View metadata, citation and similar papers at core.ac.uk

brought to you by CORE

provided by Research Papers in Economics

Shareholder Protection

Diversity in Shareholder Protection in Common Law Countries

Priya P. Lele and

Mathias M. Siems*

Following the pioneering work of La Porta, Lopez-de-Silanes, Shleifer and Vishny (La Porta et al. 1998; "LLSV"), it has become fashionable among economists to classify countries according to their legal origin and study different aspects of their company laws and economic development to compare them. One important element of the LLSV research lies in the idea that the "legal origin" of a country – namely, the world-wide distinction between different legal families, such as common law and French, German, and Nordic civil law – in some way influences national financial development.

In an earlier paper Siems (2007) already discussed the unhelpfulness of legal origins in comparing laws across countries and suggested instead more precise criteria for this purpose. Our paper uses a "leximetric analysis"[1] of shareholder protection in three common law countries (the UK, the US and India) to show that even amongst three undoubtedly "English legal origin countries" the laws can vary so much as to make their classification into one single group according to their legal origins seem almost naïve.

This article is structured as follows: first we set out the main contentions of the LLSV studies. Second, we discuss our new shareholder protection index and the choice of the UK, the US and India for this article. By using our leximetric analysis we then compare the laws of the UK, the US and India.

Main contentions of the LLSV studies

Put simply, the core arguments of the LLSV studies are that (i) the extent of protection afforded to shareholders and creditors by a legal system determines the extent to which firms will be able to obtain external financing; and (ii) the common law countries ("English legal origin countries") offer greater protection than the civil law countries ("French, German, and Nordic legal origin countries"). Legal origins thus determine the financing of corporate growth, and through that and other channels, the nature of the financial system and ultimately, perhaps, overall economic growth.

While LLSV's initial research was a bit crude or ad hoc, over time it became slightly more refined (La Porta et al. 2006; Djankov et al. 2003, 2005, 2006; Botero et al. 2004)[2] and included efforts to try and explain the causal mechanisms by which legal origin may influence financial development. One of the leading hypotheses explaining the causal relationship is the "adaptability mechanism". According to this hypothesis, judges in common law legal systems are able to change the law on a case-by-case basis, thereby keeping pace with changes in the society and ensuring the adaptability of regulation to changed circumstances. In contrast, civilian legal systems suffer from rigidity, as changes through legislation may be made infrequently.[3] LLSV also claim that there is a difference in "regulatory style": common law systems typically favour market solutions, i.e. contracts and private litigation as opposed to detailed "top down" regulation and enforcement through government agencies in civilian systems (Beck et al. 2003; Botero et al. 2004).

---

* Priya P. Lele (P.P.Lele.04@cantab.net) is Junior Research Fellow, Centre for Business Research, University of Cambridge; Mathias M. Siems (siems@fulbrightweb.org) is Reader in Commercial Law, University of Edinburgh and Research Associate, Centre for Business Research and Peterhouse, University of Cambridge. This article was produced out of our work on the project "Law, Finance and Development" at the Centre for Business Research, University of Cambridge, UK and as such ties in with our earlier papers – Lele and Siems (2007) and Siems (2006a).

[1] This term was first used by Cooter and Ginsburg (2003). For an explanation of the term, see Lele and Siems (2007).

[2] For critical accounts, see e.g. Siems (2005a and b); Ahlering and Deakin (2005); Roe (2006).

[3] For a more comprehensive approach to legal adaptability, see Siems (2006b).

Leximetric analysis of three common law countries

We use a new shareholder protection index of 60 variables for a period of 35 years to compare the laws of the UK, the US and India. This article thus ties in with a previous article of ours on the coding of shareholder protection in five countries.[4] However, now we look more closely at the striking features of the three common law countries and highlight the differences in the ways in which each of these countries approach the topic of shareholder protection.

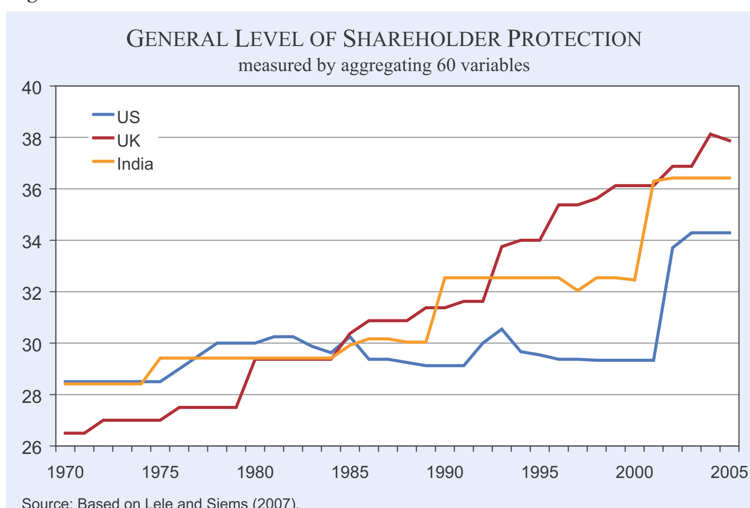
For the present article we have decided to look at the UK, the US and India only. Whilst the UK is of course the "mother country", the choice of the US is also easily defendable as the world's largest economy. We chose India because it is a "transplant country" – UK laws were transmitted to India during its colonisation by the British. India is also a developing country, with one of the fastest growing economies, and the biggest democracy in the world.

Figure 1 is a graphical representation of the aggregate of all the 60 variables from our shareholder protection index for a period of 35 years. One can see that there are differences in these countries across the time series and that the differences in the aggregates between UK and Indian law have decreased in recent times whereas those between Indian and US law have increased over the period. What is more, both the Indian and the US graphs show a similar pattern of change – namely, fewer changes (see the smaller steps and bigger plateaus) for most parts of the time-series and then a quantum leap in the last four years as opposed to the incremental and near constant changes in the UK graph. The sweeping increase in scores around 2001 for India and 2002 for the US are a result of the strengthening of corporate governance norms in these countries with the introduction of Clause 49 of the Listing Agreement and the Sarbanes Oxley Act 2002, respectively. In contrast the UK graph shows smaller, steadier and incremental changes – one can quite easily recognise, for instance, the steps resulting from the company law reform of 1980 and 1985 and then the changes in the 1990s caused mainly by the codes of best practices.[5]

It is interesting that although the UK and the Indian graphs are quite similar for 2005, it was the Indian and the US graphs that had the same score in the early 1970s.[6] To elaborate on the differences between the Indian and the UK graph: Indian commercial laws are for the most part based on the UK laws, e.g. the Indian Companies Act of 1956, which is the basic company law legislation even today, is based on the UK Companies Act of 1948. Yet, when India adopted a socialist policy after independence, it began to develop certain features of its own. For example, provisions concerning public enforcement of company law contained in the Companies Act of 1956.[7] Changes to UK law in 1980, mainly as a result of the EU Capital Directive 77/91/EEC, improved the aggregate score of the UK so that it matched the aggregate score for India. They shared the same score only until 1985, when reforms in UK company law and corporate governance codes continued the UK on its steady path of improved protection, leaving India behind. However, in recent times, the UK and Indian graphs have come closer – mainly due to the introduction of corporate governance norms in India based largely on the UK codes.[8]

With respect to the differences between the Indian and the US graph, the strengthening of provisions in

Figure 1



[4] See Lele and Siems (2007); for details of our data, see http://www.cbr.cam.ac.uk/research/programme2/project2-20output.htm.
[5] Companies Act 1980; Companies Act 1985; Cadbury Committee, Code of Best Practice 1992; Greenbury Committee, Code of Best Practice 1995; Hampel Committee, Combined Code of Best Practice 1998.
[6] Of course, a similar score does not mean that the two countries have identical laws. Indeed, as we looked at different aspects of company law that can protect shareholders, it is possible that the same score is a result of both countries protecting shareholders in entirely different areas; see also Lele and Siems (2007; 37).
[7] See "Public control and mandatory law", below (p. 6), for details.
[8] Clause 49 of the Listing Agreement, introduced in 2000 by the SEBI, vide its circular dated 21-2-2000 and implemented from 2001 onwards.

relation to public enforcement of company law in India in 1975 moved the two countries apart. A further increase in India's score in the late 1980s and early 1990s, mainly due to changes in its takeover law, increased this gap.[9] Although both countries made a quantum leap in the last four years as a result of the strengthening of corporate governance norms, the basic gap between the two continues to exist.

The difference in the UK and US graphs has been considerable almost throughout the entire 35 years, with the exception of a brief period between 1985 and 1986 when they both shared the same score. To elaborate, US law had a slightly better score until 1984 but then the steady improvement in the UK shareholder protection law slowly reduced the gap between the two. These improvements strengthened the directors' duty of care and included a remedy against minority oppression and the duty to disclose major shareholder ownership. It is also interesting to note that, after a brief period in the mid-1980s when they both shared the same score, the UK curve continued to climb higher with improved scores mainly resulting from successive company law reforms and codes of best practices.[10] The US score on the other hand only improved in the last few years, mainly because of the Sarbanes Oxley Act 2002, but it is still a much lower score than that of the other two countries.[11]

Modes by which shareholder protection is changed

It is obvious from Figure 1 above that the scores of all three countries have increased over time, so that one can say that shareholder protection has increased in these countries over the past 35 years. What is not so obvious, however, are the mechanisms adopted by each of these countries to protect shareholders and also the mode by which changes have occurred across this time.

With respect to the latter, we observe that the most common mode of legal reform in all three common law countries has been legislative changes. Of the 101 (UK: 33; US: 40; India: 28) times that changes in these three countries occurred in the relevant period, 86 of them were a result of legislation or subordinate legislation. Thus, contrary to the predictions of the adaptive mechanism, according to which judges in common law countries are deemed to be better equipped to define law on a case-by-case basis and hence adopt the law to suit the changes in the society – at least in the field of shareholder protection – the most common form of bringing changes in the law has been through legislation.

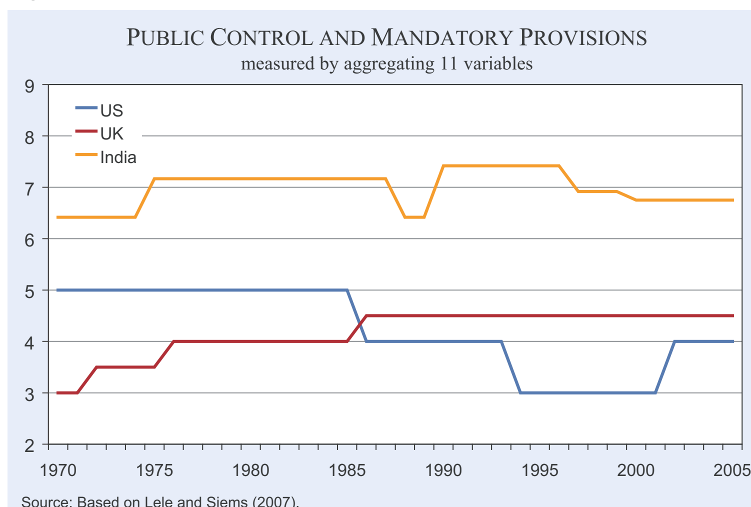
Particularly, whilst the Indian curve in this picture of aggregates exhibits a change at least 28 times, not a single change is attributable entirely to the authoritative restatement of the law by the judiciary. This is based on various historical and systemic reasons: most areas of substantive as well as procedural laws applicable in India were inherited in the form of codified laws drafted by the British as early as the 1870s. Socialistic policy post-independence meant that preference was given to top-down regulation and central planning and that there was a bias towards legislative mechanisms for legal reform. Further, inordinate judicial delays seriously impede the working of jurisprudence as a mechanism of legal reform in India. For instance, on an average it takes anywhere up to 20 years for a case to be resolved.[12] To be sure, the point here is not that judicial precedents are not important in India – indeed true to its common law legal origin (at least to this extent), judicial precedents are given their due, considered almost sacrosanct and created consciously bearing in mind their consequences for future parties.[13] But the point is that judicial delays curtail the role of the judiciary in reforming the law to better adapt to the changing needs of the society. Over time, therefore, India seems to have moved away from the common law tradition of changing the law on a case-by-case basis and toward the tradition of detailed rule-making backed by public enforcement mechanisms, which is usually associated with the civil law countries.[14]

The UK, the US and India differ not only in the modes by which shareholder protection has changed over time but also in the mechanisms by which they protect shareholders and in the areas of emphasis. To further highlight the differences in areas of emphasis, in Figure 2, we aggregate the variables dealing with

[9] Introduction of Clause 40 B of the Listing Agreement in 1980; SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 1994; SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 1997.
[10] See note 5 above.
[11] It should be noted that our 60 variables are included and coded because they are relevant for shareholder protection, but they do not represent "maximum" or "optimum" protection for shareholders. A larger score on our index need not necessarily mean better protection for shareholders. Please see Lele and Siems (2007; 33–35) for more on this.

[12] See Debroy (2000).
[13] Interviews with judges in India by John Armour and Priya Lele in September 2006.
[14] For similar or more on this, see also a forthcoming paper by Armour and Lele (2007).

Figure 2



Source: Based on Lele and Siems (2007).

public control and mandatory provisions. In Figure 3, we aggregate variables that deal with voting power of shareholders, and in Figure 4 we aggregate variables that are particularly significant for listed companies.

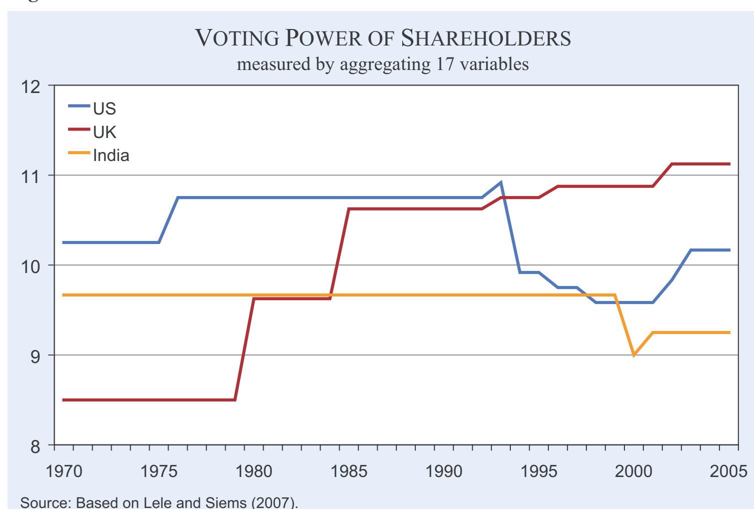
There are various ways in which shareholders may be protected in a legal system. For instance, with respect to the protection of minority against majority shareholders, quorum and supermajority requirements may ensure that a significant majority approves decisions, fiduciary principles may control the voting of the majority shareholder, or appraisal rights may provide the minority shareholder a way to exit the company for full compensation (see Lele and Siems 2007). But it is possible that these private means do not work or are not deemed very effective so that the state acts to protect the interests of the involved parties. We looked at some of the ways in which the state may interfere to protect the interests of the shareholders, and these variables are clubbed together and represented graphically in Figure 2 as "public control and mandatory provisions". These include variables relating to public enforcement, for instance, directors' disqualification, public authorisation for director's self-dealing of substantial transactions, public authorisation for appointment of managers, power to intervene in cases of prejudice to public interest or interest of the company, as well as variables that measure the extent to which company law is mandatory.

In the case of India, following a socialistic precepts, the state took on an even greater role in company law to protect interests of the involved parties – hence the higher scores. For instance, whilst a director's self dealing does not require general meeting approval in Indian law, it requires central government authorisation. Similarly, minority shareholders in India may approach the central government to intervene in cases of oppression or mismanagement by a majority (although actual intervention by government is extremely rare). However, it is interesting to note that even in India, there is an increasing trend to (i) reduce instances requiring the state's authorisation, and (ii) even where such authorization is required, to delegate the powers of the central government to the local company registrars for speedier action and convenience to all. Thus, for instance, the requirement of prior authorisation of the government for appointment of managerial personnel has been relaxed since 1988, with the introduction of Schedule XIII (as amended from time to time), admittedly to make the law more flexible and to give companies more freedom in this respect.[15]

Unsurprisingly, the two developed countries contain fewer provisions for public control and mandatory law and hence score lower on this graph. However, there are some provisions that are mandatory or involve public enforcement or control in the US and the UK, and we observe some development in their curves during the relevant period. In the US this is not based on company but on securities law. For instance, mandatory securities law addresses directors' disqualification, proxy voting and the one-share one-vote principle. The only question of company law which is coded here is the 1986 amendment to Delaware's corporate law, which now provides that directors' liability for breach of duty of care is no longer mandatory but can be excluded in the certificate of incorporation – therefore the drop in the US curve in 1986. Finally, UK company law has the least amount of mandatory features or provisions concerning public control. Concerning the rules on disqualification of directors, which were strengthened in the UK, first in 1976 and then in 1989, we observe some improvement in the UK scores leading to small "steps" in the UK curve during that period.

[15] Finally, although we do not code proposed changes, it is interesting to note that the 2005 JJ Irani Report on Company Law Reform (available at http://www.primedirectors.com/pdf/JJ%20Irani%20Report-MCA.pdf) proposes to remove public control of self-dealing by directors and instead to require a general meeting resolution.

Figure 3



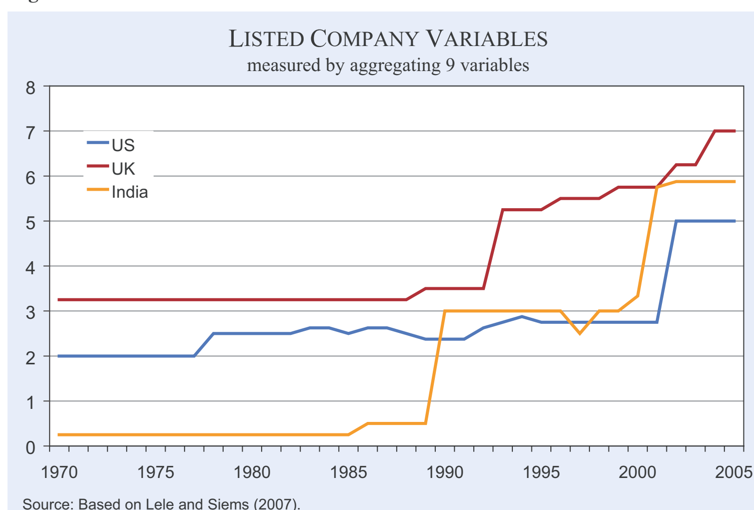
Source: Based on Lele and Siems (2007).

A "democratic" perception of the company may suggest that shareholder voting in the general meeting is most important. Thus, Figure 3 we have aggregated all variables which directly concern the voting power of shareholders. This concerns, on the one hand, ten variables which code different powers of the general meeting. On the other, we considered the importance of the vote of minority shareholders by coding quorum and supermajority requirements, the one-share one-vote principle, cumulative voting, and prohibition of voting by interested parties. However, other topics which are related to the general meeting, such as involvement and information in its run up or the right to ask questions, have not been taken into a account in this aggregate.

The most interesting feature about Figure 3 is that the laws of the three countries evolved in different directions. Whilst the UK curve shows an improvement, the US curve actually fell a few points, and the Indian curve remained more or less stable. The improvement in scores for the UK is attributable to the strengthening of powers of the general meeting in 1980 and then in 1985.[16] In contrast to this, whilst the US law on the powers of the general meeting has hardly changed, with respect to the one-share one-vote principle, the 1994 amendments to the NYSE Listed Company Manual made it easier to issue shares with multiple-voting rights and voting caps – thereby reducing the US score. Finally, the Indian curve has remained stable for most parts of the time series apart from a minor decrease in the score in 2000 due to changes in the law allowing issuance of new shares with differential voting rights and then the partial recovery in 2001 resulting from the introduction of a provision which facilitates election of a small shareholders' director.[17]

For the general aggregate (see above) we coded the law as applicable to listed companies, yet most variables of our index would also apply to unlisted companies. Some of the variables are usually only significant for listed companies, however. In Figure 4, we aggregate such variables. These include, for instance, variables relating to the composition of the board of directors, disclosure requirements in relation to directors' remuneration and of major share ownership, requirements of strict neutrality in case of takeovers and of mandatory and public bids, as well as compliance with corporate governance codes.

Figure 4



Source: Based on Lele and Siems (2007).

In Figure 4 the difference between the two developed countries and India is most obvious. Yet, there are differences between the UK and the US curves as well. The initial slight advantage of the UK law over the US law is mainly due to the

[16] Regarding allotment of shares and long-term service contracts in 1980 and de-facto changes in 1985.
[17] This marginally improved the score in relation to the variable on "proportional representation" included in this group of aggregates.

differences in their regulation of takeovers – of the two only UK law contains requirements of mandatory bid and strict neutrality in case of takeovers.[18] In the 1990s the various best practice codes further improved the UK's score steadily. The US curve only made some progress with the Sarbanes Oxley Act in 2002. Still, the consistently lower score of the US may be surprising. It is important to point out, however, that because of our focus on rules that address the protection of shareholders (and not investors and capital markets in general), numerous aspects of securities law have not been taken into account. For instance, the rules on insider trading and transparency of financial information are not coded in our index.

The Indian curve has the lowest scores for almost the first two decades because the law in India in this area only began to develop in the late 1980s and since the beginning of this century has experienced a considerable leap.[19] Although India is one of the few developing countries that had a comparatively well developed equity market at independence – fragmented but active stock markets –, socialism, which followed in India in the 1950s through to the 1970s, led to a stagnation of the markets. In the 1950s the first blow to the free market came with the closing of the capital account and under the new socialistic legislation, like the Securities Contract Regulation Act 1954, the equity markets suffered from excessive control. For instance, not only was the issuance of fresh equity regulated – in the sense that it required permission from the government – but pricing was controlled as well. Reforms that began in the late 1980s and mostly after the liberalisation of the Indian economy, i.e. post-1991, have made a huge difference in the law relating to listed companies. The establishment of the Securities Exchange Board of India (SEBI) was a landmark in this regard: it is an independent regulator with powers to enact subordinate legislation for coordinating market activities and governing listed companies, and is backed by powers of enforcement. Securities legislation, mostly in the form of subordinate legislation from SEBI, including the changes in the Listing Agreement, the enactment of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations in 1994 and 1997, and the introduction of corporate governance norms by adding Clause 49 to the Listing Agreement led to a rise in the scores of the index.

[18] For the differences in US and UK takeover law, see also Armour and Skeel (2007).
[19] For this development, see also a forthcoming paper by Armour and Lele (2007).

Conclusion

Previous research often emphasised the similarity of shareholder protection in common law (or "English legal origin") countries. This article, however, has found a remarkable diversity of shareholder protection in common law countries. Using our new shareholder protection index with 60 variables, we have presented some graphical representations to highlight and discuss diversity across the UK, the US and India. Our study shows that the UK, the US and India not only differ in the modes by which laws on shareholder protection have changed over time but also in the mechanisms by which they protect shareholders and in the areas of emphasis. For instance, we found that of the three countries, the Indian law on shareholder protection has changed the least due to laws made by judges and contains the maximum number of provisions relating to "public control or mandatory law" as a mechanism for protecting shareholders. The UK law on "voting powers" has improved over the concerned period with increased empowerment of the general meeting. With respect to the laws dealing with "listed company variables", we found that in the UK the law has improved steadily since the 1990s and in the US there was a dramatic leap in 2002. The laws in India in this regard began developing only after the late 1980s and early 1990s with major improvements around 2001. Thus our study shows that even amongst three undoubtedly "English legal origin countries" the laws vary so much that their classification into one single group according to their legal origins seems almost naïve. This also casts a doubt on the claim that a particular legal origin has an impact on the quality of law, which in turn affects corporate growth and economic development.

References

Ahlering, B. and S. Deakin (2005), "Labour regulation, Corporate Governance and Legal Origin: A Case of Institutional Complementarity?", CBR Working Paper, available at http://ssrn.com/abstract=898184 (and Law & Society Review, forthcoming).

Armour, J. and P. Lele (2007), "Law, Finance, and Development in India", CBR Working Paper, in press.

Armour, J. and Skeel, D. (2007), "Who Writes the Rules for Hostile Takeovers, and Why? The Peculiar Divergence of US and UK Takeover Regulation", *Georgetown Law Journal,* in press, draft version available at http://ssrn.com/abstract=928928.

Beck, T., A. Demirguc-Kunt, and R. Levine (2003), "Law and Finance. Why Does Legal Origin Matter?", *Journal of Comparative Economics* 31, 653–57.

Botero, J., S. Djankov, R. La Porta, and F. Lopez-de-Silanes (2004), "The Regulation of Labor". *Quarterly Journal of Economics* 119, 1339–382.

Cooter, R. and T. Ginsburg (2003), "Leximetrics: Why the Same Laws are Longer in Some Countries than Others", working paper , available at http://ssrn.com/abstract=456520.

Debroy, B. (2000), "Some Issues in Law Reform in India" in J.-J. Dethier (ed.), *Governance, Decentralization and Reform in China, India and Russia,* Kluwer, Dordrecht Kluwer pp. 339–68.

Djankov, S., R. La Porta, F. Lopez-de-Silanes, and A. Shleifer (2003), "Courts", *Quarterly Journal of Economics* 118, 453–517.

Djankov, S., R. La Porta, F. Lopez-de-Silanes, and A. Shleifer (2005), "The Law and Economics of Self-Dealing", working paper, available at http://ssrn.com/abstract=864645.

Djankov, S., C. McLiesh and A. Shleifer (2007), "Private Credit in 129 Countries", *Journal of Financial Economics,* in press.

La Porta, R., F. Lopez-de-Silanes, A. Shleifer and R. W. Vishny (1998), "Law and Finance", *Journal of Political Economy* 106, 1113–155.

La Porta, R., F. Lopez-de-Silanes, and A. Shleifer (2006), "What Works in Securities Laws?", *Journal of Finance* 61, 1–32.

Lele, P. and M. Siems (2007), "Shareholder Protection – A Leximetric Approach", J*ournal of Corporate Law Studies,* 17, 17–50, draft version available at http://ssrn.com/abstract=897479.

Roe, Mark J. (2006), "Legal Origins and Modern Stock Markets", *Harvard Law Review,* 120, 460–527.

Siems, M. (2005a), "Numerical Comparative Law – Do We Need Statistical Evidence in Order to Reduce Complexity?", *Cardozo Journal of International and Comparative Law* 13, 521–40.

Siems, M. (2005b), "What does not work in comparing securities law" *International Company and Commercial Law Review,* 300–05.

Siems, M. (2006a), "Shareholder Protection Across Countries – Is the EU on the Right Track?". *DICE Report: Journal for Institutional Comparisons* 3, 39–43.

Siems, M. (2006b), "Legal Adaptability in Elbonia", *International Journal of Law in Context,* 2, 393–408, draft version available at http://ssrn.com/abstract=899507.

Siems, M. (2007), "Legal Origins: Reconciling Law & Finance and Comparative Law", *McGill Law Journal,* in press, draft version available at http://ssrn.com/abstract=920690.