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The Dark Side of Shareholder Influence: Managerial Autonomy and Stakeholder Orientation in Comparative Corporate Governance

Martin Gelter*

This article proposes a new, functional explanation of the different roles of non-shareholder groups (particularly labor) in different corporate governance systems. The argument depends on the analysis of a factor that has so far received relatively little attention in corporate governance research: the level of shareholder influence on managerial decision making. Pro-employee laws mitigate holdup problems—opportunism from which shareholders benefit ex post, but which will deter firm-specific investment in human capital ex ante. Since holdup takes place within what is considered legitimate managerial business judgment and all shareholders (both majority and minority) are its financial beneficiaries, the degree of managerial autonomy from shareholders is an important factor. In the United States, proponents of a stakeholder view of corporate law have argued that the insulation that U.S. boards of directors have from shareholders mitigates the risk of holdup of nonshareholder constituencies by shareholders, thus encouraging firm-specific investment such as investment in human capital. However, the large degree of autonomy of U.S. boards is unusual. This autonomy is eliminated, for example, by concentrated ownership, which prevails in Continental Europe. This article therefore suggests that, given their costs, laws aiming at the protection of stakeholders—such as codetermination and restrictive employment laws—may be normatively more desirable in the presence of stronger shareholder influence, particularly under concentrated ownership. The theory is corroborated by the observation that such laws tend to be more strongly developed in corporate governance systems with stronger shareholder influence. The United Kingdom, which has both stronger shareholder influence and stronger employment law than the United States, is classified as an intermediate case.

I. INTRODUCTION

The predominant academic view of corporate law today rests on the principal-agent paradigm. Most corporate law scholarship continues to analyze

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the law in terms of agency relationships, including both the classic Berle-Means-type separation of ownership and control under a dispersed ownership structure, and the agency conflict between controlling and minority shareholders under concentrated ownership. The interests of stakeholders other than shareholders are usually left on the sidelines, descriptively and sometimes even normatively. However, recognizing developments in economic theory, corporate law theory is increasingly debating the significance of firm-specific investment by other constituencies; the most prominently discussed case is specific investment in human capital by employees. While specific investment is said to enhance the firm's productivity and competitiveness, it also exposes workers to holdup, which in turn creates disincentives for specific investment in the first place.[1] Some scholars, such as Margaret Blair and Lynn Stout, have suggested that the insulation of directors from shareholders in U.S. corporate law mitigates potential holdup problems.[2]

In the comparative corporate governance literature, the impact of stakeholder theory has remained fairly limited. The literature typically juxtaposes two types of corporate governance systems. On the one side, arm's length or outsider systems—mainly the U.S. and the U.K. systems—are said to be characterized by dispersed ownership, strong securities markets, and agency problems between shareholders and managers that are held in check by market mechanisms, most of all the market for corporate control. Control-oriented or insider systems—such as those of Continental European countries—have concentrated ownership,[3] less developed securities markets, and a managerial agency problem mitigated by the monitoring function of large shareholders and, sometimes, creditors. Large shareholders' private benefits of control then pose another agency problem.[4] In both systems, the

1. In economic theory, the term holdup problem refers to a situation where one party makes an investment that is specific to the investment of another party. Since this investment cannot be used to gain the same benefits in a relationship with a third party, the party having made the investment can be threatened with opportunistic renegotiation of the contract, resulting in the loss of the rent on the investment if contractual protection is incomplete. Benjamin Klein, *Hold-up problem*, *in* 2 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 241 (Peter Newman ed., 1998). The paradigmatic example is the Fisher Body-General Motors case. Following an unexpected surge in the demand for cars, Fisher was able to charge General Motors a supracompetitive price for its car bodies. Ultimately, the problem was solved by a merger between the two firms in 1926. *See* Benjamin Klein, Robert G. Crawford & Armen A. Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297, 308–10 (1978).

2. *See* Margaret Blair & Lynn Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999); *infra* notes 65–67 and accompanying text.

3. *See* Randall K. Morck, *Introduction* to CONCENTRATED OWNERSHIP STRUCTURE 1, 1 (Randall K. Morck ed., 2000); Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Corporate Taxonomy*, 119 HARV. L. REV. 1641, 1645–50 (2006) (both summarizing evidence on ownership concentration).

4. *See, e.g.*, Erik Berglöf, *A Note on the Typology of Financial Systems*, *in* COMPARATIVE CORPORATE GOVERNANCE: ESSAYS AND MATERIALS 151, 159–64 (Klaus J. Hopt & Eddy Wymeersch eds., 1997); Brian R. Cheffins, *Does Law Matter? The Separation of Ownership and Control in the United Kingdom*, 30 J. LEGAL STUD. 459, 465 (2001); John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 3 (2001).

scholarship tends to emphasize the importance of protecting investors against self-dealing by managers and large shareholders.

It is another staple narrative of comparative corporate governance that Anglo-Saxon systems either do not take stakeholder interests into account, or do so to a much smaller degree than do Continental systems.[5] Some commentators suggest that this description is clichéd, and that actual practice does not differ significantly.[6] Others have observed a shift toward stakeholder rhetoric in business practice since the early 2000s.[7] Nevertheless, the dominant view holds that shareholder primacy is the economically efficient corporate objective, and that the Anglo-Saxon model of corporate law will ultimately prevail in a Darwinian struggle.[8] Protecting the interests of other constituencies is usually thought to be counterproductive, as long as it cannot be explained by "enlightened shareholder value," that is, a long-run view toward shareholder wealth that requires some regard to stakeholder interests in the short run.[9] U.S. corporate law, hardened by regulatory competition and efficient markets, is presumed to deviate from this principle only in exceptional circumstances. Focusing on agency problems, much of the literature emphasizes that deviations from the "standard" model must be inefficient.[10]

Functional explanations providing economic reasons for different degrees of stakeholder orientation are conspicuously absent from the debate.[11] True, some corporate governance scholars have sought explanations for the perceived cross-national variation in the concern for stakeholders.[12] Some have emphasized cultural norms,[13] others diverse religious backgrounds.[14] Mark

5. *E.g.*, Brian R. Cheffins, *The Metamorphosis of "Germany Inc.": The Case of Executive Pay*, 49 AM. J. COMP. L. 497, 500–01 (2001); Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 443–49 (2001); Amir N. Licht, *The Maximands of Corporate Governance: A Theory of Values and Cognitive Style*, 29 DEL. J. CORP. L. 649, 733 (2004); Klaus J. Hopt, *Labor Representation on Corporate Boards: Impacts and Problems for Corporate Governance and Economic Integration in Europe*, 14 INT'L REV. L. & ECON. 203, 208–09 (1994).

6. *See* MATHIAS M. SIEMS, CONVERGENCE IN SHAREHOLDER LAW 175–90 (2008).

7. Lisa M. Fairfax, *The Rhetoric of Corporate Law: The Impact of Rhetoric on Corporate Norms*, 31 J. CORP. L. 675, 690–98 (2006).

8. Hansmann & Kraakman, *supra* note 5, at 443–49.

9. *See, e.g.*, John Armour, Simon Deakin & Suzanne J. Konzelmann, *Shareholder Primacy and the Trajectory of UK Corporate Governance*, 41 BRIT. J. INDUS. REL. 531, 537 (2003).

10. Hansmann & Kraakman, *supra* note 5, at 441–49.

11. *But see* Ronald J. Gilson & Mark J. Roe, *Lifetime Employment: Labor Peace and the Evolution of Japanese Corporate Governance*, 99 COLUM. L. REV. 508 (1999) (discussing the role of industry- and firm-specific investment in human capital in Japanese corporate governance).

12. *See, e.g.*, PETER A. GOUREVITCH & JAMES SHINN, POLITICAL POWER AND CORPORATE CONTROL 8 (2005); Mark J. Roe, *Political Preconditions to Separating Ownership from Corporate Control*, 53 STAN. L. REV. 539, 542 (2000) (both criticizing the neglect of employees in corporate governance models).

13. Licht, *supra* note 5, at 667–86, 733–39 (suggesting that Anglo-Saxons are more likely to accept single maximand variables such as shareholder wealth).

14. Dirk A. Zetzsche, *An Ethical Theory of Corporate Governance History* 23 (Ctr. for Bus. & Corp. Law, Working Paper No. 0026, 2007), *available at* http://ssrn.com/abstract=970909 (arguing that Catholic and Lutheran ethical values were historically more conducive to stakeholder orientation than Calvinist and Anglican ones).

Roe has suggested that shareholder primacy could be inefficient in concentrated industries, as the consumer surplus will be partly captured by shareholders and partly lost.[15] Pro-stakeholder institutions could, therefore, be seen as complementary to noncompetitive product markets,[16] which should then disappear once barriers to free trade have been removed. However, Roe has also argued that social democratic policies help to entrench the strong position of stakeholders in many countries. Since the results of these policies—such as labor codetermination—impede the monitoring of managers, they also provide the *raison d'être* for the continued existence of concentrated ownership, which in spite of its problems keeps managers under control, thus lessening agency cost.[17] To be sure, the significance of cultural and political factors is hard to deny, and it would not be credible to claim that every aspect of any corporate governance system is determined by economic efficiency. However, it is reasonable to believe that relatively successful economic systems, such as those of the United States and of most Western European states, cannot be too far away from a local optimum with respect to corporate governance.

I argue that the "specific investment" view of the corporation can provide such an explanation in combination with another important factor that has been largely overlooked in the comparative literature. Theories suggesting that the powerful position of the board of directors mitigates holdup risk for nonshareholder constituencies are sometimes criticized on the grounds that insulation exacerbates managerial agency problems and is, therefore, not necessarily helpful to stakeholders. This argument has some value, but it conflates two different issues. First, corporate law is largely concerned with protecting investors against illicit self-dealing by managers and large shareholders. This *shareholder protection* is the concern of most comparative corporate governance theories. By contrast, whether stakeholders such as employees are subject to holdup risks depends on what decisions are taken by managers within the scope of their *legitimate business judgment*—for example, whether a production site is closed. Such decisions are not usually second-guessed by courts. Since shareholders are the financial beneficiaries of this type of exploitation of employees' expectations, the questions of whether they can influence these decisions directly and whether managers otherwise have an incentive to pursue ex-post shareholder wealth maximiza-

15. Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. Pa. L. Rev. 2063, 2066 (2001).

16. *Id.* at 2080–81.

17. Mark J. Roe, Political Determinants of Corporate Governance (2003) [hereinafter Roe, Political Determinants]; Roe, *supra* note 12, at 542; *see* Gourevitch & Shinn, *supra* note 12 (interpreting corporate governance structures as result of coalition-building between owners, managers and workers); Marco Pagano & Paolo F. Volpin, *The Political Economy of Corporate Governance*, 95 Am. Econ. Rev. 1005 (2005) (suggesting that majority voting systems favor strong shareholder protection and weak employment protection, while proportional voting systems tend to result in the opposite arrangement); *see also* Gilson & Roe, *supra* note 11 (discussing the role of industry- and firm-specific investment in human capital in Japanese corporate governance).

tion are important. This crucial factor in my analysis is what I will refer to as *shareholder influence.* I attempt to explain how capital structure and asset specificity are connected. Specifically, I argue that, all else being equal, concentrated ownership exacerbates holdup problems regarding stakeholders, since shareholder influence is much greater than in a classical Berle-Means firm.[18]

Shareholder influence may help to explain differences we observe in pro-stakeholder laws in different countries of the "wealthy west." Continental European corporate governance systems, which are characterized by strong shareholder influence due to concentrated ownership, have pro-stakeholder institutions in their corporate governance systems and much more rigid employment laws than the United States, which to some degree protects employees against holdup. Since pro-stakeholder laws come at considerable cost, their desirability varies depending on the respective degree of shareholder influence. Thus, I argue that both the U.S. and Continental European systems are close to their respective local optima given their respective ownership structures. I provide a new, functional explanation for differences in pro-stakeholder laws between different systems and institutional complementarities in corporate governance. However, my explanation differs from the "varieties of capitalism" literature, according to which divergent systems are characterized by different modes of production that drive institutional differences.[19] I propose that differences in the law are influenced by different ownership structures, which have repercussions on the type of productive strategies. My analysis suggests that similar levels of firm-specific investment may be possible under different institutions. However, each possible set of institutions comes with a different set of costs.

My view is that differences in shareholder influence are variations in degree rather than absolute differences. For my theory to be plausible, team production theory does not necessarily have to provide the best possible descriptive account of U.S. corporate law.[20] The point is that it provides a much better fit in the United States than in Europe. Most of this article focuses on the differences between U.S.-style dispersed ownership and Continental European concentrated ownership, and how these types of owner-

18. Some authors have suggested that large shareholders may expropriate stakeholders with relative ease, but the issue has not yet been analyzed in detail. *See* Gérard Charreaux & Philippe Desbrières, *Corporate Governance: Stakeholder Value versus Shareholder Value*, 5 J. MGMT. & GOV. 107, 116 (2001); Gregory Jackson, *Employee Representation on the Board Compared: A Fuzzy Sets Analysis of Corporate Governance, Unionism and Political Institutions*, 12 INDUSTRIELLE BEZIEHUNGEN 252, 258 (2005); Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 758 (1997); *see also* Michel A. Habib, *Monitoring, Implicit Contracting, and the Lack of Permanence of Leveraged Buyouts*, 1 EUR. FIN. REV. 139 (1997) (modeling ownership choices following leveraged buyouts).

19. *See generally* Peter A. Hall & David Soskice, *Introduction* to VARIETIES OF CAPITALISM 1 (Peter A. Hall & David Soskice eds., 2001).

20. For an interesting critique of Blair and Stout's team production theory, see John C. Coates IV, *Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?*, 24 J. CORP. L. 837 (1999).

ship affect holdup problems. However, I also emphasize that shareholder influence varies between the United States and the United Kingdom: U.S. corporate and securities law is highly unusual in the extent to which it disenfranchises shareholders from both explicit and implicit influence. I argue that the United Kingdom, which is often lumped together with the United States in comparative corporate governance, constitutes an intermediate case, standing between the United States and Continental Europe, both in terms of shareholder influence and legal protection of employees against holdup.[21]

Part II of this Article outlines the "agency" and "specific assets" perspectives of the firm. While the classical agency perspective is the basis of the view that only shareholders should be taken into account in corporate law, the specific-assets perspective illustrates that this view may be too narrow. Part III outlines the core thesis of the Article. I define the concept of "shareholder influence" in detail and describe the different degrees to which it is present in the United States and Continental Europe. While various economic and legal aspects of U.S. corporate governance ensure that U.S. directors are comparatively independent in their control of the firm, Continental European directors typically can be influenced by large shareholder groups with relative ease. Part IV discusses legal strategies responding to shareholder influence, focusing on employees, who are the most important stakeholder group. The most important of these strategies are employee participation systems, such as German codetermination, and employment protection law. Part V puts together the pieces of the puzzle by suggesting that the respective combinations of shareholder influence and stakeholder protection in the United States and Continental Europe possibly constitute two different local optima—in other words, strong stakeholder protection should be seen as a complement to shareholder influence, given that shareholder influence exacerbates the holdup problem. In Part VI, I incorporate the United Kingdom into the theory as an intermediate case, both with respect to shareholder influence and with respect to pro-stakeholder laws. On the one hand, while the United Kingdom shares the preponderance of dispersed ownership with the United States, coordination between shareholders is easier. Furthermore, U.K. takeover law forces directors to take

21. While I focus on employees, the analysis might conceivably be extended to other groups, particularly creditors. Some legal scholars have suggested that creditors may benefit from the strong position of managers when there is a conflict of interest with shareholders. *See* Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 42–43 (1996) (arguing that managers will resist shareholders' attempts to externalize risks by crediting highly leveraged legal entities); Mark J. Roe, *Corporate Strategic Reaction to Mass Tort*, 72 VA. L. REV. 1, 17–30 (1986) (describing how the incentive effects of pro-shareholder institutions fail in a crisis induced by mass tort claims). The impact of corporate governance structures on the cost of debt in financial economics is still controversial. *See* Hollis Ashbaugh-Skaife, Daniel W. Collins & Ryan B. LaFond, *The Effects of Corporate Governance on Firms' Credit Ratings*, 42 J. ACCT. & ECON. 203 (2006); *see also* Michael Bradley, Dong Chen, George Dallas & Elisabeth Snyderwine, *The Relation Between Corporate Governance and Credit Risk, Bond Yields and Firm Valuation* (Dec. 2007) (unpublished manuscript), *available at* http://ssrn.com/abstract=1078463; Roman Inderst & Holger H. Müller, *Ownership Concentration, Monitoring, and the Agency Cost of Debt* (Sept. 1999) (unpublished manuscript), *available at* http://ssrn.com/abstract=190497.

shareholder interests into account much more strongly than Delaware law. On the other hand, U.K. employment law is weaker than Continental European regulations, but stronger than U.S. law. Part VII summarizes and concludes.

II. Two Views of the Corporation

Most discussion of policy issues within corporate law today is based on the economic theory of the firm. Regardless of complexities of this theory, there are two broad perspectives, which can be labeled the "agency" and the "specific investment" views. Whereas the former emphasizes the relationship between shareholders and managers, the latter brings other groups into the analysis.

A. *The Agency Perspective*

Most corporate law scholarship, and almost all comparative corporate scholarship, is dominated by the agency view. The scholarship of Berle and Means, who first empirically identified the strong separation of ownership by shareholders and control by managers in large U.S. firms in 1932,[22] can be counted among its early antecedents. However, agency theory was formalized and achieved its breakthrough with Jensen and Meckling's seminal 1976 article.[23] While these authors emphasized the nature of the firm as a nexus of contracts—that is, a focal point of coordination of productive factors consisting of explicit and implicit contracts[24]—the nature of the firm as a legal entity is not explained under the terms of the theory. Jensen and Meckling focused on conflicts of interest between shareholders and managers and described the phenomenon of agency cost, consisting of monitoring costs, bonding costs, and residual losses that cannot be eliminated by contractual mechanisms.[25]

Most corporate law theory today relies on agency theory, which has a broad set of applications and can also be used to analyze the relationship between the firm and other stakeholders. However, corporate theory uses it chiefly to analyze the relationship between shareholders and managers, suggesting that the purpose of corporate law should be the reduction of agency cost in that relationship, and on the parallel phenomenon arising when management is under the influence of large shareholders, in which case there

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22. Adolph A. Berle & Gardiner C. Means, The Modern Corporation and Private Property (1932). Other authors, most famously Adam Smith, identified the issue even earlier.

23. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305 (1976).

24. *E.g.*, Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 12 (1991). The nexus of contracts metaphor is usually attributed to Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 Am. Econ. Rev. 777 (1972).

25. Jensen & Meckling, *supra* note 23, at 308.

will typically be strong conflicts of interest with the minority.[26] While it is normatively recognized that corporate law should maximize the aggregate welfare of all corporate constituencies,[27] the interests of constituencies other than shareholders remain on the sidelines of the debate, as these are usually thought to be sufficiently protected by contract.[28] The design of the respective corporate law and corporate governance environment will therefore not normally affect the incentives of groups such as creditors, employees, suppliers, and others who enter into relationships with it under specified contractual rights and obligations.

By contrast, shareholders do not have such rights, but are left with residual cash flows,[29] which is why their relationship to management is said to be of primary importance. As residual risk bearers, shareholders are said to have the best incentives to monitor other constituencies, maximize the total value of the firm, and thus maximize social welfare. Thus, residual risk bearing should be aligned with residual control and the power to change the arrangement of the use of production factors.[30] If managers have incentives to maximize shareholder value, it follows logically that all other constituencies, whose rights are fixed contractually, receive the full maximum value as well. Shareholders should therefore be the beneficiaries of managers' fiduciary duties. Creditors are often considered an exception to the pure shareholder primacy view,[31] as they become residual risk bearers when the company approaches bankruptcy.[32]

B. *The Specific Investments Perspective*

Without doubt, the agency perspective is of fundamental importance in the analysis of corporate law. However, it can be criticized as being focused too strongly—or, in practice, even exclusively—on the financial structure of

26. *E.g.*, Hansmann & Kraakman, *supra* note 5, at 440–43.

27. Henry Hansmann & Reinier Kraakman, *What Is Corporate Law?*, *in* THE ANATOMY OF CORPORATE LAW 1, 18 (Reinier Kraakman et al. eds., 2004). As pointed out by these and other authors, the ultimate goal is to maximize total social welfare. *See generally* LOUIS KAPLOW & STEVEN SHAVELL, FAIRNESS VERSUS WELFARE (2002). Anyone whose utility is affected by corporate conduct can be understood as a stakeholder of the firm. *See* Janice Dean, *Stakeholding and Company Law*, 22 COMPANY LAW. 66, 69–71 (2001); *see also* Jean Tirole, *Corporate Governance*, 69 ECONOMETRICA 1, 23–25 (2001) (defining stakeholders by reference to the firm's externalities).

28. *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 24, at 11.

29. *Id.* at 10–11.

30. Alchian & Demsetz, *supra* note 24, at 781–83.

31. Hansmann & Kraakman, *supra* note 5, at 442.

32. *See* Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147 (1977); *see also* Angelo, Gordon & Co., L.P. v. Allied Riser Commc'ns Corp., 805 A.2d 221 (Del. Ch. 2002); Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784 (Del. Ch. 1992); Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., No. 12150, 1991 Del. Ch. LEXIS 215, at *108 n.55 (Del. Ch. Dec. 30, 1991); W. Mercia Safetywear Ltd. v. Dodd, [1988] B.C.L.C. 250 (Eng.) (all suggesting corporate duties toward creditors near insolvency). *But see* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007) (denying *direct* fiduciary claims by creditors).

firms, while leaving out the important aspect of bundling of various resources into a joint endeavor.[33]

Coase pointed out the importance of transaction costs to the organization of economic activity in 1937,[34] and the specific investment perspective has its roots in the theory of transaction costs and incomplete contracts theory. Of course, agency costs are the consequence of incomplete contracts with shareholders, but the theory suggests that contracts with other stakeholders may be incomplete as well. Oliver Williamson emphasized that there were important impediments to complete contingent contracting, such as information asymmetry, opportunism, and bounded rationality.[35] These factors essentially eliminate a crucial assumption implicit in the agency-theoretical perspective of corporate law. Oliver Hart and his coauthors developed the "property rights" or "incomplete contracts" approach, which attempts to explain the assignment of property rights by reference to specific assets of various parties within the corporate nexus. This theory emphasizes the importance of who "owns" an asset—that is, who has residual control over it. In those states of the world not specified by contract, decisions will be made by the owner, which implies a potential to put pressure on other parties who made such investments in order to appropriate the other parties' rents.[36]

There is widespread agreement today that workers often make investments by acquiring skills that are only useful in a particular employment relationship.[37] For the productive process of the firm, firm-specific investments may be beneficial, as workers with specialized human capital may be able to do their jobs more quickly, make fewer mistakes, and create higher-quality products. Overall, specific investment may make the firm more competitive and therefore better able to succeed in the market. Those investments may originally be costly for workers to acquire, but it allows them to gain quasi-rents in the course of the relationship with the firm. For example, employees may agree to accept a wage below their outside earning capacity during the training period, but expect to receive wages above their marginal

33. *E.g.*, Bernd Frick, Gerhard Speckbacher & Paul Wentges, *Arbeitnehmermitbestimmung und moderne Theorie der Unternehmung*, 69 ZEITSCHRIFT FÜR BETRIEBSWIRTSCHAFT 745, 748, 750 (1999). *But see* RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE 949 (8th ed. 2006).

34. Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937).

35. OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 43–55 (1985); *cf.* OLIVER HART, FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE 23 (1995).

36. HART, *supra* note 35, at 29–33.

37. *See, e.g.*, BREALEY ET AL., *supra* note 33, at 949; HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 26 (1996); James M. Malcolmson, *Individual Employment Contracts*, *in* 3B HANDBOOK OF LABOR ECONOMICS 2291, 2330–33 (Orley Aschenfelter & David Card eds., 1999) (reviewing the labor economics literature on contractual protection of specific investment); Larry Fauver & Michael E. Fuerst, *Does Good Corporate Governance Include Employee Representation? Evidence from German Corporate Boards*, 82 J. FIN. ECON. 673, 679 (2006); Stewart J. Schwab, *Life-Cycle Justice: Accommodating Just Cause and Employment at Will*, 92 MICH. L. REV. 8, 13 (1993). However, not only employees, but also employers, may make specific investment in the employment relationship. See *infra* notes 62–65 and accompanying text regarding Rajan & Zingales' theory of the firm, which responds to this complication.

product once they have acquired experience and have achieved a senior status within the firm.[38] While wages are normally fixed claims, other rewards are not, such as certain types of retirement benefits, expectations regarding job security and advancement within the corporate hierarchy, and the safety of working conditions.[39]

At times, it may be hard to see why skills learned by employees may be less useful for them in other jobs. However, firm-specific human capital can be understood broadly. As labor economist Edward Lazear suggests, sometimes it is not individual skills that are specifically useful within one employment relationship only, but idiosyncratic combinations of skills.[40] For example, a combination of knowledge in tax law, economics, and JAVA programming, required in a firm producing tax optimization software,[41] will normally not be useful in a single new employment relationship, although one or two of these skills will probably be useful.[42] In the case of a job change, the employee will lose part of his investment and possibly will need to reinvest.[43] Employees may also need to learn to work within a different corporate culture or organizational structure.[44] A related factor is the cost incurred by employees to relocate to an area near a potential new place of employment and to make arrangements to live there, including the reorganization of their social lives.[45] These costs cannot be fully recovered.[46] The employee may not necessarily be "locked in" with the particular employer, but rather with his employment options in the region where he lives. The effect is the same if the line of work in which the employee is trained is only demanded by one employer in the region. Even if other employment oppor-

38. *E.g.*, Thomas Eger, *Opportunistic Termination of Employment Contracts and Legal Protection Against Dismissal in Germany and the USA*, 23 INT'L REV. L. & ECON. 381, 383–84 (2004); Schwab, *supra* note 37, at 13.

39. Kent Greenfield, *The Place of Workers in Corporate Law*, 39 B.C. L. REV. 283, 305–07 (1998).

40. Edward P. Lazear, *Firm-Specific Human Capital: A Skill-Weights Approach* (Inst. for the Study of Labor, Discussion Paper No. 813, 2003), *available at* http://www.iza.org/publications/dps.

41. *Id.* at 2.

42. *Id. But see* HANSMANN, *supra* note 37, at 71 (suggesting middle- and upper-level managers are more likely to specifically invest).

43. However, flexibility to retrain may decrease over the years. HANSMANN, *supra* note 37, at 26. Obviously, many investments in skills will be industry-specific, which raises two concerns. First, industry-specific skills make it harder for the employer to hold up the employee because the latter can find alternative employment without losing rents. However, if the employee is not geographically mobile, industry-specific investment may effectively become firm-specific. Second, as far as costs of skills acquisition are borne by employers, industry-specific skills allow employees to hold up employers by taking them elsewhere. *See* Gilson & Roe, *supra* note 11, at 509–16 (suggesting that Japanese firms are able to invest in employee training because their employees have no outside career options).

44. John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 74 (1986).

45. *See* ANNALEE SAXENIAN, REGIONAL ADVANTAGE: CULTURE AND COMPETITION IN SILICON VALLEY AND ROUTE 128, at 35 (1994) (quoting an engineer contrasting the difficulty of getting another job in the same industry in Texas on one hand and the ease in Silicon Valley on the other).

46. HANSMANN, *supra* note 37, at 26; *see* EIRIK G. FURUBOTN & RUDOLF RICHTER, INSTITUTIONS AND ECONOMIC THEORY 232 (2000). In Europe, language barriers and cultural differences may add to the costs of relocations.

tunities are available, he will not be able to make the same wage in a line of work for which he has no special qualification. Other corporate stakeholders may suffer a similarly precarious position, such as suppliers who tailor their production to the needs of a particular purchaser or who set up their production site near the purchaser's site.[47] Stakeholders will make such investments only if they can expect to gain a rent or quasi-rent, such as payment above marginal cost, at a later time.

While the predominant view in the economic analysis of corporate law still assumes that contracts with members of nonshareholder constituencies are complete contingent ones, real-life contracts are normally not, a fact that exhibits the highly theoretical characteristic of determining payoffs for all parties for each possible state of the world.[48] For many states of the world, the necessary transaction cost would exceed the potential welfare gains from incorporating such a provision into the contract, because each state's probability is very small. Humans are boundedly rational: the parties are unable to foresee certain possible contingencies because of cognitive limitations or because the costs of considering them exceed the benefits ex ante.[49] Other terms are not included in contracts because they cannot be observed by the parties ex post or verified by courts. It is, for example, hard to objectively anticipate and measure "the demand for cars, or the degree of innovation, or the extent of government regulation, or the actions of competitors."[50]

Because of the incompleteness of contractual protection, stakeholders can be subject to holdup by the group in control. If, for example, employees are locked into the employment relationship, the employer may engage in opportunistic wage negotiations by threatening dismissal unless employees agree to a reduction of wages to marginal revenue products,[51] terminate pension plans,[52] or default on implicit expectations regarding the employment relationship, such as career advancement prospects. Shareholders would be the ex post beneficiaries, as they capture the firm's increased profits available

47. Lynn Stout mentions two interesting examples. First, in the case of PeopleSoft's takeover by Oracle, companies relying on PeopleSoft's products apparently would have suffered from its integration into Oracle. Second, the move of a factory from the United States to Mexico may hurt those who purchased real property in the town where the factory is located. Lynn A. Stout, *Takeovers in the Ivory Tower: How Academics Are Learning Martin Lipton May Be Right*, 60 BUS. LAW. 1435, 1448 (2005).

48. *See, e.g.*, Alan Schwartz, *Incomplete Contracts*, *in* 2 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 277 (Peter Newman ed., 1999). Complete contingent contracts would have to include payoffs for all parties involved depending on numerous exogenous factors, such as market demand, actions of competitors, legal regulation and many others. *Id.*

49. This concept is attributed to Herbert Simon. Herbert A. Simon, *A Behavioral Model of Rational Choice*, 69 Q.J. ECON. 99 (1955); *see also* WILLIAMSON, *supra* note 35, at 45–46; HART, *supra* note 35, at 80–82; Christine Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1477 (1998).

50. HART, *supra* note 35, at 24.

51. Eger, *supra* note 38, at 384–85.

52. Coffee, *supra* note 44, at 70 n.194.

for distribution.[53] Ex ante, they may suffer if they cannot commit not to hold up stakeholders.

In many cases, human capital investments will be beneficial for the promotion of the total welfare of both shareholders and employees.[54] They may shift a company's production function, allowing for larger output for the same amount of inputs. In the terminology of the theory of incomplete contracts, those investments will frequently not be verifiable by a third party and will sometimes perhaps not even be observable ex post by the parties involved. Human capital cannot be made a part of an enforceable contract, as a third party like a court will not be able to tell whether an employee has made the specified amount of relationship-specific investments.[55]

However, if investments can at least be observed by the firm's management or inferred with at least some degree of certainty from output, management will be able to reward employees for having invested. The prospect of a reward may constitute part of an implicit contract with the person or group in charge, which is necessary to induce employees to make such investments ex ante.[56] For example, workers may be paid below their marginal product early in their careers for incentive reasons, having the legitimate expectation of being rewarded with higher wages later. A supplier may expect to do business with the firm again if his performance was good and he built a plant tailored to the need of producing for the firm.[57] Ex post, it may pay for shareholders to renege on these implicit deals. However, members of non-constituency groups can be expected to make firm-specific investments only if their investments can be protected, either by a complete contract or an implicit arrangement.

If such long-term implicit contractual arrangements are not possible, constituencies such as employees will fail to make firm-specific investments where they can avoid it, unless they enjoy some protection. This may work to the detriment of all, including shareholders, as the "total pie" of the company will be smaller. In that situation, holdup risk is not simply an external effect of the agency relationship between shareholders and managers borne by employees. The result may be that ultimately all constituencies are worse off.

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53. Another reason for holdup could be off-work related capital, such as residence near the site of employment or family and social relations. *See* Tirole, *supra* note 27, at 23.

54. *E.g.*, Andreas Engert, *Eine juristische Theorie des Unternehmens*, *in* FESTSCHRIFT FÜR ANDREAS HELDRICH ZUM 70. GEBURTSTAG 87–89 (Stephan Lorenz et al. eds., 2005); Charreaux & Desbrières, *supra* note 18, at 116–19 (both arguing in favor of maximization of rents received by all stakeholders). This conforms to the general objective of normative law and economics to maximize total utility. *See* KAPLOW & SHAVELL, *supra* note 27, at 15–38; ANDREU MAS-COLLELL, MICHAEL D. WHINSTON & JERRY R. GREEN, MICROECONOMIC THEORY 825–31 (1995). *But see* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 12–17 (5th ed. 1998).

55. *Cf.* HART, *supra* note 35, at 37–38 n.15 (distinguishing the terms "verifiable" and "observable").

56. Andrei Shleifer & Lawrence Summers, *Breach of Trust in Hostile Takeovers*, *in* CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 33, 37–38 (Alan J. Auerbach ed., 1988).

57. *Id.*

Shareholders may not always benefit from the elimination of holdup possibilities. In some cases the interests of shareholders and stakeholders will coincide. That is, catering to the interests of nonshareholder constituencies will also increase long-term shareholder value because long-term relations are essential for a firm's success. In other cases, the gain in welfare to nonshareholder constituencies may exceed losses to shareholders,[58] or the losses incurred by nonshareholder constituencies in a transaction may be smaller than the gains to shareholders.[59] However, from a welfare perspective, furthering stakeholders' interests will be desirable. This does not mean that shareholders should be entirely stripped of their power over corporations. Their contribution to the firm may still be of crucial importance to the corporate nexus, as the aggregate of a firm's shareholders cannot withdraw its contribution to the corporation without liquidating it.[60] Individual selling shareholders will typically not be able to so without incurring losses, which may explain why some residual control rests with shareholders in every Western corporate governance system. However, there are limits to its descriptive and normative explanatory power. Hart and Moore's "property rights" solution suggested that an agent should be

> more likely to own an asset if his action is sensitive to whether he has access to that asset and is important in the generation of surplus, or if he is a crucial trading partner for others whose actions are sensitive to whether they have access to the asset and are important in the generation of surplus.[61]

Rajan and Zingales developed a theory of the firm based on the property rights approach, but replaced ownership with the concepts of power and access to resources.[62] They suggest that there are two risks of underinvestment associated with firm-specific assets. First, any party not in control of the "nexus of specific assets" has an incentive to underinvest in firm-specific assets to avoid being subject to holdup by the controlling party as under the Hart approach. Second, firm-specific investments may make it less lucrative to sell the property right to a third party and more difficult to hold up others, since the owner will also expect a quasi-rent from the asset.[63] As the party in control should not have an incentive against specializing the asset,

58. *See, e.g.*, Colin Mayer, *Financial Systems and Corporate Governance: A Review of the International Evidence*, 154 J. INSTITUTIONAL & THEORETICAL ECON. 144, 146 (1998) (recognizing that the objective of the firm expands past increasing market value when taking into account the interests of non-shareholder parties).

59. An example is the possible liquidation and subsequent sale of Rover by BMW to Phoenix rather than to Alchemy. *See* Armour et al., *supra* note 9, at 543–45.

60. *Cf.* WILLIAMSON, *supra* note 35, at 304–05.

61. Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119, 1149 (1990).

62. Raghuram G. Rajan & Luigi Zingales, *Power in a Theory of the Firm*, 113 Q. J. ECON. 387 (1998).

63. Essentially, Rajan & Zingales relax the assumption that the value of an asset for other uses increases at least somewhat with specific investment, which need not necessarily be true. *Id.* at 406–11.

it may be more efficient to assign ownership rights to a party that does not specifically invest at all if specific investments by others are important.[64]

In a series of articles, Margaret Blair and Lynn Stout have developed a "team production" approach to corporate law in which they expand on these models and suggest that the U.S. solution to this problem is to give control over the firm to the board of directors. Building on incomplete contracts theory and, more specifically, the Rajan and Zingales model, they suggest that the fiction of a corporation's legal personality independent from its members may be a solution to the contracting problems of specific investment. In this view, corporate stakeholders, including shareholders, yield control over their specific investments to the board of directors, making it impossible for them to control how they are used, while exit from the firm is made difficult by the fact that losses would result.[65] Crucially, control over the firm's assets is not actually given to shareholders, but to the fictional legal entity of the firm itself.[66] Team members submit to hierarchy and ownership on their own, as it works for their own benefit.[67] Blair and Stout assert that shareholders are not the only residual risk bearers in a corporation.[68] Of course, shareholders are the residual risk bearers in the traditional sense as the group whose financial claims are satisfied with what remains when everyone else has gotten his due. But on the other hand, other corporate constituencies frequently make firm-specific investments—for example, employees specialize their human capital. As a "mediating hierarchy" standing between all constituencies, including shareholders, directors have the task of balancing countervailing interests and, if necessary, rearranging production factors. Thus, Blair and Stout interpret the board's duty to serve the interest of the corporation not as shareholder interest, but as the aggregate welfare function.[69]

This view is supported by the large degree of autonomy U.S. corporate law typically assigns to the board. The picture of directors acting as shareholders' agents seems incomplete when considering shareholders' inability to command directors. Fiduciary duties to shareholders are not enough to ensure that directors will pursue shareholder primacy, and directors have broad discretion to adopt takeover defenses, which allows them to promote other

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64. *Id.* at 422–23.

65. Margaret M. Blair & Lynn A. Stout, *Specific Investment and Corporate Law*, 7 EUR. BUS. ORG. L. REV. 473, 492 (2006).

66. Blair & Stout, *supra* note 2, at 274 n.57.

67. *Id.* at 274.

68. *See also* Charreaux & Desbrières, *supra* note 18, at 124 (stakeholders assume a part of the residual risk).

69. Blair & Stout, *supra* note 2, at 288–89. Team production theory has been extended to Chapter 11 bankruptcy reorganization. *See* Lynn M. LoPucki, *A Team Production Theory of Bankruptcy Reorganization*, 57 VAND. L. REV. 741 (2004). For Canadian corporate law, see Stephanie Ben-Ishai, *A Team Production Theory of Canadian Corporate Law*, 44 ALBERTA L. REV. 299 (2006).

constituencies' interests over short-term shareholder value maximization.[70] Shareholders' voting rights may also be overrated and are considered by some to be largely a fig leaf.[71] The fact that such rights exist reflects the necessity of someone actually voting for directors, and shareholders are likely to exhibit more homogeneous objectives than other groups, which makes the voting process less costly.[72] It has also been suggested that, while the residual risk bearers argument for shareholder primacy is inconclusive, enforceable fiduciary duties are normally restricted to shareholders because their interests are not well-protected by other mechanisms relative to those of other constituencies, who usually have more effective means than judicial lawmaking at their disposal.[73]

While proponents of the shareholder primacy view often denounce the absence of shareholder influence in the United States as inefficient, the team production approach attempts to provide an efficiency explanation for the attenuation of shareholder influence.[74] However, its adherents do acknowledge that board autonomy may be a second-best solution, as it worsens the classic agency problem.[75] I try not to make a strong statement whether team production provides the best descriptive fit to U.S. corporate governance. There are a number of objections to the team production approach, such as its ineffectiveness in some publicly traded firms[76] and the persistence of a market for corporate control.[77] The point of the comparative theory advanced in this article is not how it compares to agency theory as a descriptive account of U.S. corporate governance, but rather that it is a much better description of corporate governance in the United States than in other countries.[78]

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70. Blair & Stout, *supra* note 2, at 290–315; *see also* D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277 (1998) (arguing that the shareholder primacy norm of Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919) is overrated and that the actual issue was a minority-majority conflict); *cf.* Jill E. Fisch, *Measuring Efficiency in Corporate Law*, 31 J. CORP. L. 637, 651 (2006) (pointing out that Delaware takeover case law permits directors to consider the interests of stakeholders unless the board has put the company up for sale).

71. *See* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675 (2007).

72. Blair & Stout, *supra* note 2, at 309–13; *see also* HANSMANN, *supra* note 37, at 44, 62–64, 89–119 (suggesting collective decision-making costs as a reason for ownership by providers for finance, given their greater homogeneity of interests compared to other groups).

73. Fisch, *supra* note 70, at 667–68.

74. Other explanations have emerged in the literature. *See* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 556–58 (2003) (arguing that "director primacy" is necessary to avoid collective decision-making problems that would result from direct shareholder involvement); Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733 (2005) (suggesting that the board's autonomy permits directors to react to the pressure of moral and social sanctions as a sole entrepreneur would, allowing social norms to fill the gaps left by public enforcement).

75. Blair & Stout, *supra* note 65, at 493.

76. Coates, *supra* note 20, at 840–41.

77. *Id.* at 849–59.

78. This may well be the reason why the "team production" theory has so far received little attention in Europe.

III. The Stakeholder Perspective in Dispersed and Concentrated Ownership Systems

Part III proposes that *shareholder influence* may be the cause of holdup of nonshareholder constituencies, and that stronger shareholder influence, particularly in the case of concentrated ownership, implies a greater risk of expropriation for stakeholders, such as employees. Part III.A defines shareholder influence. Part III.B describes the situation in the United States and argues that shareholder influence is comparatively small. Part III.C provides the contrasting picture of Continental European concentrated ownership systems. In both the United States and Continental Europe, aspects of corporate law reinforce their respective stances toward shareholder influence.

A. *Shareholder Influence Defined*

By *shareholder influence*, I refer to the explicit or implicit influence of shareholders on managerial decision making within managers' legitimate business judgment. Shareholder influence must not be confused with *shareholder protection* against illicit activity by managers or controlling shareholders, which is the subject of much of the literature on agency problems in large corporations.[79] The distinction roughly corresponds to the traditional dichotomy between the duties of loyalty and care to which directors are subject under U.S. corporate law.[80] The duty of loyalty is, at its core, concerned with self-dealing transactions, and requires a manager to act fairly to the company when she is self-interested.[81] By extension, it also applies to controlling shareholders.[82] The duty of loyalty is usually thought to be vigorously enforced by the courts in dealing with the misappropriation of corporate assets by directors, managers, or large shareholders to their own personal benefit.[83]

79. *See, e.g.*, Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430 (2008); Priya P. Lele & Mathias Siems, *Shareholder Protection: A Leximetric Approach*, 7 J. CORP. L. STUD. 17 (2007). Note that the definition of shareholder influence differs from the one espoused by Zetzsche, who focuses mostly on legal mechanisms of shareholder protection. *See* Dirk Zetzsche, *Explicit and Implicit Systems of Corporate Control—A Convergence Theory of Shareholder Rights* 23 (Ctr. for Bus. & Corp. L., Working Paper No. 0001, 2004), *available at* http://ssrn.com/abstract=600722.

80. *See, e.g.*, WILLIAM T. ALLEN, REINIER KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATIONS 241 (2d ed. 2007).

81. *E.g.*, DEL. CODE ANN. tit. 8, § 144 (2001); ROBERT C. CLARK, CORPORATE LAW 166–71 (1986); Melvin A. Eisenberg, *The Duty of Good Faith in American Corporate Law*, 3 EUR. COMPANY & FIN. L. REV 1, 14 (2006) [hereinafter Eisenberg, *Good Faith*]; Melvin Aron Eisenberg, *Self-Interested Transactions in Corporate Law*, 13 J. CORP. L. 997, 997 (1988). For a comparative overview, see Luca Enriques, *The Law of Company Directors' Self-Dealing: A Comparative Analysis*, 2 INT'L & COMP. CORP. L.J. 297 (2000); Gerard Hertig & Hideki Kanda, *Related Party Transactions*, *in* THE ANATOMY OF CORPORATE LAW 101, 114–18 (Reinier Kraakman et al. eds., 2004).

82. Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971); Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 518 (Mass. 1975); ALLEN ET AL., *supra* note 80, at 306–07.

83. Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L.Q. 403, 427 (2001).

One might think that the ideal to which directors and managers are held should be shareholder value maximization.[84] However, it is doubtful whether the "shareholder primacy norm" is good law at all. For example, Gordon Smith argues that the famous shareholder primacy argument of *Dodge v. Ford Motor Co.*,[85] and even older case law, did not arise in the context of actual shareholder-stakeholder conflicts but was used to resolve conflicts of interest between controlling shareholders and minority investors.[86] More than half of U.S. states have introduced constituency statutes, which allow or require directors to take employee interests into account, particularly in response to hostile takeovers.[87] In other states, most of all Delaware, takeover case law has required directors to take into account "the impact on 'constituencies' other than shareholders"—creditors, customers, employees, and perhaps even the community generally.[88] While there is a good case to say that the shareholder primacy norm is not good law in the United States at all,[89] even scholars who do not follow this view are in agreement that the shareholder primacy norm is enforced only very rarely.[90]

The duty of care is a much looser constraint on managerial conduct. The crucial delineation of the duty of care is the business judgment rule, according to which directors are given plenty of leeway in daily decision making as long as they gather the relevant information before deciding, act in good faith, and stay clear of self-interest.[91] The prominent provision of Delaware General Corporation Law ("DGCL"), section 102(b)(7), even allows firms to entirely preclude liability for violations of the duty of care,[92] and most Delaware corporations have made use of this option.[93] While doctrinal structures

84. *See* Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919).

85. *Id.*

86. Smith, *supra* note 70, at 315–20.

87. Jonathan D. Springer, *Corporate Constituency Statutes: Hollow Hopes and High Fears*, 1999 ANN. SURV. AM. L. 85, 125–28 (1999) (listing a total of thirty-two statutes; among those, thirty constituency statutes and twenty statutes explicitly allowing directors to consider the corporation's continued independence as optimally serving the corporation's and shareholders' interests). Nebraska's statute was repealed in 1995. *Id.* at 95.

88. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985). The Unocal "reasonableness" standard of review continues to characterize the Delaware case law on directors' actions in facing hostile takeovers. *See infra* notes 117–18 and accompanying text; *e.g.*, Black v. Hollinger Int'l, 872 A.2d 559, 565 (Del. 2005); Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 918, 928, 931, 932 (Del. 2003).

89. *See* Lynn A. Stout, *Why We Should Stop Teaching Dodge v. Ford*, 3 VA. L. & BUS. REV. 163 (2008) (arguing that *Dodge v. Ford* is not good law and hardly ever used as a precedent).

90. *See* ALLEN ET AL., *supra* note 80, at 295. Courts tend to defer to managers regarding whether a managerial decision promotes shareholder primacy or not. *E.g.*, Shlensky v. Wrigley, 237 N.E.2d. 776, 778 (Ill. App. Ct. 1968).

91. ALI PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(c) (1994).

92. DEL. CODE ANN. tit. 8, § 102(b)(7) (2001).

93. Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1160–61 (1990) (reporting that ninety percent in a random sampling of 180 publicly traded firms introduced such a provision). Regarding the more recently developed "duty of good faith", which is not covered by § 102(b)(7), see In re The Walt Disney Company Derivative Litigation, 906 A.2d 27 (Del. 2006); Eisenberg, *Good Faith*, *supra* note 81; Steven A. Ramirez, *The Special Interest Race to CEO Primacy*

vary and the business judgment rule is not universal,[94] it appears to be recognized across jurisdictions that directors should not be constrained too narrowly by a standard of care.[95] Shareholder suits remain rare outside of the United States.[96] Mark Roe summarizes this state of affairs by stating that "[c]orporate law does not even try to directly control the cost of managerial mismanagement or non-conflicted disloyalty, from managers not working hard enough for shareholders."[97] It does "little, or nothing, to directly reduce shirking, mistakes and bad business decisions that squander shareholder value."[98] While Roe talks about U.S. law in the context of the second quotation, the situation is similar elsewhere.

In short, as long as managers do not steal, they have wide discretion on how to run a business within what is generally considered their legitimate business judgment.[99] Day-to-day business decisions and some fundamental decisions of the firm are made by top management, although more significant decisions may sometimes require approval by shareholders.[100] Manage-

and the End of Corporate Governance Law, 32 DEL. J. CORP. L. 345, 379 n.197 (2007); Hillary Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456 (2004).

94. For example, there is no business judgment rule under U.K. law. *See* PAUL L. DAVIES, GOWER AND DAVIES' PRINCIPLES OF MODERN COMPANY LAW ¶ 16–15 (8th ed. 2008); Brian R. Cheffins & Bernard S. Black, *Outside Director Liability Across Countries*, 84 TEX. L. REV. 1385, 1401 (2006); *see also* Companies Act, 2006, c. 46, §§ 170–81 (U.K.) (codifying directors' duties without introducing such a rule).

95. Regarding the United Kingdom, see DAVIES, *supra* note 94, ¶ 16–15; Cheffins & Black, *supra* note 94. Regarding France, see 1 YVES GUYON, DROIT DES AFFAIRES 459 (12th ed. 2003). Regarding Italy, see Giuseppe Campana, *La responsabilità civile degli amministratori delle società di capitali*, 16 NUOVA GIURISPRUDENZA CIVILE COMMENTATA II 215, 224–26 (2006); Antonio Rossi, *Art. 2392: Responsabilità verso la società*, *in* IL NUOVO DIRITTO DELLE SOCIETÀ 790, 796–803 (Alberto Maffei Alberti ed., 2005). A German statute modeled on the U.S. business judgment rule (§ 93(2) AktG) was introduced by the Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts [Integrity of Undertakings and Modernizing the Law of Contestation Act] ("UMAG") (Sept. 22, 2005, BGBl. I at 2802) after broad managerial latitude had been already recognized in the case law. *See* Bundesgerichtshof [BGH] [Federal Court of Justice] Apr. 21, 2004, II ZR 175/95 (known as the "ARAG/Garmenbeck" decision). Regarding the decision, see Erich Schanze, *Directors' Duties in Germany*, 3 COMPANY & FIN. INS. L. REV. 286, 291–92 (1999).

96. Regarding the United Kingdom, see, e.g., Geoffrey Miller, *Political Structure and Corporate Governance: Some Points of Contrast Between the United States and England*, 1998 COLUM. BUS. L. REV. 51, 61–63 (1998); regarding France, Germany, and Italy, see Pierre-Henri Conac, Luca Enriques & Martin Gelter, *Constraining Dominant Shareholders' Self-Dealing: The Legal Framework in France, Germany, and Italy*, 4 EUR. COMPANY & FIN. L. REV. 491, 507–12 (2007).

97. ROE, POLITICAL DETERMINANTS, *supra* note 17, at 162.

98. Mark J. Roe, *Corporate Law's Limits*, 31 J. LEGAL STUD. 233, 243 (2002).

99. *See* Mark J. Roe, *On Sacrificing Profits in the Public Interest*, *in* ENVIRONMENTAL PROTECTION AND THE SOCIAL RESPONSIBILITY OF FIRMS 88, 88, 90–91 (Bruce L. Hay, Robert N. Stavins & Richard K.H. Vietor eds., 2005) ("The business judgment rule is in fact so large that it effectively allows managers the discretion to sacrifice profits in the public—and any other—interest, without fear that shareholders could successfully sue them.")

100. Shareholder approval requirements are more important in Continental Europe than in the United States. *See, e.g.*, Sofie Cools, *The Real Difference in Corporate Law Between the United States and Continental Europe: Distribution of Powers*, 30 DEL. J. CORP. L. 697, 739–41 (2005); PRIYA P. LELE & MATHIAS M. SIEMS, SHAREHOLDER PROTECTION INDEX FOR THE UK, THE US, GERMANY, FRANCE, AND INDIA (2007), *available at* http://www.cbr.cam.ac.uk/pdf/Lele-Siems-Shareholder-Index-Final1.pdf (comparing the power of the shareholder meeting in France, Germany, the United Kingdom, the United

rial decisions of this kind may have considerable impact on the wealth or well-being of shareholders and other stakeholders, and may even pitch these interests against each other (for example, when management considers the closure of a plant or negotiates a collective bargain with union representatives). Neither the law nor the courts will dictate a particular decision to managers.[101] How they will use their discretion will depend on their personal interests and incentives.

With this distinction in mind, it is obvious that *shareholder protection* against self-dealing either by managers or by controlling shareholders may be well-developed, while at the same time, *shareholder influence* may remain small. Legal remedies against illicit private benefits may be an effective deterrent without any shareholder influence on regular decision making and without any incentives aligning managerial conduct with shareholder primacy. U.S. corporate law is generally thought to provide good shareholder protection against managerial self-dealing, while the strong role of the board of directors in corporate governance is evident.[102]

Shareholder influence can be created in various ways within what is considered reasonable business judgment. There are effectively two broad types of shareholder influence, which can be labeled *explicit* and *implicit shareholder influence.* Explicit shareholder influence is created by direct intervention of shareholders into management. It is strongest in the presence of a *controlling shareholder*, but even a number of cooperating large shareholders may directly influence important business decisions. This type of influence is most relevant under concentrated ownership. Implicit influence refers to incentives created by the institutional framework that might force managers to act as if shareholders were directing business. This may be the result of strong market mechanisms that implicitly force managers to pursue shareholder interests.[103] Implicit shareholder influence is important in a system characterized by dispersed ownership. Shareholder influence thus describes all institutional factors that determine whether managers are forced or incentivized to pursue shareholder interests within the discretion assigned to them by corporate law.[104]

States, and India); Henry Hansmann & Reinier Kraakman, *The Basic Governance Structure*, *in* THE ANATOMY OF CORPORATE LAW 33, 57–58 n.107 (Reinier Kraakman et al. eds., 2004).

101. This may change when a firm approaches bankruptcy. *See, e.g.*, Gerard Hertig & Hideki Kanda, *Creditor Protection*, *in* THE ANATOMY OF CORPORATE LAW 71, 88–91 (Reinier Kraakman et al. eds., 2004).

102. *See* Bainbridge, *supra* note 74, at 573 (emphasizing that U.S. law provides a strong shareholder wealth maximization objective but little shareholder influence). *But see* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005) (arguing that U.S. corporate governance would benefit from stronger shareholder power).

103. *Cf.* Zetzsche, *supra* note 79, at 17–21 (characterizing Continental corporate governance systems as explicit systems with direct shareholder influence while characterizing Anglo-Saxon systems as implicit systems).

104. Explicit influence is most important in control-oriented systems, while implicit influence is most important in arm's length systems. On the distinction, see Berglöf, *supra* note 4 and accompanying text.

B. *Separation of Ownership and Control as a Possible American Advantage*

1. *Insulation of Managers from Shareholder Influence*

As described above, alternative economic interpretations of U.S. corporate law and governance, particularly team production theory,[105] emphasize the large degree of autonomy managers enjoy in the United States. Regarding the theory that shareholder influence on managerial business judgment exacerbates holdup problems, it is evident that this factor is less significant under the typical U.S. corporate governance structure than elsewhere.

Consider *explicit shareholder influence*. Dispersed shareholders are subject to collective action problems caused by rational apathy and the free-rider phenomenon.[106] Notably, explicit shareholder influence is reinforced by certain requirements of corporate and securities laws. While the Delaware courts are generally protective of the voting process as such[107] and have considered the possibility of ousting managers as a safety valve for discontent shareholders,[108] proxy contests remain quite rare. Lucian Bebchuk reports that the number of contested proxy solicitations per year never exceeded forty for the period between 1996 and 2004, during which time there were about 300 contested solicitations in total.[109] Some of the reasons mentioned are staggered boards and the costs of electoral challenges.[110] While incumbents can be sure to finance their proxy costs out of the corporate cashbox, challengers only have a chance to be reimbursed if their assault on the corporate fortress succeeds.[111]

In an environment of dispersed ownership, coordination between shareholders is a prerequisite to *explicit shareholder influence*. However, some of the most severe impediments are established by federal securities law. Under section 13(d) of the Securities Exchange Act, anyone directly or indirectly acquiring beneficial ownership of five percent of any class of equity security must submit a 13(d) filing to the SEC within ten days.[112] An important aspect is SEC Rule 13d-5(1), under which persons acting together "for the purpose of acquiring, holding, voting or disposing of equity securities" are deemed a group for purposes of section 13(d), and are thus required to submit a 13(d) filing if they jointly surpass the five percent threshold. This

105. *See* discussion *supra* Part II.B.

106. *See* EASTERBROOK & FISCHEL, *supra* note 24, at 63–72; *see also* CLARK, *supra* note 81, at 390–93.

107. Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437 (Del. 1971); Blasius Indus., Inc., v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988).

108. *See, e.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985).

109. Bebchuk, *supra* note 71, at 682–83. Not all of these were electoral challenges, and less than half of them were successful. *Id.* at 686–87.

110. *Id.* at 688–91, 694.

111. *See* Rosenfeld v. Fairchild Engine & Airplane Corp., 128 N.E.2d 291, 293 (N.Y. 1955) (establishing the "Froessel rule"). For a deeper analysis, see Lucian Arye Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1071, 1106–26 (1990).

112. Securities Exchange Act of 1934 § 13(d), 15 U.S.C. § 78(m)(d) (2000); 17 C.F.R. 240 § 13d-1(a) (2008).

requirement is generally thought to inhibit, if not entirely prevent, coordination between shareholders because proponents run the risk of a lawsuit by the company or other shareholders on the basis that they may have failed to disclose their plans completely.[113] Another impediment to coordination is the danger of communication between security holders triggering the costly duty to file a proxy statement under section 14 of the Securities Exchange Act if it is "reasonably calculated to result in the procurement, withholding or revocation of a proxy."[114] Most shareholder proposals are therefore made under Rule 14a-8, which allows a proposal to be included in the company's proxy statement. However, this option is limited to specific subject matters and requires submission six months before the shareholder meeting.[115]

Implicit shareholder influence could be created by incentives for managers to act in the interest of shareholders, most of all during hostile takeovers. Before the backdrop of the U.S. takeover wave of the 1980s, Coffee, and shortly thereafter, Shleifer and Summers, suggested that hostile takeovers create an opportunity for shareholders to renege on implicit contracts with employees by selling out to a raider who will break up the firm.[116] However, while it would be an overstatement to say that takeovers were a fad that passed with the 1980s, they have become considerably rarer as a consequence of the development of Delaware case law during the 1990s. With the narrowing of the *Unocal*[117] standard in *Unitrin*[118] and the restriction of *Revlon*[119] duties under the two *Paramount*[120] cases, managers are essentially able to "just say no"[121] to a hostile bid. The second element of an anti-takeover bulwark is the staggered board. Under DGCL section 141(d), if permitted by the charter or bylaws, a board of directors may be classified into three groups, each of which faces election every three years, meaning that only one

113. Bernard S. Black, *Shareholder Activism and Corporate Governance in the United States*, *in* 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 459, 461 (Peter Newman ed., 1998); John C. Coffee, Jr., *The SEC and the Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837, 842, 877–82 (1994).

114. Securities Exchange Act of 1934 § 14, 15 U.S.C. § 78(n) (2000); 17 C.F.R. 240 § 14a-1(l)(1)(iii) (2008).

115. Black, *supra* note 113, at 459; *see also* Coffee, *supra* note 113, at 884. Regarding impediments affecting institutional shareholders such as banks and insurers, see MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994) (arguing that banking regulation and other New Deal-era laws prevented banks and insurance firms from taking a greater role in U.S. corporate governance).

116. Coffee, *supra* note 44, at 70–71, 73–81; Shleifer & Summers, *supra* note 56; *see also* Julian Franks & Colin Mayer, *Capital Markets and Corporate Control: A Study of France, Germany and the UK*, 5 ECON. POL'Y 189, 213–14 (1990) ("Changes in ownership undermine the ability of firms to sustain a reputation for long-term relationships.").

117. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

118. Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361 (Del. 1995).

119. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 179 (Del. 1986).

120. Paramount Commc'ns, Inc. v. QVC Network, Inc., 637 A.2d 34, 47 (Del. 1993); Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140, 1153 (Del. 1989).

121. *E.g.*, Jeffrey N. Gordon, *"Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffet*, 19 CARDOZO L. REV. 511, 516 (1997).

third of the directors are elected each year.[122] By default, in the case of a classified board, shareholders may remove directors only for cause.[123] Thus, a takeover bidder or someone launching a proxy contest needs to sustain his attack over two subsequent elections in order to obtain a majority of the board. In the case of what Bebchuk, Coates, and Subramanian have defined as an "effective staggered board"[124] where this type of board structure has been implemented in the company's charter, dismantling it requires approval by the board itself.[125] The bidder cannot simply take control of the shareholder meeting and subsequently de-stagger the board. These authors provide strong empirical evidence that,[126] due to the combination of staggered boards, poison pills,[127] and the cost of committing to an offer price over two elections,[128] U.S. boards can effectively shield themselves, rendering hostile takeovers almost impossible in many cases.[129] Thus, the current regime of takeover law offers powerful defenses to managers, further attenuating possible implicit shareholder influence through market forces. This contrasts noticeably with the United Kingdom, where directors are required to maintain neutrality vis-à-vis a hostile bid and where the number of hostile takeovers is higher.[130]

To be sure, holdup situations could also be the result of a friendly takeover of a firm with dispersed ownership. In fact, overall mergers and acquisitions activity has by no means decreased after the end of the takeover wave.[131] Kahan and Rock have suggested that performance-based executive compensation schemes rewarding managers in the case of an acquisition have developed as "adaptive devices" by shareholders in response to the prevalence of strong takeover defenses, thus turning what would otherwise be hostile takeovers into friendly ones and aligning the interests of managers with shareholders.[132]

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122. *See* DEL. CODE ANN. tit. 8, § 141(a) (2000).

123. *Id.* § 141(k)(i). Most states other than Delaware allow staggered boards. *See* Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 893–94 (2002).

124. Bebchuk et al., *supra* note 123, at 894.

125. An amendment of the charter requires approval of both the board of directors and shareholders. *See* DEL. CODE ANN. tit. 8, § 242(b) (2000).

126. Bebchuk et al., *supra* note 123, at 925–39.

127. Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985) (accepting the legality of "shareholder rights plans," otherwise known as poison pills).

128. Bebchuk et al., *supra* note 123, at 922–23.

129. *See also* Stout, *supra* note 47, at 1436 ("the board of directors of a public company enjoys at least as much legal authority to decide whether or not the company will sell itself as . . . in 1979").

130. *See infra* notes 369–78 and accompanying text.

131. *See, e.g.*, Factset Mergerstat, M&A Activity: U.S. and U.S. Cross-Border Transactions, http://www.mergerstat.com/newsite/free_reports_m_and_a_activity.asp (last visited Oct. 29, 2008); *see also* Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871, 879–80 (2002).

132. Kahan & Rock, *supra* note 131, at 896–99; *see also* Jeffrey N. Gordon, *An American Perspective on Anti-Takeover Laws in the E.U.: The German Example*, *in* REFORMING COMPANY AND TAKEOVER LAW IN EUROPE 541, 553–54 (Guido Ferrarini et al. eds., 2004).

However, there are also a number of objections to this view. Critics of current executive compensation practices (writing from a shareholder primacy perspective) have pointed out that it is very difficult to design compensation plans that provide an alignment with shareholder interests equivalent to that provided by an effective market for corporate control, as the "reward" provided by a golden parachute could easily be too high or too low to provide the right incentives.[133] Others have criticized that the theory depends on the debatable assumption that unconstrained managers will agree to a compensation scheme making them accountable to shareholders.[134] Furthermore, a windfall gain from a friendly takeover will not subject managers to a constant threat of losing their position if they do not maximize shareholder wealth.[135] This is consistent with the empirical evidence in the United States that does not appear to support the "bargaining power" hypothesis of staggered boards, as these boards generally appear not to produce higher premia for shareholders.[136] It is of course possible that in some cases a bidder may "bribe" management into letting a takeover go forward and then reap holdup profits from stakeholders. To the extent that this is a common phenomenon, U.S. corporate governance may indeed have diverged from the local optimum described in this Article[137] as a result of the takeover wave and the subsequent rise of executive compensation. However, for this Article's objective of comparing the degree of shareholder influence in different systems, it is important to note takeover activity in general (including friendly mergers) is more intense in the United Kingdom.[138] While friendly takeovers and mergers may happen for a variety of reasons (including efficiency), this appears to support the conclusion that the United King-

133. Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973, 1013–16 (2002). Generally, U.S. executive compensation practices have in recent years come under criticism for allowing managers to draw rents from the firm instead of aligning their interests with those of shareholders. *See, e.g.*, Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP. 71 (2003); Lucian A. Bebchuk & Jesse M. Fried, *Pay without Performance: Overview of the Issues*, 30 J. CORP. L. 647 (2005); *see also* Bruno S. Frey & Margit Osterloh, *Yes, Managers Should Be Paid Like Bureaucrats*, 14 J. MGMT. INQ. 96, 99–100 (2005) (suggesting that managers should receive fixed compensation); Tirole, *supra* note 27, at 26.

134. John Armour & David A. Skeel, Jr., *Who Writes the Rules for Hostile Takeovers, and Why? The Peculiar Divergence of U.S. and U.K. Takeover Regulation*, 95 GEO. L.J. 1727, 1742 (2007).

135. *Id.*

136. Bebchuk et al., *supra* note 123, at 935–36; *see also* Guhan Subramanian, *Bargaining in the Shadow of Takeover Defenses*, 113 YALE L.J. 621 (2003) (arguing that the empirical evidence does not support the hypothesis that takeover defenses allow managers to bargain for higher prices for shareholders).

137. *See* discussion *infra* Part V.A.

138. Armour & Skeel, *supra* note 134, at 1738 (providing data indicating that the United Kingdom does not merely have a larger proportion of hostile takeovers, but also a considerably larger volume of total mergers and acquisitions activity in relation to GDP). The total GDP of the United States is about six times as large as that of the United Kingdom, see Central Intelligence Agency, *The World Factbook*, https://www.cia.gov/library/publications/the-world-factbook/index.html, whereas Armour & Skeel report 54,849 mergers in the United States and 22,014 in the United Kingdom for the period between 1990 and 2005, Armour & Skeel, *supra* note 134, at 1738.

dom's corporate governance system is still characterized by a higher degree of implicit shareholder influence.[139]

2. *How Stakeholders May Benefit from the Insulation of Managers*

Managers and directors are by no means required to pursue the interests of employees and other stakeholders, and their interests are not necessarily aligned with these groups.[140] However, proponents of team production theory have argued that directors must serve corporate constituents well if they want to keep their jobs,[141] while social norms—reinforced by corporate law—dissuade them from engaging in self-dealing and compel fairness and loyalty toward the firm's constituents.[142] Part of the argument is that managers often behave in a way that would be considered economically rational in a narrow sense, but that they need to enter into relationships of trustworthiness with stakeholders in order to further the joint goals of the corporate coalition.[143]

The social norms argument is fairly controversial. A social norm of short-term stockholder value maximization is often blamed for corporate scandals,[144] and it may well be true that there is no uniform answer regarding what kind of social norm prevails.[145] However, this could be a recent pathology resulting from the incompatibility of increased implicit shareholder influence and a team production approach.[146] More importantly, there is some evidence that entrenched management is associated with a low Tobin's Q[147] (a measure of shareholder wealth), while takeovers seem to correlate with reductions in wages of varying degrees.[148] Antitakeover statutes are associ-

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139. *See* discussion *infra* Part VI.

140. Bebchuk, *supra* note 102, at 909–11.

141. Blair & Stout, *supra* note 2, at 315.

142. *Id.* at 315–16.

143. Blair & Stout, *supra* note 83, at 438–41.

144. *See, e.g.*, William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1357 (2002) (citing SEC chairman Arthur Levitt); John S. Reed, *Values and Corporate Responsibility: A Personal Perspective*, *in* RESTORING TRUST IN AMERICAN BUSINESS 35, 36–37 (Jay W. Lorsch, Leslie Berkowitz & Andy Zelleke eds., 2005).

145. Roe, *supra* note 99, at 93–94.

146. Frey & Osterloh, *supra* note 133, at 99–100.

147. *See* Michael D. Frakes, *Classified Boards and Firm Value*, 32 DEL. J. CORP. L. 113 (2007). *See generally* Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409 (2005) (providing empirical evidence regarding charter-based staggered boards).

148. *See* Jagadeesh Gokhale, Erica L. Groshen & David Neumark, *Do Hostile Takeovers Reduce Extramarginal Wage Payments?*, 77 REV. ECON. & STAT. 470 (1995) (finding a reduction of extramarginal payments to senior workers after a hostile takeover); Frank R. Lichtenberg & Donald Siegel, *The Effect of Ownership Changes on the Employment and Wages of Central Office and Other Personnel*, 33 J. L. & ECON. 383 (1990); Joshua G. Rosett, *Do Union Wealth Concessions Explain Takeover Premiums?*, 27 J. FIN. ECON. 263 (1990). *But see* David Neumark & Steven A. Sharpe, *Rents and Quasi-Rents in the Wage-Structure: Evidence from Hostile Takeovers*, 35 INDUS. REL. 145 (1995) (finding no higher likelihood of firms with extramarginal wage payments being subject to hostile takeovers). Similarly, bondholders with little contractual protection tend to lose wealth. *See* Paul Asquith & Thierry A. Wizman, *Event Risk, Covenants, and Bondholder Returns in Leveraged Buyouts*, 27 J. FIN. ECON. 195 (1990); *see also* Gilles Chemla, *Hold-up,*

ated with higher pay.[149] Similarly, takeover defenses seem to be associated with lower cost of debt, suggesting an advantage for creditors.[150] Another recent study finds that managerial entrenchment is connected to enhanced corporate social performance and worker satisfaction.[151]

Behavioral theory suggests that when managers are subject only to loose constraints they generally do not try to maximize profits, but to "profit-satisfice" by determining what payoff would be acceptable for providers of equity.[152] Profits made by the firm cannot be verified by outside shareholders and therefore need not necessarily be disgorged to shareholders to their full extent.[153] Empirical findings suggest that managers tend to prefer a "quiet life," where such things as plant closings are avoided,[154] which will typically be in the interest of employees. More generally, a preference for the continuation of operations without any fundamental changes should also imply avoiding job cuts and union antagonization. Under certain circumstances, such as when facing hostile takeovers, employees and top management are therefore natural allies.[155]

One might object by arguing that the insulation of managers exacerbates the agency problem with respect to shareholders, which is a more important concern. No interest group, apart from managers themselves, benefits from illicit managerial self-dealing. This type of conduct is typically addressed by the duty of loyalty. Furthermore, there is the potential problem of insufficient effort by managers and employees. Hence, the creation of an optimal

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Stakeholders and Takeover Threats, 14 J. FIN. INTERMEDIATION 376, 379 (2005) (summarizing the literature).

149. *See* Marianne Bertrand & Sendhil Mullainathan, *Enjoying the Quiet Life? Corporate Governance and Managerial Preferences*, 111 J. POL. ECON. 1043 (2003) (finding higher wages for workers following antitakeover statutes, but suggesting that these did not lead to higher productivity); Marianne Bertrand & Sendhil Mullainathan, *Is There Discretion in Wage Setting? A Test Using Takeover Legislation*, 30 RAND J. ECON. 535 (1999); *see also* Henrik Cronqvist, Fredrik Heyman, Mattias Nilsson, Helena Svaleryd & Jonas Vlachos, *Do Entrenched Managers Pay Their Workers More?* (Ctr. for Econ. Policy Research, Working Paper No. 5731, 2005), *available at* http://ssrn.com/abstract=883717 (reporting data for Sweden).

150. Ashbaugh-Skaiffe et al., *supra* note 21. *But see* Bradley et al., *supra* note 21 (finding that this holds only for investment grade firms).

151. Jordi Surroca & Josep A. Tribó, *Managerial Entrenchment and Corporate Social Performance*, 36 J. BUS. FIN. & ACCT. 748 (2008).

152. JESSE H. CHOPER, JOHN C. COFFEE, JR. & RONALD J. GILSON, CASES AND MATERIALS ON CORPORATIONS 30–31 (7th ed. 2004); Coffee, *supra* note 44, at 29; Elhauge, *supra* note 74, at 804. The theory of "satisficing" can be traced to Simon, *supra* note 49. *See also* Julius Margolis, *The Analysis of the Firm: Rationalism, Conventionalism, and Behaviorism*, 31 J. BUS. 187, 190 (1958); Christoph Engel, *The Behaviour of Corporate Actors: A Survey of the Empirical Literature* (Max Planck Inst. for Research on Collective Goods, Preprint No. 23, 2008), *available at* http://ssrn.com/abstract=1135184.

153. *E.g.*, M. Pagano & P.F. Volpin, *Managers, Workers, and Corporate Control*, 60 J. FIN. 841, 842 (2005).

154. Bertrand & Mullainathan, *supra* note 149, at 1066–67.

155. *See, e.g.*, Martin Hellwig, *On the Economics and Politics of Corporate Finance and Corporate Control*, *in* CORPORATE GOVERNANCE: THEORETICAL AND EMPIRICAL PERSPECTIVES 95, 122–25 (Xavier Vives ed., 2000) (describing the alignment of managerial and stakeholder interests); Pagano & Volpin, *supra* note 153, at 864 ("Managers and workers are natural allies against a takeover threat."); Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 120–22 (1987) (arguing that managers and workers often form coalitions against hostile takeovers at the political level).

corporate governance regime should be seen as an exercise of striking the right balance between the minimization of agency costs and holdup costs.

For this Article, the crucial aspect of the analysis is the comparison of the U.S. situation to a system with pervasive shareholder influence. Holdup will take place only if there are beneficiaries whose interests align with those of managers. In the absence of shareholder influence, and as long as they are the exclusive beneficiaries, managers will weigh costs and benefits against each other when deciding whether to put pressure on other stakeholders. When managers have to share benefits with shareholders, their incentive to engage in holdup is reduced and is more likely to be outweighed by other factors. Hence, to rule out the possibility that stakeholders benefit from insulation of managers, one would either have to show that there are no significant firm-specific investments by stakeholders or that managers are the exclusive beneficiaries of holdup (without any ex post benefit to shareholders), both of which are very strong assumptions.

C. *Concentrated Ownership and Holdup Potential in Continental Europe*

1. *How Ownership Blocks Create Potential for Holdup*

The scenarios described in previous sections do not apply in the presence of a controlling shareholder. Concentrated ownership of shares, even in the case of large, listed corporations, prevails in virtually every country except the United States and the United Kingdom, and particularly in the large Western European countries.[156] Team production theory would require modification in order to prove applicable because it assumes powerless shareholders.[157]

Under prototypical concentrated ownership, a large shareholder holds both considerable voting power and considerable cash flow rights. The well-known advantage of concentrated ownership is that a large or controlling shareholder with extensive cash flow rights has a strong incentive to monitor managerial misconduct.[158] Thus, the classic Berle-Means *managerial* agency problem of the separation of ownership and control is eliminated.[159] However, as a negative side-effect, large and controlling shareholders have the

156. Marco Becht & Ailsa Roëll, *Blockholdings in Europe: An International Comparison*, 43 EUR. ECON. REV. 1049 (1999); Mara Faccio & Larry H.P. Lang, *The Ultimate Ownership of Western European Corporations*, 65 J. FIN. ECON. 365 (2002); Gilson, *supra* note 3, at 1645 (summarizing the empirical evidence); Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999). *Contra* Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States* (June 2007) (unpublished manuscript), *available at* http://ssrn.com/abstract=991363 (suggesting that dispersed ownership is not more prevalent in the United States than elsewhere).

157. *Cf.* Bebchuk, *supra* note 102, at 909.

158. *E.g.*, Shleifer & Vishny, *supra* note 18, at 754–55.

159. *See generally* Andrei Shleifer & Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461 (1986).

opportunity to obtain private benefits of control.[160] Controlling shareholders are typically able to siphon money out of the firm by entering into non-arm's-length deals with the firm or by exploiting corporate opportunities.[161] Thus, leaving stakeholder issues aside, the most important policy goal of corporate law in such systems is to keep large shareholders' opportunities to abuse their position in check.

However, concentrated ownership also exacerbates the holdup problem vis-à-vis nonshareholder constituencies.[162] In a firm with a controlling shareholder, that shareholder can easily replace the firm's managers. As suggested by Charreaux and Desbrières, in a situation of crisis, management, in order to avoid eviction, will find it beneficial to reduce the share of firm value assigned to stakeholders—employees in particular—and "to maintain that of the dominant shareholder so that this one may obtain at least the normal market return."[163] To a certain extent, stakeholders instead of shareholders thus become the firm's residual risk bearers.[164] The controlling shareholder is in a position to induce managers to pressure other constituencies into giving up quasi-rents and rents on their specific investment. Naturally, this kind of opportunism would be in the ex post interest of shareholders irrespective of capital structure. Under dispersed ownership, collective action problems impede the required coordination,[165] and these problems are reinforced by certain aspects of U.S. corporate law.[166]

Shareholders' incentive to expropriate stakeholders is financial, as a considerable share of holdup profits will end up in shareholder pockets. If a shareholder (or shareholder coalition) has both a controlling interest and a large claim to cash flow, that individual or group has a monetary incentive and an opportunity. Thus, keeping other factors constant, holdup risk for other constituencies will increase with a higher degree of explicit shareholder influence—which in turn will typically increase with a higher share for the controlling shareholder—and with an increase in the controlling shareholder's monetary share in the firm.

The argument that holdup problems are small in the United States compared with other jurisdictions rests on the insulation of managers from shareholder influence. In an extreme version of a Berle-Means firm, where

160. *See generally* Mark J. Roe, *The Institutions of Corporate Governance*, *in* Handbook of New Institutional Economics 371, 374–75 (Claude Ménard & Mary M. Shirley eds., 2005); Shleifer & Vishny, *supra* note 18, at 758–61.

161. *See* Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Tunneling*, 90 Am. Econ. Rev. (Papers & Proc.) 22 (2000).

162. Similarly, the presence of blockholders may be associated with a higher cost of debt. *See* Ashbaugh-Skaife et al., *supra* note 21, at 240.

163. Charreaux & Desbrières, *supra* note 18, at 116.

164. *Id.*

165. Habib, *supra* note 18, at 146–48. Some evidence, however, suggests that dispersed ownership may increase firm value in some circumstances. *Id.* at 148.

166. *See* discussion *supra* Part III.B.1; *see also* Bebchuk, *supra* note 102, at 848; Hansmann & Kraakman, *supra* note 100, at 41–44.

insulation is complete in the sense that shareholders are unable to influence managers, managers would also have no reason to use their business judgment to promote shareholder interests if there are tradeoffs with the interests of other constituencies.[167] Managers may have opportunities to gain advantages from all constituencies without favoring particular groups; thus, the primary beneficiaries of holdup are shareholders, not managers. However, as the result of controlling the firm's business activities on a day-to-day basis, managers may feel socially attached to employees and even long-term business partners.[168] The classical moral hazard problem analyzed under the principal-agent paradigm of corporate governance is therefore likely to be more severe than the expropriation of other constituencies. Dispersed shareholders, who are distant from management in day-to-day decision making and, as a group, cannot exit the company,[169] may therefore be in the weakest position of all. Consequently, in such an extreme version of a Berle-Means firm, stakeholder problems may be nearly irrelevant.

2. *Explicit Shareholder Influence in Continental Europe*

It is easy to see that controlling shareholders in Continental Europe typically have a strong influence on management. French law,[170] for example, allows shareholders to revoke the appointment of members of the board of directors (*conseil d'administration*) at any time,[171] without giving a reason.[172] Similarly, the *conseil*, which appoints the CEO of a company (*directeur général*),[173] can remove the CEO at any time.[174] Assistant general managers

167. Habib, *supra* note 18, at 147 (arguing that "not being a shareholder, [the manager] has nothing to gain from [reneging on promises of deferred compensation made to employees]"). The situation in a Berle-Means firm approximates that in a non-profit organization ("NPO"), which is characterized by a non-distribution constraint (i.e., there is not even an interest group with financial incentives to monitor management and interfere in decision making). The generally accepted explanation for the existence of the non-distribution constraint is that the NPO's stakeholder would object to an owner receiving profits because of severe information asymmetries regarding the NPO's product, Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 846–48 (1980), or because it has non-contractible properties that could not be verified by courts, Edward L. Glaeser & Andrei Shleifer, *Not-for-Profit Entrepreneurs*, 81 J. PUB. ECON. 99 (2001).

168. *See, e.g.*, ROE, POLITICAL DETERMINANTS, *supra* note 17, at 34 (arguing that "these managerial tendencies fit well with employees' goals").

169. WILLIAMSON, *supra* note 35, at 304–05.

170. This section describes only the predominant one-tier structure. Since the 1966 reforms, French corporate law has alternatively offered a German-style two-tier structure with *directoire* and *conseil de surveillance*. As of 2002, 6,491 among 150,000 *sociétés anonymes* had a dualistic structure, but about twenty-five percent of the CAC 40 stock index has this structure. *See* PHILIPPE MERLE & ANNE FAUCHON, DROIT COMMERCIAL. SOCIÉTÉS COMMERCIALES 417 n.2 (10th ed. 2005).

171. *See* CODE DE COMMERCE [C. COM.] art. L.225–18 (Fr.).

172. Chambre Commerciale et Financière [Cass. Com.] [highest court of ordinary jurisdiction], Bordeaux, Oct. 26, 1959, J.C.P. 1960, II, 11696 (Fr.); Jan. 3, 1985, RÉPERTOIRE DU NOTARIAT DEFRÉNOIS 1987, 620, J. Honorat (Fr.); *see* MICHEL GERMAIN & LOUIS VOGEL, TRAITÉ DE DROIT COMMERCIAL, n.1653 (G. Ripert & R. Roblot eds., 18th ed. 2001).

173. C. COM. art. L.225-51-1. Before the NRE Act of 2001, Law No. 2001-420 of May 15, 2001, Journal Officiel de la République Française [J.O.] [Official Gazette of France], May 16, 2001, p. 7776, the *directeur général* had to be a member of the *conseil d'administration*.

174. C. COM. art. L.225-55.

(*directeurs délégués*), who are appointed upon proposal by the CEO,[175] can likewise be removed.[176] While some commentators emphasize the strong position of the "PDG" (*président directeur général*), who is both president of the *conseil* and CEO,[177] his power is constrained by large shareholders and the potential threat of replacement.[178] Before the 2001 reform,[179] shareholders were even able to directly remove the PDG by revoking his appointment to the *conseil*, as he was required to be one of its members.[180] Similarly, in Italy, under the traditional system of board organization[181] the appointment of a director (member of the *consiglio di amministrazione*) can be revoked at any time by shareholders. However, the firm may have to pay damages to the director if the revocation was without cause.[182] In both countries, these provisions are mandatory.[183] In countries such as France and Italy, where management is kept on a short leash by large shareholders, the potential for holdup of stakeholders is high. Large shareholders either control the board

175. *Id.* art. L.225-53.

176. *Id.* art. L.225-55.

177. *E.g.*, Christiane Alcouffe, *Judges and CEOs: French Aspects of Corporate Governance*, 9 EUR. J.L. & ECON. 127, 129 (2000).

178. *See* Hansmann & Kraakman, *supra* note 100, at 41 ("The shareholder majority nevertheless holds the PDG at the end of a short leash by virtue of the majority's removal power."); *see also* GUYON, *supra* note 95, at 289 (characterizing the general shareholder meeting and not the board as the "supreme organ" of the company); Yves Guyon, *L'évolution Récente des Assemblées D'Actionnaires en Droit Français*, *in* MÉLANGES GUY FLATTET 39 (Bernard Dutoit, Josef Hofstetter & Paul Piotet eds., 1985).

179. *See generally* NRE Act of 2001, *supra* note 173.

180. GERMAIN & VOGEL, *supra* note 172, at 453. The reform may have slightly strengthened the position of management by stipulating damages if there is no cause for dismissal (unless the *directeur général* is also a member of the *conseil*). *See* C. COM. art. L.225-55.

181. Since 2004, Italian firms can choose between three different types of organizational structure. Decree-Law No. 6, Jan. 17, 2003, Gazz Uff. No. 17, Supp. Ord. 8/L, Jan. 22, 2003 (Italy). For an overview of recent Italian corporate law reforms, see Guido Ferrarini, Paolo Guidici & Mario Stella Richter, *Company Law Reform in Italy: Real Progress?*, *in* 69 RABELS ZEITSCHRIFT FÜR AUSLÄNDISCHES UND INTERNATIONALES PRIVATRECHT 658, 659–61 (2005). Besides the traditional structure (*consiglio di amministrazione* and *collegio sindacale*, as discussed in the text), firms may choose an English-style monistic and a German-style dualistic structure. In both systems, shareholders have the power to elect and revoke the appointment of managing directors at any time. *See* CODICE CIVILE [C.c.] art. 2409(19) (Italy) (board members in a monistic system), C.c. art. 2409 (9) para. 3, para. 5 (managing board members in dualistic system), C.c. art. 2409 (20) para. 5 (supervisory board members).

182. *See* C.c. art. 2383 para. 3.

183. For France, see GERMAIN & VOGEL, *supra* note 172, at 1653; MERLE & FAUCHON, *supra* note 170, at 386. For Italy, see 1 GUIDO CAPOZZI, LE SOCIETÀ DI CAPITALI, LE SOCIETÀ COOPERATIVE E LE MUTUE ASSICURATRICI 679 (2005). The Italian board of auditors (*collegio sindacale*), which is also elected by shareholders, is of less interest here. Its members are elected by shareholders, but can only be removed for cause. C.c. art. 2400(1), (2). It is less involved with individual business decisions and strategy than the German supervisory board. *See, e.g.*, Ferrarini et al., *supra* note 181, at 676–77; Klaus J. Hopt & Patrick C. Leyens, *Board Models in Europe—Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy*, 1 EUR. COMPANY & FIN. L. REV. 135, 158–59 (2004). The duties of the board of auditors are set out in C.c. art. 2403 para. 1. *See also* Eugenio Ruggiero, *Italy*, *in* THE LEGAL BASIS OF CORPORATE GOVERNANCE IN PUBLICLY HELD CORPORATIONS 79, 106 (Arthur R. Pinto & Gustavo Visentini eds., 1998).

through direct representation or can directly threaten the firm's senior managers with removal from their positions.[184]

By contrast, German law provides insulation of the board from shareholder influence as a matter of theory. German *Aktiengesellschaften* have a mandatory two-tier board structure; a management board (*Vorstand*) takes care of the operations of the company, while a supervisory board (*Aufsichtsrat*) is expected to monitor it. Section 76 of the German Stock Corporation Act (*Aktiengesetz*), which resembles DGCL section 141, explicitly charges the management board with the exclusive responsibility of managing the company[185] and implies that instructions from the supervisory board or shareholders are invalid.[186] The provision is mandatory.[187] The management board's independence is reinforced by appointment and dismissal procedures. The supervisory board elects and dismisses management board members, but premature dismissal requires a showing of cause, which includes a vote of no confidence by shareholders.[188] Thus, dismissal requires agreement between major shareholders and the supervisory board. Supervisory board members are elected by shareholders,[189] have a period in office of up to five years,[190] and normally can only be dismissed prematurely by a supermajority of three quarters.[191] Interestingly, the motivational report accompanying the 1937 *Aktiengesetz* that first introduced this structure[192] states:

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184. *See, e.g.*, Ruggiero, *supra* note 183, at 83–84 (describing the influence of controlling shareholders and coalitions on listed Italian firms).

185. Aktiengesetz [AktG] [Stock Corporation Act], Sept. 6, 1965, BGBl. I at 1089, § 76 (1) (F.R.G.).

186. Wolfgang Hefermehl & Gerald Spindler, § 76, cmt. 21, *in* 3 MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ 58, 66–67 (Bruno Kropff & Johannes Semler eds., 2d ed. 2000); Hans-Joachim Mertens, § 76, cmt. 42, *in* 2 KÖLNER KOMMENTAR ZUM AKTIENGESETZ 1, 37 (Wolfang Zöllner ed., 2d ed. 1988); UWE HÜFFER, 53 AKTIENGESETZ § 76, cmt. 10 (6th ed. 2006) (also pointing out that there is no *direct* fiduciary relationship between either a management board and an individual shareholder or a management board and the shareholder meeting).

187. HÜFFER, *supra* note 186, § 23, cmt. 36; *see also* Andreas Pentz, § 23 cmt. 156, *in* 1 MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ 491, 541 (Bruno Kropff & Johannes Semler eds., 2d ed. 2000). On control agreements, see generally Hertig & Kanda, *supra* note 101, at 71, 86; Hertig & Kanda, *supra* note 81, at 124–25; Peter Hommelhoff, *Protection of Minority Shareholders, Investors and Creditors in Corporate Groups: The Strengths and Weaknesses of German Corporate Group Law*, 2 EUR. BUS. ORG. L. REV. 61, 64–66 (2001).

188. AktG § 84 (3).

189. AktG § 101 (1). Half of the board members are employee representatives, but in the case of a tie the vote of the chairman (who is one of the shareholder-appointed members) is decisive. On codetermination, see *infra* notes 246–55 and accompanying text.

190. The rule in AktG § 102 (1) on the term of office depends on when the annual general meeting is held, but effectively results in a period of about five years. *See* HÜFFER, *supra* note 186, § 102, cmt. 2.

191. AktG § 103 (1). The charter may entitle the owners of registered shares (with restricted transferability) to appoint up to one third of the board members who are appointed by shareholders; the respective shareholder also has the right to revoke the appointment at any time. AktG §§ 101 (2), 103 (2). Supervisory board members may be removed for cause by a court. AktG § 103 (3).

192. On the historic development, see Wolfgang Hefermehl & Johannes Semler, *Verfassung der Aktiengesellschaft: Vorbemerkung*, § 76, cmts. 10–20, *in* 3 MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ 3, 8–10 (Bruno Kropff & Johannes Semler eds., 2d ed. 2000).

> Under current law, the shareholder meeting is the supreme decision making body of the corporation; the authority of the management board and the supervisory board is derived from it. Fundamental decisions regarding the fate of the corporation are made by the majority of the providers of funds, who are personally not responsible, who usually lack precise and competent insight into business and the firm's operations, and who typically *put the concerns of capital into the foreground.* The development of corporations has shown that conflicts of interest and power struggles between the administration and the shareholder meeting tend to develop, which are by no means to the advantage of the company and business life.[193]

The report goes on to explain that the law is intended to limit the role of the shareholder meeting. The quoted passage addresses concerns raised by shareholder empowerment, one of which appears to be close to the motivation of team production theory, where a lopsided focus on capital is seen as harmful. The act concurrently introduced section 70(1), which required directors "to manage the corporation as the good of the enterprise and its retinue and the common weal of folk and realm demand."[194] The provision set out the doctrine of the "Unternehmensinteresse," under which the institutional interest of the firm transcends the interests of specific constituencies. Although the provision was introduced in 1937 and has linguistically been influenced by Nazism,[195] it was not exclusive to that ideology. The origins of the doctrine can be traced to earlier writers such as Walther Rathenau,[196] and it reflects a broader trend in German political and economic theory of the 1920s and

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193. FRIEDRICH KLAUSING, GESETZ ÜBER AKTIENGESELLSCHAFTEN UND KOMMANDITGESELLSCHAFTEN AUF AKTIEN 56 (1937) (official report introducing the reform, own translation). A more ideological aspect of the strengthening of the corporate administration in this reform was the *Führerprinzip* (leader principle) that stood at the heart of Nazi ideology. However, it was not implemented to its fullest possible extent. *See id.* at 63*–64*.

194. Translation following Detlev Vagts, *Reforming the "Modern" Corporation: Perspectives from the German*, 80 HARV. L. REV. 23, 40 (1966).

195. *See id.* (using the term "retinue" to translate the German "Gefolgschaft," which "Nazism claimed to find in the teutonic past," and describing a pseudo-feudal relationship between the firm and its employees).

196. WALTHER RATHENAU, VOM AKTIENWESEN. EINE GESCHÄFTLICHE BETRACHTUNG. (1917). The famous term "Unternehmen an sich" ("enterprise as such") was coined by Haussmann, who used it to describe and criticize Rathenau's theory. *See* FRITZ HAUSSMANN, VOM AKTIENWESEN UND VOM AKTIENRECHT (1928). Other scholars of the time viewed it more favorably. Rathenau was an industrialist and a moderate liberal politician, who was serving as German foreign minister when he was assassinated by nationalists in 1922. However, Friedrich Klausing, the editor of the motivational report accompanying the 1937 Aktiengesetz, was most likely a Nazi. He committed suicide after being dismissed as the rector of the University of Prague in 1944, when his son had been identified as one of the conspirators in the assassination attempt on Hitler of July 20. *See* Bernd Rüthers, *Spiegelbild einer Verschwörung: Zwei Abschiedsbriefe zum 20. Juli 1944*, 14 JURISTENZEITUNG 689 (2005). For a detailed review of Rathenau's and Haussmann's partly contradicting ideas, see ARNDT RIECHERS, DAS 'UNTERNEHMEN AN SICH' 7–25 (1996).

1930s.[197] When the requirement to promote the "good of the enterprise" was dropped in the 1965 reform, the stated reason was that it was self-evident that the interests of employees and of the public had to be taken into consideration.[198] The doctrine continues to play a role in German corporate law.[199] However, it is no longer seen as the metaphysical interest of the business "as such," but as a proxy for the interests of various groups that must be reconciled.[200]

Nevertheless, actual German corporate governance practice departs from the law on the books attempting to insulate management from shareholders. Large German firms are often controlled by single large shareholders, and sometimes by medium-sized ones,[201] who exercise control by forming coalitions and electing confidants to the supervisory board. Members of the management board must face re-election after a period of at most five years,[202] at which time they face the scrutiny of these directors and, by extension, of core shareholders.[203] Furthermore, the requirement of cause to remove board members prematurely can be met by a vote of no confidence. Due to the close connection between large shareholders and supervisory board members and the fact that supervisory board members themselves can be removed by a supermajority of seventy-five percent in the shareholder meeting, managers no longer enjoying the confidence of the controlling shareholder or coalition will typically be unable to maintain their position.[204]

Controlling shareholders and coalitions are therefore typically able to impose their will on the firm by threatening to replace the managers. Employee representatives on the board are typically not in a position to object,

197. *See* RIECHERS, *supra* note 196, at 26–42.

198. FEDERAL REPUBLIC OF GERMANY, AKTIENGESETZ WITH COMMITTEE REPORT 97 (Bruno Kropff ed., 1965).

199. Notably, the Bundesgerichtshof referred to the "Unternehmensinteresse" in its Mannesmann opinion. Bundesgerichtshof [BGH] [Federal Court of Justice], May 5, 2005, 59 NEUE JURISTISCHE WOCHENSCHRIFT [NJW] 529 (560) (F.R.G); *see, e.g.*, Gerald Spindler, *Vorstandsvergütungen und Abfindungen auf dem aktienrechtlichen Prüfstand—Das Mannesmann-Urteil des BGH*, 27 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT [ZIP] 349, 352 (2006). Recent scholarship influenced by law and economics tends to attack the doctrine. *See, e.g.*, Holger Fleischer, § 76, cmts. 30–31, *in* KOMMENTAR ZUM AKTIENGESETZ (Gerald Spindler & Eberhard Stilz eds., 2007).

200. HÜFFER, *supra* note 186, § 76, cmt. 15.

201. *See* Marco Becht & Ekkehart Boehmer, *Voting Control in German Corporations*, 23 INT'L REV. L. & ECON. 1 (2003); Ekkehard Boehmer, *Who Controls German Corporations?*, *in* CORPORATE GOVERNANCE REGIMES 268 (Joseph A. McCahery et al. eds., 2002); Jeremy Edwards & Marcus Nibler, *Corporate Governance in Germany: The Role of Banks and Ownership Concentration*, 15 ECON. POL'Y 239, 246–51 (2000); F. Jens Köke, *New Evidence on Ownership Structures in Germany*, 34 KREDIT UND KAPITAL 257, 268–72 (2001); Dariusz Wójcik, *Change in the German Model of Corporate Governance: Evidence from Blockholdings 1997–2001*, 35 ENV'T & PLAN. A 1431 (2003).

202. AktG § 84 (1).

203. Peter Doralt, *Die Unabhängigkeit des Vorstands nach österreichischem und deutschen Aktienrecht—Schein und Wirklichkeit*, *in* DIE GESTALTUNG DER ORGANISATIONSDYNAMIK. FESTSCHRIFT FÜR OSKAR GRÜN 31, 47 (Werner H. Hoffmann ed., 2003); Jean du Plessis & Claus Luttermann, *The Dominant Role of the German Banks and New Players in the German Financial Sector*, *in* GERMAN CORPORATE GOVERNANCE IN INTERNATIONAL AND EUROPEAN CONTEXT 205, 209–210 (Jean J. du Plessis et al. eds., 2007).

204. Doralt, *supra* note 203, at 47–48.

as the vote of the president of the supervisory board—a shareholder representative—is decisive in the case of a tie.[205] Exceptions are possible, such as cases where groups of shareholders fall out among each other and employee representatives are decisive. However, as a general matter, shareholder influence as such would be strong enough to extract rents and quasi-rents from stakeholders, even under German corporate law.

3. *Holdup Incentives in Spite of European Pyramid Structures*

One might object that the large financial incentive for holdup may be eliminated by divergences between financial ownership and control, such as deviations from the "one share-one vote" principle that is normally thought to create optimal incentives for efficient shareholder decisions.[206] Such structures are sometimes thought to be common in Continental Europe, or at least in some European countries. Examples are dual-class shares, cross-ownership of shares, and most interestingly, stock pyramids.[207] Pyramidal structures, if carried to the extreme, may allow a controller to vote the majority of the stock of a publicly traded firm while owning only a minimum of capital and cash flow rights. For example, if shareholder *A* owns fifty percent of the shares of company *B*, which in turn holds thirty percent of publicly traded firm *C*, *A* will effectively vote thirty percent of *C*'s shares with a financial stake of merely fifteen percent. Luca Enriques and Paolo Volpin describe the case of Telecom Italia, where, in 2005, one person controlled eighteen percent of the voting stock with a capital share of only 0.7% of capital by means of a chain of four intermediary firms (two of them publicly traded).[208]

Pyramidal structures and other divergences from "one share-one vote" are usually considered problematic from an agency perspective because they allow the controller to externalize his decisions on minority shareholders.[209] Extreme types of pyramids approximate the Berle-Means corporation in important respects: the manager, without owning much stock, is fully in control of the firm and minimally accountable to minority shareholders. Hostile takeovers are impossible. Thus, pyramids combine the worst features of both dispersed and concentrated ownership.[210] One might think that the control-

205. Mitbestimmungsgesetz [MitbestG] [Codetermination Act], May 4, 1976, BGBl. I at 1153, § 29 (2) (F.R.G.); *see* Hansmann & Kraakman, *supra* note 100, at 36.

206. Sanford J. Grossman & Oliver D. Hart, *One Share-One Vote and the Market for Corporate Control*, 20 J. FIN. ECON. 175 (1988); HART, *supra* note 35, at 186–89; EASTERBROOK & FISCHEL, *supra* note 24, at 72–74.

207. *E.g.*, Lucian Arye Bebchuk, Reinier Kraakman & George Triantis, *Stock Pyramids, Cross-Ownership, and Dual-Class Equity*, *in* CONCENTRATED CORPORATE OWNERSHIP 295, 297–301 (Randall K. Morck ed., 2000).

208. Luca Enriques & Paolo Volpin, *Corporate Governance Reforms in Continental Europe*, 21 J. ECON. PERSP. 117, 119–21 (2007).

209. Guido Ferrarini, *One Share-One Vote: A European Rule?*, 3 EUR. COMPANY & FIN. L. REV. 147, 160 (2006).

210. *See* Bebchuk et al., *supra* note 207, at 295.

ler of such a firm could function as a "mediating hierarch," as under Blair and Stout's team production theory. Holdup problems would be largely eliminated because the controlling shareholder lacks a financial incentive.[211] However, a closer look reveals that even if the controller of the firm only has a nominal entitlement to the firm's cash flow, holdup is still an issue in subsidiaries at the bottom of the pyramid.

First, benefits that can be squeezed out of the firm on the bottom of the pyramid by reneging on implicit deals with nonshareholder constituencies could be used for projects at another level of the pyramid. Assume that shareholder *X*, through a chain of subsidiaries, owns ten percent of the cash flow rights of Widget Holding ("WidHold"), but controls fifty percent of votes. WidHold owns fifty percent of Widget Operative ("WidOp"), which is thus indirectly controlled by *X*. In theory, *X*'s financial holdup incentive should be only five percent compared to a situation where he is the sole owner of WidOp.

However, the controller *X* may be able to obtain a share of the gains exceeding five percent at the cost of other shareholders—perhaps from lower wages—after threatening employees with plant closures. Such techniques are well known from the debate on agency conflicts under concentrated ownership. These techniques include tunneling through transactions between WidOp and WidHold under terms unfavorable to WidOp,[212] transactions between WidOp and *X* under terms unfavorable to WidOp, and stock dilution.[213] WidOp could be merged into an entity controlled by *X* or WidHold under an exchange ratio that benefits *X* at the expense of WidHold's other shareholders.[214] If either is possible, *X* will be able to increase the ratio from five percent to a higher amount by diverting the profit into an entity in which her share is higher. The degree to which the controlling shareholder benefits depends on how much must be given to minority shareholders. Tunneling opportunities and the possibility of merging the two firms and diluting the minority's stock will increase the controller's incentive to hold up stakeholders. By contrast, if *X* cannot illicitly increase her share in holdup gains, and holdup gains only accrue to her through dividends and the share price, minority shareholders proportionally share in these gains. When minority shareholders share in holdup gains, the reduced monetary incentives for the controlling shareholder suggest that she will not

211. Regarding agency cost, it is often said that pyramidal structures eliminate the large shareholder's incentive to monitor managers. *See* Bebchuk et al., *supra* note 207, at 301, 305 (suggesting an increase in agency costs); Köke, *supra* note 201, at 264.

212. *See* Johnson et al., *supra* note 161.

213. For a definition and discussion of techniques, see, for example, Conac et al., *supra* note 96, at 523–24; Vladimir Atanasov, Bernard Black & Conrad S. Cicotello, *Unbundling and Measuring Tunneling*, (Univ. of Tex. Sch. of Law, Law and Economics Working Paper No. 17, 2007), *available at* http://ssrn.com/abstract=1030529 (distinguishing between asset tunneling, cash flow tunneling, and equity tunneling).

214. The controlled entity could either be within the pyramid at a level where *X*'s financial stake is higher, outside of the pyramid, or even within another pyramid controlled by *X*.

engage in holdup in marginal cases where gains are outweighed by personal holdup costs such as reduced empire-building possibilities or loss of reputational commitments to good relations with stakeholders.[215] Stakeholders may therefore benefit from improved protection of minority shareholders.

Second, even if some pyramids greatly reduce the controller's holdup incentive, this incentive may resurface under circumstances where funds are needed at a higher level of the pyramid. In the above example, WidHold might experience financial constraints and need additional liquidity, which short-term holdup gains in WidOp may provide, as in an exogenously induced crisis or a leveraged buyout of the parent firm. While X's personal advantage may not be significant, as her cash flow rights in both WidHold and WidOp are relatively small, the requirement to make interest payments in WidHold creates a joint interest—by all of WidHold's shareholders, its creditors, and even its employees—that triggers pressure to extrude financial means from its subsidiary WidOp. Despite the fact that the personal financial incentive of X, the controller of both firms, is weaker than in a situation where she directly owns a large share of WidOp, the joint pressure from WidHold's stakeholders may make up for that difference. X is unlikely to resist because her financial share in WidHold is still bigger than her share in WidOp. Hence, her priority will be to assure the survival and long-term prosperity of the parent firm and to satisfy the demands of its stakeholders, rather than to maintain friendly relations with stakeholders on the subsidiary level. Such a situation, triggered by a crisis or a leveraged buyout, may even pit stakeholders against stakeholders, as nonshareholder constituencies on the parent level may benefit from holdup of stakeholders of the subsidiary.

Third, the controller can sell his share of the company at any time.[216] A sale can happen at any level of the pyramid and might be particularly lucrative if the pyramidal separation between ownership and control is removed. The new controller would then have a much greater financial incentive to hold up stakeholders. Hence, even if there is no current holdup risk, there is always a potential one, and even this potential risk should discourage specific investment.

Finally, it is important to note that pyramids in which the controller actually holds a substantial chunk of equity in the bottom subsidiary seem to be more the rule than the extreme form described by Enriques and Volpin.[217] For example, if the controlling entity owns twenty percent of cash

215. For a discussion of long-term commitment by large shareholders, see *infra* Part III.C.4.

216. For example, in Germany, while there is little hostile takeover activity, there is a thriving market of controlling blocks. Julian Franks & Colin Mayer, *Ownership and Control of German Corporations*, 14 Rev. Econ. Stud. 943, 955 (2001).

217. Empirical evidence is available at La Porta et al., *supra* note 156, at 498–500, 511 (concluding that, while pyramids are common, the magnitude of deviations from the one share-one vote ideal tends to be small); Stijn Claessens, Simeon Djankov & Larry H.P. Lang, *The Separation of Ownership and Control in East Asian Corporations*, 58 J. Fin. Econ. 81, 100 (2000) (reporting mean ratios of cash flow rights to

flow rights but forty percent of votes, the financial interest is certainly significant and distinguishable from ownership stakes of managers of U.S. companies. In an empirical study of ownership structures in the German manufacturing industry, Köke concludes that the agency problem resulting from pyramidal structures "is probably irrelevant for most German firms."[218]

4. *Large Ownership Blocks as Such Do Not Create a Commitment to Stakeholders*

Several scholars have previously observed that holdup of nonshareholder constituencies may be facilitated by large shareholders.[219] By contrast, others have suggested that, particularly in Europe, the long-term horizon of large financial investors may facilitate specific investment by managers[220] or implicit contractual relationships and commitment by other nonshareholder constituencies.[221]

The claim that large shareholders may alleviate holdup problems is quite puzzling. While it is commonly thought that large shareholders in control-oriented finance systems hold shares for extended periods of time,[222] the existence of a large shareholder *as such* likely does not facilitate specific investment. Such a claim would assume a constant threat of hostile takeovers that is not in fact present in the United States. It is true that managers, employees, and other stakeholders are shielded from hostile takeovers by large shareholders under concentrated ownership. However, holdup can take place for two reasons. First, large shareholders themselves can obtain financial benefits. Second, large shareholders refraining from ex post opportunism

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control rights between 0.602 and 0.941 for East Asian economies); Franks & Mayer, *supra* note 216, at 950–51 (reporting an average ratio between voting and cash flow rights of 1.6 in a sample of 38 German pyramids); Köke, *supra* note 201, at 280–81 (reporting a ratio between cash flow and voting rights of less than seventy-five percent in only ten percent of a sample of 5788 German manufacturing firms with a pyramidal structure); Faccio & Lang, *supra* note 156, at 392 (reporting mean ratios of cash flow to control rights between .740 and .941 for 13 Western European countries); Roberto Barontini & Lorenzo Caprio, *The Effect of Family Control on Firm Value and Performance. Evidence from Continental Europe* 43 (Eur. Corp. Governance Inst., Finance Working Paper No. 88/2005, 2005), *available at* http://ssrn.com/abstract=675983 (reporting a wedge between cash flow and control rights of more than twenty percent in only 11.6% of firms).

218. Köke, *supra* note 201, at 285.

219. Shleifer & Vishny, *supra* note 18, at 758; Charreaux & Desbrières, *supra* note 18, at 116; *see also* Habib, *supra* note 18 (mathematical model in the leveraged buyout context); Pagano & Volpin, *supra* note 153, at 841 (modeling managers' incentive to voluntarily protect employees in order to make the firm unattractive as a target of takeovers, with the incentive resting on managers holding only a small stake).

220. Julian Franks & Colin Mayer, *Ownership and Control in Europe*, in 2 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 722, 728–29 (Peter E. Newman ed., 1998); William W. Bratton & Joseph A. McCahery, *Comparative Corporate Governance and Barriers to Global Cross Reference*, in CORPORATE GOVERNANCE REGIMES 23, 27 (Joseph A. McCahery et al. eds., 2002).

221. *See, e.g.*, Stephan Woolcock, *Competition Among Forms of Corporate Governance in the European Community: The Case of Britain*, *in* NATIONAL DIVERSITY AND GLOBAL CAPITALISM 179, 183 (Suzanne Berger & Ronald Dore eds., 1996); Ruth V. Aguilera & Gregory Jackson, *The Cross-National Diversity of Corporate Governance: Dimensions and Determinants*, 28 ACAD. MGMT. REV. 447, 451 (2003).

222. *See, e.g.*, Bratton & McCahery, *supra* note 220, at 26.

may sell to a third party, even when they are unwilling to hold up stakeholders themselves.

With regard to managers, economic theory already tends to emphasize that specific investment is discouraged by concentrated ownership, as managers only retain their position in the firm at the whim of the dominating shareholder or coalition. Burkart, Gromb, and Panunzi discuss the tradeoff between reducing agency cost through monitoring by large shareholders, on one hand, and managerial initiative, on the other, which is stifled by constraints imposed by blockholders. Managerial initiative, which is interpreted as a form of specific investment, is avoided ex ante if managers cannot be certain to receive the private benefit of being able to retain control over the firm ex post if there is a blockholder.[223]

The same reasoning applies to groups such as employees,[224] where the presence of a large or controlling shareholder *as such* cannot signal commitment not to engage in holdup. Consider a fully entrenched manager not subject to explicit or implicit shareholder influence and a controlling shareholder with full control over the firm's crucial business decisions, both considering whether to threaten employees with redundancy to increase profits. For reasons discussed above, the entrenched manager's interest may to some degree be aligned with that of employees.[225] Similar reasons might apply to the controlling shareholder if he actually controls the firm's operations. However, while the entrenched manager draws no personal benefit from holdup, the controlling shareholder reaps a big chunk of the financial gains. Thus, assuming that the same countervailing incentives apply both to the manager and the controlling shareholder, the latter will be more eager to expropriate nonshareholder constituencies. Naturally, the manager's incentives may be different because of what I have described as *implicit shareholder influence*, that is, when the threat of a hostile takeover is considerable or managerial incentives are otherwise closely aligned with shareholders.[226]

One reason why concentrated ownership may facilitate specific investment is the difficulty of selling a large share in a publicly held firm.[227] However, opportunism vis-à-vis nonshareholder constituencies does not necessarily imply a sale of the share or even the threat of liquidating the firm, in which case a large shareholder would indeed typically incur losses. In fact, the assertion that holdup is easier under dispersed ownership is often made

223. Mike Burkart, Denis Gromb & Fausto Panunzi, *Large Shareholders, Monitoring, and the Value of the Firm*, 112 Q. J. ECON. 693, 693–94 (1997); *see also* Philippe Aghion & Jean Tirole, *Formal and Real Authority in Organizations*, 105 J. POL. ECON. 1 (1997).

224. *See* Burkart et al., *supra* note 223, at 702; Marco Becht, Patrick Bolton & Alisa Roëll, *Corporate Law and Governance*, *in* 2 HANDBOOK OF LAW AND ECONOMICS 829, 855 (A. Mitchell Polinsky & Steven Shavell eds., 2007); BREALEY ET AL., *supra* note 33, at 949 (both extending this reasoning to employees).

225. *See supra* Parts II.B, III.B.2.

226. Managerial incentives are much less closely aligned with shareholders in the United States than in the United Kingdom, a fact that will be discussed in Part VI.

227. Aguilera & Jackson, *supra* note 221, at 451.

with regard to the possibility of a *hostile* takeover,[228] when a dispersed ownership structure is replaced by a dominating shareholder.

From the perspective of stakeholders fearing holdup, the counterpart to a hostile takeover in a controlled firm is a voluntary sale of control.[229] Unlike hostile takeovers, such sales are unlikely to change managerial incentives, as managers under concentrated ownership are under constant supervision by controlling shareholders.[230] However, they may influence stakeholders' incentives regarding specific investment.[231] As the current shareholder will effectively decide on holdup, the decision whether to sell the firm has a large impact on the potential for holdup. Even if the current shareholder is unwilling to hold up stakeholders, a purchaser may be. If short-term shareholder value can be increased through holdup, a buyer may offer a price to the current shareholder in excess of the current value of the firm. Thus, the protection of stakeholders hinges on whether the controlling shareholder is (1) both unable *and* unwilling to expropriate nonshareholder constituencies himself, and (2) also not susceptible to a lucrative offer from a third party (which will inevitably come if holdup benefits are sufficiently large). For the second condition to be met, the controlling shareholder must draw what is known as a *non-pecuniary private benefit*.[232]

Whether non-pecuniary private benefits arise depends on the identity of the shareholder. First, the controlling shareholder may be a government entity whose agents have to bear a political cost if they act against workers' interests, such as by cutting jobs. However, whether a government entity fosters specific investments depends on the stability of political preferences. The political process may at times lead to the predominance of the view that state-controlled enterprises should be run in a more efficient way in order to save taxpayers' money.

The second possible situation under which non-pecuniary benefits might be present is family ownership. Members of founding families may feel personally attached to the business of their forefathers, and they may sometimes even have a personal commitment to the firm and its employees that will

228. *See, e.g.*, Franks & Mayer, *supra* note 220, at 729.

229. *See, e.g.*, Armour et al., *supra* note 9, at 543–45 (describing BMW's sale of Rover to the "Phoenix consortium"; BMW would have liquidated the firm if it had not found a buyer. The acquirer (Phoenix) pressured unions into making concessions, in spite of labor law strengthening their negotiating position.); *see also* Martin J. Conyon et al., *Do Hostile Mergers Destroy Jobs?*, 45 J. ECON. BEHAV. & ORG. 427 (2001) (finding no significant difference in impact on labor demand between firms acquired through hostile takeover and voluntary sale).

230. *Cf.* Klaus Gugler & B. Burcin Yurtoglu, *The Effects of Mergers on Company Employment in the USA and Europe*, 22 INT'L J. INDUS. ORG. 481, 497 (2004) (summarizing the empirical finding that in the United States, only tender offers, but not other deals, have a significant negative effect on employment).

231. *See* Coates, *supra* note 20, at 858–59 (criticizing the applicability of team production theory in controlled firms by suggesting that buyers will be motivated exclusively by shareholder concerns in a friendly merger).

232. *See* Gilson, *supra* note 3, at 1663–64 (defining non-pecuniary benefits as "forms of psychic and other benefits that, without more, involve no transfer of real company resources and do not disproportionately dilute the value of the company's stock to a diversified investor").

make it hard to close production sites. Particularly in small countries, the position as a founding family may confer additional benefits in political and social life.[233] However, not all such benefits are necessarily passed on to subsequent generations.[234] Later generations may lose interest in the firm or lack the entrepreneurial skills of their progenitors. Non-pecuniary benefits may thus result in a deterioration of the firm's market position over time, making a sale of control to a more effective controller more lucrative.[235] Thus, while such non-contractible private benefits may create a temporary shield against holdup,[236] at some point the combination of efficiency and holdup gains may become too tempting. Even in countries with a long-standing tradition of family control in many important firms, such as France, family influence is not always seen as positive in politics.[237] Even without conclusive evidence about the effects of family control, this analysis supports the intuition that there may be considerable conflicts of interest between family owners and workers.

The third possibility for non-pecuniary benefits is the controlling shareholders' ability to enter into transactions with the firm on unfavorable terms.[238] This may occur if another business run by the controlling shareholder complements that of the firm. Take the example of firm *A* producing motors and firm *B* producing cars. As the controlling shareholder of *A*, *B* could gain from buying motors below the usual market price. Not every potential purchaser of the share in *A* would be able to obtain the same benefit. However, corporate law theory generally disdains this kind of private benefit, as it hurts minority investors.[239] As minority shareholder protection improves, this potential shield against holdup will also diminish.[240]

In sum, concentrated ownership *as such* cannot serve as a commitment mechanism facilitating specific investment by stakeholders. Even when

233. *See* Mike Burkart et al., *Family Firms*, 58 J. FIN. 2167, 2168 (2003) ("A founder may derive pleasure from having his child run the company that bears the family name."); *see also* Gilson, *supra* note 3, at 1666 (describing how leading families in Sweden enjoy social and political positions unparalleled in a large country like the United States).

234. *See* Sandy Klasa, *Why Do Controlling Families of Public Firms Sell Their Remaining Stake?*, 42 J. FIN. & QUANTITATIVE ANALYSIS 339 (2007).

235. *See* Gilson, *supra* note 3, at 1668–69 (describing the impact of business inheritance on performance).

236. *See* Burkart et al., *supra* note 233, at 2178 (modeling the conditions under which a founding family retains control because of non-pecuniary benefits in spite of superior abilities of an outside manager).

237. *See, e.g.*, Antoin E. Murphy, *Corporate Ownership in France*, *in* A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD 185, 188 (Randall K. Morck ed., 2005) (referring to prime minister Edouard Daladier's famous criticism of the alleged two hundred "grandes familles" in 1930); *see also* Marie-Laure Djelic & Rolv Petter Amdam, *Americanization in Comparative Perspective: The Managerial Revolution in France and Norway, 1940–1990*, 49 BUS. HIST. 483, 493–94 (2007) (discussing the replacement of family ownership with state ownership in France).

238. *See supra* note 213.

239. *E.g.*, Djankov et al., *supra* note 79.

240. The evidence suggests that this kind of shareholder protection has increased over the past years in several major jurisdictions. *See* Lele & Siems, *supra* note 79, at 31.

holdup is not a current threat, potential holdup by a friendly acquirer may create a deterrent against firm-specific investment similar to the threat of a hostile takeover. The final reason why concentrated capital may be willing to cooperate with labor is the one emphasized in the following section: Legal institutions strengthening the position of labor leave no other choice.

IV. Legal and Regulatory Responses to Holdup

Given the holdup problem created by concentrated ownership, reasonably successful corporate governance systems have developed responses. Conspicuously, European corporate governance systems with concentrated ownership have much stronger pro-employee institutions than U.S. ones. Part A gives an overview of these legal responses, and Part B addresses the puzzle why these rules are almost always mandatory law.

A. *Legal Strategies to Contain Shareholder Influence*

First, the standard of conduct to which managers are subject sometimes takes stakeholders into account. Both German and French laws are generally thought not to adhere to the ideal of shareholder primacy, but to the director's obligation to promote the *Unternehmensinteresse*[241] (the interest of the business) or *intérêt social*[242] (the interest of the association). These are usually understood to entail a broader corporate objective than mere shareholder wealth. The practical impact of these provisions and the difference from Anglo-Saxon jurisdictions should not be overestimated, however. The shareholder primacy norm may not be particularly good law in the United States,[243] and even the United Kingdom has a statute requiring directors to "have regard" to the interests of employees and other stakeholders.[244] Enforcement mechanisms that could be used by employees are absent in all of these countries, including the Continental European countries,[245] so in a

241. *See supra* text accompanying notes 183–89.

242. According to the majority opinion, the "social interest" of the firm transcends the mere common interest of shareholders. *See* Alcouffe, *supra* note 177, at 133–35; *see also* Jean Paillusseau, *Entreprise, société, actionnaires, salariés, quels rapports?*, Recueil Dalloz, 15 Chronique 157, 164–65 (1999); Philippe Bissara, *L'intérêt Social*, 117 Revue des sociétés 5, 14 (1999); J. Simon, *L'évolution du Gouvernement d'entreprise en France*, 77 Revue de Droit international et de Droit Comparé 368, 373 (2000); Didier Poracchia, *Le rôle de l'intérêt social dans la société par actions simplifiée*, 118 Revue des sociétés 223, 224 (2000); Didier Danet, Crony capitalism *et gouvernement d'entreprise*, 14 Revue internationale de droit Économique 247, 273 (2000). *Contra* Dominique Schmidt, *De l'intérêt social*, JCP 1995 éd. E. 1995, 38-488.

243. *See supra* Part III.A.

244. Formerly Companies Act, 1985, c. 6, § 309 (1) (U.K.), now Companies Act, 2006, c.46, § 172 (U.K.).

245. For the United States, see John C. Coates IV, Note: *State Takeover Statutes and Corporate Theory: The Revival of an Old Debate*, 64 N.Y.U. L. Rev. 806, 855 (1989); Springer, *supra* note 87, at 108, 121; for the United Kingdom, see D.D. Prentice, *A Company and Its Employees: The Companies Act 1980*, 10 Ind. Law. J. 1, 4–5 (1981); *see also* L.S. Sealy, *Directors' "Wider" Responsibilities—Problems Conceptual,*

situation of strong, explicit shareholder influence, it is unlikely to be meaningful.

Second, some legal systems endow employees with decision rights. The paradigmatic case is German codetermination, which assigns up to half of the seats on the (supervisory) board to employees (increasing in the number of the firm's employees) and thus gives limited but explicit influence to this group.[246] A similarly intrusive system exists in the Netherlands,[247] with more moderate employee participation systems in Austria,[248] the Czech Republic, Slovenia, Slovakia, Hungary,[249] Luxemburg, Denmark, Sweden, and Finland.[250]

In most cases, the impact on decisions may actually be quite limited, except where there are significant conflicts between different groups of shareholders. Even under German "quasi-parity," the decisive vote is cast by the chairman, who is one of the directors elected by shareholders.[251] However, codetermination may serve as a channel that transmits crucial information to employee representatives,[252] which puts employees in the position to act early and improves their bargaining position. Furthermore, a consensus-oriented culture of the board of directors may make sure that employee interests are taken into consideration. While the debate on whether (and to what extent) codetermination is efficient has not reached a final conclusion, the existing evidence allows some preliminary conclusions. A study by Gorton and Schmid found that equal codetermination—fifty percent of seats held by employees—was linked to a thirty-one percent discount on the value of the firm's share in the stock market compared to firms where em-

Practical and Procedural, 13 MONASH U. L. REV. 164, 177 (1987); J. E. PARKINSON, CORPORATE POWER AND RESPONSIBILITY 83 (Oxford University Press, 1993).

246. *See, e.g.*, Katharina Pistor, *Codetermination: A Sociopolitical Model with Governance Externalities*, in EMPLOYEES AND CORPORATE GOVERNANCE 163, 168 (Margaret M. Blair & Mark J. Roe eds., 1999); Henry Hansmann & Reinier Kraakman, *supra* note 27, at 63–64.

247. Firms exceeding a certain size are required to have a supervisory board whose members are appointed under a system of cooptation and include employee and shareholder representatives. *See* STEVEN R. SCHUIT ET AL., CORPORATE LAW AND PRACTICE OF THE NETHERLANDS 111–17 (Kluwer Law Int'l 2002); Edo Groenewald, *Corporate Governance in the Netherlands: From the Verdam Report of 1964 to the Tabaksblat Code of 2003*, 6 EUR. BUS. ORG. L. REV. 291, 294–95 (2005); Abe de Jong & Alisa Roëll, *Financing and Control in the Netherlands*, in A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD 467, 473 (Randell K. Morck ed., 2005).

248. For Austria, see Arbeitsverfassungsgesetz [ArbVG] [BGB1] No. 22/1974, as last amended by BGBl. I No. 104/2006 § 110 (Austria).

249. Thomas Raiser, *Unternehmensmitbestimmung vor dem Hintergrund europarechtlicher Entwicklungen*, *in* VERHANDLUNGEN DES SECHSUNDSECHZIGSTEN DEUTSCHEN JURISTENTAGES B 1, B 42 (Ständige Deputation des deutschen Juristentages ed., 2006). Slovenia, which initially adopted the German version of codetermination after independence, abandoned it after its constitutional court declared it unconstitutional. *Id.* at B 42–B 43).

250. *Id.* at B 43–B 44; *see also* Hansmann & Kraakman, *supra* note 27, at 62 (noting that, among EU countries, only Portugal, Belgium, Italy and the United Kingdom have no employee participation systems, whereas Ireland, Spain and Greece mandate employee directors only for state-owned firms).

251. Mitbestimmungsgesetz [MitbestG] [Codetermination Act], May 4, 1976, BGB1. I at 1153, §§ 27(2), 29(2) (F.R.G.).

252. *See* Gérard Hertig, *Codetermination as a (Partial) Substitute for Mandatory Disclosure?*, 7 EUR. BUS. ORG. L. REV. 123, 128–30 (2006).

ployees only held one third of the seats on the board.[253] However, Fauver and Fuerst found a positive effect of "moderate" codetermination—one third of board members—depending on the industry. According to their recent study, shareholder value, measured in Tobin's Q, is actually increased by moderate codetermination in German trade, transportation and manufacturing firms.[254] Finally, according to FitzRoy and Kraft, the introduction of codetermination in 1976 has led to slight gains in productivity.[255] While it is too early for a final verdict, taking these studies together indicates that employee decision rights that are not excessive may improve the firm's productivity and competitiveness, and that mitigating holdup problems may be one of the reasons.

Third, and most importantly, employment laws make it difficult and costly to lay off workers, thus eliminating potential threats that can result in holdup-type renegotiations. Countries characterized by ownership concentration tend to be those with strong legal job protection.[256] In comparative indices of labor flexibility, the United States is usually found to be one of the industrial countries with the smallest degree of employment protection.[257] The baseline default rule in virtually all U.S. states is employment at will,[258] meaning that both the employee and, more importantly, the employer can end the employment relationship at any time without having to show cause. Further, work conditions can be changed intermittently.[259]

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253. Gary Gorton & Frank A. Schmid, *Capital, Labor and the Firm: A Study of German Codetermination*, 2 J. EUR. ECON. ASS'N 863 (2004).

254. Fauver & Fuerst, *supra* note 37. These results do not hold when the employee representatives do not actually work in the firm but are appointed by unions.

255. Felix FitzRoy & Kornelius Kraft, *Co-determination, Efficiency and Productivity*, 43 BRIT. J. INDUS. REL. 233 (2005).

256. For empirical evidence, see Roe, *supra* note 98, at 263–64; ROE, POLITICAL DETERMINANTS, *supra* note 17, at 51–52 (finding a negative correlation between the number of medium-sized firms without a blockholder and the OECD Employment Law Index); Beth Ahlering & Simon Deakin, *Labour Regulation, Corporate Governance and Legal Origin: A Case of Institutional Complementarity* 26 (ECGI Law Working Paper No. 72/2006), *available at* http://ssrn.com/abstract=898184 (finding a correlation between the employment law index and blockholder size, but not between collective industrial relations nor social security and blockholder size); Marc Goergen, *Corporate Stakeholders and Trust* (ECGI Finance Working Paper No. 213/2008, 21, 34), *available at* http://ssrn.com/abstract=1156102 (finding a strong negative correlation); *see also* Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *The Economic Consequences of Legal Origins*, 46 J. ECON. LIT. 285, 311 (2008) ("[C]ountries that have strong shareholder protection indeed have weak protection of labor . . . .").

257. ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, THE OECD JOBS STUDY: EVIDENCE AND EXPLANATIONS, PT. II: THE ADJUSTMENT POTENTIAL OF THE LABOUR MARKET 74, tbl. 6.7 (1994); *see also* Juan C. Botero, Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *The Regulation of Labor*, 119 Q.J. ECON. 1139, 1362 tbl. 3 (2004).

258. *Cf.* J. Hoult Verkerke, *An Empirical Perspective on Indefinite Term Employment Contracts: Resolving the Just Cause Debate*, 1995 WIS. L. REV. 837, 839 (pointing out that only Montana had abrogated the common law rule by statute); Ellen Dannin, *Why At-Will Employment Is Bad for Employees and Just Cause Is Good for Them*, 58 LAB. L.J. 5, 8–9 (2007) (describing Montana and Arizona as the only states with statutes abrogating the employment-at-will rule).

259. *E.g.*, Katherine V.W. Stone, *Revisiting the At-Will Employment Doctrine: Imposed Terms, Implied Terms, and the Normative World of the Workplace*, 36 INDUS. L.J. 84, 84–85 (2007); Jay M. Feinman, *The Development of the Employment at Will Rule*, 20 AM. J. LEGAL HIST. 118, 118 (1976); Payne v. Western & Atlantic Railroad, 81 Tenn. 507, 518–19 (1884) (first case applying the employment at will rule); *see also*

While the case law has developed limitations and modifications in recent decades,[260] employment-at-will is still the baseline rule of employment in the United States. While there appears to be no precise recent data, past estimates on the number of employees subject to it have ranged between sixty percent[261] and seventy to seventy-five percent[262] of the U.S. private-sector, non-agricultural workforce.

By contrast, in Continental European jurisdictions, employers are often required to show a good reason for ending an employment relationship. For example, in Germany, redundancies of employment relationships that lasted more than six months require a "social justification,"[263] which means that, if the employer cannot show cause, he must show a compelling operational requirement. Termination of the employment relationship must be a measure of last resort.[264] Similarly, in France a *cause réelle et sérieuse*, which could be a reorganization of the enterprise,[265] has been required since 1973[266] and might be scrutinized by a court.[267] Furthermore, cumbersome procedural requirements must be met.[268] The need to obtain administrative authorization was abolished in the case of dismissals "for economic reasons"[269] in

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Max Schanzenbach, *Exceptions to Employment at Will: Raising Firing Costs or Enforcing Life-Cycle Contracts?*, 5 AM. L. & ECON. REV. 470, 470 (2003); Carol Daugherty Rasnic, *Die Kündigung, Licenciement, Recesso dal Contrato, 'Firing', or 'Sacking': Comparing European and American Laws on Management Prerogatives and Discretion in Termination Decisions*, 18 IND. INT'L & COMP. L. REV. 19, 86 (2008) (both describing U.S. employment law as an outlier compared to other industrialized countries).

260. *See, e.g.*, David H. Autor, William R. Kerr & Adriana D. Kugler, *Does Employment Protection Reduce Productivity? Evidence from US States*, 117 ECON. J. F189, F191–F194 (2003).

261. Jack Stieber, *Recent Developments in Employment-At-Will*, 36 LABOR L.J. 557, 558 (1989).

262. William L. Mauk, *Wrongful Discharge: The Erosion of 100 Years of Employer Privilege*, 21 IDAHO L. REV. 201, 204 (1985); Cindy Barber, *Note: Comparison of International and U.S. Employment Termination Procedures: How Far Have We Come?—A Step in the Right Direction*, 19 SYRACUSE J. INT'L & COM. L. 165, 165 (1993); INTERNATIONAL LABOR ORGANIZATION, TERMINATION OF EMPLOYMENT DIGEST 356 n.2 (2000).

263. Kündigungsschutzgesetz [KSchG] § 1 (1), § 23 (1) (Legal protection against dismissal applying only to firms with more than ten employees). The threshold was subject to some legislative variations during the past years. The number was increased from 5 to 10 for employees who started to work after Dec. 31, 2003. *See* Horst Weigand, § 23 KSchG, cmts. 33–33f, *in* GEMEINSCHAFTSKOMMENTAR ZUM KÜNDIGUNGSSCHUTZGESETZ UND ZU SONSTIGEN KÜNDIGUNGSSCHUTZRECHTLICHEN VORSCHRIFTEN (Peter Bader et al., 2007).

264. *See* Bundesarbeitsgericht [BAG] [Supreme Labor Court] Sept. 27, 1984, 2 AZR 62/83 (F.R.G.) (finding an offer to move an employee to another department must take precedence over an outright termination).

265. JEAN PÉLISSIER, ALAIN SUPIOT & ANTOINE JEAMMAUD, DROIT DU TRAVAIL 457 (20th ed. 2000).

266. Roland Voize-Valayre, *The French Law of Unjust Dismissals*, 23 N.Y.U. J. INT'L. L. & POL. 519, 523 (1991).

267. CODE DU TRAVAIL [C. TRAV.] art. L.122-14-3 (Fr.); *see* PÉLISSIER ET AL., *supra* note 265 at 454.

268. C. TRAV. art. L.122-14 (Fr.) (Failure to comply with the procedures may result in damages). *See also* C. TRAV art. L.122-14-4 (Fr.).

269. C. TRAV. art. L.321-1 (Fr.) (The definition also includes substantial modifications of the contract of employment); *see* Ordinance No. 45-1030 of May 24, 1945, Journal Officiel de la République Française [J.O.] [Official Gazette of France], May 25, 1945, p. 2970; Decree No. 45-1891 of August 23, 1945, J.O., Aug. 24, 1945, p. 5298; Injunction of October 6, 1945, J.O., Oct. 7, 1945, p. 6335 (The requirement was incorporated into the *Code du Travail* by the Loi du 3 janv. 1975); *see also* FRANCK MODERNE, LE CONTRÔLE ADMINISTRATIF DES LICENCIEMENTS ÉCONOMIQUES 16 (1983).

1986,[270] but the role of the works council (*comité d'entreprise*) was strengthened.[271] Larger employers may even be required to select employees according to "social" criteria.[272]

More importantly for holdup issues, large operative reorganizations that result in the redundancy of more than twenty (Germany) or ten (France) employees trigger the duty to provide a "social plan" for employees that has to be agreed upon with the works council.[273] Such a plan is costly for the employer and typically includes severance payments or the creation of a trust fund for employees failing to find subsequent employment.[274] French case law states that employers have to take all possible measures within the means of the firm to continue to employ the employees or to facilitate their reassignment to another job.[275]

Employment protection law in other Continental European countries resembles the situation in Germany and France. The combination of procedural hassle, employment protection, and social plans deters dismissals. For example, a survey among German firms found that seventy-six percent of firms had had difficulty pursuing dismissals "for compelling operational reasons" in the past, often due to the standard of proof demanded by the courts to establish operational reasons, or the difficulty of correctly applying the social criteria of selecting employees for dismissal.[276] Lawsuits are prevalent; studies covering the periods of September 1999 to November 2000 and the years 1998 to 2003 concluded that lawsuits were brought in 11.1% and 15.3% of dismissals, respectively.[277] There are slightly lower numbers for

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270. Law No. 86-797 of July 3, 1986, J.O., Jul. 4, 1986, p. 8302; Law No. 86-1320 of December 30, 1986, J.O., Dec. 31, 1986, p. 15888.

271. *See* JEAN-EMMANUEL RAY, DROIT DU TRAVAIL DROIT VIVANT 229 (9th ed. 2000).

272. C. TRAV. art. L.321-1-1 (Fr.). *But see* GEORGES RIPERT, ASPECTS JURIDIQUES DU CAPITALISME MODERNE 296–300 (1946) (arguing that these acquire a property right comparable to that of an owner by contributing to the firm due to the requirement to indemnify dismissed employees).

273. Betriebsverfassungsgesetz [BetrVG] [Labor Relations Act], Jan. 15, 1972, BGB1. I at 2518, § 112 (F.R.G.). A notable decision of the federal labor court in 1979 explicitly stated that mere reductions of personnel also required social plans. Bundesarbeitsgericht [BAG] [Supreme Labor Court] May 22, 1979, 33 NEUE JURISTISCHE WOCHENSCHRIFT 83 (1980) (F.R.G.); C. TRAV art. L.321-4-1 (Fr.). Originally, the provision was not part of the law, but a national collective bargaining agreement (*accord national interprofessionnel du 21 novembre 1974*). *See* Gérard Couturier, *Le plan social: aspects juridiques*, 7-8 DROIT SOCIAL 643, 643 (1985). The social law became part of the labor code only in 1986 (Law No. 86-1320 of December 30, 1986, J.O., Dec. 31, 1986, p. 15888. Amended by Law No. 89-549 of August 2, 1989, J.O., Aug. 8, 1989, p. 9954; Law No. 93-121 of January 27, 1993, J.O., Apr. 23, 1993, p. 1576).

274. *See* Harald Hess, § 112, cmt. 61, *in* KOMMENTAR ZUM BETRIEBSVERFASSUNGSGESETZ (Harald Hess et al., 7th ed. 2008). BetrVG § 112a sets out minimum thresholds of affected employees. A study covering the early 1980s found that social plans were often very costly, with payments exceeding fourteen percent of annual profits and seven percent of equity for half of the firms. *See* EDMUND HEMMER, SOZIALPLANPRAXIS IN DER BUNDESREPUBLIK 43, 66, 78 (1988).

275. *See* PÉLISSIER ET AL., *supra* note 265, at 500–01.

276. Heide Pfarr, Silke Bothfeld, Lutz C. Kaiser, Martin Kimmich, Andreas Peuker & Karen Ullmann, *REGAM-Studie: Die Kündigungs-, Klage- und Abfindungspraxis in den Betrieben*, 59 BETRIEBS-BERATER 106, 109–10 (2004).

277. *Id.* at 106.

dismissals "for compelling operational reasons," with estimates ranging between eight percent and ten percent.[278]

The effect of these mechanisms is twofold. First, judicial review of dismissal decisions, severance payments, and procedural hurdles all make dismissal more costly to employers and hence reduce the credibility of a holdup threat.[279] Second, explicit and implicit costs borne by the employer, such as payments resulting from a social plan, can be interpreted as a mechanism to internalize the harm incurred by employees with shareholders as a result of a dismissal, since the result is that there will only be an incentive to close a plant if the gain to shareholders exceeds compensating payments.[280] Some of the labor economics literature suggests that rules making dismissals more expensive, such as severance payments, are associated with greater incentives to invest in specific human capital.[281] While these legal mechanisms may be responsible for inflexibility in the labor market, they have the upside of protecting employees' specific investment against holdup. To be sure, individual and collective protection *by law* is not the only relevant factor. Collective bargaining agreements may have similar effects, and unions may help workers to police implicit commitments by firms.[282] However, the bargaining power of unions may be greater in the shadow of a more worker-friendly law.

B. *Why Mandatory Law May Be Needed*

A possible objection to the interpretation of pro-labor laws as facilitating specific investment is that they are mandatory across the board. Detractors have pointed out that adequate protection could be provided voluntarily by stipulating employment protection in the work contract or codetermination in the corporate charter.[283] Whereas voluntary codetermination is observed only rarely in practice, individual employment contracts occasionally pro-

278. Harald Bielinski, Josef Hartmann, Heide Pfarr & Hartmut Seifert, *Die Beendigung von Arbeitsverhältnissen: Wahrnehmung und Wirklichkeit*, 51 ARBEIT UND RECHT 81, 87 (2003) (estimating eight percent); Pfarr et al., *supra* note 276, at 108 (estimating ten percent).

279. *See* Eger, *supra* note 38, at 387.

280. Engert, *supra* note 54, at 109; regarding the United Kingdom, see John Armour & Simon Deakin, *Insolvency and Employment Protection: the Mixed Effects of the Acquired Rights Directive*, 22 INT'L REV. L. & ECON. 443, 445–46 (2003).

281. Alison Booth & Monojit Chatterji, *Redundancy Payments and Firm-specific Training*, 56 ECONOMICA 505 (1989); Alison L. Booth & Gylfi Zoega, *On the Welfare Implications of Firing Costs*, 19 EUR. J. POL. ECON. 759 (2003); Susan N. Houseman, *The Equity and Efficiency of Job Security: Contrasting Perspectives on Collective Dismissal Laws in Western Europe*, *in* NEW DEVELOPMENTS IN THE LABOR MARKET 185, 187–88 (Katharine G. Abraham & Robert B. McKersie eds., 1990); Jens Suedekum & Peter Ruehman, *Severance Payments and Firm-Specific Human Capital*, 17 LAB. 47 (2003).

282. *See* Chad Hogan, *Enforcement of Implicit Employment Contracts Through Unionization*, 19 J. LAB. ECON. 171 (2001).

283. Richard A. Epstein, *In Defense of the Contract at Will*, 51 U. CHI. L. REV. 947, 956–57 (1984) (suggesting that parties to an employment contract "as a general matter know how to govern their own lives"); Michael C. Jensen & William H. Meckling, *Rights and Production Functions: An Application to Labor-managed Firms and Codetermination*, 52 J. BUS. 469, 472–75 (1979) (arguing that the burden of proof as to why mandatory labor laws are required lies with the proponents of codetermination).

vide some direct protection against dismissal—such as in the case of tenure for university professors—or severance payments that internalize some of the harm inflicted on the dismissed employee with the firm by making dismissal more costly.[284] There are two responses to this objection.

First, there are a number of arguments why pro-labor laws should be mandatory. Adverse selection is probably the argument most frequently cited. Fauver and Fuerst suggest that for a single firm introducing codetermination voluntarily, the increased bargaining power of workers would reduce the wage differential between senior management and workers, while job security would be strengthened. Thus, the firm would risk losing the best managerial talent to competitors and attracting the least productive workers with the strongest preference for job security.[285] Similarly, it is often suggested that firms offering generous redundancy entitlements within an environment without employment protection may attract poor employees; for an employee, it may be irrational to bargain for job protection as it may signal the absence of a commitment to work hard.[286] Armour and Deakin further suggest that the appropriate matching of individual redundancy entitlements may be excessively costly to contract for, both because of the difficulty in specifying outputs in individual states of the world and because specific investment is hard to observe.[287] While any job protection law is less tailored to the individual situation than a private contract, the point is that such laws increase workers' bargaining power, particularly on the collective level.[288]

Sunstein also points out that successful bargaining for employment protection may be ruled out by an endowment effect, that is, the existence of a difference between the amount someone is willing to pay for a right she does not possess and the amount for which she would sell it if she does.[289] By extension, a crude "sense of entitlement" similar to the one associated with endowment effects may make the voluntary provision of codetermination difficult, as it would be hard to "sell" a codetermination scheme to inves-

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284. *See, e.g.*, Verkerke, *supra* note 258, at 867 (reporting empirical findings on the prevalence of employment-at-will and voluntary restrictions of dismissals to "just cause").

285. Fauver & Fuerst, *supra* note 37, at 679.

286. David I. Levine, *Just-Cause Employment Policies in the Presence of Adverse Worker Selection*, 9 J. LAB. ECON. 294 (1991); Cass R. Sunstein, *Human Behavior and the Law of Work*, 87 VA. L. REV. 205, 225–26 (2001); *see also* Armour & Deakin, *supra* note 280, at 447–48. *But see* Verkerke, *supra* note 258, at 902–05.

287. Armour & Deakin, *supra* note 280, at 447–48; *see also* Margit Osterloh & Bruno S. Frey, *Shareholders Should Welcome Knowledge Workers as Directors*, 10 J. MGMT. & GOV. 325, 328 (2006) (pointing out the high transaction cost of protecting specific investment by contract).

288. Collective bargaining agreements may facilitate overcoming these problems; for example, an industry-wide agreement with a union could eliminate the adverse selection problem. On the related possibility of unions policing implicit commitments by firms to workers, see Hogan, *supra* note 282.

289. Sunstein, *supra* note 286, at 220–24. On the endowment effect, see generally Daniel Kahneman, Jack L. Knetsch & Richard H. Thaler, *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325 (1990); Thomas S. Ulen, *Rational Choice Theory in Law and Economics*, *in* 1 ENCYCLOPEDIA OF LAW AND ECONOMICS 790, 804–06 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000).

tors. While the "traditional" justification of shareholder primacy resting on shareholder ownership[290] of the firm has become obsolete in academic circles with the development of the contractarian model, it is still preeminent in the public consciousness. As "natural" owners of the firm, investors may feel entitled to control its governance structure and hence be unwilling to partly cede control,[291] even if the actual influence of small shareholders is ruled out by the presence of a controlling shareholder. Benefits that are hard to describe in terms of financial figures may not be understood by investors.[292] According to a related behavioral explanation, employer representatives may fear an increased sense of entitlement among workers due to job protection laws, which may affect what bargains employees consider as fair, thus hurting the employer's bargaining position.[293]

On top of that, codetermination and other pro-labor mechanisms often work on the collective level. In other words, they are not individual workers' rights that could be stipulated in individual employment contracts. It is true that, to some extent, firms could enter into collective agreements with unions. However, in order to formally involve employee representatives on the level of corporate law, as codetermination does, any agreement would have to be implemented in the corporate charter, which shareholders cannot commit to refrain from amending at a later time.

The second response to the objection to mandatory law is that rules that are intended to be mandatory may not always be binding in practice and are effectively default rules for at least some employees. For example, mandatory severance payments sometimes have the effect of turning full-time jobs into part-time employment—where the law is less strict—resulting in an outsourcing of work to atypical employment relationships.[294] Low skilled workers are more frequently affected by this phenomenon,[295] which may imply that employers are in fact able to differentiate between workers where some employment protection is desirable. Even German codetermination has always been non-mandatory to the extent that shareholders may decide to break up a large firm into smaller, non-affiliated ones, which are subject to a

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290. *E.g.*, Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, THE NEW YORK TIMES MAGAZINE, Sept. 13, 1970, at 32.

291. *But see* Margaret M. Blair, *Corporate "Ownership"*, 13 BROOKINGS REV. 16 (1995) (criticizing the concept of "ownership" of the firm as misleading and a reason for distortions in corporate law policy debates).

292. Frick et al., *supra* note 33, at 751–53.

293. Houseman, *supra* note 281, at 191–92.

294. Edward P. Lazear, *Job Security Provisions and Employment*, 105 Q.J. ECON. 699, 724–25 (1990); *see also* David H. Autor, *Outsourcing at Will: The Contribution of Unjust Dismissal Doctrine to the Growth of Employment Outsourcing*, 21 J. LAB. ECON. 1 (2003) (arguing that increased firing costs lead to increased outsourcing).

295. *See, e.g.*, Bernhard Boockmann & Tobias Hagen, *The Use of Flexible Working Contracts in West Germany: Evidence from an Establishment Panel* 9–10 (Ctr. for Eur. Econ. Research, Discussion Paper No. 01-33, 2003), *available at* http://ssrn.com/abstract=358341 (finding that temporarily employed workers have comparatively less education).

less stringent employee participation regime.[296] To the extent that such possibilities exist, mandatory law effectively becomes default law, which seems to be as efficient as transaction-cost-saving standard rules in a system with strong shareholder influence.

Taking these two responses together, the prevalence of mandatory law does not undermine the theory advanced in this Article.

V. Re-interpreting Comparative Corporate Governance Structures

In this Section, I draw together the elements presented above—different degrees of shareholder influence and stakeholder protection laws in the United States and Continental Europe—into a unifying theory. First, I suggest that the two combinations may constitute different local optima from a normative perspective (Part A). I then briefly discuss the chronology of their development, which suggests that employment legislation was preceded by strong shareholder influence (Part B), and briefly discuss potential consequences for the future (Part C).

A. *Two Local Optima*

We have seen that U.S. corporate governance provides relatively little explicit or implicit shareholder influence, despite pervasive rhetoric about shareholder primacy. In contrast, Continental laws like those of France and Germany are usually said to have a broader corporate objective and a dearth of shareholder primacy. However, the prevailing concentrated ownership structure creates a considerable degree of explicit shareholder influence, which exacerbates holdup risk for other groups. Even though German corporate law does not provide for strong shareholder influence, in contrast to French or Italian law, the explicit influence of large shareholders in German corporate governance renders the law on the books irrelevant in that respect.[297] Apart from the United States, the laws of these states have other

296. However, such split-ups may result in considerable costs. *See* Gorton & Schmid, *supra* note 253, at 895. In recent years, the possibility of forming a European Company (SE) or merging companies from different Member States has created some possibilities of reducing the influence of employees in German firms. Both the creation of an SE and a cross-border merger trigger a negotiation process about the future employee participation regime, in which employees are in a strong bargaining position. *See* Andrew Johnston, *EC Freedom of Establishment, Employee Participation in Corporate Governance and the Limits of Regulatory Competition*, 6 J. Corp. L. Stud. 71, 109 (2006). However, an SE can be merged into a national legal form without any employee participation after two years. Council Regulation 2157/2001, art. 66.1, 2001 O.J. (L 294) 1, 17 (EC). Council directive 2005/56, art. 16.7, 2005 O.J. (L 310) 1, 8 (EC) requires Member States to protect employee participation rights in the event of subsequent domestic mergers for a period of three years. Some authors are therefore speaking of an "erosion" of codetermination. *See* Mathias Habersack, *Grundsatzfragen der Mitbestimmung in SE und SCE sowie bei grenzüberschreitender Verschmelzung*, 171 Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht 613, 643 (2007).

297. *See* Zetzsche, *supra* note 79.

mechanisms to compensate for this, such as tightly-knit rules designed to protect employees.

In the U.S. context, Lucian Bebchuk criticizes team production theory,[298] and more generally claims that stakeholder holdup problems are mitigated by mechanisms curbing the influence of dispersed shareholders. Bebchuk points out that if this were a real concern, analysts supporting limitations on the power of dispersed shareholders would also have to "support limiting the intervention power of controlling shareholders."[299] The comparative discussion in the preceding section confirms this prediction: mechanisms protecting employees against shareholder intervention are comparatively weaker in the United States than in Continental European countries. No aspect of a corporate governance system will be optimal for each and every individual firm. We observe both public firms with core shareholders in countries otherwise dominated by dispersed ownership and widely-held firms in countries with mostly concentrated ownership.[300] However, since concentrated ownership is much more prevalent in Continental Europe than in the United States, my analysis suggests that, all else being equal, stronger protection of stakeholders will have stronger benefits in these countries.

In fact, both U.S. and the prototypical Continental European corporate governance systems, without being perfect, may be close to equilibrium. This assumes that there are two options regarding shareholder influence ("strong" and "weak" shareholders) and two options regarding the protection of employees against opportunism by or on behalf of shareholders ("strong" and "weak" stakeholders). The possible combinations are shown in Table 1. Among these four options, there are only two local optima. Deviations on one axis, therefore, will be suboptimal for a corporate governance system.

A	**weak shareholders** **weak stakeholders**	B	strong shareholders weak stakeholders
C	weak shareholders strong stakeholders	D	**strong stakeholders** **strong shareholders**

Table 1: Local optima of shareholder influence and stakeholder protection

A and D are local optima. Each of A and D outperforms B and C. The United States is near point A; Continental European corporate governance systems such as France and Germany may be near D. Corporate governance

298. *See generally* Part II.B.
299. Bebchuk, *supra* note 102, at 909.
300. *See* Gilson, *supra* note 3, at 1657–60.

systems may be ill-advised to move out of the local optima of A and D along the vertical axis. Regarding the relationship between firms and their employees, there are two types of costs to consider. Most of all, this article has been concerned with holdup cost, which increases with the degree of shareholder influence. The "strong stakeholders" option may mitigate it, but that choice is not without cost. German codetermination, for example, is often criticized on the grounds that it is detrimental to an efficient functioning of the board, because the board of directors grows in size and a diversity of interests among heterogeneous groups hampers decision making.[301] Strong employment protection is a crude and costly instrument, as it heightens the bargaining power not only of "deserving" employees making valuable specific investment, but also of employees with low productivity, who may be the first to lose their jobs in times of crisis and who should be the first to be dismissed if the overarching goal is the total welfare of all corporate constituencies.[302]

The labor economics literature emphasizes how employment protection laws and mandatory severance payments may make it difficult for firms to adjust to modified circumstances.[303] In a "strong shareholders" environment, these costs will typically be outweighed by the benefits of reduced holdup risk, which is why D will be preferable to B. By contrast, for a corporate governance system starting out in a "weak shareholders" world, a "strong stakeholders" strategy would be excessive, as there is little to gain on the holdup front, while the strategy's intrinsic costs are still present, which is why A will outperform C.

It is easy to make a parallel argument on the political level to explain why either A or D can be stable against moves along the vertical axis—that is, against changes in the strength of pro-employee laws. Once human capital investments have been made, employees have a strong incentive to lobby against the abolition of such laws, given the large potential for holdup, which should be smaller under dispersed ownership. Furthermore, once the system is in place it is doubtful whether the incentives of the representatives of "business interests" to lobby for the abolition of pro-employee laws are particularly strong, since making holdup more difficult may be mutually beneficial. True, large shareholders' incentive to "exploit" employees may translate to the political level, particularly in firms where overall welfare is increased by pro-stakeholder laws, but shareholder wealth is decreased. However, in other cases pro-stakeholder laws tying the blockholders' hands will be mutually beneficial, as they allow commitment to avoid holdup. This may mitigate the overall incentive to lobby against them. Pro-stake-

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301. *E.g.*, Pistor, *supra* note 246, at 178–79. *But see* HANSMANN, *supra* note 37, at 110–12.

302. *See* Suedekum & Ruehmann, *supra* note 281, at 59 (stating that mandatory severance payments may create both incentive effects and lethargy effects).

303. *See, e.g.*, Lazear, *supra* note 294; John T. Addison & Paulino Texeira, *The Economics of Employment Protection*, 24 J. LAB. RES. 85, 107–15 (2003); David H. Autor, John J. Donohue III & Stewart J. Schwab, *The Costs of Wrongful-Discharge Laws*, 88 REV. ECON. & STAT. 211 (2006).

holder laws are precisely the reason why the structure is effective; without them, controlling shareholders would have ample opportunities to exploit stakeholders, thus destroying stakeholder incentives to make specific investments. Pro-stakeholder laws substitute the commitment not to exploit stakeholders that controlling shareholders are otherwise unable to provide.

Thus far, this Article has generally accepted concentrated or dispersed ownership as unavoidable. Many comparative corporate governance theories try to explain why dispersed or concentrated ownership persists in a particular country. This Article's argument is not incompatible with theories on differences in ownership concentration, but instead demonstrates how these differences interact with managerial autonomy. To complete the analysis of the local optimality of points A and D in Table 1, first consider the persistence of a concentrated ownership structure, or the domination of D over C. The predominant theory of the persistence of concentrated ownership is the "law matters" thesis, according to which large ownership blocks serve as a substitute for adequate legal protection of shareholders.[304] The theory states that good corporate law, or, failing that, monitoring by large shareholders, can hold the private benefits of control and self-dealing by managers in check. However, the presence of a large shareholder creates other problems, especially those associated with private benefits.[305] "Law matters" can also suggest that bad law inadequately protects the minority against large shareholders, who therefore have an incentive to maintain their position despite an inefficient allocation of risk.[306] Increased holdup risk joins the ranks of the vices of concentrated ownership.[307] The "law matters" theory is intertwined with the "legal origins theory," according to which common law legal systems are supposedly more protective of minority shareholders.[308] Some scholars have argued that civil law systems are more protective of employees than common law systems.[309] If it is true that common law systems are inherently linked to dispersed ownership, the thesis of this Article provides a theoretical basis for a link to employment law. In addition, it does

304. Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997); Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1145–51 (1998); John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 647–48 (1999); Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 834–35 (2001); Cheffins, *supra* note 4, at 461–65.

305. Lucian Arye Bebchuk, *A Rent-Protection Theory of Corporate Ownership and Control* (NBER Working Paper No. 7203, 1999), *available at* http://ssrn.com/abstract=203110.

306. William W. Bratton & Joseph A. McCahery, *Incomplete Contracts Theories of the Firm and Comparative Corporate Governance*, 2 THEORETICAL INQ. L. 1, 34–36 (2001); Gilson, *supra* note 3, at 1644, 1654.

307. Failing legal protection, the possibility of holding up stakeholders might create an additional incentive not to sell the controlling block on the market and allow ownership to disperse.

308. La Porta et al., *supra* note 304; Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3 (2000); *see also* Paul G. Mahoney, *The Common Law and Economic Growth: Hayek Might Be Right*, 30 J. LEGAL STUD. 503 (2003).

309. *See* Botero et al., *supra* note 257 (finding that labor markets are more regulated in civil law countries than in common law countries); Pagano & Volpin, *supra* note 17, at 1024 (table showing the statistical significance of legal origins for employment protection).

not need to refer to common law and civil law as proxies for different approaches to government regulation of markets, with "civil law" standing for a greater degree of state intervention to achieve goals of social justice and common law for the protection of property rights.[310]

If corporate law in Continental Europe and elsewhere is indeed moving toward a better protection of minority shareholders,[311] the "law matters" theory would predict more ownership dispersion. In the framework of this section, the consequence would be reduced shareholder influence, which would facilitate an incremental reduction of pro-stakeholder laws. However, there are a number of countervailing factors, in particular the possible development of implicit shareholder influence, as we have seen in the United Kingdom.[312]

As an alternative to the "law matters" thesis, one could use Roe's political theory to explain why horizontal moves from D to C are difficult. Roe argues that pro-stakeholder laws such as codetermination or employment protection are the consequences of exogenous political factors to which he applies the label "social democracy."[313] Roe also suggests that the ultimate reason for the prevalence of social democracy may be the history of war and turmoil during the first half of the twentieth century in the core civil law countries.[314] In a country with strong stakeholders, pro-stakeholder laws help managers to pursue their own goals to the detriment of stockholders. Providers of capital are thus likely to congregate to amass large ownership stakes in order to improve monitoring of managers.[315] D will therefore result in more competitive firms than C. Combining Roe's theory and that of this Article may help to explain why strong shareholder influence and strong stakeholder influence are complementary factors that reinforce each other, as suggested by Roe. This may be the reason why we are not seeing a rapid move to an end of history for corporate governance, leaving only the U.S. model,[316] but—for the time being—the persistence of differences.

Part A of Table 1, which corresponds to the situation in the United States, should normatively dominate B, where weakly protected stakeholders face strong shareholder influence. Concentrated ownership systems are associated with a loss of liquidity and greater difficulty in tapping capital mar-

310. *See* La Porta et al., *supra* note 256 (giving a unified interpretation of various results of legal origins in different fields); Thorsten Beck, Asli Demirgüç-Kunt & Ross Levine, *Law and Finance: Why Does Legal Origin Matter?*, 31 J. COMP. ECON. 653, 657–58 (2003).

311. *E.g.*, Hansmann & Kraakman, *supra* note 5, at 442, 453.

312. *See infra* Part VI.

313. *See supra* note 17 and accompanying text.

314. *See generally* Mark J. Roe, *Legal Origins, Politics, and Modern Stock Markets*, 120 HARV. L. REV. 462 (2006); Mark J. Roe & Jordan I. Siegel, *Political Instability's Impact on Financial Development* (Harvard Pub. Law Working Paper No. 08-29, 2008), *available at* http://ssrn.com/abstract=963214.

315. Roe, *supra* note 12, at 544–60; ROE, POLITICAL DETERMINANTS, *supra* note 17, at 35–36.

316. *See generally* Hansmann & Kraakman, *supra* note 5.

kets for additional finance.[317] At the level of individual firms, a move from A to B corresponds to the "breach of trust" situation described by Coffee, Shleifer, and Summers.[318] While the "discovery" of financing a hostile takeover with high-yield debt greatly facilitated or even allowed the takeover wave of the 1980s,[319] the development of the case law up to the mid-1990s ultimately brought U.S. corporate governance back closer to A.[320] As described above, due to the limits on takeovers, it is once again relatively hard for shareholders of individual firms to opt out of A once ownership has become dispersed.[321] At the level of the corporate governance system as a whole, my theory adds the potential augmentation of holdup risks to the other vices of concentrated ownership. For this reason, a move from A to B should not be beneficial unless any increase of shareholder influence is accompanied by a strengthening of pro-stakeholder laws.[322] Furthermore, excessive implicit shareholder influence in the form of an executive-pay-induced shareholder value maximization norm has often been blamed for recent corporate scandals.[323] Such occurrences may well result in an elimination of firms diverging from point A and possibly in a backlash on the level of both politics and social norms.

B. *The Chronology: Ownership Structure Before Pro-Stakeholder Laws*

The question remains whether the enactment of pro-stakeholder laws preceded or followed shareholder influence. While the analysis of this Article focuses the former, Roe emphasizes the causal connection running *from* pro-employee laws *to* concentrated ownership (without ruling out a connection between the two in both directions). He suggests that employee power, as a consequence of certain political preconditions in a given country, impedes the development of dispersed ownership, since ownership concentration is needed to provide increased monitoring in view of the agency costs exacer-

317. Patrick Bolton & Ernst-Ludwig von Thadden, *Liquidity and Control: A Dynamic Theory of Corporate Ownership Structure*, 154 J. INSTITUTIONAL & THEORETICAL ECON. 177, 177 (1998); Bratton & McCahery, *supra* note 306, at 12.

318. Coffee, *supra* note 44, at 70–71; Shleifer & Summers, *supra* note 56.

319. DAVID SKEEL, ICARUS IN THE BOARDROOM 111–30 (2005); Armour & Skeel, *supra* note 134, at 1755.

320. The disappearance of the edge in shareholder value (measured in Tobin's Q) that Delaware corporations had over firms incorporated elsewhere in the mid-1990s has been attributed to the Delaware case law, including the *Unitrin* case, *supra* note 118. Guhan Subramanian, *The Disappearing Delaware Effect*, 20 J.L. ECON. & ORG. 32, 52–54 (2004).

321. *See supra* notes 115–31 and accompanying text.

322. On the political level, the weak position of shareholders in the United States is entrenched by the lobbying of other groups. The antitakeover statutes of the 1980s were typically promoted by a broad coalition of interests, including managers and labor. *See* Romano, *supra* note 155, at 120–28. The SEC's 2003 shareholder access proposal, which might have facilitated a limited degree of explicit shareholder influence, was successfully opposed by the Business Roundtable. *See* Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2522–23 (2005).

323. *See supra* note 144 and accompanying text.

bated by stakeholder influence.[324] However, the two theories may be compatible. Roe acknowledges that blockholding predated German codetermination.[325] In addition, he argues that focusing on the historical sequence misses the point because German block ownership and codetermination are two complementary institutions, each of which calls forth the other. Thus, it is difficult to change one without changing the other.[326]

In fact, as concentrated ownership is the international norm and dispersed ownership the exception, one could speak of concentrated ownership as the primeval state of any corporate governance system.[327] Newly created firms are invariably privately held at their beginnings, and only by growing and tapping the stock exchanges can they develop into Berle-Means style corporations. Thus, it is not the persistence of concentrated ownership, but rather its unraveling in the United States and the United Kingdom that calls for an explanation.[328] In Germany, despite a trend toward concentration of firms and increased ownership dispersion, the majority of large enterprises have remained under the control of small groups of owners who make strategic decisions.[329] While a minority of manager-controlled firms established itself in the 1920s,[330] any nascent movement toward dispersed ownership had come to a halt by the years after World War II, when private households exited the stock markets.[331] Similarly, France may have been on its way to a corporate governance system characterized by strong equity markets and dispersed ownership before World War I, but "this flirtation [with the stock market], unlike the love affair in the United States and the United Kingdom, did not persist through the twentieth century."[332] Thus, shareholder

324. *See supra* note 17 and accompanying text.

325. Roe, Political Determinants, *supra* note 17, at 17–18.

326. Roe, Political Determinants, *supra* note 17, at 78. *But see* Holger M. Mueller & Thomas Philippon, *Concentrated Ownership and Labor Relations* (Centre for Econ. Pol'y, Discussion Paper No. 5776, July 2006), *available at* http://ssrn.com/abstract=933094 (suggesting hostile labor relations as the proximate cause for concentrated ownership, without ruling out a feedback loop between the two). However, hostile labor relations could well be an alternative consequence of concentrated ownership.

327. *See supra* note 3 and accompanying text.

328. There is extensive literature seeking to explain why the United States and the United Kingdom have developed dispersed ownership structures (and developed securities markets) while most other countries have not. The "law matters" theory is probably the most widely accepted. Its adherents argue that good corporate law protecting shareholders against managerial misconduct (and, at the same time, against misconduct by large blockholders) allows the unraveling of large ownership blocks and the development of a dispersed ownership structure. *See supra* notes 304–06 and accompanying text. The leading contender is Mark Roe's political theory, according to which, regulation of financial institutions in the United States has inhibited the activities of large blockholders, whereas in Continental Europe, pro-labor laws have solidified the presence of blockholders to balance labor power. *See supra* notes 314–15 and accompanying text.

329. Caroline Fohlin, *The History of Ownership and Control in Germany*, *in* A History of Corporate Governance Around the World 223, 227–33 (Randall K. Morck ed., 2005).

330. *Id.* at 229.

331. *Id.* at 231–32.

332. Murphy, *supra* note 237, at 203 (referring to the data compiled by Rajan & Zingales, according to whom France had one of the highest ratios of total market capitalization to GDP in 1913, but only a

influence not only came before codetermination, but also before employment law and other pro-stakeholder mechanisms in Europe. Pro-stakeholder legislation in Continental Europe often followed a period of labor conflict and/or political instability. Earlier precursors to codetermination and employment protection were passed in Germany shortly after World War I.[333] Contemporary employment protection law has its roots in the years after World War II.[334] Codetermination was expanded most recently in 1976, following a period of labor strikes in the early 1970s.[335] The French and Italian employment laws that characterize their respective labor markets today were passed in that period as well.[336]

This chronology does not imply that holdup problems were the only factor or proximate cause for pro-employee laws. Political results are the consequence of complex social and historical developments. Roe points out that certain structures of production may not be politically stable and therefore may have induced social democratic policies, such as codetermination, whose purpose was to rein in bankers and industrialists.[337] At times, legislation making important changes must overcome serious obstacles, but crises and the discreditation of elites—as in the case of post-war legislation in Germany—may serve as a catalyst. Persistent strikes and social unrest that have often contributed to the passing of pro-stakeholder laws can be interpreted as a symptom of imbalance in corporate governance systems.

At the time pro-employee laws surfaced for the first time in Germany in the 1920s, dispersed ownership was already predominant in the United States due to the development of the large railroads in the last quarter of the nineteenth century[338] and the merger wave of the 1890s and early 1900s.[339]

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comparatively small one in later decades); *see* Raghuram G. Rajan & Luigi Zingales, *The Great Reversals: The Politics of Financial Development in the Twentieth Century*, 69 J. FIN. ECON. 5, 15 (2003); *see also* Leslie Hannah, *The 'Divorce' of Ownership from Control from 1900 Onwards: Re-calibrating Imagined Global Trends*, 49 BUS. HIST. 404, 406 (2007) (comparing the relative sizes of the New York, London, Paris, and Berlin stock markets in 1900).

333. Betriebsrätegesetz [Labor Representative Law] 1920, Reichsgesetzblatt [RGBl] § 147 (introducing works councils); Gesetz über die Entsendung von Betriebsratsmitgliedern in den Aufsichtsrat [Labor Representative Appointment Law] 1922, RGBl § 209 (introducing employee representatives on the supervisory board for the first time); *see* Thomas Raiser, *The Theory of Enterprise Law in the Federal Republic of Germany*, 36 AM. J. COMP. L. 111, 117–18 (1988); ROE, *supra* note 115, at 213; Raiser, *supra* note 249, at B11. A 1920 law first allowed employees to challenge "socially unacceptable" dismissals in court if the works council supported their complaint. *See* Stefan Fiebig, *Einleitung*, cmt. 104, *in* KÜNDIGUNGSSCHUTZGESETZ HANDKOMMENTAR (Stefan Fiebig et al. eds., 2d ed. 2004).

334. The *Kündigungsschutzgesetz* (KSchG) was passed in 1951 to reunify laws in the Western zones. *See* Fiebig, *supra* note 333, cmts. 108–13; *see also* 4 RECHT DER ARBEIT 61–63 (1951) (the official proposal).

335. ROE, *supra* note 115, at 213.

336. Regarding France, *see supra* note 266 and accompanying text; Alan Hyde, *A Theory of Labor Legislation*, 38 BUFF. L. REV. 383, 398–404 (1990).

337. ROE, POLITICAL DETERMINANTS, *supra* note 17, at 112–13; *see also* Mark J. Roe, *Backlash*, 98 COLUM. L. REV. 217 (1998).

338. *See, e.g.*, Coffee, *supra* note 4, at 24–26; BERLE & MEANS, *supra* note 22, at 13; ALFRED D. CHANDLER, THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS 87 (1977).

339. SKEEL, *supra* note 319, at 59–62; Coffee, *supra* note 4, at 33. *See generally* CHANDLER, *supra* note 338, at 331 (background information discussing the political and legal reasons for mergers); NAOMI

By the time Berle and Means published their famous book in 1932, dispersed ownership was prevalent,[340] and stock ownership had become common in the middle class.[341] As a result, managerial power and the atomization of shareholders became the paradigmatic image of the large U.S. firm.[342] The political reaction to the Great Depression included reforms that further strengthened the entrenchment of managers and shielded them against shareholder influence, particularly by further stymieing the growth of financial institutions that might have become important large shareholders as they did elsewhere.[343] Pro-stakeholder legislation remained relatively rare. True, the Depression-era Wagner Act strengthened the position of unions,[344] but its pro-labor effects were greatly mitigated after little more than a decade by the Taft-Hartley Amendments of 1947.[345] While antitakeover statutes that also had the effect of shielding managers passed, pro-labor legislation rarely made it to the legislative drawing board.[346] Still, the United States has enjoyed stable labor relations during most of the twentieth century.

C. *The Future: Path Dependence and Continental European Corporate Governance Reforms*

The world keeps turning, and both the law and corporate governance structures change. Like most comparative corporate governance theories, my basic thesis may be better at explaining corporate governance structures around 1990 than the trends of the late 1990s and 2000s and future developments. In the United States, prominent commentators have identified a decline in the managerialist view of the firm, with some of the contributing

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LAMOREAUX, THE GREAT MERGER MOVEMENT IN AMERICAN BUSINESS, 1895–1904, at 1–2 (1985) (providing historical data regarding the number of consolidations that occurred during the merger movement).

340. *See* Gardiner C. Means, *The Separation of Ownership and Control in American Industry*, 46 Q.J. ECON. 68, 94 (1931) (summarizing the data); *see also* BERLE & MEANS, *supra* note 22, at 47–68; CHANDLER, *supra* note 338, at 451 (describing an increasing distinction between ownership and control in the 1910s); ALFRED D. CHANDLER, SCALE AND SCOPE: THE DYNAMICS OF INDUSTRIAL CAPITALISM 85, 191 (1990); Colleen A. Dunlavy, *Social Conceptions of the Corporation: Insights from the History of Shareholder Voting Rights*, 63 WASH. & LEE L. REV. 1347, 1361 (2006) ("[B]y the second decade of the twentieth century, the plutocratic corporation . . . was already being transformed into the 'modern' corporation that Berle and Means would put in the spotlight of their 1932 book.").

341. *See generally* Gardiner C. Means, *The Diffusion of Stock Ownership in the United States*, 44 Q.J. ECON. 561 (1930).

342. ROE, *supra* note 115, at 6.

343. *Id.* at 95–101.

344. National Labor Relations Act, 49 Stat. 499 (1935) (current version at 29 U.S.C. §§ 151–69 (1998)).

345. 61 Stat. 135 (1947) (current version at 29 U.S.C. §§ 141–97 (1998)); *see, e.g.*, WILLIAM B. GOULD IV, A PRIMER ON AMERICAN LABOR LAW 31 (4th ed. 2004) (describing the impression that "the pendulum had swung too far" in favor of labor between 1935 and 1947); ARCHIBALD COX ET AL., LABOR LAW CASES AND MATERIALS 80–81 (14th ed. 2006) (describing concerns about excessive union power before 1947).

346. *See, e.g.*, Hyde, *supra* note 336, at 392–96.

factors being increased takeover activity since the 1980s and a move toward greater emphasis on shareholder value.[347] Similarly, scholars have remarked that core Continental European corporate governance systems, such as that of Germany, may be moving closer to more dispersed ownership, suggested by a moderate decrease of the median size of the largest voting block of publicly traded firms between 1997 and 2001,[348] while also sliding toward a legal framework and economic structure that emphasizes the concerns of dispersed investors to a stronger degree.[349] At the same time, at least some hostile takeovers, which are only possible in cases of relatively dispersed ownership, began to emerge on the Continent, such as in the widely discussed takeover of the Mannesmann conglomerate by the British mobile phone company Vodafone Airtouch PLC.[350] Concurrently, employment protection laws have been subject to increased scrutiny in recent years. Regulatory arbitrage possibilies created by E.U. law lead to the erosion of national employee participation systems,[351] while criticism of codetermination is on the rise among German legal scholars.[352]

I have attempted to elucidate the interaction between shareholder influence and employee exposure to holdup. Changes with regard to this relationship might be connected to the structure of production and the amount of specific investment optimal under current circumstances; a decrease in the protection of firm-specific investment might coincide with a change in production technology or with a decline of traditional industries where such investment by employees was important. Concurrently, the takeover wave of

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347. *See* Hansmann & Kraakman, *supra* note 5, at 444; *see also* Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1510–35 (2007) (discussing the history and evolution of the corporate board during the latter half of the twentieth century). *Cf. id.* at 1514 n.187 (suggesting that Blair & Stout's team production model may rather be a description of the role of the board of U.S. corporations in the 1950s).

348. Wójcik, *supra* note 201, at 1442–43. *But see* Sigurd Vitols, *Changes in Germany's Bank-Based Financial System: Implications for Corporate Governance*, 13 CORP. GOV. 386 (2005) (suggesting that Germany's finance system still remains largely bank-centered in spite of the reduction of banks' holdings in publicly traded firms).

349. Cheffins, *supra* note 5, at 501–05; *see* John W. Cioffi, *Restructuring "Germany Inc.": The Politics of Company and Takeover Law Reform in Germany and the European Union*, 24 L. & POL'Y 355 (2002); *see also* Enriques & Volpin, *supra* note 208, at 131–34 (summarizing pro-shareholder reforms of the past 15 years in France, Germany and Italy). *But see* Sigurd Vitols, *Negotiated Shareholder Value: the German Variant of an Anglo-American Practice*, 8 COMPETITION & CHANGE 357 (2004) (arguing that changes have been overestimated and that institutional investors are merely being accepted as additional participants in the compromise between different groups).

350. For an account of the case and the litigation that ensued, see, Franklin A. Gevurtz, *Disney in a Comparative Light*, 55 AM. J. COMP. L. 453, 459–62 (2007).

351. *See supra* note 296 and accompanying text.

352. *See, e.g.*, Jean J. Du Plessis & Otto Sandrock, *The Rise and Fall of Supervisory Codetermination in Germany*, 16 INT'L COMM. & CO. L. REV. 67, 74–76 (2005) (providing an overview of the critique and evasion strategies by firms); Michael Adams, *Das Ende der Mitbestimmung*, 27 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (ZIP) 1561 (2006) (harshly criticizing codetermination). *But see* Christine Windbichler, *Cheers and Boos for Employee Involvement: Co-determination as Corporate Governance Conundrum*, 6 EUR. BUS. ORG. L. REV. 507 (2005).

the 1980s may have left a lasting impression by teaching employees to avoid specific investment and not allow themselves to be "cheated" again.

Still, I have highlighted institutional complementarities that may result in path dependence.[353] In spite of the competitive pressures of a globalized economy, past choices matter, and a convergence of corporate governance structures is not inevitable.[354] While some path dependence theories focus mostly on aspects of legal culture and the persistence of doctrinal categories, the reason given here rests essentially on switching costs.[355] The combination of shareholder influence and employee protection is partly determined by law and partly by empirical facts such as ownership concentration. Assuming the availability of a stable amount of optimal specific investment, changing either of these abruptly seems unwise. Abolishing strict employment protection law while concentrated ownership is still in place would create considerable holdup costs. Changes with respect to both dimensions may be difficult or costly, if not outright unfeasible in some circumstances. For example, if we knew that the U.S.-style equilibrium A was superior to Continental-style equilibrium D, it might be difficult to get there simply by abolishing pro-employee laws, which might not be enough to induce the development of dispersed ownership by itself. Dispersion may require a combination of several factors that develop only over the course of several decades. Reform-oriented scholars and policymakers should be aware of the risks involved and take institutional complementarities seriously. However, if ownership structures on the European continent are actually moving toward less concentrated ownership, the rationale for pro-employee laws may be subsiding. Reforms in employment law and reforms with respect to codetermination should be incremental and should take the development of ownership structures into account.

In the long run, product market competition resulting from the increased openness of national economies to foreign trade may demonstrate which of the two local optima is also optimal for the world as a whole. While there may be no unique answer, it may turn out that one or the other is better suited for particular industries.

VI. Putting the United Kingdom Back on the Map

Although this Article has thus far focused on the contrast between the United States and Continental Europe, the United Kingdom presents a pe-

353. For a general description in the context of the "varieties of capitalism" literature, see Hall & Soskice, *supra* note 19, at 17–21.

354. *See* Reinhard H. Schmidt & Gerald Spindler, *Path Dependence, Corporate Governance and Complementarity*, 5 Int'l Fin. 311, 312–13 (2002); *see also* Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 Harv. L. Rev. 641, 643–44 (1996).

355. *See generally* Schmidt & Spindler, *supra* note 354, at 314–15 (discussing the switching cost argument for path dependence).

culiar case for comparative corporate governance theories.[356] While scholars dispute the exact time at which the corporate landscape of the United Kingdom came to be characterized by dispersed ownership,[357] the majority believe blockholders "unwound" at a later time than in the United States, with dispersion only solidifying by the 1980s.[358] While ownership dispersion is the norm in the United Kingdom, *both explicit and implicit shareholder influence* are stronger there than in the United States.[359] While the U.S. system is characterized by little influence of either type, the United Kingdom has partly replaced explicit shareholder influence with implicit influence.

First, the empirical evidence tells us that dispersion in the United Kingdom is actually less pronounced than in the United States. Individual blocks are bigger, and about seventy percent of shares are in the hands of institutional investors, as opposed to fifty percent in the United States.[360] In 1994, the five biggest investors typically owned more than thirty percent of shares in smaller firms.[361] Some researchers even expressed doubts that dispersed ownership defined companies in the United Kingdom.[362] Others argued that that large British firms were not dominated by managers like a typical Berle-Means firm, but were instead governed by "constellations of controlling interests" consisting of about twenty shareholders who jointly controlled most listed corporations.[363] The data of La Porta, Lopez-de-Silanes, Shleifer, and Vishny support this view, suggesting that most publicly traded

356. *See* Mark J. Roe, *Political Foundations for Separating Ownership from Control*, *in* CORPORATE GOVERNANCE REGIMES 113, 129–30 (Joseph A. McCahery et al. eds., 2002) (pointing out difficulties both for the political- and law-based theories).

357. *See, e.g.*, Brian R. Cheffins, *Law, Economics and the UK's System of Corporate Governance: Lessons from History*, 1 J. CORP. L. STUD. 71, 82 (2001) (citing various authors giving dates ranging from the 1950s to the 1980s).

358. *See, e.g.*, *id. But see* Andrew Johnston, *Takeover Regulation: Historical and Theoretical Perspectives on the City Code*, 66 CAMBRIDGE L.J. 422, 426 (2007) (identifying the merger wave of the 1960s as crucial for dispersed ownership in Britain). Regarding the alternative thesis of Franks, Mayer and Rossi, see *infra* notes 410–413 and accompanying text.

359. *See* Simon Deakin et al., *Anglo-American Corporate Governance and the Employment Relationship: A Case to Answer?*, 4 SOCIO-ECON. REV. 155, 161 (2006); Jennifer Hill, *The Shifting Balance of Power Between Shareholders and the Board: News Corp's Exodus to Delaware and Other Antipodean Tales* 14–16 (VAND. UNIV. L. SCH., L. & ECON. RESEARCH PAPER NO. 08-06, 2008), *available at* http://ssrn.com/abstract=1086477 (tracing differences to the origins of U.K. and U.S. corporate law).

360. John Armour, Brian R. Cheffins & David A. Skeel, Jr., *Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom*, 55 VAND. L. REV. 1699, 1750 (2002); *see* Bernard S. Black & John C. Coffee, Jr., *Hail Britannia? Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997, 2002 (1994).

361. Black & Coffee, *supra* note 360, at 2002.

362. *See* G.P. STAPLEDON, INSTITUTIONAL SHAREHOLDERS AND CORPORATE GOVERNANCE 10 (1996) (suggesting that truly dispersed ownership was not present in the majority of listed U.K. firms in the early 1990s).

363. John Scott, *Corporate Control and Corporate Rule: Britain in an International Perspective*, 41 BRIT. J. SOC. 351, 359–65 (1990). Perhaps more controversially, Scott makes the same claim for the United States. *Id.* at 369–70; *see also* JOHN SCOTT, CORPORATE BUSINESS AND CAPITALIST CLASSES 92–93 (1997) (making the same claim for both countries, while acknowledging that ownership dispersion is greater in the United States than the United Kingdom).

medium-sized British firms have at least one blockholder with at least ten percent of shares.[364]

While classifying Britain as an outsider corporate governance country,[365] Armour, Cheffins, and Skeel point out that British securities law, quite contrary to the law in the United States,[366] does not impede the formation of coalitions between institutional investors.[367] Showing a certain "British reserve," investors sometimes exercise concerted influence when a firm is experiencing difficulties. For example, they might require a restructuring of management when new shares are issued.[368] Comparing the United States and the United Kingdom, Bebchuk observes that "[t]he corporate law system of the United States is the one that stands out . . . in how far it goes to restrict shareholder initiative and intervention."[369]

However, the more important factor is *implicit shareholder influence.* The most conspicuous difference between the United States and the United Kingdom in that respect is in takeover law, where the two countries are situated at two opposing ends of the possible regulatory spectrum. In stark contrast to the "just say no" defense available to U.S. directors,[370] the British "City Code on Takeovers and Mergers" of 1969[371] binds the board to strict neutrality regarding takeover bids. During the course of an offer, or even when the board has reason to believe that a bona fide offer is imminent, it may not "take any action which may result in any offer or bona fide possible offer being frustrated or in shareholders being denied the opportunity to decide on its merits."[372] There are rules that prevent poison pills and similar defensive measures,[373] and the board is required to seek shareholder approval if it wishes to enter into certain types of transactions that may threaten the financial viability of a takeover.[374]

As a result, the discretion of U.K. boards to act against takeovers is much more curtailed than that of their U.S. counterparts. Once a hostile bid appears on the radar screen, the only workable countermeasures are "defense

364. *See* La Porta et al., *supra* note 156, at 495.

365. Armour et al., *supra* note 360, at 1751–52.

366. *See supra* Part III.B.1.

367. Armour et al., *supra* note 360, at 1751–52.

368. *Id.* at 1751–52; Black & Coffee, *supra* note 360, at 2037, 2053; *see* STAPLEDON, *supra* note 362, at 122–29.

369. Bebchuk, *supra* note 102, at 848–49 (referring to differences in shareholders' agenda-setting power); *see also* Hansmann & Kraakman, *supra* note 100, at 46–47.

370. *See supra* Part III.B.1.

371. The City Code was enacted in 1968, but was preceded by the "Queensbury Rules of 1959." BANK OF ENGLAND, NOTES ON THE AMALGAMATION OF BRITISH BUSINESSES (1959), *cited in* Armour & Skeel, *supra* note 134, at 1759; *see also* Johnston, *supra* note 358, at 432–34.

372. THE PANEL ON TAKEOVERS AND MERGERS, THE CITY CODE ON TAKEOVERS AND MERGERS, at R. 21.1(a) (8th ed. 2006). Before the 2006 amendments to the Code, this general clause was not part of Rule 21, but General Principle 7 of the Code. For a discussion of these amendments, *see* Geoffrey K. Morse, *Proposed Amendments to the Takeovers Code to Implement the 13th EC Directive*, 2006 J. BUS. L. 242 (2006).

373. THE PANEL ON TAKEOVERS AND MERGERS, THE CITY CODE ON TAKEOVERS AND MERGERS, at R. 21.1.(b)(i)–(iii) (8th ed. 2006).

374. *Id.* at 21.1.(b)(iv)–(v).

documents," such as strong public criticism of the price and terms of the bid, or efforts to find an alternative transaction by bringing in a "white knight" to defeat the hostile offer or management buyout.[375] As Paul Davies puts it, "the directors of the target are thrown back on their powers of persuasion."[376] Empirical evidence suggests that the threat of a hostile takeover looms more prominently over U.K. managers than over their U.S. peers. While the U.S. economy is six times larger than the British economy, only twice as many hostile takeovers occurred in the United States during the 1990s.[377] More than eighty percent of takeovers in the United Kingdom between 1990 and 2005 were hostile, as opposed to fifty-seven percent in the United States. While forty-three percent of hostile takeovers were successful in the United Kingdom, only twenty-four percent went through in the United States, with the United Kingdom actually surpassing the United States in the absolute number of successful bids.[378] These numbers may even underestimate the actual effect of U.S. antitakeover regulation and case law, since they do not reflect those takeovers that were deterred in the first place. Armour, Cheffins, and Skeel conclude that "the City Code sets up a regime that focuses director attention in the conduct of a bid on the immediate question whether it is in the shareholders' best interests to accept a tender offer."[379]

Takeovers are perhaps the most important situations that can result in a holdup problem,[380] but they are only one part of the picture. Davies and Hopt point out that this striking difference is not an idiosyncrasy of takeover law, but rather the reflection of a different general attitude of corporate law toward centralized management.[381] According to Armour and Skeel, U.K. takeover regulation gives directors "a greater incentive to focus on returns to shareholders."[382] One could be led to suspect that U.K. employees make fewer specific investments than others.[383] The mere threat of a hostile takeover is said to have made British managers more likely to increase distributions to shareholders.[384] However, on the flipside of the coin, the British

375. STEPHEN KENYON, SLADE, MERGERS AND TAKEOVERS IN THE U.S. AND U.K. ¶ 10.07 (2004).

376. DAVIES, *supra* note 94, ¶ 28–18.

377. Christian Kirchner & Richard W. Painter, *European Takeover Law—Towards a Modified Business Judgment Rule for Takeover Law*, 2 EUR. BUS. ORG. L. REV. 353, 377–79 (2000); Paul Davies & Klaus Hopt, *Control Transactions*, *in* THE ANATOMY OF CORPORATE LAW 157, 173 (Reinier Kraakman et al. eds., 2004).

378. Armour & Skeel, *supra* note 134, at 1737–38; *see also* Julian Franks & Colin Mayer, *Hostile Takeovers and the Correction of Managerial Agency Failure*, 40 J. FIN. ECON. 163, 164 (1996).

379. Armour et al., *supra* note 9, at 536; *see also* Deakin et al., *supra* note 359, at 163.

380. Shleifer & Summers, *supra* note 56, at 41–42; Simon Deakin, Richard Hobbs, David Nash & Giles Slinger, *Implicit Contracts, Takeovers and Corporate Governance: In the Shadow of the City Code*, *in* IMPLICIT DIMENSIONS OF CONTRACTS 289, 292–95 (David Campbell, Hugh Collins & John Wightman eds., 2003).

381. Davies & Hopt, *supra* note 377, at 173.

382. Armour & Skeel, *supra* note 134, at 1739.

383. *See* Deakin et al., *supra* note 380, at 329–30; *see also* Johnston, *supra* note 358, at 453–54.

384. Johnston, *supra* note 358, at 442.

system differs from the United States in important aspects of employee protection as well. While the United Kingdom does not score highly in the OECD employment protection index[385] and other leximetric studies of employment protection,[386] it is typically ranked between the United States and Continental European countries.[387]

A brief look at the law in the United Kingdom provides further evidence for an intermediate classification. While the United Kingdom has never had the employment-at-will doctrine,[388] labor legislation came to the country later than Continental Europe,[389] finally arriving during the 1960s and 1970s under Labour and Conservative governments.[390] In addition to other reforms, the Industrial Relations Act 1971 introduced the concept of "unfair dismissal" to the common law, requiring the employer to show a "fair reason" for dismissal, which could include redundancy.[391] Tribunals qualified dismissals as unfair in many cases,[392] including cases in which redundancy was given as the reason for termination.[393] The Redundancy Payments Act of 1965 introduced mandatory redundancy payments.[394] Finally, following an EU directive,[395] legislation was introduced in 1975[396] under which employers laying off twenty or more employees at one establishment within a period of ninety days must consult employee representatives.[397]

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385. ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, OECD EMPLOYMENT OUTLOOK 117 (2004).

386. Botero et al., *supra* note 257, at 1362–63.

387. *See* Irene Lynch-Fannon, *Employees as Corporate Stakeholders: Theory and Reality in a Transatlantic Context*, 4 J. CORP. L. STUD. 155, 178 (2004) (assessing the level of labor market regulation in the United Kingdom as medium-high, whereas the level in the United States is considered to be "low" and the level in some Continental European countries to be "high"); *see also* Gugler & Yurtoglu, *supra* note 230, at 484–85 (summarizing doubts about the conventional wisdom that the United Kingdom has a relatively flexible labor market compared to other European states).

388. The default common law rule required reasonable notice to be given by either party. GWYNETH PITT, EMPLOYMENT LAW, cmt. 8–004 (2004).

389. *Cf.* HUGH COLLINS, JUSTICE IN DISMISSAL 25 (1992) (pointing out that not even the Labour Government elected in 1945 had employment protection on its agenda).

390. PAUL DAVIES & MARK FREEDLAND, LABOUR LEGISLATION AND PUBLIC POLICY 150 (1993).

391. Now found in the Employment Rights Act, 1996, § 98(1), (2) [hereinafter ERA].

392. For an overview on the case law see PITT, *supra* note 388, cmts. 8–030 to 8–063.

393. Vokes Ltd. v. Bear, [1974] I.C.R. 1 (Nat'l Indus. Relations Ct.); Williams v. Compare Maxam Ltd., [1982] I.C.R. 156 (Emp. Appeal Tribunal); Polkey v. Dayton Services Ltd., [1988] A.C. 344 (H.L.).

394. SIMON DEAKIN & GILLIAN S. MORRIS, LABOUR LAW 386 (4th ed. 2005); Steven D. Anderman, *The Weakened Edifice of Job Protection Laws in Britain*, 20 STAN. J. INT'L L. 393, 395–99 (1984). The provisions are now found in ERA §§ 135–46.

395. The relevant provision of E.U. law is Council Directive 98/59/EC, art. 2, 1998 O.J. (L 225) 16, of 20 July 1998 on the approximation of the laws of the members states relating to Collective Redundancies. The original directive was 75/129/EEC.

396. *See, e.g.*, Mark Hall & Paul Edwards, *Reforming the Statutory Redundancy Consultation Procedure*, 28 INDUS. L.J. 299, 300 (1999). For a historical overview of the provisions' development, see Jill Smith, Paul Edwards & Mark Hall, REDUNDANCY CONSULTATION: A STUDY OF CURRENT PRACTICE AND THE EFFECTS OF THE REGULATIONS (DTI EMPLOYMENT RELATIONS RESEARCH SERIES NO. 5, 1–2, 1999).

397. "Appropriate representatives" can be either a recognized union or representatives elected by the employees affected. *See, e.g.*, Edwards & Hall, *supra* note 395, at 302; Trade Union and Labour Relations (Consolidation) Act [TULCRA], 1992, § 188(1).

The policy behind most British employment legislation was to make the labor market more flexible. Redundancy payments were intended to facilitate mobility and to overcome resistance against change, most importantly among unions.[398] Previously, dismissals had often been very costly to employers, as they were often met by spontaneous industrial action.[399] Studies showed that the reforms encouraged layoffs[400] and reduced the number of strikes over redundancy issues,[401] with employees even volunteering for redundancies.[402] Firms introduced formal procedures to make dismissals appear more legitimate to employees and tribunals,[403] reducing the number of strikes and litigation risks.[404]

Although pro-stakeholder laws arrived in the United Kingdom much later than in Germany, shareholder influence was pervasive before these laws came into existence, often because of concentrated ownership or takeovers. One interpretation is that that employment legislation brought U.K. corporate governance into balance. Armour, Deakin, and Konzelmann suggest that job protection laws, redundancy payments, and consultation requirements giving "voice" to stakeholders, particularly in insolvency, play a role in protecting their quasi-rents.[405] British unions were notoriously powerful before the Thatcher government of the 1980s,[406] and unions may have protected employee quasi-rents before these laws came into existence by organizing strikes and frequent industrial action. For most of the twentieth century, British labor relations were characterized by what Otto Kahn-Freund famously described as "collective laissez-faire," under which there was little government interference in labor issues, such issues were instead resolved through collective bargaining between employers and powerful unions.[407] By the time employment legislation was introduced, this "solution"

398. *See, e.g.*, CYRIL GRUNFELD, THE LAW OF REDUNDANCY 2 (3d ed. 1989).

399. Ahlering & Deakin, *supra* note 256, at 18.

400. HUGH COLLINS, K. D. EWING & AILEEN MCCOLGAN, LABOUR LAW TEXT AND MATERIALS 1003 (2001).

401. S.R. PARKER, C.G. THOMAS, N.D. ELLIS & W.E.J. MCCARTHY, EFFECTS OF THE REDUNDANCY PAYMENTS ACT 13 (1971).

402. *Id.* at 62–63; *see also* Victoria Wass, *Who Controls Selection Under 'Voluntary' Redundancy? The Case of the Redundant Mineworkers Payments Scheme*, 34 BRIT. J. INDUS. REL. 249, 250–51 (1996) (evidence from the mining industry).

403. DAVIES & FREEDLAND, *supra* note 390, at 203; JILL EARNSHAW, JOHN GOODMAN, ROBIN HARRISON & MICK MARCHINGTON, INDUSTRIAL TRIBUNALS, WORKPLACE DISCIPLINARY PROCEDURES AND EMPLOYMENT PRACTICE (DTI EMPLOYMENT RELATIONS RESEARCH SERIES NO. 2, 4–5, 1998); DEAKIN & MORRIS, *supra* note 394, at 392–93; LINDA DICKENS, MICHAEL JONES, BRIAN WEEKES & MOIRA HART, DISMISSED: A STUDY OF UNFAIR DISMISSAL AND THE INDUSTRIAL TRIBUNAL SYSTEM 230, 235 (1985).

404. *See* COLLINS, *supra* note 400, at 26.

405. Armour et al., *supra* note 9, at 541–45; Armour & Deakin, *supra* note 280.

406. *See, e.g.*, J.R. Shackleton, *Industrial Relations Reform in Britain Since 1979*, 19 J. LAB. RES. 581, 581–85 (1990).

407. Otto Kahn-Freund, *Labour Law*, *in* LAW AND OPINION IN ENGLAND IN THE 20TH CENTURY 215, 224 (Morris Ginsberg ed., 1959); *see, e.g.*, DAVIES & FREEDLAND, *supra* note 390, at 8–59; Paul L. Davies, *A Note on Labour and Corporate Governance in the U.K.*, *in* COMPARATIVE CORPORATE GOVERNANCE 373, 374–75 (Klaus J. Hopt, Hideki Kanda, Mark J. Roe, Eddy Wymeersch & Stefan Prigge eds., 1998); SIMON DEAKIN & FRANK WILKINSON, THE LAW OF THE LABOUR MARKET 200 (2005).

to the holdup problem seems to have become very costly compared to U.S. or Continental solutions, as interruptions of the production process are counterproductive to the success of both the affected firm and to a corporate governance system as a whole. The increase of employment protection was accompanied by a drop in strikes. Employment law reduced resistance by unions and ultimately aided in curbing their influence, which helped to break up the petrification of the labor market. While explicit shareholder influence exerted by controlling families was being replaced by implicit shareholder influence through a strong threat of takeovers, the United Kingdom may have moved to a local optimum on the employment protection scale by protecting employees against dismissal. Apparently, this allowed ownership dispersion to deepen in the United Kingdom, or at least did not impede it.[408] With the rise of the Thatcher government and the ensuing attack on union power during the early 1980s,[409] the United Kingdom seems to have completed the shift to a new equilibrium in which industrial action had lost its significance: explicit shareholder influence had to some extent given way to less intrusive implicit influence. Union power was greatly reduced, but the British version of employment protection laws was here to stay.

Unlike most other scholars, Franks, Mayer, and Rossi found empirically that dispersed ownership had developed during the first decades of the twentieth century, as early as in the United States, and deepened during the later decades.[410] They argue that the introduction of takeover law—at the behest of financial institutions and not the corporate sector—helped the United Kingdom to solidify dispersed ownership, leading it further away from Continental-style corporate governance.[411] Under this revised chronology the analysis would have to be different, but still lend itself to a plausible interpretation. According to the argument presented in this Article, comparatively weak shareholder influence (before the introduction of takeover law during the 1960s) would have provided an ill fit to powerful unions. However, the U.K. economy did not perform well from 1945 to 1980 relative to other OECD countries, whereas the Thatcher labor market reforms of the early 1980s are often credited for the country's subsequent favorable development.[412] The U.K. equilibrium may therefore only have been reached after union power had been curbed.

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408. *See also* Cheffins, *supra* note 4, at 466–68; Roe, Political Determinants, *supra* note 17, at 100.

409. *See, e.g.*, Shackleton, *supra* note 406, at 585–89 (reviewing legislative curbs on union power under the Thatcher government); *see also* Davies, *supra* note 407, at 379.

410. Julian Franks, Colin Mayer & Stefano Rossi, *Ownership: Evolution and Regulation* (Nov. 2006) (unpublished manuscript), *available at* http://ssrn.com/abstract=354381.

411. Julian Franks, Colin Mayer & Stefano Rossi, *Spending Less Time with the Family*, *in* A History of Corporate Governance Around the World 581, 604–05 (Randall K. Morck ed., 2005); *see also* Deakin et al., *supra* note 380, at 329–30 (suggesting that the City Code may have reduced the willingness of U.K. employees to make specific investments).

412. *E.g.* Erasmus K. Kersting, *The 1980s Recession in the UK: A Business Cycle Accounting Perspective*, 11 Rev. Econ. Dyn. 179, 187–90 (2008).

The United Kingdom qualifies as an intermediate case.[413] It has a higher degree of shareholder influence than the United States, particularly because of the Takeover Code, but a lower degree than the Continent. Employment law is stronger than in the United States but weaker than in Continental Europe.

VII. Conclusion

In this Article, I have advanced the argument that increased shareholder influence on managerial decision making exacerbates holdup problems regarding other constituencies, particularly employees. *Ceteris paribus*, pro-stakeholder institutions are therefore more justified in terms of efficiency in systems where shareholder influence is stronger than in others. Comparative patterns in the law of large industrial countries seem to confirm this hypothesis.

The core assumption is that the risk of not being rewarded later for firm-specific investment in human capital will deter employees from making such investment, resulting in productivity losses for firms. Since shareholders are the ex post beneficiaries of holdup, different levels of development of pro-stakeholder laws are normatively desirable in different systems, depending on the degree to which managers are insulated from explicit and implicit shareholder influence. A similar degree of safety from holdup may require an entirely different degree of legal protection that needs to be weighed against its cost. This Article discusses an important aspect influencing the firm's relationship to labor in that respect, namely the effects of shareholder influence on managers. Shareholder influence can either be exerted directly, as in the case of ownership concentration in Continental Europe, or through a set of arrangements that forces managers to pursue shareholder value maximization, as in the United Kingdom. U.S. corporate governance is unique in that it largely excludes shareholder influence, grants unusually broad latitude of action to managers, and shields them from shareholder influence more than in European systems on either side of the English Channel.

Given the typically strong influence of large shareholders on managerial decision making, employment protection and other pro-stakeholder laws are, *ceteris paribus*, more justified in terms of efficiency in systems with concentrated ownership. This is not necessarily so in systems with dispersed ownership, given the relative freedom managers enjoy. Thus, the theory provides a new explanation for the way pro-labor institutions, such as codetermination and employment protection, tend to be relatively stronger in Continental Europe than in the United States. However, there are also

413. *Cf.* Lynch-Fannon, *supra* note 387, at 171–72 ("[T]o speak of an Anglo-American model of governance is incorrect.").

important differences between the two major systems (the United States and the United Kingdom) characterized by dispersed ownership. Takeover law and other aspects of corporate governance commit managers to maximize ex post shareholder wealth more strongly in the United Kingdom than in the United States. The United Kingdom seems to be in the middle between the United States and Continental Europe both with respect to shareholder influence on managerial decision making and with respect to pro-labor laws, thus confirming the general theory. All of these systems may be in, or close to, two very different local optima.

Different equilibria have different advantages and disadvantages. Tightly-knit regulation may increase the costs of adapting to changed circumstances, as it makes it harder to dismiss employees in situations where it is desirable or even imperative for the maximization of total social welfare. The U.S. system is probably more flexible, as managers with broad discretion may more easily respond to changed external circumstances than is the case with one-size-fits-all regulatory solutions. However, the U.S. system has other drawbacks. Although shareholder protection against managerial misconduct must be distinguished from shareholder influence (the crucial factor for holdup risk), there are certain links between the two. Most of all, managerial insulation may be the cause of the system's instability and the recurrence of large scandals.[414] The absence of shareholder influence implies that shareholder-stakeholder conflicts are relatively insignificant, while both providers of capital and labor are equally exposed to rent-seeking by managers. The U.S. preoccupation with principal-agent problems could therefore be explained as viewing managerial rent-seeking as a shared threat that (unlike in Continental Europe) turns both constituencies into natural allies.[415]

The other lesson we should keep in mind is that institutional complementarities need to be taken seriously. Legal reforms aiming at increased shareholder influence in the United States should be met with caution, as should reforms of pro-stakeholder laws in Europe. The intention is not to claim that the law of each of the corporate governance systems discussed is perfect under the given circumstances. However, reforming only one of the two sides of the coin may turn out to be detrimental. One-size-fits-all solutions may be a bad fit in corporate governance systems different from the systems in which those solutions originated.

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414. *See* Mark J. Roe, *The Inevitable Instability of American Corporate Governance*, *in* RESTORING TRUST IN AMERICAN BUSINESS 9, 13–20 (J.W. Lorsch, Leslie Berlowitz & Andy Zelleke eds., 2005).

415. *See* GOUREVITCH & SHINN, *supra* note 12, at 65–67 (discussing "transparency coalitions," in which workers and shareholders join forces to constrain managerial agency costs).