Nonprofit Organizations as Investor Protection: 
Economic Theory, and Evidence from East Asia

Curtis J. Milhaupt

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Nonprofit Organizations as Investor Protection: Economic Theory, and Evidence from East Asia

Prof. Curtis J. Milhaupt
Columbia Law School

Abstract

Enforcement problems plague shareholder activism and investor protection in many parts of the world. The importance of solving this problem has led scholars to consider a range of partial alternatives to weak domestic corporate law enforcement regimes, ranging from writing “self enforcing” corporate laws to using cross listings on foreign stock exchanges as a means of bonding firms to higher quality enforcement.

The recent experience of the three largest capitalist market economies of East Asia suggests that there is another partial solution to the problem of weak investor protection and corporate law enforcement, one that has received no theoretical or empirical attention—the nonprofit organization. This partial solution emerges from a puzzle at the center of contemporary East Asian corporate governance. With the possible exception of the government itself, nonprofit organizations (NPOs) have emerged as the most important corporate law enforcement agents in Korea, Japan and Taiwan. In each system, an NPO holding a portfolio of shares is engaged directly in the exercise of shareholders’ rights to combat corporate fraud and mismanagement, and to improve the investor protection climate. In numerous instances, these organizations have won significant court victories or settlements against management. This development is puzzling because the defining characteristic of an NPO is the nondistribution constraint. That is, while nonprofits are not prohibited from making profits, they are prohibited from distributing them to their owners. Why are three organizations operating within the nondistribution constraint—rather than institutional investors or individual shareholders represented by plaintiffs’ attorneys—the principal shareholder activists cum corporate law enforcement agents in this region?

This paper analyzes the role of NPOs in East Asian corporate governance, and applies economic theory on the existence of nonprofits as suppliers of public goods (along with several complementary theories) to explain the rise of NPOs as suppliers of investor protection in the region. The paper also examines the academic and policy implications of the East Asian experience. Academically, the NPO as a corporate law enforcement mechanism is a highly distinctive illustration of functional convergence in corporate governance: several societies have spontaneously generated substitutes for the attorney-oriented incentive mechanisms relied upon in the United States to enhance investor protection. Yet each NPO displays its own unique structure and strategy, differences that can be tied directly to the distinct domestic legal and political structures in which they operate. At the level of law reform, for transition economies the NPO has several advantages as a corporate law enforcement device, particularly in societies reluctant or unable to transplant the U.S. “attorney as bounty hunter” model of law enforcement. First, the nondistribution constraint inherent in the NPO form provides a built-in check on frivolous litigation. Second, shareholder activist NPOs seek to use and improve local law enforcement institutions, while most of the alternatives discussed in the literature involve abandoning weak local enforcement regimes.
Nonprofit Organizations as Investor Protection: Economic Theory, and Evidence from East Asia

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Introduction

Enforcement problems plague shareholder activism and investor protection efforts in many parts of the world. These problems are particularly severe in transition economies, where weaknesses in legal and market constraints are prevalent. The importance of solving this problem has led legal scholars to consider a range of partial alternatives to domestic enforcement regimes. For example, Bernard Black and Reinier Kraakman devised a “self-enforcing” corporate law for Russia, designed specifically to minimize resort to legal authority.¹ John Coffee has recently emphasized the role of cross-listings on foreign stock exchanges as a mechanism by which firms in weak enforcement regimes can bond themselves to “good” corporate law by listing on a foreign

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stock exchange that imposes high disclosure requirements and subjects listed firms to a stringent foreign regulatory and private enforcement regime.²

But there is another partial solution to the problem of weak investor protection and corporate law enforcement, one that has received no theoretical or empirical attention—the nonprofit organization. This partial solution emerges from a puzzle at the center of contemporary East Asian corporate governance. With the possible exception of the government itself, nonprofit organizations³ (NPOs) have emerged as the most important corporate law enforcement agents in Korea, Taiwan and Japan. In Korea, the shareholders’ rights committee of a large, diversified NPO known as Peoples’ Solidarity for Participatory Democracy (PSPD) “has brought the only significant shareholder actions to date,”⁴ winning two major court victories, including one against the chairman and managers of a leading chaebol firm. In Taiwan, a nonprofit foundation known as the Securities and Futures Institute, established with the support of the government and the financial sector, has organized and filed de-facto class action suits in securities and corporate fraud cases on behalf of thousands of small investors. In Japan, a group of activist lawyers and academics calling themselves the Shareholder [Kabunushi] Ombudsman “dominates the market [for derivative actions], has no recognizable equal, and has litigated several of the more high profile cases in Japan.”⁵

³ A common definition of an NPO is an organization (formal or informal) that is private, self-governing, non-profit-distributing and voluntary. Global Civil Society at a Glance: Major Findings of the Johns Hopkins Comparative Nonprofit Sector Project, available at www.jhu.edu/~crip/pdf/glanc.pdf.
This brand of shareholder activism is puzzling on several levels. First, the defining characteristic of an NPO is the nondistribution constraint. That is, while NPOs are not prohibited from making profits, they are prohibited from distributing profits to their members or others who control them. Why are three organizations operating within the nondistribution constraint—rather than institutional investors or individual shareholders represented by plaintiffs’ attorneys—the principal shareholder activists cum corporate law enforcement agents in the three largest market economies of East Asia? Second, civil society is a comparatively recent development in this region, where the state has traditionally not created much space for the formation of organizations pursuing independent objectives. Why isn’t the phenomenon of corporate law enforcement by NPO shareholder activists witnessed more extensively elsewhere, including in countries, which have active nonprofit sectors?

A partial solution to the puzzle of corporate law enforcement in East Asia, as well as the contours of a possible role for nonprofits in improving investor protection in some

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7 See, e.g., Richard Estes, Charitable Foundations in East Asia: Tax Shelters for the Well Off or Partners in Development?, unpublished manuscript at 14.
8 Of course, NPOs involved in corporate governance and corporate social responsibility are now prevalent throughout the world. In the United States, organizations such as the Corporate Library, the Shareholder Action Network and the Investor Responsibility Research Center (IRRC) seek to promote good corporate governance. But these organizations differ in significant respects from the NPOs discussed in this article. The U.S. NPOs principally serve as information clearinghouses or, as in the case of IRRC, to promote the interests of their large institutional members. They are not civil society organizations as that term is commonly understood. Also, from an operational standpoint, NPOs in the U.S. do not organize plaintiffs in shareholder litigation, though nothing in U.S. tax law appears to prohibit nonprofits from playing a more direct role in corporate law enforcement by, for example, holding portfolios of stock so as to exercise shareholders rights.
Perhaps the closest analogue outside of East Asia is the Institute of Corporate Law and Corporate Governance in Russia, founded by a former Chairman of the Federal Commission for the Securities Market of the Russian Federation. This organization’s objective is to protect investor rights by improving corporate governance in Russia. Its principal method for doing so is creating corporate governance ratings for Russian firms to allow investors to make informed investment and voting decisions.
The NPOs in East Asia are unique in that they not only focus their efforts on corporate law and corporate governance per se (as opposed to broader social issues), but also take direct action in organizing plaintiffs, holding portfolios of stock in their own right, and actively exercising rights as shareholders themselves (as opposed to the more passive role of providing information about corporate governance to investors).
other economies, come into focus when we turn from facts to theory. For considerably longer than corporate law scholars have debated the causes of cross-country diversity in corporate structures, social scientists have sought to explain the existence of NPOs, and the vast disparity in the size of the NPO sector in individual countries around the world. While no single theory garners universal support, several influential, related theories help explain the recent phenomenon of NPO shareholder activism in East Asia. By extension, understanding the East Asian experience may suggest ways to improve investor protection elsewhere. One theory views NPOs as a response to unsatisfied demand for public goods—demand that grows as societies become more diverse, opening gaps in supply caused by government and market failures. In order to understand how this theory fits the East Asian experience, note that investor protection in the form of corporate and securities law enforcement is a public good: many of the benefits of the enforcement effort accrue to persons who are not required to bear their share of the enforcement costs. Note as well that demand for investor protection and “good” corporate governance have grown rapidly in the region, a result of the Asian financial crisis, domestic corporate scandals, and persistent economic malaise in Japan. Under these circumstances, if the infrastructure for private law enforcement is inadequate and the government is unable or unwilling to meet the increased demand for investor protection, the government failure/market failure theory predicts the emergence of NPOs to supply investor protection, at least where legal and social conditions for the development of an NPO sector are favorable.

A related, “contract failure” theory views the NPO form as a device to economize on the costs of producing public goods, particularly where consumers are unable to

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evaluate the quality or quantity of the services provided. This theory rests on the premise that the nondistribution constraint makes NPOs more “trustworthy” suppliers where information asymmetries are present, because the owners of such organizations have fewer incentives to take advantage of consumers. As we will see, this theory, applied to the government, helps explain why the Taiwanese securities regulatory agency supports an investor protection NPO, and suggests that government-NPO partnerships have potential to supplement weak state enforcement of corporate and securities laws.

A third theory focuses the supply side, noting that the demand for public good production can only be met by NPOs if there is an adequate stock of individuals (“social entrepreneurs”) to found and operate these organizations. This theory recognizes that certain social environments are more conducive than others to the supply of social entrepreneurs. The literature has focused on the role of religious competition in expanding supply, but this is hardly the only environment conducive to social entrepreneurship. For example, a comparatively larger stock of social entrepreneurs would likely exist in societies with a history of organized protest against the government, a circumstance relevant to the East Asian experience.

These theories help explain why NPO shareholder activists have emerged to fill a shortfall in the supply of investor protection-related public goods in the increasingly diverse socio-economic structures of Japan, Korea and Taiwan. This form of law enforcement appears most successful in Korea, where the supply and quality of social entrepreneurs is highest due to its recent history of organized protest against authoritarian governments, and where government policy and the legal environment are conducive to

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an active NPO sector. The Taiwanese example is also noteworthy, because the
government has consciously co-opted an NPO into its public good supply chain. The
Japanese NPO, comparatively less prominent than its other East Asian counterparts,
reflects both a somewhat more robust corporate law enforcement environment (hence
to fewer gaps in the supply of public goods), a smaller stock of experienced activists, and a
political and legal environment that has traditionally channeled organized
nongovernmental activism into highly localized causes.

NPO shareholder activism in East Asia, which has been the focus of virtually no
theoretical or comparative analysis, has significant implications for ongoing academic
debates in comparative corporate governance as well as real-world reform efforts.
Academically, two points are well recognized in comparative corporate governance
theory, but not thoroughly explored empirically. First, the quality of law enforcement is
at least as important to “good” investor protection as high quality statutory law. Second,
convergence of legal systems at the formal level may not eliminate differences in
practice; and conversely, functional equivalents may lead to convergent outcomes even
where significant differences remain among corporate governance systems at the formal
level.

The emergence of NPOs as the leading non-state corporate law enforcement
agents in East Asia is a novel and important illustration of both points. Despite recent,

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12 The activities of the three NPO shareholder activists have been separately described in several excellent
English-language publications cited extensively in Part III. But no attempt has been made to explain the
emergence of these organizations theoretically or in comparative perspective, or to examine the academic
and practical implications of their activities beyond the confines of the separate systems in which they
operate.

13 See, e.g., Luca Enriques, Off the Books, But on the Record: Evidence from Italy on the Relevance of
Judges to the Quality of Corporate Law, in Global Markets, Domestic Institutions: Corporate Law and

14 Ronald J. Gilson, Globalizing Corporate Governance: Convergence of Form or Function, 49 Am. J.
extensive corporate governance reform in all three countries at the statutory level, the enforcement environment remains problematic. While by no means perfect, the NPOs analyzed here are important—perhaps even the only—aggressive enforcement agents in the corporate governance environments of the three countries in which they are active. All three organizations have found ways to improve the quality of investor protection in their home countries, despite—or perhaps more accurately, because of—shortcomings in public and private enforcement mechanisms.

Moreover, the NPO as a supplier of investor protection is a highly distinctive illustration of functional convergence: several societies have spontaneously generated substitutes for the attorney-oriented incentive mechanisms relied upon in the United States to provide law enforcement-related public goods in the corporate governance arena. Neither the NPO nor the “private attorney general” ensures an optimal supply of investor protection, but these two enforcement alternatives are distinct paths toward the same goal.

Yet the experience of East Asia with NPOs as corporate law enforcers is not an unalloyed convergence story. Even in their common use of the nondistribution constraint to advance the objective of investor protection, Japan, Korea and Taiwan display striking diversity in the organizational form, strategy and success of their NPOs. This diversity can be traced to the distinctive legal, political, and social environments in which NPOs have emerged and exist in the three systems.

At the level of law reform, the lessons from East Asia for other transition economies may be significant, particularly where there is hesitation or inability to replicate the U.S. private attorney general model of corporate law enforcement. While the use of the NPO form as a law enforcement device has its own serious limitations
(explored in Part IV below), this innovation is worthy of serious study as a way to improve the corporate governance environments in China, Russia and other transition countries. NPOs may be less effective compared to other functional substitutes for domestic enforcement, such as firms bonding themselves to “good” corporate law through cross-listings on foreign exchanges. However, shareholder activist NPOs are inherently *domestic* organizations, and that attribute holds out the promise of improvement of *local* law enforcement institutions. The other alternatives discussed in the literature (save for massive long-term investments in legal infrastructure) generally involve *abandoning* local legal regimes.

The paper is organized into four parts. Part I presents the puzzling yet significant role of nonprofit organizations in the corporate governance environments of Korea, Taiwan and Japan. Part II outlines several complementary theories from social science literature explaining the existence of NPOs, theories that shed light on the puzzling form corporate law enforcement has taken in East Asia. Part III applies these theories, first to explain the emergence of NPO shareholder activism in Japan, Korea and Taiwan, and second, to explain why substantial diversity exists in the structure and operations of these NPOs despite their common role as corporate law enforcement agents. Part IV draws implications from this distinctive East Asian experience for comparative corporate governance literature, and for corporate law enforcement in transitional economies.

**I. A Puzzle: The Role of NPOs in East Asian Corporate Governance**

As noted in the Introduction, a puzzling feature of contemporary East Asian corporate governance is the presence of an organization operating within the nondistribution constraint as a major corporate law enforcement agent in each of the three
largest market economies in the region. This part introduces the puzzle by describing the three shareholder activist/investor protection NPOs operating in Korea, Japan, and Taiwan, respectively.

A. Korea

The People’s Solidarity for Participatory Democracy (PSPD) was founded in 1994. Legally, it is a “nonprofit private organization” formed under a special law enacted in 2000. Its membership has grown rapidly, from 200 at its founding to over 12,000 in 2002, so that today, 80 percent of its monthly budget is funded out of membership fees. It has a professional staff of fifty, but its activities rely heavily on voluntary participation of lawyers and other experts. PSPD is actually a nonprofit “holding company” for several “action bodies” engaged in a wide variety of advocacy efforts, including judicial oversight and a taxpayer’s movement. One of these action bodies is the Participatory Economic Committee, which launched a Small Shareholders Rights Campaign in 1997. The aim of this campaign is to protect minority shareholder rights and improve corporate management by mobilizing small shareholders to act collectively against the chaebol. Through the activities of the PEC, PSPD has become the leading shareholder activist, and indeed, the most influential civic movement in Korea. (For simplicity, hereafter I will refer only to PSPD.)

16 Unless otherwise noted, factual information in this section is taken from the PSPD website: www.pspd.org.
17 Hyuk-Rae Kim, NGOs in Pursuit of “the Public Good” in Korea, in Collective Goods, Collective Futures in Asia 58, 66 (Sally Sargeson ed, 2002).
18 For a detailed discussion of PSPD’s corporate governance activities, see Jooyoung Kim and Joongi Kim, Shareholder Activism in Korea: A Review of How PSPD has Used Legal Measures to Strengthen Korean Corporate Governance, 1 J. Korean L. 51 (2001).
19 Sung, cited in Hyuk-Rae Kim, NGOs in Pursuit of “the Public Good” in Korea, in Collective Goods, Collective Futures in Asia 58, 68 (Sally Sargeson ed, 2002).
PSPD consciously targeted the leading *chaebols* for its initial activism efforts, seeking to make them good role models for other firms.\(^{20}\) While it engages in a variety of non-legal activities to promote corporate governance, PSPD has utilized the legal system as its principal tool of reform.\(^{21}\) Toward this end, it holds a portfolio of stock so that it has standing to exercise shareholders’ rights. By participating in shareholder meetings, PSPD has obtained disclosure of information and managerial acceptance of corporate governance reform at a number of major *chaebol* firms, including SK Telecom, Hyundai Heavy Industries, and Daewoo Corporation.\(^{22}\) It has also successfully sued to nullify resolutions passed at a shareholders meeting at which irregularities occurred. PSPD has also launched several proxy solicitations aimed at attracting foreign institutional investors to its cause, sought injunctions against illegal managerial conduct, and filed administrative complaints against lawyers and accountants for aiding in such conduct.\(^{23}\) In addition, it has successfully proposed a series of reforms to the Commercial Code and Securities Exchange Act.

Most importantly, PSPD has achieved two major victories in shareholder derivative suits.\(^{24}\) The first—indeed the first shareholder derivative suit in Korean history—was a suit against the former directors of Korea First Bank, filed on behalf of sixty one minority shareholders. The claim alleged that the directors had accepted bribes in return for the extension of credit to a failing conglomerate, while instructing

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\(^{22}\) Hyuk-Rae Kim, *NGOs in Pursuit of “the Public Good” in Korea*, in Collective Goods, Collective Futures in Asia 58, 67 (Sally Sargeson ed, 2002).


\(^{24}\) A derivative suit is brought by a shareholder to enforce a corporate cause of action. The action seeks recovery, on behalf of the corporation, for damages caused by a director’s breach of duty.
staff to proceed with the loans despite knowledge of the borrower’s poor financial condition. A 40 billion won ($44 million) decision was rendered against the directors in 1998, making directors aware, for the first time, of their fiduciary obligations to their shareholders.\(^{25}\) In 2001, PSPD won a judgment in a shareholder derivative suit brought on behalf of twenty two shareholders against the controlling shareholder and nine directors of Samsung Electronics. In the case, which bears a resemblance to \textit{Smith v. Van Gorkom}, the court held the directors liable for failing to exercise business judgment in the acquisition of a failing target company. As in \textit{Van Gorkom}, the court found the directors’ conduct to lie beyond the protective confines of the business judgment rule where negotiations proceeded with undue haste and inadequate diligence by the board. In addition, the chairman of the firm was found liable for making an illegal political contribution, and six directors were held liable for approving a related-party transaction on unfair terms. According to Korean corporate law experts, the Samsung Electronics case sent an even more powerful message to the business community than the Korea First Bank case, indicating that even managers of Korea’s most profitable and well known firms are legally accountable to their shareholders.\(^{26}\)

\textbf{B. Taiwan}

The Securities and Futures Institute (SFI) is an ingenious mechanism for overcoming collective action problems in shareholder litigation. The SFI was founded as a nonprofit foundation in 1984 through the cooperation of Taiwan’s securities regulatory


agency and the local banking and securities industries. Its principal source of income has been an assessment on securities transactions. The SFI has a large and highly professional staff of 91 full-time employees. The SFI holds 1000 shares (one trading unit) in each public company in Taiwan, so that it has standing to assert claims as a shareholder. It also functions as a public interest law firm on investor protection issues. The SFI has procedures in place to take on claims of private investors in securities cases. In cases where a public prosecution has been initiated, the SFI will either assert its own claim or bring a “de facto class action” as an agent for other investors. Court costs and attorneys’ fees are funded by the SFI, and in turn by the SFI’s sources of funds. Thus, SFI’s contributors “are willing to subsidize the cost of civil enforcement.”

The SFI engages in both none enforcement and enforcement activities. Non-enforcement related activities include taking investor complaints, helping settle disputes, providing legal consultation, and promoting investor education. As a shareholder, SFI also participates in shareholders meetings, particularly where a company is in financial crisis or is issuing substantial amounts of new equity. Enforcement actions fall into several categories: executing disgorgement rights for short-swing trading profits (on

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27 It was founded as the Institute of Securities Market Development. The name was changed in 1992. The discussion in text is drawn from Lawrence Liu, Simulating Securities Class Actions: The Case of Taiwan.
29 Securities and Futures Institute, 2001 Annual Report, at 15. (The staff includes 1 PhD, and 25 masters degrees).
30 Lawrence S. Liu, Corporate Governance in Taiwan, unpublished manuscript, at 12-13.
31 Liu, Corporate Governance in Taiwan, unpublished manuscript, at 13.
33 Securities and Futures Institute, 2001 Annual Report, at 34.
grounds similar to Section 16 of the U.S. Securities Exchange Act of 1934),\textsuperscript{34} and acting as agent in shareholder suits and de-facto class actions.

Statistics indicate that the SFI has been active in its law enforcement role. As of 2002, the SFI has filed class actions against twenty four companies on behalf of 9700 investors, seeking NT$ 4.7 billion (about $150 million) in civil damages.\textsuperscript{35} Since 1998, SFI has filed more than 2000 disgorgement actions for short-swing profits, seeking NT$ 8.7 billion (about $300 million). It played a leading enforcement role in a series of major corporate scandals that emerged in Taiwan in the late 1990s. Typically acting on behalf of hundreds of investors, SFI sued numerous so-called “landmine companies,” whose controlling shareholders had used affiliates to manipulate stock prices and siphon off corporate assets.\textsuperscript{36}

\textit{C. Japan}

Shareholder Ombudsman, “dedicated to the goal of reforming Japanese management practices to incorporate the views of ordinary shareholders and citizens,”\textsuperscript{37} was founded in 1996 by a group of lawyers, accountants and academics.\textsuperscript{38} The organization is a spin off of Osaka-based Citizens’ Ombudsman, a watch dog group that monitors the bureaucracy and the relationship between government and business. At its founding, Shareholder Ombudsman had 150 members and a portfolio of 300 stocks. Its members were divided into three groups: shareholder members, specialist members, and

\textsuperscript{34} Unlike U.S. securities law, however, under the Taiwanese securities law the \textit{corporation} must force disgorgement of such profits, and shareholders may sue if the corporation fails to do so.

\textsuperscript{35} Securities and Futures Institute, 2002 Annual Report (draft).

\textsuperscript{36} Lawrence S. Liu, Simulating Class Actions: The Case of Taiwan, unpublished manuscript, at 9-16.

\textsuperscript{37} www1.neweb.ne.jp/wa/kabumbu/English-02.htm.

\textsuperscript{38} Hiroshi Otsuka, Iraishanaki Hodoin: “Kabunushi Onbuzuman” to kabunushi daihyo sosho [Client-less Law-Movers], 47 Kobe hogaku zasshi 705, 733 (1997); www1.neweb.ne.jp/wa/kabumbu/English-02.htm.
citizen members, but the core group of active participants only numbered about 15.39

Given the legal nature of its work, specialist members in the form of elite attorneys are the core of the organization.

Although not legally established as a nonprofit organization under Japan’s Civil Code due to the onerous formation requirements in effect at the time of its founding, Shareholder Ombudsman is organized and functions as if its members were bound by the nondistibution constraint.40 As one observer has noted, while Shareholder Ombudsman has the legal form of a limited liability company [yugen gaisha], the objectives stated in its charter—exercising shareholders’ legal rights, improving corporate information disclosure, and serving as a voice for the expression of shareholder opinion—are public goods.41 Since the organization’s principal weapon is the derivative suit—an action in which compensation won by plaintiffs returns to the corporation—the only direct economic returns available to members of the organization are attorney’s fees. But senior Shareholder Ombudsman attorneys typically donate any fees to which they are entitled to the organization. Indeed, all of the organization’s operating expenses are funded by such

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40 Hiroshi Otsuka, Iraishanaki Hodoin: “Kabunushi Onbuzuman” to Kabunushi daihyo sosho [Client-less Law-Movers], 47 Kobe hogaku zasshi 705, 736 (1997). According to lawyers involved with the organization, the nonprofit form was not selected due to the high initial endowment requirements under the Civil Code. The Civil Code provides for two types of nonprofit organizations: incorporated foundation [zaidan hojin] and incorporated association [shadan hojin]. The required minimum endowment to establish an incorporated association is 100 million yen (about $800,000). Moreover, nonprofits are granted legal status under the Civil Code only at the discretion of government ministries with jurisdiction over their activities. Even if legal status as a nonprofit is obtained, tax deductibility for contributions to such organizations is granted only at the discretion of the Ministry of Finance. Less than 3 percent of the 9000 nonprofit organizations formed under the Civil Code have been granted tax-favored status. Yoshinori Yamaoka, untitled draft, at 6. In 1998, a new NPO law was enacted, providing for registration as of right to organizations that meet specified statutory requirements. Law to Promote Specified Nonprofit Activities, Art. 12. Shareholder Ombudsman has applied for NPO status under this law.
41 Hiroshi Otsuka, Iraishanaki Hodoin: “Kabunushi Onbuzuman” to Kabunushi daihyo sosho [Client-less Law-Movers], 47 Kobe hogaku zasshi 705, 737 (1997).
donations. While junior attorneys working on successful cases do receive modest compensation out of the attorneys fees paid by the defendant corporation, this does not set Shareholder Ombudsman apart from NPOs that pay modest salaries to their staff members.

As noted in the Introduction, Shareholder Ombudsman has been involved in many of the high-profile shareholder derivative suits in Japan. From 1996 to 2001, according to information published by the organization, Shareholder Ombudsman filed twelve derivative suits, including cases against the directors of some of Japan’s best known companies, such as Sumitomo Corporation, Nomura Securities, Takashimaya Department Store, Daiichi-Kangyo Bank, Ajinomoto, Yamaichi Securities, Japan Airlines, Kobe Steel, and Mitsubishi Motors.

Although Shareholder Ombudsman has obtained a favorable judgment in only one case, it has settled at least a half dozen suits, including a 430 million yen ($4 million) settlement with the directors of Sumitomo Corporation for unauthorized copper trading losses, a 310 million yen ($3 million) settlement with the directors of Kobe Steel for payoffs to racketeers, and a settlement with the directors of Japan Airlines for failure to comply with a law mandating that a certain percentage of its workforce be comprised of disabled workers. Many of these settlements involve not only cash reimbursements by the directors to their respective corporations, but also commitments from the firm to establish mechanisms to prevent the conduct from recurring. For example, the Kobe Steel settlement included a commitment by the corporation to establish a compliance

42 Correspondence to author.
43 Mark D. West, Why Shareholders Sue: The Evidence from Japan, 30 J. Legal Stud. 351, 369 (2001); Correspondence to author.
committee to prevent future malfeasance. The Japan Airlines settlement included a commitment to increase the employment of disabled workers over time until the statutory requirement was met, together with the payment of a 40-50 million yen ($400,000-$500,000) fine to the government annually for an extended period of time. Thus, some of these settlements are arguably the equivalent of a judicial victory both in terms of compensation received--indeed, the settlement in the Takashimaya case slightly exceeded the amount of damages sought in the litigation--and their impact on the corporate community. The proximity of Shareholder Ombudsman’s settlement to a victorious judgment is particularly close in cases such as the Kobe Steel suit, in which the district court publicly released a settlement memorandum outlining its finding of clear violations of the duty of care and loyalty by the directors.45

Apart from derivative litigation, Shareholder Ombudsman has engaged, to a limited extent, in other activist efforts. It has directly, or through shareholders affiliated with the group, filed shareholder proposals against several prominent firms such as Sony and Sumitomo Bank. While none of the proposals has garnered sufficient votes to be adopted, management has responded to some of the organization’s recommendations.46 Recently, for example, Shareholder Ombudsman withdrew a shareholder proposal against a scandal-plagued food products company after the corporation agreed to appoint an outside director nominated by a national consumer group.47 Shareholder Ombudsman has also made two forays into the legislative reform process, promoting an amendment to the Commercial Code’s derivative suit procedures in response to a ruling party proposal

45 Sosho no shoki shuketsu ni mukete no saibansho no shoken [The Court’s Findings on Early Termination of the Litigation], available at www1.neweb.ne.jp/wa/kabuombu/koube01.htm.
supported by business groups, and more recently, a whistle blower statute. Finally, Shareholder Ombudsman has carried on campaigns to improve the shareholder meeting process.

II. Theory: NPOs, Public Goods, Trust, and Social Entrepreneurship

Although the nonprofit sector has been described as the “‘lost continent’ on the social landscape of modern society,”48 a burgeoning literature explores questions that closely parallel those now preoccupying scholars of comparative corporate governance. These questions include how to account for significant cross-country diversity in NPO size and role, and the impact of domestic legal environments on the establishment and performance of NPOs.49

Paralleling the theory of the firm debate in corporate literature, much theoretical attention has been devoted to the fundamental question why NPOs exist. While no single theory garners universal support, one highly persuasive theory,50 most closely associated with Burton Weisbrod, views NPOs as a response to government and market failures in the supply of public goods.51 In classical economics, market failure is of course the major justification for government. But Weisbrod noted that in a democracy, “government failure” is also common, since decisions about which public goods to produce and in what quantity will most often reflect the preferences of the median voter.

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49 This literature predates the comparative corporate governance debate by a decade. See, e.g., The Nonprofit Sector: A Research Handbook (Walter W. Powell ed. 1987).
51 Burton Weisbrod, Toward a Theory of the Voluntary Non-Profit Sector in a Three-Sector Economy, in Altruism, Morality, and Economic Theory (Edmund S. Phelps, 1974); Burton Weisbrod, The Voluntary Nonprofit Sector (1977). See also Hyuk-Rae Kim, NGOs in Pursuit of “the Public Good” in Korea, in Collective Goods, Collective Futures in Asia 58, 62 ( Sally Sargeson ed, 2002). (“There is a functional logic to the emergence of NPOs as providers of goods that are under-supplied by both the market and the government.”).
The more heterogeneous the population, therefore, the larger the unsatisfied demand for public goods. In Weisbrod’s framework, NPOs emerge to supply public goods that are not provided by the state or the market.

The “government failure/market failure” theory generates a straightforward hypothesis: the size of the NPO sector should vary with the degree of heterogeneity in society. While by no means unchallenged in its dominance, this theory in fact finds considerable empirical support.52

An important extension of this theory is the notion of “contract failure” developed by Henry Hansmann.53 Hansmann noted that people are in fact willing to produce public goods in many circumstances. However, difficulties inherent in measuring the quantity and quality of public goods create severe information problems for consumers. The NPO form economizes on the costs of writing and enforcing a contract ensuring that consumers’ expenditures bear a relationship to the goods supplied. That is, demand for some public goods is most likely to be met by NPOs as opposed to for-profit firms, because the nondistribution constraint makes the NPO a more trustworthy producer.54

Influential as the government failure/market failure theory may be (particularly in combination with the contract failure concept), responses to the demand for public goods are not likely the sole explanation for the emergence of NPOs. A corollary theory focuses on the individuals who supply public goods. The supply-side theory recognizes that the demand for public goods can be met by NPOs only if there is a supply of

52 See, e.g., Lester M. Salomon and Helmut K. Anheier, Social Origins of Civil Society: Explaining the Nonprofit Sector Cross-Nationally, 9 Voluntas 213, 232-237(1998). In the literature, heterogeneity is measured by ethno-linguistic fractionalization. In theory, however, other forms of heterogeneity should be equally important.
people—“social entrepreneurs”—with the qualifications and incentive to establish NPOs. As one commentator notes, however, “the appearance of such individuals is not random….It is most likely under particular circumstances.” While religious competition is typically viewed in the literature as the factor most conducive to the emergence of social entrepreneurs (because the provision of social services is a way to attract new adherents to a religion), intuitively it should not be the only such factor. Among other environments likely to spawn social entrepreneurs is the young democracy, particularly one that has recently emerged out of an authoritarian regime that drew organized popular protests. Such a society should be more likely to have a stock of trained and motivated social entrepreneurs who received their “training” in movements against the prior regime.

In addition to this theoretical work, there are close parallels in the NPO scholarship to the influential “law and finance” work, which links the size of the capital markets and dispersion of shareholding around the world to the quality of domestic legal environments. Just as law influences the size and financing structure of firms in the for-profit economy, so too law matters to the size and role of the nonprofit sector around the world.

While the theories outlined above by no means explain the totality of the nonprofit sector of the economy, they do suggest that corporate law enforcement, as a

58 For example, as Mel Eisenberg pointed out to me, existing theory seems impoverished in its emphasis on government and market “failures” as the motivating impulse for the creation of NPOs. The nonprofit sector
public good, could be fertile ground for NPO involvement. This should be particularly true in a region such as East Asia, where expectations about corporate governance, corporate performance, and the role of the state in economic management became more heterogeneous due to rapid economic growth and political change, and as demand for corporate law enforcement increased with the decline of institutional structures that at one time partially substituted for formal law enforcement. This is not to suggest that NPOs will always emerge to remedy government and market failures in the supply of investor protection. Indeed, theory suggests that an environment conducive to NPO activity is elusive, and highly sensitive to the social and legal conditions.

III. Application: NPOs as Investor Protection

In this part of the paper, I show that the emergence of NPOs as suppliers of investor protection in Japan, Korea and Taiwan is consistent with the theory outlined above, helping to unravel the puzzle of corporate law enforcement in East Asia, and suggesting a potentially more active role for NPOs in the corporate governance environments of other countries. The discussion begins by briefly examining the public goods attributes of corporate law enforcement, and moves to an evaluation of specific factors in these systems that may lead to gaps between supply and demand for this public good. It then moves to an analysis of several common and divergent attributes of the NPOs in East Asia that have emerged to meet the unmet demand, and ties the differences to diversity in local legal, historical and political environments. The final section reviews how well the predictions from theory explain the East Asian experience, and evaluates an alternative, cultural explanation for this phenomenon.
A. Corporate Law Enforcement as a Public Good

Since the dominant theory views NPOs as a response to gaps in the supply of public goods, the first step in our discussion is to highlight the public goods qualities of corporate law enforcement. Indeed, corporate law enforcement displays the classic attributes of a public good, indivisibility and nonexcludability. A shareholder’s “consumption” of investor protection and good corporate governance does not reduce the benefits available to others, and it is not possible for the law enforcer/activist to exclude others from most or all of the benefits conferred by his or her efforts. The shareholder derivative suit presents the problem in its most extreme form. The plaintiff bears the cost of the suit. But each of the firm’s shareholders indirectly partake of any monetary award, and benefit from any specific deterrent effect the suit has on management. The shareholding public benefits to the extent that the enforcement effort has a general deterrent effect on other corporate managers. And to the extent that the law enforcement effort results in the creation of “better” law, the general public benefits from the updating of common law, which contributes to a more efficient environment for economic activity.\(^59\)

In many ways, the United States and East Asia stand at opposite ends of the spectrum in their approach to the public goods problem of law enforcement. As John Coffee notes, “Probably to a unique degree, American law relies upon private litigants to enforce substantive provisions of law that in other legal systems are left largely to the discretion of public enforcement agencies.”\(^60\) This U.S. “private attorney general” model


\(^{60}\) John C. Coffee, Jr., Understanding the Plaintiff’s Attorney: The Implications of Economic Theory for Private Enforcement of Law through Class and Derivative Actions, 86 Colum. L. Rev. 669, 669 (1986).
rests on procedural rules that establish fee arrangements for plaintiffs’ attorneys. These mechanisms may lead to over-enforcement, particularly as they relate to corporate and securities law.\textsuperscript{61} In any event, they stand in sharp contrast to the corporate law enforcement environment in East Asia, which as explored more fully in the next section of the paper, contains relatively weak private incentives for law enforcement.

As a crude illustration of the difference in approach, consider the number of shareholder derivative suits filed in the United States versus the East Asian countries. Definitive data on the number of shareholder suits in the United States are unavailable, but all existing evidence indicates that large numbers of suits are filed in any given year. For example, one prominent study found that 19 percent of a random sample of 535 publicly traded U.S. corporations experienced derivative litigation between the late 1960s and 1987.\textsuperscript{62} Table 1 sets forth the number of shareholder derivative suits filed in Japan, Korea and Taiwan.


Table 1
Shareholder Derivative Suits Filed in Japan, Korea and Taiwan

<table>
<thead>
<tr>
<th></th>
<th>Date of enactment of shareholder derivative suit procedure - 1990</th>
<th>1991-2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan (1950)</td>
<td>20</td>
<td>494</td>
</tr>
<tr>
<td>Korea (1962)</td>
<td>0</td>
<td>12</td>
</tr>
<tr>
<td>Taiwan (1966)</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

Japanese data are based on information provided by the Supreme Court Secretariat. The data exclude suits filed 1991-1992, and suits filed outside of the Tokyo and Osaka District Courts for the years 1993-1995, for which data are not available. Korean and Taiwanese data are based upon estimates of domestic corporate law scholars. Taiwanese data exclude suits involving unlisted companies.

As Table 1 indicates, the shareholder derivative suit mechanism has never been invoked against the directors of a public company in Taiwan. The same situation prevailed in Korea until 1997. Since then, a handful of suits have been filed, but the number remains low, particularly considering the major corporate governance problems of Korean firms exposed by the Asian financial crisis. Japan averaged about one suit every two years for the first forty years in which its derivative suit mechanism was in place, until a procedural change in 1993 lowered enforcement costs. As Table 1 shows, since that time, there has been a modest explosion of shareholder litigation. This suggests that enforcement costs and related obstacles, rather than cultural values, dampen
corporate law enforcement in the region, themes developed in the next two sections of the paper.

The incidence of derivative litigation is by no means a perfect measure of corporate law enforcement and the quality of investor protection in a given system. Indeed, for reasons that have been explored elsewhere, many derivative suits may have little to do with investor protection, and much to do with attorney incentives. Yet the incidence of derivative litigation in a given system is at least one objective measure of the extent to which shareholders’ rights are exercised, and this measure seems to correlate with a broader range of available evidence on law enforcement in the various countries. This comparison, though crude, lends support to the common perception that the United States and East Asia have adopted quite different approaches to the public goods problem inherent in corporate law enforcement.

B. Corporate Law Enforcement in East Asia: Demand and Supply

Though difficult to measure precisely, demand for investor protection has increased substantially in Korea, Taiwan and Japan over the past half decade. The single most important reason for this shift in demand is the Asian financial crisis, because poor corporate governance practices are widely seen as a major contributing factor. In countries such as Korea, investor protection received virtually no attention prior to the outbreak of the crisis, but it became a leading public policy concern thereafter. While Taiwan escaped the Asian financial crisis relatively unscathed (largely due to macro-

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64 See, e.g., Mark D. West, Why Shareholders Sue: The Evidence from Japan, 30 J. Legal Stud. 379-80 (2001) (increasing rates of derivative litigation post-1993 correlate with increased prosecution of white collar crime).
65 Simon Johnson et al., Corporate Governance in the Asian Financial Crisis, 58 J. Fin. Econ. 141 (2000).
economic differences between it and the crisis countries), it encountered a spate of serious corporate scandals at the end of the 1990s, which had the equivalent effect of exposing serious problems in corporate shareholding structures and managerial oversight mechanisms. In Japan, a decade of economic malaise and a long series of problems in the corporate and financial sectors have made corporate governance reform a leading topic.

Expectations toward corporate governance and investor protection have also changed as the constellation of shareholders in these countries shifts. Both foreign institutional investment and foreign direct investment in the region have increased substantially over the past five years, bringing with them distinct perspectives on the proper goals and behavior of corporate management.

Governments in all three countries have responded to this increase in demand with a host of corporate and securities law revisions, many of which were designed to improve the position of minority shareholders. Yet despite considerable reform of corporate law, corporate law enforcement in East Asia remains highly problematic, suggesting that gaps remain between demand for and supply of investor protection.

Before surveying the principal impediments to more active corporate law enforcement, it is useful to note that the three countries share a common legal tradition. Japan transplanted basic features of the continental civil law tradition, most notably the German system, into its legal system at the end of the nineteenth century. As a result, Japan’s Company Law, part of the Commercial Code, bears many structural similarities to the German Commercial Code. Moreover, the basic features of its judicial and civil litigation systems are familiar to anyone trained in the civil law tradition. Through
colonization in the early twentieth century, Japanese influence on the legal systems of Korea and Taiwan was substantial. Thus, with (increasingly prevalent) country-specific variations, one encounters across the three systems basic similarities in the structure of the judiciary and legal profession, the procedural environment for civil litigation, and the substantive provisions and overall “approach” of the Company Law.

1. **High statutory thresholds and economic risk:**

High shareholding thresholds for the exercise of important shareholder rights and the significant economic risks of filing suit have historically been major obstacles to shareholder activism in East Asia. In both Korea and Taiwan, until recently minority shareholders had to collectively own 5 percent of the outstanding shares to file a derivative suit. Given the average market capitalization of listed companies in Korea as of 1997, for example, this requirement meant that minority shareholders had to hold, in the aggregate, over 3 billion won ($3.5 million) in shares to file a derivative action.66

Post-Asian financial crisis corporate law reforms in Korea reduced that threshold to 0.01 percent for listed firms. Recent Taiwanese reforms lowered the threshold to 3 percent of the outstanding shares held continuously for one year, but this still poses a formidable barrier to obtaining standing. By contrast, standing is not a problem in Japan, where only a single share, held continuously for six months, is required to file a derivative suit.

Beyond meeting standing thresholds to bring suit, plaintiffs need access to corporate information in order to build a case against management. In all three systems, the corporate law poses a high bar to plaintiffs. In Japan, 3 percent of the voting rights are needed to inspect corporate books and records, and to appoint an inspector to examine

corporate affairs and records. The same thresholds were in effect in Korea until 1997, although they have been reduced through recent reforms. While 3 percent of the outstanding shares are still required to appoint an inspector (1.5 percent for specified large companies), holders of 0.1 percent of the outstanding shares are now entitled to inspect books and records of public companies (0.05 percent for specified large companies). In Taiwan, 3 percent shareholders may appoint an inspector.

The cost and attendant financial risks of filing suit can also pose obstacles to derivative litigation in all three systems. In Japan, until a 1993 amendment fixed the fee at a nominal amount, most courts interpreted a procedural statute to require that plaintiffs in derivative suits pay a filing fee on a sliding scale based on the amount of damages sought. Under this scale, a $10 million claim against management, for example, would require a filing fee of $25,000—a fee that is forfeited if the plaintiffs lose. As seen from Table 1, revision of the filing fee touched off a small explosion of derivative litigation in Japan. Even today, however, upon the defendant’s motion, plaintiffs in derivative suits may be required to post a bond for expenses, a requirement that was eliminated from most U.S. state corporate laws because it chills both frivolous and meritorious suits. In cases in which the Japanese courts have granted the motion, the bond has averaged about $1.5 million, virtually the equivalent of a dismissal of the suit.

In Taiwan, the financial risks of derivative litigation are even more severe. Plaintiffs must advance 1 percent of the claim as a filing fee at the district court level, and

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69 Description of the Taiwanese system is drawn from Lawrence S. Liu, Corporate Governance in Taiwan, unpublished manuscript.
1.5 percent at both the appellate court and the court of last resort.\textsuperscript{70} As in Japan, the loser pays court costs plus his own attorneys fees. Thus, even if enough minority shareholders could be assembled to meet the 3 percent threshold for filing suit, they face the risk of huge out-of-pocket loss—up to 3.5 percent of the damages sought plus their attorneys fees—if they ultimately lose the case.

Filing fees and court costs are not major obstacles to derivative litigation in Korea. Korean procedural law has always set the filing fee in derivative suits at a nominal amount, consistent with current Japanese law. And while Korean courts, as in Japan and Taiwan, are empowered to order that the plaintiff post a bond for expenses, they have not done so in the small number of derivative suits filed to date. In Korea, the losing party pays court costs including attorneys’ fees, but only up to a nominal amount determined by formula.\textsuperscript{71}

2. \textit{Weak infrastructure for private law enforcement:} Civil enforcement of corporate and securities cases in all three countries is hampered by several features common to all legal systems in the civil law tradition: the lack of a formal discovery system to aid the production of evidence, the absence of class action procedures to overcome collective action problems in litigation, and limited remedies for breach of fiduciary duty, diminishing the incentives to file suit. These features of the procedural landscape for civil litigation are exacerbated by the structure of the legal profession in the three systems. The population of judges is low by comparative standards (see Table 2), leading to significant delay in clearing cases, at least in Taiwan. Equally significantly,

\textsuperscript{70} These fees were recently increased to 1.1\%, 1.65\%, and 1.65\%, respectively.
\textsuperscript{71} Supreme Court Rule No. 758. However, both the Commercial Code and the Securities Transaction Act allow successful derivative suit plaintiffs to recover actual attorneys’ fees from the corporation. This rule obviously has no bearing on the plaintiff’s calculation of downside risk in the event he loses the case.
the judiciary is organized as a career bureaucracy, with the only major port of entry at the bottom. This results in a dearth of judges with professional experience in corporate law or white-collar crime. Judges unfamiliar with business practices, particularly those operating in the more code-bound civil law tradition, are more likely to avoid breaking new doctrinal ground in identifying unlawful conduct and fashioning flexible remedies to address contemporary corporate governance issues.

The infrastructure for private law enforcement is further constrained by low lawyer populations in general (see Table 2), small numbers of attorneys who specialize in corporate and securities law in particular, and a lack of high-powered incentive compensation mechanisms for attorneys to seek out worthy plaintiffs in corporate and securities cases.72

<table>
<thead>
<tr>
<th></th>
<th>U.S.</th>
<th>England</th>
<th>Germany</th>
<th>France</th>
<th>Japan</th>
<th>Korea</th>
<th>Taiwan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lawyers</td>
<td>906,611</td>
<td>80,868</td>
<td>85,105</td>
<td>29,395</td>
<td>16,368</td>
<td>4,300</td>
<td>3,900</td>
</tr>
<tr>
<td>Per 100,000 Population</td>
<td>339.87</td>
<td>154.89</td>
<td>103.77</td>
<td>50.15</td>
<td>13.0</td>
<td>9.45</td>
<td>18.13</td>
</tr>
<tr>
<td>Judges</td>
<td>30,888</td>
<td>3,170</td>
<td>20,999</td>
<td>4,900</td>
<td>2,093</td>
<td>1,400</td>
<td>1,607</td>
</tr>
<tr>
<td>Per 100,000 Population</td>
<td>11.6</td>
<td>6.07</td>
<td>25.6</td>
<td>8.4</td>
<td>1.7</td>
<td>3.07</td>
<td>7.47</td>
</tr>
</tbody>
</table>

Note: Data for Korea and Taiwan as of 2000. Other country data as of 1997.

3. **Network shareholding structures and passive institutional investors**: The shareholding climate in East Asia is relatively nonconductive to shareholder activism. In Korea and Taiwan, founding families still exercise disproportionate control over group

72 Cf. John C. Coffee, Jr., Understanding the Plaintiff’s Attorney: the Implications of Economic Theory for Private Enforcement of Law through Class and Derivative Actions, 86 Columbia L. Rev. 669, 669-70 (1986) (“the key legal rules that make the private attorney general a reality in America today…are not substantive but procedural—namely, those rules that establish the fee arrangements under which these plaintiff’s attorneys are compensated.”).
firms, which play a major role in both economies. In Japan, although the distinct identities of *keiretsu* corporate networks have been diluted and cross shareholding is declining steadily, as recent episodes of shareholder activism have demonstrated, management threatened by an unwelcome advance can still mobilize friendly shareholder networks to fend off a challenger.\(^{73}\)

Although the situation is beginning to show signs of change, domestic institutional investors thus far have not played a significant role in corporate governance in any of the three countries. This is a simple reflection of the identities and goals of the investors. As commentators have noted, for example, in Korea, “most domestic institutional investors are affiliates of the *chaebol* or rely upon them for business, and thus remain captive and passive monitors.”\(^{74}\) Similarly in Japan, most domestic institutional investors place priority on maintaining reciprocal business relationships over increasing shareholder value. They vote, but rarely coordinate with other institutional investors on corporate governance issues, make shareholder proposals, release focus lists, or engage in other efforts to improve performance at portfolio firms.\(^{75}\) In Taiwan, there is less room for institutional investor activism because the stock market is dominated by

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73 For example, institutional investors with stable shareholding and business ties to a firm called Tokyo Style gave unconditional support to management in a high profile proxy fight initiated by the firm’s largest shareholder. The support of these institutional shareholders allowed management to defeat the unwelcome advance. See Institutions Threaten Corporate Governance, Nikkei Weekly, July 22, 2002, available in Westlaw, Allnews directory.


75 Koichi Akaishi, Kikan toshika no coporeeto gabansu katsudo no igi—waga kuni no kikan toshika wa kokateki na gabansu katsudo ga dekiru ka [The Significance of Corporate Governance Activities by Institutional Investors: Can Institutional Investors in Our Country Play an Effective Role?], unpublished report (2002).
individual investors. Even where institutional investors do take stakes in portfolio firms, as in the other two countries, they play a passive role in corporate governance.

Given these shareholding patterns and the passivity of institutional investors, shareholder discipline in the form of the market for corporate control is virtually nonexistent in the three systems. By comparison, in the United States, takeovers are one of the main contexts in which shareholders exercise rights, and one of the main vehicles for the creation of law on directors’ fiduciary duties.

4. **Constraints on state enforcement**: Given this litany of obstacles to private enforcement of corporate law, criminal prosecution has had to play the leading role in all three systems. Indeed, piggybacking on public enforcement has often been the only realistic means of obtaining the information necessary to pursue private litigation.

Yet heavy reliance on state enforcement of corporate and securities law via the criminal justice system and regulatory authorities can be problematic. At the most basic level, corruption and political favoritism remain obstacles to vigorous criminal and regulatory enforcement in Korea and Taiwan. Moreover, the deterrent effect of criminal prosecution is diluted by the fact that trials in Taiwan are drawn out, and in

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77 Lawrence S. Liu, Corporate Governance in Taiwan, unpublished manuscript at 12 (in Taiwan, court fees are also waived in piggyback cases); Kon Sik Kim and Joongi Kim, Revamping Fiduciary Duties in Korea: Does Law Matter in Corporate Governance?, in Global Markets, Domestic Institutions: Corporate Law and Governance in a New Era of Cross-Border Deals (Curtis J. Milhaupt ed., forthcoming 2003) (first derivative suit in Korean history only possible because shareholder plaintiffs had access to information produced in criminal investigation); Mark D. West, Why Shareholders Sue: The Evidence from Japan, 30 J. Legal Stud. 351, 377-380 (2001) (Japan).

78 See, e.g., Jong-Sup Chong, Political Power and Constitutionalism, in Recent Transformations in Korean Law and Society 11, 25 (Dae-Kyu Yoon, ed. 2000) (“Law enforcement organs are still subservient to political power. Political decisions give great influence to judicial interpretations.”). A senior Taiwanese securities regulator publicly acknowledges that “compliance with law is often influenced by political relationships. Enterprises having good relationships with political parties have more leverage to avoid compliance with regulations.” Chi-Hsien Lee, Corporate Governance in Taiwan: Recent Developments in Government Policy—A View from Government, unpublished manuscript (Nov. 2001) at 18.
Korea, convicted white-collar criminals are frequently granted amnesties by political leaders. While prosecutorial and judicial corruption is rare in Japan, more subtle factors diminish the effectiveness of state enforcement. For example, it is common for convicted white-collar criminals to receive suspended sentences. Recently, courts have justified these light sentences on the theory that corporate fraud of the type conducted by the defendant managers was widespread in the Japanese business community at the time the offense occurred. While justifiable on some levels from an equity perspective, these lenient sentencing practices, like the amnesties in Korea, significantly dilute the deterrent effect of prosecution.

C. Explaining Cross-Country Diversity in NPO Shareholder Activism

The three shareholder activist organizations described above share two important traits: First, though bound—either legally in the case of PSPD and the SFI, or voluntarily in the case of Shareholder Ombudsman—by the nondistribution constraint, all three organizations have overcome financial incentive problems to play a noteworthy role in the corporate governance environment of their home countries. Even in the absence of significant financial incentives, busy, talented professionals in all three systems have organized themselves into firms designed to produce public goods.

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80 See, e.g., Jong-Sup Chong, Political Power and Constitutionalism, in Recent Transformations in Korean Law and Society 11, 25 (Dae-Kyu Yoon, ed. 2000).
81 For example, five former officials of Snow Brand Foods pleaded guilty in connection with a major food mislabeling scheme, public disclosure of which destroyed their firm. They received suspended two-year prison terms because the court found that while the defendants engaged in a “vicious crime that defrauded [a government subsidy program] and abused peoples’ trust,” it had been a long-standing practice in the industry to falsify product information. Corporate Social Responsibility News and Resources, available at www.mallenbaker.net/csr/nl/page.php?Story_ID=698.
82 As one commentator notes of the Japanese group, “since ‘Shareholder Ombudsman’ effectively has no client for its activities, without strong personal incentives to participate on the part of attorneys, the organization could not have been formed.” Hiroshi Otsuka, Iraishanaki Hodoin: “Kabunushi Onbuzuman” to kabunushi daihyo sosho [Client-less Law-Movers], 47 Kobe hogaku zasshi 705, 709-10 (1997).
Discerning the motives of individuals operating within the nondistribution constraint is obviously difficult. An NPO is an interest group by another name, and critics of these groups see dark motives at work, such as political ambition, hidden financial rewards, careerist maneuvering, and even betrayal of national interests. Some of the motives cannot be discounted; for example, the Korean leader of PSPD’s shareholder rights group has become widely known through his activities, and lawyers may be lured to these organizations principally by the experience, media attention, and networking opportunities provided by these cases. It is even plausible that lawyers working for these organizations are engaged in a kind of “loss leader” activity, creating a domestic climate conducive derivative litigation so that they can capture the market for this business in the future. It is virtually impossible to discern whether and to what extent “selfish” motives may be at work among the individuals involved in these NPOs. But other motives seem plainly to be at work as well, including altruism (in the form of a strong desire to reform negative aspects of one’s society) and anger (directed at widespread, unpunished wrongdoing by powerful individuals and organizations). It seems unlikely that these groups could have attained the respect they enjoy among professionals at home and abroad if selfish motives predominated. And regardless of underlying motives, the net effect of these organizations’ activities on the corporate governance environments of their home jurisdictions appears positive, though

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83 For example, PSPD and the leader of its shareholder rights’ movement have been castigated in some segments of the Korean media as out to overturn the country’s capitalist system. See Boog-Kyu Lee, Don Quixote or Robin Hood?: Minority Shareholder Rights and Corporate Governance in Korea, 15 Colum. J. Asian L. 345, 347 (2002). Shareholder Ombudsman’s case selection has been criticized, and critics occasionally make comparisons between the group and the Japanese racketeers known to seek payoffs in return for not disrupting shareholders meetings.

84 This possibility was suggested to me by Eric Talley.
admittedly the precise effect is impossible to measure. Some people do appear willing to produce public goods, at least in tandem with the pursuit of selfish motives.

Second, all three organizations use the legal system of their home country—specifically, the domestic corporate and securities laws—as the primary tool for the advancement of their objectives. This is significant because it sets these groups apart from other corporate governance-oriented nonprofits, which either tend to focus on broad social issues such as the environment or largely confine their activities to information gathering and analysis. It is also significant because all three systems, to a greater or lesser degree, have been characterized in the contemporary corporate governance literature as having comparatively weak investor protections and enforcement regimes tied to their shared civil law origin. Indeed, as this Part of the paper has showed, there is evidence to support such a characterization. Yet despite, or perhaps more accurately, in the face of these weaknesses, motivated individuals have organized firms between the interstices of public and private action to enforce these laws, warts and all.

These common traits, however, mask substantial differences in the formal structure, strategy, and limitations of the three NPOs in their home countries. Consistent with theory, the origin of this diversity can be traced directly to the distinctive legal, social, and historical environments in which they emerged.

For example, it is instructive to compare PSPD with Shareholder Ombudsman, since the two groups have generally similar objectives. PSPD has 15,000 members with

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85 Several readers suggested that I compare cases brought by the NPOs to those brought by for-profit law firms to discern the motives of the NPOs. Arguably, one could conclude that the cases brought by the NPOs in Korea and Japan are comparatively “high profile” cases. Even if accurate, however, this conclusion does not lead to unambiguous conclusions about underlying motives. It could be that NPO members are publicity seekers. It could also be that the high profile nature of the cases made them particularly suitable for their deterrent and precedent-setting effects.

an annual budget of almost $1.5 million (funded almost entirely out of membership dues), and a professional staff of 50. The PEC (the operational arm of PSPD engaged in shareholder activism) has three full time paid staff and about twenty volunteers. PSPD pursues a national agenda of *chaebol* reform. Toward that end, it created a list of target companies on which to focus its efforts, hoping to make an example of Korea’s best known firms. As part of this national agenda, PSPD actively pursues legislative reform, including the enactment of a class action mechanism for securities cases, through lobbying efforts. Moreover, PSPD has consciously attempted to co-opt foreign institutional investors into its program, using proxy fights and international road shows to advance and publicize its cause. And as noted above, PSPD is associated with two historic court victories, one of which came at the expense of the chairman and managers of one of Korea’s most famous firms.

Two related characteristics of PSPD help account for its visibility, aggressiveness and success. First, in many respects PSPD it is the nonprofit equivalent of the *chaebol* it is fighting—large, highly diversified, closely associated with its founding members, and highly attuned to national politics. Its leadership consciously avoids localized issues so as to minimize internal conflicts and to pursue its cause at the center of power—the national government and the largest business organizations. Second, PSPD, like other major civic groups in Korea, traces its lineage directly to protest movements against past military governments. Some of the leaders of these groups, now lawyers or other

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87 The Secretary General of the PSPD has noted the criticism of his organization as a “department store” seeking to monopolize a wide range of issues. Won Soon Park, NGO Development in Korea, 15 [Korean journal title] 75 & n.26 (2000). PSPD focuses its activities on the national government due to the highly centralized nature of government in Korea. Park, The Role of NGOs in Transition—Centering on the People’s Solidarity for Participatory Democracy (PSPD), unpublished manuscript 2001.

88 Author interview with PSPD founding member Won Soon Park, Seoul (September 2002).
professionals in their 30s and 40s, were once student activists jailed for their fight against military rule. \(^{89}\) Thus, PSPD and the larger civil movement of which it is a leading member were born directly out of social cleavages resulting from rapid economic growth under authoritarian regimes. \(^{90}\) As one commentator notes, “[l]ong lasting authoritarian rule produced many dissidents who are advocates of public issues. As authoritarian rule receded, many activists pursued specific public interests in civic organizations….The inauguration of the first civilian government in the early 1990s provided a fertile milieu for active civil movements.” \(^{91}\) Today, the Korean government actively supports NPOs. Indeed, PSPD is eligible for government funding, but declines to accept it so as not to cloud its independence. \(^{92}\)

Japan’s Shareholder Ombudsman, by contrast, was formed in a very different climate for social entrepreneurship. Unlike Korea, Japan has limited national experience with large, independent activist groups, partly the result of “one of the most severe regulatory environments [for NPOs] in the developed world.” \(^{93}\) This regulatory environment has provided incentives for the development of organizations that are small and local in nature, while hobbling the development of large, professional civic groups. Historically, this dichotomy reflects a conscious policy decision to limit the scope of

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91 Dae-Kyu Yoon, Legal Aid and Public Interest Lawyering, in Recent Transformations in Korean Law and Society 377, 383 (Dae-Kyu Yoon, ed. 2000).
92 Correspondence to author.
NPO activities so that citizen efforts are not diverted from the pursuit of governmentally chosen goals.94

A close evaluation of Shareholder Ombudsman reveals this pattern. As noted above, at the time it was formed, Shareholder Ombudsman could not meet the financial requirement for establishment as a nonprofit membership organization [shadan hojin] under the Civil Code. As a result, it was organized as a limited liability company [yugen gaisha]. Yet this organizational form has clear disadvantages for a civic organization. Legally, it may have no more than 50 members, so most of its membership is informal. It does not enjoy tax-favored status and is not eligible for government funds. Formally, its members are not bound by the nondistribution constraint, which may diminish the trust it enjoys among potential members and the public as a whole. Moreover, Shareholder Ombudsman’s strategy is more “localized,” at least in comparison to PSPD’s national agenda. As one affiliated academic explained, the goal of Shareholder Ombudsman is not to “make law,” or to directly change society, but to improve management one firm at a time.95 This may explain why Shareholder Ombudsman has chosen to settle most of its cases. Under a one-company-at-a-time strategy, obtaining commitments from target management to rectify their practices may be more important, and certainly less resource intensive, than obtaining a judgment in court. All of these factors may account for the relatively low profile of Shareholder Ombudsman in Japan’s corporate governance environment, notwithstanding the organization’s considerable activities.

In Taiwan, as in Korea, the activist social environment and nascent democracy have been conducive to the mobilization of civil society. Yet Taiwan’s SFI reflects yet

95 Correspondence to author.
another approach to NPOs and the supply of public goods. It is a creative partnership between the public and private sectors, reflecting a conscious government strategy:

Since martial law ended in 1985, the government especially welcomed the establishment of foundations, viewing them as social resources ready to aid in government functions of delivering services and distributing resources to society….

The current legal framework reflects a cooperative approach on the part of government, by which it intends to become involved in the goals, operations, and supervision of NPOs.96

The collaborative effort between the state and an NPO to provide investor protection provides a novel twist on the “contract failure” theory. Recall this theory posits that NPOs exist to provide goods or services whose quality or quantity is difficult for consumers to evaluate. The theory predicts that where such information asymmetries are great, consumers turn to NPOs as trustworthy producers of public goods. But as the SFI illustrates, the government may also turn to NPOs to overcome asymmetric information and trust problems.97 The NPO form provides a layer of insulation between the government and politically or technically problematic enforcement efforts.98 At the most basic level, the measurement problems inherent in the supply of investor protection services renders the SFI (bound by the nondistribution constraint) superior to a contract with a local law firm to locate and organize worthy plaintiffs in securities and corporate fraud cases. More importantly, perhaps, trust in the NPO form among market participants provides the government leeway to expand its enforcement efforts into the

96 Joyce Yen Feng, Taiwan, in Philanthropy and Law in Asia 315, 326-7 (Thomas Silk, ed., 1999).
98 See Michael Krashinsky, Stakeholder Theories of the Non-Profit Sector: One Cut at the Economic Literature, 8 Voluntas 149, 155 (1997).
“civil” realm by co-opting the SFI into its investor protection agenda, and obtaining private sector funding for those enforcement efforts.

The limitations of the SFI in fulfilling its mission seem largely unrelated to the domestic NPO environment. Rather, the costs and risks inherent in Taiwanese litigation discussed above have limited its potential as a deterrent device. One example is the Hua Loon case, which involved a straightforward question: is an insider who bought common stock and sold convertible preferred shares within the statutorily prescribed period captured by the short-swing trading disgorgement rules? The SFI hesitated to pursue this “certain victory” in court because filing suit required payment of a NT$ 10 million ($300,000) fee. If SFI had lost the case despite its optimistic assessment of the merits, its endowment would have been devastated. Ultimately, SFI filed suit and won, but the episode shows the impact of procedural rules on enforcement decisions.99

To address these issues, a Securities and Futures Investor Protection Law was passed in 2001. The most interesting feature of the law is that it is designed principally to enhance the enforcement capabilities of the SFI. In that sense, it serves as a powerful political endorsement of the SFI’s role in corporate governance. It authorizes the establishment of an Investors Protection Foundation (IPF) to take over the investor protection service of SFI in a stand-alone foundation. The foundation’s endowment will be funded by mandatory contributions from securities and futures companies, as well as the stock and futures exchanges. The IPF is prohibited from seeking compensation for its litigation activities on behalf of investors,100 reinforcing the nondistribution constraint. The law also provides several advantages to the IPF in litigation. Courts are instructed to

99 Interview with Chi-Hsien Lee, Commissioner, Taiwan Securities and Futures Commission, October 16, 2002.
100 Securities and Futures Investor Protection Law (2001), Art. 33.
waive the security for expenses bond posting requirement in motions for provisional relief.\textsuperscript{101} In the calculation of court fees, the amount of investor claims serving as the basis of calculation will be deemed not to exceed NT$ 100 million ($3.3 million).\textsuperscript{102} This reduces the required filing fee and limits the court fees payable upon a final, adverse judgment. Securities regulatory officials anticipate that with these more favorable procedural rules, IPF will have a general deterrent effect on corporate managers similar to the effect of class action litigation in the United States.\textsuperscript{103}

\textit{D. Summary and Evaluation}

The government failure/market failure theory helps explain why NPOs have spontaneously emerged in all three countries to address gaps in the supply of investor protection and corporate law enforcement. NPOs as providers of investor protection appear to have emerged (in the case of the Korean PSPD and Japan’s Shareholder Ombudsman) and become very active (in the case of Taiwan’s SFI) at this particular time for a simple reason: The demand for investor protection has increased significantly in Korea, Taiwan and Japan in the past half decade, due to the Asian financial crisis, domestic scandals, stock market declines, and more heterogeneous expectations of investors. These factors have coincided with the gradual demise of the postwar institutional structure for corporate governance (featuring heavy bank and government involvement in corporate finance), leading to increased awareness of investor protection and corporate law enforcement as significant policy issues. Despite significant corporate law reform in each of these countries, neither government nor market mechanisms have

\textsuperscript{101} Id., Art. 36.  
\textsuperscript{102} Id., Art. 35.  
\textsuperscript{103} Interview with Chi-Hsien Lee, Commissioner, Taiwan Securities and Futures Commission, October 16, 2002. A prominent corporate practitioner and scholar in Taiwan is more skeptical that the foundation can fully supplant a more plaintiff-friendly procedural environment. Correspondence to author.
fully responded to the increase in demand for “good” corporate governance, particularly in the form of robust enforcement. While corporate and securities law reforms have plainly improved the position of minority investors in these countries, the surrounding legal infrastructure remains relatively plaintiff unfriendly in these cases. Moreover, there is considerable public antipathy in the region toward allowing lawyers to play a larger role (at least for profit) in the resolution of economic problems. The emergence of corporate law-related NPOs in Korea, Taiwan and Japan at this time also coincides with a surge in public interest in the NPO form as a tool of social and economic governance in all three countries, the end of authoritarian rule in Taiwan and Korea, and the deregulatory movement in Japan. In such an environment, the NPO is a brilliant, if partial, response to the public goods problem of corporate law enforcement.

The NPO shareholder activism experience in the region is consistent with several additional, complementary strands of NPO theory and scholarship. For example, as noted above, the contract failure theory—applied to governmental rather than consumer demand—may help explain the unique role of a government-supported NPO in Taiwan’s investor protection environment. More generally, differences in the political and legal climate for social entrepreneurship appear to account for many of the basic differences in organizational form, strategy and success of the three organizations in their respective countries. This is consistent with literature on both nonprofit and for-profit firms indicating that legal and underlying political differences account for much of the cross-national diversity in the size and structure of these organizations.

Thus far, no mention has been made of culture. Is there a cultural reason why this form of shareholder activism has emerged most prominently in three East Asia countries?
These societies are commonly perceived to be homogeneous, and to share important religious (Buddhist) and philosophical (Confucian) traditions—traditions, it is said, which downplay the assertion of legal rights and individual empowerment.104 If the recent mobilization of the NPO form to enhance investor protection is an artifact of “Asian” culture, then the experience may not be replicable elsewhere. While I do not claim that the economic theories discussed above account completely for the NPO phenomenon in East Asia, several factors suggest that the explanatory power of culture here is rather weak. First, recall existing research indicates that ethno-linguistically homogeneous societies are less conducive to nonprofit activity than heterogeneous ones.105 While Taiwan (contrary to common perception) is fairly heterogeneous on this level, Japan and Korea are very homogeneous.106 Thus, Korea and Japan may have had to overcome ethnic and social obstacles to activate their NPO sectors. Similarly, to the extent that one acknowledges the existence of Confucian-laced “Asian values,” as noted above they would appear to undermine the development of the NPO as a device to promote the assertion of legal rights, unless somehow the collective nature of the NPO moderates the cultural distaste for individual legal action. More importantly from my perspective, surface commonalities in religious and philosophical traditions among the three societies grow much more attenuated upon closer inspection, making it difficult to

106 On a commonly used scale of ethno-linguistic fractionalization, Japan scores 1, Korea 0, and Taiwan 42, with higher scores for greater heterogeneity. For comparison, the United States scores 50, India scores 89.
identify a common variable that could account for this form of NPO activism. Even assuming, somewhat counterfactually, that Buddhism is a strongly shared contemporary religious tradition in these countries, there is no evidence that a particular religious affiliation—as opposed to religious competition— is conducive to NPO activity. Given these facts, a cultural explanation for the emergence of NPOs as corporate law enforcement agents in East Asia seems far less convincing than the economic theories explored above.

IV. Implications

A. For Comparative Corporate Governance Literature

Two questions dominate the comparative corporate governance literature today: Precisely how does law matter to corporate governance? And are corporate governance systems converging, specifically toward a shareholder-oriented Anglo-American model? While views are divided along several lines with respect to both debates, important areas of consensus have emerged from existing scholarship. For example, it is widely accepted that the quality of law enforcement is at least as important to “good” corporate governance as high quality protections for minority shareholders located in the statutory law. A second point of agreement is that in order to discern whether convergence is occurring, the concept of convergence must be disaggregated into formal and functional components. Convergence at the statutory (formal) level may not eliminate differences

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107 For example, there are major variations in religious affiliation across the three countries: Korea: 49% Christian, 47% Buddhist, 3% Confucian. Japan: Shinto and Buddhist mixed: 84%, Christian 0.7%. Taiwan: Mixture of Buddhist, Confucian and Taoism 93%, Christian 4.5%. CIA World Fact Book (2002).


110 For a recent entry in the debate discussing many of the approaches to this question, see Stephen J. Choi, Law, Finance, and Path Dependence: Developing Strong Securities Markets, 80 Tex. L. Rev. 1657 (2002).
in practice, for example if differences in enforcement infrastructure remain; and functional equivalents among systems may lead to convergent effects even where significant differences remain at the formal level. Both of these points find novel and previously unexplored illustrations in the East Asia’s experience with NPOs as corporate law enforcement agents.

Recognition of the importance of strong enforcement to good corporate governance has prompted commentators to explore both the supporting infrastructure for effective enforcement of corporate and securities laws and to analyze functional substitutes for good local law and enforcement regimes. Bernard Black’s assessment of the legal and institutional preconditions of strong securities markets is sobering, because as he rightly concludes the “institutions …at the heart of a good national investor protection system …are neither transplantable nor easily created.”111 Certainly it would be folly to assume that NPOs can take the place of honest and experienced courts or sound procedural mechanisms for the promotion of individual investor claims. But the East Asian experience should at least put scholars and policymakers on notice that enforcement can take novel forms. While commentators have explored a number of private and public enforcement alternatives, including writing a corporate law that consciously minimizes the need for investors to resort to legal authority,112 virtually no attention has been devoted to alternatives that lie between private and public enforcement.

On this point, the NPO as a supplier of investor protection is a highly distinctive illustration of functional convergence: several societies have found substitutes for the

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attorney-oriented incentive mechanisms and mass litigation procedural devices relied upon in the United States to provide law enforcement-related public goods in the corporate governance arena. Indeed, general antipathy toward such mechanisms in East Asia makes the transplantation of these procedural devices quite problematic, and likely motivated the search for a functional substitute. Neither the NPO nor the “private attorney general” ensures an optimal supply of investor protection, but these two enforcement mechanisms are distinct paths toward the same goal.

NPOs may be less effective compared to other functional substitutes for domestic enforcement, such as firms bonding themselves to “good” corporate law by listing on a foreign stock exchange that imposes high disclosure requirements and subjects listed firms to a stringent foreign (U.S.) regulatory and private enforcement regime. But these NPOs are inherently domestic organizations, and that attribute holds out the promise of improvement of local law enforcement institutions. By contrast, the bonding alternative may actually induce a further hollowing out of local regimes through the creation of a lemons market, and these negative effects will ultimately reach even the firms that have “escaped” their weak home-country institutions through foreign listings. As Bernard Black has pointed out, such escape is only partial: “A company’s reputation is strongly affected by the reputations of other firms in the same country. And reputation unsupported by local enforcement and other institutions isn’t nearly as valuable as the same reputation buttressed by those institutions.” Thus, while it would be inaccurate to invest NPOs with “functional equivalence” in comparison to more market-driven

substitutes for high quality domestic enforcement regimes, NPOs hold out the unique promise of actually improving, rather than abandoning, those local regimes.

Yet the experience of East Asia with NPOs as corporate law enforcers is not an unalloyed convergence story. Even in their common use of the nondistribution constraint to advance the objective of investor protection, Japan, Korea and Taiwan display striking diversity in the organizational form, strategy and success of their NPOs. This diversity can be traced to the distinctive legal, political, and social environments in which NPOs have emerged and exist in Japan, Korea and Taiwan, illustrating again that “convergence” and “diversity” are extraordinarily complex concepts in corporate governance.

B. For Corporate Law Enforcement in Transition Economies

There are no obvious solutions to the under-production of corporate law enforcement in many countries around the world, other than major, long-term investments in legal infrastructure and human capital. But NPOs appear to merit at least as much consideration as partial answers to the enforcement problem as promoting bonding through cross-listings, writing “self-enforcing” corporate laws, or transplanting the private attorney general model. In this section, I briefly outline the major advantages and problems of NPOs as suppliers of investor protection.

One benefit of NPOs as shareholder activists is that the nondistribution constraint confers a built-in safeguard against frivolous litigation. Because the enforcement agent is an organization with limited funding and a legal or reputational constraint on the distribution of profits to its controlling members, it must be very selective about the cases it pursues. The nondistribution constraint removes upside incentives to gamble on long-
shot cases, and limited endowments or other sources of funding create the risk of organization-ending financial losses in the event of poor case selection. In this sense, nurturing NPOs to supplement law enforcement may be superior to transplanting attorney compensation mechanisms. This may be a way of motivating meritorious derivative litigation while avoiding the problem of meritless derivative litigation driven purely by attorney’s fee incentives.

While risk aversion on the part of NPOs may cause them to pass up some meritorious cases, as compared to attorneys, the litigation decisions of NPOs may be better from a social welfare perspective. Unlike attorneys, the members of NPOs internalize the costs of their litigation decisions (at least in the absence of government subsidies). NPOs are more likely than for-profit firms to bring cases where the principal gain from the litigation is improved corporate governance, in the form of deterrence, commitments from the firm to institute new practices, or the generation of precedent. Indeed, one important reason NPOs may have emerged in East Asia to perform corporate law enforcement functions is that shareholder litigation in the region generally has a negative net present value, for the reasons outlined in the previous section of the paper. Only an NPO, operating on non-financial motives, would take on such cases. By contrast, for-profit firms bring shareholder lawsuits in the United States because financial payouts are a likely (and perhaps often the exclusive) gain from the litigation.

Another benefit of the NPO as supplier of investor protection is that it leaves open the possibility of improvement in both government and market alternatives, and may in fact spur such improvements. The NPO can be viewed as a transitional device that may be competed out of existence when alternative supplies of law enforcement public goods
are developed. Direct shareholder activism and corporate law enforcement by NPOs is not seen in the United States and the UK because it is not needed. Shareholder Ombudsman’s role in the Japanese corporate governance environment seems limited in part because there is less need for the organization there than in the Korean and Taiwanese contexts. There may come a time when the shareholder activist NPOs of Japan, Taiwan and Korea wither away or pursue other objectives, as the investor protection environment improves, or as for-profit enforcers (attorneys) take over a larger share of the market.

Finally, as noted above, NPOs are a distinctly local approach to improving the quality of law enforcement. Unlike “self-enforcing” models of corporate law or cross-listing on foreign exchanges by local firms, NPOs seek to use and improve, rather than escape, domestic enforcement institutions.

This discussion is not meant to suggest that the NPO model of corporate law enforcement that has emerged in East Asia is inherently superior to the “bounty hunter” model relied upon the United States. Rather, the point is that the two models have emerged in response to quite different enforcement environments. Both models have their limitations, and the role of NPOs in East Asian corporate governance should not be overstated. Each of the three organizations has achieved a measure of success in its home jurisdiction. But substantial gaps remain in the enforcement of corporate and securities laws, gaps that probably cannot be filled solely by NPOs. The problems with the nonprofit form are well recognized; “voluntary failure” is as palpable a phenomenon as
government failure and market failure.  

NPOs tend to be chronically short of funding because they must rely on donations and retained earnings, since by definition they do not issue equity.  

Due to funding shortages, NPOs pay only modest, if any, salary to their professional staff. Thus, expertise also tends to be in chronically short supply.

Moreover, the governance of NPOs themselves can be highly problematic. There are several reasons to believe that agency problems are most severe in nonprofit firms, since many of the constraints operating in the for-profit economy are missing from the NPO environment. As one commentator notes,

[I]n the nonprofit world, owners are not well-defined; their voting rights are questionable or non-existent; charitable goals are ambiguous, or at least difficult to quantify; no significant second-order markets operate; and the residual claimants are either unable to monitor effectively or unwilling to do so….There is no market for corporate control; there are no proxy battles, no shareholder derivative suits, and there is very little market competition.

Given these serious limitations, the NPO form should best be viewed as an early stage or supplementary supplier of investor protection particularly in transition economies, rather than a full-scale substitute for development of good public and private enforcement institutions. Thus, in East Asia, for example, creating better market-oriented mechanisms for the private supply of enforcement services, such as through the introduction of class action and civil discovery systems, and enhancements in the number and business background of judges and lawyers, properly remains high on the agenda of all three countries.

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The potential of NPOs in corporate governance seems most promising in China. Until very recently, private investors had virtually no recourse against management for losses resulting from fraudulent corporate activity. While China’s highest court has recently ruled that investors can seek compensation from firms convicted of securities fraud, observers are skeptical of the impact of this development on corporate governance, because of the prohibitive cost and time-consuming nature of litigation in China.\footnote{See Janet Ong, China Legal Landmark, International Herald Tribune, November 13, 2002, at 15 (housewife settles first investor suit, seeking 1300 yuan ($157) in damages, against listed company for 800 yuan (about $70).}

Yet commentators have begun to recognize the potential of NPOs in advancing the rule of law in China. One study argues that while NPOs remain highly constrained by the political, regulatory and social climate of the PRC, they can play a role in law enforcement in China.\footnote{C. David Lee, Legal Reform in China: A Role for Nongovernmental Organizations, 25 Yale J. Int’l L. 363, 418, 423 (2000).} Given that the government itself seems committed, at least within certain parameters, to a healthy corporate governance environment, a Taiwan-style partnership between the state and a corporate-law-enforcement-oriented NPO seems highly feasible, at least where such activities do not have overtly political overtones, such as exposing corruption state-owned enterprises. China already has a state-sponsored NPO in the consumer protection area that could serve as a model for a nonprofit shareholder protection organization.\footnote{See C. David Lee, Legal Reform in China: A Role for Nongovernmental Organizations, 25 Yale J. Int’l L. 363 (2000). The organization is the China Consumer’s Association, which performs quasi-regulatory functions under the supervision of state agencies.} Chinese securities regulators have in fact expressed interest in the Taiwan model.

The NPO form may have potential in other transitional economies as well, and a principal motivation for this paper was to spur examination of that possibility in other
regions of the world. The notion of nonprofits as suppliers of investor protection is not novel in other systems suffering from low quality corporate law and governance. For example, in Russia, a former securities regulator founded the Institute for Corporate Law and Corporate Governance. The Institute has created an index to measure the quality of corporate governance among major Russian firms, to enhance investment and voting decisions among investors. But the activities of this organization are less direct than those of its East Asian counterparts, as it does not seek to become an investor itself in order to exercise shareholder rights. Drawing on the East Asian experience, organizations such as this might possibly make even larger contributions as corporate governance activists by becoming more directly involved as corporate law enforcement agents.

**Conclusion**

High quality enforcement is one key to good corporate governance, yet it remains an elusive goal in many countries. To date, virtually all commentators grappling with this problem have focused their attention on conventional enforcements tools—attorney-incentive mechanisms, cross-listing on foreign stock exchanges, and market oriented gatekeepers. Yet the activities of nonprofit organizations in the three largest market economies of East Asia indicate the potential for other, creative solutions to the under-production of corporate law enforcement that afflicts many economies.

As theory predicts and the evidence from East Asia confirms, nonprofit organizations of various types can play an important, if supplemental, role in corporate law enforcement, particularly where political or ideological constraints put brakes on the development of attorney-centered mechanisms heavily relied upon in the United States.
To be sure, NPOs suffer from their own weaknesses and appear to flourish only in certain social and legal environments. Yet where NPOs can be activated to provide investor protection, they may be a superior solution to the under-production of corporate law enforcement than the private attorney general model so heavily relied upon in the United States, because the nondistribution constraint is a built-in check on over-enforcement.

And because the NPO seeks to use and improve the local enforcement regime, it avoids the lemons problem inherent in solutions that bypass weak domestic institutions. As such, NPOs deserve consideration as transitional or supplemental corporate law enforcement devices in many countries around the world. Fostering an environment conducive to NPO formation, and developing creative partnerships between government agencies and nonprofit organizations for the betterment of corporate governance, seems more feasible than transplanting class action mechanisms and attorney incentive schemes from the United States, and at least as worthy of consideration as trying to write self-enforcing corporate laws for numerous countries.

Careful examination of the nonprofit experience in this region also illustrates the complexities inherent in the question whether national corporate governance systems are converging. On the one hand, the three largest market economies in East Asia, experiencing similar economic and social trends, have spontaneously converged on a distinctive corporate law enforcement mechanism to address similar gaps in their public and private infrastructure for investor protection. As such, this development is a novel illustration of functional convergence with U.S. enforcement mechanisms. Delving deeper into this important point of convergence, however, one discovers great diversity in organizational form, strategy and relationship between the nonprofit organization and the
state—differences intimately linked to the distinctive political and social structures in which these novel forms of investor protection emerged.