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Does mandating cumulative voting weaken controlling shareholders? A difference-in-differences approach☆

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ABSTRACT

Corporate scholars have long championed the use of mandatory cumulative voting in developing countries. Yet, in comparison to majority or plurality voting, we know very little about its effectiveness. Even though cumulative voting is allowed in most jurisdictions, in practice it is not widely used. Taiwan stands out as a unique jurisdiction which mandates cumulative voting on all companies. Therefore, Taiwan is the only jurisdiction, to the best of our knowledge, that can be used to test the causal effect of cumulative voting on director election. Taking advantage of an exogenous legal change that occurred in Taiwanese corporate law in December 2011, we use panel data on 640 publicly traded companies from 2009 to 2015 in a difference-in-differences framework to tease out the effect of cumulative voting. From 2001 to 2011, cumulative voting was the default rule, and 20 companies opted for majority voting. While directors and supervisors are elected every three years, not all companies change boards in the same year. Fixed-effect panel regression models show that in the 2012 election—about six months after the legal reform—the cumulative voting rule appears to have weakened the controlling shareholders' control of the companies that had previously opted for majority voting. The controlling shareholders' control in the 2013, 2014, and 2015 elections, however, did not decrease. The take-away lesson is that mandating cumulative voting may not create a long-term effect because controlling shareholders find other means to maintain influence. Policymakers should leave the governance decisions to the firm and focus on rules that could restrain private benefits of control and enhance transparency to rein in controlling shareholders.

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1. Introduction

Separation of ownership and control is a fundamental feature of governance in corporate America (Berle and Means, 1932). The misalignment of shareholders' and managers' incentives, known as the principal-agent problem (Jensen and Meckling, 1976), has been the focus of American corporate law scholarship for many years. In East Asia, however, firms—even publicly traded companies—are run differently. Corporations are often controlled by the state, families, or even single shareholders (La Porta et al., 1999: 492–493; Claessens et al., 2000). The managerial principal-agent problem, as it is conventionally understood, is not a major concern in East Asia. Instead, the principal-agent problem between controlling shareholders and minority shareholders is the central issue (Gilson 2006). Therefore, the major issue in the corporate governance of controlled companies is to restrain controlling shareholders from engaging in opportunistic behaviors and expropriate minority shareholders (Gilson and Gordon, 2003; Hansmann and Kraakman, 2004; Bebchuk and Hamdani, 2009).

One way to protect minority shareholders is to give them a voice in the boardroom. Minority board representation can ensure minority interests are protected and considered in the management decision process. Even though directors nominated by minority shareholders cannot out-vote controlling shareholder, the mere presence of an outsider can change board dynamics and

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influence group decision-making (Forbes and Milliken, 1999: 496–497). Furthermore, minority board representatives play a crucial role in monitoring conflict of interest transactions connected with controlling shareholders because such transaction normally requires disinterested director vote.

To ensure minority board representation in controlled firms, director election voting rule is critical. In the U.S., corporate directors have long been elected by plurality voting rules. Under plurality voting, even candidates with only one vote can be elected in an uncontested election. Such a voting rule calls into question the accountability of directors. Due to the demand of institutional shareholders to enhance board accountability, large U.S. firms have in the past decade moved to adopt the majority voting rule, where only candidates who receive the majority of the votes cast can be elected. In East Asia, the majority voting rule is the default rule for corporate director elections in most jurisdictions. However, neither voting rule empowers minority shareholders (Sjostrim and Kim, 2007; Cai et al., 2013). While preliminary evidence suggests that U.S. firms that adopt the majority rule may become more responsive to shareholders (Ertimur et al., 2015; Choi et al., 2016)—thus enhancing board accountability—the effect of the voting rule plays out differently in a controlled firm than it does in a widely-held firm. In a controlled firm, a controlling shareholder can easily win all of the seats on the board even with majority voting. Winner-takes-all prevents outside shareholders from monitoring controlling shareholders through board representation. Consequently, scholars like Black and Kraakman (1996) advocate mandatory cumulative voting for developing countries to ensure minority board representation in the presence of controlling shareholders.[1] Indeed, China's Company Act adopted cumulative voting as a menu option.[2] Yet, lawmakers know very little about the effectiveness of cumulative voting in terms of curbing the influence of controlling shareholders.

Cumulative voting is widely recognized as a voting rule that favors minority shareholders and ensures minority representation on the board. In cumulative voting, a shareholder has votes that equal the number of shares he/she owns, multiplied by the number of directors to be elected in that election. Shareholders can either cast all their votes for one director or spread out their votes across two or more directors[3] (Bhagat and Brickley, 1984). By allowing minority shareholders to accumulate all their votes on one or a few candidates, cumulative voting enables candidates to be elected even without the support of the controlling shareholders (Easterbrook and Fischel, 1983).

To the extent that cumulative voting increases the possibility of adding an outside (or independent) director to the board, such minority board representation may help reduce the principle-agent problem between controlling shareholders and minority shareholders in a controlled firm (Fama and Jensen, 1983: 315; Bhagat and Brickley, 1984: 340). In addition, increasing the possibility of adding an outsider to the board also elevates the likelihood of the firm being taken over. In theory, if the threat of change in control is high, insiders will have better incentives to work in the best interests of shareholders and maximize shareholder value (Young, 1950; Bhagat and Brickley, 1984: 340).[4]

Granted, for companies with controlling shareholders, the threat of a hostile takeover is not as strong as it is in companies with a dispersed ownership structure, such as most public corporations in the U.S. That said, as shown in Fig. 2, controlling shareholders in many Taiwanese public companies control only 20–40% of voting rights. They may not have full control of the board even under the majority voting rule, not to mention under the cumulative voting rule. Indeed, they only control 40–80% of the board seats. Unreported tables show that between 1 (25th percentile) and 4 (75th percentile) board seats are occupied by neither controlling shareholders nor independent directors. Hence, while controlling shareholders in most Taiwanese companies control a majority of the board, outsiders are frequently presented on the board and can blow the whistle if they disagree with the controlling shareholders. Controlling shareholders thus have incentives to gain full control, while lawmakers are justified in facilitating the election of candidates supported by outsiders.

Several leading corporate governance indexes identify cumulative voting as a measure that better protects outside investors and consider it to be a sign of "good" corporate governance. Developed by La Porta et al. (1998: 1127) in their influential article "Law and Finance," which attempts to assess and explain the level of investor protection in 49 countries, the world-famous "Antidirector Rights Index" consists of six measures of shareholders' rights, of which one is cumulative voting. Similarly, in their "Governance Index," Gompers et al. (2003: 147) use 24 governance rules as proxies for the level of shareholder protection in large public firms. Among the 24 rules, cumulative voting is one of the two provisions that are considered to increase shareholders' rights.

Even though cumulative voting has been widely presumed to be a mechanism that would enhance investor protection, empirical studies of its effect on shareholder value are scant. One difficulty that faces empirical tests on cumulative voting is that firms have the option of choosing their own voting rules, and the choice of cumulative voting itself is inherently endogenous. Furthermore, other corporate governance mechanisms are often adopted around the same time, thereby confounding the empirical results regarding the impact of cumulative voting.

To our knowledge, no empirical article has identified the causal effect of cumulative voting on controlling shareholders' control over firms. Two prior works examined the effect of cumulative voting on corporate value, but the results are mixed. Bhagat and Brickley (1984) find that amendments to eliminate cumulative voting are associated with statistically significant negative stock returns. They cannot make causal inferences because firms usually undertake several amendments together, and in some situations firms were facing takeover threats. A more recent study by Xi and Chen (2014) examines the market reaction to the adoption of cumulative voting in the Chinese context, where a majority of the public companies are controlled firms. Their results show that the market reacted negatively, but not statistically significantly so, to the adoption of cumulative voting. Xi and Chen (2014) hypothesize that the result could be partly attributed to the lack of a significant second-largest shareholder and the small size of boards in Chinese public firms.

In this article, we exploit a quasi-natural experiment in Taiwan to tease out empirically the effect of cumulative voting on controlling shareholders' levels of control over firms. Taiwan stands out as a unique jurisdiction which mandates cumulative voting on all companies. An OECD survey of 26 countries shows that only Brazil mandates companies to adopt cumulative voting under certain con-

[1] Posner and Weyl (2014) advocate quadratic voting to enhance corporate governance. Under quadratic voting, "everyone interested in a corporate outcome that is subject to a vote may buy as many votes as he wants for the purpose of casting them in that particular election. The price of the votes is a quadratic function of the number of votes purchased. For example, one can buy one vote for $1, two votes for $4, and three votes for $9" (Posner and Weyl, 2014: 252–253).

[2] For menus in general, see Ayres (2006). For the power of menus in American corporate law, see Listokin (2009). For the power of menus in corporate laws in China, Hong Kong, and Taiwan, see Lin and Chang (2017).

[3] 8 Del. Code §§ 214.

[4] Opponents of cumulative voting believe it would deviate from the one-share one-vote principle and would incur agency costs because of the misalignment of equity rights and voting rights. Furthermore, minority representation on the board would cause inconsistent or illogical decisions (Easterbrook and Fischel, 1983: 409–410).

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