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Commonalities and Prescriptions in the Vertical Dimension of Global Corporate Governance

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Commonalities and Prescriptions in the Vertical Dimension of Global Corporate Governance

by

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Discussions of comparative corporate governance have renewed the old question of corporate social responsibility, for whose benefit is the corporation to be operated? [2] It is customary to think that US and UK law require that corporations be operated primarily for the benefit of shareholders. It is equally customary to think that German and other continental European law require that corporations be operated for the common good–shareholders, workers, creditors, communities and so on. At a general and abstract level both these customary ways of thinking are correct.

But the truth of these general statements does not altogether hold up at the level of particular application. The variety of practices within particular countries and across national borders and the range of interests implicated and protected in different ways in both contexts render it difficult to describe national models except at a fairly high level of generality. Generalized descriptions can of course be very useful, but it is also useful when it is possible to conceive of mechanisms that enable more specific comparisons that transcend borders, whether international or intra-national. To do so requires a framework to distinguish types of governance mechanisms corporations use.

Corporate governance mechanisms can be divided into three categories, two internal and one external. Internal governance mechanisms that address the relationship between those in control of the corporation on the one hand and all other constituents on the other (including shareholders, workers, lenders and communities) can be called vertical. Internal governance mechanisms that regulate directly the relationship between these various constituencies *inter se* can be called horizontal. External governance mechanisms are those rules and regulations imposed upon the corporate entity to address concerns beyond the penumbra of interests the corporation impacts directly, and include rules about competition and antitrust, national trade and security and so on.

External and horizontal governance mechanisms tend to pose the most striking and specific

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[2] *Compare* Adolf A. Berle, Jr., Corporate Powers as Powers in Trust, 44 Harv. L. Rev. 1049 (1931) (corporate powers are "at all times exercisable only for the ratable benefit of all the shareholders") *with* E. Merrick Dodd, For Whom Are Corporate Managers Trustees?, 45 Harv. L. Rev. 1145, 1148 (1932) (the corporation is "an economic institution which has a social service as well as a profit making function"). For updates on this famous debate, *see* A.A. Sommer, Jr., Whom Should the Corporation Serve? The Berle-Dodd Debate Revisited Sixty Years Later, 16 Del. J. Corp. L. 33 (1991).

distinguishing features of comparative corporate governance, while vertical governance mechanisms tend to be more universal and general. All these mechanisms are undergoing change and convergence around the world. Yet sufficient differences remain to enable presentation of generalized pictures of comparative corporate governance. This piece starts off with such pictures, describing in Part I a typical way of thinking about comparative corporate governance. It is a statement of the main characteristics of dominant models of corporate governance and finance: the market model (chiefly US and UK), the European bank model (chiefly Germany and France), and (more briefly) the Japanese bank model.

These characteristics are increasingly blurring, however, and many differences have been overdrawn, as the descriptive and theoretical evidence presented in Part II suggests. Governance mechanisms from these models are converging or have been overlapping and market, structural and regulatory forces have contributed to these phenomena. A key insight is that problems of vertical corporate governance–the relation between those in control and others–and the mechanisms to address them transcend much of the underlying differences posed or created by the differing external and horizontal mechanisms of corporate governance.

That insight suggests that there is reason to worry around the world as much or more about vertical corporate governance mechanisms than external or horizontal ones. Accordingly, Part III moves to a prescriptive identification and evaluation of key vertical governance issues of importance across borders. These include some of the central topics of corporate governance generally and ones most likely to pose increasing difficulties as globalization proceeds (executive selection and compensation; acquisition policies; and capital allocation and dividend policy) with an emphasis on the role boards of directors must and can play in addressing them. Among the chief mechanisms available to enhance such board action are rules governing or affecting director liability, constituency voice and unimpaired markets. The thesis, in short, is that signposts on the road to global corporate governance must mark such vertical governance issues and the pavement must be laid with such sensible vertical mechanisms to address the common problems facing corporate constituencies worldwide.

I. Comparative Corporate Governance

The phrase comparative corporate governance has been used to describe the study and evaluation of differences in how and why countries allocate power among participants in the corporation as well as the roles of financial institutions, institutional investors, and markets in monitoring and constraining managerial discretion.[3] It considers a range of national differences in law and practice on such matters as to whom managers are responsible, the role of labor and lenders in the corporate governance system, and the effect of different qualities of capital markets in corporate control and performance.

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[3] For an extensive list of scholarship devoted to comparative corporate governance, see Edward B. Rock, America's Shifting Fascination with Comparative Corporate Governance, 74 Wash. U. L.Q. 367, 367 (1996).

It is common in describing the results of studying comparative corporate governance to offer a somewhat stylized and simplified story of the dominant models, along substantially the following lines, that tends to emphasize at an abstract level the major differences.[4] Principal general differences between the models can be thought of as lying upon two axes: constituency characterization (mainly shareholders versus all stakeholders) and finance characteristics (mainly disaggregated versus concentrated investment).[5]

A. The Shareholder Market Model

There are two central groups of participants in the conception and regulation of the US and UK corporation, managers and shareholders. Shareholders are the owners of the corporation's equity, whose value rises and falls with the fortunes of the corporation. Managers are both the day-to-day operators of the corporation (the officers) and those who oversee and supervise those operations (the directors). The key problem in US and UK corporate governance and perhaps the key starting point of the subject is the resulting separation of ownership from control.[6] Sometimes described as the problem of agency costs,[7] it is addressed through two broad sets of mechanisms, monitoring and exit.[8]

Monitoring mechanisms include principally the imposition of the duties of care and loyalty on managers for the benefit of stockholders. They also include such mechanisms as annual

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[4] Much of the literature on comparative business law deals with particular countries or particular issues. For extensive collections, see The Sloan Project on Corporate Governance at Columbia Law School, Corporate Governance Today 629-738 (1998) and Frank Woolridge, Company Law in the United Kingdom and the European Community: Its Harmonization and Unification (1991).

[5] Another principal distinction could be that between advanced or developed economies and emerging or undeveloped economies. *See* Bernard S. Black & Reinier Kraakman, A Self-Enforcing Model of Corporate Law, 109 Harv. L. Rev. 911 (1996). This article deals directly only with the former, but its insights should apply with some force to the latter as well. *See* Masahiko Aoki & Hyng-Ki Kim, Corporate Governance in Transitional Economies: Insider Control and the Role of Banks (1995).

[6] This foundational insight is always credited to Adolf Berle & Gardiner Means, The Modern Corporation and Private Property (1932).

[7] This description is always credited to Michael C. Jensen & William H. Meckling, The Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structures, 3 J. Fin. Econ. 305 (1976).

[8] This conception of the shareholder's position and choices is always credited to Albert O. Hirschman, Exit, Voice and Loyalty (1970).

shareholder elections of directors, powers to remove and replace directors, shareholder rights of action, and other governance devices.[9] Exit mechanisms include principally the free transferability of ownership interests that enable shareholders to sell their stock and thus exit the corporation at will, often called the Wall Street Rule.

These two kinds of mechanisms are reinforced through market mechanisms that facilitate them and their disciplining effect on attenuating the separation of ownership from control. A market for corporate control enables disgruntled shareholders to use monitoring mechanisms such as proxy voting contests and consent solicitations to oust inferior managements. The free transferability of ownership interests has contributed to the development of deep, liquid and functionally efficient capital markets through which stock can also be traded for the purpose of effecting changes in control of a corporation. These market forces are made possible due in large part to the system of disclosure required under both state and federal law in the US that promotes transparency of performance.

That same transparency, coupled with the common law tradition of at-will employment, also facilitates reasonably functioning labor markets. For managers, poor performance can lead not only to ouster from current positions but also can make it difficult for them to find employment from other employers afterwards. These markets are far from perfect, however, and it is not uncommon to see senior executives earn staggering compensation despite mediocre performance or worse.[10]

At the same time, managers generally have a fair amount of flexibility in contracting and expanding their employee base as necessary to enhance performance. To be sure, labor unions often gain substantial power through collective bargaining agreements that are protected through contract law and Federal labor laws, but that power remains a product of voluntary contracting rather than externally imposed regulation. Like it or not, finally, a consumer culture also contributes to reasonably functioning product markets through which preferences are registered and performance further disciplined.

Reinforcing these monitoring mechanisms in the US is the great-American past time, litigation.[11] Shareholders are equipped with a vast arsenal of legal claims, procedural devices, and legal and equitable remedies to protect their interests. They benefit from an entire sub-profession of lawyers who specialize not only in bringing direct, derivative and class actions under state and federal law, but also in identifying and communicating to management the bases for such actions and

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[9] These sorts of checks on managerial power were captured as the anti-managerialist stance in Oliver E. Williamson, Markets and Hierarchies: Analysis and Antitrust Implications (1975).

[10] *See infra* text accompanying notes [Part III.A].

[11] *See* Charles M. Yablon, On the Contribution of Baseball to American Legal Theory, 104 Yale L.J. 227 (1994).

often financing them.[12]

The rights of other participants in the corporation in the US and UK model differ from those of shareholders. The rights of employees, suppliers, creditors, customers and others are set by contract. One rationale for this treatment takes note that upon bankruptcy or liquidation of the corporation the shareholders are residual claimants on the corporation's assets–their claims are paid only after the claims of these and other groups are paid. By directing management to act in the best interests of these residual claimants as owners, the interests of these prior claimants are protected indirectly. Hence there is no need, for example, for corporate managers to owe fiduciary duties or other non-contractual duties to lenders, although in that formulation the tension between the interests of lenders and equity holders is defined.[13]

In this model, corporate governance can therefore be used as a way to describe the study of the relationships among all the participants in the corporation. The tendency given the special status of shareholders in the US and UK is to concentrate on the relationship between managers and shareholders, including all the rules governing director action such as voting, meetings, attention, conflicts and so on, as mechanisms to attenuate the significance of the separation of ownership from control. While reform-minded proponents regularly urge greater rights for other participants in the firm, particularly labor,[14] and their role is of course very important, the rights of these other participants tend to be addressed by other substantive bodies of law, most notably contracts but also labor law, commercial law, debtor-creditor law, consumer protection law and corporate finance.

Putting shareholders first in corporate governance by these devices leads to the description of this model as the shareholder market model. The central finance characteristic of this model is fragmented ownership of equity securities in corporations. An underlying cultural generator of this ownership structure is said be an entrepreneurial spirit that encourages widespread participation in equity investment, both in terms of those who demand it (start ups or expanding enterprises) and those who supply it (venture capitalists and investors generally). This structure to some extent also rests upon a cultural aversion to concentrations of power. The legal and political roots of the US model lay in a preference for diffusion of power. This landscape was drawn primarily through the Glass-Steagall Act which segregated the industry of investment banking from that of commercial

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[12] *See* Lester Brickman, Contingent Fees Without Contingencies: Hamlet Without the Prince of Denmark?, UCLA L. Rev. (1989).

[13] In the "vicinity of insolvency," director duties may alter to elevate creditor interests above equity interests. *See* Credit Lyonnais Nederland, N.V. v. MGM Pathe Communications Co., 1991 WL 277613, 42 n.55 (Del. Ch. 1991).

[14] *E.g.*, Kent Greenfield, The Place of Workers in Corporate Law, 39 B.C. L. Rev. 283 (1998).

banking.[15]

A principal consequence of these forces at the level of technical corporate governance is a complex system of checks and balances on managerial power for shareholder protection. Coupled with a deeply ingrained principle of freedom of contract and judicial enforcement of contracts rights, a shareholder primacy model within corporate law tended to emerge with the interests of other participants in the corporation being addressed through contract.[16]

B. The Bank/Labor Model

In contrast to this general market model epitomized by the US and UK corporate governance and finance system is what can be called the bank/labor model, characteristic of many continental European corporate finance models. The central finance feature of this model is substantial investment intermediation and ownership concentration, in sharp contrast to the market model's fragmentation.[17]

Banks act as financial intermediaries by accepting individual deposits and collecting them for investment in corporations. There tend to be far fewer such investing entities. With concentration of ownership and debtholdings, there was far less pressure for the development of actively-functioning, deep and liquid capital markets.[18] Moreover, unlike with the US Glass-Steagall Act, no formal or legal separation of commercial and investment banking prevent this concentration of investment ownership.

This concentration of investment results in a powerful and small body of shareholder/debt

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[15] *See* Mark J. Roe, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance (1994).

[16] Another effect is a substantially greater use of equity than debt in the average corporate capital structure. Yet the disciplining forces of the equity market are also facilitated by an active debt market, sometimes creating exceptions to that typical debt:equity ratio. An American-style leveraged buy-out (LBO), for example, is the acquisition of all or a substantial percentage of the stock of another entity financed in material part by using or encumbering assets of that target entity. Common means of financing such buy-outs include the target advancing cash to the acquier, pledging its assets as security for the acquier's acquisition financing, or giving guarantees of that indebtedness. The capital structure of the target immediately following such a leveraged acquisition often contains a debt:equity ratio much higher than average.

[17] Mark J. Roe, Some Differences in Corporate Structure in Germany, Japan and the United States, 102 Yale L.J. 1927, 1939 (1993) [hereinafter Roe, Some Differences].

[18] This may explain why there tends to be a greater proportion of debt than equity in the average corporate capital structure as compared to the debt-equity mix in the market model.

holders whose dual position requires little in the way of regulatory governance mechanisms, and certainly far less than the intricate system of checks and balances seen in the US-UK market model. As the same bank tends to occupy seats as both shareholder and debt holder, the tension between those interests essentially disappears and there is less pressure to choose between a shareholder primacy model and some other model and therefore less need to develop any sort of system of checks and balances or for a well-developed system of disclosure obligations.

There is also less need for such a system due to traditions that have put labor at the center of the governance structure rather than as a participant whose interests are defined chiefly by contract. European nations have a deep tradition of worker protection, evidenced in wage-setting policies, and laws that make it difficult to fire workers (in contrast to the at-will employment rule of the common law). These sorts of forces may also explain the relatively narrower disparity in compensation levels between senior executives and ordinary laborers, as compared to the market model.

The German (as well as the Dutch) version of this model formally elevates labor as a third key participant in the leadership of a corporation. German corporations operate with worker councils in factories and in offices that must be consulted on a variety of matters concerning corporate policy affecting them.

In terms of formal governance, German corporations generally have a two-tiered board system consisting of a Management Board and a Supervisory Board. The Management Board (*Vorstand*) manages the corporation, represents it in its dealings with third parties, and submits regular reports to the Supervisory Board. The Supervisory Board (*Aufsichstrat*) appoints and removes the members of the Management Board and oversees the management of the corporation. Under German law, Supervisory Boards are typically composed one-half of employee-elected representatives and one-half of shareholder-elected representatives. While it cannot make management decisions, the Supervisory Board may determine that certain actions or business measures to be taken by the Management Board require its prior approval.

The German dual-board structure is based on the concept of co-determination (*Mitbestimmung*). At least in theory, labor and capital co-determine a corporation's future course. Labor's formal representation on one board of a two-tiered board structure is intended to mean that its interests are protected directly from within the corporate governance system rather than solely through contract or governmental regulation or protection. With concentrated shareholderings by banks comprising the other half of the board, the separation of ownership from control characteristic of the market shareholder model is also substantially absent in this bank/labor model.

French corporations, known as *societe anonyme*, are typically governed by a Directorate and a Supervisory Board. The Directorate has extensive powers to manage the business affairs of the corporation. The primary function of the Supervisory Board is to oversee the Directorate and to exercise permanent control over the management of the corporation. The Supervisory Board also chooses the members of the Directorate, determines the remuneration of the members of the Directorate, authorizes any agreements between the corporation and the members of the Directorate or the Supervisory Board and allocates attendance fees among its members.

Within this structure, while not as formal as the German co-determination model, the French version also purports to take literally the statement that management owes its duties to the corporation as a whole. This statement is understood and treated as defining a stakeholder model of corporate governance. Managerial duties run to all participants in the corporation–shareholders yes, but also lenders and labor.

Indeed in the bank-labor model, even sole shareholders sometimes may lack power to remove or replace management, especially under two-tiered board structures such as are prevalent in Germany and The Netherlands. This is in part due to work council regulations adopted across Europe. The EC mandates that all members (other than the UK, which opted out of the EC's so-called social chapter) require most of their corporations to establish procedures for employee consultation and/or work council formation.[19]

Many continental European countries have gone further than the EC mandates to require that virtually all corporations establish and maintain worker councils with power to represent labor in various ways vis-a-vis management. Management is obligated to consult with these councils on major corporate policy affecting labor interests, including layoff schemes and in many cases potential changes of control.[20] Galvanizing this labor element in the model, the EC also requires that employment contracts "travel with" business assets when sold as a going concern, so that a buyer of such assets is automatically subject to those agreements by operation of law.[21]

The Japanese variation on the bank/labor model deepens both the role of labor and the role of lender banks in the governance structure compared to the European bank model. As in Europe,

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[19] *See* EC Works Council Directive (relates to corporations with more than 1,000 total employees which have 150 or more employees in at least two EC countries, not including the UK).

[20] In the following countries, the number of employees of a corporation triggering the requirement of forming a work council and the obligation to consult it on pending changes of control are as indicated: Belgium (100; pre-signing consultation and management must inform shareholders of council's views); France (5; pre-signing consultation); Germany (5; inform council at the latest immediately following signing); The Netherlands (35; pre-signing notification, and the councils have some power to suspend or block the transaction upon application to a court). Italy does not require worker councils and while Spain requires them it does not require any action upon an impending change of control, but in both countries executives of companies have substantial rights following a change in control. *See* Clifford Chance, Buying a European Business: A Guide to Negotiated Acquisitions in Western Europe (2d ed. 1997).

[21] *See* EC Acquired Rights Directive.

banks tend to own the vast bulk of debt and equity of industrial companies. The distinguishing factual characteristic is based on a production model called horizontal coordination.[22] Workers tend to be generalists in the production process and to engage in a substantial amount of information sharing and mastery of learning throughout the system of production. This limited specialization calls for relatively high corporate investment in labor markets to develop human capital, both in general and in specific applications at particular corporations.

Japanese corporations thus face higher risk of loss on investment from workers whom they train at great expense and then may defect to other firms. Workers also face the risk of acquiring non-transportable firm-specific skills. To address these risks, corporations and workers developed the system of lifetime employment through which workers had permanent job security and corporations benefitted from a concomitantly restricted labor market.[23]

Yet since this mutual security system was not in the form of an express binding contract, additional structural protection was created through corporate cross-ownership. Industrial corporations in Japan own substantial percentages of the securities of other industrial corporations.[24] The resulting ownership concentration is even more acute than in the European model, with a commensurate dilution of capital market disciplining power.

C. Theories and Trade-Offs

As competition increasingly crosses borders in product markets, the topic of comparative corporate governance has also begun to consider whether these differences affect corporate competitiveness and the degree to which these various models are converging.[25] Here important normative questions are at stake, including (a) whether there is an optimal model, either one of the existing models or a blend characterized by aspects of all of them and (b) whether these differences are undergirded by distinctive and immutable cultural, political, or social differences that render model optimality irrelevant except at a theoretical level.[26]

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[22] *See* Ronald J. Gilson, Reflections in a Distant Mirror: Japanese Corporate Governance Through American Eyes, 1998 Colum. Bus. L. Rev. 203 [hereinafter, "Reflections"].

[23] *See* Ronald J. Gilson & Mark J. Roe, Lifetime Employment: Labor Peace and the Evolution of Japanese Corporate Governance (March 1998) (unpublished manuscript on file with the author and available on the internet).

[24] *See* Roe, Some Differences, *supra*.

[25] *E.g.*, Theodor Baums, Corporate Governance Systems in Europe: Differences and Tendencies of Convergence (unpublished manuscript on file with the author).

[26] *See generally*, Roberto Romano, A Cautionary Note on Drawing Lessons from Comparative Corporate Law, 102 Yale L.J. 2021 (1993).

At a theoretical level, some US corporate law scholars had interpreted the US experience as a dynamic process of evolution toward a state of laudable maximum efficiency. This state was achieved through an exercise of corporate contracting and was recognizable once one noticed that corporations were simply a nexus of contracts.[27] All constituencies of the corporation held interests in it that were defined by contract or something resembling contract and the force of contractual freedom led to wealth maximizing relationships. There was pretty much only one destiny for this process and the US system was pretty much characterized by its qualities.

Tempting as it is to understand one's past and present as moving on an inexorable path of progress toward such a unique ideal, not all agreed. Some countered these contentions on their own terms,[28] while others looked abroad and noticed that a variety of different models existed and succeeded. The inexorable path began to look more like just one path of many that could share a pedestal of normative privilege.[29]

In the wake of these contrasting views of different models of corporate governance and finance stands a theoretical stand-off. Answers to the profound questions of optimality remain elusive. Indeed, as a matter of theory, the models suggest less about inevitabilities than about trade-offs, principally between swiftness of adaptation and sureness of dislocation.

A key virtue of the shareholder-market model is its adaptability to changing environments. Deep and liquid capital markets oriented towards shareholder interests facilitate fast responses to deteriorating financial conditions. The external monitoring function of strong capital markets manifests itself pretty much on a daily basis in very many mundane ways. Volume of shares traded, vast quantities of detailed analysis and reporting by financial analysts and business journalists, corporate public relations departments and chief executive officers devoting substantial efforts to information dissemination and interpretation are some examples.

More dramatic evidence of systemic adaptability hastened by the external monitoring of capital markets comes from innovations in techniques for improving corporate performance. The proliferation in the US of junk bond financing was used to wage hostile takeover battles that forced changes within corporate America in the 1980s. A high volume of management buy outs, especially leveraged buyouts, during the same period did the same. In the 1990s, waves of consolidations and takeovers financed by equity securities, along with record numbers of initial public offerings of securities, show the US capital markets at work in raising and allocating funds to improve

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[27] *E.g.*, Roberto Romano, The Genius of American Corporate Law (1993); Frank A. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law (1991).

[28] *E.g.*, William W. Bratton, The Economic Structure of the Post-Contractual Corporation, 87 Nw. L. Rev. 180 (1992).

[29] Roe, *supra*. A whole literature emerged that drew upon the science of path dependence to explore these possibilities.

performance.

These sorts of capital market monitoring activities also translate into other dramatic evidence of the adaptability of business within the market model. Reengineering, downsizing, restructuring, outsourcing, spin offs, split ups, mergers, leaner organizational structures and so on are not only buzzwords (they certainly are that) but labels for real activities of change that take place regularly among US and UK corporations across the decades.

Perhaps the most striking evidence of the adaptability of the US-UK model is the comeback of corporate America that began in the early 1980s. American industry lagged that of Japan and conventional wisdom had begun to hold that the Japanese main bank model was the way to outperform–with lifetime employment for horizontal coordination and cross-shareholdings. Then corporate America rebounded with a vengeance, swiftly and surely, producing the longest expansion in the post-war economy, while Japan and the rest of Asia spun into financial crisis.[30]

Such swift adaptation does not come without a cost of course. The very slogans of downsizing and re-engineering capture some of the fall out that workers, communities and other corporate constituents face. Workers are fired or laid off. Host towns to closed corporate plants fall into economic abysses. Severe ripple effects can run through local economies and sometimes through the national economy as a whole. The weak and the losers are ground out by the market model of corporate finance and governance into the dustbins of history.

This kind of fall-out has been an especially sensitive issue among European countries whose history and social politics place a far greater value on the security of workers over the short term and whose laws requiring work councils, setting wages and imposing substantial restrictions on an employer's ability to fire workers can impair adaptation. This does not mean that economies and corporations of those countries do not both suffer and rebound from economic malaise. What seems to differ is that the speed with which adaptation occurs is slower and possibly the degree of severity of the economic hardship is either less or spread across more sectors of the economy or constituents of the corporation.

With these trade-offs and the associated characterization of the key differences between these models in terms of constituency identification (shareholders verus stakeholders) and finance traits (disaggregated versus concentrated), prescriptions may be urged at normative or theoretical levels as to which model would better suit the coming world of global interconnectedness. However, the reality of global corporate governance and finance resembles less the abstract models sketched here and something more far more overlapping and convergent, as the next Part's examination of trends, traditions, and practices suggests.

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[30] See Gilson, Reflections, *supra*.

II. Global Corporate Governance

Multinational and transnational firms have to be domiciled somewhere yet they compete everywhere. The choice of domicile can entail different governance structures, due to legal, cultural, economic, or political constraints, which vary across domiciles. That choice can affect the entity's competitiveness in global markets vis-a-vis entities domiciled elsewhere. If it does, one can expect mobile entities organized in disadvantaged regimes to proselytize for change or simply go elsewhere. [31] Increasingly keen competition among product markets throughout the world should effect requisite discipline without regard to domestic (national/internal) financial market design. On the other hand, there are strong links between product markets and methods and corporate finance markets and governance structures. After all, for example, a key explanation for the distinctive governance model of Japan is precisely its horizontal coordination method of production.

In the past couple of decades this tension has been resolved toward substantial global harmonization, as countries around the world spruce up their corporate governance structures with best practices from elsewhere.[32] Moreover, while global competition in product markets has raged for many decades international capital markets had tended to be isolated from each other. This is changing. Financial markets across borders increasingly compete with one another as investors (suppliers of capital) look across borders for additional investment opportunities. Simultaneously, corporations (and other organizations) seek lowest cost capital from any market in the world where it can be obtained. So the isolation of capital markets is disappearing and real head to head competition among financial markets has ensued.

A robust competition that is proceeding among corporations in product, labor and capital markets is being replicated spontaneously in a robust competition for types of corporate governance models. That competition occurs as an immediate and direct by-product of competition in these other markets and has produced trends suggesting an increasing blending and integration of corporate governance practices around the world. On the other hand, there are obstacles to harmonization and

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[31] The world would witness replication of the similar practice of competition among the states within the United States. *See* Terence L. Blackburn, The Unification of Corporate Laws: The United States, the European Community and the Race to Laxity, 3 Geo. Mason Indep. L. Rev. 1 (1994). On that phenomenon in the US, see Roberto Romano, The State Competition Debate in Corporate Law, 8 Cardozo L. Rev. 709 (1987); Jonathan R. Macey & Geoffrey P. Miller, Toward an Interest-Group Theory of Delaware Corporate Law, 65 Tex. L. Rev. 469 (1987). The classic stances on the virtues of such competition are known as the Cary-Winter debate. *Compare* William L. Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 Yale L. J. 663 (1974) *with* Ralph K. Winter, Jr., State Law, Shareholder Protection and the Theory of the Corporation, 6 J. Leg. Stud. 251 (1977).

[32] *See* Henry Hansmann & Reinier Kraakman, The End of History for Corporate Law (Dec. 5, 1997) (unpublished manuscript available on the internt and from Columbia Law School) (Columbia conference "Are Corporate Governance Systems Converging?").

systemic rigidities that preserve substantial diversity among national laws governing corporations.[33] To that extent, it is highly doubtful that a single harmonic model ever will emerge, but the direction is towards that end rather than away from it.[34]

A. Trends

The European Union is itself a corporate finance/governance integration in all sorts of ways. In the deepest way, adoption of a single currency will harmonize the fundamental competitive because in a single currency area, productivity differentials–the fruits of technological advancement and higher investment for example–are shared. Business expense differentials, particularly wages, should tend to evaporate. The process is just beginning with adoption of the euro at present permitting sovereign exchange in local currencies, with those currencies to be abandoned within just a few years.

Nearly as profound, throughout Europe barriers to cross-border capital flows have been greatly diminished. A series of EC Directives seeks to compel abolition of foreign investment controls. Member states have enthusiastically responded to this call by relaxing substantially their historical controls. In general, the remaining restrictions are limited to notification requirements[35] or to specified sectors posing national security or public health, safety and welfare concerns.[36] Many European countries have simply retained authority to implement such controls without any being in

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[33] See Amir N. Licht, International Diversity in Securities Regulation: Roadblocks on the Way to Convergence, 20 Cardozo L. Rev. 227 (1998).

[34] *See* Corporate Governance Update, 5 Corp. Governance: Int'l Rev. 256 (1997); *see also* Ronald J. Gilson, Globalizing Corporate Governance: Convergence of Form or Function (Dec. 5, 1997) (unpublished manuscript available on the internet and from Columbia Law School) (Columbia conference "Are Governance Systems Converging?").

[35] The following countries substantially relaxed their foreign investment control laws in the indicated year and now call for the notification indicated: France (1996, foreign investors need to file a declaration of investment with the Treasury Department of the Ministry of the Economy); Spain (1992, foreign investors must report to General Directorate of Commercial Policy and Foreign Investment, except that for investments exceeding approximately $3.8 million they also must receive prior administrative clearance); Germany (19xx, report to Bundesbank); Belgium (19xx, report to Central Bank); The Netherlands (19xx, report to Central Bank). *See* Clifford Chance, Buying a European Business, *supra* note.

[36] *E.g.*, France (investments in governmental or public authorities, research and arms); Spain (investments in aviation, radio, television, telecommunications, gaming, arms, and national defense). *Id.*

effect or in regular use.[37]

Within Europe also accounting rules are harmonized along a series of fundamental principles. These include a requirement of uniform formats of financial statement presentation; common valuation principles, including historical cost and accrual accounting principles and the principle of conservatism (called prudence); a general mandate that the financial statements show true and fair value; an annual audit; public filings;[38] and consolidation principles.[39]

Against these trends in Europe are periodic instances of apparent resistance to harmonization. There are 13 EC Directors dealing with European Company Law, as well as a proposal to create a European Corporation ("*societas europaea*") that would supplement but not substitute for the national corporate form in individual states, but neither is currently among the EC's high priorities.[40] On a few occasions, particularly early on in EU convergence efforts, proposals for employee board representation derailed adoption of some integrated governance proposals.[41] Much of this resistance emanates from the UK, which has for decades debated whether its future will be better served by alliances along an Anglo-Saxon US-UK axis or along a continental European EU axis. Whatever obstacles this ambivalence may seem to pose for EU harmony, the UK has actually produced microcosmic convergence by drawing on both.

US corporate law, both common law and statutory law, drew upon Anglo-Saxon traditions and then refined them. The UK has in turn recaptured them in its 1992 Cadbury Report on corporate

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[37] *E.g.*, Belgium, The Netherlands, Germany and the UK (although in the UK the Secretary of State is empowered to prohibit a non-UK resident from acquiring control of UK manufacturing entities if allowing it would be contrary to the public interest). *Id.*

[38] *See* Council Directive No. 78/660 O.J. (L 222) 11 (1978) (Fourth EC Company Law Directive).

[39] *See* Council Directive No. 83/349 26 O.J. (L 193) 1 (1983) (Seventh EC Company Law Directive).

[40] *See* Singhof & Seiler, at 537, n.166; see also Terence L. Blackburn, The Societas Europea: The Evolving European Corporation Statute, 61 Fordham L. Rev. 695 (1993) (critical appraisal of the original proposal).

[41] An early EU attempt at adopting governance structures that would have provided for employee representation on corporate boards was dropped in the face of strong opposition. *See* Proposal for a Fifth Company Law Directive, 1983 O.J. (C240) 2. Similarly, an early proposal to compel financial disclosure for the benefit of employees was fiercely opposed and ultimately abandoned. *See* Commission Proposal for a Council Directive on Procedures for Informing and Consulting the Employees of Undertakings with Complex Structure, in Particular Transnational Undertakings, 1980 O.J. (C297) 3.

governance,[42] followed in 1998 by the final version of that report renamed the Hampel Report in 1998.[43] Both seek to identify "best practices" among global corporations and tend to pick up on technical innovations in regulatory corporate governance adopted in the US, such as increasing the number and roles of independent directors, creating board audit and nominating committees comprised mostly of independent directors and other governance devices heralded and adopted in the US. Institutional investors that proselytize for these sorts of corporate governance reforms from the UK and the US have also joined forces to promote global corporate governance efforts.[44]

The UK's substantial role in Europe coupled with these UK links to US corporate governance has tended to magnetize continental models toward the market model. Consider what has been happening in France. If French corporate governance and finance have been characterized by the stakeholder model and financial intermediation, French capitalism has been characterized by a state-dominated industrial policy, firms of far smaller average size than in other capitalist countries, and an industrial elite recruited not from within industry but from outside it.[45] In this environment capital markets have been limited in depth and in monitoring capability.

This French model is being revised in ways that resemble a market model, beginning with a loosening of the state's hold on industry through privitization in the face of globalization and liberalization.[46] The number of small shareholders is also growing and, following the UK, technical governance reforms based on US models have been instituted widely.[47] Audit and compensation committees are forming across French corporate boards, minority shareholders are taking on increasingly important roles, and economic transparency is being enhanced through superior flows in information quantity and quality.[48]

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[42] Report of the Committee on Financial Aspects of Corporate Governance (Cadbury Report) (Dec. 1, 1992).

[43] Committee on Corporate Governance Final Report (Hampel Report) (Jan. 1998).

[44] *See* Joann S. Lublin & Sara Calian, Activist Pension Funds Create Alliance Across Atlantic to Press Lackluster Firms, Wall St. J., Nov. 23, 1998 at A4 (reporting on alliance between CalPers, the largest US pension fund, and Hermes Pensions Management Ltd., the largest UK pension-fund manager, together holding nearly $1 trillion in investments, to cooperate "across the oceans to affect corporate governance").

[45] Olivier Pastre, Corporate Governance: The End of "L'Exception Francaise"?, 1998 Colum. Bus. L. Rev. 79.

[46] *E.g.*, France to Sell Up to 30% Of Thomson Multimedia, N.Y. Times, July 31, 1998, at D3.

[47] *See* Pastre, *supra*.

[48] *Id.*

The German model of "co-determination" with formal worker representation on the Supervisory Board looks radically different from the typical conception of the US-UK model as one dedicated to the best interests of the shareholders. The practice within most German Supervisory Boards, however, means pretty much only access to information and a voice at the table rather than any real decision-making authority on operations, finance or other corporate matters.[49] Indeed, the tendency has been for Managerial Boards, composed of managers and shareholders, to dilute the power of the labor-dominated Supervisory Boards.[50] Ironically, this has been achieved in part with some classical devices of corporate governance such as the use of committees and strategic channeling of information.[51]

Japan has also been moving toward a shareholder market model and away from long term employment commitments for horizontal coordination. There is increased recognition that profit maximizing strategies are consistent with the protections these devices provide.[52] More and more Japanese workers–particularly younger workers–have indicated that they do not expect to stay with one employer for more than a few years at a time, let alone maintain lifetime employment with a single firm.[53]

The forces of regulatory competition are also at work in promoting sovereign state competition through private use of forum-shopping techniques that effectively locate business organizations in host countries with attractive laws.[54] To give a simple example, most European countries do not permit tax deductions for amortization expense of goodwill or other intangibles.

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[49] Mark J. Roe, German Codetermination and German Securities Markets, 1998 Colum. Bus. L. Rev. 167 [hereinafter, "German Codetermination"]; Roe, Some Differences, *supra* note , at 1942-43.

[50] *Id.*

[51] *Id.*

[52] *See* Survey, Japanese Finance, *The Economist*, June 28, 1997; Governance Debate Hits Far East, The Corporate Governance Advisor, May/June 1988 at 32.

[53] *Id.*

[54] For a few excellent articles on international regulatory competition in securities regulation, see James D. Cox, Regulatory Competition in Securities Markets: An Approach for Reconciling Japanese and United States Disclosure Philosophies, 16 Hastings Int'l & Comp. L. Rev. 149 (1993); James D. Cox, Rethinking U.S. Securities Laws in the Shadow of International Regulatory Competition, Law & Contemp. Probs., Autumn 1992, at 157; Bevis Longstreth, A Look at the SEC's Adaptation to Global Market Pressure, 33 Colum. J. Transnt'l L. 319 (1995); on regulatory competition in general, see also William J. Bratton & Joseph McCaHery, N.C. L. Rev. (1995).

But some do (Italy, the Netherlands, Spain) and assets acquired elsewhere (say France) can subsequently be sold to an entity in one of those countries and simultaneously leased back to the French entity.[55] The sale-leaseback device neutralizes the cross-border difference, despite anything France (or the other country for that matter) was trying to accomplish. To that extent, the legal differences can in effect be contracted around and end up as trivial.[56]

European capital markets are also deepening. The Frankfurt and London Stock Exchanges announced in July 1998 a plan to integrate their facilities and to permit trading of each other's listed securities on the other's exchange. France quickly announced its disappointment at being left out of the initial plans and the Frankfurt-London alliance as quickly announced that the Paris bourse would be a welcome addition to the alliance (although as a 20% player compared with 40% for each of the founding exchanges). Not long thereafter, France made the unilateral announcement of its inclusion in the emerging pan-European exchange,[57] and exchange officials in Milan, Madrid, Amsterdam and Brussels echoed eagerness to participate in the venture that the London exchange estimates would list companies with aggregate market capitalization of $5.5 trillion (compared with the New York Stock Exchange's $8.7 trillion).[58]

There is further evidence of integration in securities listing and trading. Stock exchanges have for years been pushing for harmonization or relaxation to enable global listing, most famously achieved by Daimler-Benz's listing on the New York Stock Exchange.[59] These efforts continue, and with increasing success.[60] SAP, a 25-year old German software firm listed on the New York Stock Exchange in early August 1998, exactly ten years to the day after its initial public offering on the

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[55] *See* Clifford Chance, Buying a European Business, *supra* at 20-27.

[56] *See* Bernard S. Black, Is Corporate Law Trivial? A Political and Economic Analysis, 84 Nw. L. Rev. 542 (1990) (arguing that state corporate in the US is trivial as it can be contracted around to enable corporations to adopt pretty much any governance structure desired).

[57] *See* Alan Cowell, French Agree to a European Stock Exchange, N.T. Times, Nov. 20, 1998, at C2 (the French announcement was accompanied by statements from London and Frankfurt indicating that the announcement may have been somewhat premature).

[58] *Id.* (NY Times, Nov. 20, 1998).

[59] *See* Lee H. Radebaugh et al., Foreign Stock Exchange Listings: A Case Study of Daimler-Benz, 6 J. Int'l Fin. Mgmt. & Acct. 158 (1995).

[60] *See* James L. Cochrane, Are U.S. Regulatory Requirements for Foreign Firms Appropriate?, 17 Fordham Int'l L. J. S58 (1994); James A. Fanto & Roberta S. Karmel, A Report on the Attitudes of Foreign Companies Regarding a U.S. Listing, 3 Stan. J.L. Bus. & Fin., 51 (1997).

Frankfurt Stock Exchange.[61] SAP is widely characterized as having generated "US-style growth" and "US-style rewards."[62] Its listing on the NYSE was characterized by senior executives as showing that SAP had "outgrown" the Frankfurt stock market and also showed that SAP is a transnational entity–one combining features of a variety of governance models.[63]

Signs of the international times in securities trading include creation of the International Securities Exchange (ISE) announced in November 1998. On-line brokerage firm E-trade and a group of broker-dealers led by Adirondack Trading Partners announced their intention to invest about $80 million in establishing this all electronic options exchange.[64] The founders touted their ability to slash costs of trading substantially, but as important is the ability to conduct trading in staggering sums of billions and trillions of dollars solely through electronic means that transcend geographic boundaries.[65] The ISE is by no means the first to inaugurate electronic trading, but in its efforts to emulate the widespread use of such trading in Europe, its commitment cements this new

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[61] The company name stands for Systems, Applications, Products and its major product is the innovative enterprise resource planning (ERP) software, which can run a company's entire business process and is used by most of the world's major corporations, including Microsoft. The product and the company's success earned the company the nickname "Germany's Microsoft."

[62] *See* The Financial Times, Aug. 3, 1998.

[63] SAP reportedly shrugged off the usual "stuffy Germany" style of corporate governance and instead cultivated an environment characterized by entrepreneurship, speedy growth, and informality, making it more at home in Silicon Valley than in the Rhine. The company is also multi-national, with research labs in Palo Alto, Tokyo, Moscow and India. One-fourth of its investors are American, 40% of its business is in the United States and so are its biggest rivals (Oracle and PeopleSoft). Along with the American characteristics, moreover, SAP has a more German cultural characteristic: "good programmers get paid as much as top line managers." *Id.*

[64] *See* Bloomberg News, Broker-Dealers Plan Electronic Options Market, *The Houston Chronicle*, Nov. 11, 1998.

[65] Rather than require the physical presence of people in a single location conducting live auctions as exiting capital markets do, an all-electronic market conducts such auctions solely on computer screens and thus obliterates the significance of physical location. Auction markets operate by a customer instructing a broker to effect a trade, who submits the trade to the exchange floor where a crowd of traders bid on it in an "open-outcry" auction overseen by a specialist in the subject security there to fill orders when others won't. Electronic trading operates in a similar way except the auction is conducted through bids announced via computer rather than human voice. *Id.* *See generally* Lawrence A. Cunningham, Capital Market Theory, Mandatory Disclosure and Price Discovery, 51 Wash. & Lee L. Rev. 843 (1994).

era of globally-connected securities trading.[66]

Trends in the US are also taking pages from models elsewhere. First, there has been a softening of the boundaries between investment and commercial banking. The Federal Reserve Board in December 1996 increased the amount of investment banking income a commercial bank can earn from investment banking subsidiaries from 10% to 25%. These so-called Section 20 subs engage in capital markets businesses and investment banking.[67] This change contributed substantially to the wave of mergers between commercial and investment banks in the ensuing period, and breaks down an historical cause of ownership fragmentation in the US.[68]

Second, the US litigation system often seems to encourage undue volumes of shareholder lawsuits against management in class actions as well through derivative suits whereas most legal systems put substantial restrictions on such suits.[69] While there is little reason to believe that such litigation will decline materially in the US, it is equally clear that protections against litigation abuse have been pursued in the US.[70] Other countries that may increasingly look toward litigation to enforce corporate governance principles will increasingly be able to adapt these and other sorts of built-in anti-abuse systems.[71]

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[66] *See* Steven M. Sears, Big US Options Exchanges See Threat From a Planned All-Electronic System, Wall St. J., Nov. 23, 1998, at B13I (reporting that the ISE "hopes to mimic the success of European electronic exchanges by luring customers with lower fees").

[67] *E.g.*, Note, The New American Universal Bank, 110 Harv. L. Rev. 1310 (1997); James R. Smoot, Bank Operating Subsidiaries: Free at Last or More of the Same?, 46 DePaul L. Rev. 651 (1997); H. Rodgin Cohen, Section 20 Affiliates of Bank Holding Companies, 1 N.C. Banking Inst. 113 (1997).

[68] *See* Roe, Strong Managers, Weak Owners, *supra*. Mergers included Nationsbank-Montgomery Securities; Bank America-Robertson Stpehens (later sold when Nationsbank bought BofA); Travelers-Citicorp; Bankers Trust-Alex. Brown. Other equity ownership trends in the US may suggest convergence as well. *See* Roe, Some Differences, *supra* note at 1965 ("US firms may be evolving–weakly and unevenly–toward the German and Japanese style of ownership" and the "next natural evolutionary stage of American corporate finance might be the entrance of financial institutions into corporate boardrooms").

[69] *See infra* text accompanying notes [Part III.D].

[70] *E.g.*, The Private Securities Litigation Reform Act of 1995.

[71] *See generally* Uriel Procaccia, Crafting a Corporate Code from Scratch, 17 Cardozo L. Rev. 629, 641-43 (1996) (discussing Israel's approach to derivative suits as a corporate governance tool); *see infra* text accompanying notes [Part III.D].

Third, accounting principles in the US are being harmonized with those prevalent worldwide.[72] In October 1996, the US Congress passed the National Securities Markets Improvements Act of 1996, which among other things required the US Securities and Exchange Commission to report to Congress on progress being made in developing international accounting standards.[73] The SEC has been working with the International Accounting Standards Committee for nearly a decade to promulgate a core set of accounting pronouncements constituting a comprehensive basis of generally accepted accounting principles.[74] In October 1997, the SEC published a report to the US Congress on the progress of the the International Accounting Standards Committee (IASC).[75]

The SEC joins organizations throughout the world in supporting the IASC's initiatives.[76] The Finance Ministers and Central Bank Governors of the G7 countries announced their support of the IASC and encouraged it to complete its proposed set of core principles by early 1999.[77] The World

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[72] A general trend towards harmonization of international accounting standards, also suggested a few pages earlier, is reflected in accounting textbooks and professional literature. E.g., Sideny J. Gray & Lee H. Redebaugh, International Accounting and Multinational Enterprises (4th ed. 1997); Gerhard G. Mueller, et al., Accounting: An International Perspective (4th ed. 1997); Shahrokh M. Saudagaran & Gary M. Meek, A Review of Research on the Relationship Between International Capital Markets and Financial Reporting by Multinational Firms, 16 J. Acct. Lit. 127-59 (1997).

[73] National Securities Markets Improvements Act of 1996, Section 509.

[74] *See* International Accounting Standards 7 (International Accounting Standards Comm. 1997).

[75] Report on Promoting Global Preeminence of American Securities Markets (Oct. 1997) <www.wec.gov/news/studies/acctgsp.htm>

[76] The SEC's support emphasizes that any international accounting standards must be comprehensive, produce comparability and transparency, provide for full disclosure, and be capable of being rigorously interpreted and applied. *Id.* Indeed, Chairman Levitt's broad-based initiative to crack-down on earnings management abuses among US corporations (*see* SEC Release and web site) is seen by many as a response to the increasing attractiveness of international harmonization of accounting standards that the SEC wants the US to lead rather than follow. *See* Elizabeth MacDonald, SEC's Levitt Pushes Harder for Changes in Fiscal Reporting, and Some Cry Foul, Wall St. J., Nov. 17, 1998, at A2 & A10 ("the SEC fears that the growing economic globalization will put pressure on U.S. regulators to conform to international accounting rules, which are generally looser").

[77] Declaration of G7 Finance Ministers and Central Bank Governors, Oct. 30, 1998 (the IASC's proposals can promote "greater transparency and openness in the financial operations of individual countries, of financial and corporate institutions, and of the international financial

Bank has requested the world's Big Five international auditing firms to insist that financial statements be prepared in accordance with international accounting standards.[78] Exemplifying leading voices from around the world, Tony Blair, Prime Minster of the UK,[79] and Robert E. Rubin, Treasury Secretary of the US,[80] also have emphasized that a key part of the global financial system must be development and implementation of international accounting standards.

B. Traditions

The trends summarized in the preceding Section are operating as forces to harmonize some of the finance aspects of the models sketched in Part I. As for the constituency characterization of those models, the models are more capacious than the highly-generalized summary in Part I suggests and the capacity for overlap has increasingly been filling up rather than contracting.

Corporate social responsibility remains an important dimension of US corporate governance.[81] The simple argument that shareholder-based profit maximization lifts the boats of all other participants has been supplemented by more direct efforts to do so. Scores of substantial organizations promote this more direct approach to corporate constituencies on issues including affirmative action, child labor, downsizing, environmental, fair wages, privacy, sexual harassment,

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institutions").

[78] Jim Kelly, Big Five Criticized Over Global Audit Standards: World Bank Action May Speed Up International Code, *The Financial Times*, p. 1 (Oct. 19, 1998). The President of the World Bank, James D. Wolfensohn, made the same point more broadly in a speech to the joint annual meeting of the World Bank and the International Monetary Fund on October 6, 1998 (calling for new development framework with internationally recognized accounting and auditing standards for the private sector).

[79] Speech of Tony Blair to the New York Stock Exchange, Sept. 21, 1998.

[80] Speech of Robert E. Rubin to a Dow Jones/Wall Street Journal Conference, Oct. 1, 1998 (calling for "a new openness in international finance").

[81] *E.g.*, David Millon, Redefining Corporate Law, 24 Ind. L. Rev. 223 (1991); Lawrence E. Mitchell, A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes, 70 Tex. L. Rev. 579 (1992); Lawrence E. Mitchell, Progressive Corporate Law (1995) (collecting numerous articles). Prescriptions related to the idea of corporate social responsibility include advocacy of altruistic capitalism, a sort of constrained profit maximization mandate. *See* Elliott J. Weiss, Social Regulation of Business Activity: Reforming the Corporate Governance System to Resolve an Institutional Impasse, 28 UCLA L. Rev. 343 (1981).

and work-family life balance.[82] They do so through advocating programs including employee training and assistance, mission statements, and social responsibility audits.[83]

Leading groups include Business for Social Responsibility, an organization founded in 1992 and comprised of over 1,400 corporate members with annual revenues exceeding $1 trillion, total employees of nearly 5 million, and featuring such brand corporate names as AT&T, Bristol-Myers Squibb, Coca-Cola, DuPont, Federal Express, Home Depot, Motorola, Polaroid and Time-Warner.[84] Large numbers of mutual funds and other institutional investors commit themselves to investing only in socially responsible enterprises, some–but not all–of whom claim to believe that investing this way can also be shareholder wealth-maximizing.[85] Many corporations follow suit by emphasizing their social responsibility–not just the well-known exemplars of the traditional left such as Ben & Jerry's and Body Shop[86]–but also companies including Philips-Van Heusen Corporation, headed by CEO Bruce Klatsky, an advisor on US trade policy to the Bush and Reagan administrations, as well as Hasbro, Reebok and Wal-Mart.[87]

These positions are entirely consistent with US state law, for US state laws mandate that directors act in the best interests of the "shareholders and the corporation as a whole." While often read to mean that shareholders are the primary beneficiaries of director duties,[88] the language easily and often extends the benefit to others including creditors, communities and workers. And while German law is seen to take more seriously the idea that beneficiaries of those duties include corporate constituents other than shareholders, that law also forbids directors from acting contrary to shareholder interests and indeed often requires precisely acting in the "aggregated shareholder

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82 *E.g.*, Francesco Cantarella, The Growth of Corporate Responsibility Committees, 20 The Corporate Board (Nov.-Dec. 1998) (see also <www.corpsocialsol.com>).

83 *Id.*

84 *See* Business for Social Responsibility, <http://www.bsr.org/bsrfacts.htm>

85 *See* Maria O. Hylton, "Socially Responsible" Investing: Doing Good Versus Doing Well in an Inefficient Market, 42 Am. U. L. Rev. 1 (1992).

86 *See* Lewis D. Solomon, On the Frontier of Capitalism: Implementation of Humanomics by Modern Publicly Held Corporations: A Critical Assessment, 50 Wash. & Lee L. Rev. 1625 (1993); *see also* Lewis D. Solomon, The Future of Business Organizations, 20 Cardozo L. Rev. xxx (forthcoming 1999).

87 *See* Business for Social Responsibility, <http://www.bsr.org/bsrfacts.htm>

88 *See supra* text accompanying notes [Part I.A].

interest."[89]

US and German corporate law therefore contemplate protection of all corporate constituencies.[90] Both prescribe this protection by imposing on management the duties of care and loyalty. Both US and German corporate law treat the duty of care as a species of what is recognizable as a quasi-negligence standard, with US states requiring the exercise of "fully-informed business judgment"[91] and German law requiring directors to exercise the standard of care of a "prudent and diligent businessperson."[92] In the US, state court judges defer to managerial decision-making under the business judgment rule so long as directors act in good faith and without a conflict of interest. Under German law there is no business judgment rule and directors bear the burden of

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[89] *See* Bernd Singhof & Oliver Seiler, Shareholder Participation in Corporate Decisionmaking Under German Law: A Comparative Analysis, 24 Brooklyn J. Int'l L. 493, 550 (1998):

> Management's fiduciary duties toward the company under German law corporate law are repeatedly referred to as *Loyalitats-und Treuepflichten*. Since the shareholders are the 'ultimate owners' of each corproation, courts and scholars interpret the somewhat sweeping language of Aktiengesetz section 93 paragraph 1 [the statutory mandate that directors act "with the care of a diligent and conscientious manager"] as primarily embracing the notion of aggregated shareholder interest and long-term profit maximiation. However, there is a longstanding debate in Germany about the strong emphasis on protecting shareholder interests.

Id.

[90] *See* Singhof & Seiler, *supra* at 553 (citing Marc von Samson-Himmelstjerna, Personliche Haftung der organe von Kapitalgesellschaften, 89 Zeitschrift fur Vergleichende Rechtswissenschaften 288, 303 (199) as "indicating the similarity of the U.S. and German standards") but also noting others who argue that Germany fiduciary duty "falls short of the standard set in American case law and statutes").

[91] The DGCL provides that the board of directors has the ultimate responsibility for managing the business and affairs of a corporation. DGCL § 141(a). The duty of care requires the exercise of an informed business judgment, taken to mean that directors must inform themselves of all material information reasonably available to them. Having become so informed, they then must act with requisite care in the discharge of their duties. Liability of directors for breach of the duty of care in some circumstances requires a finding by a court that the directors were grossly negligent. *See* Smith v. Van Gorkum, 488 A.2d 688 (Del. 1985).

[92] *See* Singhof & Seiler, *supra*, at 550 (AktG § 93(1) requires directors to act "with the care of a diligent and conscientious manager").

proving they have discharged their duties.[93]

The duty of loyalty under US state laws requires directors to subordinate their personal interests to the interests of the corporation when those interests conflict,[94] and again German law (as well as French law) is to a similar effect.[95] Specific applications of this general duty do vary between these domiciles, yet the variation is not much more pronounced than the nuanced variation across states within the US as the following four examples suggest.

First, many US states authorize boards to approve loans to directors without shareholder or other constituency approval, often without any restrictions on board authority to do so other than a requirement that the board determine that the loans benefit the corporation.[96] German law requires that loans to directors exceeding one months salary be approved by the Supervisory Board.[97] French law flatly forbids corporate loans to directors as well as corporate guanrantees of direct borrowings by them or on their behalf.[98]

Second, most US state laws adopt a textured set of rules governing other interested director transactions under which such transactions are generally permissible or at least largely insulated from judicial review if: (1) the interest is disclosed and a majority of disinterested directors consent; (2) the interest is disclosed and holders of a majority of shares entitled to vote consent; and/or (3) the transaction is fair to the corporation at the time it is authorized.[99] German law contains the somewhat clearer requirement that for any transaction between the corporation and a member of the Management Board, the corporation must be represented by the Supervisory Board.[100] On the other

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[93] *See* Singhof & Seiler, supra at 552 & n.243.

[94] Stated in the more usual terms, the duty of loyalty requires that directors and officers place the corporation's interests above her or his own interests. *See* RMBCA Subchapter F, Introductory Comment.

[95] *See* Singhof & Seiler, *supra* at 552.

[96] *E.g.*, NYBCL § 713.

[97] Loans made to Supervisory Board members must be approved by the Board without the borrowing member's vote. *See*

[98] *See* John H. Crabb, French Business Enterprises: Basic Legislative Texts.

[99] *E.g.*, Cal. Corp. Code § 820 (*construed in* Remillard Brick Co. v. Remillard-Dandini Co., 241 P.2d 66 Cal. 1952)); DGCL § 144 (*construed in* Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976) and in Marciano v. Nakash, 535 A.2d 400 (Del. 1987)); RMBCA § 8.31 (*construed in* Cookies Food Prod., Inc. v. Lakes Warehouse Distrib., Inc., 430 N.W.2d 447 (Iowa 1988)).

[100] *See*

hand, German law does not go on to police the process or substance of the resulting transaction other than through general rules against fraud.[101] French law requires advance approval of interested director transactions by the Supervisory Board and an evaluation and report by the corporation's auditors to be furnished to the shareholders.[102]

A branch of the US duty of loyalty imposes limitations on transactions directors and officers may exploit in their non-corporate capacity if those transactions have certain characteristics–such as being in the corporation's line of business–indicating that the corporation should be given the opportunity to exploit the transaction.[103] German law contains similar restrictions against members of the Management Board engaging in competition with the corporation without the approval of the Supervisory Board.[104]

The differences in the duties of care and loyalty between the US (and the UK, which is similar) and Germany (and France) are thus far more subtle and less pronounced than often recognized. This is particularly so in that specific identification of beneficiaries of the basic duties of care and loyalty matter very little in settings like director loans, interested transactions and corporate opportunities. The prescriptions are meant to address the content of those duties rather than their discrete beneficiaries.

In that sense, they are vertical governance mechanisms intended to preserve and expand the size of the corporate pie rather than address the manner in which the pie (whatever its size) is sliced up and allocated. Questions of pie size pit managerial interests against the interests of all other constituencies of the corporation and it should be unsurprising that these vertical corporate governance mechanisms differ so little across borders of advanced economic countries. And far from impairing governance convergence they obviously promote it. The potentially more contrasting case concerns situations where allocation is at stake, a problem of horizontal corporate governance and most potentially visible in the case of threats to corporate control.

C. Threats in Fact

In the context of threatened changes of control and related defensive actions, most US state laws impose either or both a heightened standard of duty upon directors or a heightened standard of judicial review of director conduct, in each case concerning whether the directors acted to get the best deal for shareholders. No such heightened standards exist under German law, at least at

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[101] *Id.*

[102] *See*

[103] *E.g.*, Guth v. Loft, 5 A.2d 503 (Del. 1939); *see also* ALI, Principles of Corporate Governance § 5.05(b) (1994) (defining corporate opportunity).

[104] *See*

present,[105] and instead directors are simply expected not to act counter to the stockholders' interest and to have due regard for the common interest.

The degree to which this heightened standard in the US separates the US model from the German model should not be overstated, however. Many states also empower directors to consider the interests of non-shareholder constituencies in some circumstances. True, Delaware case law routinely emphasizes the shareholder primacy norm, as the rhetoric of cases such as *Revlon*[106] and *QVC*[107] suggest. Yet those very cases mediate the rhetorical norm by permitting directors to consider "the impact [of their decisions] on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally)."[108] This is consistent with a general principle of corporate law that allows directors to do so as long as the effect on shareholders is not too great.

Delaware law has sometimes gone even further, as when it accepted arguments made by Time Inc. directors who had resisted an unwanted takeover in part on the ground that doing so was necessary to preserve its culture of journalistic integrity.[109] Even under the most rigorous judicial review of board actions in takeover contexts–that to which *Revlon*'s shareholder value maximization rhetoric applies–Delaware law gives directors wide berth.[110] It does not require any particular action

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[105] The absence of any such standards may in part be due to the absence of many opportunities to develop them–an absence likely to change as increasing numbers of mergers, particularly involving cross-border entities, involving German companies occur.

[106] Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985).

[107] Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34 (Del. 1994).

[108] *Unocal Corp. v. Mesa Petroluem Co.*, 493 A.2d 946, 955 (Del. 1985); *see Time*, 571 A.2d at 1153; *Macmillan*, 559 A.2d at 1285 n. 35; *see also Moran v. Household Int'l, Inc*., 500 A.2d 1346, 1357 (Del. 1985) (not upsetting director decision to adopt poison pill intended to deter certain takeovers that threaten various nonshareholder constituencies).

[109] *Time*, 571 A.2d at 1143, n.4, 1145; *see also* Charles M. Yablon, *Corporate Culture in Takeovers*, 19 Cardozo L. Rev. 719 (1997). This position is not limited to Delaware courts. *See Herald Co. v. Sewall*, 472 F.2d 1081, 1094-95 (10th Cir. 1972) (upholding takeover defenses adopted by directors of newspaper publisher and noting the corporation had a duty to its readers).

[110] *Revlon* permits consideration of other constituencies so long as it is "rationally related to benefits accruing to the stockholders," *Revlon*, 506 A.2d at 180,–a standard that is not all that tough to meet. *See* Lawrence A. Cunningham & Charles M. Yablon, Delaware Fiduciary Duty Law After *QVC* and *Technicolor*: A Unified Standard (And the End of *Revlon* Duties?), 49 Bus. Law. 1593 (1994).

(such as an auction),[111] nor does it impose on directors any duty to insure shareholders get maximum value.[112] The unifying inquiry in virtually all these cases concerns whether there is a threat to *the corporation*, not solely or even necessarily to shareholder interests.[113]

More dramatically, consider the fight for corporate control between Allied-Signal and AMP.[114] In August 1998, Allied-Signal offered a 55% premium over the market price of AMP–in an all cash/all shares offer–for a company whose profitability had been declining. It also announced its intention to wage a consent solicitation to amend AMP's by-laws, expand the AMP board and fill the vacancies with its nominees and, later in the battle, to strip AMP's board of power to amend AMP's poison pill and put that power in the hands of a three-person committee.

AMP shareholders overwhelmingly supported Allied-Signal, as of mid-September tendering 72% of AMP's outstanding into Allied-Signal's original offer. Shareholder supporters included the family of one of the company's founders (Robert Hixon) and many of the institutional shareholders that owned about 80% of the stock, including TIAA-CREF. Indeed, TIAA-CREF was part of a shareholder group that sued AMP's board and also took the extraordinary step of separately filing an amicus brief supporting Allied-Signal in direct litigation between Allied-Signal and AMP. TIAA-CREF argued that AMP had trampled on basic "principles of shareholder democracy."

AMP's management had done so–despite this overwhelming shareholder support for Allied-Signal–by erecting a series of defensive barriers to the bid, taking advantage of Pennsylvania laws that require directors to act in the best interests *not of the shareholders but of the corporation* and further permit boards to act in what they perceive to be the best interests of employees, lenders, communities and others.[115] These barriers included amending its dead hand poison pill provision from one providing that if a change of control occurred only directors in office prior thereto could remove the pill to one that simply could not be changed period after a change of control occurs (at

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[111] *See Barkan*, 567 A.2d at 1286.

[112] S*ee In re* RJR Nabisco, Inc. Shareholders Litig., [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194 at 91,714 (Del. Ch. Jan. 31), *appeal refused*, 556 A.2d 1070 (Del. 1989).

[113] *E.g.*, Unitrin, Inc. v. American General Corp., 651 A.2d 1361 (Del. 1995) ("threat to Unitrin" and "threat to Unitrin's uninformed stockholders"); Williams v. Geier, 671 A.2d 1368 (Del. 1996) ("corporate threat"); *In re* Santa Fe Pacific Corp. Shareholder Litig., 669 A.2d 59 (Del. 1995); Moore Corp. Ltd. v. Wallace Computer Services, Inc., 907 F. Supp. 1545 (D. Del. 1995) (applying Delaware law) ("threat to Wallace and its shareholders"); *see also* Hilton Hotels Corp. v. ITT Corp., 978 F. Supp. 1342 (D. Nev. 1997) (construing Delaware law for application to Nevada corporation) ("threat to corporate policy and effectiveness").

[114]*AMP Inc. v. Allied Signal Inc.*, 1998 US Dist. LEXIS 15617 (E.D. Pa. Oct. 8, 1998).

[115] 15 Pa. Cons. Stat. Ann. §§ 1712, 1715.

least not until the pill's expiration date)–an extraordinary device.[116] AMP sought and won an injunction prohibiting Allied-Signal's consent solicitation unless and until each proposed director candidate affirmed that if elected he or she would be duty-bound under Pennsylvania law to act in the best interests of the corporation as a whole not just for AMP's shareholders.[117]

In upholding the AMP board's extraordinary actions against Allied-Signal's claim that it had breached its fiduciary duties in its response to the Allied-Signal bid, the court repeatedly emphasized a "stakeholder" standard that appears to be at the heart of Pennsylvania law in the following unequivocal terms:

> "Directors may weigh the interests of the shareholders against the interests of other constituencies, [and] asserts no specific duty to shareholders above or beyond those owed to those other constituencies."[118]
>
> directors "may, in considering the best interests of the corporation consider the effects on all groups affected by such action, including shareholders, employees, suppliers, customers, and creditors of the corporation, and upon communities in which offices or other establishments

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[116] Even dead hand pills of the former type (i.e., directors ousted in a proxy vote retain sole power to amend pill) have been struck down in New York (Irving Bank Corp. v. Bank of New York (1988) and in Delaware (Carmody v. Toll Brothers, Del. Ch. Oct. 1998) (Jacobs, V.C.) And the Delaware court is presently considering the validity of a limited-time dead hand more nearly like that in AMP in the case of Mentor Graphics Corp. v. Quickturn Design Systems Inc. (pending in November 1998). They were approved in Georgia in Invacare Corp. v. Healthdyne Technologies Inc. (1997). For discussion and analysis of these and other pill-related matters, see Jeffrey N. Gordon, "Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett, 19 Cardozo L. Rev. 511 (1997).

[117] These directors would also have to say they have duties under Delaware law to act in Allied-Signal and its shareholders best interests and that this might pose a conflict. Allied-Signal promptly told the judge they could do this within 48 hours and did so. The court, after taking a remand of the case back from its appeal on the Third Circuit, accepted these certifications and allowed the consent solicitation to proceed. *See* N.Y. Times, Nov. 19, 1998.

In a deposition AMP's Chairman Robert M. Ripp testified that he and his fellow board members would be obligated to "evaluate any reasonable offer" for the company–including Allied-Signal's–though he also believed that AMP was not for sale. *See* Chief Says AMP Would Look at Other Bids, *N.Y. Times*, Nov. 14, 1998, at C15. In late November, AMP announced that it had entered into a white knight business combination with Tyco for a price about 10% higher than what Allied had offered. *See* Wall St. J., Nov. 23, 1998 at A2.

[118] *AMP*, at .

of the corporation are located."[119]

directors "shall not be required, in considering the best interests of the corporation or the effects of any action, to regard any corporate interest or the interests of any particular group affected by such action as a dominant or controlling interest or factor."[120]

These are obviously note statements of a shareholder primacy norm. Less obviously, but equally true, the Delaware standards summarized above show far less of a shareholder primacy norm in the US than the standard rhetoric would suggest.[121] Nor are these far-fetched or isolated examples, for many other US state laws adopt a similar framework.[122] Such statements would be right at home under German law, moreover, perhaps capturing the German sense of the common interest.

On the German side, consider the Daimler-Chrysler deal. While German law permitted Daimler's directors evaluating that merger to consider the interests of workers, lenders and the so-called common interest, it also required that the board not act counter to the best interests of shareholders.[123] Though giving that special place to shareholders is certainly not a statement of shareholder primacy, nor is it the standard formulation of the stakeholder model. In short, US practice more nearly resembles German practice than it resembles US rhetoric and German practice more nearly resembles American practice than it does German rhetoric.

D. Threats in Theory

This same effect of uniting global corporate fiduciary duties in practice can be produced at the level of theory. Traditional accounts of US corporate law as private law treat corporate law as consisting of voluntary associations of private actors agreeing to property arrangements that are

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119 *Id.* at .

120 *Id.* at .

121 *See generally* William T. Allen, Our Schizophrenic Conception of the Business Corporation, 14 Cardozo L. Rev. 261, 263-65, 272-74 (1992).

122 *E.g.*, Ohio Rev. Code Ann. § 1701.59(E) (directors determining what is in the best interests of the corporation "shall consider the interests of the corporation's shareholders and, in his discretion, may consider" the "interests of the corporation's employees, suppliers, creditors, and customers" as well as "community" interests); Conn. Stock. Corp. Act § 33-313(e) (requiring directors evaluating sale of all or substantially all a corporation's assets to consider the interests of such other constituencies); Ind. Bus. Corp. L. § 23-1-35-1(f) (like Pennsylvania, permitting directors to subordinate shareholder interests to the interests of other constituencies).

123 *See* Chyrsler Corporation, Proxy Statement 47, 131-32 (Aug. 6, 1998); see also Singhof & Seiler, supra, at 552.

contractual rather than political in nature.[124] Critics have contended that this rights-based approach to thinking about corporate law is mere metaphor, rooted not in foundational normative argument but rather declared as a starting point that treats shareholders as "owners" of corporations and therefore as possessing private property and contract rights.[125]

The result of this treatment of shareholders as owners with superior rights to other corporate constituents may be seen to generate a paradox within US corporate law doctrine when conjoined with that doctrine's business judgment rule. A strict and literal insistence on shareholder wealth maximization seems incongruous with judicial deference given to managerial decisions under the business judgment rule.[126] Accounts of this seeming paradox have ranged from the dubious claim that judges are simply not competent to review ordinary business decisions, to the ideological claim that their own insulation from market forces should keep them out of reviewing business decisions that are subject to market forces, to the philosophical claim that this reveals some irrationality in the underlying duty.[127]

The seeming paradox is not limited to the relationship between the duty of care and the business judgment rule. It also may seem to exist in the way US judges at least analyze the duty of loyalty. While that duty is stated in the strictest and loftiest terms, it is usually analyzed with a greater emphasis upon decision making process than resulting substance.[128] Similarly, for all the rhetoric of judicial scrutiny of takeover defense decisions in cases like *Unocal* and *Revlon*, ultimately substantial judicial deference is given director decisions even in those charged contexts.[129] Much the same could be said as a practical matter of both the duty of care and duty of loyalty under

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[124] E.g., Ralph K. Winter, State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. Legal Stud. 271 (1977); Frank H. Easterbrook & Daniel R. Fischel, The Corporate Contract, 89 Colum. L. Rev. 1416 (1989); William Carney, The American Law Institute's Corporate Governance Principles: The Death of Property Rights?, 61 Geo. Wash. L. Rev. 898 (1993).

[125] *See* Kent Greenfield, From Rights to Regulation, in Patfield, Perspectives on Company Law (1997); s*ee also* Licht, *supra*; Melvin A. Eisenberg, The Structure of Corporation Law, 89 Colum. L. Rev. 1461 (1989).

[126] Greenfield, *supra*.

[127] *See* Kent Greenfield & John E. Nilsson, Gradgrind's Education: Using Dickens and Aristotle to Understand (and Replace?) The Business Judgment Rule, 63 Brooklyn L. Rev. 799, 825-836 (1997).

[128] *See* Lawrence E. Mitchell, Fairness and Trust in Corporate Law, 43 Duke L.J. 425 (1993).

[129] *See* Cunningham & Yablon, *supra* note.

German law. While directors of German corporations do not benefit from any business judgment rule, shareholders of German corporations lack the sort of litigation enforcement mechanism available to those of US corporations.[130]

The duty-deference paradox may be stronger in the case of the duty of care/business judgment rule than in the duty of loyalty/process focus with the paradox in the takeover defense context somewhere in between. Each of these may be stronger again than the German paradox, which is due to structural limitations rather than doctrinal ones. The degrees of difference in paradox strength in turn correlate with the rhetoric used to describe the duty, which enables understanding the duties and the paradox in a range from a strong form to a weak form.

The stronger the form of the duty–say the duty of loyalty rather than the duty of care–the closer it is to vertical governance regulation–a mandate to act for the best interests of the corporation as a unit. For example, a loan to a director implicates the duty of loyalty and pits his personal interests against the corporation's interest rather than poses a conflict between constituents. The weaker the form of the duty, the closer it is to horizontal governance regulation–a mandate to act for the best interests of a particular group–say, shareholders as opposed to other constituents. For example, a gift to a charity in the corporation's community implicates the duty of care and pits a community constituent interest against those of shareholders (and other constituents).

The weaker the form of the duty, moreover, the greater judicial deference becomes–greater deference is given to the charitable donation decision than to the director loan decision. Yet in all but the extreme case, the duties in application do not impose on directors a mandate to maximize shareholder wealth, although the rhetoric often suggests it. And the rhetoric is strongest in the case of vertical issues such as director loans and weakest in the case of horizontal issues such as charitable giving. It is in between in takeover defense cases, being also in the middle of the range between vertical and horizontal concerns.

US corporate fiduciary duty law is thus as much about rhetoric as it is about substance. And it may sometimes work. Fiduciary rhetoric, even if not applied, "performs a significant socializing and educational role in corporate governance"[131] and the "aspirational aspect of fiduciary duty influences [director] behavior."[132] Corporate law judges embrace the rhetoric and spirit of traditional fiduciary principles because they understand that they have a "hortatory, tutelary, and moral function, and are not just drafting loan agreements."[133] Yet they also recognize that hardly

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130 *See* Singhof & Seiler, *supra* at 553-55; *infra* Part III.D.

131 *See* Robert C. Clark, The Genesis and Goals of the ALI's Corporate Governance Project, 8 Cardozo L. Rev. 691 (1987).

132 *Id*. at 715-16.

133 *Id.*

anyone can believe that directors can act, in Cardozo's famous purple prose, with the "punctilio of an honor the most sensitive."[134] Nor can anyone really believe it is possible for directors solely to make decisions in ways that maximize shareholder wealth.[135]

In addition to the proselytizing function of fiduciary rhetoric, it also serves a function of judicial administration. When judges recognize objectionable conduct deemed liability worthy, they have a ready-made and measured stick with which to say so. [136] Yet the rhetoric is sufficiently fluid that it is also easy to escape from it when the conduct being analyzed does not offend judicial sensibilities.[137]

Fiduciary rhetoric thus may be explained as a tool of director proselytization or judicial administration that serves useful ends even while at the level of particular application it would be foolhardy to compel compliance with it. The seeming paradox in the duty-deference framework dissolves. So too does the significance of the inconclusive debate over the shareholder primacy norm versus other corporate constituents.[138] At least in the context of theoretical comparative corporate governance, the legal distance between the market and bank models of corporate governance shrinks.

E. Deals

One source of resistance to the harmonization factors discussed previously in this Part is the role of labor within the US/UK versus the European governance models as a function of the more profound and foundational law and custom governing employment itself. Employment-at-will traditions in the US and UK are fundamentally different from worker-protection traditions in Europe and Japan. Yet while such differences are highlighted in abstract accounts of comparative corporate

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[134] Meinhard v. Salmon, 249 N.Y. 458 (1928).

[135] *Cf.* Note, Craig S. Warkol, Resolving the Paradox Between Legal Theory and Legal Fact: The Judicial Rejection of the Theory of Efficient Breach, 20 Cardozo L. Rev. 321 (1998) (for all the talk of the theory of efficient breach of contract in law teaching and scholarship, judges do not apply the theory because it rests upon unrealistic assumptions, is amoral, misconceives fundamental roles of contract and ignores practical problems of quantification).

[136] *E.g.*, *QVC*, as analyzed in Cunningham & Yablon, *supra*.

[137] *E.g., Time-Warner, id.*

[138] On the debate, *compare* Jonathan R. Macey, An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Fiduciary Duties, 21 Stetson L. Rev. 23 (1991) *with* Greenfield, *supra.*

governance,[139] even these deep traditions are changing. In the US, employment-at-will is certainly still strong, but as surely it has been moderated by a variety of US worker protection legislation and judicial decision-making.[140] In Japan, lifetime employment remains valued, but less so than it used to be.[141] In both countries and in Europe and the UK, cross-border business combinations reinforce the underlying demographic forces that are altering these traditions in ways that impact directly on corporate governance.

Global mergers like Daimler-Chrysler pose the challenge strikingly. In the first instance, a typical merger creates substantial duplication of work force resources across the enterprise. The overlap is eliminated to avoid duplication of expenses and entails work force reductions straight across the entity, from research to marketing to accounting. In the US, that goes with the territory whereas in Germany and the rest of Europe it goes against the grain. Daimler-Chrysler's management team had to choose from these models or something in between, and it looks as if it chose something in between. At least publicly, it addressed the role of employees in the new entity mainly by reassuring them that while some synergies would create some redundancies, the entity was going to grow the business so rapidly that these employees would be retained and deployed in other ways within the corporation.[142]

Subsequent to a merger, the question of employee relations arises as it does in other business organizations–economic contractions reduce demand for an entity's products that reduce the demand for labor. Standard responses in the US and in Europe differ, with European entities facing more pressure to retain workers despite their redundancy. One source of pressure within Germany apart from legal requirements is the presence on the Supervisory Board of labor representatives positioned to encourage compliance in letter and spirit with those rules. In the case of Daimler-Chrysler, the German company's Supervisory Board will include of its 10 labor representatives one from the US United Auto Workers union (UAW). But as peculiar as that may sound from a US perspective, it is not something entirely new to Chrysler–the UAW had a seat on the Chrysler board as part of the multi-party deal worked out when the US government provided loan guarantees to Chrysler in the

[139] *See supra* text accompanying notes [Parts I.A & B & C].

[140] *See* Lawrence A. Cunningham & Arthur J. Jacobson, Corbin on Contracts, §4.2 and sections cross-referenced (1998 Supp.). *Compare* Richard A. Posner, Employment at Will, with Drucilla Cornell, Employment Communities, 10 Cardozo L. Rev. (1987).

[141] *See supra* text accompanying notes [Part I.B].

[142] *See* Gregory L. White, DaimlerChrylser Puts Consumers In Back Seat in New Ad Campgain, N.Y. Times, Nov. 16, 1988 at B11 (investors and employees are the two most important audiences for new advertising campaigns launched by Daimler-Chrysler as of the effective time of the merger, not customers and quoting a company executive as saying that "We're going to show [employees] right off the bat they they're the most important thing that we have").

early 1980s (the UAW representation ended in 1991).

Cross-border deals like Daimler-Chrysler thus draw on and reinforce convergence trends and may reshape traditions that do so, even on issues as profound as treatment of workers and allocation of executive power within the resulting entity. These reinforcements are driven by business needs associated with the integration of two separate entities. They are also reinforced by professionals advising the merging entities, the repeat and regular participants in the global mergers and acquisitions market.

These players include major global banking, law and accounting firms. On a global scale, this is a relatively small group that is getting even smaller.[143] Members share a common interest in developing substantially uniform practices and expectations concerning all aspects of a wide range of cross border deals ranging from private financings to public securities offerings to business combinations.[144]

Indeed the task of the global lawyer has become to pierce conceptual comparative corporate governance and to confront and use the tools of local law and practice to facilitate transnational corporate life. Not only do clients seek and expect that sort of service, achieving it also in the interest of those professionals apart from client service. Global lawyers advising boards of directors about their fiduciary duties in a variety of situations–from the more mundane such as director loans to the more charged such as takeover defenses–find it far easier to advise corporate boards from a variety of countries if the variations in those countries are not too large. The forms of agreement with which to begin negotiation and structuring of transactions can be more nearly standardized and the related legal opinions easier to render the more harmonious the governance and finance structures become.

Budding professional cultures that are asked and interested in promoting increased harmony can be expected to deepen in the coming decade as the sorts of bridges that enable transnational deals to proceed are likely to be replicated elsewhere. Indeed, within the auto industry in particular, analysts foresee continued consolidation through cross-border deals once considered too intractable to achieve.[145] The publishing industry is also in the midst of substantial consolidation, increasingly

[143] In accounting, consider the amalgamations over the past decade that have reduced the number of major firms from the Big Eight to the Big Five; in finance, consider the merger of Travelers and Citibank to form Citigroup; in law, consider the merger of Brown & Wood and White & Case, and the emergence of "global law firms"such as Clifford Chance and Allen & Overy.

[144] *See* Clifford Chance, Buying a European Business, *supra*.

[145] *See* Keith Bradsher, Capacity Glut Likely to Spur More Auto Mergers, *N.Y. Times*, Nov. 14, 1998, at C-1. Industry capacity ranges to approximately 70 million vehicles annually while average annual demand has generally peaked at 50 million and only about 10 of the globe's

through global transactions including a number of transactions involving the giant German publisher Bertelsmann.[146] Global alliances are increasingly being seen in many other industries once thought unlikely candidates for cross-border consolidation, including such banking deals as that between Deutsche Bank and Bankers Trust,[147] and oil deals such that between British Petroleum and Amoco. As these and other cross-border deals are consummated, differences should continue to evaporate and a greater and greater degree or uniformity of practices and expectations should emerge.

F. Information

One of the most striking and potentially persistent practical differences participants face in approaching a cross-border deal concerns the nature and amount of available information concerning a counterparty. A wealth of information is available concerning a target organized in a market model country. These countries tend to operate with systems of public recordation of real property as well as intellectual property. A well-developed securities and M&A industry augment this information culture. Buyers and sellers understand the need for the buyer to obtain information for purposes of valuation and the need of the seller to obtain contractual protection to preserve its confidentiality. The custom is to execute a confidentiality agreement early in the exploration process and to provide the buyer with substantial proprietary data before any sort of other agreement is even discussed.

The culture in bank model countries differs significantly. Even where mandatory disclosure rules apply to public companies, access to property records is limited, information is more jealously guarded, and no or limited securities or M&A industries have fostered an appreciation of the need for confidential disclosure of information when its recipient is not bound to consummate the deal. Less well-developed or routinized systems of legal enforcement of such contracts also often leaves a seller apprehensive about the assurance of confidentiality even if in principle it is willing to consider it.

Substantively, the sorts of information understood to be relevant as between the models may also vary. In the market model, and especially the US, disclosure concerning potential environmental law and retiree liabilities have been standard for many years. Environmental regulation abroad began to develop later and a traditionally greater reliance upon public social

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40 auto manufacturers are profitable. *Id.* Buyer candidates include Ford and Volkswagen (which acquired UK's Rolls Royce in early 1998) and target candidates include Nissan (Japan), Volvo (Sweden), and BMW (Germany). *Id.*

[146] *See* Doreen Carvajal, Bertelsmann Signs Deal for Springer-Verlag, N.T. Times, Nov. 21, 1998 at C2. Bertelsmann acquired Random House in early 1998 and entered into an on-line joint venture with Barnes & Noble later in 1998, and late in the year was involved in discussions with the French media company Havas S.A. *Id.*

[147] *See* Deutches Bank Seen in Deal to Acquire Bankers Trust, N.Y. Times, Nov. 21, 1998 at A-1.

security systems has put private plans off center stage (even in countries, such as Germany, where such liabilities can not only be substantial but also uncovered by any particular asset base).

Periodic corporate reporting is way more extensive in the US than in Europe (and Japan). US Federal and state law as well as stock exchange rules and general market pressures and expectations in the US result in corporations disclosing extraordinary amounts and types of information to shareholders and to other interested people. Far more limited and far less effective disclosure requirements are imposed elsewhere.

As global corporations as diverse as Daimler-Chrysler and SAP increasingly list shares on numerous stock exchanges in the US and around the world, they will be subject to US-style disclosure requirements both as a matter of regulatory mandate and market expectations and demand. More generally, as the same group of international professionals helps to consummate cross-border transactions calling for disclosure and evaluation of information, similar pressures are emerging in a wide variety of settings. Participants are finding that US-UK style information disclosure is in fact consistent with existing corporate traditions in most countries, perhaps especially Germany, so that broadening global corporate laws to require it is also quite possible.[148]

Just such an effort has been underway by public regulators. The SEC has been working with the International Organization of Securities Commissions (IASC) to develop a set of international standards for non-financial statement disclosure. These standards are intended to facilitate cross-border financing and listing by transnational companies while holding them to a single global standard of disclosure. Progress has been made, culminating in a planned final but delayed proposal by IOSCO in 1998.[149] Further progress is also expected (and needed), however, as these rules are limited to offerings and listings of common equity securities only and to transactions for cash and do not extend to additional disclosure called for in connection with such transactions as tender and exchange offers, business combinations, or going private or other affiliated transactions.[150]

The factors reviewed above suggest some basis for forecasting the hybridization of corporate governance models in terms of both constituency and finance characteristics, a move that might make the proper study not so much comparative corporate governance but global corporate

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[148] *See* Singhof & Seiler, *supra* at 531.

[149] See Robert Bruce, Tolstoy Would Have Been Proud of IASC, Times (London). May 14, 1998, at 32. Check out IOSCO's web site <www.iosco.org>.

[150] The SEC's own separate work carries with an aspect of harmonization as well. It has undertaken a substantial revision of its entire disclosure system, dubbed the Aircraft Carrier Release due to the enormity of its scope. *See* SEC Release, Proposed Rules to Ease Regulations on the Public Offering Process and Regulations Relating to Takeovers and Shareholder Communications (Oct. 15, 1998).

governance. Numerous reports on comparative corporate governance published in the last couple of years reinforce this view. In April 1998, for example, the OECD (Organization for Economic Cooperation and Development) published a report elaborating on principles of corporate governance suited for an integrated international world market.[151] These efforts reflect not only the descriptive reality and theory discussed in this Part, but also contribute a prescriptive course for global corporate governance to which the next Part also seeks to contribute.

III. Vertical Corporate Governance

The relative and increasing harmony among the various models and descriptions of corporate governance around the world is most likely simply an incident to the corporate form of business organization. Taken literally or too seriously, neither the abstract standard of shareholder wealth maximization nor the broad stakeholder model is sustainable.[152] Sustained application of the generalized shareholder primacy norm is unachievable given management control and power and its relationship with other constituents and a sustained application of the generalized stakeholder model is unachievable given that shareholders do supply capital that fuels the engine of the corporation. The mixed model reality optimizes among competing interests and constraints rather than maximizes a single objective.[153]

Accordingly, what should be of greater concern than any competition between shareholders and workers (or other non-management constituencies) is the competition between these groups on the one hand and management on the other.[154] In the takeover context, for example, whose interests were really going to be served by AMP's resistance to Allied-Signal's bid?[155] AMP's shareholders did not think their interests were being served and AMP's own plan to boost the company's profitability included cutting the work force by about 9% or 4,200 jobs and closing 10 factories. AMP's board may ultimately have served the corporation's interests in concluding a deal with a

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[151] OECD, Corporate Governance: Improving Competitivreness and Access to Capital in Global Markets (preapred by the Business Sector Advisory Group on Corporate Governance). Other reports include: Final Report of the Hampel Committee on Corporate Governance (Jan. 1998); Conseil d'Administation des Societes Cotees (the Vienot Report) (1995).

[152] See William T. Allen, Ambiguity in Corporation Law, 22 Del. J. Corp. L. 894-897 (1997).

[153] *See generally*, William J. Bratton, The Nexus of Contracts Corporation: A Critical Appraisal, 74 Cornell L. Rev. 407 (1989).

[154] In old fashioned terms, this is an endorsement for revival of the so-called managerialist school of thought in corporate law championed by Williamson with a modern emphasis on constituency unity. *See* Williamson, Markets and Hierarchies, *supra*.

[155] *See supra* text accompanying notes [Part II.C].

friendly partner,[156] but their approach was undoubtedly laden with pressure from AMP's CEO and management to resist what by all accounts looked good for shareholders in favor of something that looked bad for workers.

In thinking about the future of such vertical relationships, the key question is which sorts of practices should emerge. It would be a mistake to assume that whatever is prevalent in a leading economic country should be replicated elsewhere. On the contrary, deficiencies exist within all the models.[157] It is those deficiencies that are important and work must be done to avoid allowing them to spread like diseases around the corporate world.

The starting point for all models, as a matter of law certainly and perhaps as a matter of structural inevitability, is the board of directors overseers. Attention must be focused on what jobs boards perform, which are most important, and which current approaches are worst and need improvement. It turns out, perhaps unsurprisingly, that the most important jobs are also the ones that need the most improvement. They are also ones that are pretty much the same across borders and will increasingly be so as globalization continues.

The most important job any corporate board of directors is entrusted with is selecting an effective chief executive. That is true as much in the US as in Germany and other countries. The next most important jobs they have are to (a) set the compensation of the CEO and other senior managerial executives, (b) evaluate and take corporate positions on takeovers, both defensively and offensively, and (c) to make or review and approve capital allocation decisions. In each of these three areas, the major tension is vertical–between managerial interests and those of all other constituencies collectively. Effective performance of these jobs depends ultimately not so much on governance mechanisms as such but on board integrity. Vertical governance mechanisms can be

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[156] *See supra* note.

[157] Apart from the fact that no pure form of any particular model really exists, there is no reason to believe that any such abstracted model or existing model is optimal. For example, the US/UK market model disappoints even from its own point of view measured by industrial leadership in terms of shareholder wealth creation. The three strongest corporations in the automobile industry, for example, are not US companies: BMW, Toyota and Honda dominate the performance in that sector. *See* Morgan Stanley Dean Witter, Asset Allocation Review and Outlook (2Q Review, 3Q Outlook 1998). That is not to say that Ford and General Motors are not extremely strong leaders and contenders as well. It is to say that their governance and finance models do not necessarily guarantee superior performance as against corporations operating under different models. Indeed, among the worse performers are Nissan, which has lost money in 6 of the last 7 years and has faced difficulty obtaining additional bank funding in recent years *See* Keith Bradsher, Capacity Glut Likely to Spur More Auto Mergers, *N.Y. Times*, Nov. 14, 1998. Japan's governmental Investment Bank agreed in early November 1998 to provide Nissan some funding, much as the US government funded Chrysler when it faced financial straits in 1980. *Id.*

expected to do no more than foster integrity and those both best suited and most at risk of dilution from current trends are (a) director liability, (b) constituency voice, and (c) market discipline.

A. Executive Compensation[158]

One of the most striking differences between US and German corporate governance is the levels of executive compensation. The raw level of compensation is substantially higher in the US than in Germany, much of it consisting of stock options and awards given to managers. These so-called incentive compensation plans purport to align the interests of managers with shareholders. Some would say their widespread use in the US just reflects the priority given that goal in the US and their lesser frequency in Germany reflects that goal's absence or irrelvance. But the talk of alignment is a myth that sanitizes management compensation packages that conflict with shareholder and labor interests.[159]

There is no evidence that the prevailing structure of executive compensation in the US comes anything close to aligning such interests and much evidence that the structure is simply random![160] Many corporations pay their managers stock options whose value increases simply by retention of earnings, rather than by superior deployment of capital to improve performance. But

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[158] Portions of this Section appeared previously in some of the author's other works: Lawrence A. Cunningham, The Essays of Warren Buffett: Lessons for Corporate America (1998), [*reprinted from* 19 Cardozo L. Rev. 1, 11 (1997)]; Lawrence A. Cunningham, Global Corporate Governance LXX No. 3 Aspen law & Business (Dec. 1998); and Lawrence A. Cunningham, The Endless Quest for Integrity in Financial Reporting, 2 PLI's 30th Annual Institute on Securities Regulation 11 (1998).

[159] *See* Andrei Shleifer & Robert W. Vishny, A Survey of Corporate Governance 14 (NBER Working Paper 5554, April 1996) ("options are often not so much an incentive device as a somewhat covert mechanism of self-dealing"); Charles M. Yablon, Overcompensating: The Corporate Lawyer and Executive Pay, 92 Colum. L. Rev. 1867 (1992).

[160] *See* Graef Crystal, Maximum Wage, Slate <http://www.slate.com> (July 17, 1997):

> [T]he variability of pay from one company to another is amazing. For 1996, 42 percent of the variation in CEO pay levels could be accounted for by company size and performance. Bigger companies pay a lot more than smaller companies, while better performing companies pay a tiny bit more than worse-performing companies. But that leaves 58 percent of the variation in pay unexplained. *It seems completely random.*

Randomness is a just a description of a state of ignorance. As likely, this variation is probably attributable to the lack of rigorous linking of pay to performance, in turn a function of inadequate board attention to this major problem of vertical corporate governance.

simply by retaining and reinvesting earnings, managers can report annual earnings increases without doing anything to improve real returns on capital. Stock options thus often rob the corporation and its shareholders of wealth and allocate the booty to the optionees. Indeed, once granted, stock options are often irrevocable, unconditional, and benefit the grantees without regard to individual performance–a form of instant robbery.

Even if stock options instill a culture that encourages optionees to think as if they were shareholders, optionees are not exposed to the same downside risks as shareholders. If economic performance improves and the stock price rises above the exercise price, they will exercise the option and share with shareholders in that increase. But if economic performance is unfavorable and the stock price does not rise above the exercise price, then they will not exercise the options. Shareholders suffer from the unfavorable performance but the option holder does not.[161]

Not only does the putative alignment of option holder and shareholder interests turn out to be a myth, these awards exacerbate misalignment of interests between option holders of the corporation–usually senior executives–and other workers. It increases substantially the ratio of compensation of high-paid executives to ordinary laborers, which is vastly higher in the US than in Germany or other European countries. Reaction to these sorts of problems has consisted mainly of sustained but mostly unavailing pressure to link stock options and other kinds of performance-based compensation to real performance of the individual optionee. At least as a matter of rhetoric, senior managers have recognized the point.[162] But how could they not? Opposing options linked to performance would be the executive equivalent of congressional opposition to motherhood.

One of the key issues in forging the merger between Chrysler and Daimler-Benz was the enormous executive compensation differences between those companies and of the ratios within those companies of compensation between the highest paid and lowest paid employees. In 1997, for example, Robert Eaton, Chrysler's chair, was paid total compensation of about $10 million or over 200 times average worker pay and nearly as much as the total compensation paid to all 10 members of Daimler-Benz's Management Board combined. Daimler's Chairman, Jurgen Schrempp was paid about one-tenth of what Eaton was paid, putting his compensation within a ratio of about 20:1 compared to average Daimler workers.

A major question was how the combined entity's compensation structure would look. Schrempp pointed out that the existing pay differences reflected cultural differences, particularly the somewhat more egalitarian corporate culture in Germany expressed through labor representation on Supervisory Boards. He also predicted that the way forward for Daimler-Chrysler and other transnational entities was precisely the US model (surprise), except that "the only way to make big

[161] *See* Subrata Chakrovarty, Three Little Words, *Forbes* 52-53 (Apr. 13, 1998) (quoting the author to the foregoing effect).

[162] *E.g.*, Annual Survey of CFO Compensation, *CFO Magazine* (Nov. 1998) (quoting a highly-paid CFO as being fully in favor of linking pay to performance).

pay packets socially acceptable is by linking them closely with performance."[163]

That is of course the rhetoric of corporate America, and given that the other corporate governance differences noted here are often more nuanced and subtle than generally advertised, one worries if this was Schrempp's main point when he said Daimler-Chrysler creates "the first German company with a North American culture."[164] If so, shareholders and laborers both better watch out, and also ought to unite for they have coextensive interests in policing this key area of vertical corporate governance.

German law so far has not been tested for its efficacy in policing excessive executive compensation due to its relative absence and the rarity of stock options to fuel it. US law has been tested and has failed as ill-equipped to police executive compensation. As a matter of corporate law, the general stance of Delaware and other courts has been to evaluate it, if at all, under a waste standard, an extremely rare doctrinal basis for upsetting corporate decisions.[165] In the case of executive compensation in particular, the courts have been quite deferential to management indeed.[166]

As a matter even of securities disclosure laws, while the SEC has for several years required substantial and focused disclosure of top executive compensation in comparative performance charts,[167] this form of compensation remains largely off-financial statement. Indeed, under US GAAP, except in the historically rare case of so-called variable stock option plans, nothing requires recording stock option awards as an expense on the income statement or as a liability on the balance sheet.[168]

SFAS 123 encourages but does not require entities to recognize compensation expense for

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[163] Financial Times

[164] Financial Times, Aug. 1998.

[165] *E.g.*, Steiner v. Meyerson, 1995 WL 441999 at *5 (Del. Ch. 1995) (allowing that claims of fraud, self-dealing and sometimes negligence can be sustained against corporate directors but that claims of non-fraudulent and non-negligent deals between disinterested parties that meet the legal standard of waste may are "rarest of all" and "possibly non-existence").

[166] *E.g.*, *id*. (grant of immediately exercisable stock option not subject to judicial review under doctrine of corporate waste so long as "there is *some* rational basis for directors to conclude that the amount and form of compensation is appropriate") (*emphasis added*).

[167] *See* Regulation S-K, Item 402, 17 C.F.R. § 229.402 (1998).

[168] *See* Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 123 (1998).

awards of stock, stock options and other equity instruments. (It only requires such accounting for such issuance effected to acquire goods or services from non-employees.) Entities opting out of recognition must disclose pro forma effects on net income and earnings per share of such issuance in the footnotes to financial statements. SFAS 123 also requires extensive disclosure from all entities offering stock-based plans concerning plan terms, exercise prices, and fair value assumptions.

As a practice matter, what this means is that management must measure the fair value of the awards using the fair value principles of SFAS 123. They then must decide, for employee compensation, whether to recognize these amounts as compensation expense on the income statement pursuant to SFAS 123 or continue to employ APB 25 and make the required footnote disclosure and pro forma calculations. The decision will invariably be based upon what ends up looking more attractive for the bottom line, rather than the degree to which the resulting financial statements have or lack integrity. This liberates boards and managers from burdening reported income with these expenses and gives boards enormous insulation from rebuke for allowing exorbitant option packages to be given out.

More charitably, SFAS 123's requirement of footnote and pro forma disclosure does provide users of financial statements with the tools to understand the significance of this form of compensation. But this should not be understood as a concession to the standard argument against recognition: that stock options are hard to value. They are no harder to value than almost everything else accounting has to value (think about the numerous judgments necessary to determine appropriate annual depreciation expense on a fixed asset such as an airplane).[169] Indeed with techniques such as the Black-Scholes option pricing model now widely used and understood it becomes more and more plausible to believe that valuing stock options is easier than valuing depreciated aircraft.[170]

Without the constraints of law or accounting, the job of policing executive compensation lies with the board. Its chief job on this subject–in US, German and other corporations–is to insist that executive compensation be pegged to contributions to corporate performance. Measuring executive performance by business profitability is the most definitive baseline, for shareholder interests as well as labor interests. Profits for measuring performance should be reduced by a charge for the capital employed in the relevant business or the earnings retained by it. Stock options should be granted,

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[169] *See* Lawrence A. Cunningham, Introductory Accounting and Finance for Lawyers 68-70 (1997).

[170] At least on one particularly pernicious practice concerning the re-pricing of stock options, however, financial reporting may begin to capture financial reality. Stock option re-pricing is a decision made by the issuer's board to reduce the exercise price of previously-granted options, usually in the light of a decline in the prevailing trading price of the optioned stock. It is in effect a gift to managers from managers that has proliferated substantially in recent years. FASB has announced that using this re-pricing technique renders a plan a so-called variable plan as opposed to a fixed plan and as such is subject to special treatment under APB 25 that requires recording expense currently (equal to the amount by which the exercise price is reduced).

if at all, based on how each individual optionee performed within his or her area of responsibility rather than on overall corporate performance.

As various groups around the world work to promulgate new international accounting standards,[171] the US position on accounting (or, more precisely, not accounting) for stock options should be resisted. The rhetoric of alignment of shareholder and manager interests through executive stock options should also be abandoned. Attention should be focused on creation of value for the corporation as a whole, properly measured, with rewards appropriately recorded. Boards need to take the leading role in these efforts. It is particularly important for US boards to do so immediately, to forfend spreading the disease of random executive compensation to other parts of the world as corporate globalization proceeds. More selfishly, if they fail to do so, it is also quite possible that US law will come to enable shareholders as well as workers to turn their social pressure into effective legal claims.[172]

B. Takeovers–Defenses and Offensive Strategies[173]

Just as the disease of random executive compensation must be contained as globalization spreads, so too as cross-border acquisitions proliferate must care be taken to minimize their downside as both a matter of offensive acquisition policies and defensive stances. Offensive acquisition strategies require careful board attention because of the strong possibility that even outstanding senior managers have interests that can conflict with corporate interests. Acquisitions are thrilling, particularly for CEOs. They give the CEO enormous psychic benefits by expanding his dominion and generating more action. When these sorts of impulses drive a CEO toward an acquisition, the acquisition often comes at corporate expense. Indeed, most acquisitions both result in workforce reductions which directly impair worker interests and fail to achieve gains in business value which directly impairs shareholder interests.[174]

The governance problem is that most acquisitions do not come to the board for discussion until the process is substantially underway and until after the CEO has invested substantial personal capital in it. To reject an acquisition proposal presented at that stage, a board easily can be seen as rejecting the CEO who brought it to them. It embarrasses the CEO at a time when he is very much

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[171] *See supra* text accompanying notes [Part II.A].

[172] *See* Lewis v. Vogelstein, 699 A.2d 327, 336-39 (Del. Ch. 1997) (denying motion to dismiss shareholder complaint alleging stock options plans amounted to waste); *see also* Greenfield, The Place of Workers, *supra*.

[173] Portions of this Section appeared previously in some of the author's other works: Cunningham, Buffett Essays, *supra*; Lawrence A. Cunningham, Warren Buffett on the Role of the Board, 19 The Corporate Board 6 (July/Aug. 1998).

[174] *See* NY Times, Nov. 27 or 29, 1998.

in the spotlight of his troops. Consequently, all directors–including non-employee directors–are under significant pressure to approve most acquisitions, even those that harm or do nothing to improve the lot of shareholders and workers.

It would be nice if a governance mechanism could be designed to alleviate this sort of pressure on the board, but the timing problem makes that difficult. It would be a mistake, moreover, to believe that an appropriate mechanism would be to adopt a strategic plan by which acquisitions can be measured.[175]

A better–and more fundamental–strategy is to improve some of the basic thinking that goes into evaluating acquisitions in the first place. For example, in paying for acquisitions, a company should issue stock only when it receives as much in business value as it gives. Many buyers, when not using cash or debt, violate this simple rule. Sellers in stock acquisitions measure the purchase price by the market price of the buyer's stock, not by its intrinsic value. If a buyer's stock is trading at a price equal to, say, half its intrinsic value, then a buyer who goes along with that measure gives twice as much in business value as it is getting. Its manager, usually rationalizing his or her actions by arguments about synergies or size, is elevating thrill or excessive optimism above corporate interests. In doing so, shareholders and workers interests are subordinated to management interests.

The flip-side of offensive acquisition strategy is takeover defenses. Anti-takeover devices such as the US poison pill protect management decision-making (as AMP's defense against Allied-Signal attests).[176] They can be anti-shareholder to the extent that they have the effect of discouraging attempts to acquire the corporation or remove incumbent directors even if some or a majority of stockholders deem such an attempt to be in the corporation's and their best interest and even if the potential acquiror is willing to pay a premium over the prevailing market price of the corporation's common stock. They equally can be anti-stakeholder. Restructurings that entail plant closings, for example, can impair employee interests and those that entail increased leverage in the capital structure can also impair lender interests–also as AMP's resistance to Allied-Signal suggested.

To be sure, there are cases where hostile offers are indeed inadequate and not in the interests of the corporation or any of its constituents. Yet incumbent managers facing unwanted takeover overtures are naturally going to resist, whether or not resisting is best for the corporation. After all, in most such cases their jobs are on the line. For US corporations–and probably increasingly for others–that also often will mean that unmatured stock options are at risk. Thus mechanisms that can aid in resisting inferior bids may equally be used in resisting superior bids and when so used are simply pro-management and anti-corporation.

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[175] *See* Lawrence A. Cunningham, Conversations from the Warren Buffett Symposium, 19 Cardozo L. Rev. 719, 740 (1997) (quoting Warren Buffett as saying that "more dumb acquisitions are made in the name of strategic plans than any other").

[176] *See supra* text accompanying notes.

Boards of corporations around the world must in these situations recognize that the CEO and his troops are under fire, much as they would be when proposed offensive acquisitions are challenged. As in that case, managers can be expected to adopt a siege mentality that obscures honest thinking about what is in the corporate interest. Also as in that case, there is no clear mechanism that can assure boards will respond properly, but recognizing what is happening psychologically is necessary to enable them to act effectively at all.

C. Capital Allocation and Dividend Policy

Virtually all jurisdictions put limits on the powers of a corporation to make distributions to its shareholders, but the limits are formal[177] and manipulable[178] and repose enormous discretion without meaningful limits in boards to set dividend policy, one of the most important sort of capital allocation decision there is.

US law gives boards of directors otherwise unbridled discretion in declaration and payment

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[177] Archaic legal capital apparatus are intended to do the work in the UK and in leading US states of incorporation, including Delaware and New York, although the RMBCA has created a regime that permits the dismantling of that system. DGCL §§ 160, 170, 172-74, 242(a)(3); 244; RMBCA §§ 6.21, 6.22; NYBCL §§ 504, 518. While some relaxation has occurred as to what constitutes valid consideration for securities (such as intangible property and services rendered), many statutes continue to exclude things such as promissory notes and contracts for future services. *E.g.*, NYBCL § ; *see* Lawrence A. Cunningham, The Modern Sensibility of New York's New Corporate Law, 69 Aspen Law & Business, Corporation, No. 3, Section 2 (Feb. 2, 1998). Typical US legal capital regimes such as Delaware permit dividends to be paid out of surplus, or if there is no surplus, net profits and permits share repurchases so long as effecting them would not impair the corporation's capital. DGCL §§ 160, 170; NYBCL § 510.

German law more nearly resembles the far more enlightened position of the RMBCA, which forbids dividends and other distributions unless after effecting them the corporation would have a positive net worth and be able to pay its debts as they come due in the ordinary course. German law also goes a nod further in the shareholder's direction by permitting dividends to be paid out of distributable profits as determined by resolution at a shareholder general meeting for the preceding fiscal year. French law in effect combines these limitations by permitting payment of dividends only out of retained earnings so long as they do not impair share capital and only if at the time of and immediately after such distribution, the amount of the corporation's net assets is at least equal to the sum of its share capital plus undistributed reserves.

English law is to the same effect, allowing a distribution only if at that time and immediately afterwards, the amount of the corporation's net assets is at least equal to share capital plus undistributed reserves. English law also provides that dividend declarations must give reference to accounts showing the availability of distributable reserves, usually its last audited accounts or interim unaudited accounts filed with the Registrar of Companies of England and Wales. English Articles may permit directors to authorize payment to shareholders of such interim dividends (i.e. dividends resolved to be paid by directors without the approval of shareholders in a general meeting), as appear to the directors to be justified by the company's distributable profits.

[178] *E.g.*, Klang v. Smith's Food & Drug Centers, Inc., 702 A.2d 150 (Del. 1997) (upholding management decision to revalue its balance sheet that made lawful a shareholder distribution (in the form of a share repurchase) that would have been unlawful under the legal capital rules without the revaluation).

of dividends,[179] which is rarely restricted in charters though it is sometimes restricted pursuant to a corporation's loan and credit agreements. Those restrictions are as often imposed on German corporations, whose Management Board otherwise also possesses pretty much full discretion in setting dividend policy as well.[180]

The policy of most US boards is to pay regular quarterly cash dividends, often at a stable or steadily increasing dollar amount, and the typical levels of dividends among US corporations is higher than among German and other European corporations. Given the importance of dividend policy in capital allocation decisions, these policies are often set for strange reasons such as giving the appearance of steadiness and reliability, signaling confidence and so on.[181]

A more rigorous approach should be used and if it were, the resulting payout ratios would probably converge, becoming lower in the US-UK and higher in Europe. The proper approach to a company's earnings payout versus retention decision should be based on a single test: each dollar of earnings should be retained if retention will increase market value by at least a like amount; otherwise it should be paid out.[182] Earnings retention is justified and should be done when, but only when, capital retained produces incremental earnings at least equal to what is generally available to the shareholders.[183] For companies that are able to do so, no dividends should be paid and boards should pay no attention to what "signals" this sends (though they might also pay attention to the tax advantages to shareholders of doing so).[184]

On the related question of distributions via share repurchases, one would also expect the

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[179] The exceptional case was Dodge v. Ford Motor Co., 170 N.W. 668 (1919), involving a closely-held corporation engaged in a larger business and competitive battle. Most cases even in those sorts of contexts refuse to upset board dividend policy decisions, e.g., Gottfried v. Gottfried, 73 N.Y.S.2d 692 (Sup. Ct. 1947), even if they are patently stupid (and involve public companies), e.g., Kamin v. American Express Co., 387 N.Y.S.2d 993 (1st Dep't 1976).

[180] *See* Enno W. Ercklentz, Jr., Modern German Corporation Law 149-51 (1979).

[181] *See* Lawrence E. Mitchell, Lawrence A. Cunningham & Lewis D. Solomon, Corporate Finance and Governance: Cases and Materials 740-44 (2d ed. 1996) [hereinafter Mitchell, Cunningham & Solomon].

[182] This is the standard, traditional, teaching of Ben Graham and David Dodd. *See* Cottle, Murray & Block, Graham & Dodd's Security Analysis 555-559 (5th ed. 1998) [hereinafter, Graham & Dodd]. It is also followed devotedly by Warren Buffett. *See* Cunningham, Buffett Essays, *supra*.

[183] *See* Graham & Dodd, *supra*, at 557; Cunningham, Buffett Essays, *supra*.

[184] *See* Mitchell, Cunningham & Solomon, *supra*, at 737-38.

optimal level to be somewhere between the norms prevalent in the US/UK and Europe. Share repurchases are far less common in Europe than in the US, but they are also too infrequent in the US. European law often either prohibits share repurchases or discourages them.[185] One reason behind this European aversion is a governmental attitude preferring reinvestment of available cash on the theory that that is a better way to create jobs.[186] This is of course only seduction, a view that focuses on the superficial and the political rather than the substantive and economic.

Dividends and repurchases recycle investment rather than dissipate it.[187] To the extent the level of share repurchases in the US is lower than optimal is probably due to a different reason: managerial cash hoarding for acquisition feasts of the type described a few pages ago. The dangers to American violators of the retained earnings test are the same dangers that afflict excessive retention in European corporations–the venturing into unprofitable projects that serve only managerial and not shareholder or worker interests.

D. Director Liability

Directors' feet must be held to the fire for all corporate constituencies in connection with

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[185] German law allows a corporation to acquire its own shares upon the authorization by shareholders in only limited circumstances and in any event not more than 10% of the outstanding shares. *See* . French law generally prohibits corporate share repurchases, except in limited circumstances such as to effect reductions in capital not motivated by losses and purchases of shares for the account of employees or to stabilize the trading price of the company's stock on a stock exchange. *See* .

[186] *See* 3 *Insights from the Investment World* (Oct.-Dec. 1998) at 12 (private investment newsletter written and published by Dr. John M. Theolotitis) (on file with the author) [hereinafter, Insights].

[187] *See* Insights, *supra.* Moreover:

> share repurchases are preferable because large dividend payments leave shareholders with unwanted tax bills and the question of the reinvestment of proceeds, and in the case of compounding businesses, extra money from the powerful compounding effect. The cautious application of a well designed dividend policy has long ago been established as a key factor that determines the company's good reputation–despite its questionable value–and as such is followed by almost all companies. In the case of compounding businesses where the compounding rate exceeds the free reinvestment rate of dividend amounts, after also taking into account the effects of taxation, shareholders will undoubtedly be far better off with the minimum or no dividend at all and the reinvestment of net earnings in share buybacks.

Id.

CEO selection, executive compensation, takeovers, and capital allocation. Yet neither in the US/UK nor in Europe does that occur for these types of actions. In the US, this is due in part to the business judgment rule and the rhetorical nature of fiduciary duty law, not to any lack of procedural enforcement devices through litigation. It is also due to liberal policies of director liability indemnification and immunization. In Europe, it is due not to any business judgment rule or rhetorical fiduciary tradition nor to director liability limitations but rather to a lack of enforcement mechanisms or incentives. In both models, therefore, directors are insulated (though from different sources) and on this comparative score of vertical corporate governance improvements in both models are coming due.

What risks of liability are US directors really exposed to? Almost none.[188] Most board decisions are strongly insulated from judicial review under the business judgment rule. Those involving conflicts or potential self-dealing are provided substantial protection via interested director statutes that sanitize such transactions and even when evaluated judicially the focus is on the process of decision-making rather than the substance.[189] Those involving corporate monitoring programs remain subject to evaluation under the duty of care and it is not very difficult to meet the required standard.[190] As already lamentably noted, it takes very little to discharge duties in connection with decisions concerning such key issues as executive compensation and dividend policy.[191]

While some boards have occasionally been held liable in connection with takeover defenses, that is rare, and in the case of offensive strategies basically unheard of. One of those rare cases was *Smith v. Van Gorkum,*[192] the case that spawned adoption of further insulation from director liability. In that case, the source of liability was the failure of directors to become adequately informed before taking a decision of enormous consequence to the corporation–the sale of the corporation! The legislative response to judicial imposition of director liability was a statutory invitation to director liability insulation via simple charter amendment[193] or, in some states, a statutory declaration of

[188] Apart from those to which all persons are subject, such as liability for crimes and fraud, including fraud under such sections of the the federal securities disclosure rules as Rule 10b-5 and Rule 14a-9.

[189] *See supra* text accompanying notes [Part II.D].

[190] *See In re* Caremark Int'l Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996); Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125 (Del. Ch. 1963).

[191] *See supra* text accompanying notes [Part III.A & C].

[192] 488 A.2d 858 (Del. 1985).

[193] *E.g.*, DGCL § 102(b)(7); RMBCA § 2..02(b)(4).

insulation without any need for a charter amendment.[194] Moreover, most US state laws also permit corporations to provide for indemnification of officers and directors defending third party actions arising from their service so long as the person acted in good faith and reasonably.[195]

These devices have functionally sealed off any real exposure to liability for directors of US corporations (other than red-handed thieves and defrauders). That has the virtue of helping to attract top directors to positions. It has the vice of helping to attract horrible or (and this is worse because it is less obvious) mediocre directors to the same jobs. They may be efficient to the extent that shareholders are better bearers of risk than managers and the insulation enables directors to optimize their risk taking and undertake projects that more risk-averse liability-exposed directors would shun.[196] On the other hand, the insulation can go too far in relieving directors of risk and shifting it to shareholders and other corporate constituents.[197]

Of course directors should not be entirely exposed to liability for all their decisions and it should not be possible to extract rents from them through extortionate lawsuits. The key point is that

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[194] *E.g.*, Ind. Code Ann. § 23-1-35(1)(e)(2) (immunizing directors from personal liability for breaches of the duty of care other than for willful misconduct or recklessness); *see also* Va. Code Ann. § 13.1-692.1 (while not changing the standard of conduct, imposing dollar limits on extent of director personal liability).

[195] They also generally allow the corporation to advance expenses needed by an officer or director to defend an action as long as they agree to repay the amount if later found not to be entitled to indemnification, as well as to provide directors and officers with insurance. *See* E. Norman Veasey et al, Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification and Insurance, 42 Bus. Law. 401 (1987). Often corporations will not indemnify for expenses when a director or officer is adjudged liable to the corporation in a derivative action, but do indemnify officers and directors when they are successful in defending a third party or derivative action The DGCL provides that the indemnification provided for in the DGCL shall not be deemed exclusive of any other rights under any bylaw, agreement, vote of stockholders or disinterested directors, or otherwise, and provides that expenses may be advanced to officers and directors in a specific case upon receipt of an undertaking to repay if the indemnified party is ultimately determined not to be entitled to it. *See* Advanced Mining Systems, Inc. v. Fricke, 623 A.2d 82 (Del. Ch. 1992) (noting that advancement of legal expenses and ultimate entitlement to indemnification are two distinct questions). In addition, the DGCL permits the determination as to whether an officer or director has met the applicable standard of conduct to be made in certain circumstances by independent legal counsel.

[196] *See* Reinier Kraakman, Corporate Liability Strategies and the Cost of Legal Controls, 93 Yale L. J. 857 (1984).

[197] *See* Joseph W. Bishop, Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers, 77 Yale L. J. 1078 (1968).

a balance between director protection and exposure must be struck. While it is hard to strike, abstractly or in particular,[198] the current balance is far out of whack. Doctrinally, the US middle ground has been staked out by the American Law Institute, which recommends mechanisms that neutralize disproportionate liability by director protection that does not abrogate the duty of care.[199] That balanced stance leaves at least some meaning to potential power of fiduciary duty rhetoric.[200]

Under that framework, it should be possible to require directors to be fully informed about, say, executive compensation packages and dividend policies, and know that if they approve pay packages unlinked to performance without knowing they were doing so or dividend policies that hoard cash at poor rates of return which are later spent on profitless acquisitions, that they might be responsible for those actions in the form of personal liability. Would exposing directors to personal liability for this sort of ineptitude reduce the number of directors willing to serve by deterring some from service? Probably, but the deterred would equally probably be those who would not give the attention those sorts of important questions deserve in any event and they should not be on boards in the first place.

Europe has not had such conceivable recruiting trouble, despite absence of rules of director immunization. German law does not permit director exculpation and extremely limits indemnification[201] and French law permits neither.[202] The formal exposure to liability these laws sustain for European directors may not at present be especially meaningful since where large bank debtholders and shareholders are also those serving on the boards, lawsuits by holders against boards are not very likely.[203] But consider English law, which also does not permit immunization and also

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[198] *See* James J. Hanks, Jr., Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification, 43 Bus. Law. 1207 (1988).

[199] *See* ALI, Principles of Corporate Governance § 7.19 (1994). At the other extreme, those who see no substantive value in the duty of care itself would be happy to abolish it, including through exculpation and indemnification mechanisms. *E.g.*, Kenneth E. Scott, Corporation Law and the American Law Institute Corporate Governance Project, 35 Stan. L. Rev. 927, 935-37 (1983).

[200] *See supra* text accompanying notes [Part II.D].

[201] It does permit corporations to indemnify a director for attorneys fees if successful in defending actions brought in jurisdictions in which winning parties bear their own litigation costs and, with shareholder approval, to waive or settle claims against directors over three years old. It also permits a corporation to indemnify its officers and in certain circumstances it must do so and permits corporations to buy insurance for directors and officers.

[202] *See*

[203] *See supra* text accompanying notes [Part I.B].

severely limits indemnification to narrow circumstances.[204] These have not deterred attracting top directors to shareholder market model corporations in the UK. And even if these European laws that expose directors to personal liability without indemnification now may not mean very much, as the forces of globalization continue the exposure is unlikely to remain unimportant. Retaining those laws will be important, however, and it can be expected that efforts to change them will be made and should be resisted.

Another possible reason for these national differences in director liability exposure (between the US and Germany at least) is the availability of enforcement mechanisms, principally litigation. US state laws permit shareholders to bring derivative actions on behalf of the corporation as well as class actions.[205] All the more reason to restrict director liability. German corporate law (and English law) provides for neither class actions nor generally permits shareholders to bring derivative suits.[206] All the less need to do so.[207] Again, as the landscape continues to change, however, attention should be paid to the interaction between these stances and their role in corporate governance.

The ability to maintain lawsuits is an important aspect of US corporate governance. It contributes to the depth and liquidity of capital markets by encouraging investment[208] and can help to discipline managers.[209] It is made possible in part due to a general cultural orientation toward

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[204] English companies may not indemnify directors or officers against liability for negligence, default, or breach of duty or trust, except liability incurred defending cases he wins (or if a court determines that even though he lost he had acted honestly and reasonably and should fairly be excused). They are permitted to buy insurance for directors and officers against such liability.

[205] Ordinarily, the shareholder must have been a shareholder at the time of the transaction which is the subject of the suit and through the duration of a derivative suit. Prior to bringing a derivative suit, the shareholder usually must make a demand on the directors of the corporation to assert the corporate claim unless such a demand would be futile.

[206] However, shareholders of German corporations acting at a meeting by a majority of votes cast or shareholders holding 10% of the outstanding shares may request the corporation to claim damages against directors of either board for breaches of their duties.

[207] In contrast, French law permits these suits, even as it limits director liability exculpation.

[208] *See* Andrei Shleifer & Robert W. Vishny, A Survey of Corporate Governance, 52 J. Fin. 737 (1997).

[209] *See* Philip E. Strahan, Securities Class Actions, Corporate Governance and managerial Agency Problems (Nov. 1998) (manuscript on file with the author).

judicial dispute resolution, but also through incentive structures not accepted elsewhere. In particular, it neutralizes an otherwise skewed incentive structure of derivative claims: the nominal plaintiff incurs substantial costs but reaps the gains only in proportion to its contribution to the corporate entity's equity (the payoff goes to the corporation). Some cultures may find it unattractive to so cede "ownership" of the claim from the shareholder to the lawyer[210] or may not see the shareholder as the proper "owner" of the claim in the first place.

Another way to address the skewed incentive structure would realign the incentives on the cost side by authorizing a country's public securities authority (analogous to the SEC) to fund lawsuits and on the benefit side by authorizing judges to award lead plaintiffs compensation for their efforts.[211] Another way to address the question of the proper claimant would be to allow not only shareholders but also other constituencies to sue. While this is pretty much off limits in US corporations,[212] it is not inconceivable[213] and would be in tune at least with historical traditions in Europe. On the other hand, in line with the trends in Europe that retreat from those traditions, precisely that sort of proposal died on the vine there.[214] The outlook for resolving these questions is therefore very murky indeed, though that tends to underscore rather than undermine the need for increased attention to the importance of vertical corporate governance worldwide.

E. Constituency Voice

Getting boards to listen to constituents would be an effective method of corporate governance but again legal and practical limits have frustrated this simple vehicle across the globe. Constituency voice is limited in part by rational apathy and collective action problems, but this is only part of the trouble.

Most US state laws authorize corporations to establish procedures governing the making of

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[210] *See* Procaccia, *supra* note, at 641-43.

[211] *Id.*

[212] Instead, workers of US corporations have claims, if any, against the corporation as a juridical entity, yet they also have a bewildering array of grounds available to them to protect their interests. Workers and lenders of course may have contract rights, in the form of employment or collective bargaining agreements on the one hand or loan agreements on the other. The sources of these rights, unlike in Europe, derive not so much from the internal governance mechanisms of corporate law but from other bodies of law.

[213] *See* Greenfield, The Place of Workers, *supra* note [Part I.A]..

[214] *See supra* text accompanying notes [Part II.A].

shareholder proposals at annual or special meetings[215] and SEC rules impose additional rules on what proposals management must include in its proxy statements and which it may exclude.[216] As a matter of practice, management would on average strongly prefer rules that enable them to omit shareholder proposals from their proxy statements and every year hundreds of them try to do so.[217]

In many of those proposals, constituency interests do conflict. This is principally because in the US virtually anyone can satisfy the eligibility requirements for compelling a corporation to include a so-called "shareholder" proposal on the corporation's annual proxy statement. Under US Federal proxy rules it is enough to be eligible to own 1% or $1,000 in market value of the corporation's equity for one year.[218] "Shareholder" proposals thus often turn out to be made by nominal shareholders,[219] proposing such things as reporting requirements concerning environmental impacts of corporate actions or relating to race and sex discrimination or human rights activities around the world.[220]

One of the most dramatic recent examples of the controversial contours of these rules was championed by employees advocating greater toleration for gay and lesbian workers of Cracker Barrel Stores.[221] The SEC vacillated on whether management could exclude that proposal on the grounds that it interfered with the "ordinary business operations" grounds for exclusion under the shareholder proposal rule.[222] It ultimately yielded and, in promulgating new rules governing these proposals reversed its position to prohibit management to refuse to include such proposals to the

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215 *See* Auer v. Dressel, 306 N.Y. 427 (1954); Campbell v. Loew's, Inc., 134 A.2d 852 (Del. 1957).

216 *See* Securities Exchange Act of 1934, §14(a) and Securities and Exchange Commission Rule 14(a)(8).

217 *See* No-Action letters file in the SEC web-site or LEXIS data base.

218 Rule 14a-8(a)(1).

219 *See* Record Number of Resolutions Win Majority Votes, 8 IRRC Corporate Governance Highlights 129 (Oct. 24, 1997) [hereinafter, Record Number].

220 *See* Henry G. Manne, Shareholder Social Proposals Viewed by an Opponent, 24 Stan. L. Rev. 481 (1972).

221 Cracker Barrel Old Country Stores, Inc., No-Action Letter, 1992 WL 289095, 1992 SEC No-Act. LEXIS 984, *43 (Oct. 13, 1992).

222 Rule 14a-8(c)(7).

extent they implicate questions of social policy.[223]

German law is somewhat tougher. It empowers shareholders to put a matter on the agenda for resolution and have the Management Board submit a proposal at shareholder meetings but only if they hold in the aggregate at least 5% of the outstanding shares. The 5% requirement makes it pretty much prohibitive for non-shareholder interests to use this vehicle of voice as it has been used in the US. It is possible to understand this difference between German and US law also in terms of historical governance structures that gave formal representation to workers on boards and a corporate conception of the common interest or common good. Yet again, as these devices prove to be more formal than real[224] and as German corporations increasingly have shareholders from the US and other foreign countries,[225] the need for other avenues of constituency voice is likely to increase.

The US mechanisms for shareholder or other constituency voice can have meaningful constraining effects on managerial discretion. They have led to substantial changes in policies at many major corporations, for both shareholders and others. Beginning in the 1930s, the shareholder proposal rule was used to enhance shareholder rights with proposals seeking such things as cumulative voting and dissemination of post-meeting reports to shareholders.[226] The power of this device was harnessed by other constituencies to effect social change beginning in the 1970s with the famous Campaign GM that led to integration of GM's board of directors.[227] In the past couple of decades shareholders and other constituencies alike have used the device thousands of times and although most such campaigns do not carry a majority vote, increasing numbers are winning.[228]

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[223] The SEC initially determined that "distinctions between policies implicating broad social issues and the conduct of day-to-day business simply too hard to draw as regards the employment of the general workforce." *See* Amalgamated Clothing and Textile Workers Union v. Wal-Mart Stores, Inc., 821 F. Supp. 877 (S.D.N.Y. 1993). The Wal-Mart court rebuked the SEC's position on the grounds that it "sharply deviate[d]" from other positions it had taken, leading the court to refuse to defer to the SEC's positions. *Id.* As part of a general review and improvement of the shareholder proposal rule adopted in 1998, the SEC indicated that it had reversed its position in the original Cracker Barrel no-action letter. *See* SEC Release Concerning Rule 14a-8 (May 21, 1998) (new rules effective June 29, 1998).

[224] *See supra* text accompanying notes [parts of Parts I.A-D].

[225] For example, half of Daimler-Chrysler shareholders are US residents and a quarter of SAP's are. [Update for Deutsch Bank and Bankers Trust, etc.]

[226] *See* Lewis D. Solomon *et al.*, Corporations Law and Policy 597 (4th ed. 1998).

[227] *See* Donald E. Schwartz, The Public-Interest Proxy Contest: Reflections on Campaign GM, 69 Mich. L. Rev. 419 (1971).

[228] *See* Record Number, *supra*.

The problem is that management often opts not to implement even a winning proposal anyway.[229] And that is no surprise. After all, if management believed in the proposal they would have adopted it without need for a constituency proposal or vote. It may be that the only available tools to police director conduct in such settings–fiduciary duties–are simply inadequate for such a job. In addition, in the US there is a problem of stakeholder versus shareholder interest. Since everyone knows proposals can be made by nominal shareholders, even a proposal that wins the support of a majority of shareholders can be taken lightly.

Yet it is incongruous to allow constituencies (nominally shareholders) to exercise this right of voice and then allow management to ignore it. This may simply mean that the SEC rules are inappropriate or tend too much to alter conceptual underpinnings of state corporate law allocations of power between boards and managers on the one hand and shareholders and other constituencies on the other. But the overall framework of the shareholder proposal rule is dedicated to respecting such state laws and indeed is ultimately designed as a mechanism through which the proxy voting apparatus can serve as a surrogate for the old-fashioned live shareholder meeting.[230]

Indeed, the combination of easy access for all constituents of the proposal mechanism, and the requirement of a shareholder vote, should have the opposite effect on management in a corporate governance system that does extend its protections to a range of constituents. Boards should take these exercises of constituency democracy seriously. To do so, the traditional formulation and application of fiduciary duties would have to be modified on directive lines. In particular, boards could be called upon to review the proposal, to become fully informed with respect to it, and to adopt it following majority vote unless they can furnish compelling reasons not to. In short, if constituents vote favorably upon a proposal properly submitted, management should be obligated to act.[231]

F. Markets

Director liability and constituency voice can promote effective board superintendence of managerial power, yet neither these nor any other will impose sufficient discipline either at all corporations or in all contexts. Fortifying these mechanisms must be markets, particularly capital

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[229] *Id.*

[230] Federal courts evaluating the legitimacy of a corporation's claimed ground of exclusion look to state law to make that determination. E.g., International Brotherhood of Teamsters General Fund v. Fleming Cos., Inc., 1997 US Dist. LEXIS 2980 (W.D. Okla. Jan. 24, 1997), *appeal pending on certified question to the Oklahoma Supreme Court*. Trouble is, since the enactment of the Federal proxy rules the SEC has led the way in making determinations about application of the shareholder proposal, leaving state law on the subject pretty much undeveloped. *See Wal-Mart*, 821 F. Supp. at n.7.

[231] *Cf.* James P. Holdcroft, Jr. & Jonathan R. Macey, Flexibility in Determining the Role of the Board of Directors in the Age of Information, 19 Cardozo L. Rev. 291 (1997).

markets and executive labor markets. Governance mechanisms–here including external governance mechanisms–must be evaluated in part in terms of their impact on the operation of these markets.

In terms of reputational interest as a supplier of services in a market, individual managers or directors can be disciplined through public scrutiny and reporting of their performance.[232] Bad press leads to bad reputations and bad job prospects. That series of threats can hold directors' (and other managers' and people generally) to the fire. Yet a whole series of mechanisms exist that tend to interfere with the activation of these threats, including particularly a few mentioned earlier.

Excessive executive compensation neutralizes the threat by weakening the executive's dependency on labor income. Limits on director liability for inattention or foolishness also insulate the offending director from the kind of scrutiny that those actions would generate if a court were to announce that they were objectionable. The mechanisms of vertical corporate governance should not inhibit the mechanisms of external corporate governance in these ways, but unless revised along the lines suggested above they will continue to do so.

As for capital markets, they can impose discipline both in terms of a corporation's ability to attract capital and on its ability to evade becoming a takeover target. To be effective, depth and efficiency are required–a possible condition in the US/UK and an increasingly possible condition in Europe.[233] As with impairment of executive labor markets, the devices of vertical governance that capital markets facilitate are often impaired by external governance constraints, especially takeover regulation.

While continental European law is often seen as entailing substantial governmental regulation and intervention (and is called corporatist) and US/UK law as free market (and is called capitalist) this is no more a complete picture than the abstract comparative pictures drawn of governance models in Part I. The US and UK impose substantial external governance regulations on these markets compared to Europe,[234] retarding efficiency in ways that render those markets' effectiveness more like their effectiveness in Europe (in much the same way directors are insulated from liability in both models from different sources).[235]

In the UK, takeovers of PLCs are regulated by the City Code on Takeovers, which contains

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[232] *See* Cunningham, Conversations from the Buffett Symposium, *supra* note , at 727-28.

[233] *See supra* text accompanying notes [Part II.A].

[234] *See* Fabrizio Barca, Some Views on U.S. Corporate Governance, 1998 Colum. Bus. L. rev. 1 & Gerard Hertig, Corporate Governance in the United States as Seen From Europe, 1998 Colum. Bus. L. Rev. 27.

[235] *See supra* text accompanying notes [Part III.D].

a number of restrictions on action by target company boards that would frustrate a takeover offers, including issuance of new shares without prior shareholder approval.[236] The English Companies Act also contains rules relating to takeover offers, including a requirement that if an acquirer obtains or agrees to obtain 90% or more in value of shares, it may within two months after reaching the 90% level, by notice, acquire the remaining shares on the same terms as the offer.[237] Holders of those remaining shares can apply to a court to be relieved of the obligation to sell to the acquirer or to have the court specify different terms of transfer. Alternatively, those remaining shareholders not given such notice may compel the acquirer to buy their shares.

The US Exchange Act contains extensive provisions regulating tender offers, mainly imposing requirements on the form of an offer and also requiring comprehensive and detailed disclosure upon commencement of a tender offer. Requirements include a 20 business day minimum offering period, shareholder withdrawal rights coextensive with the offering period, withdrawal rights after 60 days from the date of the initial offer if the offeror has failed to pay, pro rata acceptance for oversubscribed offers, nondiscrimination among offerees, and the extension of any price increase during the tender offer to all shareholders who had previously tendered. These all have the effect of tilting the level of play in favor of targets and against insurgents.[238]

Worse, state laws also impose extensive regulation of takeovers in the US that often makes hostile takeovers far more difficult and costly to effect. Typical examples prohibit business combinations[239] between a corporation and a 10% or greater shareholder (called an interested holder) unless either the share acquisition or business combination was approved by the board of directors of the corporation before the shareholder became an interested shareholder or a period of years–often five–have elapsed and the deal is either approved by a majority of the non-interested shareholders or those shareholders are paid fair value for their stock. Other statutes provide that upon an acquirer obtaining 20% or more of the target's voting stock it must file a disclosure statement, following which target management may call and hold a special shareholders meeting (within say 50 days) at which disinterested shareholders vote to determine whether the acquirer's shares should have voting rights–absent that approval, those shares lack voting rights. Moreover, failure to file the required disclosure statement empowers the target to redeem the acquiror's shares at a price determined by

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[236] *See*

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[238] *See* Dale Arthur Oesterle, Revisiting the Anti-Takeover Fervor of the '80s Through the Letters of Warren Buffett: Current Acquisition Practice Is Clogged by Legal Flotsam from the Decade, 19 Cardozo L. Rev. 565 (1997).

[239] These statutes typically define business combinations to include certain mergers, sales of assets, sales of five percent or more of outstanding stock, loans, recapitalizations, liquidations and dissolutions.

the target.[240]

These devices impair the efficacy of capital market discipline, which is already limited by its own internal inefficiencies evidenced by gigantic stock gyrations as the norm with an average company's high and low over a 52-week period extending in a range of 50%.[241] These regulations have been virtually nonexistent in continental Europe, but with the new European exchange structure[242] you can be sure there will be pressure in that direction.[243] Granted, these devices–like

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[240] A main consequence of many takeovers effected by management against shareholder interests is the cashing out of shareholders at prices the shareholders deem inadequate. When the front-end devices of internal corporate governance fail in that respect, shareholders can be protected by appraisal rights as back-end discipline. Under US state laws, a stockholder of a corporation participating in certain major corporate transactions may, under varying circumstances, be entitled to receive cash equal to the fair market value of the shares held by such stockholder (as determined by a court of competent jurisdiction or by agreement of the stockholder and the corporation), in lieu of the consideration it would otherwise receive in the transaction. Some states–notably Delaware and New York, though not the RMBCA states—also provide a "stock-market" exception to these rights with respect to (a) a sale of assets, (b) a merger by a corporation, if the shares of the corporation are either listed on a national securities exchange or designated as a national market security on an interdealer quotation system by the National Association of Securities Dealers, Inc. or held by more than 2,000 shareholders of record or if stockholders receive shares of the surviving corporation or of a listed or widely-held corporation, or (c) a merger in which the corporation is the surviving corporation if no vote of its stockholders is required to approve the merger. This is a pro-management exception unknown to German law, where shareholders are entitled to a valuation proceeding to determine the adequacy of consideration to be paid in connection with transactions including mergers and freeze-outs, subject to statutory procedural requirements. Some may see these differences as properly reflecting different degrees of efficiency in the respective capital markets of the US and Germany. While there are certainly differences, there is also reason to doubt that US capital markets are so efficient to justify this exception to the appraisal remedy.

[241] *See* Thomas C. Frame, Equities: US Equities, in Morgan Stanley Dean Witter, Asset Allocation Review and Outlook (3Q 1998 & 4Q 1998) (on file with the author); *see also* Lawrence A. Cunningham, From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Market Hypothesis, 62 Geo. Wash. L. Rev. 546 (1994).

[242] *See supra* text accompanying notes [Part II.A].

[243] *See supra* text accompanying notes [Part II.A]. It is possible that these anti-takeover mechanisms are unnecessary in Germany since worker representation on the supervisory board would resist allowing shareholders to wrest control if they intended to disrupt employment as a result. *See* Roe, Some Differences, *supra* note at 1970. Yet not all takeovers have such an effect on workers so co-determination is not a complete anti-takeover device. Managers facing

poison pills and other private company takeover defenses–are sometimes useful in enabling boards to deflect offers that would dis-serve corporate interests.[244] Finding the ideal balance is an awesome challenge, as the experience in the US shows. It will be no less challenging for Europe and the rest of the future corporate world as it moves, seemingly inexorably, toward convergence, compromise, and middle grounds in trade-off dilemmas.[245]

Conclusion

The proliferation of cross border deals is hastening the fusion of corporate governance principles around the world. Despite substantial cultural, legal and business differences that do exist and persist across national boundaries, the differences are not so pronounced as to prevent business combinations of companies organized in different countries and those business combinations both draw upon points of governance harmony and help to forge deeper fusion. Cross-border alliances among businesses and active engagement with their implications by numerous global organizations are leading to the articulation of a new global corporate governance template that uses existing tools to build a new corporate world order. The ultimate shape of that order should be guided by recognition of the extensive degree of commonality of challenges and forged to meet those challenges in a realistic way. In particular, the core problems world-wide corporations face are not all that different, particularly in terms of the vertical relationship between those in control of corporations and others. In those terms, the central jobs corporate boards face are at bottom pretty much identical. The sorts of basic vertical governance mechanisms that offer promise of helping directors do these jobs are also pretty much the same and the cultural barriers to enabling them are far lower than in cases of external or horizontal governance settings.

enhanced capital market scrutiny may begin to look for other devices.

244 *See supra* text accompanying notes [Part I.C].

245 *See supra* text accompanying notes [Part I.C].