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†

Lawrence A. Cunningham††

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INTRODUCTION

Discussions of comparative corporate governance have revived the old question of corporate social responsibility: For whose benefit does the corporation operate?¹ Customarily, it is thought that corporations in the United States and United Kingdom operate primarily for the benefit of shareholders. On the other hand, corporations in Germany and other continental European countries are thought to operate for the common good—for the benefit of the shareholders, workers, creditors, and communities. At an abstract level, both generalizations are correct.

Commentators describe national models of corporate governance at a high level of generality for two reasons. First, a variety of corporate governance practices exists both within a particular country as well as across national borders. Second, the various legal systems that relate to corporate governance aim at protecting different interests, and they do so in diverse ways. A national model simply cannot incorporate all of these nuances. Therefore, it is always useful to encourage new conceptions of corporate governance that do not rely on a national model, but that instead transcend borders, whether international or intranational. To arrive at such a conception requires a new framework that distinguishes between the differing types of governance mechanisms that corporations use.

Corporate governance mechanisms can be divided into the following three categories: (1) internal-vertical, (2) internal-horizontal, and (3) external. Internal governance mechanisms are classified as vertical when they address the relationship between those in control of the corporation and all other constituents (including shareholders, workers, lenders, and communities). Internal governance mechanisms are considered horizontal when they directly regulate the relationships among these various constituencies *inter se*. External governance mechanisms are those rules and regulations imposed upon the corporate entity to address concerns beyond the direct interests of the corporation. They include rules about competition and antitrust, national trade, and public health and safety. In comparative corporate governance, horizontal and external mechanisms usually demonstrate specific distinguishing features, while vertical governance mechanisms appear more universal and general.

¹ Compare A.A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049, 1049 (1931) (stating that corporate powers are "at all times exercisable only for the ratable benefit of all the shareholders"), with E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1148 (1932) (asserting that the corporation is "an economic institution which has a social service as well as a profit-making function"). For recent analysis 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).

Part I of this Article examines the main characteristics of dominant models of corporate governance and finance: the market model (followed in the United States and United Kingdom); the European bank/labor model (followed in Germany and France); and, briefly, the Japanese bank model. The increased globalization of market economies has caused the differences in governance mechanisms to wane. Part II presents descriptive and theoretical evidence supporting this thesis and demonstrates how commentators have overdrawn these differences. It also emphasizes how market, structural, and regulatory forces have contributed to the convergence of governance mechanisms. This Article asserts that vertical mechanisms play an important role in comparative corporate governance and, in fact, transcend much of the underlying differences created by the various external and horizontal mechanisms.

This insight suggests that commentators ought to worry about vertical corporate governance mechanisms at least as much as they concern themselves with the external or horizontal ones. Accordingly, Part III identifies and evaluates key international vertical governance issues. It includes both general topics of corporate governance and an analysis of specific issues most likely to pose increasing difficulties as globalization proceeds.² In particular, Part III emphasizes the role boards of directors must and can play when they address vertical governance issues. Among the chief mechanisms available to inform such board action are the rules governing or affecting director liability, constituency voice, and unimpaired markets. The thesis, in short, is that vertical governance issues will play a central role in the globalization of corporate governance because the underlying issues and corrective mechanisms are common to corporate constituencies worldwide.

I

COMPARATIVE CORPORATE GOVERNANCE

Comparative corporate governance is the study of different ways in which countries allocate power among participants in a corporation. This study typically includes an analysis of how financial institutions, institutional investors, and markets monitor and constrain managerial discretion.³ It considers a range of national differences in law and practice on such matters as to whom managers are responsible, the roles of labor and lenders in the corporate governance sys-

² As Part III describes, these problematic issues include executive selection and compensation, acquisition policies, and capital allocation and dividend policies.

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 n.1 (1996).

tem, and the effects of different qualities of capital markets on corporate control and performance.

Commentators commonly describe results of comparative corporate governance inquiries as a stylized and simplified story of the dominant models, which emphasizes major differences only in the abstract.⁴ One can think of these generalized differences as lying upon two axes: constituency characteristics (mainly shareholders versus all stakeholders) and finance characteristics (mainly disaggregated versus concentrated investment).⁵

A. The Shareholder Market Model

In the United States and United Kingdom, two internal groups constitute and regulate a corporation: managers and shareholders. Shareholders own the corporation's equity, the value of which fluctuates with the fortunes of the corporation. Managers consist of both the daily operators of the corporation (the officers) and those who oversee and supervise those operations (the directors). The key problem in U.S. and U.K. corporate governance is the separation of ownership from control resulting from the shareholder-manager dichotomy.⁶ Sometimes described as a problem of agency costs,⁷ two broad sets of mechanisms—monitoring and exit—address the issues raised by this problem.⁸ Monitoring mechanisms either impose duties on managers⁹ or empower the shareholders to take action against the

⁴ Much of the literature on comparative business law deals with particular countries or particular issues. For extensive collections, see FRANK WOOLDRIDGE, *COMPANY LAW IN THE UNITED KINGDOM AND THE EUROPEAN COMMUNITY: ITS HARMONIZATION AND UNIFICATION* (1991); Takeo Hoshi, *Understanding Japanese Corporate Governance*, in *CORPORATE GOVERNANCE TODAY* 649 (The Sloan Project on Corporate Governance at Columbia Law School ed., May 1998) [hereinafter *The Sloan Project*]; Jonathan Macey, *Italian Corporate Governance: One American's Perspective*, in *The Sloan Project*, *supra*, at 677; Geoffrey Miller, *Political Structure and Corporate Governance in England*, in *The Sloan Project*, *supra*, at 629; Mark J. Roe, *German Codetermination and German Securities Markets*, in *The Sloan Project*, *supra*, at 727; Paul Windolf, *The Governance Structure of Large French Corporations*, in *The Sloan Project*, *supra*, at 695.

⁵ Another principal distinction could be that between advanced or developed economies, and emerging or undeveloped economies. See Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1920-29 (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 & HUNG-KI KIM, *CORPORATE GOVERNANCE IN TRANSITIONAL ECONOMIES: INSIDER CONTROL AND THE ROLE OF BANKS* (1995).

⁶ This foundational insight is always credited to ANOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

⁷ This description is always credited to Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308-10 (1976).

⁸ This conception of the shareholder's position and choices is always credited to ALBERT O. HIRSCHMAN, *EXIT, VOICE, AND LOYALTY* (1970). For a brief description of exit and voice, see *id.* at 3-5.

⁹ Examples include the duties of care and loyalty for the benefit of the stockholders.

managers.¹⁰ Exit mechanisms include, most importantly, the free transferability of ownership interests, which enables shareholders to sell their stock and thus exit the corporation at will, often called the "Wall Street Rule."¹¹

Monitoring and exit mechanisms reinforce the financial and labor markets, and vice versa. Shareholders may only oust inferior managements using monitoring mechanisms, such as proxy contests and consent solicitations, because a market for managing and controlling corporations exists.¹² The free transferability of ownership interests—an exit mechanism—has contributed to the development of deep, liquid, and functionally efficient capital markets. Disclosure laws in the United States, which promote the transparency of corporations' performances, are primarily responsible for these market forces.¹³

Corporate transparency, coupled with the common law tradition of at-will employment, also facilitates reasonably well-functioning labor markets. For example, if managers perform poorly, corporate transparency makes it more likely that shareholders will vote to oust them and other corporations will refuse to hire them readily. At the same time, however, managers can contract and expand their employee base to enhance performance. Of course, labor unions often gain substantial power through collective bargaining agreements which contract and federal labor laws protect. That power does not derive, however, from externally imposed regulation, but rather from the product of voluntary contractual arrangements. Finally, consumer product markets also contribute to the discipline of corporate managerial performance by registering preferences which eventually lead to corporate profits.¹⁴ Nonetheless, in the end, labor markets are far from perfect, and it is not uncommon, for example, to see senior ex-

¹⁰ Examples include shareholder election of directors, powers to remove and replace directors, and shareholder rights of action.

¹¹ See Arthur R. Pinto, *Section III: Corporate Governance: Monitoring the Board of Directors in American Corporations*, 46 AM. J. COMP. L. 317, 344 (1998) ("In the past, shareholders disappointed with their investment would follow the 'Wall Street Rule' and choose to sell their shares rather than try to influence corporate behavior.").

¹² See, e.g., Daniel R. Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1, 5-7 (1978) (discussing the market for corporate control).

¹³ See Lawrence A. Cunningham, *Capital Market Theory, Mandatory Disclosure, and Price Discovery*, 51 WASH. & LEE L. REV. 843, 856-61 (1994) (noting the importance of price discovery in the marketplace and how mandatory disclosure rules further this discovery). But see FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 276-314 (1991) (arguing that the present structure of mandatory disclosure laws does not necessarily promote more efficient markets).

¹⁴ See *infra* Part III.A.I.

ecutives earn staggering compensation despite mediocre or subpar performance.¹⁵

In the United States, the great American pastime, litigation, reinforces these monitoring mechanisms.¹⁶ Shareholders are equipped with a vast arsenal of legal claims, procedural devices, and legal and equitable remedies to protect their interests. They benefit from a specialized group of lawyers who not only bring direct, derivative, and class action suits under both state and federal law, but also identify and communicate the bases for such actions and even finance them.¹⁷

The rights of other constituencies in the corporation differ from those of shareholders. Contracts set employee, supplier, creditor, and customer rights. Several rationales exist to support this treatment.¹⁸ For example, upon bankruptcy or liquidation of a corporation, shareholders become residual claimants of the corporation's assets; their claims are paid only after the claims of other groups are paid. Shareholders, aware of their position in bankruptcy, theoretically protect their interests as prior claimants by directing management in ways that avoid financial trouble. Hence there is no need, for example, for corporate managers to owe noncontractual duties to lenders.¹⁹

In the market model, corporate governance can therefore describe the relationships among all of the participants in the corporation. Yet, the special status of shareholders in the United States and United Kingdom forces one to concentrate on their legal relationship with managers as a mechanism to attenuate the significance of the separation of ownership from control. While proponents of reform regularly urge greater rights for other participants in the firm,²⁰ other substantive bodies of law—most notably contracts, but also labor law,

¹⁵ Cf. *infra* Part III.B.3 (discussing how capital markets and executive labor markets impose discipline on managers).

¹⁶ See Charles Yablon, *On the Contribution of Baseball to American Legal Theory*, 104 YALE L.J. 227, 228 (1994) ("It is a pastime Americans indulge in more frequently than any other people on earth. That game, of course, is litigation.").

¹⁷ For a brief history that outlines the rise of contingency fee arrangements, an increasingly common device by which lawyers finance lawsuits for their clients, see Lester Brickman, *Contingent Fees Without Contingencies: Hamlet Without the Prince of Denmark?*, 37 UCLA L. REV. 29, 35-44 (1989).

¹⁸ See Mark E. Van Der Weide, *Against Fiduciary Duties to Corporate Stakeholders*, 21 DEL. J. CORP. L. 27, 39 (1996) ("A linchpin of the argument on behalf of the shareholder model is the proposition that other stakeholders in the corporation are capable of protecting their interests by statute or contract").

¹⁹ In this particular example, however, lenders and equity holders may have conflicting interests that managers must appease. See, e.g., *Credit Lyonnais Bank Nederland, N.V. v. Pathe Comm. Corp.*, 1991 WL 277613, 42 n.55 (Del. Ch. 1991), in 17 DEL. J. CORP. L. 1099, 1155 n.55 (1992) (describing how the possibility of insolvency can alter director duties, elevating creditor interests above equity interests).

²⁰ Proponents of labor most notably make this argument. See, e.g., Kent Greenfield, *The Place of Workers in Corporate Law*, 39 B.C. L. REV. 283, 287 (1998) (advocating "the inclusion of workers' concerns and interests within the heart of the corporate enterprise").

commercial law, debtor-creditor law, consumer protection law, and corporate finance—address nonshareholder interests.

The special status of shareholders also 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 aspect of the fragmented ownership structure generates an entrepreneurial spirit which encourages widespread participation in equity investment, both in terms of those who demand it (startups and expanding enterprises) and those who supply it (venture capitalists and investors generally). This ownership structure also rests upon a cultural aversion to concentrations of power. An example of this preference for power diffusion can be seen in the Glass-Steagall Act,²¹ which segregated the industry of investment banking from that of commercial banking.²²

Corporate governance mechanisms reflect these forces and embody a complex system of checks and balances on managerial power to protect shareholders. Additionally, these forces, when coupled with the deeply ingrained principle of freedom of contract in the United States, have produced a shareholder-primacy model which protects the interests of other participants in the corporation through contract law.

B. The Bank/Labor Model

The bank/labor model is characteristic of many continental European corporate finance models. In contrast to the shareholder market model’s fragmentation of ownership, the central finance features of the bank/labor model are ownership concentration and substantial investment intermediation.²³

Banks act as financial intermediaries by accepting individual deposits and compiling them for investment in corporations. Only a relatively small number of such investing entities exists. This concentration of ownership and debt holdings reduces the pressure for the development of actively functioning, deep, and liquid capital

²¹ Banking Act of 1933 (Glass-Steagall), ch. 89, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.).

²² See 12 U.S.C. § 24 (1994); MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* 42-44 (1994).

²³ See Mark J. Roe, *Some Differences in Corporate Structure in Germany, Japan, and the United States*, 102 YALE L.J. 1927, 1939 (1993) (“To an American observer, this control over large voting blocks [by German banks], rather than control over credit, is the biggest difference between the German and the American structure.”). According to Roe, “frequently a handful of institutional shareholders votes 20% of a [German or Japanese] firm’s stock,” while “even after the concentration and institutionalization of recent years, the largest five shareholders [in a U.S. firm] rarely together control as much as 5% of a large firm’s stock.” *Id.* at 1936.

markets.²⁴ Moreover, unlike with the U.S. Glass-Steagall Act, no legal separation of commercial and investment banking mitigates this concentration of investment ownership.

This centralization results in a small and powerful body of shareholders and debt holders, whose dual position requires few regulatory governance mechanisms as compared to the intricate system of checks and balances seen in the U.S.-U.K. market model. Because a single bank acts as both primary shareholder and debt holder, there is less pressure to choose between models that favor either shareholders or other constituencies of the corporation.

Also, less need exists for regulating governance mechanisms due to traditions that have put labor at the center of the governance structure, rather than as a participant with contractually defined interests. European nations have a deep commitment to worker protection, evidenced by their wage-setting policies and their laws that make firing workers difficult (in contrast to the at-will employment rule of the common law). These sorts of forces also may explain why the disparity in compensation levels between senior executives and ordinary laborers is relatively narrower under the bank/labor model than under the market model.²⁵

The German and 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 which management must consult on a variety of matters concerning corporate policy.

In terms of formal governance, German corporations generally have a two-tiered board system which consists of a management board and a supervisory board.²⁶ The management board (*Vorstand*) manages the corporation, represents it in third-party dealings, and submits regular reports to the supervisory board.²⁷ The supervisory board (*Aufsichtsrat*) appoints and removes the members of the management board and oversees the management of the corporation.²⁸ Under German law, employee-elected and shareholder-elected representa-

²⁴ This concentration of ownership may explain why there tends to be a greater proportion of debt than equity in the average corporate capital structure under the bank/labor model as compared to the debt-equity mix in the market model.

²⁵ See, e.g., *infra* text accompanying notes 193-98 (describing how the enormous difference in compensation rates between the United States and Germany raised a difficult issue in the Chrysler and Daimler-Benz merger).

²⁶ For a general discussion of Germany's two-tiered model, including the roles of both the management board and the supervisory board, see Thomas J. Schoenbaun & Joachim Lieser, *Reform of the Structure of the American Corporation: The "Two-Tier" Board Model*, 62 Ky. L.J. 91, 95-108 (1973).

²⁷ See *id.* at 95-98.

²⁸ See *id.* at 98-107.

tives compose the supervisory board in equal shares.²⁹ While it cannot make management decisions, the supervisory board may determine that certain actions or business measures contemplated by the management board require its prior approval.

The German dual-board structure is based on the concept of co-determination (*Mitbestimmung*).³⁰ According to this theory, because labor and capital co-determine a corporation's future, labor should protect its interests from within the corporate governance system through formal representation on the supervisory board rather than through contract or governmental regulation. Banks, which occupy the unique positions of debt holder and shareholder, comprise the other half of the supervisory board. Consequently, the separation of ownership from control, a defining characteristic of the shareholder market model, is expressly absent in the bank/labor model.

A directorate and a supervisory board typically govern a French corporation, known as a *société anonyme*. The directorate has extensive powers to manage the business affairs of the corporation.³¹ The supervisory board oversees the directorate and exercises permanent control over the management of the corporation.³² The supervisory board also chooses the directorate's members, determines their remuneration, authorizes any agreements between the corporation and the members of the directorate or of the supervisory board, and allocates attendance fees among its members.³³

While not as formal as the German co-determination model, the French version does purport to take literally the statement that management owes its duties to the corporation as a whole. This statement describes a stakeholder model of corporate governance. Managerial duties run to all participants in the corporation, including not only shareholders but also lenders and labor.

In the bank/labor model, even sole shareholders may lack power to remove or replace management. This lack of power is especially pronounced under the two-tiered board structure prevalent in Germany and the Netherlands, in large part due to work council regulations adopted across Europe. The European Community (EC) mandates that all members, save the United Kingdom, require most of their corporations to establish procedures for employee consultation and worker council formation.³⁴

²⁹ See *id.* at 99.

³⁰ See *id.* at 109-15.

³¹ See David J. Berger, *Guidelines for Mergers and Acquisitions in France*, 11 Nw. J. INT'L L. & BUS. 484, 491-93 (1991).

³² See *id.*

³³ See FRENCH BUSINESS ENTERPRISES: BASIC LEGISLATIVE TEXTS 38-40 (John H. Crabb trans. & ed., 1979).

³⁴ See Council Directive 94/45, arts. 1-2, 1994 O.J. (L 254) 64.

Many continental European countries have gone further than the EC mandates and require that virtually all corporations establish and maintain worker councils. Management must consult with these councils on major corporate policy affecting labor interests, including layoff proposals and, in many cases, potential changes of control.³⁵ Galvanizing this labor element in the corporate governance model, the EC also requires that employment contracts follow business assets when sold as a going concern, so that a buyer of such assets remains subject to those agreements by operation of law.³⁶

Compared to the European model, the Japanese variation deepens the roles of both labor and lender banks in the governance structure. As in Europe, banks tend to own the vast bulk of the debt and equity of industrial companies.³⁷ The distinguishing factual characteristic is the Japanese production model called "horizontal coordination."³⁸ Workers are generalists when it comes to the production process, and they engage in a substantial amount of information sharing and training throughout production. Limited specialization, however, requires high corporate investment in labor markets to develop the necessary human capital.

Japanese corporations thus face a higher risk of loss on investment from worker defection than European or American corporations. On the other hand, workers face the risk of acquiring nontransportable, firm-specific skills. Corporations and workers have addressed these risks by developing the system of lifetime employment. This policy provides workers with permanent job security and affords corporations a concomitantly restricted labor market.³⁹

³⁵ In the following countries, the number of employees of a corporation triggering the requirement of forming a worker council and the resultant obligation to consult the council on pending changes of control is as indicated: Belgium (100; presigning consultation, and management must inform shareholders of the council's views); France (50; presigning consultation); Germany (5; inform council, at the latest, immediately following signing); the Netherlands (35; presigning notification, and the council has some power to suspend or block the transaction upon application to a court). Italy does not require worker councils. While Spain requires them, it does not require any action upon an impending change of control. However, in both Italy and Spain, executives of companies have substantial rights following a change of control. See CLIFFORD CHANCE, *BUYING A EUROPEAN BUSINESS: A GUIDE TO NEGOTIATED ACQUISITIONS IN WESTERN EUROPE* 43 (2d ed. 1997).

³⁶ See Council Directive 77/187, arts. 1-5, 1997 O.J. (L 61) 26.

³⁷ See Roe, *supra* note 23, at 1936-40 & tbl.III (showing that a typical, large Japanese firm's stock is held in concentrated voting blocks and noting that "[t]he ownership of large firms in Japan is roughly analogous to that in Germany").

³⁸ Ronald J. Gilson, *Reflections in a Distant Mirror: Japanese Corporate Governance Through American Eyes*, 1998 COLUM. BUS. L. REV. 203, 207 ("Japanese production is characterized by horizontal coordination in which operating units are defined by the need for shared knowledge, rather than skill specialization.").

³⁹ See Ronald J. Gilson & Mark J. Roe, *Lifetime Employment: Labor Peace and the Evolution of Japanese Corporate Governance* (Mar. 5, 1998) (unpublished manuscript, on file with author).

No express, binding contract guaranteed this mutual security system, so the Japanese model turned to corporate cross-ownership to provide the necessary structural protections. Industrial corporations in Japan own substantial percentages of the securities of other industrial corporations.⁴⁰ The resulting ownership concentration is even more centralized than in the European model, and it causes a commensurate dilution of capital market disciplining power.

C. Theories and Trade-Offs

As cross-border competition has increased in product markets, comparative corporate governance scholars have begun to consider whether these differences affect corporate competitiveness and the degree to which competing models are converging. Important normative questions are at stake, including: (1) whether an optimal model exists, either one of the current models or a combination of all of them; and (2) whether the current models' differences derive from cultural, political, or social differences which render each model's optimality irrelevant except at a theoretical level.⁴¹

Some U.S. corporate law scholars interpret the U.S. experience as an evolutionary process toward a state of maximum efficiency, achieved through corporate contract.⁴² All constituencies of the corporation hold interests defined by contract or something resembling contract, and, according to proponents of this theory, the force of contractual freedom leads to wealth-maximizing relationships. As tempting as it is to understand one's past and present as moving along an inexorable path, not everyone would characterize the current approaches as inevitable. Some have challenged this contention directly while others have simply pointed to the variety of different models available.⁴³ Either way, the inexorable

⁴⁰ See Roe, *supra* note 23, at 1972 ("[In Japan] stocks . . . moved from individuals to banks and insurers, and cross-ownership bound finance and industry together.").

⁴¹ See generally Roberta Romano, *A Cautionary Note on Drawing Lessons from Comparative Corporate Law*, 102 YALE L.J. 2021, 2022 (1993) (contending that no "compelling evidence" exists to support a preference for German or Japanese models over the U.S. model).

⁴² See, e.g., EASTERBROOK & FISCHEL, *supra* note 13, at 1-39; ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* (1993); see also William W. Bratton, *The Economic Structure of the Post-Contractual Corporation*, 87 NW. U. L. REV. 180, 180 (1992) ("The large American corporation reemerged as a nexus for a set of contracts among individual factors of production.").

⁴³ See, e.g., Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641 (1996). Professor Roe, after comparing issues in U.S., German, and Japanese corporate structures and noting the path-dependent nature each institution has taken, asks whether "refining the evolutionary model [would] matter." *Id.* at 658. He quickly replies yes, and offers the following reasons:

First, we sometimes want to understand why we have the institutions we have, and efficiency alone cannot explain them all. Second, satisfactory resolution does not mean optimal resolution. Some systems would do better

path begins to look more like one attractive option among many.⁴⁴

These different models of corporate governance and finance have created a theoretical standoff. 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 quick responses to deteriorating financial conditions. The external monitoring function inherent in strong capital markets manifests itself on a daily basis and takes a variety of mundane forms, like the following: a tremendous volume of shares traded, vast quantities of detailed analysis and reports by financial analysts and business journalists, and information disseminated from corporate public relations offices and CEOs.

Innovations that improve corporate performance provide more evidence of the systemic adaptability hastened by the external monitoring of capital markets. Junk bond financing used to wage hostile take-over battles in the 1980s forced changes within corporate America. A large number of management buyouts (especially leveraged buyouts) had the same effect. In the 1990s, waves of consolidations and take-overs financed by equity securities, along with record numbers of initial public offerings, illustrate the U.S. capital markets at work—raising and allocating funds to improve performance. These sorts of capital market monitoring activities further prove the adaptability of U.S. and U.K. businesses within the market model. Reengineering, downsizing, restructuring, out-sourcing, spin-offs, split-ups, mergers, and leaner organizational structures are labels for real activities of change which take place regularly among U.S. and U.K. corporations.

Perhaps the most striking evidence of the adaptability afforded by the U.S.-U.K. model is the comeback of corporate America that began in the early 1980s. American industry lagged behind that of Japan, and conventional wisdom held that the Japanese bank model of corporate governance, with its lifetime employment and cross-sharehold-

by having more organizational techniques available: firms with different organizational forms would then compete for consumers' allegiance. Third, in analyzing legal business institutions, a path dependence search can affect our presumptions: if an institution, legal rule, or dominant practice arose to resolve a problem that is irrelevant today, then it should get less of a presumption of continuing utility.

Id.

⁴⁴ A whole literature that drew upon the science of path dependence emerged to explore these possibilities. See, e.g., Rock, *supra* note 3; Roe, *supra* note 43.

ing, created this gap. Corporate America soon rebounded with a vengeance, producing the longest expansion in the post-war economy, while Japan and the rest of Asia spun into financial crisis.⁴⁵

Such swift adaptation does have a downside. The very slogans of "downsizing" and "reengineering" capture some of the fallout which workers, communities, and other corporate constituents face. Workers get laid off. Plants close, causing factory towns to fall into economic stagnation. Moreover, such severe local economic downturns can create ripple effects that reach into the national economy.

This kind of fallout has been an especially sensitive issue among European countries, whose history and social politics place a far greater value on the short-term security of workers. As a result, these countries have laws requiring work councils, setting wages, and limiting an employer's ability to fire workers. These laws, however, come at a price: adaptability. This choice does not mean that European economies and corporations neither suffer nor recover from economic malaise. The key differences appear to be that adaptation occurs more slowly in Europe but economic hardships generally seem less severe because they are diffused across more economic sectors and corporate constituents.

With these trade-offs in mind and by characterizing the key differences between these models in terms of constituency (shareholders versus stakeholders) and finance traits (disaggregated versus concentrated), one may urge normative and theoretical prescriptions as to which model would better suit the coming world of global interconnectedness. However, the reality of global corporate governance and finance is less discordant and more convergent than the foregoing discussion suggests. The next Part examines the trends, traditions, and practices that support this reading of global corporate governance as polyglot.

II

GLOBAL CORPORATE GOVERNANCE

A multinational or transnational firm's selection of domicile entails choosing among different governance structures shaped by legal, cultural, economic, or political constraints. This decision can affect the entity's competitiveness in global markets, and if it does, one can expect firms organized in unfavorable regimes to push for change or simply to go elsewhere.⁴⁶ Increasingly keen competition among prod-

⁴⁵ See Gilson, *supra* note 38, at 215-20.

⁴⁶ The world would witness replication of the similar practice of competition among the states within the United States. See generally 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) (proposing that unless the European Union unifies its corporate

uct markets throughout the world should effect discipline without regard to domestic financial market design. On the other hand, strong links continue to exist between product markets or methods and corporate finance markets or governance structures. For example, the Japanese model often is explained by reference to its horizontal coordination method of production.

Movement toward global harmonization has eased the tension between competing corporate governance models in the past two decades because countries have sought to improve their corporate governance structures by implementing the best practices from around the world.⁴⁷ Increasingly, financial markets compete internationally just as product markets have done for decades. Investors (suppliers of capital) now look across borders for additional investment opportunities, while corporations and other organizations seek the lowest-cost capital from any market in the world. The isolation of capital markets is disappearing, and head-to-head competition among financial markets has ensued.

The robust competition among corporations in product, labor, and capital markets is being matched by a robust competition among corporate governance models. This competition suggests an increased integration of corporate governance practices around the world. However, obstacles to harmonization and systemic rigidities continue to preserve diversity among national laws governing corporations.⁴⁸ Thus, it is highly unlikely that a single, harmonic model will ever emerge, but the trend continues toward that end rather than away from it.⁴⁹

laws it "will experience a race to laxity" similar to what happened among the states of the United States). On that phenomenon in the United States, see Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987) (comparing two themes that explain Delaware's preeminence as a competitive supplier of corporate charters); Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709 (1987) (examining state competition for corporate charters). The classic stances on the virtues of this competition are reflected in the Cary-Winter debate. Compare William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974) (arguing for more federal regulation of corporations), with Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977) (arguing for the preferability of state regulation of corporate governance).

⁴⁷ See Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law* (Dec. 5, 1997) (unpublished manuscript, on file with Columbia Law School) (Columbia conference "Are Corporate Governance Systems Converging?").

⁴⁸ See Amir N. Licht, *International Diversity in Securities Regulation: Roadblocks on the Way to Convergence*, 20 CARDOZO L. REV. 227, 263-78 (1998).

⁴⁹ See *Corporate Governance Update*, 5 CORP. GOVERNANCE: AN INT'L REV. 255, 256 (1997) ("The harmonization of company law throughout the member states has been a long-standing ambition of the EC Commissioners in Brussels."); see also Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function* (Dec. 5, 1997) (unpublished manuscript, on file with the Columbia Law School) (Columbia Sloan Convergence Conference) (surveying various kinds of corporate governance convergence and conclud-

A. Trends

1. *Movement in Europe and Asia Toward a Shareholder Market Model*

The European Union (EU) is itself an integration of corporate finance and governance in many respects. Most significantly, adoption of a single currency will harmonize competition through the sharing of productivity differentials—the fruits of technological advancement and higher investment. Business expense differentials, particularly wages, should evaporate. The process is just beginning as countries adopt the euro and, within just a few years from now, abandon their local currencies.

Nearly as profound, new EC innovations have greatly diminished barriers to cross-border capital flows. A series of EC Directives seeks to compel abolition of foreign investment controls. Member states enthusiastically have responded to this call by relaxing their controls. The remaining restrictions generally are limited to notification requirements⁵⁰ or to specified sectors that pose national security or public health, safety, and welfare concerns.⁵¹ Many European countries simply have retained authority to implement such controls if necessary.⁵²

ing that “the most we can predict is substantial variation both across and within different national systems”).

⁵⁰ The following countries substantially relaxed their foreign investment control laws in the indicated year and now call for the notification indicated in table below:

RELAXING FOREIGN INVESTMENT CONTROL

Country	Year investment control relaxed	Remaining notification requirements
France	1996	Foreign investors in a “sensitive sector” ^a need to file a declaration of investment with the Treasury Department of the Ministry of the Economy
Spain	1992	Foreign investors must report to the General Directorate of Commercial Policy and Foreign Investment ^b
Germany	—	Report to Bundesbank
Belgium	—	Report to the Central Bank
The Netherlands	—	Report to the Central Bank

SOURCE: CLIFFORD CHANCE, *supra* note 35, at 40-41.

^a Sensitive sectors include government activities, research, manufacture or sale of arms, and those investments that may affect the public order, health, or safety. Foreign investments made in these sectors may be postponed for one month for a full review of the application. See CLIFFORD CHANCE, *supra* note 35, at 40-41.

^b Investments exceeding approximately \$3.8 million also must receive prior administrative clearance.

⁵¹ Examples of countries with such restrictions are France, which has certain restrictions on investments in activities of governmental or public authorities, research, and arms, and Spain, which imposes certain restrictions on investments in aviation, radio, television, telecommunications, gaming, arms, and national defense. See CLIFFORD CHANCE, *supra* note 35, at 40.

⁵² Examples of such countries include Belgium, the Netherlands, Germany, and the United Kingdom (although in the United Kingdom, the Secretary of State is empowered to

A series of fundamental principles has harmonized accounting rules within Europe. These principles include (1) a requirement of uniform formats for financial statements; (2) common valuation principles, including historical cost, accrual accounting, and the principle of conservatism called prudence; (3) a general mandate that financial statements show true and fair value; (4) an annual audit; (5) public filings;⁵³ and (6) consolidation principles.⁵⁴ This trend has further pushed the EU toward integration of corporate finance and governance.

Periodic resistance does rise up against these harmonization trends in Europe. For example, thirteen EC Directives 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,⁵⁵ were intended to promote at least regional (if not global) harmonization. However, none of these measures is currently among the EC's highest priorities.⁵⁶ On a few occasions, particularly during early EU convergence efforts, proposals for employee board representation derailed adoption of some integrated governance proposals.⁵⁷ Much of this resistance originated in the United Kingdom, which has for decades debated whether its future will be served better by an Anglo-Saxon, U.S.-U.K. alliance or a continental European, EU alliance.⁵⁸ Whatever obstacles this uncertainty may seem to pose for EU harmony, the

prohibit a non-U.K. resident from acquiring control of U.K. manufacturing entities if allowing such investment would be contrary to the public interest). See *id.* at 40-41.

⁵³ See Council Directive 78/660, 1978 O.J. (L 222) 11.

⁵⁴ See Council Directive 83/349, 1983 O.J. (L 193) 1.

⁵⁵ See Bernd Singhof & Oliver Seiler, *Shareholder Participation in Corporate Decisionmaking Under German Law: A Comparative Analysis*, 24 BROOK. J. INT'L L. 493, 537 & n.166 (1998).

⁵⁶ See *id.* at 537; see also Terence L. Blackburn, *The Societas Europaea: The Evolving European Corporation Statute*, 61 FORDHAM L. REV. 695, 763-69 (1993) (criticizing the original proposal).

⁵⁷ An early EU attempt at adopting governance structures requiring employee representation on corporate boards was dropped in the face of strong opposition. See Proposal for a Fifth Directive to coordinate the safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the SEC Treaty, as regards the structure of sociétés anonymes and the powers and obligations of their organs, art. 4, 1972 O.J. (C 131) 49. Similarly, an early proposal to compel financial disclosure for the benefit of employees was fiercely opposed and ultimately abandoned. See Amended proposal for a Fifth Directive founded on Article 54(3)(g) of the EEC Treaty concerning the structure of public limited companies and the powers and obligations of their organs, 1983 O.J. (C 240) 2. For an interesting and succinct history of the proposed directive and its subsequent amendment, see Bridget Montgomery, Comment, *The European Community's Draft Fifth Directive: British Resistance and Community Procedures*, 10 COMP. LAB. L.J. 429, 431-37 (1989).

⁵⁸ See generally Montgomery, *supra* note 57, at 437-51 (discussing British resistance to the proposed Fifth Directive).

United Kingdom actually has produced domestic convergence by drawing on both models.

U.S. corporate law, both common and statutory, drew upon and refined Anglo-Saxon traditions. The United Kingdom in turn has recaptured these traditions in its 1992 Cadbury Report on corporate governance,⁵⁹ renamed the Hampel Report in its final, 1998 version.⁶⁰ Both reports seek to identify the "best practices" of global corporations, and they tend to pick up on U.S. technical innovations in regulatory corporate governance, such as increasing the number and roles of independent directors, and creating board audit and nominating committees comprised mostly of independent directors.⁶¹ Institutional investors from the United States and United Kingdom that have pushed for these sorts of corporate governance reforms also have joined forces to promote global corporate governance efforts.⁶²

The United Kingdom's substantial role in Europe coupled with these U.K. links to U.S. corporate governance have tended to move the continental models toward the market model. The French experience serves as a helpful example. The stakeholder model and financial intermediation historically have characterized French corporate governance. At the same time, a state-dominated industrial policy has characterized French capitalism, producing firms of a smaller average size than in other capitalist countries and an industrial elite recruited not from within industry but from outside it.⁶³ This environment limits its capital markets' depth and monitoring capabilities.

Recently, however, the French model has been following the trend toward globalization and liberalism. The revisions have made the French model more closely resemble a market model, beginning with a loosening of the State's hold on industry through privatization efforts.⁶⁴ Additionally, the number of small shareholders is also growing and, following the United Kingdom, technical governance reforms based on U.S. models have been instituted widely.⁶⁵ Moreover,

⁵⁹ See COMMITTEE ON THE FIN. ASPECTS OF CORPORATE GOVERNANCE, THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE (1992) (CADBURY REPORT).

⁶⁰ See COMMITTEE ON CORPORATE GOVERNANCE FINAL REPORT (1998) [hereinafter HAMPEL REPORT].

⁶¹ See *id.*

⁶² 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 the alliance between CalPERS, the largest U.S. pension fund, and Hermes Pensions Management Ltd., the largest U.K. pension-fund manager—together holding nearly \$1 trillion in investments—to cooperate "across the oceans to affect corporate governance" (internal quotation marks omitted)).

⁶³ See Olivier Pastré, *Corporate Governance: The End of "L'Exception Française"?*, 1998 COLUM. BUS. L. REV. 79, 80-84.

⁶⁴ See, e.g., *France To Sell up to 30% of Thomson Multimedia*, N.Y. TIMES, July 31, 1998, at D3.

⁶⁵ See Pastré, *supra* note 63, at 86-87.

audit and compensation committees are forming in French corporate boards, minority shareholders are taking on increasingly important roles, and information superior both in quantity and quality is enhancing economic transparency.⁶⁶

A wave of European merger activity burst out in early 1999, with three major hostile take-over battles erupting. In France, Banque Nationale de Paris launched a \$38 billion hostile bid to take-over its two major French banking rivals, Société Générale and Paribas (and these two had only recently announced their own plan to merge with each other). In Italy, Olivetti launched a \$60 billion hostile bid to acquire its major rival Telecom Italia, which in turn erected a series of substantial defensive tactics designed to thwart the overture, including a white-knight alliance with Germany's Deutsche-Telecom. In another cross-border battle, France's LVMH Moët Hennessy Louis Vuitton waged a protracted and intense battle to obtain control of Gucci, an Italy-based but Netherlands-incorporated entity, which also strenuously resisted this unwelcome overture. These kinds of deals—in both their offensive and defensive modes—are reminiscent of U.S.-style merger activity and really are unprecedented in Europe.⁶⁷

The German model of "co-determination," with its formal worker representation on supervisory boards, looks radically different from the typical conception of the U.S.-U.K. model, which is dedicated to serving shareholders. The practice on most German supervisory boards, however, is limited to information access and a voice at the table rather than any real decision-making authority on operations, finance, or other corporate matters.⁶⁸ Indeed, managerial boards, composed of managers and shareholders, tend to dilute the power of the labor-dominated supervisory boards.⁶⁹ Ironically, the classical devices of corporate governance, such as the use of committees and strategic channeling of information, have driven this dilution.

Japan also has been moving toward a shareholder-market model and away from long-term employment commitments and horizontal coordination. Increasingly, Japan has recognized that profit-maximizing strategies actually are consistent with the protections its traditional devices provide.⁷⁰ More and more Japanese workers—particularly

⁶⁶ See *id.*

⁶⁷ For a discussion of all three mergers, see John Tagliabue, *A Mixed Verdict on Big European Mergers*, N.Y. TIMES, Mar. 12, 1999, at C2.

⁶⁸ See Mark J. Roe, *German Codetermination and German Securities Markets*, 1998 COLUM. BUS. L. REV. 167, 168-77; Roe, *supra* note 23, at 1942-43.

⁶⁹ See Roe, *supra* note 23, at 1942 ("German codetermination . . . induces shareholder representatives to want the supervisory board to supervise less . . .").

⁷⁰ See *Capital Ideas*, ECONOMIST, June 28, 1997 (Supplement, *A Survey of Japanese Finance: A Whopping Explosion*), at 13, 14-15; *Governance Debate Hits Far East*, THE CORPORATE GOVERNANCE ADVISOR, May-June 1988, at 32.

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.⁷¹

The forces of regulatory competition also are driving forum-shopping by corporations that look to locate in host countries with attractive laws, thereby further promoting sovereign-state competition.⁷² To give a simple example, most European countries do not permit tax deductions for amortization expense of goodwill or other intangible assets. However, Italy, the Netherlands, and Spain do allow these deductions. This difference creates an incentive for corporations that acquire assets elsewhere (France, for instance) to sell the assets to a related entity in one of those countries and then to lease the assets back to the French entity.⁷³ The sale-leaseback device neutralizes the cross-border difference, thereby subverting French tax policy. Thus, a little creative contracting quickly can minimize legal differences among nations.⁷⁴

Another important change is the deepening of European capital markets. 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 both exchanges.⁷⁵ France, unhappy with its exclusion, quickly was admitted to the Frankfurt-London alliance (although as a 20% player, compared with 40% for each of the founding exchanges).⁷⁶ Soon after France announced its inclusion in the emerging pan-European exchange, exchange officials in Milan, Madrid, Amsterdam, and Brussels echoed eagerness to participate in the venture as well.⁷⁷ The London exchange estimates the venture

⁷¹ See *Governance Debate Hits Far East*, *supra* note 70, at 32.

⁷² 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 Pressures*, 33 COLUM. J. TRANSNAT'L L. 319 (1995). For an excellent article on regulatory competition in general, see William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C. L. REV. 1861 (1995).

⁷³ See CLIFFORD CHANCE, *supra* note 35, at 24.

⁷⁴ See generally Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542 (1990) (arguing that state corporate law in the United States is trivial because it can be contracted around to enable corporations to use whatever governance structure they desire).

⁷⁵ See Edmund L. Andrews, *London and Frankfurt Stock Exchanges Form Alliance*, N.Y. TIMES, July 8, 1998, at D4.

⁷⁶ See Alan Cowell, *French Agree to a European Stock Exchange*, N.Y. TIMES, Nov. 20, 1998, at C6 (reporting that the French announcement was accompanied by statements from London and Frankfurt indicating that the announcement may have been somewhat premature).

⁷⁷ See *id.*

will eventually list companies with an aggregate market capitalization of \$5.5 trillion (compared with the New York Stock Exchange's \$8.7 trillion).⁷⁸

One can find further evidence of integration in securities listing and trading. Foreign firms for years have pushed for global listing, most famously achieved by Daimler-Benz's listing on the New York Stock Exchange (NYSE) beginning in 1993.⁷⁹ These efforts continue, and with increasing success.⁸⁰ SAP, a twenty-five-year-old German software firm, listed on the NYSE in early August 1998, ten years to the day after its initial public offering on the Frankfurt Stock Exchange.⁸¹ SAP is widely said to generate "U.S.-style growth" and "U.S.-style rewards."⁸² SAP executives characterized its listing on the NYSE as evidence that SAP had "outgrown" the Frankfurt stock market and that it properly should be considered a transnational entity—one combining features of a variety of governance models.⁸³

Further signs of an international trend in securities trading include the creation of the International Securities Exchange (ISE), announced in November 1998.⁸⁴ Additionally, an on-line brokerage firm, E*Trade, and a group of broker-dealers led by Adirondack Trading Partners announced their intention to invest nearly \$80 million in establishing this all-electronic options exchange.⁸⁵ The founders touted their ability to slash transaction costs while simultaneously conducting staggering sums of electronic trades which will transcend geo-

⁷⁸ See *id.*

⁷⁹ See *Germany's Daimler-Benz Finds Parking Spot on NYSE*, L.A. TIMES, Oct. 6, 1993, at D2; see also Lee H. Radebaugh et al., *Foreign Stock Exchange Listings: A Case Study of Daimler-Benz*, 6 J. INT'L FIN. MGMT. & ACCT. 158, 165-69 (1995) (dissecting the issues Daimler-Benz faced when considering whether it could or should list on NYSE).

⁸⁰ See James L. Cochrane, *Are U.S. Regulatory Requirements for Foreign Firms Appropriate?*, 17 FORDHAM INT'L L.J. S58, S59 fig.2 (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, 58-60 (1997).

⁸¹ See *America Embraces the German Triumvirate*, FIN. TIMES (London), Aug. 3, 1998, at 9. 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." See *id.*

⁸² *Id.*

⁸³ *Id.* 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. *Id.* The multinational company operates research labs in Palo Alto, Tokyo, Moscow, and India. One-fourth of its investors are American, and 40% of its business is in the United States along with its biggest rivals (Oracle and PeopleSoft). Aside from these American characteristics, SAP has a more German cultural characteristic: "[g]ood programmers get paid as much as top line managers." *Id.*

⁸⁴ See *Broker-Dealers Plan Electronic Options Market*, HOUSTON CHRON., Nov. 11, 1998, at 4.

⁸⁵ See *id.*

graphic boundaries.⁸⁶ ISE is by no means the first to inaugurate electronic trading (such trading is widespread in Europe), but its commitment cements this new era of globally connected and border-invisible securities trading.⁸⁷

2. *Movement in the United States Toward a More Global Model*

The trend toward convergence in corporate governance principles also has affected the United States, which has begun to emulate models from elsewhere. First, regulators softened the boundaries between investment and commercial banking. In December 1996, the Federal Reserve Board increased the amount of investment banking income a commercial bank can earn from investment banking subsidiaries from 10% to 25%.⁸⁸ The so-called "Section 20 subs" ushered in this regulatory change,⁸⁹ which contributed substantially to the ensuing wave of commercial and investment bank mergers, and reversed an historical cause of ownership fragmentation.⁹⁰

Second, the U.S. litigation system encourages large volumes of shareholder class action and derivative lawsuits against management. In contrast, most legal systems put substantial restrictions on such suits.⁹¹ Although it does not appear that litigation will decline substantially in the United States, it is clear that lawmakers have pursued some measures designed to curb litigation abuse in the United

⁸⁶ See *id.* Rather than require the physical presence of people in a single location conducting live auctions, as existing capital markets do, an all-electronic market conducts auctions solely on computer screens and thus obliterates the significance of physical location. Auction markets begin with a customer who instructs a broker to effect a trade. The broker then 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 who will fill orders when others will not. Electronic trading operates in a similar way except the auction is conducted through bids announced via computer rather than human voice. See generally Cunningham, *supra* note 13, at 863 n.74 (discussing different stock exchange systems).

⁸⁷ See Steven M. Sears, *Big U.S. Options Exchanges See Threat from a Planned All-Electronic System*, WALL ST. J., Nov. 23, 1998, at B131 (reporting that the ISE "hopes to mimic the success of European electronic derivative exchanges by luring customers with lower fees").

⁸⁸ See H. Rodgin Cohen, *Section 20 Affiliates of Bank Holding Companies*, 1 N.C. BANKING INSTR. 113, 115-16 (1997).

⁸⁹ See *id.*; James R. Smoot, *Bank Operating Subsidiaries: Free at Last or More of Same?*, 46 DEPAUL L. REV. 651, 669 (1997); Note, *The New American Universal Bank*, 110 HARV. L. REV. 1310, 1314 (1997).

⁹⁰ Cf. Roe, *supra* note 23, at 148-49 (describing several, historic legal impediments that worked to keep "American banks small and weak"). Mergers occurring after the Fed's change in regulations include the following: Nationsbank-Montgomery Securities, Bank America-Robertson Stephens (later sold when Nationsbank bought Bank of America), Travelers-Citicorp, and Bankers Trust-Alex Brown. Other equity ownership trends in the United States suggest convergence as well. See *id.* at 165 ("U.S. 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 . . .").

⁹¹ See *infra* notes 238-43 and accompanying text.

States.⁹² Other countries that may increasingly look toward litigation to enforce corporate governance principles can adopt these and other sorts of built-in anti-abuse systems.⁹³

Third, the United States is harmonizing its accounting principles with those prevalent worldwide.⁹⁴ In October 1996, Congress passed the National Securities Markets Improvement Act of 1996, which requires the U.S. Securities and Exchange Commission (SEC) to report to Congress on progress in developing international accounting standards.⁹⁵ The SEC has been working with the International Accounting Standards Committee (IASC) for nearly a decade to promulgate a core set of accounting pronouncements.⁹⁶ In October 1997, the SEC published a report to Congress on the progress of the IASC,⁹⁷ and it joined organizations throughout the world in supporting the IASC's initiatives.⁹⁸ The finance ministers and central bank governors of the

⁹² See, e.g., Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (to be codified in scattered sections of 15 U.S.C.) (federalizing securities fraud class actions); Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C. (Supp. II 1996)) (revising the securities laws in an effort to curb abusive securities litigation). For an excellent discussion of the background and passing of the 1998 Uniform Standards Act, including a detailed description of Congress's concern that plaintiffs' lawyers were abusing the class action mechanism, see Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 CORNELL L. REV. 1 (1998). The 1995 Reform Act, which sought to "curb . . . abusive lawsuits by making it more difficult for plaintiffs' lawyers to take advantage of the general antifraud provision of the federal securities laws," Michael B. Dunn, Note, *Pleading Scienter After the Private Securities Litigation Reform Act; Or, a Textualist Revenge*, 84 CORNELL L. REV. 193, 195 (1998), in part heightened the pleading standard that plaintiffs must satisfy to maintain a case brought under Rule 10b-5. See generally *id.* (discussing, in detail, the heightened pleading standard under the 1995 Reform Act).

⁹³ See 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); *infra* notes 238-43 and accompanying text.

⁹⁴ The general trend towards harmonization of international accounting standards is reflected in accounting textbooks and professional literature. For examples of this reflection, see GERHARD G. MUELLER ET AL., *ACCOUNTING: AN INTERNATIONAL PERSPECTIVE* (4th ed. 1997); LEE H. RADEBAUGH & SIDNEY J. GRAY, *INTERNATIONAL ACCOUNTING AND MULTINATIONAL ENTERPRISES* (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. LITERATURE 127 (1997).

⁹⁵ See National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 509, 110 Stat. 3416, 3449.

⁹⁶ See, e.g., International Accounting Standards Committee, *United States Securities and Exchange Commission Announcement* (1999) <http://www.iasc.org.uk/frame/cen1_6_3.htm> (reprinting a 1996 announcement by the SEC, which noted the SEC's desire to establish "standards [that] include a core set of accounting pronouncements that constitutes a comprehensive, generally accepted basis of accounting").

⁹⁷ See SEC Report on Promoting Global Preeminence of American Securities Markets (last modified Dec. 12, 1997) <<http://www.sec.gov/news/studies/acctgsp.htm>>.

⁹⁸ The SEC emphasizes that any international accounting standards must be comprehensive, produce comparability and transparency, provide for full disclosure, and be amenable to rigorous interpretation and application. See *id.* Indeed, many view SEC Chairman

G7 countries have also announced their support for the IASC and have encouraged it to complete its proposed set of core principles by early 1999.⁹⁹ Additionally, the World Bank has requested the world's "Big Five" international auditing firms to insist that firms prepare their financial statements in accordance with international accounting standards.¹⁰⁰ Leading voices from around the world, including Tony Blair, Prime Minister of the United Kingdom,¹⁰¹ and Robert E. Rubin, Treasury Secretary of the United States,¹⁰² also have emphasized that a key part of the global financial system must be the development and implementation of international accounting standards.

B. Traditions

The trends summarized in the preceding section operate to harmonize some of the finance aspects of the various models that Part I sketches. As for the constituency characteristics of those models, they are more ample than the highly-generalized summary in Part I suggests.

Corporate social responsibility remains an important dimension of U.S. corporate governance.¹⁰³ In recent years, direct efforts to im-

Levitt's broad-based initiative to crack down on earnings abuses by management in U.S. corporations as a response to the increasing attractiveness of international harmonization of accounting standards, which the SEC wants the United States 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 ("[T]he SEC fears that the growing economic globalization will put pressure on U.S. regulators to conform to international accounting rules, which are generally looser.").

⁹⁹ See International Accounting Standards Committee, *Declaration of G7 Finance Ministers and Central Bank Governors* (Oct. 30, 1998) <http://www.iasc.org.uk/news/cen8_128.htm> ("We call upon . . . the IASC to finalise by early 1999 a proposal for a full range of internationally agreed accounting standards."). The Declaration noted that 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 Institutions." *Id.*

¹⁰⁰ See Jim Kelly, *World Bank Warns Big Five over Global Audit Standards*, FIN. TIMES (London), Oct. 19, 1998, at 1. 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. See The World Bank Group, *Addressing "The Other Crisis"* (Oct. 6, 1998) <<http://www.worldbank.org/html/extdr/extme/1964.htm>> (calling for a new development framework with internationally recognized accounting and auditing standards for the private sector).

¹⁰¹ See Agis Salpukas, *Remodel World Bank and I.M.F., Blair Urges*, N.Y. TIMES, Sept. 22, 1998, at A13 (calling for "greater openness and transparency, which would include the setting up of international accounting standards").

¹⁰² See David E. Sanger, *Rubin Urges More Disclosure in Global Finance and Making Investors Pay Bailout Share*, N.Y. TIMES, Oct. 2, 1998, at A10 (pressing for "a new openness in international finance" (quoting Rubin)).

¹⁰³ See PROGRESSIVE CORPORATE LAW (Lawrence E. Mitchell ed., 1995); 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, 595-603 (1992). Prescriptions related to the idea of corporate social responsibility include advocacy of altruistic capitalism, a sort of constrained profit-maximization mandate. See Elliott

prove the lot of nonshareholder constituencies have supplemented the simple argument that shareholder-based profit maximization helps all other participants. Scores of organizations promote this more direct approach to respond to the needs of corporate constituencies on a variety of issues, including affirmative action, child labor, downsizing, the environment, fair wages, privacy, sexual harassment, and work/family life balance.¹⁰⁴ These organizations operate through employee training and assistance programs, mission statements, and social responsibility audits.¹⁰⁵

Social responsibility has reached the large organizational level. For example, Business for Social Responsibility, an organization founded in 1992, currently has over 1400 corporate members, annual revenues exceeding \$1 trillion, and total employees of nearly five million. It features household corporate names such as AT&T, Bristol-Myers Squibb, Coca-Cola, DuPont, Federal Express, Home Depot, Motorola, Polaroid, and Time-Warner.¹⁰⁶ Large numbers of mutual funds and other institutional investors also commit to investing only in socially responsible enterprises. Some of the investors claim to believe that investing this way maximizes shareholder wealth.¹⁰⁷ Many corporations also follow suit and emphasize their social responsibility. Beyond the well-known exemplars of the traditional Left such as Ben & Jerry's and the Body Shop,¹⁰⁸ companies such as Philips-Van Heusen Corporation—headed by CEO Bruce Klatsky, an advisor on U.S. trade policy to the Bush and Reagan administrations—as well as Hasbro, Reebok, and Wal-Mart also have begun to follow this trend. This social emphasis is entirely consistent with state laws, which mandate that directors act in the best interests of the shareholders and the corporation as a whole.¹⁰⁹

J. Weiss, *Social Regulation of Business Activity: Reforming the Corporate Governance System To Resolve an Institutional Impasse*, 28 UCLA L. REV. 343, 422-26 (1981).

¹⁰⁴ See generally Francesco Cantarella, *The Growth of Corporate Responsibility Committees*, CORP. BOARD, Nov.-Dec. 1998, at 16 (discussing the rise of corporate social responsibility committees as the conscience of corporations).

¹⁰⁵ Cf. *id.* at 18 (discussing social responsibility mission statements and board committees' responsibilities).

¹⁰⁶ See Business for Social Responsibility (1998) <<http://www.bsr.org>>.

¹⁰⁷ See Maria O'Brien Hylton, "Socially Responsible" Investing: *Doing Good Versus Doing Well in an Inefficient Market*, 42 AM. U. L. REV. 1, 13-23 (1992).

¹⁰⁸ 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, 1637-67 (1993); see also Lewis D. Solomon, *Reflections on the Future of Business Organizations*, 20 CARDOZO L. REV. (forthcoming 1999) (examining the interrelatedness of spirituality, or the pursuit of social goals as opposed to profit maximization alone, and corporate governance).

¹⁰⁹ See, e.g., DEL. CODE ANN. tit. 8, § 141(a) (1991); MODEL BUS. CORP. ACT. § 8.01(b) (1998).

German law takes more seriously the idea that beneficiaries of directors' duties include corporate constituents other than shareholders, yet Germany also forbids directors from acting contrary to shareholder interests and indeed often requires acting in the "aggregated shareholder interest."¹¹⁰ U.S. and German corporate law therefore contemplate protection of all corporate constituencies.¹¹¹ Both prescribe this protection by imposing on management the duties of care and loyalty. Both U.S. and German corporate law treat the duty of care as a quasi-negligence standard. U.S. states require the exercise of a fully informed business judgment,¹¹² while German law requires directors to exercise the standard of care of a prudent and diligent businessperson.¹¹³ In the United States, 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.¹¹⁴ On the other hand, under German law, no business judgment rule exists, and directors bear the burden of proving they have properly discharged their duties.¹¹⁵

The duty of loyalty under U.S. state law requires directors to subordinate their personal interests to those of the corporation if con-

¹¹⁰ As noted by Singhof and Seiler:

Managements' fiduciary duties toward the company under German corporate law are repeatedly referred to as *Loyalitäts- und Treuepflichten*. Since the shareholders are the "ultimate owners" of each corporation, 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 maximization. However, there is a long-standing debate in Germany about the strong emphasis on protecting shareholder interest.

Singhof & Seiler, *supra* note 55, at 550-51 (citation omitted).

¹¹¹ See *id.* at 553 (citing Marc von Samson-Himmelstjerna, *Persönliche Haftung der Organe von Kapitalgesellschaften*, 89 ZEITSCHRIFT FÜR VERGLEICHENDE RECHTSWISSENSCHAFTEN 288, 303 (1990) as "indicating the similarity of the U.S. and German standards," but also noting others who argue that the German fiduciary duty "falls short of the standard set in American case law and statutes" (quoting Ernest C. Steefel & Bernhard von Falkenhausen, *The New German Stock Corporation Law*, 52 CORNELL L.Q. 518, 531 (1967))).

¹¹² For example, Delaware General Corporation Law (DGCL) provides that the board of directors has the ultimate responsibility for managing the business and affairs of a corporation. See DEL. CODE ANN. tit. 8, § 141(a) (1991). 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 prudently and reasonably in the discharge of their duties. Under U.S. law, the 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 Gorkom*, 488 A.2d 858, 873 (Del. 1985).

¹¹³ See Singhof & Seiler, *supra* note 55, at 550 (quoting § 93(1) of *Aktiengesetz* (AktG) [Stock Corporation Law], v. 06.09.1965 (BGBl. I S.1089), which requires directors to act "with the care of a diligent and conscientious manager").

¹¹⁴ See PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(c), at 181-82 (proposed final draft 1992).

¹¹⁵ See Singhof & Seiler, *supra* note 55, at 532-53 (citing AktG § 93(2)).

flict exists.¹¹⁶ German law, as well as French law, has a similar standard.¹¹⁷ Specific applications of this general duty vary among these domiciles, but the variation is not much more pronounced than the nuanced differences across states within the United States. First, many U.S. states authorize board approval for loans to directors without shareholder or other constituency approval, so long as the board determines that the loans benefit the corporation.¹¹⁸ German law, however, requires that the supervisory board approve loans to directors exceeding one month's salary.¹¹⁹ French law, in contrast, flatly forbids corporate loans to directors as well as corporate guarantees of direct borrowings by directors.¹²⁰

Second, most U.S. state laws adopt a textured set of rules governing other interested-director transactions. These rules allow such transactions, or at least largely insulate them from judicial review, so long as (1) the interest is disclosed and a majority of disinterested directors consent, (2) the interest is disclosed and the holders of a majority of shares entitled to vote consent, or (3) the transaction is fair to the corporation at the time it is authorized.¹²¹ German law contains a clearer requirement: the supervisory board must represent the corporation in any transaction between the corporation and a member of the management board.¹²² Nonetheless, German law, unlike U.S. law, does not go on to police the process or substance of the resulting transaction other than through general rules against fraud. French law also requires the supervisory board to approve interested-director transactions, and it further requires the corporation's auditors to prepare an evaluation and report, which they must furnish to the shareholders.¹²³

The differences between the United States (and the United Kingdom) and Germany (and France) in the duties of care and loyalty are thus far more subtle and less pronounced than often recognized. The varying prescriptions are meant to address the content of those duties

¹¹⁶ In other words, the duty of loyalty requires that directors and officers place the corporation's interests above their own interests. Cf. MODEL BUS. CORP. ACT subch. F, introductory cmt., at 8-97 (noting that the duty of loyalty "protect[s] against unfair dealing by self-aggrandizing directors").

¹¹⁷ See Singhof & Seiler, *supra* note 55, at 552.

¹¹⁸ See, e.g., N.Y. BUS. CORP. LAW § 713(a) (McKinney 1986).

¹¹⁹ See THE GERMAN STOCK CORPORATION ACT 89-90 (Hannes Schneider & Martin Heidenhain eds., 1996) (Series of Legislation in Translation No. 1); CHRYSLER CORP., PROXY STATEMENT: FOR A SPECIAL MEETING OF ITS STOCKHOLDERS TO BE HELD ON SEPTEMBER 18, 1998, at 140 (Aug. 6, 1998) (on file with SEC).

¹²⁰ See FRENCH BUSINESS ENTERPRISES: BASIC LEGISLATIVE TEXTS, *supra* note 33, at 39.

¹²¹ See, e.g., DEL. CODE ANN. tit. 8, § 144 (1991 & Supp. 1998), construed in *Fliegler v. Lawrence*, 361 A.2d 218 (Del. 1976), and *Marciano v. Nakash*, 535 A.2d 400 (Del. 1987); MODEL BUS. CORP. ACT § 8.31 (1998).

¹²² See THE GERMAN STOCK CORPORATION ACT, *supra* note 119, at 10.

¹²³ See FRENCH BUSINESS ENTERPRISES: BASIC LEGISLATIVE TEXTS, *supra* note 33, at 46.

rather than their discrete beneficiaries. In this sense, director duties are vertical governance mechanisms intended to preserve and expand the size of the corporate pie rather than to address the manner in which the pie is divided and allocated. Questions of pie size pit managerial interests against the interests of all other constituencies. It is thus unsurprising that these vertical mechanisms differ little across the borders of economically advanced countries. In contrast, legal regimes will tend to differ when allocation is at stake, a problem of horizontal corporate governance. This problem manifests itself most acutely when threats to corporate control arise.

C. Threats

1. *Threats in Fact*

In the context of threatened changes of control and related defensive actions, most U.S. state laws impose either a heightened standard of duty upon directors or a heightened standard of judicial review of director conduct. The issue in either instance is whether the directors acted in the best interest of shareholders. No such heightened standards exist under German law.¹²⁴ Instead German law simply expects directors not to act contrary to the stockholders' interest and to have due regard for the common interest.

However, one should not overstate the degree to which this heightened standard in the United States separates the American model from the German model. Many states empower directors to consider the interests of nonshareholder constituencies in some circumstances. For example, although Delaware case law routinely emphasizes the shareholder-primacy norm—as the rhetoric in cases such as *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*¹²⁵ and *Paramount Communications, Inc. v. QVC Network, Inc.*¹²⁶ suggest—other 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).”¹²⁷ This allowance is consistent with the general principle of corporate law that allows directors to act in favor of

¹²⁴ The absence of any such standards may in part be due to the absence of many opportunities to develop them. This absence likely will disappear once increasing numbers of mergers, particularly involving cross-border entities, occur.

¹²⁵ 506 A.2d 173 (Del. 1986).

¹²⁶ 637 A.2d 34 (Del. 1994).

¹²⁷ *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985), cited in *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1153 (Del. 1989), and *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1285 n.35 (Del. 1988); see also *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1357 (Del. 1985) (refusing to upset director decision to adopt poison pill intended to deter certain take-overs that threaten various non-shareholder constituencies).

nonshareholder constituencies so long as the effect on shareholders is not too great.

Delaware law has sometimes gone even further. For example, the Delaware Supreme Court accepted the arguments of Time Inc.'s directors who had resisted an unwanted take-over, in part on the ground that doing so was necessary to preserve its culture of journalistic integrity.¹²⁸ Even under the most rigorous judicial review of board actions in take-over contexts—those instances when *Revlon's* shareholder value-maximization rhetoric applies—Delaware law gives directors wide latitude.¹²⁹ This law does not require any particular action, such as an auction,¹³⁰ nor does it impose on directors any duty to ensure that shareholders receive maximum value.¹³¹ The unifying inquiry in virtually all these cases is whether a threat to the corporation exists, not solely or even necessarily whether the shareholder's interests are in jeopardy.¹³²

For a dramatic example of what may occur under laws that look beyond shareholder interests, consider the fight for corporate control between AlliedSignal and AMP.¹³³ In August 1998, AlliedSignal offered a 55% premium over the market price of AMP—a company whose profitability had been declining. AlliedSignal also announced its intention to wage a consent solicitation to amend AMP's by-laws, to expand the AMP board, and to fill the vacancies with its own nominees. Then later in the battle, AlliedSignal intended to strip AMP's

¹²⁸ See *Time*, 571 A.2d at 1143 & n.4, 1145; see also Lawrence A. Cunningham ed., *Conversations from the Warren Buffett Symposium*, 19 CARDOZO L. REV. 719, 766 (1997) (including discussion by Charles M. Yablon regarding the role of corporate culture in take-overs). This position is not limited to Delaware courts. See *Herald Co. v. Seawell*, 472 F.2d 1081, 1094-95, 1100-01 (10th Cir. 1972) (upholding take-over defenses adopted by directors of newspaper publisher and noting that the corporation had a duty to its readers).

¹²⁹ *Revlon* permits consideration of other constituencies so long as it is "rationally related [to] benefits accruing to the stockholders," *Revlon*, 506 A.2d at 182, a standard that is not all that tough to meet. See generally 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) (discussing *Revlon* duties in light of subsequent cases and commentary).

¹³⁰ See *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1286 (Del. 1989).

¹³¹ See *In re RJR Nabisco, Inc. Shareholders Litig.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,714 (Del. Ch. Jan. 31, 1989).

¹³² See, e.g., *Hilton Hotels v. ITT*, 978 F. Supp. 1342, 1347 (D. Nev. 1997) (construing Delaware law for application to Nevada corporation and describing a "threat to corporate policy or effectiveness"); *Moore Corp. v. Wallace Computer Servs., Inc.*, 907 F. Supp. 1545, 1560 (D. Del. 1995) (applying Delaware law and evaluating the claims to see if a "threat to Wallace and its shareholders" existed); *Williams v. Geier*, 671 A.2d 1368, 1371 (Del. 1996) (mentioning a "corporate threat"); *In re Santa Fe Pacific Corp. Shareholder Litig.*, 669 A.2d 59, 72 (Del. 1995) (detailing a "threat posed by Union Pacific"); *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1375 (Del. 1995) (discussing the "threat to Unitrin" and "threat to Unitrin's uninformed stockholders").

¹³³ See *AMP, Inc. v. Allied Signal, Inc.*, No. CIV.A.98-4405, 1998 WL 778348, at *1 (E.D. Pa. Oct. 8, 1998).

board of its power, to amend AMP's poison pill, and to put that power in the hands of a three-person committee.¹³⁴

AMP shareholders overwhelmingly supported AlliedSignal, and as of mid-September they had tendered 72% of AMP's outstanding shares in accordance with AlliedSignal's original offer.¹³⁵ Shareholder supporters included the family of company founder Robert Hixon and many of the institutional shareholders, which owned approximately 80% of the stock, including the Teacher's Insurance Annuity Associate-College Retirement Equities Fund (TIAA-CREF). Indeed, TIAA-CREF was part of a shareholder group that sued AMP's board. That group also took the extraordinary step of separately filing an amicus brief supporting AlliedSignal in direct litigation between AlliedSignal and AMP.¹³⁶ TIAA-CREF argued that AMP had trampled on basic "principles of shareholder democracy."¹³⁷

Despite this overwhelming shareholder support for AlliedSignal, AMP's management successfully erected a series of defensive barriers to the bid. Management took advantage of Pennsylvania laws that require directors to act in the best interests *not of the shareholders, but of the corporation* and that further permit boards to act in what they perceive to be in the best interests of employees, lenders, communities, and others.¹³⁸ One such barrier that AMP's management erected involved amending its dead-hand poison pill provision. The provision originally stated that if a change of control occurred, only directors in office prior to that time could remove the pill.¹³⁹ The revised pill stated simply that it could not be removed after a change of control occurred, at least not until its expiration date.¹⁴⁰ This barrier represented an extraordinary measure.¹⁴¹ AMP sought and won an injunc-

¹³⁴ See *id.* at *1-3.

¹³⁵ See *id.* at *2.

¹³⁶ See Amicus Brief of TIAA-CREF, *AMP* (No. CIV.A.98-4405).

¹³⁷ *Id.*; see also Transcript, *Corporate Social Responsibility: Paradigm or Paradox?*, 84 CORNELL L. REV. 1282, 1296-98 (1999) (comments of Peter Clapman, Senior Vice President and Chief Counsel for Investments at TIAA-CREF) (discussing TIAA-CREF's stance on the AMP litigation and on corporate social responsibility generally).

¹³⁸ See 15 PA. CONS. STAT. ANN. §§ 1712, 1715 (West 1995).

¹³⁹ See *AMP*, 1998 WL 778348, at *2.

¹⁴⁰ See *id.*

¹⁴¹ Even dead-hand pills of the former type, in which directors ousted in a proxy vote retain sole power to amend the pill, have not withstood scrutiny in New York, see *Bank of New York Co. v. Irving Bank Corp.*, 528 N.Y.S.2d 482 (Sup. Ct. 1988), and in Delaware, see *Carmody v. Toll Bros.*, C.A. No. 15983, 1998 WL 418896, at *1 (Del. Ch. July 27, 1998). Further, the Delaware Supreme Court recently affirmed a Chancery Court decision that invalidated a limited-time dead-hand that more closely resembled AMP's provision. See *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998). Georgia, however, approved dead-hand provisions. See *Invacare Corp. v. Healthdyne Techs., Inc.*, 968 F. Supp. 1578 (N.D. Ga. 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).

tion prohibiting AlliedSignal'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 merely in the shareholders' interests.¹⁴²

The court upheld AMP's extraordinary actions against AlliedSignal's claim that AMP's board had breached its fiduciary duties in its response to the AlliedSignal bid. In its opinion, the court repeatedly emphasized a "stakeholder" standard, which appears to be at the heart of Pennsylvania law, and used the following unequivocal terms: "[D]irectors may weigh the interests of the shareholders against the interests of other constituencies, [and the law] asserts no specific duty to shareholders above or beyond those owed to those other constituencies."¹⁴³ The opinion also states that directors "'may, in considering the best interests of the corporation, consider[] . . . [t]he effects . . . upon . . . 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 of the corporation are located.'"¹⁴⁴ Additionally, the court asserted that 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.'"¹⁴⁵

The previous excerpts obviously do not suggest a shareholder-primacy norm. A less obvious point, but one that is equally true, is that the Delaware standards summarized above show far less of a shareholder-primacy norm in the United States than the standard rhetoric suggests.¹⁴⁶ Moreover, Delaware standards are not far-fetched or

¹⁴² These directors also would have to say they have duties under Delaware law to act in both AlliedSignal's and its shareholders' best interests, and that these duties might pose a conflict. AlliedSignal promptly told the judge that they could act in this manner within 48 hours, and AlliedSignal did so. After taking a remand of the case from its appeal to the Third Circuit, the court accepted these certifications and allowed the consent solicitation to proceed. See *Allied Signal Case Back to Lower Court*, N.Y. TIMES, Nov. 19, 1998, at C5.

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 AlliedSignal's offer, although he also claimed to believe that AMP was not for sale. *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 approximately 10% higher than what Allied had offered. See Steven Lipin & Gordon Fairclough, *Tyco Reaches Agreement To Buy AMP in Stock Swap Valued at \$11.3 Billion*, WALL ST. J., Nov. 23, 1998, at A3.

¹⁴³ AMP, 1998 WL 778348, at *5.

¹⁴⁴ *Id.* (quoting 15 PA. CONS. STAT. ANN. § 1715(a) (West 1993)).

¹⁴⁵ *Id.* (quoting 15 PA. CONS. STAT. ANN. § 1715(b) (West 1993)).

¹⁴⁶ See, e.g., William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261, 264-66, 272-74 (1992).

isolated examples. Many other U.S. state laws adopt a similar framework.¹⁴⁷

Statements such as these also appear consistent with German law, perhaps even capturing the German sense of the common interest. Consider the Daimler-Chrysler merger. Although German law permitted the Daimler directors to evaluate the interests of workers, lenders, and the so-called common interest, the law also required that the board not act contrary to the best interests of shareholders.¹⁴⁸ Giving such deference to shareholders is certainly not a statement of shareholder primacy, nor is it the standard formulation of the stakeholder model. In short, U.S. practice more closely resembles German practice than it does U.S. rhetoric, and German practice more closely resembles U.S. practice than it does German rhetoric.

2. *Threats in Theory*

Uniting global corporate fiduciary duties can be done at a theoretical level as well. Traditional accounts treat U.S. corporate law as a collection of voluntary associations of private actors who agree to property arrangements that are contractual rather than political in nature.¹⁴⁹ Critics have contended that this rights-based approach to conceptualizing corporate law is merely metaphorical. They assert that this approach is not rooted in a foundational normative argument but rather is declared as a starting point which treats shareholders as "owners" of corporations and, therefore, as possessing private property and contract rights.¹⁵⁰

Treating shareholders as owners with rights superior to other corporate constituents generates a paradox within U.S. corporate law doctrine when conjoined with the business judgment rule. A strict insistence on shareholder-wealth maximization seems incongruous with the judicial deference given to managerial decisions under the

¹⁴⁷ See, e.g., IND. CODE ANN. § 23-1-35-1(f) (Michie 1995) (permitting directors to subordinate shareholder interests to the interests of other constituencies); OHIO REV. CODE ANN. § 1701.59(E) (Anderson 1997) (stating that a director 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 . . . [t]he interests of the corporation's employees, suppliers, creditors, and customers" as well as "community" interests).

¹⁴⁸ See THE GERMAN STOCK CORPORATION ACT, *supra* note 119, at 94; CHRYSLER CORP., *supra* note 119, at 47, 131-32; see also Singhof & Seiler, *supra* note 55, at 551 (noting that, although debate persists over the degree to which German law mandates the protection of shareholders' interests, such protection is surely contemplated in some form).

¹⁴⁹ See, e.g., William J. Carney, *The ALI's Corporate Governance Project: The Death of Property Rights?*, 61 GEO. WASH. L. REV. 898 (1993) (asserting that neoclassical contracts accurately describe traditional legal definitions of the firm); Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989) (characterizing corporate charters as adhesion contracts); Winter, *supra* note 46, at 252-53.

¹⁵⁰ See Kent Greenfield, *From Rights to Regulation in Corporate Law*, in 2 PERSPECTIVES ON COMPANY LAW 1, 15-25 (Fiona Macmillan Patfield ed., 1997).

business judgment rule.¹⁵¹ Accounts of this apparent paradox have taken several forms. One is the dubious claim that judges simply lack the competency to review ordinary business decisions. Another characterization is an ideological claim that the judges' insulation from market forces should prevent them from reviewing business decisions, which are subject to market forces. Still another characterization relies on the philosophical claim that this paradox reveals some irrationality in the underlying duties.¹⁵²

The paradox extends beyond the relationship between the duty of care and the business judgment rule. It also seems to exist in the way U.S. judges analyze the duty of loyalty. While that duty is stated in the strictest and loftiest terms, courts usually analyze it with a greater emphasis on the decision-making process than on the resulting substance.¹⁵³ Similarly, notwithstanding the rhetoric embodied in judicial scrutiny of take-over defense decisions in cases like *Unocal Corp. v. Mesa Petroleum Co.*¹⁵⁴ and *Revlon*, courts tend to give directors' decisions substantial judicial deference even in these charged contexts.¹⁵⁵

In this sense, as a practical matter, both the duty of care and duty of loyalty could be similarly described under German law. Although directors of German corporations do not benefit from a business judgment rule, shareholders of German corporations lack the sort of litigation-enforcement mechanism available to shareholders of U.S. corporations.¹⁵⁶ This result is just as paradoxical as the result under U.S. law. The sources of the paradox differ of course. The U.S. paradox results from substantive doctrinal articulations, and the German paradox results from structural procedural features of the legal system itself. Those doctrinal articulations nevertheless produce a functional system having much in common with the German one.

Indeed, to the extent that German law tends to permit directors to base decisions on grounds of maximizing the interests of multiple constituencies, the structure of fiduciary rhetoric in the United States does the same thing. The strongest forms of fiduciary duties are those embedded in the duty of loyalty, a duty that is vertical in nature in that it insists on selfless director service for the benefit of the whole corporation. Loans to directors, for example, are subject to duty of loyalty

¹⁵¹ See *id.* at 21-25.

¹⁵² See Kent Greenfield & John E. Nilsson, *Gradgrind's Education: Using Dickens and Aristotle To Understand (and Replace?) the Business Judgment Rule*, 63 BROOK. L. REV. 799, 825-36 (1997).

¹⁵³ See Lawrence E. Mitchell, *Fairness and Trust in Corporate Law*, 43 DUKE L.J. 425, 434-36 (1993) (asserting that courts have a process-oriented concept of fairness).

¹⁵⁴ 493 A.2d 946 (Del. 1985).

¹⁵⁵ See Cunningham & Yablon, *supra* note 129, at 1601-02, 1606-14.

¹⁵⁶ See Singhof & Seiler, *supra* note 55, at 553-56; see also *infra* Part III.B.1 (comparing the roles and prevalence of shareholder litigation in various countries).

scrutiny—a seemingly tough standard, but one that implicates a director's interest against the interest of all other corporate constituencies collectively. In contrast, a corporation's gift to a charity in its community is evaluated under the duty of care standard, under which judicial deference is even greater, yet it implicates the horizontal governance question of whether the interests of that charity and the community or the interests of the shareholders are to be paramount with respect to the proposed gift.

Thus, like German law, but using different devices, U.S. law is tough when it comes to the easier questions of vertical governance—directors have to subordinate their own interests to the corporation's—and fairly lax when it comes to the harder questions of horizontal governance—directors have a lot more leeway to decide whose interests are paramount when multiple constituencies can make plausible claims to a corporation's resources. The U.S. devices that produce these results include the body of fiduciary duties of corporate law, a body of law as much about rhetoric as it is about substance. Fiduciary rhetoric, even if not applied, “performs a significant socializing and educational role in corporate governance,” and the “aspirational aspect of fiduciary duty influences [director] behavior.”¹⁵⁷ 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.”¹⁵⁸ However, these judges also recognize that few believe that directors can act, as Judge Cardozo once explained, with the “punctilio of an honor the most sensitive.”¹⁵⁹ Nor can anyone sincerely believe that it is possible for directors to make decisions in ways that solely maximize shareholder wealth.¹⁶⁰

Fiduciary rhetoric serves the function of judicial administration as well as a proselytizing function. When judges recognize objectionable conduct deemed worthy of liability, they have a ready-made and measured stick with which to characterize this behavior.¹⁶¹ However, the

¹⁵⁷ Marleen A. O'Connor, *How Should We Talk About Fiduciary Duty? Directors' Conflict-of-Interest Transactions and the ALI's Principles of Corporate Governance*, 61 GEO. WASH. L. REV. 954, 968 (1993).

¹⁵⁸ *Genesis: Panel Response*, 8 CARDOZO L. REV. 687, 695 (1987) (comments of Dean Robert C. Clark).

¹⁵⁹ *Meinhard v. Salmon*, 249 N.Y. 458, 464 (1928).

¹⁶⁰ Cf. Craig S. Warkol, Note, *Resolving the Paradox Between Legal Theory and Legal Fact: The Judicial Rejection of the Theory of Efficient Breach*, 20 CARDOZO L. REV. 321 (1998) (claiming that despite the talk surrounding the theory of efficient breach of contract, 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).

¹⁶¹ See, e.g., Cunningham & Yablon, *supra* note 129, at 1601-09 (discussing the QVC litigation).

rhetoric is sufficiently fluid so that it might avoid imposing liability when the conduct in question does not offend judicial sensibilities.¹⁶²

Therefore, one may explain fiduciary rhetoric as a tool of director proselytization or judicial administration. Rhetoric serves useful ends, although at the level of specific application, it would be foolhardy to compel compliance with it. The apparent paradox in the duty-deference framework thus dissolves. The significance of the inconclusive debate over the shareholder-primacy norm versus other corporate constituents dissolves as well.¹⁶³ At least in the context of theoretical comparative corporate governance, the legal distance between the market and bank/labor models of corporate governance shrinks.

D. External Forces Driving Convergence

1. *Deals*

The role of labor within the U.S.-U.K. models versus the European governance models, which implicates the more profound and foundational law and custom governing employment itself, provides one source of resistance to the harmonization factors just discussed. Employment-at-will traditions in the United States and United Kingdom are fundamentally different from worker-protection traditions found in Europe and Japan. Although only abstract accounts of comparative corporate governance highlight such differences, the deep labor traditions are changing, which requires a more detailed examination of the competing models. In the United States, employment-at-will remains strong, but a variety of U.S. worker protection legislation and judicial decision making has clearly moderated this tradition.¹⁶⁴ In Japan, lifetime employment remains valued, but less so

¹⁶² See, e.g., *id.* at 1603-14 (discussing the various interpretations Delaware courts have used when assessing directors' duties in the take-over context and the doctrinal tension it has fostered).

¹⁶³ On the debate, compare Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23 (1991) (discussing various criticisms leveled at nonshareholder-constituency statutes and settling on one as a justifiable rationale for having fiduciary duties run only to shareholders), with Greenfield, *supra* note 150, at 25 (concluding, in part, that "[c]hanges in corporate governance and expansion of legal duties to include more than profit maximization may allow corporations to be proactive in addressing issues of societal concern, which in turn might be more efficient than relying on the mostly reactive power of government regulation").

¹⁶⁴ See 1 LAWRENCE A. CUNNINGHAM & ARTHUR J. JACOBSON, CORBIN ON CONTRACTS § 4.2 (rev. ed. Supp. 1999). Compare Drucilla Cornell, *Dialogic Reciprocity and the Critique of Employment at Will*, 10 CARDOZO L. REV. 1575, 1576 (1989) (proposing the adoption of "unwaivable rational-cause statutes to replace the current doctrine of employment at will"), with Richard A. Posner, *Hegel and Employment at Will: A Comment*, 10 CARDOZO L. REV. 1625, 1626 (1989) (disagreeing with Cornell's proposal and characterizing it as "inefficient and regressive").

than in previous years.¹⁶⁵ In the United States, Japan, and Europe, cross-border business combinations reinforce the underlying demographic forces that are altering these traditions in ways that directly impact corporate governance.

Global mergers like the one between Daimler-Benz and Chrysler strikingly pose the challenge. A typical merger creates substantial duplication of work-force resources throughout the enterprise. Merged firms tend to eliminate this overlap in order to avoid multiplication of expenses, and this process entails work-force reductions throughout the entity, in departments ranging from research to marketing to accounting. In the United States, this result is consistent with the territory, whereas in Germany and the rest of Europe, such practice defies the norm. DaimlerChrysler's management team had to choose either from these models or one in between, and management appears to have selected the latter. At least publicly, DaimlerChrysler's management addressed the role of employees in the new entity mainly by reassuring its labor force that although some synergies would create redundancies, it intended for the new entity to grow so rapidly that these employees would be retained and deployed in other ways within the corporation.¹⁶⁶

The issue of employee relations arises following a merger as it does in other business reorganizations. Economic contractions reduce demand for an entity's products, which then reduces the demand for labor. Standard responses in the United States and in Europe differ: European entities face more pressure to retain workers despite their redundancy. For example, one source of pressure within German corporations, apart from legal requirements, is the presence of labor representatives on the supervisory board. These representatives encourage compliance with both the letter and the spirit of the rules. In the case of DaimlerChrysler, the German company's ten labor representatives on its supervisory board now include one representative from the American United Auto Workers Union (UAW).¹⁶⁷ As peculiar as that may sound from a U.S. 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 U.S. gov-

¹⁶⁵ See *supra* notes 70-71 and accompanying text.

¹⁶⁶ See Gregory L. White, *Daimler-Chrysler Puts Consumers in Back Seat in New Ad Campaign*, WALL ST. J., Nov. 16, 1988, at B11 (explaining that investors and employees, not customers, are the two most important audiences for new advertising campaigns launched by DaimlerChrysler as of the effective time of the merger and quoting a company executive as saying that "[w]e're going to show [employees] right off the bat that they're the most important thing that we have").

¹⁶⁷ See David Phillips, *UAW Wins Daimler Board Seat: Union Will Be Represented on Supervisory Panel Created by Merger with Chrysler*, DETROIT NEWS, May 28, 1998, at A1.

ernment provided loan guarantees to Chrysler in the early 1980s. UAW representation ended in 1991.¹⁶⁸

Thus, cross-border deals like the one between Daimler-Benz and Chrysler both draw on and reinforce convergence trends. These trends can reshape traditions, even on issues as profound as the treatment of workers and the allocation of executive power within the resulting entity. Business needs associated with the integration of two separate entities drive these convergence trends. Professionals advising the merging entities, who are repeat and regular participants in the global mergers and acquisitions market, further reinforce these trends.

These professionals include major global banking, law, and accounting firms. On a global scale, this group of professionals is relatively small and becoming even smaller.¹⁶⁹ Members of the group share a common interest in developing substantially uniform practices and expectations concerning all aspects of a wide range of cross-border deals. Such deals include private financings, public securities offerings, and business combinations.¹⁷⁰

Indeed, the task of the global lawyer now involves piercing conceptual comparative corporate governance schemes, and confronting and using the tools of local law and practice to facilitate transnational corporate life. Clients seek and expect this sort of service and achieving it also furthers other interests of those professionals. Global lawyers advising boards of directors about their fiduciary duties in a variety of situations—from the more mundane director loans to the more charged take-over defenses—find their job far easier if the differences among the laws of the various countries are not too substantial. If the governance and finance structures become more harmonious, attorneys may better standardize the forms of agreement with which to begin negotiating and structuring transactions, and they may more easily render the related legal opinions.

One can expect budding professional cultures that strive to promote increased harmony to expand in the coming decade, as they seek to replicate around the world the types of bridges that enable transnational deals to proceed. Indeed, within the auto industry in particular, analysts foresee continued consolidation through cross-

¹⁶⁸ See Jesus Sanchez & Donald Woutat, *Chrysler To Drop Union President's Spot on Its Board*, L.A. TIMES, Mar. 14, 1991, at D1.

¹⁶⁹ In accounting, consider the amalgamation over the past decade that has 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 proposed merger of Brown & Wood and White & Case, and the emergence of "global law firms" such as Clifford Chance and Allen & Overy.

¹⁷⁰ See, e.g., CLIFFORD CHANCE, *supra* note 35, at 1.

border deals that we once considered too intractable to achieve.¹⁷¹ The publishing industry is also in the midst of substantial consolidation due to the increasing number of global transactions. These transactions include numerous ones involving the giant German publisher Bertelsmann.¹⁷² Global alliances occur more frequently in industries once viewed as unlikely candidates for cross-border consolidation. These alliances include banking deals, such as the one between Deutsche Bank and Bankers Trust, and oil deals, such as the one between British Petroleum and Amoco. As firms continue to consummate these deals and others, differences in corporate governance regimes should continue to evaporate, and an increased degree of uniformity of practices and expectations should emerge.

2. Information

One of the most striking, and often persistent, practical differences participants face in cross-border deals concerns the nature and amount of available information regarding a counterparty. In market-model countries, a wealth of information is available concerning targets organized therein. These countries tend to operate systems of public recordation for real as well as intellectual property. Well-developed securities and M&A industries strengthen such an information culture. Buyers and sellers understand the need for information to allow proper valuations and the need for contractual protection to preserve confidentiality. Sellers customarily meet these needs by executing confidentiality agreements early in the exploration process and providing the buyer with substantial proprietary data before discussing agreements any further.

The culture in bank/labor model countries differs significantly from this market model culture. Access to property records is limited, information is more jealously guarded, and the limited securities and M&A industries have not fostered an appreciation for the confidentiality of information when its recipient is not bound to consummate the deal. Moreover, less well-developed systems of legal enforcement for such contracts leave sellers apprehensive about confidentiality even if in principle they are willing to consider it disclosing information to potential buyers.

¹⁷¹ See Keith Bradsher, *Capacity Glut Likely To Spur More Auto Mergers*, N.Y. TIMES, Nov. 14, 1998, at C1. Industry capacity ranges up to approximately 70 million vehicles annually while average annual demand generally has peaked at 50 million, and only about 10 of the globe's 40 auto manufacturers are profitable. See *id.* Buyer candidates include Ford and Volkswagen (which acquired the United Kingdom's Rolls Royce in early 1998) and target candidates include Japan's Nissan, Sweden's Volvo, and Germany's BMW. See *id.*

¹⁷² See Doreen Carvajal, *Bertelsmann Signs a Deal for 82% of Springer-Verlag*, N.Y. TIMES, Nov. 21, 1998, at C2. Bertelsmann acquired Random House in early 1998, entered into an on-line bookstore joint venture with Barnes & Noble later that year, and also had discussions with the French media company Havas S.A. See *id.*

Substantively, the type of information understood as relevant also may vary between the models. In the market model, and especially in the United States, disclosing potential environmental or retiree liabilities has been standard for many years. Other countries only recently have developed environmental regulation. Also, other countries traditionally have relied more greatly upon public social security systems, removing private plans from center stage (even in countries, such as Germany, where such liabilities not only can be substantial, but are also uncovered by any particular asset base).

The United States also engages in far more periodic corporate reporting than Europe or Japan. U.S. federal and state law, as well as stock exchange rules and general market pressures and expectations in the United States, result in corporations disclosing extraordinary amounts and types of information to shareholders and other interested people. Other countries impose far more limited, and far less effective, disclosure requirements.

As global corporations as diverse as DaimlerChrysler and SAP increasingly list shares on U.S. stock exchanges and stock exchanges around the world,¹⁷³ they will find themselves subject to U.S.-style disclosure requirements as a matter of both regulatory mandate and market expectations and demand. More generally, as the same group of international professionals helps consummate cross-border transactions requiring the disclosure and evaluation of information, pressures toward uniform disclosure requirements will emerge in a wide variety of settings. In fact, participants find that U.S./U.K.-style information disclosure is consistent with existing corporate traditions in most countries, most notably Germany.¹⁷⁴ Accordingly, broadening global corporate laws to require such disclosure seems quite possible.

Public regulators have undertaken just such an effort. The SEC has been working with the International Organization of Securities Commissions (IOSCO) to develop a set of international standards for nonfinancial statement disclosure. These efforts are intended to facilitate cross-border financing and listing by transnational companies while holding them to a single, global standard of disclosure.¹⁷⁵ The IOSCO has made progress, which culminated in a planned, but

¹⁷³ See *supra* notes 79-83 and accompanying text.

¹⁷⁴ See Singhof & Seiler, *supra* note 55, at 531 ("Disclosure has a longstanding tradition in the United States and can be easily extended in the German Corporation Act without violating a deep-rooted corporate tradition. It is just a small step . . .").

¹⁷⁵ See *Global Issues and Implementing Core International Accounting Standards: Where Lies IASC's Final Goal?* (Oct. 23, 1998) <http://www.iasc.org.uk/news/cen8_130.htm> (remarks of Sir Bryan Carsberg, Secretary-General, IASC) ("[In April 1996,] [t]he SEC said that it would consider accepting [IASC's] standards for use in cross border listings in the United States once [it] had completed the core set of standards, achieving good quality—particularly transparency and comparability—with standards rigorously applied and interpreted.").

delayed, final proposal in September 1998.¹⁷⁶ Further progress is also expected and needed, however, because these rules are limited to cash transactions and to offerings and listings of common equity securities only. They do not yet extend to such transactions as tender and exchange offers, business combinations, privatizations, and other affiliated transactions.¹⁷⁷

The analysis above suggests some basis for forecasting the hybridization of corporate governance models in terms of both constituency and finance characteristics. This trend seems to make the proper focus of study not so much comparative corporate governance but rather global corporate governance. Numerous reports on comparative corporate governance published in the last couple of years reinforce this view. In April 1998, for example, the Organization for Economic Cooperation and Development (OECD) published a report setting forth and elaborating on principles of corporate governance suited for an integrated, international world market.¹⁷⁸ These efforts not only reflect the descriptive reality and theory discussed in this Part, but also prescribe a course for global corporate governance, a topic taken up in the next Part.

III

VERTICAL CORPORATE GOVERNANCE

The increasing harmony among the various models and descriptions of corporate governance around the world most likely results simply from the corporate form of business organization. Taken literally, no corporation could sustain either the abstract goal of shareholder wealth maximization or the broad stakeholder model.¹⁷⁹ Sustained application of the generalized shareholder-primacy norm is unachievable given management's control, power, and relationship to other constituents. Similarly, the fact that shareholders supply the capital necessary to fuel the corporate engine precludes the sustained application of the generalized stakeholder model. Only a mixed

¹⁷⁶ See generally Robert Bruce, *Tolstoy Would Have Been Proud of IASC*, LONDON TIMES, May 14, 1998, at 32 (noting the daunting nature of the task faced by the IOSCO).

¹⁷⁷ The SEC's own work contains an aspect of harmonization as well. It has undertaken a substantial revision of its entire disclosure system, which is dubbed the "Aircraft Carrier Release" because of the enormity of its scope. See SEC Release S 33-7606 and 34-40, 632 (Oct. 15, 1998).

¹⁷⁸ BUSINESS SECTOR ADVISORY GROUP ON CORPORATE GOVERNANCE, ORGANIZATION FOR ECON. CO-OPERATION AND DEV., *CORPORATE GOVERNANCE: IMPROVING COMPETITIVENESS AND ACCESS TO CAPITAL IN GLOBAL MARKETS* (1998). Other reports on corporate governance include: the January 1998 HAMPEL REPORT, *supra* note 60, and LE CONSEIL D'ADMINISTRATION DES SOCIÉTÉS COTÉES (the Vienot Report) (1995).

¹⁷⁹ See Chancellor William T. Allen, *Ambiguity in Corporation Law*, 22 DEL. J. CORP. L. 894, 895-97 (1997) (discussing generally these two goals).

model can optimize considerations of competing interests and constraints and avoid focusing on maximizing a single objective.¹⁸⁰

Accordingly, what should be of greater concern than any competition between shareholders and workers (or among other nonmanagement constituencies) is the competition between these groups and management.¹⁸¹ In the take-over context, for example, whose interests were really going to be served by AMP's resistance to Allied-Signal's bid?¹⁸² 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 4200 jobs, and closing ten factories. AMP's board ultimately may have served the corporation's interests in concluding a deal with a friendly partner,¹⁸³ but AMP's CEO and management undoubtedly pressured the board 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 practices should emerge. It would be a mistake to assume that other countries should replicate whatever model firms in an economically leading country currently follow. On the contrary, deficiencies exist within all the models.¹⁸⁴ It is these deficiencies that are important and must not be allowed to spread like diseases through the corporate world. The starting point for all models, as a matter of law and perhaps as a matter of structural inevitability, is the board of directors. Attention must be focused on what jobs boards perform, which jobs are most important, and which current approaches are in-

¹⁸⁰ See generally William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407, 406-07 (1989) (discussing the "new economic theory of the firm," one which "explains corporate relationships and structures in terms of contracting parties and transaction costs").

¹⁸¹ In old-fashioned terms, this statement 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 OLIVER E. WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS* (1975).

¹⁸² See *supra* notes 135-45 and accompanying text.

¹⁸³ See *supra* note 144.

¹⁸⁴ Apart from the fact that no pure form of any particular model really exists, there is no reason to believe that any such abstract or existing model is optimal. For example, the U.S.-U.K. market model, which measures industrial leadership in terms of shareholder wealth creation, falls short even from its own point of view. The three strongest corporations in the automobile industry, for example, are not U.S. companies: BMW, Toyota, and Honda. See MORGAN STANLEY DEAN WITTER, *GLOBAL INVESTING: THE COMPETITIVE EDGE* 43, 53 (1998). That is not to say that Ford and General Motors are not extremely strong leaders and contenders as well. Instead, it implies that their governance and finance models do not necessarily guarantee performance superior to that of corporations operating under different models. Indeed, among the worst performers is Nissan, which has lost money in six of the last seven years and has faced difficulty obtaining additional bank funding in recent years. See Bradsher, *supra* note 171. Japan's governmental Investment Bank agreed in early November 1998 to provide Nissan with some funding, much as the U.S. government funded Chrysler when it faced financial straits in 1980. See *id.*

effective and need improvement. It turns out, perhaps unsurprisingly, that the most important jobs are also those that need the most improvement. They are also the jobs that are essentially the same across borders and will increasingly be so as globalization continues.

The most important job entrusted to any board of directors is selecting an effective chief executive. This is true as much in the United States as it is in Germany or any other country. The next most important jobs include the following: (1) setting the compensation of the CEO and other senior managerial executives; (2) evaluating and taking corporate positions on take-overs, both defensively and offensively; and (3) making or reviewing and approving capital allocations. In each of these three areas, the major tension is vertical—between managerial interests and all other constituencies collectively. Effective performance of these jobs ultimately depends not so much on governance mechanisms, but on board integrity. One can expect vertical governance mechanisms to do no more than foster integrity. Those mechanisms best suited to perform this function and most at risk of being diluted by current trends are (1) director liability, (2) constituent voice, and (3) market discipline.

A. Key Responsibilities Entrusted to Boards of Directors

1. *Executive Compensation*¹⁸⁵

One of the most striking differences between U.S. and German corporate governance is the level of executive compensation. The raw level of compensation is substantially higher in the United States 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 those of shareholders. Some would say that the widespread use of these plans in the United States simply reflects the priority given to this goal in the United States, and that their relative infrequency in Germany reflects the absence or irrelevance of this goal. However, the talk of alignment is more myth than truth and too often an attempt to sanitize management compensation packages that conflict with shareholder and labor interests.¹⁸⁶

¹⁸⁵ Portions of this subsection appeared previously in some of the author's other works. See Lawrence A. Cunningham, *The Essays of Warren Buffett: Lessons for Corporate America*, 19 CARDOZO L. REV. 1, 5 (1997) (compiling and introducing essays authored by Warren E. Buffett) [hereinafter Cunningham, *Buffett Essays*]; Lawrence A. Cunningham, *The Endless Quest for Integrity in Financial Reporting*, 2 PLI'S 30TH ANN. INST. ON SEC. REG. 11 (1998); Lawrence A. Cunningham, *Global Corporate Governance*, CORP. (Dec. 1, 1998), at 1; Lawrence A. Cunningham, *Warren Buffett on the Role of the Board*, CORP. BOARD, July-Aug. 1998, at 6.

¹⁸⁶ See ANDREI SHLEIFER & ROBERT W. VISHNY, A SURVEY OF CORPORATE GOVERNANCE 14 (National Bureau of Econ. Research Working Paper No. 5554, 1996) ("[O]ptions are often not so much an incentive device as a somewhat covert mechanism of self-dealing."); see

No evidence indicates that the prevailing structure of executive compensation in the United States comes anywhere close to aligning these interests; on the contrary, a great deal of evidence demonstrates that the compensation structure is simply random.¹⁸⁷ Many corporations pay their managers stock options, which increase in value simply through earnings retention, rather than by improved performance due to superior deployment of capital. Simply by retaining and reinvesting net income, managers can report annual earnings increases without doing anything to improve real returns on capital. Thus, stock options 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 encourage optionees to think as shareholders would, 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 in the increase with shareholders. But if economic performance is unfavorable and the stock price remains below the exercise price, then optionees simply will not exercise the option. Shareholders suffer from the corporation's unfavorable performance, but the option holder does not.¹⁸⁸

These awards not only fail to align the interests of option-holders and shareholders but also exacerbate the misalignment of corporate option-holders' (usually senior executives) and other workers' interests. The awards substantially increase the ratio of compensation of high-paid executives to ordinary laborers, a ratio which is vastly higher in the United States than in Germany or other European countries. Solutions to this misalignment have consisted mainly of sustained pressure to link stock options and other performance-based compensation to the optionee's real performance. At least as a matter of rhet-

generally Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 COLUM. L. REV. 1867 (1992) (reviewing GRAEF CRYSTAL, *IN SEARCH OF EXCESS* (1991), arguing against excessive executive compensation, and proposing possible remedies).

¹⁸⁷ See Graef Crystal, *Good Girl, Bad Girl* (July 17, 1997) <<http://www.slate.com>>. Crystal notes the following:

[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.*

Id. (emphasis added). Randomness is just a description of a state of ignorance. Just as likely, this variation is probably attributable to the lack of rigorous linking of pay to performance, which is in turn a function of inadequate board attention to this major problem of vertical corporate governance.

¹⁸⁸ See Subrata N. Chakravarty, *Three Little Words*, *FORBES*, Apr. 6, 1998, at 52, 53.

oric, senior managers have recognized these attempts.¹⁸⁹ But how could they not?

A key issue in the merger between Chrysler and Daimler-Benz was the enormous difference between the two companies both in the level of executive compensation, and in the compensation ratios of the highest paid and lowest paid employees.¹⁹⁰ In 1997, for example, Robert Eaton, Chrysler's Chairman of the Board, was paid total compensation of about \$10 million—over 200 times the average worker's pay and nearly as much as the total compensation paid to all 10 members of Daimler-Benz's management board combined.¹⁹¹ Daimler-Benz's Chairman, Jürgen Schrempp, was paid about one-tenth as much as Eaton, making his compensation approximately twenty times that of the average Daimler-Benz worker.¹⁹²

Thus, a major question in the merger was the form that the combined entity's compensation structure should take. Schrempp pointed out that the existing pay differences reflected cultural differences, particularly the somewhat more egalitarian corporate culture in Germany, as demonstrated by labor representation on supervisory boards.¹⁹³ He also predicted that the U.S. model would prove to be the proper form for DaimlerChrysler and other transnational entities, except that "the only way to make big pay packets socially acceptable is by linking them closely to performance."¹⁹⁴ That, of course, is the rhetoric of corporate America, and given that the other corporate governance differences noted in this Article often are more nuanced and subtle than generally advertised, one wonders if this was Schrempp's main point when he said DaimlerChrysler creates "the first German company with a North American culture."¹⁹⁵ If so, both shareholders and laborers should keep a watchful eye and unite their 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 the relative absence of such compensation and the rarity of stock options in German corporations. U.S. law has been tested and has failed, showing us that it is ill-

¹⁸⁹ See, e.g., Linda Corman, *As Good as it Gets: The 1998 Compensation Survey*, CFO, Nov. 1998, at 41, 53 (quoting a highly-paid CFO as being fully in favor of linking pay to performance).

¹⁹⁰ See, e.g., *Stockholders Approve Chrysler Merger: 150 Attend Meeting in U.S. as 16,000 Crowd Daimler-Benz Session in Germany Stock*, WASH. POST, Sept. 19, 1998, at D1 ("Germans [] expressed horror at the huge pay packages of Chrysler executives.").

¹⁹¹ See Haig Simonian & Nikki Tait, *U.S. Executives Earn Much More*, FIN. TIMES (London), Aug. 3, 1998, at 22.

¹⁹² See *id.*

¹⁹³ See *id.*

¹⁹⁴ *Id.*

¹⁹⁵ *Id.*

equipped to police executive compensation. As a matter of corporate law, the general stance of courts in Delaware and other state courts has been to evaluate compensation issues, if at all, under a waste standard—a doctrinal basis that has rarely upset corporate decisions.¹⁹⁶ In the case of executive compensation, it seems the courts have been quite deferential to management indeed.¹⁹⁷

As for securities disclosure laws, the SEC for several years has required substantial and focused disclosure of top executive compensation in comparative performance charts.¹⁹⁸ Nonetheless, corporations continue to structure executive compensation packages as off-balance sheet transactions. Indeed, under U.S. Generally Accepted Accounting Principles (GAAP), nothing requires recording stock option awards as an expense on the income statement or as a liability on the balance sheet, except in the historically rare case of so-called variable stock option plans.¹⁹⁹

In its Statement of Financial Accounting Standards No. 123 (SFAS 123), the Financial Accounting Standards Board (FASB) encourages but does not require entities to recognize compensation expenses for awards of stock, stock options, and other equity instruments.²⁰⁰ Entities opting out of recognition must disclose the pro forma effects of the awards on net income and earnings per share in footnotes to their financial statements.²⁰¹ SFAS 123 also requires extensive disclosure, from all entities offering stock-based plans, concerning plan terms, exercise prices, and fair-value assumptions.²⁰²

As a practical matter, management must measure the fair value of the awards using the principles of SFAS 123. Then they must decide, with regard to employee compensation, whether to recognize these amounts as compensation expenses in the income statement pursuant to SFAS 123, or to continue to employ APB 25²⁰³ and make the re-

¹⁹⁶ See, e.g., *Steiner v. Meyerson*, No. CIV.A.13139, 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 non-fraudulent (and non-negligent) claims against disinterested parties that meet the legal standard of waste may be “rarest of all” and “possibly non-existent”).

¹⁹⁷ See, e.g., *id.* at *8 (holding a grant of immediately exercisable stock options not wasteful under the doctrine of corporate waste “[s]o long as there is *some* rational basis for directors to conclude that the amount and form of compensation is appropriate” (emphasis added)).

¹⁹⁸ See Executive Compensation, 17 C.F.R. § 229.402 (1998).

¹⁹⁹ See ACCOUNTING FOR STOCK-BASED COMPENSATION, Statement of Financial Accounting Standards No. 123, ¶ 26 (Financial Accounting Standards Bd. 1995) [hereinafter FAS 123].

²⁰⁰ See *id.* ¶ 8 (requiring such accounting only for an issuance effected to acquire goods or services from nonemployees).

²⁰¹ See *id.* ¶ 45.

²⁰² See *id.* ¶¶ 45-48.

²⁰³ ACCOUNTING FOR STOCK ISSUED TO EMPLOYEES, APB Opinion No. 25 (1972).

quired footnote disclosure and pro forma calculations. The decision invariably will rest upon what the entity perceives is most attractive for the bottom line, rather than upon the degree to which the resulting financial statements have or lack integrity. This option liberates boards and managers from burdening reported income with these expenses, and it gives boards enormous insulation from rebuke for allowing payment of exorbitant option packages.

More charitably, SFAS 123's requirement of footnote and pro forma disclosure provides users of financial statements with the tools to understand the significance of executive compensation. This requirement should not be understood as a concession to the standard argument against recognition: that stock options are hard to value. Options are no harder to value than many financial statement items to which entities must assign an accounting value under GAAP.²⁰⁴ Indeed with techniques such as the Black-Scholes option-pricing model now widely used, valuing stock options may be easier than valuing depreciated aircraft.²⁰⁵

Without legal or accounting regulations, the job of policing executive compensation lies with the board. Its chief job in this regard should be to insist that executive compensation be pegged to individual contributions to corporate performance. Measuring executive performance by business profitability is the most definitive yardstick with regard to shareholder as well as labor interests. Furthermore, when measuring performance, entities should reduce earnings by the capital employed in the relevant business or by the earnings the firm retains. Corporations should grant stock options, if at all, based on individual optionee performance within his or her area of responsibility, rather than on overall corporate performance.

As various groups work to promulgate new international accounting standards,²⁰⁶ the U.S. position on accounting for (or, more precisely, not accounting for) stock options should be resisted. The chimera of an alignment of shareholder and manager interests

²⁰⁴ See, e.g., LAWRENCE A. CUNNINGHAM, *INTRODUCTORY ACCOUNTING AND FINANCE FOR LAWYERS* 68-70 (1997) (describing the numerous judgments required to properly account for fixed assets over time). Think about the numerous judgments necessary to determine appropriate annual depreciation expense on a fixed asset such as an airplane.

²⁰⁵ In at least one particularly pernicious practice of repricing stock options, however, financial reporting may begin to capture financial reality. Stock option repricing occurs when the issuer's board reduces the exercise price of previously granted options, usually due to a decline in the prevailing trading price of the optioned stock. It is, in effect, a gift to managers from managers—a practice that has proliferated substantially in recent years. The Financial Accounting Standards Board (FASB) has announced that repricing renders the plan a "variable plan" as opposed to a "fixed plan" and, as such, is subject to special treatment under APB 25 and must record a current expense equal to the amount by which the exercise price is reduced. See FAS 123, *supra* note 199, ¶¶ 35, 188.

²⁰⁶ See *supra* notes 95-103 and accompanying text.

through executive stock options also should be abandoned. Instead, regulators should focus attention on rewarding creation of corporate value, properly measured, with appropriately recorded rewards. Boards must lead these efforts. It is particularly important for U.S. boards to begin such efforts immediately to avoid spreading the practice of random executive compensation to other parts of the world as corporate globalization advances. More selfishly, if U.S. boards fail to change the current practices, U.S. law may come to enable shareholders, as well as workers, to turn their heretofore ignored social pressure into effective legal claims.²⁰⁷

2. *Take-Overs: Defenses and Offensive Strategies*²⁰⁸

Just as the disease of random executive compensation must be contained as globalization spreads, the proliferation of cross-border acquisitions indicates the need to minimize certain dangers posed by offensive acquisition policies and defensive tactics. Offensive acquisition strategies require careful board attention because of the strong possibility that even outstanding senior managers have individual interests that conflict with corporate interests. Acquisitions give CEOs enormous psychic benefits by expanding their dominion and generating more action. Acquisitions driven by these sorts of impulses often come at the corporation's expense. Indeed, most acquisitions result in workforce reductions that directly impair worker interests and that fail to achieve gains in business value, thereby also impairing shareholder interests.²⁰⁹

A governance problem exists because most acquisition attempts 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. Rejecting an acquisition proposal after the CEO has invested substantial personal capital is often considered a rejection of the CEO who presented the proposal to the board. Consequently, all directors—including nonemployee directors—are under significant pressure to approve most acquisitions, even those that harm or do nothing to improve the lot of shareholders and workers.

²⁰⁷ See, e.g., *Lewis v. Vogelstein*, 699 A.2d 327, 336-39 (Del. Ch. 1997) (denying motion to dismiss shareholder complaint alleging stock-option plans amounted to waste or a breach of fiduciary duty). For a general discussion of the pressures firms face from shareholders and from other constituencies, see Greenfield, *supra* note 20, at 303-11.

²⁰⁸ Portions of this section appeared previously in some of the author's other works. See *supra* note 185.

²⁰⁹ See, e.g., Louise Kehoe, *Compaq Hurt by Cost of Digital Acquisition*, FIN. TIMES (U.S.), July 16, 1998, at 39 (discussing, in part, the workforce reductions necessitated by Compaq's acquisition of Digital Computer in June 1998, which, as subsequent poor performance at Compaq showed, did little to help its profitability).

The timing problem makes it difficult to design a governance mechanism that would alleviate this sort of pressure on the board. It would be a mistake, moreover, to adopt a strategic plan outlining which acquisitions the board should approve.²¹⁰ A better strategy is to improve the basic thinking that goes into evaluating acquisitions. 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 often 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 buyers who agree to that measure give twice as much in business value as they are getting. The buyer's manager, usually rationalizing his or her actions with arguments about synergies or size, has elevated thrill or excessive optimism above corporate interests. In doing so, the interests of shareholders and workers are subordinated to management interests.

Take-over defenses are the flip-side of offensive acquisition strategies. Anti-take-over devices, such as the U.S. poison pill, protect management's decision making by discouraging attempts to acquire the corporation or to remove incumbent directors (as AMP's defense against AlliedSignal attests).²¹¹ If some or a majority of stockholders deem a take-over attempt to be in the corporation's and their best interest, and the potential acquiror is willing to pay a premium over the prevailing market price or intrinsic value of the corporation's common stock, then anti-take-over devices work against shareholders. Such devices can also be antistakeholder. Restructurings that entail plant closings, for example, can impair employee interests, and restructurings that involve increased leverage in the capital structure can impair lender interests.

To be sure, situations exist in which hostile offers are inadequate and not in the interests of the corporation or any of its constituents. Yet incumbent managers facing unwanted take-over talks naturally will resist the efforts of the acquiring firm, whether or not this resistance best serves the corporation. After all, in most cases their jobs are at risk. Within U.S. corporations—and probably increasingly within corporations organized elsewhere—takeovers will put unmatured stock options at risk. Faced with this prospect, managers might employ mechanisms designed to resist inferior bids in an effort to resist superior bids. This activity can only be characterized as promanagement and anticorporation.

²¹⁰ See Cunningham ed., *supra* note 128, at 740 (quoting Warren Buffett as saying that "more dumb acquisitions are made in the name of strategic plans than any other").

²¹¹ See *supra* text accompanying notes 127-37.

In these situations, boards of corporations around the world must recognize that CEOs and their troops are under fire, just as they are when a board challenges one of their proposed offensive acquisitions. In both situations boards should expect managers to adopt a siege mentality which obscures honest thinking about what is in the corporate interest. In both offensive and defensive situations, there is no clear mechanism that can assure boards will respond properly, but boards must at least recognize what is happening psychologically in these situations if they hope to respond effectively at all.

3. *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 formal²¹²

²¹² A system of archaic legal capital apparatus is intended to limit distributions in the U.K. and in leading U.S. states of incorporation, including Delaware and New York, although the MBCA has created a regime that permits the dismantling of that system. *See* DEL. CODE ANN. tit. 8, §§ 160, 170, 172-74, 242(a)(3), 244 (1991 & Supp. 1998); N.Y. BUS. CORP. LAW §§ 504, 518 (McKinney 1986 & Supp. 1999); MODEL BUS. CORP. ACT § 6.21 (1998). Some relaxation has occurred as to what constitutes valid consideration for securities, such as intangible property and services rendered. *See, e.g.*, 1997 N.Y. Laws 449, § 9 (repealing § 504(b), which stated that "[n]either obligations of the subscriber for future payments nor future services shall constitute payment or part payment for shares of a corporation"). However, many statutes continue to exclude payments in the form of promissory notes or contracts for future services. *See, e.g.*, CAL. CORP. CODE § 409(a) (West 1990) ("[N]either promissory notes of the purchaser . . . nor future services shall constitute payment or part payment for shares of the corporation . . ."). *See also* Lawrence A. Cunningham, *The Modern Sensibility of New York's New Corporate Law*, CORP. (Feb. 2, 1998, § 2), ¶ 23.1 (noting New York's recent adoption of that position). Typical U.S. legal capital regimes such as Delaware permit dividends to be paid out of surplus or net profits and permit share repurchases so long as they do not impair the corporation's capital. *See* DEL. CODE ANN. tit. 8, §§ 160, 170; N.Y. BUS. CORP. LAW § 510 (McKinney 1986 & Supp. 1999).

German law more closely resembles the far more enlightened position of the MBCA, which forbids dividends and other distributions unless the corporation can continue to maintain a positive net worth and to pay its debts as they become due in the ordinary course of business. *See* MODEL BUS. CORP. ACT § 6.40(c) (1998). German law also goes further in favor of the shareholder by permitting dividends to be paid out of distributable profits, as determined by resolution at a shareholder general meeting. *See* 1 ENNO W. ERCKLENTZ, JR., *MODERN GERMAN CORPORATION LAW* 257-59 (1979). French law in effect combines these limitations. It permits payment of dividends only out of retained earnings, only if 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. *See* FRENCH BUSINESS ENTERPRISES: BASIC LEGISLATIVE TEXTS, *supra* note 33, at 88-89.

English law has 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 in the form of the corporation's last audited accounts or interim unaudited accounts filed with the Registrar of Companies of England and Wales. English articles permit directors to authorize payment to shareholders of interim dividends—dividends resolved to be paid by directors without the approval of shareholders in a general meeting—if the directors feel

and manipulable.²¹³ These restrictions grant enormous discretion to boards setting dividend policy—one of the most important capital allocation decisions—yet create no meaningful limits.

Aside from the formal limits, U.S. law gives boards of directors unbridled discretion in the declaration and payment of dividends.²¹⁴ Corporate charters rarely restrict dividend policies, although a corporation's loan and credit agreements sometimes impose limits on these policies. Dividend restrictions are often imposed on German corporations, whose management board possesses discretion in setting dividend policy.²¹⁵

The policy of most U.S. boards is to pay regular quarterly cash dividends at a stable or steadily increasing dollar amount. The typical dividend level among U.S. corporations is higher than that of their German and other European counterparts. Given the importance of dividend policy in capital allocation decisions, certain common reasons that boards use to justify their policies, such as signaling confidence and giving the appearance of reliability, seem strange.²¹⁶

Boards should use a more rigorous approach for setting dividend policy. Under more stringent policies, the payout ratios would probably converge, becoming lower in the United States and the United Kingdom and higher in Europe. A company's decision either to pay out its earnings or to retain them should be based on a single test: each dollar of earnings should be retained if the firm's market value will increase by at least that amount; otherwise, the dollar of earnings should be paid out.²¹⁷ Boards can only justify retaining earnings if,

such dividends are justified by the company's distributable profits. See VICTOR JOFFE, *THE COMPANIES ACT 1980: A PRACTICAL GUIDE*, ¶ 7.001-405 (1980) (discussing the distribution of profits and assets under English law).

²¹³ See, e.g., *Klang v. Smith's Food & Drug Ctrs., Inc.*, 702 A.2d 150, 153-56 (Del. 1997) (upholding management's decision to revalue its balance sheet, which made lawful a share repurchase that would have been unlawful under the legal capital rules without the revaluation).

²¹⁴ The exceptional case was *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919), involving a closely-held corporation engaged in a larger business and competitive battle. In *Dodge* the court held that, in light of the corporation's enormous surplus, "it was [the directors'] duty to distribute . . . a very large sum of money to stockholders." *Id.* at 685. Even in this *Dodge* context most courts refuse to upset board dividend policy decisions. See, e.g., *Kamin v. American Express Co.*, 383 N.Y.S.2d 807, 812 (Sup. Ct. 1976) ("The question of to what extent a dividend shall be declared . . . is ordinarily subject only to the qualification that [it] be paid out of surplus. The Court will not interfere unless a clear case is made out of fraud, oppression, arbitrary action, or breach of trust." (citation omitted)); *Gottfried v. Gottfried*, 73 N.Y.S.2d 692, 695 (Sup. Ct. 1947) ("[T]he mere existence of an adequate corporate surplus is not sufficient to invoke court action to compel . . . a dividend.").

²¹⁵ See, e.g., *THE GERMAN STOCK CORPORATION ACT*, *supra* note 119, at 65.

²¹⁶ See LAWRENCE E. MITCHELL ET AL., *CORPORATE FINANCE AND GOVERNANCE* 740-44 (2d ed. 1996).

²¹⁷ Warren Buffett devotedly follows this standard. See Cunningham, *Buffett Essays*, *supra* note 185, at 124.

and only if, the capital retained produces incremental earnings at least equal to the return generally available to the shareholders.²¹⁸ For companies that can reinvest earnings in this manner, dividends should not be paid and boards should not pay attention to what signals this policy sends (though they might pay attention to the resulting tax advantages to shareholders).²¹⁹

On the related question of distributions via share repurchases, one again would expect the optimal policy to fall somewhere between the norms prevalent in the United States/United Kingdom and in Europe. Although share repurchases are far less common in Europe than in the United States, they are still too infrequent in the United States. European law often prohibits share repurchases or discourages them.²²⁰ Governments in Europe view the reinvestment of available cash as a good way to create jobs.²²¹ This seductive view, however, focuses on the superficial and the political rather than on the substantive and the economic.

Both dividends and repurchases recycle investment rather than dissipate it.²²² However, boards should subject both policies to the retained earnings test. American violators of the retained earnings test face the same danger as their European counterparts: funding unprofitable projects that serve managerial interests rather than shareholder or worker interests.

²¹⁸ See *id.* at 18.

²¹⁹ See MITCHELL ET AL., *supra* note 216, at 737-38.

²²⁰ German law allows a corporation to acquire its own shares upon the authorization by shareholders in only limited circumstances, and in no event may the corporation purchase more than 10% of the outstanding shares. See THE GERMAN STOCK CORPORATION ACT, *supra* note 119, at 73; CHRYSLER CORP., *supra* note 119, at 137. French law generally prohibits corporate share repurchases. It allows them 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 FRENCH BUSINESS ENTERPRISES: BASIC LEGISLATIVE TEXTS, *supra* note 33, at 66-67.

²²¹ See *Corporate Share Buybacks in Europe*, INSIGHTS FROM THE INVESTMENT WORLD, Oct.-Dec. 1998, at 12 (private investment newsletter written and published by Dr. John M. Theologitis, on file with the author) [hereinafter INSIGHTS].

²²² See *id.* Moreover:

[S]hare 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," extract 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. (emphasis omitted).

B. Governance Mechanisms to Promote Board Integrity

1. *Director Liability*

Directors should be accountable for their decisions regarding CEO selection, executive compensation, take-overs, and capital allocation. Nonetheless, the legal regimes in the United States, United Kingdom, and the rest of Europe largely excuse directors from liability in these contexts. In the United States, this lack of accountability exists because of the business judgment rule and the rhetorical nature of fiduciary duty law, not because of any lack of procedural enforcement devices through litigation. Liberal policies of director liability indemnification and immunization also contribute to the absence of director liability. In Europe, director accountability is missing because of a lack of enforcement mechanisms or incentives. Both models, therefore, insulate directors (though for different reasons), and on this comparative score, vertical corporate governance improvements in both models are necessary.

U.S. directors are exposed to almost no risks of liability. The business judgment rule strongly insulates most board decisions from judicial review. Those board decisions involving conflicts or potential self-dealing are provided substantial protection via interested-director statutes, which can sanitize these transactions. Even when courts evaluate board decisions, the focus is on the process of decision making rather than on the outcome.²²³ Additionally, the duty of care standard governs board decisions involving corporate monitoring programs and this standard can be easily met.²²⁴ Lamentably, therefore, it takes very little to discharge duties in connection with decisions concerning such key issues as executive compensation and dividend policy.²²⁵

Courts only occasionally hold boards liable in connection with take-over defenses, and director liability for offensive take-over strategies has been basically unheard of. *Smith v. Van Gorkum*,²²⁶ the case that spawned adoption of further measures to insulate directors from liability, provides a rare example of one of these cases. In that case, the directors' failure to become adequately informed before making a

²²³ See *supra* note 155 and accompanying text.

²²⁴ See, e.g., *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996) ("[A] director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists . . ." (emphasis added)); *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. Ch. 1963) ("If [a director] has recklessly reposed confidence in an obviously untrustworthy employee, has refused or neglected cavalierly to perform his duty as a director, or has ignored either willfully or through inattention obvious danger signs of employee wrongdoing, the law will cast the burden of liability upon him.").

²²⁵ See *supra* Part III.A.1-3.

²²⁶ 488 A.2d 858 (Del. 1985).

decision to sell the corporation was the source of liability. Many legislatures responded to this court's imposition of director liability by statutorily inviting director liability insulation through a simple charter amendment.²²⁷ Other states responded by statutorily insulating boards and not even requiring a charter amendment.²²⁸ Moreover, most U.S. state laws also permit corporations to provide for indemnification of officers and directors who are defending against third-party actions arising from their service so long as the officer or director acted reasonably and in good faith.²²⁹

These devices have functionally sealed off any real exposure to liability for directors of U.S. corporations (other than red-handed thieves and defrauders). This protection has the virtue of helping attract top candidates to director positions. The lack of exposure to liability also helps to attract mediocre directors to the same jobs. These rules 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.²³⁰ On the other hand, the insulation can go too far by relieving directors of risk and shifting too much risk to shareholders and other corporate constituents.²³¹

Of course, directors should not be exposed to liability for all their decisions, and it should not be possible to extract rents from them

²²⁷ See, e.g., DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1998); MODEL BUS. CORP. ACT § 2.02(b)(4) (1998).

²²⁸ See, e.g., IND. CODE ANN. § 23-1-35-1(e)(2) (Michie 1995) (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 (Michie 1993) (imposing dollar limits on extent of director personal liability but not changing the standard of conduct).

²²⁹ These laws generally also allow corporations (1) 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, and (2) 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. 399, 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 will indemnify officers and directors when they are successful in defending a third party or derivative action. The DGCL provides that the indemnification provided for under Delaware law shall not be deemed exclusive of any other rights under any bylaw, agreement, vote of stockholders or disinterested directors, or otherwise. See DEL. CODE ANN. tit. 8, § 145(f) (Supp. 1998). This law further 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 *id.* § 145(e); see also *Advanced Mining Sys., Inc. v. Fricke*, 623 A.2d 82, 84 (Del. Ch. 1992) (noting that advancement of legal expenses and ultimate entitlement to indemnification are two distinct questions). In addition, the DGCL permits an independent legal counsel to determine whether an officer or director has met the applicable standard of conduct. See title 8, § 145(d).

²³⁰ See Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 864 (1984).

²³¹ See Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078 (1968).

through extortionate lawsuits. A balance should exist between protecting directors and exposing them to liability. While it is difficult to create this balance, the fact remains that the current system is not working. Doctrinally, the American Law Institute (ALI) has sought to stake out a middle ground for the United States. It has recommended mechanisms that neutralize disproportionate liability by allowing for director protection while preserving the duty of care.²³² The balanced stance of the ALI leaves at least some meaning to the potential power of fiduciary-duty rhetoric.²³³

Under the ALI framework, it should be possible for courts to require directors to be fully informed about executive compensation packages and dividend policies. It is also possible for courts to expect directors to be aware of their potential personal liability if they approve pay packages unlinked to performance or if they approve dividend policies that hoard cash at poor rates of return only to later spend the money on profitless acquisitions. Exposing directors to personal liability for this sort of ineptitude might serve as a deterrent and might reduce the number of directors willing to serve on boards. On the other hand, those deterred would likely have avoided giving the attention these sorts of important questions deserve.

European corporations have not had recruiting trouble, despite the absence of rules immunizing directors. German law does not permit director exculpation and places extreme limits on indemnification.²³⁴ French law permits neither. Admittedly, the formal exposure to liability that these laws sustain for European directors currently may not be especially meaningful. Lawsuits against boards are not very likely when large bank creditors and shareholders also serve on the boards.²³⁵ Notably, however, English law, which also both prohibits immunization and severely limits indemnification to narrow circumstances,²³⁶ has not deterred top directors from joining shareholder

²³² See PRINCIPLES OF CORPORATE GOVERNANCE § 7.19 (proposed final draft 1992). At the other extreme, there are those who see no substantive value in the duty of care and would be happy to abolish it and its exculpation and indemnification mechanisms. See, e.g., Kenneth E. Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927, 935-37 (1983).

²³³ See *supra* notes 159-65 and accompanying text.

²³⁴ 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. Also, German corporate law permits, with shareholder approval, the waiver or settlement of claims that are over three years old. See THE GERMAN STOCK CORPORATION ACT, *supra* note 119, at 95. It also permits a corporation to indemnify its officers, and in certain circumstances this indemnification is mandatory. Lastly corporations are permitted to buy insurance for directors and officers. See THE GERMAN STOCK CORPORATION ACT, *supra* note 119, at 81, 89-91; CHRYSLER CORP., *supra* note 119, at 138-39.

²³⁵ See *supra* Part I.B.

²³⁶ English companies may not indemnify directors or officers against liability for negligence, default, or breach of duty or trust. They may indemnify directors or officers for

market-model corporations in the United Kingdom. Thus, European laws that expose directors to personal liability without indemnification may not mean very much now, but that is likely to change as the forces of globalization continue. Pressure to change these laws is likely to come, but should be resisted.

Another possible reason for these national differences in director liability exposure (at least between the United States and Germany) is the availability of enforcement mechanisms, such as litigation. U.S. state laws that permit shareholders to bring derivative actions on behalf of the corporation as well as class actions²³⁷ seem to create additional reasons to restrict director liability. German and U.K. corporate law, with their allowance of extensive director liability, neither provide for class actions nor generally permit shareholders to bring derivative suits.²³⁸ There is less need to do so.²³⁹ Again, as the landscape continues to change, we should pay close attention to the interaction between these different national stances and how they affect corporate governance.

Shareholder ability to maintain lawsuits is an important aspect of U.S. corporate governance. It contributes to the depth and liquidity of capital markets by encouraging investment,²⁴⁰ and it also can help to discipline managers.²⁴¹ This ability is made possible in part by a general cultural orientation toward judicial dispute resolution as well as incentive structures not accepted elsewhere. In particular, the ability to maintain lawsuits neutralizes an otherwise skewed incentive structure of derivative claims: the nominal plaintiff incurs substantial costs but reaps gains only in proportion to its contribution to the cor-

liability incurred defending cases they win or cases they lose but in which they are considered to have acted honestly and reasonably. English corporations are permitted to buy insurance for directors and officers against personal liability. See Sarah Worthington, *The Duty To Monitor: A Modern View of the Director's Duty of Care*, in 2 PERSPECTIVES ON COMPANY LAW, *supra* note 150, at 181, 201.

²³⁷ Ordinarily, the shareholder must have been a shareholder at the time of the transaction that is the subject of the derivative suit and must continue to be a shareholder throughout the duration of a derivative suit. See, e.g., DEL. CODE ANN. tit. 8, § 327 (Supp. 1998). Prior to bringing that 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. See, e.g., N.Y. BUS. CORP. LAW § 626(c) (McKinney 1986).

²³⁸ 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 that the corporation claim damages against directors of either board for breach of their duties. See THE GERMAN STOCK CORPORATION ACT, *supra* note 119, at 150; CHRYSLER CORP., *supra* note 119, at 131.

²³⁹ In contrast, French law permits these suits, even though it limits director liability exculpation. See FRENCH BUSINESS ENTERPRISES: BASIC LEGISLATIVE TEXTS, *supra* note 33, at 72-73.

²⁴⁰ See SHLEIFER & VISHNY, *supra* note 186.

²⁴¹ See Philip E. Strahan, *Securities Class Actions, Corporate Governance and Managerial Agency Problems* (Nov. 1998) (unpublished manuscript, on file with author).

porate entity's equity (the payoff goes to the corporation). Some cultures may find it unattractive to cede ownership of the claim from the shareholder to the lawyer²⁴² 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 be to realign the incentives on the cost side by authorizing a country's public securities authority (like the SEC) to fund lawsuits. Alternatively, authorizing judges to award lead plaintiffs compensation for their efforts could achieve the same benefits.²⁴³ 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 practice is off limits in U.S. corporations,²⁴⁴ it is not inconceivable²⁴⁵ and in fact would be in tune with historical traditions in Europe. On the other hand, precisely that sort of proposal failed there. The outlook for resolving these questions is therefore very murky indeed. However, this seemingly bleak prognostication tends to underscore rather than undermine the need for increased attention to the importance of vertical corporate governance worldwide.

2. *Constituency Voice*

Convincing boards to listen to constituents would be an effective method of corporate governance, but legal and practical limits have frustrated this simple vehicle around the world. Constituency voice is limited in part by apathy and collective-action problems, but these limitations explain only part of the problem.

Most U.S. state laws authorize corporations to establish procedures governing the making of shareholder proposals at annual or special meetings.²⁴⁶ Furthermore, SEC regulations impose additional rules on the proposals management must include in proxy statements.²⁴⁷ As a matter of practice, management on average strongly

²⁴² See Procaccia, *supra* note 93, at 641 ("[Israel was] perfectly aware of the American solution [to create incentives for derivative or class action lawsuits]: the use of attorneys as private collection agencies. This solution was found unsuitable in [Israel] because it runs counter to a widely accepted ethos that . . . litigation . . . 'belongs' to the litigants themselves.").

²⁴³ See *id.* at 641-43.

²⁴⁴ Instead, workers of U.S. 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, collective bargaining, and loan agreements. 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.

²⁴⁵ See generally Greenfield, *supra* note 20 (discussing workers' role in contemporary corporate law).

²⁴⁶ See, e.g., *Campbell v. Loew's, Inc.*, 134 A.2d 852, 855-56 (Del. Ch. 1957); *Auer v. Dressel*, 118 N.E.2d 590, 593 (N.Y. 1954).

²⁴⁷ See 17 C.F.R. § 14a-8 (1998).

prefers rules that would enable it to omit shareholder proposals from its proxy statements.²⁴⁸ Among the many proposals, constituency interests often conflict, principally because in the United States virtually anyone can satisfy the eligibility requirements for compelling a corporation to include a so-called shareholder proposal in the corporation's annual proxy statement. Under the U.S. federal proxy rules, it is enough to own 1% or \$1,000 in market value of the corporation's equity for one year.²⁴⁹ Shareholder proposals thus often are made by only nominal shareholders,²⁵⁰ proposing such things as reporting requirements concerning the environmental impact of corporate actions, race and sex discrimination, or human rights activities.²⁵¹

A proposal by employees advocating greater toleration for gay and lesbian workers in Cracker Barrel Stores provides one of the most dramatic and recent examples of a controversial shareholder proposal.²⁵² The SEC vacillated on whether management could exclude that proposal on the ground that it interfered with "ordinary business operations," one standard for exclusion under the shareholder proposal rule.²⁵³ The SEC ultimately yielded and promulgated new rules governing these proposals. These rules reversed the SEC's position and prohibited management from refusing to include shareholder proposals because they implicate questions of social policy.²⁵⁴

In contrast, German law makes it somewhat more difficult for shareholders to make proposals. German law empowers shareholders to put a matter on the agenda for resolution and to have the management board submit a proposal at shareholder meetings, but only if the

²⁴⁸ One need only browse through the SEC No-Action letters, which are available both at the SEC's web site, *see* SEC, *U.S. Securities Exchange Commission* (last modified Oct. 6, 1998) <<http://www.sec.gov>>, and on Lexis (SEC No-Action, Exemptive, and Interpretative Letters database), to get a flavor for just how often management seeks to avoid including shareholder proposals in its proxy statements.

²⁴⁹ *See* 17 C.F.R. § 14a-8(a)(1) (1998).

²⁵⁰ *See Record Number of Resolutions Win Majority Votes*, 8 CORP. GOVERNANCE HIGHLIGHTS 129 (1997) [hereinafter *Record Number*].

²⁵¹ *See generally* Henry G. Manne, *Shareholder Social Proposals Viewed by an Opponent*, 24 STAN. L. REV. 481 (1972) (examining in detail the law relating to shareholder social proposals).

²⁵² *See* Cracker Barrel Old Country Store, Inc., SEC No-Action Letter, [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CGH) ¶ 76,418, at 77,284 (Oct. 13, 1992).

²⁵³ 17 C.F.R. § 14a-8(c)(7) (1998).

²⁵⁴ The SEC initially determined that "distinctions between policies implicating broad social issues and the conduct of day-to-day business [are] simply too hard to draw as regards the employment of the general workforce." *Amalgamated Clothing and Textile Workers Union v. Wal-Mart Stores, Inc.*, 821 F. Supp. 877, 888 (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.* at 890. 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* Amendments to Rules on Shareholders Proposals, Exchange Act Release No. 34-40018 (May 21, 1998), available in 1999 SEC No-Act LEXIS 253.

shareholders hold, in the aggregate, at least 5% of the outstanding shares.²⁵⁵ The 5% requirement effectively makes it prohibitive for nonshareholder interest groups to use this vehicle of voice in the same manner as constituency groups in the United States. This difference between German and U.S. law can partially be understood in terms of historical governance structures in Germany that gave formal representation to workers on boards. The development of a corporate conception of the common interest also played an important role in making this distinction. However, Germany's devices have proven more formal than real,²⁵⁶ and as German corporations increasingly have shareholders from the United States and other foreign countries,²⁵⁷ the need for other avenues of constituency voice will likely increase.

The U.S. mechanisms for shareholder or other constituency voice can have meaningful, constraining effects on managerial discretion. These mechanisms have led to substantial changes in policies at many major corporations, for both shareholders and others. For example, beginning in the 1930s, the shareholder proposal rule was used to enhance shareholder rights in such areas as cumulative voting and dissemination of post-meeting reports to shareholders.²⁵⁸ Non-shareholder constituencies harnessed the power of this device to effect social change beginning in the 1970s, with the famous Campaign GM that led to integration of GM's board of directors.²⁵⁹ In the past couple of decades shareholders and other constituencies alike have used the device thousands of times. Although most such campaigns do not carry a majority vote, increasing numbers of proposals have won.²⁶⁰

Unfortunately, management often opts not to implement a winning proposal.²⁶¹ After all, if management believes in the proposal they would adopt it without waiting for a constituency initiative or vote. The only available tools to police director conduct in such settings—fiduciary duties—simply may be inadequate for this job. In addition, in the United States a conflict between stakeholder and shareholder interests exists. Because everyone knows nominal share-

²⁵⁵ See 1 ERCKLENTZ, *supra* note 212, at 287.

²⁵⁶ See *supra* Part II.B.

²⁵⁷ For example, half of DaimlerChrysler's shareholders and a quarter of SAP's are U.S. residents.

²⁵⁸ See LEWIS D. SOLOMON ET AL., *CORPORATIONS LAW AND POLICY: MATERIALS AND PROBLEMS* 597 (4th ed. 1998).

²⁵⁹ See Donald E. Schwartz, *The Public-Interest Proxy Contest: Reflections on Campaign GM*, 69 MICH. L. REV. 419 (1971) (providing analysis of issues raised by Campaign GM in the context of using the proxy and annual meeting machinery as a means of effecting social policy).

²⁶⁰ See *Record Number*, *supra* note 250.

²⁶¹ See *id.*

holders can make proposals, management often can take lightly even those proposals that win the support of a majority of shareholders.

Yet it is incongruous to allow nominal shareholder constituencies to exercise this right of voice while also allowing management to ignore it. This contradiction may simply mean that the SEC rules are inappropriate or tend excessively to alter state corporate law allocations of power between management and constituencies. It is thus an unfortunate irony that the overall framework of the shareholder proposal rule was designed to respect these state laws. Indeed, the SEC crafted the rule ultimately to be a mechanism through which the proxy voting apparatus could serve as a surrogate for the old-fashioned live shareholder meeting.²⁶²

The combination of easy access for all constituents to the proposal mechanism and requiring a shareholder vote should have the opposite effect on management in a corporate governance system that extends its protections to a range of constituents. Boards should take these exercises of constituency democracy seriously. Accordingly, we should consider modifying the traditional formulation and application of fiduciary duties. In particular, new regulations should call for boards to review shareholder proposals, to become fully informed about them, and to adopt them following majority vote unless they can furnish compelling reasons for rejecting them. In short, if constituents vote favorably upon a properly submitted proposal, management should be obligated to act.²⁶³

3. *Markets*

Director liability and constituency voice can promote effective board supervision of managerial power. Yet neither these nor any other devices effectively will impose sufficient discipline on all corporations. Markets must fortify these mechanisms, particularly capital markets and executive labor markets. Governance mechanisms—including external governance mechanisms—must be evaluated in terms of their impact on the operation of these markets.

²⁶² Federal courts evaluating the legitimacy of a corporation's claimed ground for exclusion look to state law to make that determination. See, e.g., *International Bhd. of Teamsters Gen. Fund v. Fleming Cos.*, No. CIV-96-1650-A, 1997 US Dist. LEXIS 2980, at *1-2 (W.D. Okla. Jan. 24, 1997) (deciding a Rule 14a-8 issue based on an interpretation of Oklahoma law). Unfortunately, since the enactment of the federal proxy rules, the SEC has led the way in making determinations about application of the shareholder proposal rules, leaving state law on the subject fairly undeveloped. See *Amalgamated Clothing and Textile Workers Union v. Wal-Mart Stores, Inc.*, 821 F. Supp. 877, 884 n.7 (S.D.N.Y. 1993).

²⁶³ 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, 299-310 (1997) (proposing to substitute board leadership with more direct shareholder involvement).

Public scrutiny and reporting of management performance can discipline managers and directors by appealing to their reputational interests as suppliers of services in a market.²⁶⁴ Bad press leads to bad reputations and bad job prospects. This series of threats can hold directors (and other managers and people generally) to the fire. Yet a whole series of mechanisms exists which tends to interfere with the activation of these threats. Excessive executive compensation neutralizes these threats by weakening executive dependency on labor income. Limits on director liability for inattention or foolishness also insulate the offending director from the kind of scrutiny and rebuke that such conduct should register in a properly functioning market. The mechanisms of vertical corporate governance should not inhibit the mechanisms of external corporate governance in these ways. However, unless these devices are revised, they will continue to do so.

As for capital markets, they can impose discipline in terms of a corporation's ability both to attract capital and to avoid becoming a take-over target. To be effective, the markets must be deep and efficient—a possible condition in the United States and United Kingdom, and an increasingly possible condition in Europe.²⁶⁵ In the same way that external regulation can impair the discipline of labor markets, external regulation of take-overs can impair the discipline of capital markets.

While continental European law often is seen as entailing substantial governmental regulation and intervention (and is called corporatist), and the law of the United States and United Kingdom is seen as promoting a free market (and is called capitalist), these characteristics are no more a complete picture than the abstract comparative pictures of governance models outlined in Part I. The United States and United Kingdom impose substantial external governance regulations on their markets relative to Europe, counterbalancing their otherwise greater efficiency.²⁶⁶

In the United Kingdom, the City Code on Takeovers regulates take-overs of PLCs.²⁶⁷ The Code restricts target company boards' actions in a number of ways that would frustrate take-over offers, including issuance of new shares without prior shareholder approval.²⁶⁸

²⁶⁴ See Cunningham ed., *supra* note 128, at 727-28.

²⁶⁵ See *supra* Part II.C.

²⁶⁶ See Fabrizio Barca, *Some Views on U.S. Corporate Governance*, 1998 COLUM. BUS. L. REV. 1 (arguing that in the U.S. market-based corporate governance system, courts play a central role due to the intrinsically incomplete nature of contracts and the reliance on the market as a device to address this problem); Gérard Hertig, *Corporate Governance in the United States as Seen from Europe*, 1998 COLUM. BUS. L. REV. 27, 28-33 (suggesting that the U.S. corporate governance framework is based on the assumption of market failure).

²⁶⁷ See PANEL ON TAKEOVERS AND MERGERS, CITY CODE ON TAKEOVERS AND MERGERS AND THE RULES GOVERNING SUBSTANTIAL ACQUISITIONS OF SHARES (9th ed. 1996).

²⁶⁸ See *id.*

The English Companies Act also contains rules relating to take-over offers, including a requirement that if an acquirer obtains or agrees to obtain 90% or more of a target's shares, it may within two months after reaching the 90% level, by notice, acquire the remaining shares on the same terms as the offer.²⁶⁹ Holders of those remaining shares must apply to a court for relief of the obligation to sell to the acquirer or to have the court specify different terms of transfer. Alternatively, the remaining shareholders not given the appropriate notice may compel the acquirer to buy their shares.²⁷⁰

The SEC has promulgated rules containing extensive provisions regulating tender offers, mainly by imposing requirements on the offer's form and by requiring comprehensive and detailed disclosure upon commencement of a tender offer. Requirements include (1) a twenty business day minimum offering period, (2) shareholder withdrawal rights coextensive with the offering period, (3) withdrawal rights after sixty days from the date of the initial offer if the offeror has failed to pay, (4) pro rata acceptance for oversubscribed offers, (5) nondiscrimination among offerees, and (6) the extension of any price increase during the tender offer to all shareholders who had previously tendered.²⁷¹ These requirements all have the effect of tilting the level of play in favor of targets and against insurgents, and thus restrict free market forces.²⁷²

In addition, state laws also impose extensive regulation of take-overs in the United States that often makes hostile take-overs far more difficult and costly to effect. For example, some state statutes prohibit business combinations²⁷³ between a corporation and a 10% or greater shareholder (called an "interested holder") unless one of the following conditions is met: (1) the board of directors approves of the share acquisition or business combination before the shareholder becomes an interested shareholder or (2) a period of years—often five years—elapses and either a majority of the disinterested shareholders approves the deal, or those shareholders are paid "fair value" for their stock.²⁷⁴ A bewildering array of other statutes puts similar limits on the market for corporate control, including control share acquisition

²⁶⁹ See *id.*

²⁷⁰ See *id.*

²⁷¹ See 17 C.F.R. § 240.13e-4(f)(1) (1998).

²⁷² 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, 596-603 (1997).

²⁷³ 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.

²⁷⁴ See, e.g., DEL. CODE ANN. tit. 8, § 203 (Supp. 1998); IND. CODE ANN. § 23-1-43-18(a) (Michie 1995); N.Y. BUS. CORP. LAW § 912(b)(c) (McKinney Supp. 1999).

statutes,²⁷⁵ supermajority and fair-price statutes, appraisal statutes, and disorgement statutes.²⁷⁶

These devices impair the efficacy of capital market discipline. This discipline is already limited by its own internal inefficiencies, evidenced by gigantic stock gyrations as the norm, with an average company's fifty-two-week high and low varying as much as 50%.²⁷⁷ These regulations have been virtually nonexistent in continental Europe, but with the new European exchange structure²⁷⁸ we can be sure there will be pressure in that direction.²⁷⁹ Granted, devices like poison pills and other private company take-over defenses sometimes prove useful in enabling boards to deflect offers that would not serve corporate interests. Finding the ideal balance is an awesome challenge, as the experience in the United States shows. Discovering this balance in the future corporate world will be no less challenging as it moves to-

²⁷⁵ A main consequence of many take-overs 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, appraisal rights can protect shareholders as back-end discipline. Under U.S. state laws, a stockholder of a corporation participating in certain major corporate transactions may, in certain circumstances, be entitled to receive cash equal to the fair market value of his or her shares (as determined by a court of competent jurisdiction or by agreement of the stockholder and the corporation) in lieu of the consideration he or she would otherwise receive in the transaction. Some states—notably Delaware and New York, though not the MBCA 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, designated as a national market security on an interdealer quotation system by the National Association of Securities Dealers, or held by more than 2000 record shareholders; or (c) a merger in which the corporation is the survivor if no vote of its stockholders is required to approve the merger. See CHRYSLER CORP., *supra* note 119, at 81-82. Provisions such as these represent promanagement exceptions not found in German law. In Germany, 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 United States and Germany. While some differences certainly exist, there is also reason to doubt that U.S. capital markets are so efficient as to justify this exception to the appraisal remedy.

²⁷⁶ See generally SOLOMON ET AL., *supra* note 258, at 76-87.

²⁷⁷ See Thomas C. Frame, *Equities: US Equities*, in MORGAN STANLEY DEAN WITTER, ASSET ALLOCATION REVIEW AND OUTLOOK 16 (1998); 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) (warning against overreliance on the efficient capital market hypothesis in making policy decisions).

²⁷⁸ See *supra* notes 76-88 and accompanying text.

²⁷⁹ See *supra* Part II.A. It is possible that these anti-take-over mechanisms are unnecessary in Germany because worker representation on the supervisory board would resist allowing shareholders to wrest control if they intended to disrupt employment. See Roe, *supra* note 23, at 1970. Yet not all take-overs have this effect on workers, which means that co-determination is not a complete anti-take-over device. Managers facing enhanced capital market scrutiny may begin to look for other devices.

ward convergence, compromise, and middle grounds in trade-off dilemmas.²⁸⁰

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 which exist and persist across national boundaries, the differences are not so pronounced as to prevent business combinations of companies organized in different countries. These business combinations both draw upon points of governance harmony and help forge deeper fusion. Cross-border alliances among businesses are leading to the articulation of a new global corporate governance template which 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 it should be forged to meet those challenges in a realistic way. In particular, the core problems faced by worldwide corporations are not all that different, especially considering the vertical relationship between those in control of corporations and others. In those terms, the central jobs corporate boards face are almost identical.

²⁸⁰ See *supra* Part I.C.