

European Master in Law and Economics



**Minority foreign ownership of Filipino-
controlled corporations:
An exploratory study**

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Authorship declaration

I hereby declare and confirm that this thesis is entirely the result of my own work except where otherwise indicated. I have acknowledged on page iii the supervision I received from Prof. Ronald J. Gilson.

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Acknowledgment and dedication

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Oriolo Romano is a laid-back *comune* located just 40 km. northwest of Rome. I thank my aunt, Emilie Ricerra, for letting me write a major part of my thesis there. The food was abundant and sumptuous. The cool temperature inside her 400-year-old abode made me survive the near-tropical conditions in Italy at this time of the year.

I dedicate this to my family and friends.

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Abstract

Corporate governance has been a staple topic in the law-and-finance literature recently. The focus has traditionally been on the divergence of interests between shareholders and management. This paper instead examines the conflict between minority and controlling shareholders. It grounds itself firmly on the institutional environment where the analysis takes place—in this case, the Philippines and its legal and corporate dynamics. The conditions that determine the interaction between a family-based controlling shareholder and a minority foreign shareholder are articulated here. The main result is that it is not essentially the identity of the shareholder that matters but, rather, the main determinant of her behavior is the institutional milieu in which she locates herself: whether it allows for collusion with the controlling shareholder and whether the expropriation of the minority is relatively facile.

JEL Classification: G32, G34, K22, N25

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Perhaps the sentiments contained in the following pages, are not yet sufficiently fashionable to procure them general favor; a long habit of not thinking a thing *wrong*, gives it a superficial appearance of being *right*, and raises at first a formidable outcry in defence of custom. But the tumult soon subsides. Time makes more converts than reason.

— Thomas Paine (1776), *Common Sense*, Introduction

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1 Introduction

The explosion of research¹ on corporate governance in the 20th century—particularly in the 1990s—has overshadowed the fact that corporations have been the subject of economics as early as 1776 when Adam Smith explicitly recognized the fundamental agency problem that arises in a contractual relationship between directors and contributors of capital. In modern terms, the conflict has been recast as the “separation of ownership and control” [Berle and Means 1932], which is a direct consequence of a contractarian construction of the corporation [Jensen and Meckling 1976; Easterbrook and Fischel 1991; Shleifer and Vishny 1997]. The terminology might not have existed two centuries ago but it is obvious that Smith [1776] contemplated the inevitable bifurcation of the interests of shareholders and management: “[directors] are apt to consider attention to small matters as not for their master’s honour”. In more familiar terms, this is a variant of the classical principal–agent relationship.

Recently, a different class of principal–agent relationships within a corporation has received well-deserved attention: the relationship between differ-

¹ For comprehensive surveys, see Shleifer and Vishny [1997] and La Porta *et al.* [1999].

ent types of shareholders, particularly the relationship between a controlling shareholder and minority shareholders which is arguably more important than the traditional (i.e., shareholder–manager) agency model if only because of the global prevalence of this type of ownership structure [La Porta *et al.* 1999]. In this case, the class of minority shareholders and the controlling shareholder are thought to be the principal and agent, respectively.

Principal–agent relationships entail “agency costs”, which is the sum of “(1) the monitoring expenditures by the principal, (2) the bonding expenditures by the agent, (3) the residual loss” [Jensen and Meckling 1976:308]. Monitoring² expenditures include everything that the principal undertakes to ensure that the agent performs in the interest of the former. Bonding expenditures are guarantees that the agent provides to the principal. The guarantee is forfeit to the principal if the agent is discovered to misbehave. Finally, the residual loss is the cost of the difference between any decision taken by the agent that does not maximize the welfare of the principal.

The dispersed-ownership model of the modern corporation [Berle and Means 1932] is a phenomenon peculiar to the US³ and the UK: it is “the rarest of curiosities” [Morck *et al.* 2005:657]. Public and private companies in the rest of the world are characterized by concentrated ownership. In continental Europe⁴, the State and other large institutions own a controlling stake [Becht *et al.* 2005]. In

² The term “monitoring” is deceptively simple. It actually encompasses multiple dimensions. Consider, for example, this excerpt from Dixit [2004:17]: “Some or all of the agent’s action and cost and the principal’s gain may be observable only to the person in question, or observable to both parties but not provable or verifiable to outsiders, or verifiable to some industry experts but not to the general public including officials of state law.”

³ The US has also been observed to have a non-negligible number of group-controlled companies. This is largely made possible by pyramidal ownership and the issuance of dual-class shares. [Villalonga and Amit 2007]

⁴ Italy is exceptional considering the strong presence of the Agnelli business group. [Morck *et al.* 2005]

Japan, banks play a decisive role in the *keiretsu*⁵ while a majority of corporations in the developing world is family-controlled [Claessens *et al.* 2000; Unite and Sullivan 2002].

The most prevalent explanation for this phenomenon is that minority shareholders are afforded less legal protection outside the Anglo-Saxon world [Shleifer and Vishny 1997; La Porta *et al.* 1998]. An existing controlling shareholder will not relinquish control for fear of expropriation by a possible new controlling shareholder. Only when adequate minority-shareholder protection is in place will a controlling shareholder contemplate reducing her control. By this account, the world is then split into two parts: one part has mechanisms in place to protect a minority shareholder and the other does not. In the former, dispersed ownership is observed while in the latter, controlling shareholders.

This dichotomy is inadequate because it fails to take into account jurisdictions where minority shareholders are not oppressed but where a number of corporations have a controlling shareholder (e.g., Sweden, Canada, Australia, and New Zealand). Gilson [2005] highlights this and offers a finer framework in which to filter ownership structure. The distinction turns on whether the country has a “functionally good law” or a “functionally bad law”. The former allows for both a widely-held corporation and a majority-controlled corporation while the latter only allows for concentrated ownership.

1.1 Problem statement

In Gilson [2007], a family-controlled corporation is rationalized by appealing to reputation effects in a product market that is characterized by relationship-based

⁵ A *keiretsu* is a business group with cross-shareholdings typically with a large bank providing internal financing to all members of the group. The prototypical example is the Mitsubishi group, with the Bank of Tokyo-Mitsubishi UFJ as the lead bank.

exchange. When institutions that support anonymous market transactions are not in place, exchange is made possible by the goal of a family to either preserve its good reputation or to create one. This is done ultimately to maximize utility, pecuniary or otherwise. To the extent that behavior in the capital market can be observed, recognized, and subsequently punished by the corporation's clients or suppliers in the product market, self-enforcing exchange is more likely to prevail, where "parties perform their contractual obligations because it is in their self-interest to perform, not because of the threat of legal sanction" [Gilson 2007:4].

It is plausible that this reputation effect explains the reason why some level of minority shareholdings in a publicly listed corporation is observed. The existence of minority shareholders can act as a signal to other investors and clients that the family, through its control of the company, does not extensively—if at all—engage in activities that solely generate private benefits of control [Gilson and Gordon 2003]. If the family does not expropriate minority shareholders, so the reasoning goes, the implication is that it will not take advantage of other stakeholders, which particularly includes consumers of the company's products and services.

The question explored here is whether the composition of the group of minority shareholders has any effect at all on the performance of the firm. If the family maintains effective control over a company because of pecuniary and non-pecuniary benefits of control, and that it allows some level of minority shareholders due to reasons of reputation, does it matter who these shareholders are? Do foreign minority shareholders have any palpable effects at all in the conduct of the corporation? In other words, if there are two corporations with comparable characteristics except that one has foreign shareholders and the other does not, does

the former perform better than the latter? If so, what are the dynamics that allow this to happen?

Foreign shareholders are typically assumed to be sophisticated investors. Otherwise, they would not invest in companies listed in a foreign stock exchange. The likelihood that, say, an American citizen, company, or private-equity group would invest in a foreign stock market on a whim is negligible because of the transaction costs that she or it will have to overcome. Thus, most investments are domestic. This is an empirical regularity called the “home bias” [van Nieuwerburgh and Veldkamp 2007]. The image of a foreign investor who consciously chooses to diversify risk because she has surmounted the informational barriers and other transaction costs involved in making out-of-country investments is more plausible. To do that, she must be a capable and active investor.

The foreign investor may or may not have a general idea of “good” corporate governance. Even if she does, there is no *a priori* reason to expect her to demand that the company in which she invests institute a good corporate-governance regime. Consider the following scenario: a foreigner may buy minority shares in a corporation that operates in an environment with poor minority-shareholder protection as long as she can strike up an agreement with the controlling shareholder to expropriate other minority shareholders. Alternatively, if she believes that good corporate governance will increase the value of the firm such that the marginal benefit that accrues to her as a shareholder is greater than the marginal benefit she can commandeer (with the connivance of the controlling shareholder) from other minority shareholders, then she may insist on best practices around the world to operate in her chosen enterprise.

The task at hand is to develop a plausible narrative regarding the behavior of foreign shareholders. Gilson [2005] fine-tunes the taxonomy of the law-and-finance literature that derives from La Porta *et al.* [1998] and La Porta *et al.* [1999]. To build upon that work, distinctions based on where the minority shareholders come from are made. The hope is that a framework of analysis can be constructed that can explain shareholder behavior in a specific institutional regime better than the currently available apparatus.

1.2 Relevance

An economy that is supported primarily by relationship-based exchange is constrained. It cannot expand beyond a certain upper bound. In the absence of certain institutions that support anonymous exchange, transaction occurs with the familiar because the familiar bears trust and, perhaps more importantly, if this trust is violated, the violator can be punished. The parties with which one is familiar are only a small subset of the multitude of agents that participate in a full-fledged market economy. When the stability of anonymous market transactions is in doubt, economic agents are left with a much narrower scope for exchange. The implication for the national economy is a growth trajectory that is less than potential because of the limited opportunities.

Anonymous market transactions are not prevalent in a jurisdiction with bad commercial law. “Bad law” is more than the idea that the law on the books is poorly crafted. The term encompasses a much wider set of characteristics. Bad law also means poor or non-enforcement of the law and unpredictability of outcomes. This situation might materialize due to a number of factors (e.g., the incompetence of the judiciary and legislators, and straightforward corruption).

Having bad law means that there exists a poor institutional regime that cannot support the extensive anonymous exchange observed in developed countries.⁶

It is perhaps self-evident that “[m]arkets rest upon institutions” [Grief 2005]. Absent good institutions, market expansion is impeded. Bad commercial law inhibits economic growth because the consumer cannot turn to the judicial system to enforce a contract. Even in case of a breach, she is not sure that she will be compensated. If the legal mechanisms are not reliable, she relies on her own capacity to punish but the range of partners that she can credibly threaten is limited. “When institutions are weak, doing business with strangers is dangerous and unreliable. This impedes the operation of labor, capital, knowledge, and product markets.” [Morck *et al.* 2005:672] Thus, it is important for a developing economy to transition into one where good institutions prevail such that an expanded choice set is available to the consumer.

The absence of good institutions does not mean no transaction takes place. There is still the set of relationship-based transactions, which is expanded further if it is supported by a reputation market. A corporation, for example, builds a good reputation to signal to its consumers that it is a reliable exchange partner. This means that transactions do not necessarily have to occur between the same parties in a repeated exchange. If the information is relatively mobile and acquisition is cheap, other consumers can evaluate the company and transactions do not have to be repetitive. However, for as long as the market depends upon this type of signaling, the economy is handicapped. [Gilson 2007]

⁶ In this sense, a legal realist’s view of the law is taken, which was also explicitly taken by Gilson [2005:14]. This framework is reinforced since the subsequent analysis takes place in countries where, even if the law is clear-cut, the legal institutions that are arguably already weak are still persistently undermined.

If they know they are being exploited, minority shareholders are likely to protest against the actions of the controlling shareholder. Since foreign shareholders are assumed to be more informed than domestic shareholders, they will probably notice any expropriation by the controlling shareholder ahead of any other minority shareholder. When a company has foreign shareholders concerned with good corporate governance, better performance may be observed because the controlling shareholders would rather keep these sophisticated investors confident in the conduct of the business. Otherwise, the foreign shareholders are expected either to publicize the mishandling of the company or pull out their investment, both of which are signals to the wider investing public that the controlling shareholder is misbehaving. If this misbehavior is known, consumers are likely to lose trust in the company and refuse to transact with it.

An alternative and equally plausible scenario, especially in countries such as the Philippines⁷, is a foreign shareholder and the controlling shareholder that collude to extract private benefits of control at the expense of other minority shareholders. This may happen if domestic investors are either unable to overcome collective-action problems that prevent them from acting against oppression or are oblivious to the fact that they are being oppressed. If domestic investors are less likely to have the financial resources to publicize such oppression or if they are less credible in the eyes of the public vis-à-vis foreign shareholders, then misbehavior in the capital market may go unpunished.

The two alternative scenarios—foreign shareholders positively influencing the behavior of the controlling shareholder and foreign shareholders colluding with the controlling shareholder—have important micro- and macroeconomic ef-

⁷ The Philippines, along with many other countries in East Asia, South America, and continental Europe, have been described as having weak minority-shareholder protection [La Porta *et al.* 1998].

fects for a nation's economy. Depending on which situation obtains, the capital market may either properly allocate or misallocate resources, innovation may either be fast or slow, inequality may either fade away or persist, and economic growth may accelerate or not [Morck *et al.* 2005]. The significance of this is magnified for developing countries because it ultimately boils down to the million-dollar question: Why are some countries rich and others poor? Firm-level dynamics, partly determined by governance mechanisms in place, significantly affect national progress. Policy prescriptions targeting corporations and their governance have eventual economy-wide effects.

1.3 Scope and limitations

The discussion is largely limited to dynamics in the Philippines. Due to time and data constraints, technical and statistical acrobatics are not performed but this should not diminish the importance of such techniques or of the current endeavor. The study is exploratory in nature. It may seem like groping in the dark simply to get a feel of the corporate-governance landscape but perhaps the more appropriate analogy in this case is that of shining a flashlight in a dark room to see pockets of clarity in an otherwise obscure environment. The good thing is that we have taken the first step here and, fortunately, *alle begin is moeilijk*⁸.

1.4 Roadmap

The rest of the paper is organized as follows. The next section is a necessary digression to understand the overall framework of the paper. The concept of a corporation as a nexus of contracts and a basic but generalizable principal-agent

⁸ Dutch; "The first step is the hardest."

model are discussed. The model is then recast in terms of the problem at bar. Section 3 is a review of selected works on similar topics and an explanation of the contribution of the current paper to the literature. Next, the texture of the Philippine legal system is presented with respect to foreign equity and minority shareholders. The ownership of companies in the Philippines and their observed trends are also examined. In section 5, the conceivable behavior of a family-based controlling shareholder and foreign shareholders is discussed in light of the previous sections. Finally, the paper is summarized and conclusions are presented. Avenues for future research are also outlined.

2 Side trip: Of nexus and models

To make adequate sense of much of the material in the corporate-governance literature, one must either consciously accept the view that the firm is a nexus of contracts or at least be critically aware of it even when some authors are not explicit. This section elaborates on this concept to contextualize the rest of the paper. A simplified version of a typical principal–agent model is subsequently offered. Finally, fluidity is ensured by applying the model to underscore the problem.

2.1 The corporation as a nexus of contracts

Coase [1937] launched modern economic studies of the firm with the publication of his seminal article, *The Nature of the Firm*. Coase [1937:390] conceptualizes the firm as an alternative to the price mechanism in organizing production. The firm exists when the marginal cost associated with transactions using the market are higher than the associated cost in coordinating production within the organization. The firm itself is simply a product of the contracts that exist between and

among, for example, shareholders, managers, and employees. Alchian and Demsetz [1972] follow through with this contractarian view and emphasize the role of a “centralized contractual agent in a team productive process”.⁹ The person who plays this central role has a certain bundle of rights:

It is this entire bundle of rights: (1) to be a residual claimant; (2) to observe input behavior; (3) to be the central party common to all contracts with inputs; (4) to alter the membership of the team; and (5) to sell these rights, that defines the *ownership* (or the employer) of the *classical* (capitalist, free-enterprise) firm. The coalescing of these rights has arisen, our analysis asserts, because it resolves the shirking–information problem of team production better than does the non-centralized contractual arrangement. [Alchian and Demsetz 1972:125]

Alchian and Demsetz [1972] bridges the conceptual gap—in a sense, serving as a halfway house, at least chronologically if not substantially—between the overlapping concepts of the “firm” [Coase 1937] and the “corporation” [Jensen and Meckling 1976; Easterbrook and Fischel 1991]. Fundamentally, the former is an alternative way of organizing production vis-à-vis the market mechanism while the latter is an artificial legal concept. As such, the corporation cannot be fully understood when the analysis is conducted without regard to its legally prescribed characteristics. These general characteristics are identified as: “(1) legal personality, (2) limited liability, (3) transferable shares, (4) centralized management under a board structure, and (5) shared ownership by contributors of capital.” [Hansmann and Kraakman 2004:5] These features are present, whether conspicuously or in the background, in recent descriptions¹⁰ of the corporation. In a sense,

⁹ They do have a glaring objection to Coase: “It is common to see the firm characterized by the power to settle issues by fiat, by authority, or by disciplinary action superior to that available in the conventional market. This is delusion.” [Alchian and Demsetz 1972:777] This idea is in stark contrast to the internal operation of the firm as conceptualized by Coase [1937:387]: “If a workman moves from department *Y* to department *X*, he does not go because of a change in relative prices, but because he is ordered to do so.”

¹⁰ See, for example, Jensen and Meckling [1976], Easterbrook and Fischel [1991], and Kraakman *et al.* [2004].

the corporation is the legal extension of the firm in economics. Both are portrayed as nexus of contracts¹¹.

This construction is explicitly accepted by the Philippine Supreme Court (SC). In *Gokongwei v. SEC* [1979], the SC said, quoting *Thompson on Corporations*:

Any person “who buys stock in a corporation does so with the knowledge that its affairs are dominated by a majority of the stockholders and that he impliedly contracts that the will of the majority shall govern in all matters within the limits of the act of incorporation and lawfully enacted by-laws and not forbidden by law.” To this extent, therefore, the stockholder may be considered to have “parted with his personal right or privilege to regulate the disposition of his property which he has invested in the capital stock of the corporation, and surrendered it to the will of the majority of his incorporators. ... It cannot therefore be justly said that the contract, express or implied, between the corporation and the stockholder infringed...by any act of the former which is authorized by a majority.”¹²

Among the various contracts that bring to life a corporation, the academe has concentrated on the contractual relationship between the shareholder and the manager. The dynamics between management and finance is a cornerstone of the literature—an intersection of contract theory, the economics of information, and the theory of incentives. All together, the relationship has been depicted as one between a principal (i.e., shareholders) and an agent (i.e., managers).

The “shirking–information problem” noted by Alchian and Demsetz [1972:125] constitutes the core of the agency dilemma when control is divorced from ownership. The basic idea is as follows. In a world where a fully specified contingency contract is impossible (contract theory), a contract between shareholders and management will necessarily entail gaps and afford managers some

¹¹ This concept of the firm, although dominant and has a substantial explanatory power, has not entirely been unassailed. “A generation of scholarship...suggests that the contractarian theory is not, and never was, an accurate description of reality or a basis for policy prescription.” [Klausner 2006:781] For example, “[t]he problem was that the nexus metaphor did not support the notion that the corporation was something that could be ‘owned.’” [Blair and Stout 2006:479]

¹² *John Gokongwei, Jr. v. Securities and Exchange Commission, et al.*, G.R. No. L-45911, 11 April 1979.

latitude, which they can either use to shirk or not. Monitoring is too costly and, thus, not everything can be known to the shareholder or even if everything can be observed, it may not be understood (economics of information). The combination of incomplete contracts and asymmetric information creates an opportunity for the manager-agent not to act in the interest of the shareholder-principal but rather, in her own interest. The solution is to create incentives to re-align the objective of the agent with that of the principal (theory of incentives). The culmination of this is the intellectual triumph of the now-dominant principal–agent model in studies of corporate governance.

2.2 A basic principal–agent model

A principal–agent relationship arises when an agent acts on behalf of the principal. It becomes problematic when information is distributed asymmetrically. The model used in this situation is powerful and can be applied to a wide class of similar situations, including the type of relationship in a corporation that is of current interest: the one between a controlling shareholder and a minority shareholder. Elements of a canonical model¹³ are presented here, keeping in mind that while it is not fully elaborated, it reveals the general problem encountered with the kind of relationship that exists in many real-world contractual arrangements, of which dynamics within a corporation is merely a small fraction.

Consider a bilateral relationship with self-interested participants whom shall be called the principal and the agent, with respective state-independent von Neumann–Morgenstern utility functions $B(\cdot)$ and $H(\cdot)$ that are assumed to be

¹³ The model that is presented is a simplified combination of Ross [1973], Holmström [1979], Grossman and Hart [1983], and Macho-Stadler and Pérez-Castrillo [1997]. As this section only serves to illustrate the problem, there is no need to derive the optimal contract and discuss its properties here. For that, the reader can consult the references already mentioned in this footnote, as well as Mirrlees [1999] and Holmström [1977].

maximized under uncertainty and further characterized below. The agent can exert an effort level, e (unobservable or at least non-verifiable from the point of view of the principal), where $e \in E$, the set of all feasible effort levels, which is a non-empty and compact subset of \mathcal{R} , the set of real numbers. The payoff, x , from the effort level exerted is also a function of the random state of the world, θ , which is unknown to the agent and the principal.¹⁴ Thus, $x(e, \theta)$, where $x \in X$, the payoff set ($X \subseteq \mathcal{R}$), and $\theta \in \Theta$, the state set; x is observable to both parties *ex post*. The fact that θ is a random variable implies that x is also a random variable. Denote the probability of result x_i occurring as $p_i(e)$ —that is, x_i is conditional on e . If the members of X are discrete¹⁵, then $\sum_{i=1}^n p_i(e) = 1$. Assume that x is increasing in e .

This situation creates a problem. For the agent, her best efforts may be rendered naught because of some arbitrary θ_i , which is outside her control, that reduces x . The agent who exerts a low level of effort can claim that the outcome was simply the result of bad luck. Similarly, when the outcome is good, the agent can claim it was entirely the result of her own efforts when, in reality, it happened by chance. For these reasons, the principal faces a problem in designing the contract to ensure that the agent acts appropriately. At this stage, the principal incorporates the “participation constraint” of the agent: this is the condition that must be satisfied by the contract for it to be accepted by the agent. She will only accept it if her expected utility is greater than her reservation utility¹⁶, which is fixed by the labor market [Macho-Stadler and Pérez-Castrillo 1997]. A discussion of this problem is

¹⁴ Although θ is unknown to the principal and the agent when an effort level e is chosen, it is assumed that both have the same prior beliefs over its probability distribution.

¹⁵ $X = \{x_1, \dots, x_n\}$. For convenience, $x_1 < x_2 < \dots < x_n$.

¹⁶ The reservation utility is the utility that may be derived if the agent refuses to accept the contract and, instead, pursues the next-best opportunity in the labor market.

reserved. Instead, the strategic behavior of the agent is elaborated, which is more in line with the theme of this paper.¹⁷

There exists a wage, $w \in W \subseteq \mathcal{R}$, to be paid by the principal to the agent for the services rendered by the latter.¹⁸ This is a function of θ and e but assume that e can only affect w through x . Hence, $w = w[x(e, \theta); \theta]$.

Assign an additively separable utility function to the agent, $H(w, e) = U(w) - V(e)$, where $U: W \rightarrow \mathcal{R}$ (the utility derived from w) and $V: E \rightarrow \mathcal{R}$ (the disutility derived from e). Consequently, $H: \mathcal{R}^2 \rightarrow \mathcal{R}$. The principal is concerned only with the net payoff—that is, the payoff minus the wage—which is denoted as $p \in P \subseteq \mathcal{R}$ so the utility function of the principal is $B(p): P \rightarrow \mathcal{R}$. Assume that the utility functions are continuously differentiable [Weisstein 2007]. Specifically, the functions exhibit the following properties: $B'(p) > 0$, $B''(p) \leq 0$, $H_w > 0$, $H_{ww} \leq 0$, $H_e < 0$, $H_{ee} \leq 0$, where subscripts indicate partial derivatives.

The optimization problem of the agent can be expressed as follows:

$$(1) \quad \max_{e, \theta} \mathbb{E} H\{w[x(e, \theta)], e\} = \sum_{i=1}^n p_i(e) U(w) - V(e).$$

Here, \mathbb{E} is an expectation operator (not the effort set, E). The agent maximizes her expected utility, which is a positive function of the wage she receives and a negative function of the effort she exerts. Denote e^0 as the effort level that solves (1); it is conditional on the wage agreed upon in the prior bargaining process. Implicitly, there exists some correspondence $\pi: W \rightarrow E$.

For the risk-neutral principal, the problem is to maximize B :

$$(2) \quad \max_w \mathbb{E}_\theta B[x(e, \theta); w] = x - w.$$

¹⁷ The interested reader can consult Holmström [1977].

¹⁸ This is a result of a prior bargaining problem between the principal and the agent.

Her utility is a positive function of the payoff and a negative function of the wage she has to pay to the agent. This is subject to the participation constraint of the agent discussed earlier.

The problem is now evident from the objective functions: the agent is directly concerned only about her wage and the effort she exerts while the principal is directly affected only by the net payoff. The source of the problem is the unobservability of the supply of the productive input—the effort level—and the assumption that higher effort levels will likely result in higher payoffs. The agent will not supply a very high effort level because it is costly to her but the principal would like her to do so because a high effort level increases the likelihood of a higher payoff¹⁹. Thus, when the contract is signed and the wage is set, a strategic opportunity is created for the agent to misbehave and undersupply the productive input, as captured by π , which defines the agent's behavior—that is, the agent will depress her effort such that e^0 will be as low as possible²⁰. As Easterbrook and Fischel [1991:9] put it, “It is difficult to induce the employee to devote his best effort to the firm's fortunes. Why should he? His pay is the same no matter his performance.” The inevitable divergence in what the principal wants and the action taken by the agent—the residual loss—forms part of the total agency cost of the relationship described earlier.²¹ It is these responses to the various incentives in place that allow us to make predictions about the behavior of economic agents.

¹⁹ Note that this does not necessarily mean that the principal will always demand maximum effort. She is cost-constrained: higher effort levels are associated with higher wages.

²⁰ The agent does this, to the extent, of course, that she is not detected by the principal. In other words, in the same manner that the principal cannot demand the highest possible effort level, the agent also cannot supply the lowest possible.

²¹ The literature on incentives is rich. Other issues can be explored. These include the situation when it is the agent who is offering the contract, repeated moral-hazard games, and multiple principals. These are all undoubtedly important problems but are properly and more competently dealt with elsewhere. For an excellent introduction, see Macho-Stadler and Pérez-Castrillo [1997].

2.3 Application

The model described in section 2.2 is applicable to any situation where the agent can behave strategically in supplying the productive input. This is observed in the relationship between a controlling shareholder and a minority shareholder. In this case, the minority shareholder is the principal and the controlling shareholder is the agent, acting on behalf of the former. This is the traditional analysis that has been undertaken by the academe.

On one hand, because the controlling shareholder has a larger stake in the corporation, she is willing to bear more monitoring costs and, thus, can more effectively observe the actions of management. This reduces the agency cost that derives from the relationship between management and shareholders. On the other hand, because she has control, the controlling shareholder can influence management into taking decisions for her benefit which are not necessarily in line with the objective of other shareholders. Therefore, there is a fundamental tradeoff: reducing the agency cost associated with the relationship between management and shareholders increases the agency cost associated with the relationship between a controlling shareholder and minority shareholders. As usual, there is no free lunch.

As an example of the how controlling shareholders can abuse the minority, consider a controlling shareholder that is a family group with diverse holdings in other industries (in banking, particularly). The advantages of having corporate control over all of its holdings become obvious. Financing is raised internally when the family-controlled bank loans to another company within the same corporate group at an extremely favorable but nevertheless inappropriate interest rate. This has a two-fold effect: first, it diminishes the value of the company which

lends, and it also reduces the incentive of the borrower to perform better because, in times of crisis, it will be salvaged by the attached bank. The share of internal financing for companies that operate in developing economies is typically higher, with the share of external financing increasing as the economy develops [Khan 2002:18]. In the Philippines, the largest corporate groups in terms of sales and profits are usually associated with a family and this family group is affiliated with a large bank. For example, in the Philippines, the families Ayala, Sy, and Yuchengco are associated with the Bank of the Philippine Islands, Banco de Oro, and Rizal Commercial Banking Corporation, respectively [Saldaña 2000:180].

In terms of the model, the effort exerted by the controlling shareholder is not the optimal effort that would generate the highest payoffs, which the minority shareholder would want. The deviation from the optimal effort can take the form of “tunneling”, where benefits that should properly accrue to minority shareholders are instead transferred by the controlling shareholder into her own pockets [Johnson *et al.* 2000]. An example of such tunneling is the use of transfer prices, which were alluded to previously with respect to interest rates in intra-corporate-group loans. If Firm A has a controlling shareholder X and has transactions with Firm B, where X is also a shareholder, X may manipulate Firm A into quoting a favorable but artificial price for Firm B so that some benefit accrues to her while harming the other shareholders of one or both firms.

That managers and directors owe their responsibility to the shareholders of the corporation is a widely accepted and protected norm. Even if controlling shareholders are able to control the board of directors through the power that they wield within the corporation, they cannot extricate themselves from the responsibilities attached to their special position; they must also consider the interests of

the minority shareholders as a class. In *Gokongwei* [1979], the SC recognized the fiduciary duties owed by directors to all shareholders of a corporation:

Although in the strict and technical sense, directors of a private corporation are not regarded as trustees, there cannot be any doubt that their character is that of a fiduciary insofar as the corporation and the stockholders as a body are concerned. As agents entrusted with the management of the corporation for the collective benefit of the stockholders, “they occupy a fiduciary relation, and in this sense, the relation is one of trust.” “The ordinary trust relationship of directors of a corporation and stockholders”, according to *Ashaman v. Miller*, “is not a matter of statutory or technical law. It springs from the fact that directors have the control and guidance of corporate affairs and property and hence of the property interests of the stockholders. Equity recognizes that stockholders are the proprietors of the corporation’s interests and are ultimately the only beneficiaries thereof.”

The Court further quotes Mr. Justice Douglas in *Pepper v. Litton*²², which is reproduced here for his eloquent articulation of the directors’ fiduciary duties:

A director is a fiduciary. ... Their powers are powers in trust. ... He who is in such fiduciary position cannot serve himself first and his cestuis second. ... He cannot manipulate the affairs of his corporation to their detriment and in disregard of the standards of common decency. He cannot by the intervention of a corporate entity violate the ancient precept against serving two masters. ... He cannot utilize his inside information and strategic position for his own preferment. He cannot violate rules of fair play by doing indirectly through the corporation what he could not do so directly. He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference or advantage of the fiduciary to the exclusion or detriment of the cestuis.

It is interesting to investigate if the agent—the controlling shareholder—would behave differently if the principal were a foreign shareholder instead of a domestic shareholder. It is equally interesting to understand what drives the behavior of the foreign shareholder—that is, whether she decides to collude with the controlling shareholder and expropriate minority shareholders or whether she chooses instead to insist on good corporate governance to increase the value of the

²² *Pepper v. Litton*, 308 U.S. 309; 84 L.ed. 281, 289–291.

firm for the benefit of all its shareholders. A solid understanding of the principal–agent relationship in these types of arrangements is helpful to recognize the important elements of the problem.

3 Review of related literature

The disjoint between the objectives of the controlling and minority shareholders is not alien to the literature. While it is true that the initial interest has been between the dispersed shareholders and the managers, proper attention has been given to the conflict that having a controlling shareholder brings into the picture. The reasons why it was given belated attention is beyond the scope of this paper but it is fair to point out that it is strange especially since, save for the US and the UK, the dominant form of ownership is concentrated.

La Porta *et al.* [1998] and La Porta *et al.* [1999] acknowledge the diversity of ownership structures. They divide the world into two parts: one that has dispersed ownership and the other with concentrated ownership. The difference is owed to the quality of investor protection that exists in each jurisdiction. They come to this conclusion by examining the law on the books and contextualize these statutes by tracing the legal origin that prevails in each country (i.e., common or civil law). Among other conclusions, the literature that derives from the “La Porta group” comes away with the idea that common-law countries provide better shareholder protection than civil-law countries and, thus, dispersed ownership is generally observed in the former more than the latter, to wit:

We show that laws vary a lot across countries, in part because of differences in legal origin. Civil laws give investors weaker legal rights than common laws do, independent of the level of per capita income. Common-law countries give both shareholders and creditors—relatively speaking—the strongest, and French-civil-law countries the weakest, protection. German-civil-law and Scandinavian countries generally fall between

the other two. The quality of law enforcement is the highest in Scandinavian and German-civil-law countries, next highest in common-law countries, and again the lowest in French-civil-law countries. ... [A] very high ownership concentration may be a reflection of poor investor protection. ... [We] find a strong negative correlation between concentration of ownership...and the quality of legal protection of investors. Poor investor protection in French-civil-law countries is associated with extremely concentrated ownership. The data on ownership concentration thus support the idea that legal systems matter for corporate governance and that firms have to adapt to the limitations of the legal systems that they operate in. [La Porta *et al.* 1998:1116–1117]

From an *ex post* perspective, an investor with significant control over a corporation is more able to protect herself from wayward managers rather than if she were part of a class of dispersed owners. For a family-controlled corporation, the managers are anyway typically members of the family or very close associates. Moreover, having control rest with her means that there are fewer opportunities for other shareholders to oppress her. In other words, “ownership concentration becomes a substitute for legal protection” [La Porta *et al.* 1998:1145]. *Ex ante*, in a regime with poor shareholder protection, investors who anticipate expropriation will demand a discount on the share price as compensation for future misbehavior by either the manager or the prevailing dominant shareholder. The decrease in quantity demanded facilitates the aggregation of ownership to a select few. [La Porta *et al.* 1998:1145]

The binary nature of this framework is problematic because it does not explain the occurrence of concentrated ownership in countries with strong shareholder protection. In the words of Gilson [2005:2], it is “much too coarse”. An illustrative example that he offers is Sweden. Based on two measures of private benefits of control²³, Sweden does not exhibit characteristics of a country with poor shareholder protection. Yet, there are controlling shareholders in Sweden

²³ One is the difference in the market price of high-voting and low-voting shares (one percent); the other is the size of the premium paid to acquire a controlling stake in the corporation (seven percent) [Gilson 2005:17].

(e.g., the Wallenberg family group and their control over Skandinaviska Enskilda Banken AB and Investor AB). Therefore, for a complete account, there must be something other than unprotected shareholders to explain the Swedish phenomenon.

The explanation offered by Gilson [2005] is compelling: controlling shareholders are, on some occasions, more effective than other legally mandated monitoring mechanisms that are in place to address agency problems (e.g., a statutory requirement to have independent directors on the board). To understand this, a distinction is made between efficient and inefficient controlling shareholders:

[C]oncentrated control of publicly traded corporations can be consistent with two very different equilibria. First, the ownership pattern may reflect a structure of *inefficient* controlling shareholders, where because of bad law, the cost of private-benefit extraction exceeds the benefits of more focused monitoring of management—minority shareholders are net worse off from the controlling shareholder’s monitoring effort. Alternatively, the ownership pattern may reflect a structure of *efficient* controlling shareholders, where because of good law, the benefits of more focused monitoring exceeds the cost of private-benefit extraction and the value of minority shares increases as a result. [Gilson 2005:14]

Concentrated ownership is merely an alternative method to monitor managerial performance. If concentrated ownership is partnered with effective shareholder protection, the balance is likely to be tilted towards generating more benefits as opposed to costs that are associated with such an ownership structure.

Furthermore, a distinction is made between pecuniary and non-pecuniary benefits of control:

[Pecuniary private benefits of control are] the non-proportional flow of real resources from the company to the controlling shareholder...[Non-pecuniary private benefits of control are] forms of psychic and other benefits of control that...involve no transfer of real company resources and are not disproportionately dilutive of the value of the company’s stock to a diversified investor. [Gilson 2005:27–28]

The focus on pecuniary benefits of control²⁴ overlooks the explanatory power of recognizing its non-pecuniary counterpart. Again, Sweden proves a useful example: there is no significant pecuniary private benefit of control yet it is observed that controlling shareholders bear the cost of monitoring and, assuming their wealth is concentrated in one corporation, are thus bearing as well the costs of reduced liquidity and non-diversification. There must be something else that compensates them for these costs other than pecuniary benefits. These are the non-pecuniary benefits, such as political influence and prestige. [Gilson 2005:28–29]

This framework can further be developed by examining the composition of the equity-owners based on their nationality. This is an important endeavor because foreign shareholders and foreign direct investments have been shown elsewhere to have a positive effect on the performance of the corporation [Morck *et al.* 2005; Huizinga and Denis 2003; Ananchotikul 2006; Unite and Sullivan 2002; Chevalier *et al.* 2006; Aldrighi and Marques de Oliveira 2007]. The breadth of the literature—spanning East Asia, Eastern Europe, South America, and transition economies—emphasize the importance of fully understanding the incentives faced by foreign equity-holders. Here, attention is drawn to the evidence from Thailand [Ananchotikul 2006] and the Philippine banking sector [Unite and Sullivan 2002] while keeping in mind that similar results are found elsewhere.

The observations from Thailand is intriguing in many respects, the most significant of which is the finding that foreign investment does not necessarily improve the governance mechanism of the target company. If foreign investors become controlling shareholders themselves, they tend to expropriate other minority shareholders. In other words, the expropriation of minority shareholders by con-

²⁴ See, for example, Johnson *et al.* [2000].

trolling shareholders persists whether or not the block-holder is foreign or domestic. Second, the type of foreign investor may matter (i.e., whether it is “industrial” or “institutional”). Industrial foreign investors either own at least 10 percent of outstanding shares or otherwise exhibit significant control over the corporation such that they may be characterized as corporate “insiders” à la Morck *et al.* [2005:700]. Finally, bad corporate-governance practices are more likely to be transmitted than good ones. [Ananchotikul 2006]

Unite and Sullivan [2002] analyze the effect of foreign entry into the Philippine banking sector, particularly after it was allowed by Republic Act (RA) No. 7721. Among others, the Act²⁵ allowed foreign banks to operate in the Philippines through any of the following three means:

- (a) By acquiring, purchasing, or owning up to 60 percent of the voting stock of an existing domestic bank (including banks under receivership or liquidation, provided no final court liquidation order has been issued);
- (b) By investing in up to 60 percent of the voting stock of a new banking subsidiary incorporated under the laws of the Philippines; or
- (c) By establishing branches with full banking authority. [BSP Circular No. 51, Series of 1994]

They examine the effect of the entry of foreign banks and the acquisition of equity by foreign banks on the interest-rate spreads and other accounting-based measures of bank performance²⁶.

Consistent with the prevailing literature, the liberalization of the banking industry in the Philippines resulted in better performance for each bank (a decline in operating expenses) and for the whole industry (a decline in the interest-rate

²⁵ Republic Act No. 7721, “An act liberalizing the entry and scope of operations of foreign banks in the Philippines”, was approved on 18 May 1994. Soon after (14 October 1994), the *Bangko Sentral ng Pilipinas* (BSP; Central Bank of the Philippines) issued Circular No. 51, Series of 1994, which contains the implementing rules and regulations for RA 7721.

²⁶ Interest-rate spreads were defined as “the difference between the ratio of interest income on loans to total loans and the ratio of interest expense on total deposits to total deposits”. Bank performance was quantified with the following metrics: (1) accounting profitability or the “ratio of before-tax profits to total assets”, (2) the “ratio of non-interest income to total assets”, and (3) the “ratio of total overhead expenses to total assets”. [Unite and Sullivan 2002:2329]

spreads). They attribute their observations to the competitive pressure exerted by the foreign presence in the banking sector. Through its effect on the capital market, the efficiency enhancements brought about by foreign ownership and foreign presence are thought to accelerate national development. Additionally, these enhancements act as a shield against adverse external shocks²⁷ to the economy.

The contribution of this paper to the academic literature is the examination of the incentives faced by minority foreign shareholders in a country where there is weak minority-shareholder protection. Although the scope is narrow, an understanding of the micro-level dynamics is nonetheless crucial to make sense of what is happening at the macro level. Ultimately, policy adjustments, if necessary, at the level of the firm can have palpable effects for the entire country. Contrary to the proverb²⁸, it is sometimes necessary to turn to the trees to fully appreciate the intricacies of the forest.

4 The playing field

Even the [C]hurch has had to compromise with a melting-pot culture of Polynesian, Chinese, Spanish, and American influences and where people describe their past as “300 years in a convent followed by 50 years of Hollywood.”

— “Divorce, Manila-Style: Church and Customs Clash”,
Meg Bortin, International Herald Tribune, 26 June 1996

It is fundamental to describe the institutional-legal regime that operates in the Philippines with which corporations have to contend. It is equally important to know how corporations are owned and who owns those corporations. Both these elements constitute the localized milieu in which the incentives faced by minority foreign equity owners of Filipino-controlled corporations are described.

²⁷ In a related study [Unite and Sullivan 2000], the concern of the authors was the contagion effect of the Asian financial crisis.

²⁸ “One can’t see the forest for the trees.”

4.1 Corporations: The Philippine legal landscape

In a historico-legal sense, the Philippines is a hybrid. Owing to its varied colonial origins²⁹, the body of law is both common and civil. The influence of the Spanish and the Americans in crafting some of the major laws of the Philippines is obvious. However, the interpretation of the law is local. The use of Spanish jurisprudence as precedents in criminal law lasted only until the 1920s. Moreover, US laws and cases are considered persuasive³⁰ but are not binding legal precedents.

Foreign equity and land ownership is limited by the Philippine Constitution³¹ and other laws for various purposes (e.g., national security and protection of small- and medium-scale industries). For public utilities, the maximum share foreigners can acquire is 40 percent of total outstanding shares. Other areas where foreign ownership is completely barred include, but are not limited to, mass media (except recordings), the use of marine resources, weapons (nuclear, biological, chemical, and radiological), and small-scale enterprises.³²

Foreign land ownership is totally excluded. In *JG Summit v. CA* [2005], the Philippine Supreme Court (SC) said, quoting an earlier decision³³:

But if an alien is given not only a lease of, but also an option to buy, a piece of land, by virtue of which the Filipino owner cannot sell or otherwise dispose of his property, this to last for

²⁹ The Philippines was discovered by the Western world when Ferdinand Magellan, a Portuguese explorer working under the authority of the Spanish monarchy, found his way to the Philippines on 1521. Formal colonization under Spain occurred over 40 years later with the arrival of the *Conquistadores* led by Miguel López de Legazpi. Briefly, the British took over (1762–1764) when Spain joined the Seven Years' War. At the conclusion of the Spanish–American war, the Treaty of Paris of 1898 handed over control of the Philippines from Spain to the United States in exchange for USD 20 million. American rule lasted until Japanese forces invaded on 8 December 1941, ten hours after the attack on Pearl Harbor. Upon the formal surrender of the Japanese on 02 September 1945, the Philippines returned to American control until the US finally ended its sovereignty over the archipelago on 04 July 1946. This ended 381 years of virtually uninterrupted colonial rule over the Philippines. [Wikipedia: The Free Encyclopedia, *History of the Philippines*, Accessed on 02 July 2007, http://en.wikipedia.org/wiki/History_of_the_Philippines]

³⁰ *Commissioner of Internal Revenue v. SolidBank Corporation*, G.R. No. 148191, 25 November 2003.

³¹ Art. XII, Sec. 2, 1987 Constitution of the Republic of the Philippines.

³² Executive Order (EO) No. 389, promulgated on 30 November 2004, contains the Sixth Regular Foreign Investment Negative List (FINL).

³³ *Philippine Banking Corporation v. Lui She*, 21 SCRA 52 [1967].

50 years, then it becomes clear that the arrangement is a virtual transfer of ownership whereby the owner divests himself in stages not only of the right to enjoy the land (*jus possidendi*, *jus utendi*, *jus fruendi*, and *jus abutendi*) but also of the right to dispose of it (*jus disponendi*)—rights the sum total of which make up ownership. It is just as if today the possession is transferred, tomorrow, the use, the next day, the disposition, and so on, until ultimately all the rights of which ownership is made up are consolidated in an alien. And yet this is just exactly what the parties in this case did within the space of one year, with the result that Justina Santos's ownership of her property was reduced to a hollow concept. If this can be done, then the Constitutional ban against alien landholding in the Philippines...is indeed in grave peril.³⁴

The implication is that a corporation, more than 40 percent of the stocks of which is held by foreigners (and is, thus, considered a foreign corporation), cannot own land or “own” land in the manner described above in *JG Summit* [2005]. Basically, foreigners are denied the right to buy equity in a corporation that owns land if their acquisition will bring the level of foreign equity above 40 percent.

Corporations in the Philippines are governed by Republic Act No. 68 or the Corporation Code of the Philippines which took effect on 01 May 1980. Subsequently, the Securities Regulation Code (RA 8799) was passed to replace the Revised Securities Act of 1982. Both laws cover most companies; others are governed by the specific laws that created them. Corporations who elect to list on the Philippine Stock Exchange (PSE) are also required to abide by the listing rules of the bourse. Financially or economically distressed companies may fall under the Insolvency Law (RA 1956) while some bank transactions are covered by the General Banking Act (RA 8790) and the New Central Bank Act (RA 7653). Other governing bodies, such as the Securities and Exchange Commission³⁵ (SEC), *Bangko Sentral ng Pilipinas* (BSP; Central Bank of the Philippines) and the Insurance Commission (IC) have issued circulars, implementing rules and regulations,

³⁴ *JG Summit Holdings, Inc. v. Court of Appeals, et al.*, G.R. No. 124293, 31 January 2005.

³⁵ The SEC is covered by Presidential Decree 902-A of 1976 which defines its powers and jurisdiction.

and memoranda that complete the statutory space of companies that operate in the Philippines.³⁶

Indicative features of the Corporation Code which impact on the way ownership is organized in the Philippines and the level of protection that shareholders enjoy are highlighted here. First, multiple classes or series of shares are allowed (Sec. 6, *Classification of shares*):

Sec. 6. *Classification of shares.* The shares of stock of stock corporations may be divided into classes or series, or both, any of which classes or series of shares may have such rights, privileges, or restrictions as may be stated in the articles of incorporation...

Second, both voting by mail and through a proxy are allowed (Sec. 24, *Election of directors or trustees* and Sec. 58, *Proxies*):

Sec. 58. *Proxies.* Stockholders and members may vote in person or by proxy in all meetings of stockholders and members. Proxies shall be in writing, signed by the stockholder or member and filed before the scheduled meeting with the corporate secretary. Unless otherwise provided in the proxy, it shall be valid only for the meeting for which it is intended. No proxy shall be valid and effective for a period longer than five (5) years at any one time.

Third, provisions for cumulative voting are mandatory according to Sec. 24, *Election of directors or trustees*. This allows minority shareholders to have representation with the corporation's board of directors although it is typically difficult to successfully exercise. Finally, minority shareholders may exercise an appraisal right³⁷ to be properly compensated when she dissents from a corporate decision

³⁶ For example, the BSP has issued the Manual of Regulations for Banks. On the part of the SEC, it has issued the Code of Corporate Governance and the Self-Rating System for Corporate Governance, among others. The IC has issued Circular Letter 13-2002 (amended by Circular Letter 31-2005) to govern insurance companies and the like. Other statutes include the Anti-Money Laundering Act (RA 9160, subsequently amended by RA 9194) and the Revised Accountancy Law (RA 9298).

³⁷ Sec. 16, *Amendment of Articles of Incorporation*; Sec. 37, *Power to extend or shorten corporate term*; Sec. 40, *Sale or other disposition of assets*; Sec. 42, *Power to invest corporate funds in another corporation or business or for any other purpose*; Sec. 77, *Stockholder's or member's approval*; Title X, Sec. 81–86, *Appraisal right*.

supported by the majority. The following instances are enumerated in the Code where an appraisal right may be exercised:

1. In case any amendment to the articles of incorporation has the effect of changing or restricting the rights of any stockholder or class of shares, or of authorizing preferences in any respect superior to those of outstanding shares of any class, or of extending or shortening the term of corporate existence;
2. In case of sale, lease, exchange, transfer, mortgage, pledge, or other disposition of all or substantially all of the corporate property and assets as provided in the Code; and
3. In case of merger or consolidation. [Sec. 81, *Instances of appraisal right*, Corporation Code of 1980]

As a minimum, to be listed on the PSE requires³⁸ that the company, depending on its size, issue 10 to 20 percent of outstanding shares to the public. This means that up to 90 percent of a corporation's shares may not even be practically traded. The high ownership concentration observed in the PSE (discussed below) is made possible by the small number of shares issued to the public. [Saldaña 2000:173–174]

Granted adjudicatory powers by Presidential Decree 902-A, the SEC has dealt with cases involving intra-corporate conflicts between shareholders. *In the matter of Ayala Corporation*, decided on 01 September 1989, the SEC was adamant in protecting the rights of minority shareholders which were being abridged by an amendment to the articles of incorporation of Ayala Corporation:

We must not overlook the interest of the minority no matter how minuscule the interest in the corporation might be. To the extent that such right is threatened, the Commission must step in to thwart any attempt to undermine it. ... It has been generally recognized that there are equitable limitations on the exercise of the amendment power even when an amendment is adopted by the requisite statutory majority of shares... Even when an amendment has been regularly approved..., the relatively "unlimited" contractual right to amend the articles becomes subject to overriding equitable considerations... This is in consonance with the fundamental principle in corporate law that the reserved power of a corporation to amend its charter must be so exercised that the result will tend to benefit the corporation as a whole, and to distribute equitably the benefit or

³⁸ PSE Revised Listing Rules of 2004.

sacrifice, as the case may be, between all groups in the corporation as their interests may appear.

The SC, as the final arbiter, has also decided a lot of cases concerning the protection of shareholders, minority or otherwise. In line with the principle of *stare decisis*, the body of SC decisions is a primary source of law in the Philippines. As one example, in *Gokongwei* [1979], the right to inspect the books of the corporation is clarified: “While the right of a stockholder to examine the books and records of a corporation for a lawful purpose is a matter of law, the right of a stockholder to examine the books and records of a wholly-owned subsidiary of a corporation in which he is a stockholder is a different thing.”³⁹ The Court continued:

In the case at bar, considering that the foreign subsidiary is wholly owned by respondent San Miguel Corporation and, therefore, under its control, it would be more in accord with equity, good faith, and fair dealing to construe the statutory right of petitioner as stockholder to inspect the books and records of the corporation as extending to books and records of such wholly owned subsidiaries which are in respondent corporation’s possession and control.

The right to inspect the books is entrenched. Almost 60 years earlier, in *Pardo v. Hercules Lumber* [1924], the SC said:

It may be admitted that the officials in charge of a corporation may deny inspection when sought at unusual hours or under other improper conditions; but neither the executive officers nor the board of directors have the power to deprive a stockholder of the right altogether. A by-law unduly restricting the right to inspection is undoubtedly invalid. Authorities to this effect are too numerous and direct to require extended comment.⁴⁰

The SC then lists a number of references without commentary presumably to emphasize that this is a non-issue: “14 C.J., 859; 7 R.C.L., 325; 4 Thompson on Corporations, 2nd ed., sec. 4517; *Harkness v. Guthrie*, 27 Utah 248; 107 Am., St. Rep., 664.681”. Any shareholder wishing to examine the books of the corporation

³⁹ *John Gokongwei, Jr. v. Securities and Exchange Commission, et al.*, G.R. No. L-45911, 11 April 1979.

⁴⁰ *Antonio Pardo v. Hercules Lumber Co., Inc., et al.*, G.R. No. L-22442, 01 August 1924.

is entitled to do so by law and this right cannot be abridged under unreasonable circumstances and neither can it be exercised in equally unreasonable circumstances (such as a request to inspect the books outside normal business hours).

The SC has also specifically empowered minority shareholders. In *Financing Corporation v. Teodoro* [1953], the court, at the outset, recognized the right of minority shareholders to demand an involuntary dissolution of the corporation:

[T]he general rule is that the minority stockholders of a corporation cannot sue and demand its dissolution. However, there are cases that hold that even minority stockholders may ask for dissolution, this, under the theory that such minority members, if unable to obtain redress and protection of their rights within the corporation, must not and should not be left without redress and remedy.⁴¹

This right is exercised by minority shareholders when the corporation is perpetuated by an unyielding majority for their benefit but at the cost of reducing the wealth of minority shareholders. Normally, a dissolution case filed by a minority shareholder must be supported by the State but the Court also said in *Financing Corporation* [1953] that there are certain instances wherein the participation of the State is not necessary for the minority shareholder to ask for such a remedy. In the Court's words:

We repeat that although as a rule, minority stockholders of a corporation may not ask for its dissolution in a private suit, and that such action should be brought by the Government through its legal officer in a *quo warranto* case, at their instance and request, there might be exceptional cases wherein the intervention of the State, for one reason or another, cannot be obtained, as when the State is not interested because the complaint is strictly a matter between the stockholders and does not involve, in the opinion of the legal officer of the Government, any of the acts or omissions warranting *quo warranto* proceedings, in which minority stockholders are entitled to have such dissolution.

When directors and other people who control the corporation harm shareholders—minority or otherwise—or the corporation itself, a shareholder may

⁴¹ *Financing Corporation of the Philippines, et al. v. Jose Teodoro, et al.*, G.R. No. L-4900, 31 August 1953.

file a “derivative suit” in behalf of the corporation and other shareholders. The derivative suit can be interpreted as a defensive legal mechanism that is available to minority shareholders that they can use when the majority or controlling shareholder abuses its or her position in the corporation. It has been articulated by the SC in multiple cases and as early as 1911 in *Pascual v. Del Saz Orozco*⁴². The Court said:

A derivative suit has been the principal defense of the minority shareholder against abuses by the majority. It is a remedy designed by equity for those situations where management, through fraud, neglect of duty, or other cause, declines to take the proper and necessary steps to assert the corporation’s rights.⁴³

Among others, Philippine cases that deal with derivative suits are the following: *Angeles v. Santos* [1937], *Reyes v. Tan* [1961], *First Philippine International Bank v. CA* [1996], and *Marsman Investment Ltd. v. Philippine Abaca Development Co.* [1963].⁴⁴ The Court said in *Angeles* [1937]:

It is well settled in this jurisdiction that where corporate directors are guilty of a breach of trust—and intra-corporate remedy is futile or useless, a stockholder may institute a suit in behalf of himself and other stockholders and for the benefit of the corporation, to bring about a redress of the wrong inflicted directly upon the corporation and indirectly upon the stockholders. An illustration of a suit of this kind is found in the case of *Pascual v. Del Saz Orozco*, decided by this Court as early as 1911. In that case, the Banco Español-Filipino suffered heavy losses due to fraudulent connivance between a depositor and an employee of the bank, which losses, it was contended, could have been avoided if the president and directors had been more vigilant in the administration of the affairs of the bank. The stockholders constituting the minority brought a suit in behalf of the bank against the directors to recover damages, and this over the objection of the majority of the stockholders and the directors. This court held that the suit could properly be maintained.

⁴² 19 Phil. 82., cited in *Commart* [1991] and *Reyes* [1961], *infra*, footnotes 43 and 44.

⁴³ *Commart (Phils.) Inc. v. Securities and Exchange Commission*, G.R. No. 85318, 03 June 1991.

⁴⁴ *Angeles v. Santos*, G.R. No. L-43413, 31 August 1937; *Catalina R. Reyes v. Bienvenido A. Tan, et al.*, G.R. No. L-16982, 30 September 1961; *First Philippine International Bank, et al. v. Court of Appeals, et al.*, G.R. No. 115849, 24 January 1996; *Marsman Investment Ltd., et al. v. Philippine Abaca Development Co., et al.*, G.R. No. L-19160, 26 December 1963.

The legal landscape of the Philippines, at least on the books and the jurisprudence established by the SC, can be seen as quite advanced. Unfortunately, enforcement is quite another thing:

In the Philippines, in principle, rights of the minority are given protection under the laws. However, very few aggrieved stockholders in practice exercise their rights. Seeking legal remedies is expensive and it takes a long time for a case to be decided in court. The level of administrative sanctions is also considered to be too low to deter serious wrongdoing. [World Bank 2006:14]

The SEC “does not...have adequate resources, in terms of both technical expertise and number of professionals.” According to the World Bank report, *The Cost of Doing Business* [2005], cited in World Bank [2006:15], simply enforcing a standard contract takes 300 days at the cost of 51 percent of the debt through 25 procedures. Although better than the regional average (407 days, 62 percent, and 30 procedures), it is still noticeably worse than the OECD average of 229 days, 11 percent, and 19 procedures. As an indicative example, consider the case of *Financing Corporation* [1953] cited above in reference to involuntary dissolution. The court of first instance received the case in 1924 but the SC decision was promulgated only on 1953; not surprisingly (in the Philippines, at least), it took almost 30 years to finally resolve the case.

This highlights the danger of such studies exemplified by the La Porta group. Simply examining the law as it is written does not give an adequate picture of the legal circumstances that prevail in a certain locality. The Philippines, with advanced corporate codes and jurisprudence adopted from the US (if US laws can be considered “advanced”), can hardly be said to exhibit good law in shareholder protection if mistreated shareholders rarely ever file a case to begin with or are never able to use tools designed for minority shareholder protection, such as cu-

mulative voting⁴⁵. They are, at the outset, defeated by the legal loopholes they have to go through and the cost of these legal maneuverings. A certain sense of legal realism must be brought into the picture to obtain an accurate descriptive assessment of the actual level of shareholder protection that exists in a specific jurisdiction. Otherwise, even the researcher with the best intentions may eventually end up with spurious results.⁴⁶

4.2 Corporate ownership in the Philippines

Many researchers have accurately described the ownership of Philippine corporations as family-based [Juzhong 1999; de Ocampo 2000; Unite and Sullivan 2000; Unite and Sullivan 2002; Morck *et al.* 2005]. This is similar to the rest of the developing countries in East Asia [Claessens *et al.* 2000]. The current situation can largely be traced to the colonial origins of the Philippines, emphasizing the path-dependent aspect of institutional development:

During the Spanish and American period up to World War II, a small number of families acquired land and owned large businesses. These families built and preserved their businesses over several generations. Many of them became controlling shareholders of family-based corporations and business groups that are major players in the present-day Philippine corporate sector. [Saldaña 2000:171]

These families are well-known in the Philippines: Aboitiz, Alcantara, Ayala, Cervantes, Cojuangco, Concepcion, Consunji, Del Rosario, Enrile, Gaisano, Gatchalian, Go (George), Go (Jonathan and David), Gokongwei, Gotianun, Gow, Lim, Lopez, Lorenzo, Ortigas, Pangilinan, Puyat, Ramos, Sobrepeña, Soriano, Sy, Tan (Andrew), Tan (Lucio), Tan (Yu), Tantoco, Ty,

⁴⁵ La Porta *et al.* [1998], admittedly, classified the Philippines as a country with poor shareholder protection although new laws passed after their study was conducted could have put the Philippines together with countries with good shareholder protection. Unfortunately, it would still be a stretch to put the Philippines on the “good list” if the legal reality on the ground is as it is.

⁴⁶ Morck *et al.* [2005:694] make the same point: “[S]tatutory shareholder rights are dead letters if the judiciary, police, and regulators are all deeply corrupt.”

Uytengsu, Villar, and Yuchengco [Saldaña 2000:180–181; Unite and Sullivan 2000:196]. The list is a rundown of Spanish (the *mestizos*⁴⁷) and Chinese names (the *taipans*⁴⁸), reflecting the colonial history of the Philippines under Spain, and the trading history with and the migration into the country of the Chinese. The listed names are regarded in the politico-economic landscape of the Philippines. These families, in concert and separately, are the “movers and shakers” of the national economy. It is really the prototypical “oligarchic capitalism” that Morck *et al.* [2005:693] describe. This phenomenon has profound implications for national development:

[E]ntrusting the governance of huge slices of a country’s corporate sector to a tiny elite can bias capital allocation, retard capital-market development, obstruct entry by outsider entrepreneurs, and retard growth. Furthermore, to preserve their privileged positions under the status quo, such elites might invest in political connections to stymie the institutional development of capital markets and to erect a variety of entry barriers. These economy-wide implications can be most serious. [Morck *et al.* 2005:657]

Each family corporate group operates in more than one industry. For example, the Ayala group has companies operating in such diverse industries as banking and food. Family corporate groups typically include a main bank because it is easier to source financing within the group (i.e., internal financing) than to subject the borrower company to the scrutinizing eyes of the external capital market [Khan 2002:4]. Thus, it is not usually the case that family-controlled companies need foreign financing unless they are engaged in some expansionary policy such that internal (i.e., within the group) or domestic financing is inadequate to

⁴⁷ The “mestizo” is a Spanish term that is used to refer to someone of mixed non-indigenous (in the Philippines, usually Caucasians from Europe and the US, but now also used for the Chinese and other East Asians) and Austronesian descent. [Wikipedia: The Free Encyclopedia, *Mestizo*, Accessed on 23 July 2007, <http://en.wikipedia.org/wiki/Mestizo>].

⁴⁸ The “tai-pan” is a Cantonese word which idiomatically means “big shot” in English. [Wikipedia: The Free Encyclopedia, *Tai-Pan*, Accessed on 23 July 2007, <http://en.wikipedia.org/wiki/Tai-Pan>].

support the ambitious endeavor. Table 1 illustrates the far-reaching tentacles of each family in the Philippine economy.

Table 1. Families and industries [1994]

Group name	Number of major companies	Major industries ^a
Ayala	57	1, 3, 8, 10, 11, 12, 13, 14
Yuchengco	54	1, 2, 3, 6, 8, 11, 12, 13
Cojuangco	45	1, 3, 5, 9, 11, 13, 14, 15
Gokongwei	37	1, 2, 3, 8, 9, 11, 16
Lopez	30	1, 2, 3, 4, 10, 13
JAKA (Enrile)	25	3, 5, 8, 9, 12
Solid (Lim)	25	3, 13, 17, 18
Soriano	25	1, 3, 5, 6, 8, 11, 12, 14
Floirendo	21	3, 12, 14, 18
Concepcion	18	3, 5, 8, 14, 15, 16
Sarmiento	18	3, 8, 9, 12, 13, 15
Gotianun	9	3, 8, 9

Note: ^a 1 = banks, 2 = energy, 3 = food and agriculture, 4 = broadcasting, 5 = transportation and shipping, 6 = mining, 7 = construction, 8 = real estate, 9 = manufacturing, 10 = information technology, 11 = insurance, 12 = brokerage and financial services, 13 = import and export, 14 = tourism and hotel, 15 = basic industries, 16 = telecommunication, 17 = electronics, 18 = automotive.

Source: Unite and Sullivan [2000:197]

Since then, the Ayala group has added telecommunication to their list of industries with Globe Telecom, Inc., the fifth-highest profit-maker in 2004 with sales of PHP 11.3 billion (Table 2). Their associated bank, Bank of the Philippine Islands, is top nine. Also among the top profit-makers are companies associated with Ramon Cojuangco (Smart Communications, Inc., Philippine Long Distance and Telephone Company, and Pilipino Telephone Corporation) and the Lopez group (Bayan Telecommunications, Inc. and Bayan Telecommunications Holding Corporation). Note that the fourth-ranking company is merely a holding entity.

Table 2. Top 10 profit-makers in the Philippines [2004]

Rank	Company	Sales (in thousands PHP)
1	Smart Communications, Inc.	19,607,100
2	Philippine Long Distance Telephone Company	17,714,000
3	Bayan Telecommunications, Inc.	14,284,815
4	Bayan Telecommunications Holding Corporation	14,038,909
5	Globe Telecom, Inc.	11,257,366
6	Mirant (Philippines) Corporation	10,772,227
7	Pilipino Telephone Corporation	9,751,300
8	Mirant Sual Corporation	7,730,345
9	Bank of the Philippine Islands	6,668,000
10	Nestlé Philippines, Inc.	6,132,324

Source: SEC website <<http://www.sec.gov.ph>>

These families normally control their corporations through various combinations of multiple-class shares⁴⁹ and pyramidal ownership structures. At the top of the pyramid is usually a pure holding company, which is controlled by a family group. In 1997, the top shareholder of a holding company owned 53 percent of outstanding shares [Saldaña 2000:173], leaving no room for effective minority-shareholder participation. The depth and breadth of these pyramids can be illustrated again with the Ayala corporate group in 1998. Consider:

Ayala Corporation is a publicly listed pure holding company. It is majority-owned by Mermac, Inc., a family-owned pure holding company, with 59 percent of shares. Public investors collectively hold a minority of 41 percent. Ayala Corporation then holds a sufficient number of shares to achieve various degrees of control in two types of holding companies and two types of operating companies. It has a majority control at 71.1 percent of Ayala Land, minority control at 42.4 percent of Bank of the Philippine Islands, an active minority share at 44.6 percent of Globe Telecom, and a passive minority investment at 15 percent in Honda Cars (Philippines). The first three companies are publicly listed while the fourth, Honda Cars (Philippines), is privately owned. Ayala Corporation's majority- and minority-controlled operating companies are also holding companies. Ayala Land fully owns Makati Development Corporation and holds a minority stake, at 47.2 percent, of Cebu Holdings (a publicly listed government-owned company). Bank of the Philippine Islands owns 100 percent of the BPI-Family Savings Bank, a privately owned company. [Saldaña 2000:196]

Simply through their private ownership of the holding company Mermac, Inc., the Ayala family enjoys effective control over several other operating companies.

At the end of 2005, there were 237 companies are listed on the PSE with a total market capitalization was PHP 2.1 trillion (USD 39.8 billion). The share of market capitalization of the top ten companies is about 80 percent [World Bank 2006:2–3]. Few of these listed companies can be considered as widely held (Table 3). In all but transportation services; food, beverage, and tobacco; manufacturing, distribution, and trading; and oil, the top five shareholders own more than 50 percent of the company.

⁴⁹ As allowed by the Corporation Code, Sec. 6, *Classification of shares*.

Table 3. Ownership concentration of Philippine publicly listed companies by sector [1997]

Sector	Shareholders		
	Top 1	Top 5	Top 20
Financial institution			
Banks	26.9	59.2	76.4
Financial services	41.3	63.2	65.8
Average shareholding^a	27.2	59.2	76.2
Non-financial company			
Communication	35.4	67.3	76.9
Power and energy	21.5	55.4	72.1
Transportation services	23.8	48.4	69.2
Construction and other related products	47.7	74.0	86.2
Food, beverage, and tobacco	22.7	44.1	69.7
Holding companies	53.0	78.4	86.0
Manufacturing, distribution, and trading	37.4	42.6	68.4
Hotel, recreation, and other services	28.9	55.3	68.0
Property	54.8	69.8	74.5
Mining	23.4	56.0	51.9
Oil	19.9	45.1	64.3
Average shareholding^a	40.8	65.3	75.9

Note: ^a Weighted by market capitalization.

Source: Saldaña [2000:173]

To be truly effective, minority shareholders must ally with a dominant shareholder:

With such high levels of ownership concentration minority shareholders are unlikely to be able to influence the strategic and operating decisions of a company without the support of one or more large shareholders. The limited volume of shares issued to the public is one of the causes of the underdevelopment of the Philippine stock market. The shares of publicly listed companies are thinly traded and illiquid, and share prices are sensitive to movements of foreign funds. [Saldaña 2000:174]

The limited supply of free-float shares is made possible by the minimal amount of shares required by the PSE for a corporation to be listed⁵⁰. Thus, the general public does not participate in any significant way in the conduct of most publicly listed corporations [World Bank 2006:3], much less those that remain privately held.

This situation creates a vicious cycle of the economically privileged using their powers to influence the political development of the country, further “entrenching” themselves in their position. Citing Claessens *et al.* [2000], Morck *et al.* [2005:667] notes that the top 15 family-controlled pyramids own corporate as-

⁵⁰ PSE Revised Listing Rules of 2004.

sets worth 46.7 percent of the GDP in the Philippines. Moreover, 17.1 percent of total market capitalization is owned by a single family. Morck *et al.* [2005:658] asks, “Perhaps economists need to think less about concentration of wealth *per se* and more about concentration of wealth in whose hands?”

5 Completing the jigsaw: A discussion

All the previous elements can be considered pieces of a jigsaw puzzle that can be put together until the picture appears clearly to the patient observer. That is what is attempted here with a narrative that presupposes an understanding of the corporation as a nexus of contracts and the basic principal–agent model, knowledge of the observed worldwide trend with respect to the influence of foreign equity ownership, and a localized awareness of the Philippine legal and corporate regime. At the end of the day, “[t]he view you take of corporations and corporate law is apt to depend on your assumptions about how investors, employees, and other players come to be associated in a venture.” [Easterbrook and Fischel 1991:4]

The importance of the institutions that operate within a certain jurisdiction cannot be overemphasized. Gilson and Kraakman [2003:45] recognize this: “[W]e believe that understanding the structure of institutions is central to understanding the operation of the capital market.” It shapes the way predictions are made about how minority foreign shareholders and controlling shareholders interact in a much more profound way than a simple examination of the law as it is written. It is useful to regard foreign shareholders and controlling shareholders as economic agents (*homo economicus*) that react to an incentive structure in predictable ways. Knowing the incentives that these two groups face in the Philippines allows, at

least at this point, the formulation of reasonable and testable hypotheses that conform to the framework adopted explicitly here.

Minority foreign shareholders can affect the conduct of Filipino-controlled corporations in two ways: they can either introduce good corporate-governance measures in an attempt to increase the value of the company as a whole and to the benefit of all shareholders (but not, perhaps, to the benefit of a specific one or group—that is, the familiar difference between the size of the pie and the share of the pie should be kept in mind) or they can collude with a misbehaving family-based controlling shareholder in the expropriation of the minority. Their chosen behavior, one way or another, affects the performance of the company. Conditions upon which the behavior of minority foreign shareholders may depend are discussed below but keep in mind that the discussion of each factor is done *ceteris paribus*.

First, the origin of the foreign shareholder matters. The difference in the corporate-governance regime of the origin and destination countries indicates a lot about how the foreign shareholder will act. If the foreign shareholder comes from a regime with excellent corporate governance, particularly shareholder protection, such as the UK and Sweden, then it is more likely that she will import best practices into the Philippines.

For example, if a Swedish investor observes that a Filipino-controlled corporation has poor shareholder protection, she may ask that the corporation's by-laws be amended to reflect the same level of protection that she enjoys in Sweden. To the extent that the family-controlled corporation needs to raise external capital for expansionary or other purposes, they may concede to the Scandinavian request. Furthermore, if the behavior of the foreigner is covered by her national

laws (e.g., she is prevented from engaging in corrupt practices outside her country of origin), she may be a positive influence on countries with relatively weaker corporate governance. On top of that, she may not only be subject to her own national laws but also to the reputation market that prevails in her home country. If she is perceived to be misbehaving in countries like the Philippines, where there is ample opportunity to do so, her interests in her home country may suffer in value as her transactional partners at home extrapolate from her misbehavior abroad. This is especially true for institutional investors and corporations⁵¹ that rely on their reputation in the capital market to ensure adequate financing and robust sales.

Alternatively, if the foreign shareholder comes from a country with the same or worse level of shareholder protection, it is not likely that she will import her regime into the Philippines because she herself is a minority shareholder who is exposed to expropriation. Conceivably, the reason why she is investing abroad is the fact that her capital at home cannot safely be invested in domestic companies. The obvious catch to this is that, if she either manages to take control of the corporation or strikes up a bargain with the domestic controlling shareholder, the corporate outsiders (i.e., the remaining minority shareholders) will be worse off while the foreign shareholder and her partner enjoy the benefits of expropriation.

Second, the likelihood of misbehavior being detected matters. If the regulators (the SEC, for example) are understaffed as it is in the Philippines, then malpractices with respect to the expropriation of domestic shareholders by a partnership between the controlling and foreign shareholders will not likely be ob-

⁵¹ Consider, for example, the damage—admittedly slight—done by Nike’s poor reputation in the labor market (the alleged use of sweat-shops in poor Asian countries) to its worldwide sales. Cross-market effects do occur. The proposition in this paper is that the signal gleaned from the performance in the capital market affects the commodities market. [*Troubles add up at Nike*, The Oregonian, 04 May 1997, http://www.clrlabor.org/alerts/1997/troubles_add_up_at_nike.html]

served. In that case, it may be profitable for the foreign shareholder to collude with the controlling shareholder in the mismanagement of the corporation. Besides, for the regulators to be involved, an aggrieved party must bring the matter to its attention. It is highly unlikely that the SEC or the PSE will have enough manpower to observe the behavior of every single corporation listed on the stock exchange so someone else must report misbehavior. The ability of minority shareholders to know when they are being abused is, therefore, a crucial element. If they are passive investors from the general public, it may not be worth it to monitor the behavior of the controlling shareholder or the management. However, since foreign shareholders are assumed to be more informed about these things, she may be able to spot red flags along the way and bring the matter to the regulators. The problem is that even if she deems it worthwhile to do so, it is not certain that she will be successful in the proceedings.

Third, the expertise and efficiency of the judiciary matter. Even if misbehavior by a controlling shareholder can be detected, it does not necessarily mean that it can be corrected by the judiciary which may not be properly trained to assess the infraction. The party who loses at the SEC may be able to bring the case to the courts where there is no telling how the judge, who may not be trained in looking at financial records and econometric analyses on abnormal returns (for example), will evaluate the evidence. Even if she could, the loser in the judicial proceedings could appeal the judgment up to the Supreme Court, a process that can take so much time and money that it may not be worth it to pursue for a typical minority shareholder. To the extent that foreign minority shareholders are assumed to be more advanced and financially secure, she may be able to sustain a

drawn-out process but, nevertheless, her lack of local knowledge⁵² may deter her from pursuing a case, especially in a country where socio-political connections are widely believed to influence the administration of justice.

Fourth, the motivation of the foreign investor matters. If she is only investing to diversify risk, it may not be worthwhile for her to invest in countries where there is inadequate minority-shareholder protection. If she takes control of the corporation, she may find it profitable to invest in a regime with poor protection:

[T]he quality of corporate governance indeed affects the probability that investors hold the shares of the company in different ways. When the wedge between control and cash-flow rights is larger, the probability is lower that investors who enjoy only the security benefits—such as small domestic individual investors, institutional investors, and foreign investors—would buy shares of the company. Interestingly, the minority participation of investors who have a significant share of the control rights of at least one listed company (without controlling it) or who are board members is driven by different motives. If anything, such investors prefer to invest in companies where the wedge between the principal shareholder's control and cash-flow rights is larger. The reasons for their different behavior may be that, in contrast to small investors, they are able to defend their interests because they are better connected to the local financial community. [Giannetti and Simonov 2003:2]

That is, the benefits of risk diversification may be too small to compensate her for the costs of expropriation. However, if her motive to invest is specifically to make a profit out of extending capital in a country with poor minority-shareholder protection (either by controlling or colluding), then it might be deemed valuable enough.

Fifth, it is plausible that the family-based controlling shareholder may be using the presence of the minority foreign shareholder as a signal in a reputation-based market. Precisely because foreigners (at least, those who come from good-law countries) are seen as more informed about the workings of the capital mar-

⁵² The information asymmetry is severe for a foreign shareholder living abroad but a foreign shareholder in the Philippines, depending on how long she has stayed in the country and the extent of her socio-political capital, may be able to maneuver the legal labyrinth of the country in a way that may impress even the worst kind of controlling shareholders.

ket, and of oppressive techniques in corporate governance, the fact that there are foreign shareholders in one company may signal to the domestic capital market that the company is a safe haven for investments. To a large extent, this can be viewed as a positive externality that accrues to other domestic investors who may not have the time or skill to evaluate each company. They simply rely on the investment decisions of foreigners and follow their lead. Whether or not the company is really a safe haven for capital—at least, to the extent that the controlling shareholder will not expropriate the minority—is determined by the conditions elucidated above. Unless the investing public and consumers of the company's products and services blindly believe that any foreign shareholder contributes positively to the conduct of the corporation, the reputation effect is diminished or completely muted.

The other reason why the reputation rationale is suppressed is that it requires the ability of the transactional partners to punish the erring corporation. That is, the controlling shareholder must be using the reputation of having good minority foreign shareholders because it fears the repercussions of being perceived to be abusing her dominant position. Even assuming *arguendo* that the consumer can determine acts of abuse, punishment does not apply when the consumer is unable to credibly threaten the company, such as companies with flagrant market powers. In the Philippines, most markets served by these family-controlled corporations are either a monopoly or an oligopoly market. For the controlling shareholder to care about its reputation, it is probably necessary that there are reasonable alternatives to her company's products and services.

Everything boils down, once again, to institutions. Foreigners will invest in a country as a minority shareholder if there is adequate minority-shareholder

protection afforded by the legal regime [Huizinga and Denis 2003:3]. But it is to fall short in the analysis if the buck stops there. To the extent that foreigners are able to collude with the controlling shareholder or to take control of a corporation in industries where they are allowed by law, foreigners may also invest in a country with poor minority-shareholder protection—there is no *a priori* information to expect them to behave as effective monitors⁵³ simply because of their being foreign. If they collude or take control, they become corporate insiders who can expropriate just as well as any other domestic controlling shareholder. If they remain a minority and effectively use their monitoring powers, they become outsiders that positively influence the performance of the company and its managers.

Ultimately, it is not the identity *per se* of the shareholder—that is, whether she is a foreigner or not—that matters in determining her effect on the performance of domestic firms. What matters are the institutions that are faced by the shareholder both in her home country and the final destination of her capital. The recognition of the fundamental contribution of institutions is exceptionally important for countries like the Philippines. Dixit [2004:3] recognizes the disparity:

Only advanced countries in recent times come anywhere near the economist's ideal picture, in which the government supplies legal institutions that are guided solely by concern for social welfare and operate at low cost. In all countries through much of their history, the apparatus of state law was very costly, slow, unreliable, biased, corrupt, weak, or simply absent. In most countries, this situation still prevails. Markets with such weak underpinnings of law differ greatly from those depicted in conventional economic theory.

As the economics profession has started to realize, policy prescriptions formulated exclusively in developed countries for developed countries can have unforeseen

⁵³ Being an “effective monitor” means that she will correct or report any inappropriate behavior she observes. To be an effective monitor, it is not enough that one is able to observe and understand what is going on, which a foreign shareholder is more likely able to do. She must also attempt to stop any value-decreasing action seen. If she colludes in expropriation, then obviously it cannot be said that she is being an effective monitor.

ramifications that exacerbate the problems confronted by economic agents when recklessly transplanted elsewhere.

6 Conclusion

What's in a name? That which we call a rose
By any other name would smell as sweet.

— Juliet, *Romeo and Juliet* (II, ii, 1–2),
William Shakespeare

Thus far, the distinction in the literature has been simply whether the shareholder is foreign or otherwise. That does not seem to matter as much as it does at first glance. In the framework of analysis adopted here, a shareholder, after all, is a shareholder: her nationality *per se* does not affect her behavior directly. It is the institutional infrastructure that she confronts that matter—the *zeitgeist*⁵⁴, in a sense. By this, a distinction can be made between a shareholder from Sweden or the US who invests in the Philippines and another shareholder from Mexico or Vietnam who makes the same investment. It is not that they are foreign; it is whether they behave as corporate insiders or outsiders. Their origin and destination weigh in on this tenuous balance.

As a matter of recapitulation, this conclusion is arrived at by taking an explicit view of the corporation as a nexus of contracts. As such, the principal–agent approach was applied fruitfully. The existing research was examined to illustrate the contribution of the current endeavor to the academic literature. The dynamics within the chosen locale—the Philippines—was then described so that, finally, a meaningful discussion of the foreign shareholder–controlling shareholder interaction could take place.

⁵⁴ German; “the general intellectual, moral, and cultural climate of an era.”

As in everything in economics, it all comes down to the margin. The foreign shareholder, in her decision to either be “good” or “bad”, makes a comparison between the marginal benefit of colluding with the controlling shareholder (or taking control of the company in an economy with poor shareholder protection) and the marginal benefit of instituting good corporate governance. A crucial aspect to point out, though, is that the evaluation of costs and benefits does not involve merely the pecuniary costs and benefits. In economies such as the Philippines, the non-pecuniary costs and benefits are equally—arguably, more so—important. It is hardly a stretch of imagination to envision a situation where the pecuniary cost of poor corporate governance (say, by a decline in the value of the company through its share price) is outweighed by the non-pecuniary and private benefit of political influence. In fact, it may be the case that expropriation of minority shareholders makes it possible to buy political clout. Looking at it from the opposite end, successes in the political sphere may be cross-subsidizing failures in the corporate sector.

This study is admittedly exploratory in nature so more research is necessary but the direction of future endeavors is quite obvious and two are highlighted here. First, there is a need to quantify the effects of foreign shareholders. But it is no longer sufficient simply to use a dichotomous variable that identifies them as either foreign or not. It is clearly more fruitful to embark on research that identifies their country of origin and whether or not this country is perceived to have or actually has good or bad minority shareholder protection. Second, country-specific studies seem to be crucial in analyzing these matters because of the high degree of specificity with respect to institutional development. This does not mean that broad-based studies are useless. For comparative purposes, they should still

be on the horizon—or perhaps better yet, conducted parallel to country studies—but going back to the proverb alluded to earlier, the trees must actually be there before any forest can be appreciated. Only then can meaningful policy prescriptions be formulated that specifically address the aforementioned problems. It is true that *fra il dire e il fare c'è di mezzo il mare*⁵⁵ but this study makes the next step easier to take.

It is unfortunate that instead of simplifying matters, a complication is added, but as in many cases, the devil is in the details. To dismiss a finer perspective because it makes the analysis uncomfortable is to betray contentment with a shallow understanding of the issue. That is a trap that was hopefully avoided here. Indeed, “it takes courage to recognize the real as opposed to the convenient.”⁵⁶

⁵⁵ Italian; “An ocean lies between what is said and what is done.”

⁵⁶ Barbara Covett, *Notes on a Scandal* [2006], Richard Eyre (Director).

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