

Nonprofit Organizations  
as Investor Protection:  
Explaining the Puzzle of Corporate  
Law Enforcement in East Asia

RIETI Conference

Jan. 8-10, 2003

Curtis J. Milhaupt

Columbia Law School

# The Puzzle of Corporate Law Enforcement in East Asia

- Why are nonprofit organizations (NPOs) playing the lead role as corporate law enforcement agents in Korea, Taiwan, and Japan?
- NPOs are bound by the nondistribution constraint.
- This form of direct shareholder activism by NPOs is not observable anywhere else in the world.

# Relevance

- Corporate governance literature
  - Quality of law enforcement is a key variable in investor protection (LLSV 1997, Black 2001)
  - Convergence/diversity: formal vs. functional convergence (e.g., Gilson 2001)
- Corporate governance reform: how to solve the problem of weak enforcement? (e.g., Black & Kraakman 1996; Coffee 2002)



# Why is improving investor protection so difficult?

## Corporate Law Enforcement as a Public Good

- Specific deterrence
- General deterrence
- Clarity of the common law



# The Under-Production of Corporate Law Enforcement in East Asia

- High statutory thresholds and economic risks of exercising shareholders' rights
- Network shareholding structures and passive domestic institutional investors
- Weak institutional infrastructure for private law enforcement
- Constraints on state enforcement

# Illustration: Shareholder Derivative Suits in Japan, Korea, and Taiwan

Date of enactment of shareholder derivative suit procedure – 1990			1991-2000
Japan	(1950)	20	494
Korea	(1962)	0	12
Taiwan	(1966)	0	0

# Where NPOs Fit: Theory

- Demand-Side Theory: NPOs emerge to fill gaps in supply of public goods created by government and market failures (Weisbrod 1977)
- Contract Failure Theory: NPOs economize on costs of writing and enforcing contracts to supply public goods where consumers cannot evaluate quality (Hansmann 1980)
- Supply-Side Theory: NPOs need supply of “social entrepreneurs” (James 1987)

# Predictions from Theory

- Corporate law enforcement/investor protection could be a fertile area for the emergence of NPOs.
- NPOs should be most successful where there is an existing stock of high-quality social entrepreneurs, or where the state entrusts NPOs with supplemental enforcement role.

# Applying the Theory to East Asia

- Spontaneous emergence of an investor protection NPO in each of the three systems to supply corporate law enforcement-related public goods
- Differences in organizational structure, strategy and success generally consistent with theory, and demonstrate relevance of local law and politics

# Korea: PSPD (PEC)

- Filed suit on behalf of numerous plaintiffs in two historic court decisions on managerial responsibility
- Fought irregularities in shareholders meetings
- Lobbied for passage of class action procedure
- Filed shareholder proposals and proxy solicitations

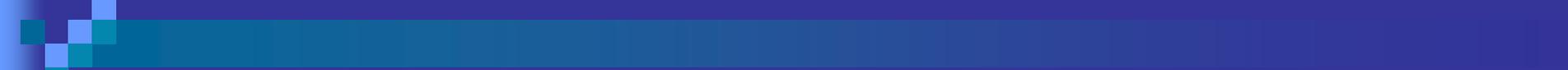
# Japan: Shareholders Ombudsman

- Obtained large monetary settlements in a number of cases
- As part of settlement, obtained commitments from management to improve governance
- Filed shareholder proposals
- Lobbied for passage of whistle blower statute



# Taiwan: Securities and Futures Institute

- Organized de-facto class action suits on behalf of thousands of small investors in securities and corporate fraud cases
- Filed numerous disgorgement actions against managers for short-swing trading profits



# Implications

- For Comparative Corporate Governance Debate
- For Corporate Governance Reform

# Corporate Governance Debate

- Novel enforcement mechanisms are possible, even where corporate law is “weak”
- Novel illustration of spontaneous, functional convergence in corporate governance
- But deeper analysis reveals continued diversity among the three NPOs tied to local history, law and politics

# Corporate Governance Reform

- NPOs may be partial solution to under-enforcement problem in transition economies (esp. China)
- NPOs may be better solution to under-enforcement problem than U.S.-style attorney incentives, due to built-in constraint against frivolous litigation
- NPOs *improve* local enforcement regime, while “bonding” through cross-listing or “self-enforcing” corporate law may accelerate hollowing out of domestic enforcement regime