allowing and in fact, indirectly abetting improper dilution.

- **Oppressed Minority Mechanisms:** Judicial venues should be available to non-controlling shareholders to challenge the management decisions, in case they believe that their interests are being compromised. For example, shareholders can file a class action suit in the US or petition the courts or the company with a complaint. Similarly, in Korea, non-controlling shareholders have a legal right to exit the firm by requiring it to purchase the minorities' shares when they object to fundamental changes such as mergers and asset sales.

Concluding Remarks

To sum up, expropriation, which can take several forms including improper dilution, is a widespread occurrence across capital markets. The problem is particularly acute in emerging markets due to the greater prominence of large, family-controlled groups in private businesses. Most often, extra-legal measures tend to be inadequate and ineffective in both redress and prevention of expropriation, underscoring that strong legal support is necessary and non-substitutable.

Strong securities, company and bankruptcy laws and high accounting standards underpin a good legal system, but institutions and mechanisms to enforce them are equally important. La Porta and Lopez-de-Silanes (1998) go to the extent of arguing that investors may enjoy high

levels of protection despite bad laws if an effective judiciary system can redress expropriations by management.

The government's institution-building policy should not only focus on the creation and development of stock exchanges, legal infrastructure, and regulatory agencies, but also ensure their *efficiency* and *integrity*. An inefficient enforcement structure significantly increases the financial and opportunity costs for the aggrieved party, encouraging poor governance and expropriation. Similarly, corruption and political influence inevitably undermine the credibility of any legal system.

Finally, for most countries, the improvement of investor protection requires radical changes in the legal system. However, the political opposition to such change has proved intense. Governments are often reluctant to introduce laws that surrender to the financiers the regulatory control they currently have over businesses and corporations. Important objections to reform also come from the families who control large corporations. What the reformers see as protection of investors, the founding families call "expropriation of entrepreneurs". But consistent with the dominance of special group politics, successful reforms have occurred only when the special interests could be destroyed or appeased. (La Porta et al., 2001). Again, a good example is Korea, where the 1997-98 financial crisis had crippled many of the large *chaebols*, which provided the then newly elected Kim Dae Jung government the perfect opportunity to push through powerful corporate and financial reforms.

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