Which Countries Give Investors the Best Protection?

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Does the owner of a share of stock in Mexico have the same rights as a shareholder in Germany or India? Is a creditor in Italy protected as well as one in Switzerland? Do laws protecting investors differ among countries in systematic ways? Are these laws sufficiently enforced everywhere? And if there are differences, do they matter for corporate finance? This Note reports on an empirical study that examines these issues by looking at the rules governing investor protection and the quality of law enforcement in a sample of countries in Europe, Asia, Africa, and North and South America.

Investor rights and governance

Shares in a company typically give their owners the right to vote for its directors, while debt gives creditors the power to, for example, repossess collateral when a company fails to make promised payments. Thus, shareholders receive dividends because they can vote out the directors who do not pay them, and creditors are paid because they have the power to repossess collateral. Without these rights, investors would not be able to get paid, and therefore firms would not have the benefit of raising funds from these investors.

But these rights also depend on the legal rules of the jurisdiction where the securities are issued. And since the protection investors receive determines their readiness to finance firms, corporate finance may critically turn on these legal rules and their enforcement. Indeed, differences in the legal protection of investors might help explain why firms are financed and owned so differently in different countries. Why do Italian companies rarely go public? Why does Germany have such a small stock market, but also maintains very large and powerful banks? Why is the voting premium—the price of shares with strong voting rights relative to that of shares with limited voting rights—small in Sweden and the United States and much larger in Italy and Israel? Indeed, why were Russian stocks nearly worthless immediately after privatization—by some estimates one hundred times cheaper than Western stocks backed by comparable assets—and why do Russian companies have virtually no access to external finance? The content of legal rules in different countries may well shed light on these corporate governance puzzles.

Analytical approach

The starting point for the analysis is the recognition that there are only four broad “families,” or “origins,” of most laws governing investor protection, and commercial laws more generally: English, or common, law, French civil law, German civil law, and Scandinavian civil law. (Most countries adopted their legal system as a result of colonization or conquest by England, France, or Germany—or Spain, which was conquered by Napoleon and so adopted its laws from France.) Thus, a study of investor protection in different countries is largely a study of protection in the four legal families. The focus of the analysis of legal rules is on a fairly narrow range of differences in two types of laws relating to investor protection: company laws and bankruptcy and reorganization laws.

Shareholder rights

The analysis begins by considering shareholder rights under company laws. Because sharehol-
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The survey sample

Common law tradition
Australia
Canada
Hong Kong
India
Ireland
Israel
Kenya
Malaysia
New Zealand
Nigeria
Pakistan
Singapore
South Africa
Sri Lanka
Thailand
United Kingdom
United States
Zimbabwe

French civil law tradition
Argentina
Belgium
Brazil
Chile
Colombia
Ecuador
Egypt
France
Greece
Indonesia
Italy
Jordan
Mexico
Netherlands
Peru
Philippines
Portugal
Spain
Turkey
Uruguay
Venezuela

German civil law tradition
Austria
Germany
Japan
Republic of Korea
Switzerland
Taiwan (China)

Scandinavian civil law tradition
Denmark
Finland
Norway
Sweden

ers exercise their power by voting for directors, evaluations of shareholder rights focus on voting rights. These include voting rights attached to shares, rights that protect the voting mechanism against interference by insiders, and remedial rights. Investors may be better protected when dividend rights are tightly linked to voting rights, that is, when companies are subject to one-share-one-vote rules. The idea is that when votes are tied to dividends, insiders cannot appropriate cash flows by maintaining voting control despite controlling only a small proportion of the company's shares.

Five other rights essentially describe how easy it is for shareholders to exercise their voting rights. These rights measure how strongly the legal system favors shareholders relative to managers in the voting process.

- To vote in shareholders meetings in some countries, shareholders must show up in person or send an authorized representative. In other countries, by contrast, they can vote by mail, which makes it easier for them to cast their votes. In Japan, for example, about 80 percent of companies hold their annual meetings the same week, and voting by mail is not allowed.

- In some countries, the law requires that shareholders deposit their shares with the company or a financial intermediary several days before a shareholders meeting. This practice prevents shareholders from selling their shares for several days around the time of the meeting and keeps shareholders who do not bother to go through this exercise from voting.

- Some countries allow cumulative voting for directors, which in principle gives minority shareholders more power to put their representatives on boards of directors.

- In some countries, the law provides minority shareholders with legal recourse against perceived oppression by directors. The mechanisms may include the right to sue directors (as in American derivative suits) or to force the company to purchase the shares of shareholders who object to such fundamental changes as mergers or asset sales.

- Company law also establishes the percentage of share capital needed to call an extraordinary shareholders meeting—the higher the percentage, the harder it is for minority shareholders to organize a meeting.

Two major facts emerge from the analysis of shareholder rights in the countries in the sample. First, countries with a common law system afford the best legal protection to shareholders. They most frequently allow shareholders to vote by mail, they never block the sale of shares for shareholders meetings, they have the highest incidence of laws protecting oppressed minorities, and they generally require a relatively small percentage of shares to call an extraordinary shareholders meeting. Second, countries with French civil law afford the worst legal protection to shareholders. They have the lowest incidence of allowing voting by mail, a high incidence of blocking share sales for shareholders meetings, and a low incidence of laws protecting oppressed minorities, and require the highest percentage of share capital to call an extraordinary shareholders meeting.

The next step is to ask whether, in a statistical sense, once all the legal rules are considered together, the origin of legal systems matters. The analysis confirms that it does. In Australia and South Africa, two common law countries, a minority shareholder can vote by mail, can trade his shares during a shareholders meeting, is protected from certain expropriations by directors, and needs only 5 percent of share capital to call an extraordinary meeting. By contrast, in Italy and Belgium, whose legal systems are based on French civil law, a minority shareholder cannot vote by mail, cannot trade his shares during a shareholders meeting, is not protected from expropriation by directors, and needs 20 percent of share capital to call an extraordinary meeting.

A final step is to control for income level and see whether origin still matters. Again, the results show that it does. Thus, the importance of legal origin comes out loud and clear from this analysis of shareholder rights.
Creditor rights

The creditor rights most essential for debt finance are those to repossess collateral and to have a say in reorganization. In some countries, the law makes it difficult for lenders to repossess collateral in part because such repossession can lead to the liquidation of firms, which is viewed as socially undesirable. In these countries, lenders may still have some powers against borrowers through their votes in decisions on how to reorganize the company and pay off the creditors. The analysis uses four variables for creditor rights.

- In some countries, the reorganization procedure imposes an automatic stay on the debtor company’s assets, preventing secured creditors from getting possession of loan collateral. This rule obviously protects managers and unsecured creditors against secured creditors and prevents automatic liquidation. In other countries, by contrast, secured creditors can pull collateral from firms being reorganized without waiting for the reorganization to be completed.

- Some countries do not ensure secured creditors the right to collateral in reorganization. In these admittedly few countries, secured creditors are in line behind the government and workers, who have absolute priority over them. In Mexico, for example, various social constituencies must be repaid before secured creditors, often leaving the creditors with no assets to back their claims.

- In some countries, management can seek protection from creditors by unilaterally filing for reorganization, without creditor consent. Such protection, called Chapter 11 in the United States, gives management a great deal of power against creditors, since creditors can at best get their money or collateral only after a delay. In other countries, creditors’ consent is needed to file for reorganization, so managers cannot so easily escape creditors’ demands.

- In some countries, management stays in place pending the resolution of the reorganization procedure, while in others, such as Malaysia, management is replaced by an agent appointed by the court or the creditors. This threat of dismissal may enhance creditors’ power.

The results of the analysis of creditor rights show a pattern similar to that for shareholder rights. Common law offers the best protection, and French civil law the worst. Thus, it does not appear that some legal families protect shareholders while others protect creditors—though German civil law countries favor secured creditors.

Adaptations

How do the countries with poor laws cope with their consequences? Do firms in these countries receive no financing? Or is finance made possible by other, substitute mechanisms of corporate governance that have been incorporated into the law or that lie outside the law? One possible adaptation to fewer laws is strong enforcement. Another is to introduce mandatory standards of capital retention and capital distribution to investors; legal scholars sometimes refer to these standards, which limit the opportunities for managerial expropriation, as “bright line” rules.

Yet another adaptation is ownership concentration. Some concentration of ownership of a firm’s shares is typically efficient: it provides managers with an incentive to perform, and large investors with an incentive to monitor the managers. But some dispersion of ownership among small investors is also desirable to diversify risk. When the law protects investors, even small investors can hope to get something back on their money. When it does not, investors must be large and powerful to stand up to management and extract payments from it.

To assess enforcement, the analysis uses five measures: efficiency of the judicial system, rule of law, corruption, risk of expropriation (outright confiscation or forced nationalization) by the government, and likelihood of contract repudiation by the government. In addition to these rule of law variables, the study uses an estimate of the quality of accounting standards.
The results show that the quality of enforcement is highest in Scandinavian and German civil law countries, next highest in the common law countries, and lowest in French civil law countries. And they show that French civil law countries are more likely to have bright line rules—mandatory dividends and capital reserves.

The analysis also shows that the quality of shareholder protection and the protection of the voting process against manipulation by directors are significant determinants of ownership concentration. Moreover, between them, these two variables account for the higher concentration of ownership in the French civil law countries. These results support the idea that heavily concentrated ownership results from poor protection of investors—and may in fact substitute for investor protection. The evidence shows that poor laws do make a difference, and that they may have costs. One of the costs of heavily concentrated ownership for large firms is that their core investors are not diversified. The other cost for these firms is that they probably have difficulty raising equity finance, since minority shareholders fear expropriation by managers and majority shareholders. Are these results simply a consequence of income level? Here again, the evidence suggests weaknesses in French civil law regardless of income level.

Is there a legal trap?

Do poor countries offer systematically lower protection to investors? The study finds no correlation between income level and shareholder rights, and, if anything, some creditor rights are weaker in richer countries. Some countries—such as France and Italy—have managed to get rich despite having few laws protecting investors. But richer countries have a higher quality of law enforcement, and poor countries' failure to consistently enforce basic investor protection may well help keep them poor.

Conclusion

The results of the analysis suggest three broad conclusions. First, laws protecting investors differ markedly around the world, though in most places they tend to give investors a rather limited bundle of rights. Countries whose legal systems stem from the common law tradition tend to protect investors considerably better than do countries whose systems are based on civil law, especially French civil law. Countries whose systems are based on German and Scandinavian civil law take an intermediate stance toward investor protection. There is no clear evidence that different countries favor different types of investors; the evidence points instead to a stronger stance favoring all investors in common law countries.

Second, law enforcement too differs a great deal around the world. German and Scandinavian civil law countries have the best law enforcement, although to some extent this reflects their higher average income. Law enforcement is also strong in common law countries, and weakest in the French civil law countries.

Third, good accounting standards, rule of law, and shareholder protection have a strong negative correlation with the concentration of ownership. This result suggests that inadequate protection of investors may be costly. If small investors are not protected, companies will be unable to raise capital from them, and entrepreneurs will be unable to diversify their holdings. High ownership concentration, then, may be a symptom of a poorly functioning capital market.