PROTECTING MINORITY INVESTORS IN PRIVATELY HELD COMPANIES IN APEC

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ACRONYMS

APEC	Asia-Pacific Economic Cooperation
EODB	Ease of Doing Business
EU	European Union
FDI	Foreign Direct Investment
GCI	Global Competitiveness Index
GDP	Gross Domestic Product
IFC	International Finance Cooperation
OECD	Organization for Economic Cooperation and Development
PMI	Protecting Minority Investors
RPT	Related Party Transaction
SMEs	Small and Medium-sized Enterprises
U.S.	United States of America
USAID	United States Agency for International Development
WEF	World Economic Forum

EXECUTIVE SUMMARY

Economies throughout the Asia-Pacific Economic Cooperation (APEC) region have among the strongest legal protections for minority investors in publicly-traded companies. On average, the APEC region scores higher than even the European Union (EU) on the Protecting Minority Investors indicator of the World Bank's Ease of Doing Business ("EODB" or "Doing Business") index. Nevertheless, the APEC region has room for significant improvement for protecting minority investors in privately-held companies—i.e., typically smaller and medium-sized companies the shares of which are not traded on an organized securities exchange.

> APEC has committed to helping its member economies improve formal rules and private ordering to help create an enabling environment for business that is conducive to increased trade and investment within and between member economies. In 2009, APEC Leaders committed to coordinating efforts to support improvements to the World Bank's Ease of Doing Business Index. APEC agreed upon an action plan to see a combined target of 25 percent improvement across key EODB priority areas including: starting a business, getting credit, trading across borders, enforcing contracts, and dealing with permits. In 2018, APEC exceeded its target. This year, APEC commissioned a deeper analysis of APEC's Protecting Minority Investors indicator as a potential new priority area under the Third Phase of the EODB Action Plan. This report aims to highlight how APEC could leverage past successes in this topic, and to support shared opportunity to improve regional performance.

The risks minority investors face in privately held companies can be complex and considerable. When unchecked by law or well-crafted shareholder agreements, a dishonest majority investor has substantial opportunities to shape company decisions for personal gain and to the detriment of minority shareholders. For example, a controlling shareholder may redirect resources from a company they own jointly to another that they own fully, fleecing minority investors of part of the value of their equity stake. Without adequate safeguards in place, majority investors could potentially do so with little transparency or room for minority shareholders to voice their opinions. Further, by investing in companies not traded publicly on an exchange, the minority investor has limited options to exit challenging situations.

The EODB index includes ten policy prescriptions designed to reduce the risks of investing in privately held companies.[1] While APEC fares well on these issues relative to other regional comparators, there is an opportunity for significant measurable gain within this set of sub-indicators. This represents an opportunity for APEC economies to reduce the legal risk that equity investors face with regards to smaller enterprises. Reducing such risk is likely to increase investment in smaller enterprises, offering a boost to a segment of firms that generate substantial income and employment across the region.

This report reviews common corporate governance frameworks, delves into data on privately-held companies in the APEC region, and reviews legal and institutional approaches to protect minority investors. It concludes with suggestions for steps that economies across APEC can take to strengthen the combination of institutions, policies, and practices of APEC economies to protect minority investors.

[1] This report is based on the World Bank Doing Business 2019 report, data, and methodology as these were the latest available at time of drafting this report.

These recommendations can help APEC economies improve their performance on the EODB index, expand the potential pool of capital available for small and medium enterprise growth, better support foreign direct investment, and facilitate more inclusive growth.

1. INTRODUCTION

In virtually all APEC economies, private companies drive economic growth and job creation. To expand and thrive in their sectors, these companies often need additional funding. Outsiders willing to share the risks and opportunities of a business venture can serve as a source of such funds, especially in sectors where risks and rewards are higher.

Organized securities markets are an important channel for attracting these funds. China and Southeast Asia for instance, have experienced a boom of late, with hundreds of growing companies listing their shares on stock markets across the region, and with investors eagerly buying them in search of the latest high-tech growth story. Yet in the shadow of these well-covered securities exchanges, there is a market for capital directed at smaller enterprises that have not yet listed; one that it is far more fragmented and far less transparent. These smaller companies, perhaps with just a few years of operation, are looking for additional funds to leverage their advantage and capture new markets. Outside investors are ready to provide such funds, but only if a growing company can offer a compelling investment opportunity.

In making investment decisions, venture capitalists and other outside investors focus on opportunity and risk. Policy makers and regulators can influence these decisions by affecting legal risk—i.e., by regulating how and to what extent an investor's bargained-for rights in an investment deal are protected by either the economy's legal rules, the institutions that enforce them, or both.

Most APEC economies have made large gains in mitigating such risks. According to the World Bank's Doing Business project, APEC economies, as a group, have implemented dozens of reforms in the area over the last decade. They now rank relatively high in terms of protecting minority investors, outscoring, for instance, the 28 economies of the European Union.[2]

Less certainty, however, surrounds the protections afforded to minority investors in privately held companies. These investors lack both the ability to exit (by selling their shares on an organized market) and the enhanced regulatory protections afforded to purchasers of publicly traded securities. As a result, investors in privately held companies tend to take on comparatively greater risk. Reducing such risk could produce substantial economic gains, given the vast number of privately held companies operating in APEC economies.[3] These companies can be a critical link between company formation (start-up) and an initial public offering on an organized exchange. As privately held companies move along this path, they employ hundreds of thousands of workers and impact a sizable portion of the gross domestic product (GDP) of APEC economies.[4]

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[2] This report is based on the World Bank Doing Business 2019 report and data as these were the latest data available at time of drafting this report.
[3] See Section 2.2.1 below for estimates.
[4] World Bank, 2009. *The Ease of Doing Business in APEC: The Impact of Regulatory Reforms,* APEC.

Privately held companies also play an important role in foreign direct investment (FDI). Large foreign takeovers of publicly held companies attract substantial media attention; and foreign institutional investors, as a group, often accumulate substantial positions in publicly traded companies. A substantial portion of FDI, however, involves individually negotiated and often substantial investments ("private placements") in privately held companies; or the creation of privately held companies to serve vehicles for joint ventures.[5] Often times, foreign investors prefer to take a controlling block of shares in such companies.

Many APEC economies impose limits on the extent of foreign equity investment in domestic companies. If such restrictions require foreigners to take a minority position, then effective corporate governance to protect these investors becomes critical if an economy wishes to attract foreign capital.

In light of the above considerations the United States proposed "protecting minority investors" as one of the topics under the contemplated Third Phase of the Ease of Doing Business Action Plan. Specifically, it suggested a focus on corporate governance in privately held companies (i.e., companies whose shares are not traded on an organized securities exchange).[6] Viet Nam, the lead of the APEC Economic Committee Friends of the Chair group on Corporate Law and Governance, agreed to co-sponsor this initiative.

Distributed as an initial draft for consultation, this report focuses on the rules, regulations, and institutions that protect minority investors in privately held companies, and how these operate within APEC. Section 2 focuses on key elements of governance for privately held companies and the importance of reform. Section 3 discusses the challenges faced by investors taking minority positions in privately held companies. Section 4 provides summary information on how APEC economies, as reflected by the indicators provided by Doing Business and the World Economic Forum, are addressing some of these challenges.

Sections 5 through 6 then discuss the various ways to mitigate the challenges facing minority investors: first by reforms suggested by the Doing Business project (Section 5); then by additional rules and safeguards (Section 6); and finally by potential practices facilitating the use of courts and other mechanisms to enforce these rules and remedies (Section 7). Section 8 offers conclusions and recommendations.

2. THE SCOPE AND SCALE OF CORPORATE GOVERNANCE IN PRIVATELY HELD COMPANIES

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[5] C. Reinhart and M. Kahn, *Portfolio Capital Flows to the Developing Country Members of APEC,* IMF, 1995.

[6] Privately held companies tend to be, but are not always, smaller than corporations with publicly traded shares. The World Bank's Doing Business methodology has referred to them as limited companies. Other texts refer to them as closely held corporations.
Regardless of the label, many privately held companies would likely be defined as either small or medium sized enterprises (SMEs) under various definitions of that term. It should be noted though, that not all SMEs are corporations legally separate from their owners. SMEs operate under various legal frameworks in addition to that of a corporation, for instance a sole proprietorship (managed by one individual) and a partnership (multiple managers). In neither case is the business considered a legal entity separate from the manager/owner. This leaves these individuals more vulnerable to claims against their non-business assets for unpaid debts of their enterprise.

This section briefly reviews the concept of corporate governance, how it applies to privately held companies, and provides background for how these rules and practices can mitigate the risk faced by minority investors in privately held companies. These topics will then be explored in more detail below.

2.1 CORPORATE GOVERNANCE

APEC has used the Principles of Corporate Governance, first set out by the Organization for Economic Cooperation and Development in 1999 (OECD Principles), as a means of promoting corporate governance since before the global financial crisis.[7] The OECD Principles, updated in 2015,[8] defines corporate governance as "a set of relationships between a company's management, its board, its shareholders and other stakeholders…[that] provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined."[9]

In the system, shareholders (referred to in this paper as investors) provide capital in exchange for equity, creating an ownership claim on the ongoing profits from business operations as well as a share of residual value from a sale. As owners, shareholders are typically entitled to control the direction of the company. This is done through direct voting on fundamental matters, as well as through electing a board of directors to provide direction to company executives. To support this decision making, investors usually have the right to information about the company's finances and operations. They are also entitled to advance notice sufficient to allow them to participate in shareholder (investor) meetings.

As noted above, the board of directors typically consists of individuals elected by the investors.[10] The directors set overall policy for the company, hire management, and provide operational oversight. The board is the "link between the people who provide capital (the shareholders) and the people who use that capital to create value (the managers)."[11] The challenges that arise in this relationship — between those who provide capital and those entrusted with it — has been described by the previous 2010 APEC Economic Policy Report as the "intrinsic problem of corporations." The separation of ownership and company management creates conditions where managers could take decisions for personal gain rather than benefitting owners.[12]

To address these challenges, governments have established various combinations of default and mandatory rules to govern the relationships between investors, directors, and managers. These are often found in an economy's corporate law regime. Some economies have one set of rules for all corporations, while more economies have two or more sets of rules roughly designed to fit the size and sophistication of the investors. Finally, some economies supplement these rules with corporate governance codes (or guidelines).

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[7] See, e.g., APEC's 2008 Ministerial Meeting Statement, which noted the work of the Economic Committee to "promote good corporate" in particular by "affirming the [Principles] and working on a plan to ensure APEC's implementation of the Principles in the Asia-Pacific Context," quoted in APEC Economic Policy Report 2010. p.1. Report hereinafter referred to as AEPR 2010.

[8] OECD, *G20/OECD Principles of Corporate Governance,* OECD Publishing 2015. https://www.oecd.org/daf/ca/Corporate-Governance-Principles-ENG.pdf

[9] *Ibid*, p. 9.

[10] Corporations in some economies have a two-board structure, but this is put aside here for simplicity's sake.

[11] S.J and M. Sangmi, "The Role of Board of Directors in Corporate Governance," *Imperial Journal of Interdisciplinary Research* 2(5) 2016, https://pdfs.semanticscholar.org/ab6c/60705060fa198a543890d4968925943cc71c.pdf

[12] APEC, *AEPR 2010,* pp. 4-5.

2.2 PRIVATELY HELD COMPANIES

Privately held companies can range from a one-member-one-director establishment[13] to a multi-billion dollar transnational firm.[14] These companies are legally separate from their owners—i.e., the owners are liable only to the extent of their investments (or promised investments) in the business. This "limited liability" afforded by these types of companies sets them apart from sole proprietorships or business partnerships, where the owners are not separate legal entities from the business and hence are liable with their personal property for the debts of the business.[15]

The World Bank's Doing Business survey includes ten questions on "limited companies". Contrasting them to a "publicly traded corporation listed on the economy's most important stock exchange," Doing Business identifies certain parameters:

- The company has multiple investors. If it were a single owner firm, many aspects of the questions pertaining to the limited company would not make sense.
- The company's shares are not freely alienable and certainly not listed on an exchange.
- The company lacks a board of directors, with investors making most decisions directly.
- The company's investors serve as officers or employees of the company.

These company forms are useful to smaller businesses. They generally require less record keeping and reporting while still maintaining limited liability for their owners. They are often used to run a family business or a business involving individuals who are already acquainted with each other, either personally or professionally.

Nevertheless, the attributes described above may not apply to all types of privately held companies in an APEC economy. Some might have legally required corporate structures that more closely resemble a publicly traded company. Others might have no legally required attributes at all, with all governance provisions worked out among investors and managers through a shareholder's agreement or other privately negotiated instruments.

2.2.1 ESTIMATING THE NUMBER OF PRIVATELY HELD COMPANIES IN APEC ECONOMIES

Collecting accurate statistics on privately held companies in the region is far more difficult than doing so for their publicly traded counterparts, which are clearly defined and required to disclose information on a regular basis.[16] The variations in employee size and income of private companies add to this difficulty.

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[13] See Philippine News Agency, "SEC Registers Country's First One Person Corporation," May 8, 2019 (detailing the registration of Smart Transportation and Solutions OPC as the first of its kind under reforms to the nation's Corporation Code). https://www.pna.gov.ph/articles/1069294.

[14] US based Cargill Incorporated and Koch Industries, each privately held, reported annual revenues above US$100 billion. Thomas C. Frohlich and Bill Friedricks "The 10 Largest Privately Held Companies in America," MSN, May 8, 2015

[15] See World Bank, "Doing Business 2015, Protecting Minority Investors" (noting that these legal structures allow a "business to flourish or fail separate from the personal assets of their owners"). https://www.doingbusiness.org/content/dam/doingBusiness/media/Annual-Reports/English/DB15-Chapters/DB15-CaseStudy-Protecting-Minority-Investors.pdf.

[16]For example, see John William Asker, Joan Farre-Mensa, and Alexander Ljungqvist, "What Do Private Firms Look Like?" NYU Working Paper No. 2451/31351 (December 2011). https://ssrn.com/abstract=1972119 "Private firms in the U.S. are not subject to public reporting requirements, so relatively little is known about their characteristics and behavior…").

More information, to a certain extent, is available on small and medium-sized enterprises (SMEs). SMEs are not perfect proxies for privately held companies. For example, some privately held companies would be too large to qualify as SMEs; and many SMEs are sole proprietorships with no minority equity positions. Nevertheless, a substantial portion of SMEs are indeed privately held companies with limited liability.

In 2013, APEC reviewed available data on SMEs in member economies. Despite inconsistent definitions and missing data, the numbers are striking: "SMEs in general accounted for over 97 percent of the total enterprises in each member economy" varying from "8,795 in Brunei Darussalam in 2009 to 56,534,492 Indonesia in 2012."[17] A substantial portion of these enterprises were considered micro-enterprises with fewer than 10 employees in some economies and fewer than 5 in others (depending on the definition). Even if 90 percent of these entities were governed as sole proprietorships or single ownership corporations, that would still leave hundreds of thousands of enterprises operating as multi-owner, privately held companies across the region.[18]

2.2.2 IDENTIFYING THE IMPACT OF IMPROVED CORPORATE GOVERNANCE AND MINORITY INVESTOR PROTECTION IN APEC

Among these hundreds of thousands of privately held companies, many will encounter new or expanded market opportunities. They will need funds to pursue these markets. A typical company has essentially three ways to obtain such financing: drawing on internally available funds or financing through external debt or equity.

The first option is to source funds internally, when the owner or owners forego profits from current operations, instead plowing them back into the business. But this requires owners with financial reserves and patience sufficient to forego these profits.

If the necessary reserves and patience are unavailable, the owner(s) will need to look externally for either debt or equity financing. If the company has a relatively predictable cash flow and assets to pledge, a bank loan might make sense. But if the company has less predictable cash flow and the opportunity has a greater potential upside, equity financing could be a preferred option.

The company's ability to attract such external financing will depend on many factors. One is the investor's perceived risk of not receiving an adequate return within a foreseeable timeframe, either because operational plans fail to meet objectives (business risk) or the investor's rights are not respected (legal risk).

Policy makers can mitigate legal risk by enacting laws and regulations that protect investors and supporting and by providing access to simple, low-cost means of enforcement when those protections are not respected.[19] Such efforts can produce bottom-line results. For instance, the World Bank's

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[17] Bernadine Zhang Yuhua, "SMEs in the APEC Region," APEC Policy Support Unit, Policy Brief No. 8, Dec. 3, 2013. p.3.

[18] For instance, in Indonesia less than 1 percent of the 56 million SMEs counted in 2012 were considered medium-sized businesses (having between 20 and 99 employees). Nevertheless, that still amounted to just under 49,000 enterprises in that economy alone. H. Salim , "Presentation of Indonesia," in COMCEC Coordination Office, *Proceedings of the First Meeting of the COMCEC Trade Working Group: Promoting the SMEs Exports in the OIC Member States,* p. 40 http://ebook.comcec.org/Kutuphane/Icerik/RaporlarVeResmiBelgeler/Toplanti_Raporlari/Ticaret/Toplanti1/files/assets/basic-html/page-1.html.

[19] World Bank, *Doing Business 2017: Equal Opportunity for All* Protecting Minority Investors section, p. 65. https://www.doingbusiness.org/content/dam/doingBusiness/media/Annual-Reports/English/DB17-Report.pdf.

efforts to protect minority investors has largely focused on self-dealing transactions between controlling investors and favored individuals outside the company.

According to the Doing Business project, research has demonstrated a link between greater protections afforded to equity investment and less concentrated ownership.[20] In a similar vein, the International Finance Corporation (IFC) has noted how "governance reforms and practices in specific [economies] have influenced firms in those [economies]."[21] The OECD Principles offer a similar sentiment, emphasizing the link between corporate governance and investor concern, particularly noting the link to attracting longer-term "patient" capital.[22] IFC-led surveys of investment firms demonstrate the converse to be true, an expectation of "steep discounts for shares in emerging market economies that lack strong governance practices."[23]

3. POTENTIAL CHALLENGES FACED BY MINORITY INVESTORS IN PRIVATELY HELD COMPANIES

Minority investors share ownership of a privately held company with individuals who, unless checked by other restraints, have *de facto* control over the company's operations and information. This creates incentives for the controlling investor(s) to divert firm resources from the company as a whole (where sharing is more likely) to other areas (where it is less likely). Anecdotal examples abound of controlling investors:

- Refusing to distribute dividends despite profits that would make such distribution reasonable;
- Granting unreasonably high salaries, bonuses and fringe benefits for management positions held by the controlling investor and favored individuals;
- Making unreasonably high payments to suppliers of the company that are controlled by the controlling investor, or by favored individuals;
- Dismissing, without cause, a minority investor from an employment position in the company; and/or
- Selling all, or nearly all, of the company's assets at an inadequate price to a third party controlled by the investor or to favored individuals.[24]

To prepare for or hide these actions, a controlling investor might withhold information from the minority investor(s). And to further consolidate power, a controlling investor might issue additional

[20] World Bank, "Protecting Minority Investors: Why Do Minority Investor Protections Matter?" Doing Business (n.d.) https://www.doingbusiness.org/en/data/exploretopics/protecting-minority-investors/why-matters#1 (citing to Djankov, Simeon, Rafael La Porta, Florencio López-de-Silanes and Andrei Shleifer. 2008. "The Law and Economics of Self-Dealing." Journal of Financial Economics 88 (3): 430–65.
[21] V.S. Khanna and R. Zyla, *Corporate Governance Matters to Investors in Emerging Market Companies*, World Bank Group 2017. http://documents.worldbank.org/curated/en/833251493190920250/Survey-says-corporate-governance-matters-to-investors-in-emerging-market-companies;
[22] OECD, *G20/OECD Principles,* p. 10.
[23] Khanna and Zyla, *Corporate Governance Matters,* p. 10.
[24] F. Hodge O'Neil, "Oppression of Minority Shareholders: Protecting Minority Rights," *Cleveland State Law Review*, 35:121 (1987), p. 125. https://pdfs.semanticscholar.org/410b/f4cc54a3f1d1007df26889c0c293e03ac4ce.pdf. The author notes that this is a "merely illustrative" list.

shares to himself or related persons, ignoring or evading a minority investor's right to acquire them on a preemptive basis.[25]

Were these actions to occur in a publicly traded company, the minority investor and likely others similarly situated could exercise their exit rights by selling their shares and depressing their prices. Alternatively, the minority investor could complain to a regulator, pointing out violations of codes of corporate governance that might be required of listed companies. In most cases, though, these remedies are not available to investors in privately held companies. The minority investor is essentially locked in with the investment, for better or worse. The only available option, in many cases, is to turn to the courts for an order halting the harmful practices or mandating the buyout of the minority investor's interest in the company. Depending on the jurisdiction, this remedy might be legally unavailable due to a gap in the law, or practically unavailable due to a sub-optimal judicial system.

Given such risks, privately held companies often face difficulties attracting individuals to provide capital as minority equity investors. The investors that do so, often rely on (i) family and social/business ties; (ii) the sterling reputation of the majority investor; and/or (iii) iron-clad contracts such as those usually required by seasoned venture capitalists. As a result, not so lucky, but nevertheless worthy companies, especially start-ups are often deprived of needed risk capital[26] or are forced to accept such capital under onerous terms.[27]

4. CORPORATE GOVERNANCE IN APEC ECONOMIES: DATA FROM THE DOING BUSINESS PROJECT AND THE WORLD ECONOMIC FORUM

Two data sets shed light on the extent and possible effectiveness of rules and institutions that APEC economies have established to protect investors from the practices described in Section 3.

4.1 DOING BUSINESS DATA

The World Bank's Doing Business project annually tracks the extent to which economies have developed rules and institutions that protect investors, primarily in publicly listed companies. Its protecting minority investors (PMI) index measures "the protection of shareholders against directors' misuse of corporate assets for personal gain and the rights and role of shareholders in corporate governance."[28] The PMI indicator is generated by answers to 42 questions[29]. The majority of these questions (32) assume that the investors are involved with a company that is publicly listed. Ten assume that the company is privately held ("limited company").[30]

At first glance, APEC economies appear to do reasonably well under the PMI index (Table 1). As a group, APEC would have ranked 47 out of 190 economies measured. Three APEC economies rank in

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[25] See Section 6.2 below on preemptive rights.

[26] See O'Neil, "Oppression of Minority Shareholders," p. 121 (noting the shortfall of "risk capital for closely held enterprises" due to investors' fear of minority oppression).

[27] David Ehrenberg, "Venture Capital Term Sheet: 7 Things You Need to Know," Early Growth Financial Services, n.d. https://earlygrowthfinancialservices.com/venture-capital-term-sheet-7-things-you-need-to-know/.

[28] World Bank, *Doing Business 2017: Equal Opportunity for All* Protecting Minority Investors section, p. 65. https://www.doingbusiness.org/content/dam/doingBusiness/media/Annual-Reports/English/DB17-Report.pdf.

[29] This report is based on the World Bank Doing Business 2019 report and data as these were the latest data available at time of drafting.

[30] The World Bank began collecting data on investing in limited companies in 2015.

the top ten, and eight APEC economies rank in the top 25. Only one economy falls outside of the top 100. Placing this performance beside the PMI rankings for the 28 EU economies puts this in better perspective.

TABLE 1. APEC AND EU PMI CHARACTERISTICS COMPARED		
PMI CHARACTERISTICS	APEC ECONOMIES	EU ECONOMIES
Average Rank as a Region[31]	47 Average Score (on a 10-point scale): 6.63	55 Average Score (on a 10-point scale): 6.29
Members among the Top Ranked Economies	3 in the top 10 5 ranking 11-25 2 ranking 26-50 Total: 10 (47.6% of members	0 in the top 10 2 ranking 11-25 10 ranking 26-50 Total: 12 (42.8% of members)
Number (and Percentage) of Economies from 51-100	10 (47.6%)	14 (50%)
Number (and Percentage) of Economies outside of the Top 100	1 (4.7%)	2 (7.1%)

This picture changes somewhat if the responses to questions are segregated into a PMI rating for only privately held companies, i.e., focusing on the results related to the 10 questions that apply to those companies. For purposes of comparison, the publicly traded PMI sub-indicator index is converted to a score on a 10-point scale.

As shown in Table 2, the scores for protecting minority investors in privately held companies were substantially below those for the publicly traded companies. In other words, in the existing regulatory framework the protections for minority investors in private companies are far more limited than the protections for minority investors in publicly traded companies, and are even further below the ideal regime contemplated by the Doing Business project. Further, as evidenced by the results from the EU, such a public-private regulatory gap is not unique to APEC economies.

TABLE 2. APEC AND EU PUBLIC TRADED AND PRIVATELY HELD PMIS COMPARED		
INDEX NAME	APEC ECONOMIES	EUROPEAN UNION
Publically Traded PMI	Average Raw Score: 34.95 On a 10-point scale: 6.99[32]	Average Raw Score: 33.28 On a 10-point scale: 6.66

[31] The authors arrived at the average score on a 10-point scale by dividing the average PMI score by the maximum score an economy could have (100) and then multiplying by 10.
[32] The authors arrived at the 10-point scale by dividing the average raw score by the maximum score an economy could have (50 points) and then multiplying by 10.

Privately Held PMI	Average Raw Score (already on a 10-point scale): 4.81[33]	Average Raw Score (already on a 10-point scale): 4.43

4.2 DATA FROM THE GLOBAL COMPETITIVENESS INDEX

Like the Doing Business project, the World Economic Forum (WEF) collects data on a wide variety of topics related to economy-level competitiveness. Among other aspects, its Global Competitiveness Index (GCI) surveys a sample of executives around the world on their opinions of:

- The extent to which the legal system protects minority shareholders;
- The extent to which companies can raise money by issuing shares and/or bonds on the capital market; and
- How easy it is for start-up entrepreneurs with innovative but risky projects to obtain equity funding.

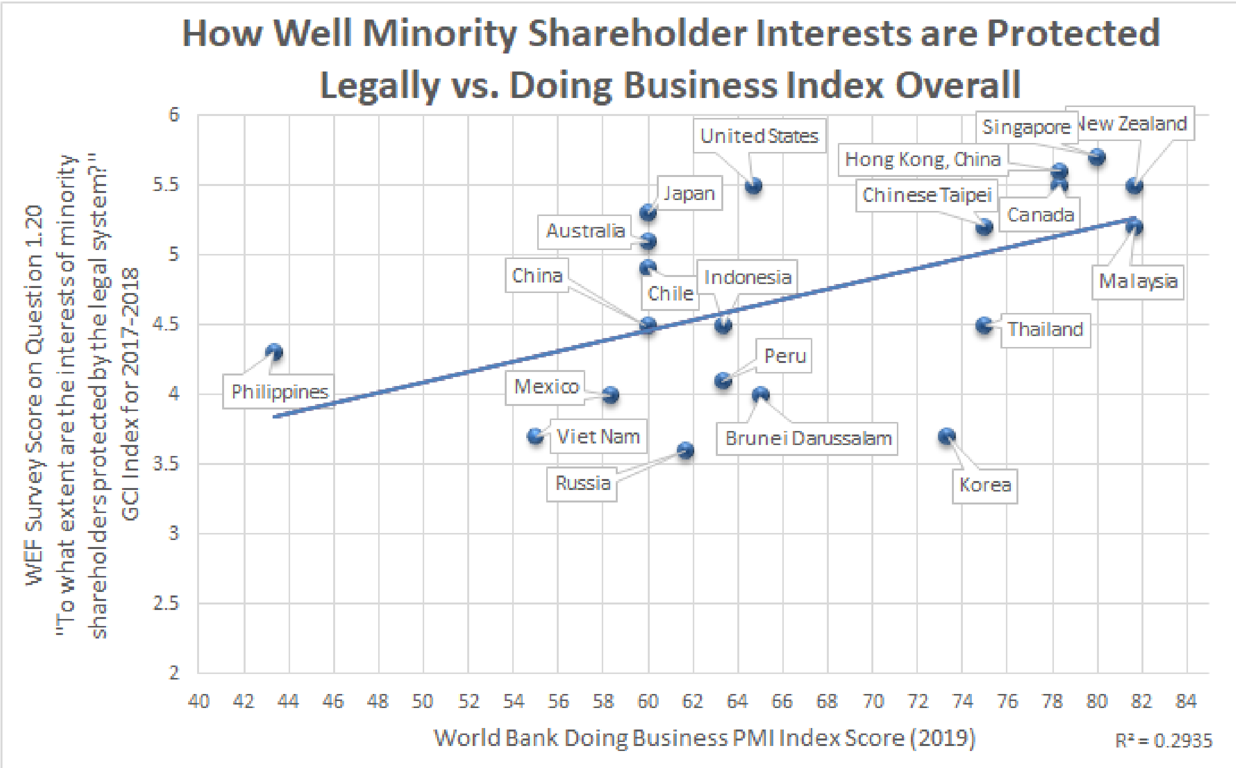
4.2.1 APEC PERFORMANCE ON WEF PROTECTING MINORITY INVESTORS

With respect to protecting minority investors, the WEF asked business executives of an economy to evaluate: "To what extent are the interests of minority shareholders protected by the legal system?" Twenty of 21 economies were surveyed in the WEF Global Competitiveness Report. Executives answered on a scale of one to seven, with one meaning "not protected at all" and seven meaning "fully protected." The responses by executives in APEC economies averaged 4.8. Nine economies received average scores above give and three scored under four. The rest bunched in between four and five.

The perceptions of company executives were analyzed against the economy-level scores on the Doing Business PMI. As shown in Figure 1, there is a clear correlation: economies that score higher on the PMI are also highly rated by global executives for having strong protections for minority shareholders. From this it could be inferred that as economies increase their performance under the PMI, protections for minority shareholders do, in fact, increase if the perceptions of business executives have any credence.[34]

[33] There is no need to convert the Privately Held PMI to a 10-point scale as it consists of ten questions with scores of zero (for no) and one (for yes).
[34] It is also possible, however, that an unspecified portion of the executives gave the scores they did because they read the PMI. It is difficult, on the basis of this analysis to rule out that possibility entirely.

Figure 1.

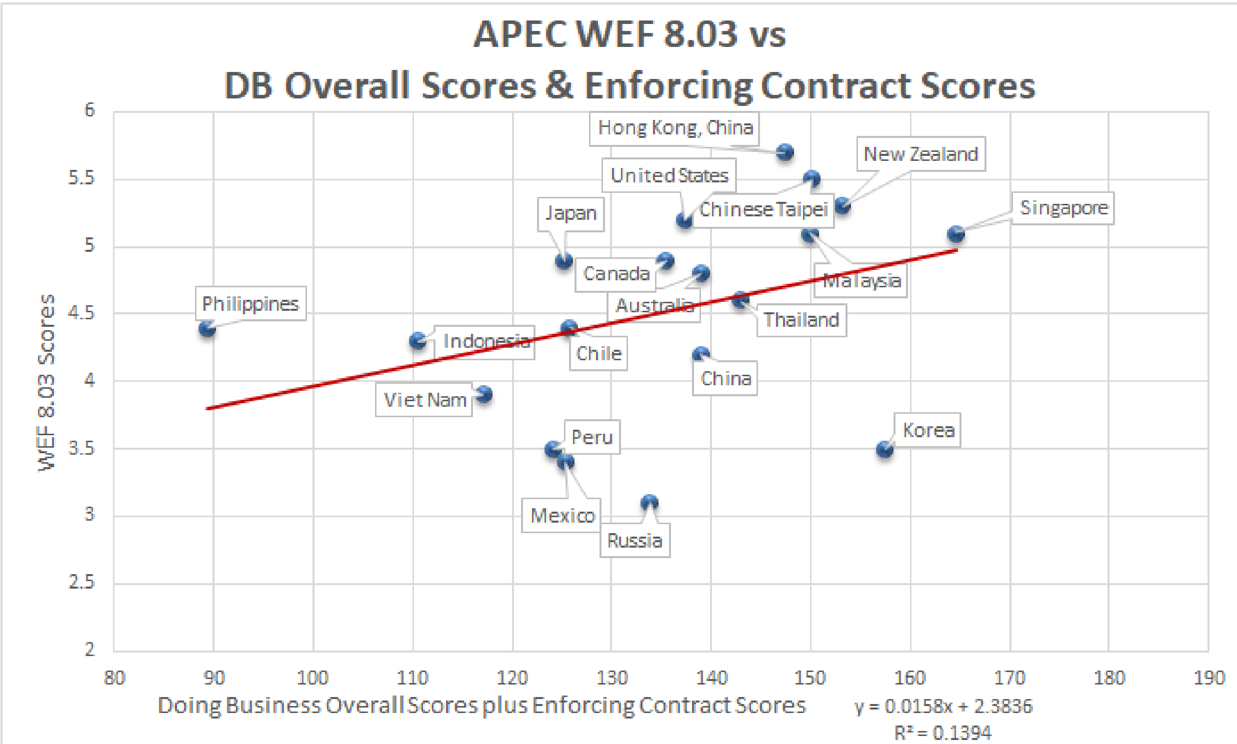


With respect to raising capital, the WEF asked business executives in 19 APEC economies: "To what extent can companies raise money by issuing shares/and or bonds on the capital market?" Executives answered on a scale of one to seven, with one meaning "not at all" and seven meaning "to a great extent."

The responses by executives in APEC economies averaged 4.5. Six economies received average scores above five and five scored under four. The rest bunched in between four and five.

These perceptions about raising capital were analyzed against the economy-level scores under the Publically Traded PMI, which calculated average scores without the ten questions that focus on limited companies. As shown in Figure 2, there is a clear correlation as well, though not as strong as the previous one. This is not surprising. Circumstances other than the protections offered to minority investors in publicly traded companies could very well factor into the ease of raising capital on a securities market, for instance current stock valuations, political risk, and the attractiveness of other asset classes. It is difficult, on the basis of this analysis alone, to rule out these possibilities.

Figure 2.



4.2.2 WEF DATA ON VENTURE CAPITAL AVAILABILITY

Just as there is a capital market for publicly traded companies, there is a market for capital directed at smaller enterprises. The difference is that it is far more fragmented and far less transparent. The readily available data set that most closely reflects this market is offered by the WEF. Executives in 20 APEC economies were asked: "How easy is it for start-up entrepreneurs with innovative but risky projects to obtain equity funding?" Executives answered on a scale of one to seven, with one meaning "extremely difficult" and seven meaning "extremely easy".

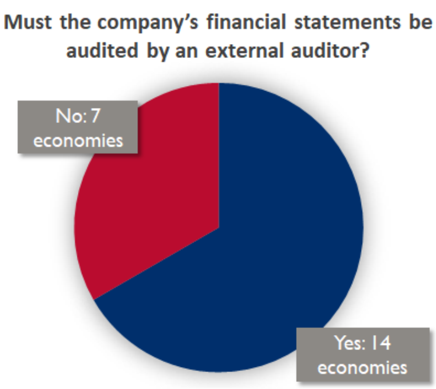
The responses of executives in APEC economies averaged 3.7, not surprisingly reflecting assumptions held by many that small companies have a harder time raising capital than publicly traded ones. Only one economy received a score above five, and four scored under three.

Unlike the other two data sets, it was difficult to find any correlation between the data on venture capital availability and any of the Doing Business Data on protecting minority investors. Several factors are at play here. First, capital availability may only be one of several factors affected by the various rules on protecting minority investors in privately held companies. Further, the ten Doing Business questions could touch on only a subset of possible issues important to minority investors in these companies. Additional factors that might influence protections for minority investors are explored in Sections 6 and 7.

5. POLICIES BEHIND THE DOING BUSINESS INDICATORS FOR PROTECTING MINORITY INVESTORS IN PRIVATELY HELD COMPANIES

The Doing Business scores for privately held companies stem from ten yes or no questions. Positive responses earn points under the PMI Index. Economies with higher scores are lauded for compliance with international best practices. This section discusses the policies under the PMI index that specifically target closely-held companies. Later sections will offer additional policy recommendations that can supplement the minority investor protections covered in this section.

5.1 POLICIES ENCOURAGING TRANSPARENCY[35]



As noted by the Doing Business project, the "[r]ights of minority investors cannot be protected without easy access to corporate information."[36] But this information is only beneficial if it is complete and accurate. Annual audits by licensed external professionals help ensure this.

Doing Business addresses transparency for minority investors in a privately held company by inquiring whether the company's financial statements must be audited by an external auditor.

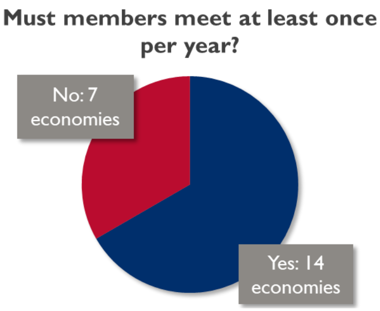
It is nearly universally accepted that publicly listed companies should undergo external audits. It is also nearly universally accepted that financial audits increase investor confidence.

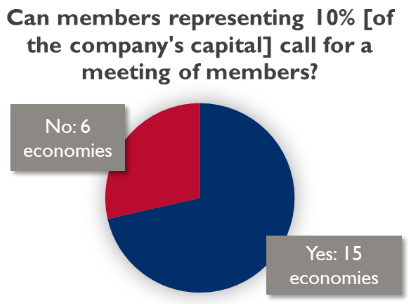
Opinions differ about whether to require privately held companies to undertake external audits. Audits can heavily burden smaller companies. Some argue that if their banks or investors are not requiring them, why should they be forced to undertake them? Numerous economies accordingly exempt small businesses from annual audit requirements. The question becomes where to draw the line. Some APEC economies, for instance, allow companies that fall under a certain financial threshold to apply for an exception. Another possibility would be to require all multiple owner companies to undergo audits while exempting single owner companies, regardless of size or until tax compliance comes into question. But wherever the line is drawn, it should be clear as to which companies are required to conduct such audits and which are not.

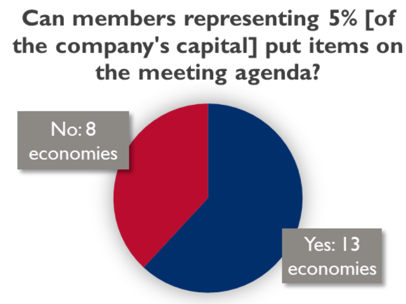
5.2 TRANSPARENCY AND PARTICIPATION POLICIES THAT PROMOTE MINORITY INVESTOR PROTECTION

[35] The wording in the title of this section and those of Sections 5.2 to 5.5 cannot be found in any Doing Business report. The questions pertaining to privately held companies are scattered among the 42 on protecting minority investors. Instead, the author has organized each of the ten questions into four policy topics.
[36] World Bank, "Protecting Minority Investors: Good Practices," n.d. https://www.doingbusiness.org/en/data/exploretopics/protecting-minority-investors/good-practices#facilitating

Doing Business provides for policies that protect investors who actively seek to protect their interests. Doing Business enquires into three topics that promote informed minority investor participation. Although APEC generally adheres to these provisions, performance varies across APEC members.







These questions point to policies that facilitate investor participation in the limited company contemplated in the Doing Business scenario. The first two questions focus on factors that ensure a controlling member (investor) cannot stifle the opportunity to meet to discuss matters pertaining to the company. The third ensures that minority members (investors) can have a say in what gets discussed when the company members (investors) do meet.

For privately held companies, these participation rights are critical, as there are most likely no readily available liquid markets for their interests in the company. Lacking a means of exit, having a voice in the governance of the company becomes more critical.[37]

If the control of the company essentially rests in the hands of a controlling investor, it is quite possible that these participation rights will rarely affect outcomes in such meetings.[38] Nevertheless, by voicing well-articulated concerns through appropriate channels, minority investors can potentially lay down the basis for a future claim against the controlling member of a breach of statutory or fiduciary duty to the company and the minority investors; or doing so can fuel a discourse that could lead to an out-of-court settlement.

Finally, it should be noted that, unlike a mandatory external audit (Section 5.1), vesting minority members with such participation rights, at least per a default rule, appears to have few downsides in terms of additional costs or paperwork for the company.

5.3 POLICIES THAT HELP MINORITY INVESTORS MAINTAIN INITIAL AGREEMENT

Minority investors typically enjoy their strongest position when negotiating their initial investment. A savvy minority investor who thoroughly considers the rights and obligations surrounding the investment,

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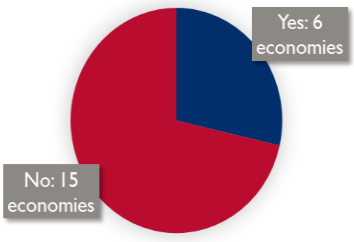
[37] Dov Solomon, "The Voice: The Minority Shareholder's Perspective," *Nevada Law Journal* 17(3): 739 (2017). https://scholars.law.unlv.edu/nlj/vol17/iss3/10/

[38] See Lucian Bebchuk and Assaf Hamdani, "The Elusive Quest for Global Corporate Governance Standards," *University of Pennsylvania Law Review* 157:1263, 1292 (2009). https://scholarship.law.upenn.edu/penn_law_review/vol157/iss5/1/
("[A]s long as a controller has enough votes to determine voting outcomes, even rules that facilitate voting by minority shareholders will not enable them to pass resolutions not favored by the controller.")

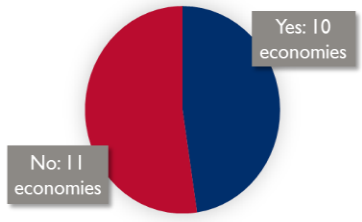
and thereafter negotiates accordingly should be relatively satisfied with the agreement, at least from a legal risk perspective.

Doing Business points to policies that help minority investors maintain the arrangements they have negotiated, or to comfortably adjust to new conditions that might arise.

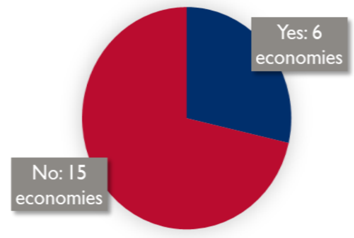
Must all, or almost all, members consent to add a new member?



Must a member first offer to sell his or her interest to the existing members before selling to a non-member?



Does the sale of 51% of [the company's assets] require member approval?



The first two questions point to legal provisions that give the existing minority shareholders a say in any changes to the makeup of the company's membership. This can be very important for smaller companies where members often work closely with each other on the company's behalf, and the right mix of people is important.

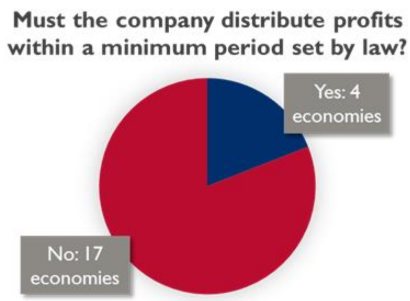
The third question points to provisions (for instance, a veto over asset sales) that give members a say in a transaction that would likely lead to a substantial change in the company's profile. It also allows them to evaluate whether the sale benefits the company.[39]

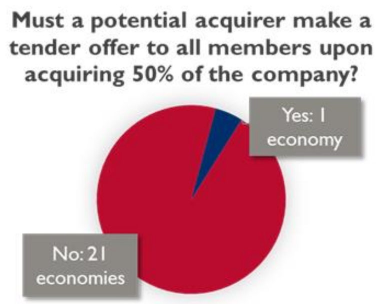
As with rules facilitating minority investor participation, there appears to be few downsides to including the rules here, at least as default ones, in a company law.

5.4 POLICIES THAT HELP ENSURE MINORITY INVESTOR ACCESS TO A SHARE OF THE COMPANY'S PROFITS AND NET VALUE

Two issues raised by Doing Business directly relate to the expectations of minority investors in sharing the fruits of the company's operations and growth. This is the area in which APEC economies had their poorest PMI scores regarding investor protections in privately-held companies.

[39] See Sections 6.6 for a discussion of related party transactions.





The first issue Doing Business explores in this regard is whether a mandate exists to share a portion of the company's profits in the form of dividends. Such a policy would help ensure that a controlling shareholder is not diverting funds to salaries or other projects that might disproportionately favor him or her. It also might prevent a well-known method of forcing minority shareholders to capitulate and agree to leave the company: dividend freezes, despite company profits, can be particularly burdensome for minority investors in jurisdictions that force them to pay tax on these profits even though they are receiving no payments.

Because a controlling investor can often point to seemingly reasonable pretexts for refusing to pay dividends, such distribution mandates might not be effective unless mandatory and proactive. At the same time, policy makers should be cautious on creating mandatory rules that compromise company reserves.

The second question addresses the problem that the shares of a controlling investor, as a block, are worth more than the shares of minority investors. This is because the controlling investor's shares enable him or her to control the company. By forcing an acquirer to purchase all the shares, the proposed policy allows the control premium to be shared with all the investors in the company.

Criticisms of such a rule usually focus on how it increases the cost of acquiring a company (purchasing 100 percent of the shares is no doubt more expensive than 51 percent). By making these acquisitions more expensive, such a rule could reduce the likelihood of an outsider purchasing the shares necessary to replace ineffective management. These concerns, however, are far more relevant to a publicly traded firm with dispersed shareholders[40] as opposed to a privately held firm with a controlling investor. As noted by Bebchuk and Hamdani:

> When a company has a majority shareholder, or at least a controller with an effective lock on control, the management team supported by the controller cannot be replaced even in the absence of any impediments to hostile bids and proxy fights: the controller simply has enough votes to prevent the team's removal.[41]

Although the authors made this point in the context of a publicly listed company, the implications are the same for private companies. Rules that force a sale of all interests in a privately held company along with those of the controlling investor can offer minority investors substantial protections with few downsides. Indeed these "tag along" rights are a common provision in shareholder agreements in jurisdictions where such rules are absent from any law.[42]

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[40] In such cases, there is a distinct risk that management and a small block of shareholders could be serving their own interests at the expense of the share price and dispersed investors. A hostile takeover bid can remedy that problem.

[41] Bebchuk and Hamdani, "The Elusive Quest for Global Corporate Governance Standards," p. 1288.

[42] See Greg Henry, "Tag Along Rights in Shareholders' Agreements," Turtons (May 11, 2018). https://www.turtons.com/blog/tag-along-rights-in-shareholders-agreements (Noting that "most (informed) investors will insist on tag along provisions")

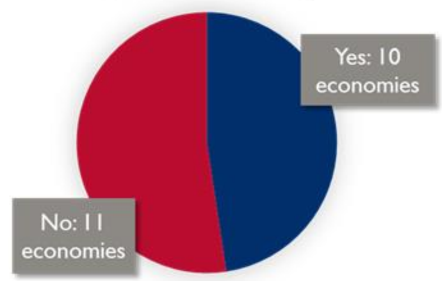
5.5 POLICIES THAT FACILITATE RESOLUTION OF DISPUTES

At least two types of potential disagreements might arise among members of a privately held company. The first involves disagreements concerning legal obligations (e.g., the controlling investor refusing to call a meeting of shareholders as called for by the company's by-laws). The other involves disagreements of particular policies that cannot be resolved by voting or other mechanisms, thereby substantially impairing company operations. This is usually referred to as deadlock.

This leads to the final Doing Business question on whether companies must have a mechanism to resolve disagreements among members. This suggests instituting a policy that creates at least a default rule for resolving these disagreements, for instance, an alternative to formal court procedures.

In the meantime, there appear to be few legal provisions that require companies to establish such mechanisms in their charters or organizing documents in the APEC region. Recently, the Philippines revised its Corporation Code to add a detailed section on the use of arbitration to resolve intra-corporate disputes. This arbitration mechanism would be "binding on the corporation, its directors, trustees, officers, and executives or managers."[43] But the decision to add such an arbitration provision to the articles of incorporation or bylaws of a company remains voluntary.[44]

Must the company have a mechanism to resolve disagreements among members?



It is difficult to imagine the practical implementation of a strict mandate to establish a "mechanism to resolve disagreements among members" at each company. Would such legislation provide a range of options of permissible mechanisms, or would it simply create an open-ended commitment for companies to implement as they see fit?

Nevertheless, dispute resolution remains a crucial component for protecting minority investors. This is discussed further in Section 7.

6. BEYOND DOING BUSINESS: SUPPLEMENTAL POLICY OPTIONS FOR PROTECTING MINORITY INVESTORS IN PRIVATELY HELD COMPANIES

The power of controlling investors to initiate transactions that can channel money out of companies they control, paired with their ability to withhold information within the company, creates a potential threat to minority shareholder interests. Beyond the ten policy prescriptions within the Doing Business PMI index, additional policy options exist to protect minority investors in privately held companies.

6.1 FACILITATING MINORITY INVESTOR PARTICIPATION: INVESTOR NOTICE OF, AND REMOTE PARTICIPATION IN SHAREHOLDER MEETINGS

[43] Congress of the Philippines, Revised Corporations Code of the Philippines, REPUBLIC ACT No. 11232 (2019), section 181. http://www.sec.gov.ph/wp-content/uploads/2019/03/2019Legislation_RA-11232-REVISED-CORPORATION-CODE-2019.pdf.
[44] Ibid, section 181.

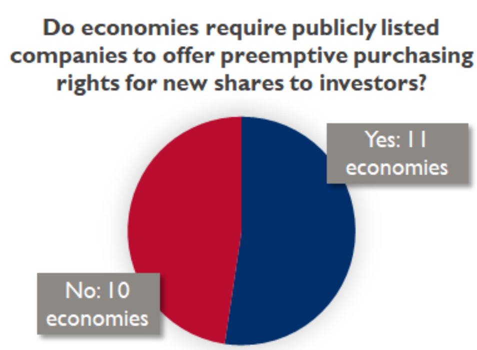
To the extent they have not done so already, APEC policy makers might consider two policies that could facilitate participation of minority investors in the governance of privately held companies. The first is establishing, as a default rule, a clear notice period for shareholder meetings of at least 21 days' prior notice unless there is an emergency. The Doing Business project asked a question that highlighted this idea with respect to such notice for publicly listed companies.[45] According to the 2019 edition of the Doing Business report, only four of the 21 APEC economies apparently have such a requirement. But there has been movement in this area in some economies. The Philippines, for instance, recently amended its Corporate Code to extend the mandatory advance notice period from two weeks to 21 days and to allow such notices to be sent electronically (rather than by hand delivery or traditional mail).[46]

Four of 21 economies require a clear notice period for shareholder meeting of at least 21 days in the absence of an emergency.

The second approach, as noted by the OECD, would be to allow investors to participate in shareholder meetings electronically. For example, recent reforms in the Philippines allow stockholders to vote for directors "through remote communication" when authorized "in the company's bylaws or by a majority of the board of directors."[47] Thailand enacted a similar reform in 2017.[48]

6.2 REQUIRING OR ENCOURAGING PREEMPTIVE RIGHTS FOR INVESTORS IN PRIVATELY HELD COMPANIES

Sometimes companies need to raise additional capital and seek to do so by offering additional shares. If current investors have no right of first refusal to current shareholders to purchase at least some of these shares, they risk having their bargained-for financial position in the company, as well as their influence, diluted. Many jurisdictions give investors the right to preemptively purchase these new shares before they are offered to outsiders. Their purchasing rights are usually proportional to their current ownership position in the company.



Preemptive rights can complicate and delay capital increases. For instance, delays may occur when a publicly traded company follows the steps necessary to comply with preemptive rights procedures before making an offer to outside investors. Investors in publicly traded companies have little call for this, as they can secure additional shares on the open market. However, investors in privately held companies do not have the opportunity to protect their equity stake against dilution. As a result, investors in a privately held corporation are likely to find such rights more valuable. Many invest based on the understanding that their shares give them voice in the company. A share capital increase can substantially dilute that voice.

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45 Extent of Corporate Transparency Index, question 4: Must a detailed notice of general meeting be sent 21 days before the meeting?
46 Congress of the Philippines, Revised Corporation Code, section 49.
47 Ibid., section 23.
48 Cynthia M. Pornavalai, "Thailand: Conducting Company Meetings by Teleconference or Video Conference" Tilleke & Gibbons (April 25, 2017). https://www.tilleke.com/resources/thailand-conducting-company-meetings-teleconference-or-video-conference

6.3 CLARIFYING THE RIGHT OF MINORITY SHAREHOLDERS TO ENTER INTO BINDING SHAREHOLDER AGREEMENTS

Most APEC jurisdictions contemplate privately held companies establishing "articles of association" or similar documents that clarify aspects of the company's governance under the chosen corporate form. The arrangements in these documents are often supplemented by agreements among some, or all, of the investors in the company.[49] As noted in a recent comparative study of closely held corporations:

> These agreements enjoy extensive use all over the world, as they assist shareholders more clearly to regulate their relationships with each other. The most common agreements cover voting rights, transfer restrictions, and exit rights, as well as the composition or remuneration of management or supervisory boards.[50]

These agreements are used more often in privately held companies than publicly held ones.[51] They have also proven valuable to foreign investors for bridging gaps in, or easing the rigidities of, the corporate laws of the economy in which are investing.[52]

Despite their widespread use, shareholder agreements are often left unaddressed in corporate statutes. APEC economies that do address shareholder agreement in their corporate legal code provisions include the Russian Federation (which amended its Federal Law on Joint Stock Companies in 2009 to clarify and confirm their legality)[53] and the United States (where the corporate statutes of some states specifically acknowledge the rights of shareholders to enter into such agreements).[54]

Other APEC economies may wish to consider whether to recognize such agreements in their corporate statutes, including any reasonable limitations on those agreements or requirements for their disclosure.

6.4 USING SPECIAL CLASSES OF SHARES

Corporate law generally embraces the principle that investors in the same class should receive equal treatment in proportion to their equity interest. While this protects shareholders within a single class, publicly traded companies can and do create multiple classes of shares with different rights that may increase the unevenness of the playing field for various investors. The founders of Facebook and Google, for instance, issued themselves classes of stock with multiple voting rights, giving them control substantially above the extent of their equitable ownership.[55] Partly in response, stock exchanges are beginning to question the benefits of such multiple share structures and are considering restrictions on

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[49] Holger Fleischer, "Comparative Corporate Governance in Closely Held Corporations" The Oxford Handbook of Corporate Law and Governance (2018).
[50] Ibid.
[51] Karina Pulec, Legal Restraints on the Use of Shareholders' Agreements for Structuring Foreign Investment Deals in Russia 45 Cornell International Law Journal 487 (2012). https://www.lawschool.cornell.edu/research/ILJ/upload/Pulec-final.pdf
[52] Ibid., p. 494.
[53] Ibid., p. 490.
[54] Holger Fleischer, "Comparative Corporate Governance in Closely Held Corporations" (noting the specific addition of such a clause into the revised model business act adopted by many states).
[55] Bob Pisani, "Shareholders Won't Force Zuckerberg's Hand in Facebook Management," CNBC (March 20, 2018). https://www.cnbc.com/2018/03/20/shareholders-wont-force-zuckerbergs-hand-in-facebook-management.html.

listing them.[56] The fear is these dual class structures will hamper takeovers and encourage expropriation.[57]

But for privately held companies, ownership structures utilizing multiple classes of shares might be useful. For instance, a high-tech entrepreneur might wish to offer a venture capitalist a substantial equity interest in his/her company but might not wish to risk ceding control. Family owned businesses might wish to distribute proceeds amongst a greater number of family members, but keep control with mom and dad. Banning or substantially limiting dual share structures might hamper these arrangements.

The corporate governance laws of several APEC economies call for a single class of shares as a default arrangement, able to be discarded by agreement. As dual-class shares should be the exception rather than the rule, this would appear to make the most sense.

6.5 ENCOURAGING MINORITY INVESTOR REPRESENTATION ON BOARDS THROUGH CUMULATIVE VOTING

Economies can offer a menu of corporate forms for privately held companies. One such offering might include a corporate structure that includes a board of directors. If such company is dominated by a controlling investor, there is a distinct likelihood that the person, voting on the basis of the number of shares he or she controls, will be able to choose all members of the board under the so-called "straight voting" procedures described below. This outcome is far less likely if the company requires that directors be elected via a procedure known as cumulative voting.

Table 3 summarizes the difference in an annual election of a three-person board of directors where all three seats are open, depending on the type of voting used. Each case involves three voting shareholders: Shareholder A with 51 shares, Shareholder B with 25 and Shareholder C with 24.

TABLE 3. DIFFERING OUTCOMES DEPENDING ON STRAIGHT OR CUMULATIVE VOTING

STRAIGHT VOTING	CUMULATIVE VOTING
A, B , C have one vote per share for each seat	A, B, C, have one vote per share for each seat
A can vote up to 51 shares for each director's seat. B and C can vote up to 25 and 24 respectively.	Shareholders may allocate any number of votes to each seat; e.g., Shareholder B can cast 75 votes for one director.
A's choice prevails for each seat.	Shareholders A and B are assured at least one seat each. Shareholder A might get a third seat if he splits his vote carefully and Shareholder C fails to cast all votes for his preferred candidate.

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56 Ibid.

57 Gwendolyn Gn, "Singapore: Taking Stock On Dual Class Shares Discussions in Singapore" Moondaq (January 22, 2018). http://www.mondaq.com/x/665880/Shareholders/Taking+Stock+On+Dual+Class+Shares+Discussions+In+Singapore

The various strategies and permutations of cumulative voting are beyond the scope of this paper. Suffice it to say that if properly explained and used correctly, it can help ensure that candidates preferred by minority investors (or the investors themselves) get elected to the board. Although they may not constitute a majority, directors backed by minority investors are likely to serve as both a voice of minority investors in the boardroom and as a source of information for minority investors regarding the company's governance.[58]

These reasons likely explain why more than a few APEC economies require cumulative voting, at the very least as a default arrangement. Further, while publicly traded companies may have good reasons for opting out cumulative voting (adding complexity to proxy fights, for instance), this is less of a concern for privately held companies.[59] Accordingly, APEC economies might consider making cumulative voting mandatory for certain corporate forms, or at least making it more difficult to opt out of such procedures.

6.6 REQUIRING DISCLOSURE AND APPROVAL OF SIZEABLE RELATED PARTY TRANSACTIONS

As defined by the Doing Business project, a related party transaction (RPT) occurs, "where the person has an economic or personal interest in both parties to the transaction."[60] Doing Business offers, as an example "a company executive entering into a supply contract with another company wholly owned by his/her spouse." Although not all RPTs are harmful, they certainly have the potential to serve as a means of channeling resources out of the company at the expense of investors.

Much of the Doing Business PMI index is focused on identifying the extent to which economies are regulating sizeable RPTs in the context of a publicly traded company. For instance, the PMI index looks at the requirements to disclose such transactions when they reach 10 percent of the company's assets. It also focuses on requirements for prior approval of these transactions from disinterested shareholders or outside auditors.[61]

A good number of APEC economies require both disclosure and prior approval of such transactions when undertaken by publicly traded companies. Almost all require these transactions to be included in regular financial reports. Failure to follow these procedural safeguards leave the transactions more vulnerable to challenge.

At least a third of the APEC economies extend these requirements to at least some types of privately held companies organized under their laws. At least a similar number allow for some sort of remedy in the event such transactions substantially harm the corporation or the shareholders.

6.7 CLAIMS TO VINDICATE HARMS INFLICTED DIRECTLY ON MINORITY INVESTORS

Given the challenges minority investors face in pursuing derivative actions, where statute or judicial precedent allows, minority shareholders can often bring a lawsuit to address conduct by directors and

[58] See Joseph A. McCahery and Erik P.M. Vermeulen, "Conflict Resolution and the Role of Corporate Law Courts: An Empirical Study" ECGI – Law Working Paper No. 132/2009 (August 12, 2009). http://dx.doi.org/10.2139/ssrn.1448192 (discussing the advantages of board membership, even if entailing minority representation only).
[59] Robert Hamilton, *The Law of Corporations* West Publishing Company (1991), p. 189.
[60] World Bank, *Doing Business 2017,* Protecting Minority Investors section.
[61] World Bank, "Protecting Minority Investors, Methodology" Doing Business (n.d.) https://www.doingbusiness.org/en/methodology/protecting-minority-investors

majority shareholders that harm minority shareholders directly (as opposed to indirectly by harming the company). For instance, under the Australian Corporations Act, a shareholder may bring a claim if a company's affairs were conducted in a manner that was "contrary to the interests of the members as a whole or oppressive to, unfairly prejudicial to, or unfairly discriminatory against, a member or members."[62] Because they claim a direct harm, such suits avoid the various requirements of derivative actions.

Examples of conduct that lead to claims under this provision include

- excluding a minority shareholder from involvement in the affairs of the company;
- denial of information; and/or
- diverting a legitimate corporate opportunity to the controlling shareholders or his/her associates.[63]

But while this appears to be a relatively narrow set of grounds for bringing a claim, some jurisdictions in practice will allow for suits on a wider set of grounds, including circumstances that one recent analysis described as situation "where in principle derivative suits would have been available."[64] The options for judicial relief are also expanding. Traditionally, courts would turn to dissolving the company as the default form of relief upon a finding of unfair prejudice or oppression. But because courts have found such options too drastic, or because legislators have started to offer more practical solutions, in many instances, the range of actions a court can take to address such harms have expanded to include monetary payments or mandatory buyouts.

As a result, such suits in APEC common law economies are becoming an "all-purpose instrument" for addressing claims of minority investors, in particular in privately held companies.[65] This trend has been documented in the United States, where, as one author describes it, "courts—using close corporation statutes, minority shareholder oppression statutes, and common law fiduciary duty theories—have greatly broadened the litigation options available to a minority shareholder."[66]

In APEC economies with civil law systems, oppression suits are less common. One exception is China. A provision of its company law provides that "shareholders abusing their rights shall be liable to the company or other shareholders in accordance with the law." Courts have used this provision to provide relief in a variety of circumstances, but only when the wrongdoer is a shareholder.[67]

6.8 LAWSUITS CHALLENGING THE VALIDITY OF SHAREHOLDER RESOLUTIONS

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[62] Australian Corporations Act, Section 232.
[63] Joe DeRuvo, "Oppression Claims by Minority Shareholders," DW FoxTucker (October 31, 2017). https://www.dwfoxtucker.com.au/2017/10/oppression-claims-minority-shareholders/#_ftn1
[64]Gelter, Martin, "Mapping Types of Shareholder Lawsuits Across Jurisdictions" (July 2, 2018) Jessica Erickson, Sean Griffith, David Webber and Verity Winship, eds., *Research Handbook on Shareholder Litigation* (forthcoming) Fordham Law Legal Studies Research Paper No. 3011444; ECGI - Law Working Paper No. 363/2017, p.20. https://ssrn.com/abstract=301144
[65] Gelter, "Mapping Types of Shareholder Lawsuits Across Jurisdictions," p. 22.
[66] Daniel Quick, "Unmoored: How Minority Shareholder Oppression Litigation Has Gone Too Far" Stout (March 1, 2015). https://www.stout.com/en/insights/article/unmoored-how-minority-shareholder-oppression-litigation-has-gone-too-far/.
[67] Gelter, "Mapping Types of Shareholder Lawsuits Across Jurisdictions," p. 22.

In many civil law jurisdictions, investors have the right to sue for the nullification of decisions taken in a shareholder meeting. These lawsuits often have fewer procedural prerequisites and thus appeal to investors seeking redress for unfair treatment, especially in jurisdictions where a wide variety of corporate decisions are put to shareholder vote. In such cases, the petitioning investors often allege that actions by the majority violated a duty of loyalty or otherwise constituted abusive conduct.

Japan and Korea are notable examples in APEC economies where such claims are recognized. The standards by which these suits are judged and whether they are available to minority investors in privately held corporations should be the subject of future consultation.

7. INSTITUTIONS FACILITATING MINORITY INVESTOR PROTECTION

As noted by the OECD, "[w]ithout effective supervision and enforcement, the letter of law and regulations have little meaning."[68] The Doing Business project echoes this sentiment, devoting a good portion of PMI to the potential liability of directors of publicly traded companies for wrongful acts and the ease with which shareholders can file suits in response.

The availability of competent and responsive institutions to enforce rights in the law books is even more important for investors of privately held companies. Such investors cannot simply sell their shares in response to corporate wrongdoing. Further, because privately held companies tend to be less well known, these companies are generally less susceptible to bad publicity that minority investors might be able to generate if they have uncovered misdeeds in corporate governance.

This section reviews institutions and other mechanisms to facilitate minority investor protection, including government agencies, courts, and alternative dispute resolution mechanisms.

7.1 GOVERNMENT AGENCIES

An important factor in enforcing minority investor rights in publicly traded companies is the work of securities regulators and, in many cases, stock exchanges and self-regulatory organizations.

The Office of the Advocate for Small Business Capital Formation at the U.S. Securities and Exchange Commission (SEC) advances the interests of small businesses and their investors at the SEC and in the capital markets, recognizing the importance of access to capital and the needs of investors in small businesses.

7.2 COURTS

Most of the burden of enforcing the rights of minority investors in privately held companies falls on the investors themselves. Their primary source for vindication of their rights is the court system where the company they have invested in is incorporated.

A potentially important determinant of court performance is the extent to which the court specializes in hearing corporate governance cases. An earlier APEC report on corporate governance noted that

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[68] OECD, *G20/OECD Principles*, p. 10. See also Fleischer, "Comparative Corporate Governance in Closely Held Corporations" ("It's the enforcement stupid! Standards of conduct for majority shareholders alone do not suffice, but must rather be supplemented by effective means of redress for minority shareholders").

judges "who handle these cases exclusively, or more than usual, are able to more quickly understand a case and deliver consistent results, making litigation more efficient."[69] More recently the Doing Business project observed that:

> Commercial courts and divisions tend to promote consistency in the application of the law, increasing predictability for court users. And judges in such courts develop expertise in their field, which may support faster and more qualitative dispute resolution.

Although these remarks were made in the context of enforcing contracts, it is not difficult to appreciate their application to corporate governance disputes as well.

A recent OECD survey asked ten APEC economies whether they operated special courts to litigate or challenge matters relating to corporate governance. Three — Malaysia, the Philippines, and Viet Nam — answered in the affirmative.[70] In the United States, for all intents and purposes, the Delaware Court of Chancery, acts as a specialized corporate court. Despite the state's limited jurisdiction (in terms of geography)[71] the Court of Chancery has had an outsized effect on both United States companies (a majority of which are incorporated in Delaware) and on U.S. corporate jurisprudence in general.

A possible factor limiting APEC economies from establishing courts specialized in corporate governance could simply be lack of demand. As noted earlier, at least with respect to publicly traded companies, a good portion of governance cases, are addressed through regulatory enforcement rather than courts.[72] To address, this some economies have adopted partial specialization by some courts. For instance in the Philippines, several dozen regional trial courts have been designated as special commercial courts, charged with hearing matters pertaining to insolvency, intellectual property, and cybercrime, in addition to matters in their regular dockets.[73]

7.3 ALTERNATIVE DISPUTE RESOLUTION

As discussed above, both enforcement by government agencies and court adjudication will often fall short as vehicles for vindication of minority investor rights in privately held companies. A potential solution is to encourage companies and investors to resort to arbitration to resolve these disputes.

In the United States, mandatory arbitration clauses in corporate bylaws have proven controversial. Plaintiffs' attorneys see these clauses as stifling shareholder rights to fully adjudicate their claims. On the other hand, companies often see them as a way to avoid costly litigation and curb "nuisance" suits. But in economies where private enforcement of minority investor rights in court is perceived as sub-optimal, such clauses could prove very useful.

While arbitration clauses are a matter of private choice, policy makers in APEC should consider clarifying their ability to bind shareholders via the inclusion of such a clause in a duly approved corporate

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[69] APEC, *AEPR 2010*, p. 29.
[70] OECD, *Survey of Corporate Governance Frameworks in Asia* 2017, p. 9. https://www.oecd.org/daf/ca/OECD-Survey-Corporate-Governance-Frameworks-Asia.pdf.
[71] Only one other state is smaller in terms of square kilometers.
[72] See APEC, *AEPR* 2010, (noting this tendency among APEC companies with civil law systems as well).
[73] Republic of the Philippines Supreme Court, Office of the Court Administrator, Circular No. 176-2016 (July 28, 2016). http://oca.judiciary.gov.ph/wp-content/uploads/2016/07/OCA-Circular-No.-176-2016.pdf.

bylaw. Opponents to such clauses have argued, at least in the United States, that such clauses are insufficient to bind all shareholders as bylaws and are not contracts.

Viet Nam resolved this potential issue by providing for alternative dispute resolution in the 2009 revisions of its Corporate Governance Code.[74] The Philippines did so as well in it recent amendments to its Corporation Code.[75] These enabling provisions should help companies make a credible commitment to fair, efficient, and effective dispute resolution. In the long run, this should attract more investment and reduce losses from drawn-out disputes.

As noted by the Enforcing Contracts indicator of the Doing Business project, courts in APEC economies are generally open to taking action to enforce arbitration awards in contractual disputes.[76] Reforms and other developments that encourage greater reliance by minority investors on arbitration clauses to resolve disputes should be accompanied by a close look at whether courts are willing and capable to enforce such awards.

8. SUMMARY OF FINDINGS AND RECOMMENDATIONS

Minority investors in privately held companies in many APEC economies lack the protections enjoyed by similarly positioned investors in publicly traded enterprises. Given (i) the importance of equity investment to APEC economies; and (ii) the substantial number of privately held companies operating in these economies, improving the regulatory and institutional protections for such investors appears to be a substantial opportunity for APEC economies to accelerate growth and create jobs.

The factors that undergird the PMI indicator under the Doing Business project suggest several areas where reforms should be considered. One of the more promising areas is facilitating minority investor participation in the governance of the company—for instance, by giving minority investors the right to call for a shareholder meeting or to put items on a meeting agenda. Another promising reform area is to support minority investors in maintaining the position they bargained for—for instance by having veto right over a decision to add a new member, or the right to buy an existing member's shares before they can be sold to outsiders.

Perhaps the reform in greatest need of review is one that would require a buyer of 50 percent of the shares of a privately held company to make a similar offer to the remaining shareholders. Only one of the 21 APEC economies require such offers. If enacted into law, this tag-along right, which is often negotiated individually by savvy investors, could make it more likely that minority investors would receive the benefits of a buyout of the company in which they have invested.

Reforms beyond those recognized by the Doing Business project are also possible. For instance, to the extent they have not already, APEC economies should consider:

- Establishing preemptive rights for investors in privately held companies;

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[74] APEC, *AEPR 2010*, p. 29.
[75] Congress of the Philippines, Revised Corporation Code, Section 181.
[76] Respondents in all 21 APEC economies indicated that "valid arbitration clauses or agreements [are] usually enforced by the courts" in the latest Doing Business Report.

- Clarifying the status of shareholder agreements;
- Encouraging the use of cumulative voting; and
- Requiring disclosure of sizeable related party transactions by controlling investors.

Perhaps more important than these *ex ante* rules, though, are *ex post* remedies in the event a minority investor's interests are compromised by a violation of a law or investment agreement. In at least several APEC economies, minority shareholders in publicly listed companies tend to rely on either governmental regulators or the local securities exchange when their rights are compromised. These types of remedies are less likely to be available to minority investors in privately held companies.

In most cases, the main avenue for relief for these investors are the courts through (i) a derivative suit, which offers several procedural hurdles; or (ii) in a growing number of jurisdictions, a direct suit based on a theory of shareholder oppression. In recent years, these direct suits based on claims of shareholder oppression have been used to address a growing number of wrongs and courts have been increasingly open to a broader array of remedies when wrongful actions are found.

Nevertheless, courts in many APEC economies continue to grapple with these types of suits, especially when they are handled by judges who lack experience with them. A standard prescription for this problem is specialization, i.e., the creation of a commercial court. Whether this is practical or not in a given APEC economy might depend on the volume of cases. If it is true that minority investors in publicly listed companies rely on regulators and courts, then there may not be sufficient cases to justify a specialized court.

In light of such challenges, a small but growing number of APEC economies are encouraging the use of alternative dispute resolution in the event of investor disputes. Relevant legislation in Viet Nam and the Philippines, for example, has helped to clarify that an arbitration provision in a company charter can be legally binding on investors. This gives companies the opportunity to commit to fair and efficient procedures in the event of an intra-corporate dispute, so long as courts in APEC economies are willing to enforce arbitration awards as they become more and more common.