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John W. Cioffi

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Author Contact: John W. Cioffi
Assistant Professor of Political Science
University of California, Riverside
Phone: (951) 827-7269
Email: john.cioffi@ucr.edu

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CORPORATE GOVERNANCE REFORM, REGULATORY POLITICS, AND THE FOUNDATIONS OF FINANCE CAPITALISM IN THE UNITED STATES AND GERMANY

Abstract: Since 1990, both the U.S. and Germany have substantially reformed their corporate governance regimes as part of an emerging paradigm of international finance capitalism increasingly dependent on securities markets and private shareholding. Corporate governance reform and the emergence of finance capitalism, however, presents a double paradox. First, the development of financial markets and the increasing importance of market relations, often linked to the *diminution* of state power, have been accompanied by a substantial and ongoing *expansion* of law and regulatory capacity into the private sphere to boost shareholder protections. Second, center-*left* parties in both countries took advantage of economic crises to press for pro-shareholder reforms against center-right opposition allied with managerial elites. This article explains these developments by analyzing reform processes in United States and Germany over the past decade. It argues that changing economic conditions empowered reformist state actors, and that they have played a central and largely autonomous role in driving the substantial institutional change underway in contemporary capitalism. The analysis also suggests that political conflict over corporate governance is likely to intensify, on the right and the left, as it impinges on the basic allocation of power within corporations and thus the political economy.

I. INTRODUCTION: BEYOND ENRON

The collapse of the 1990s stock market bubbles in the United States and Europe led to a wave of massive corporate finance scandals in the United States and stock market crashes around the world. Corporate finance scandals, such as Enron, Global Crossing, World Com, and Adelphia, joined by European counterparts such as the Netherlands' Ahold and Italy's Parmalat, have made securities market regulation and the internal structure and governance of the corporation critical issues of public concern. The spotlight on these scandals obscures the most important part of the story: a cross-national trend towards greater legal protection of shareholder interests within the capital markets and the publicly traded corporate firm itself. Economic crises have prompted corporate governance reform as part of a new paradigm of "*finance capitalism*" defined by the growth of international and domestic capital markets, the increasing importance of sophisticated financial services, and an expanding class of private investors. This article explains the processes of corporate governance reform in United States and Germany over the past decade and how they challenge prevailing explanations of political economic change. These cases illustrate how changing social and economic conditions impose new demands on the state and offer state actors opportunities to expand state capacity, develop new instruments of state authority and power, and fashion and implement new policies.

The regulatory framework of finance capitalism facilitates the development and integration of securities markets and the formation of large pools of private investment capital by addressing fundamental problems of information and power asymmetries within capital markets and the corporation. Regulatory politics defines the national corporate governance regimes that lie at the structural core of the new finance capitalism. Corporate governance law performs a crucial regulatory function by ordering the power relationships, information flows, decision-making processes, and economic incentives within the foundational economic institution of

modern capitalism—the corporation. As corporate governance changes, so too does the character of contemporary capitalism.

The emergence of finance capitalism, however, presents a double paradox. First, the development of financial markets and the increasing importance of market relations, often linked to the *diminution* of state power, have been accompanied by a substantial and ongoing *expansion* of law and regulatory capacity. The conduct of parties within the securities markets and the internal structure of the corporate firm are increasingly determined by law and the steady centralization of regulatory authority at the national level. Second, center-left parties, historically reliant on working class support and hostile to the interests of financial capital, pressed for pro-shareholder reforms in the face of resistance from conservatives allied with managerial elites. The center-left in the United States and Germany took advantage of very different sorts of economic crisis conditions to successfully pursue these policy agendas in distinctive ways. The sudden and traumatic character of the post-Enron corporate governance crisis and the neo-liberal pluralist politics in the United States produced a rapid but relatively short-lived reform movement. German corporate governance reform evolved in the context of a longer-term crisis of economic performance, coupled with EU-driven market integration, and far more coordinated policymaking institutions. Consequently, the German reforms were consensual, transformative, and sustained over more than a decade.

These paradoxes challenge prevailing theoretical approaches to corporate governance in important ways. Corporate governance reform poses the questions of both *how* state actors, through law and regulation, have come to restructured fundamental economic relationships, and *why* they have done so. Neo-liberal theories predict convergence on a more a *laissez faire*, market centered economic model. This perspective fails to explain the state's *substantially increased regulatory intervention* in the economy that has accompanied corporate governance reform. Financial regulations and regulatory bodies exist where before there were

none. Law restructures the internal structure and power relations of the corporation in new and pathbreaking ways. Corporate governance reform in the United States, as the leading “liberal market economy,” and Germany, as the leading “coordinated market economy” (Hall and Soskice 2001), sheds light on cross-national trends in reform processes, the role of the state in the economy, and the relative trajectories of American and German capitalism. Yet much recent work in contemporary comparative political economy, particularly the “varieties of capitalism” literature, maintains that institutional differences among national economies are path dependent, locked into place by the comparative economic advantages these arrangements confer on domestic firms. (*E.g.*, Hall and Soskice, 2001) This description fails to explain the degree of political economic change that has occurred in recent years and the intensely political processes that construct corporate governance regimes.

Political elites in the United States and Germany pursued corporate governance reform by expanding, centralizing, and institutionalizing regulation in the interests of shareholders and finance capital. These reforms served the interests of political elites by using capital market pressures to constrain managerial autonomy, shore up political economic legitimacy, increase corporate efficiency, and improve aggregate economic performance. They reflect the capacity of state actors to influence and take advantage of changing economic conditions, interest group preferences, and public opinion by framing public policy debates and constructing interest group alliances to overcome path dependence. These developments contradict images of stable political economic equilibria, associated with path dependence theory, as well as neo-liberal predictions of state retreat. Instead, we are seeing the emergence of varieties of finance capitalism analogous to the varieties of post-war capitalism.

This article identifies the main trends in corporate governance reform in the United States and Germany in historical and political context. Part II sets out a brief sketch of the legal, institutional, and ideological features of American and German

corporate governance regimes prior to the 1990s. These regimes embodied, respectively, distinctive liberal market and coordinated market variants of post-war capitalism, and each contained tensions and flaws that would trigger the reforms of the past fifteen years. Part III discusses the political responses to economic and corporate governance crises and shows how institutional structures influenced the course and content of the American and German corporate governance reforms since 1990. Part IV concludes with a political analysis of these reforms and their implications for the developmental trajectories of the American and German governance models.

II. THE REGULATORY STATE, PUBLIC LAW, AND THE CORPORATE FIRM

Corporate governance regimes structure the allocation of power among managers, shareholders, and employees—the principal groups involved in corporate affairs.¹ A tripartite legal structure of company (or corporate) law, securities regulation, and labor relations law defines the juridical relationships among these groups and is a central feature of national political economies. (Cioffi 2002a: 1-2; 2000) The United States and Germany represent very distinct political economic models defined by “liberal market” and “coordinated market” institutional arrangements, respectively.² (See Tables 1 and 2)

¹ Cioffi 2002a: 1; *cf.* Gerke 1998 (quotation omitted). This definition of the term corporate governance goes well beyond the narrow confines of the shareholder-manager (principal-agent) relationship that preoccupies the vast majority of scholarship in law and economics. This definition more accurately describes the function of corporate governance and its relationship to the broader political economy.

² See Hall and Soskice 2001. For a classic expression of a political economic typology in the study of national financial systems, see Zysman, 1983. An updated analysis of national corporate governance regimes from this typological perspective is presented in Cioffi, 2000 and Cioffi and Cohen, 1999.

TABLES 1: POST-WAR CORPORATE GOVERNANCE MODELS IN THE UNITED STATES (C. 1985)

UNITED STATES		
REGULATION		CORRELATED PRACTICE
SECURITIES LAW	<ul style="list-style-type: none"> • Centralized federal securities regulation by SEC imposes stringent & highly prescriptive transparency & disclosure rules. • SEC proxy rules grant managers effective control over nominations and elections to the board of directors. • Self-regulation and private rulemaking in accounting industry. 	<ul style="list-style-type: none"> • Securities markets highly capitalized, substantial use of equity finance & financial innovation, but an accompanying fragmentation of ownership (separation of ownership & control). • Managerial domination of the firm built into corporate structure. • Weak oversight of accounting industry.
COMPANY LAW	<ul style="list-style-type: none"> • State law governs internal firm structure & affairs (no uniform federal corporate law). • Fiduciary duty law favors shareholders' interests over other stakeholders. • Corporate law statutes & jurisprudence permits wide variety of anti-takeover defenses. 	<ul style="list-style-type: none"> • Broad managerial & board discretion in running firm. • Corporate law & intra-firm governance favors managerial interests. • Stakeholders receive little legal protection, creating bias in favor of short-term financial interests. • Fiduciary law weakened—strengthens position of managers & limits protection of shareholders & stakeholders alike.
LABOR LAW	<ul style="list-style-type: none"> • Law favors decentralized unions & firm-level bargaining. • Law sharply separated from corporate law to preserve managerial autonomy. 	<ul style="list-style-type: none"> • Weak, fragmented unions pursue contractual “business unionism”. • Contractual labor relations separate from firm governance (no codetermination).
ENFORCEMENT MECHANISMS	<ul style="list-style-type: none"> • Formal & litigious enforcement of complex prescriptive rules. • Legal rules favor enforcement through private litigation. 	<ul style="list-style-type: none"> • High incidence of litigation. • Wealthy & politically active plaintiffs' bar.

TABLE 2: POST-WAR CORPORATE GOVERNANCE MODELS IN GERMANY (C. 1985)

GERMANY		
REGULATION		Correlated Practice
SECURITIES LAW	<ul style="list-style-type: none"> • Weak state (Länder) transparency and disclosure regulation. • No federal regulation or regulator. • Weak shareholder rights against fraud, insider trading. 	<ul style="list-style-type: none"> • Opaque financial reporting. • Bank-centered financial system & undeveloped securities markets. • Concentrated stockholding & networks of ownership & control.
COMPANY LAW	<ul style="list-style-type: none"> • Federal company law imposes uniform rules & firm structure. • Supervisory board codetermination in large public firms. • Board members obliged to act in “the interests of the enterprise” (not the shareholders) 	<ul style="list-style-type: none"> • No pro-managerial “race to the bottom”; fosters stable system of stakeholder representation & governance. • Employees are a core stakeholder group. • Weak fiduciary obligations; no principle of shareholder primacy.
LABOR LAW	<ul style="list-style-type: none"> • Sectoral bargaining framework between centralized industrial unions & employer associations. • Strong employee rights and powers under works council codetermination. 	<ul style="list-style-type: none"> • Cooperative labor relations rest on strong unions. • Functional split between unions & works councils takes wage issues taken out of firm governance, leaving work hours, organization, etc. to be resolved through firm governance.
ENFORCEMENT MECHANISMS	<ul style="list-style-type: none"> • Weak governmental enforcement; procedural & substantive restrictions on private law suits reduces use of litigation. 	<ul style="list-style-type: none"> • Governance by negotiation among opposing interests (micro-corporatism) within the firm.

In each case, characteristic institutional structures and power relations are replicated at multiple levels of the state, market, and corporate firm. These formal arrangements are the product of political forces and cannot be explained as flowing from economic efficiency or functional necessity alone.

A. THE UNITED STATES: BETWEEN NEO-LIBERALISM AND THE REGULATORY STATE

The American economy has experienced waves of wrenching crisis and restructuring during the past thirty years. The Fordist model of mass production relied on large integrated and oligopolistic industrial firms, managerial autonomy from shareholders, long-planning horizons, stable sources of capital, and predictable product cycles in predictably expanding markets. The collapse of the Bretton Woods monetary regime, oil shocks, and stagflation during the 1970s undermined these foundations of Fordism and triggered a prolonged period of economic crisis. Deindustrialization, erosion of domestic and export market shares, and the collapse of organized labor heralded the end of the post-war economic order. The wave of hostile takeovers, mergers, and acquisitions during the 1980s signaled the arrival of a new, volatile, and financially driven form of economic organization. Securities markets became more than simply another source of finance; they drove corporate—and thus economic—restructuring.

The United States had a head start in the development of this new paradigm of finance capitalism. Its securities markets were already well developed in terms of liquidity, stock market capitalization, and the proportion of publicly listed firms. Underlying this economic and financial structure was a well-developed legal and regulatory structure dating back to its political origins in the New Deal. The structure of American corporate governance encouraged reliance on rapidly-shifting arm's-length economic relationships rather than on longer-term relational ties among management, capital, and labor. American law embodied the state's relatively non-interventionist approach to the internal affairs of the corporation that preserved an expansive private

sphere of corporate and managerial autonomy bounded by a highly developed framework of formal legal rights, obligations, and regulatory rules. This legal framework simultaneously concentrated power in the hands of the CEO and other senior managers and protected shareholders.

American corporate law is distinctive in that it has been the responsibility of state, not federal, law. State company laws function as general enabling statutes that create the bare minima of the corporate form—limited liability, legal capacity, a board of directors, and basic fiduciary duties and shareholder rights. Otherwise, corporate law gives managers and directors wide discretion in how to structure and manage the firm. American corporate law allows managers to sit on the board of directors—essentially supervising themselves. Federal securities regulations have long given *management* control over the nomination and election of directors. In theory, the fiduciary duties of corporate directors and officers should counterbalance the weakness of shareholders in corporate governance. American corporate law provides comparatively favorable procedural mechanisms to sue for breach of these fiduciary duties. In practice, however, the “business judgment rule” substantially dilutes fiduciary duties by exempting from liability those decisions taken in good faith in the ordinary course of business.

With the rise of the regulatory state in the 1930s, the United States pioneered modern securities regulation. Congress empowered the Securities and Exchange Commission—a strong, federal regulatory agency—to ensure the efficient functioning of national securities markets. The SEC’s mission was *to make the markets work* through federal *market-reinforcing disclosure regulation*. The SEC was charged with drafting and enforcing elaborate registration, disclosure, and securities trading rules, and with overseeing the administration of stock exchanges. Strong transparency, disclosure, and insider trading regulations were designed to protect minority shareholders, facilitate market transactions, and legitimate the country’s market-driven financial system. Within this regulatory framework, the “external” capital

markets in the United States became among the most developed and liquid in the world with a high proportion of publicly traded firms and a sophisticated financial services sector.

Both labor and shareholders were hobbled by the American corporate governance regime. American corporate governance law wholly excluded employees, *protecting managerial prerogatives* from encroachment by collective bargaining or other potential forms of employee influence.³ Subjects such as investment, marketing, product design, production plans, and financial strategies are considered within the “core of entrepreneurial control.” At the same time, federal law segmented the financial services industry and *mandated* portfolio diversification, precluding the use of concentrated equity ownership as a means of checking of managerial power.⁴ The distinctive combination of corporate law managerialism, strong transparency and disclosure regulation under securities law, along with the legal marginalization of labor, constitute the basic structural features of the American corporate governance regime.

The American corporate governance regime embodies a complementary and mutually reinforcing relationship between the market-driven financial system and a legalistic, transparency-based regulatory regime. The weakness of shareholders within corporate governance encouraged investors to respond to

³ See *NLRB v. Borg-Warner Corp.*, 356 U.S. 342 (1958); *Fibreboard Paper Prods. Corp. v. NLRB*, 379 U.S. 203 (1964); see also *Ford Motor Co. v. NLRB*, 441 U.S. 488, 498 (1979) (quoting *Fibreboard*); *First National Maintenance Corp. v. NLRB*, 452 U.S. 666 (1981).

⁴The Glass-Steagall Act severed investment banking from commercial banking and traditional lending; the Investment Company Act of 1940 and the Employee Retirement Income Security Act of 1974 limited the size of the stakes investment firms and funds could hold as a percentage of their own capital and of outstanding corporate equity. Under these deliberately fragmented ownership conditions, shareholders could not solve the collective action problem of coordinating and compensating the monitoring of managers. See generally See Roe, 1998, 1994, 1993b, 1991, 1990.

management problems through exit by selling their stakes rather than active participation through voice. (*See, e.g.,* Roe, 1991; Coffee, 1991; *cf.* Hirschman, 1970) Relatively stringent disclosure regulation contributed to the development of highly liquid markets that allowed shareholders to exit from ownership by selling shares quickly. The reliance on exit increased the importance of and demand for prescriptive financial disclosure regulation to protect shareholders from market failures caused by pervasive informational asymmetries.

This governance regime contained a set of structural flaws. These deficiencies were well known to commentators and policymakers prior to 2000 and some earnest attempts to address them failed politically. First, the largely self-regulating character of an accounting industry that had come to treat auditing as a loss leader to sell more lucrative consulting services undermined securities regulation that depended on disclosure of accurate information. Second, state corporate law and SEC proxy voting regulations under federal securities law give shareholders virtually no power to nominate or elect representatives to the board. This legal framework entrenched the domination of the boards of directors by the very management who, in principle, they were charged with overseeing.⁵ Third, institutional investors were not willing or able to actively monitor management as advocated by many commentators, corporate governance activists, policymakers, and academic theorists. Together, these structural defects would contribute to the systemic corporate governance crisis that peaked in 2001-2002.

⁵ Into the 1990s, even as the jobs of CEO and board chair were split with increasing frequency and larger numbers of non-managerial directors sat on boards, CEOs and senior managers largely dominated the very institutional body that was supposed to render them accountable to shareholders.

B. GERMANY: THE COORDINATED MARKET MODEL AND THE MICROCORPORATIST FIRM

The post-war German political economy and corporate governance regime stood in sharp contrast to the neo-liberal American model.⁶ A bank-centered financial system, networks of corporate cross-ownership, and interlocking boards stabilized financial and ownership relations within and among firms, freeing management to strategize for long-term growth. Strong labor unions and codetermination incorporated labor into economic and corporate governance in ways that further encouraged long-term planning and discouraged the pursuit of short-term financial returns. Overarching these arrangements, institutionalized bargaining among peak associations coordinated economic relations at the firm, sectoral, and national levels. The German corporate governance law channeled multiple contending stakeholder interests into largely self-regulating, long-term bargaining relationships.

Until the mid-1990s, the framework of German securities and company law was the mirror image of the American structure. In contrast to the centralized federal securities regulation and state level corporate law of the United States, Germany had a *uniform federal company law* and *fragmented securities regulation* that dispersed legal authority among the Länder (states) and eight local self-regulating stock exchanges. Disclosure regulations and accounting rules were weak. Company finances remained opaque. Moreover, the law provided few effective avenues for private litigation to enforce shareholder rights. In place of American-style transparency regulation, Germany's corporate governance regime relied on the power of large banks to monitor managers. Germany's bank-centered financial system defined a set of stable, interlocking ownership and governance relationships based on concentrated ownership, extensive cross-shareholding networks,

⁶ See Vagts, 1966; O'Sullivan, 2000; Roe, 1994, 1993b; Charkham, 1994.

and long-term relational finance ties between banks and corporate borrowers. Relational finance by banks ameliorated pressures for maximizing short-term financial returns and encouraged long-term adjustment and growth strategies by industrial enterprises that could balance the competing demands of capital and labor.

Large German “universal banks” combined lending, securities underwriting, brokerage, and trading at the core of the financial system. Consequently, these banks were simultaneously important lenders to, and major shareholders in, publicly traded firms. Further, under German law, banks wield even greater voting power by casting the votes of many of the shares deposited with them, if authorized by their depositor-brokerage clients.⁷ Bank representation on the supervisory board frequently cemented the combination of voting power with long-term relational lender and shareholding relationships. In theory, the banks’ status as shareholders aligned their interests with those of other shareholders; and the banks’ power within firm governance presumably protected these other investors. In fact, banks did not play the active monitoring role assumed by conventional wisdom and the contradictory status of the banks as lenders first and shareholders second generated conflicts of interest that law and regulation did not police or remedy. Absent strong shareholder protection or strong incentives for major banks to cultivate equity finance, relatively few German firms were publicly traded and securities markets remained far less developed than in the United States.

⁷ Thus, in addition to their own equity holdings, the banks wield disproportionate voting strength and substantial leverage when it comes to board nominations or influencing key strategic decisions. Charkham, 1994: 37-38; Vagts, 1966: 53-58. Even where German management attempts to maintain autonomy by diversifying sources of bank debt, Deeg, 1992: p. 208, banks have adopted a practice of designating a “lead bank” to monitor the corporation, vote their aggregate DSVRs, and maintain supervisory board representation. Vitols, 1995: p. 6.

Under German company law, public corporations (*Aktiengesellschaft* or "AG") have a dual board structure in which the supervisory board (analogous to the American board of directors) is completely separate from the management board (a more collegial version of the CEO and senior management of the American firm) with no overlapping membership. The supervisory board ("Aufsichtsrat") appoints and supervises the managing board ("Vorstand") and formulates (or at least approves) major corporate policies and strategies. The shareholders' meeting (Annual General Meeting, or AGM) has the right to receive relevant information and vote on a broad range of issues, including mergers, acquisitions, capital increases, and major changes in business strategies. German company law relied on the *internal* corporate institutions, the board and AGM, to constrain managerial power rather than the discipline of stock markets. These institutional constraints were designed to protect the interests of creditor banks and employees as important stakeholders of the firm.

Labor codetermination, the incorporation of employees into the firm's governance institutions, replicated Germany's highly organized labor relations at the firm level. Codetermination through strong works councils and supervisory board representation embodied the stakeholder vision of the corporation as an institutional and organizational entity. (*See, e.g., Katzenstein, 1987: Chap. 3; Wiedemann, 1980*) Company and labor relations law create microcorporatist structures that facilitate negotiation, compromise, cooperation, and consensus within firm governance.⁸ Board codetermination became

⁸ Supervisory board codetermination under the Codetermination Act of 1976, perhaps the most striking feature of German company law, requires most corporations with over 2,000 employees appoint equal number of shareholder and employee representatives to their supervisory boards. Wiedemann, 1980: 79. Firms with 500 to 2,000 employees must set aside only one-third of the board seats for employee representatives. Wiedemann, 1980: 80. "*Montan*" codetermination, the third (and original) variant, only applies to firms in the

enormously important as a symbol of the country's consensus-driven "social market economy," but its practical import has been modest. Works council codetermination, in contrast, provides a second and more important form employee representation in firm governance.⁹ Works councils wield substantial influence within the workplace through their ability to use information, consultation, and codetermination rights, and through their authority to demand compensation for economic injury to employees caused by managerial policy decisions. Works council codetermination has also proved beneficial to firms as a way of cooperatively coordinating labor relations in workplaces staffed by highly skilled and productive employees. Within this stakeholder governance model, a "microcorporatist" firm structure (*cf.* Assmann, 1990; Streeck, 1984) curtails managerial power and incorporates and protects the interests of both capital and labor.

The stakeholder governance model underpinned and legitimated the post-war economic order. It also facilitated the incremental innovations in industrial production that enabled German industry to focus on high quality and high value-added market niches, and allowed it to pay high wages and invest heavily in skill formation. (*See* Streeck, 1984, 1987, 1991, Vitols, 1991) But these comparative advantages came at an increasingly steep price during

coal, mining, and steel sectors employing more than 1,000 workers, provides for *full parity* of shareholder and employee representation. The decline of the mining and steel sectors in Germany has reduced the importance of *Montan* codetermination. For an excellent recent review of board codetermination, *see* Prigge, 1998.

⁹ Wiedemann, 1980: 80-82. The Works Constitution Act of 1972 provides for the election of works councils in facilities or plants of business organizations with five or more permanent employees, but many large firms voluntarily instituted enterprise (or *Konzern*) works councils covering an entire corporate group to ensure stable and cooperative labor relations. For general discussions of the political origins and impact of codetermination, *see, e.g.,* Vagts, 1966: 64-78; Streeck, 1984; Katzenstein, 1987: Chapter 3; Muller-Jentsch, 1995. For the role of works councils in German labor relations, *see* Thelen, 1991; *cf.* Turner, 1991.

the 1990s. Export markets became increasingly unstable, international competition stiffened, profits from traditional bank lending declined as a result of market saturation, and German reunification proved enormously expensive and destabilizing. (*See* Streeck, 1997) Growth stagnated at less than two per cent while unemployment soared to over ten per cent. By the early 1990s, German politicians faced the twin problems of intensifying pressures to reform sources of economic rigidity and potent resistance to structural changes that might undermine Germany's comparative advantages and/or antagonize powerful interest groups.

III. POLITICS AND POLICY REFORM

A. THE AMERICAN CORPORATE GOVERNANCE CRISIS AND THE POLITICS OF PUNCTUATED REFORM

During the 1980s and 1990s, corporate governance became an increasingly important and divisive policy domain in the United States. Yet partisan and interest group conflict blocked substantial reform until the pressures generated by the post-Enron corporate governance crisis of 2001-2002 briefly overcame the path dependence and political paralysis that had characterized the policy area. The hostile takeover wave of the 1980s focused popular and political attention on corporate governance and questions of managerial and financial power as managers mobilized coalitions with organized labor and grass-roots community groups to erect a wide variety of anti-takeover defenses.¹⁰ Following the decline of hostile takeovers, the rise of

¹⁰ By the early 1990s, these legal changes effectively protected incumbent managers from hostile takeovers and had largely eliminated the market for corporate control. There continued to be an extraordinarily vibrant *market for companies*—which reached its apogee during the 1990s boom and stock market bubble. However, the overwhelming majorities of mergers and acquisitions

institutional investors and mass shareholding gave rise to a new, if fragmented, constituency favoring pro-shareholder reform. Over the course of the 1990s, as evidence of flaws in the American corporate governance regime accumulated, policy shifted between strengthening traditional disclosure regulation and using institutional investors as corporate monitors.

A combination of fragmented governmental institutions with multiple veto points on policymaking, political polarization, and the influence of interest groups hostile to reform precluded major systemic corporate governance reforms during the 1980s and 1990s even as problems of poor auditing, balance sheet manipulation, excessive CEO pay, and value-destroying merger and acquisition activity became evident. (Cioffi, 2005) Conflicts pitted managerialist business and professional groups along with anti-regulation politicians against shareholder groups, pension funds, unions, regulators, and pro-regulation politicians. (*Id.*)

Federal corporate governance policy was caught between pro-shareholder and managerial forces during the 1990s and swerved between increased protection of shareholder interests and the preservation of managerial power and autonomy. The SEC pushed for more shareholder protections, but also suffered noteworthy political defeats over attempts to limit the consulting work done by accounting firms for their auditing clients and to require the expensing of stock options.¹¹ At the same time, pro-shareholder

during the 1990s were friendly deals that often richly rewarded senior managers. (*See, e.g.,* Cioffi 2002a, chap. 4)

¹¹ SEC Chairman Arthur Levitt, a Clinton appointee, sought to prohibit accounting firms from doing both auditing and consulting work for corporations that presented a conflict of interest and might compromise the integrity of audits. Accounting firms enlisted allies in Congress to fight the regulatory proposal, which was withdrawn after members of Congress threatened to cut the SEC's already inadequate budget. Likewise, the Financial Accounting Standards Board (FASB) and the SEC under Levitt failed in an attempt to require the expensing of stock options in corporate financial statements. Business

groups were split between those favoring expanded disclosure and those seeking to encourage monitoring of management by institutional investors. The peculiar vacillations of SEC policy during the 1990s reflected this political and ideological conflict. In 1992, the SEC amended its proxy rules to encourage corporate governance activism by large institutional investors by making it easier to communicate with each other and with management.¹² The 1992 proxy rule amendments used structural regulation that altered the institutional structure of the firm to modify behavior. In August 2000, the SEC shifted direction with the adoption of Regulation "Fair Disclosure" ("Regulation FD"). Regulation FD *prohibited* corporate managers from selectively disclosing material information to favored analysts, financial institutions, and institutional investors.¹³ The rule undermined the SEC's own 1992 proxy reforms. The 1992 reforms took it for granted that institutional investors would act on behalf of all shareholders; Regulation FD presumed they were self-interested and potentially collusive insiders. While addressing the problem of informational asymmetries between small investors and large institutions, Regulation FD limited the ability of institutional investors to pursue corporate governance activism. Transparency regulation and structural regulation relying on institutional activism have always been in tension. By the end of 2000, these two paradigms

lobbies, led by "new economy" technology firms dependent on options enlisted bipartisan congressional and executive branch support to quash the initiative.

¹² The 1992 proxy rule changes appear to have encouraged greater governance activism by institutional investors, but at the expense of transparency in governance. Institutional investors, with some notable exceptions, preferred to voice their concerns and criticisms to management in private communications that would not become public. These communications thus became occasions for managers to disclose significant information to the representative of institutional investors and analysts associated with investment banks and brokerages.

¹³ Regulation FD expressly rejected any private cause of action enabling enforcement by shareholder litigation and thus continued the anti-litigation trend of the 1990s. Regulation FD is a prescriptive rule without any effective enforcement mechanism other than a (rare) SEC enforcement action.

of corporate governance regulation and reform had collided on the levels of politics, law, and investor relations.

The bursting of the stock market bubble in 2000, with the loss of over \$7 trillion in stock market valuation, and the post-bubble corporate finance scandals of 2001-2002 unveiled the vast corruption and fraud that accompanied the economic and investment boom of the late-1990s. The massive financial scandals at Enron, WorldCom, Global Crossing, Adelphia, Tyco, and other major corporations stoked popular resentment of corporate and financial elites, inflaming political support for more wide-ranging reform of the American corporate governance regime. The most severe legitimacy crisis of the American financial and corporate governance systems since the Great Depression disrupted the grip of a conservative coalition that had favored minimal regulation and blocked reform through the 1990s. By the spring of 2002, political leaders began to fear that the American securities markets and financial system as a whole might collapse after the successive shocks of the terrorist attacks of September 11, 2001 and the seemingly endless series of corporate finance scandals and bankruptcies stretching from late-2001 through 2002.

The extraordinary scope, severity, and duration of these financial scandals undermined the legitimacy of managerial and professional elites and their political allies who opposed substantial corporate governance reform. The legitimacy crisis created a rare interregnum of partisan and interest group politics. The growing public outrage over the scandals and market losses allowed the Democratic Party to seize the policy agenda. The Bush administration, congressional Republicans, and the SEC, having resisted calls for reform, lost influence over the legislative process.

The single most striking and important feature of the reform politics of 2001-2002 was the virtual absence of interest group influence and the predominance of entrepreneurial political actors in Congress. Tainted by scandal, corporate managers and

accounting firms remained peripheral to the legislative process.¹⁴ Business interests were deeply divided over the reform effort. The spiraling corporate governance crisis induced a significant number of leading financial figures, including billionaire investor Warren Buffett, former Federal Reserve Chairman Paul Volcker, and Goldman Sachs CEO Henry Paulson, to publicly support legislative and regulatory reform. In the end, even the Business Roundtable, the preeminent lobbying group of corporate managers, submitted to the forces of reform.

The financial services sector also was divided over the proper extent of corporate governance reform and government regulation. Leading investment firms understood the depth of the crisis and had an enormous stake in ensuring that it was contained—by regulatory reform if necessary. Financial institutions, such as investment banks, dependent on public faith in the integrity of the securities markets, but also privileged insiders that benefited from the status quo, were split over the reforms. They were also weakened politically by their implication in broader scandals, including dishonesty and conflicts of interests in stock analysis, manipulating initial public offerings, and aiding dishonest corporate executives.

Large public employee and union pension funds and institutional investor groups (such as CalPERS, TIAA-CREF, and the Council of Institutional Investors) shifted their policy preferences dramatically in support of increased regulatory stringency and intervention in corporate governance. The AFL-CIO and labor unions, because of their close connection to union pension funds and their members' reliance on private pension investments, were strongly supportive of corporate governance reform and were

¹⁴ The only issue managers fought fiercely was, perhaps revealingly but not surprisingly, the regulation and more stringent accounting treatment of stock options—the mechanism that was supposed to align the interests of managers and shareholders, but which became the most effective means of managerial rent-seeking ever devised.

instrumental in rounding up Democratic votes in Congress. In contrast, mutual funds and corporate pension funds remained indifferent or hostile to reform. Neither group of institutional investors had an appreciable influence on the substance of the reforms.

Senate Democrats drove the drafting and passage of the reform legislation against the opposition of anti-regulation Republicans in Congress, the White House, and the SEC. The Senate Democrats had the temporary advantage of being in the majority and thus were able to frame and advance the reform agenda. The Democrats seized upon the scandals and reform as a way to attack the Republicans for their anti-regulation neo-liberalism while appealing to middle class voters with their long-established vision of a regulatory state that protected ordinary Americans from the depredations of dishonest business elites. The looming the 2002 midterm elections were the Democrats' leverage and political objective. They capitalized on divisions among and within interest groups, holding hearings and drafting a reform bill as the scandals and the sense of financial crisis escalated through the first half of 2002. By the late spring and early summer of 2002 the politics of reform had taken on a life of its own. The collapse of World Com amid allegations of a multibillion-dollar accounting fraud finally broke Republican resistance in early July. The Bush Administration and the Republican Congressional leadership sought to neutralize the scandals as a potent November 2002 election issue, substantially accepting corporate governance reform as the price. Senate Democrats pushed through the most comprehensive corporate governance reform in the United States since the 1930s with the passage of the Sarbanes-Oxley Act of 2002. In the words of one Republican staffer on Capitol Hill, "Congress didn't pass Sarbanes-Oxley, WorldCom did."¹⁵

¹⁵ Interviews, Washington, DC, March 2004. Interviewees inside and outside of government unanimously agreed that the World Com collapse broke Republican resistance to the Sarbanes bill.

Sarbanes-Oxley imposed a host of new requirements on publicly traded corporations, directors, corporate managers, accountants, and attorneys. The law expanded the SEC's authority and mandated the drafting of a host of new regulations governing accounting, auditing, financial disclosure, codes of ethics, risk management, and the internal governance structures and practices of public firms. Most prominently, Sarbanes-Oxley created the Public Company Accounting Oversight Board (the PCAOB), an entirely new private regulatory body appointed and overseen by the SEC, to enforce a new set of prescriptive regulations governing accounting standards and the activities of accounting firms in auditing and consulting. The creation of the PCAOB, though a private non-profit entity, represents the federalization of accounting regulation, the displacement of the Financial Accounting Standards Board (FASB) as the primary accounting rulemaking body, and the end of the predominantly self-regulatory character of the accounting profession.

The second path-breaking aspect of the Sarbanes-Oxley Act is its intervention in the *internal* structure and affairs of the corporation—the first time federal law directly encroached on the traditional preserve of state corporation law.¹⁶ Similar to recent German reforms (discussed below), Sarbanes-Oxley strengthened the independence of the board and its control over external auditing. Public firms are now required to appoint an auditing committee comprised *entirely* of independent directors and at least one member must be qualified as a financial expert. The audit committee now has direct responsibility for the appointment, compensation, and oversight of the outside auditors, as well as approval of all auditor services. Auditors now must report directly to the board audit committee, which must resolve any disputes between management and the auditors concerning

¹⁶ The Sarbanes-Oxley Act also increased civil and criminal penalties for a host of securities law violations, and extended the statute of limitations for security fraud suits, but the most important provisions of the Act were directed at the accounting industry and the structure of the corporation.

financial reporting. The Sarbanes-Oxley Act also mandated enhanced internal and external monitoring, and certification of CEOs and CFOs as to the accuracy of the corporate balance sheet. This unprecedented—and underreported—federalization of corporate law represents a sharp break with nearly two centuries of American federalism and suggests the increased prominence of structural regulation as a governance mechanism in the United States.

The Sarbanes-Oxley reforms were an exercise in damage control and the rehabilitation of systemic legitimacy (usually referred to as “investor confidence”) motivated by political opportunism and blame avoidance. The Sarbanes-Oxley Act reflects no elite consensus or coherent long-term policy agenda. The political process was a sudden, reactive, and episodic response to scandal, popular outcry, and fears of systemic crisis. Divisive party and interest group politics within a fragmented and veto-prone political structure meant that the window of opportunity would last only as long as the crisis that opened it.

Following the passage of Sarbanes-Oxley, the focus of regulatory politics moved from Congress to the SEC. In enacting the Sarbanes-Oxley Act, Congress substantially expanded the jurisdiction and powers of the SEC, but placed the agency in the middle of intense political conflicts. These conflicts, in addition to a series of public gaffes and political missteps, ultimately forced SEC Chairman Harvey Pitt’s resignation.¹⁷ However, the continuing disclosure of scandals within financial markets and

¹⁷ Pitt, President Bush’s appointee to succeed Levitt as head the SEC, had been a prominent securities lawyer on behalf of major accounting firms in private practice and his efforts to minimize the significance of the corporate scandals and to limit legislative reforms were regarded as suspect and illegitimate by reformers and, increasingly, by the public at large. The struggle over accounting regulation and appointments to the PCAOB ultimately resulted in the resignations of Pitt and the first Chairman of the Accounting Oversight Board, former FBI and CIA Director William Webster who was found to have been a director of a corporation charged with financial improprieties.

institutions raised the profile and importance of the SEC under Chairman William Donaldson (Pitt's successor) to its highest level in decades. But the rebound of SEC influence has stoked rather than subdued political conflicts over reform.

These conflicts culminated in the battle over proposed SEC proxy voting rules giving shareholders greater influence over board nominations and elections. A fundamental flaw of the Sarbanes-Oxley Act is its use of board reform to constrain managerial misconduct without reforming the proxy voting regulations that entrench management domination of boards of directors. In an omission that underscores the persistent structural constraints on the agency of state actors even under crisis conditions, Congress had not addressed the issue of competitive board elections due to its politically explosive nature. (Cioffi, 2005) Business elites, largely acquiescent regarding other reforms, closed ranks against the SEC's threatened change in the structural basis of managerial power. After nearly a year of bitter conflict within the SEC, a combination of business, Bush administration, and Republican opposition in Congress fought the proposal to a standstill. The Republican election victory in November 2004 effectively killed the proposed proxy voting rules—the only corporate governance reform successfully killed since the collapse of Enron in 2001. His political standing and support eroded, SEC Chairman Donaldson resigned in June 2005. The post-Enron era of corporate governance reform was over.

B. GERMAN CORPORATE GOVERNANCE REFORM: THE POLITICAL LOGIC OF SYSTEMIC CHANGE

The German case presents corporate governance reform and the development of finance capitalism as the object of deliberate governmental policy and the product of sustained party and interest groups politics. (Cioffi, 2002b) The substantial and comprehensive transformation of the German corporate governance regime reflects a shift in policy preferences favoring financial modernization dating back to the Helmut Kohl's CDU-FDP government. In the early 1990s, the Kohl government's

policy veered sharply in favor of increased financial market regulation that the CDU leadership accepted as the price of European unity and the EU's single market program to which it was committed. But corporate governance reform would not have gone nearly so far since the mid-1990s without substantial domestic support among powerful interest groups.

By the early 1990s, large segments of the German political and economic elites began to lose faith in the German corporate governance model. By the late 1990s, they became beguiled by the high growth and employment rates, booming stock market, and dynamic high-tech sector in United States. Declining profit margins caused by saturation and excessive competition in traditional bank lending, along with increasing domestic market penetration by British and American investment banks in financial services, triggered a shift in business strategies and policy preferences of most large German universal banks. (Cioffi 2002b) By the early 1990s, large German banks began to appreciate financial system modernization and the cultivation of new financial services capacities as the route to higher profits, returns to equity, and more lucrative international markets. (Cioffi 2002b; Lütz 1996, 2000) The elements of the new business model reinforced one another: more sophisticated market-based financial services would boost bank profits; higher profits would increase returns to equity; these higher returns would raise the price of shares that could then be used to make strategic international acquisitions that would vault German banks into the "bulge bracket" of top international financial institutions. This shift in business strategies altered the banks' policy preferences and mobilized their peak association, the powerful and well-organized BDB, and political allies in support of securities market and regulation reform.¹⁸ Beginning in the early 1990s, pro-EU CDU

¹⁸ The globalization of finance and financial markets also reinforced domestic political pressures for financial and corporate governance reform as Frankfurt sought to remain competitive in retaining and attracting domestic and international capital.

and neo-liberal FDP politicians, large financial institutions, and the banking and finance center of Frankfurt overcame the resistance of the parochial interests of the Länder governments, Länder-based (and regulated) stock exchanges, and small firms and banks. (See Cioffi 2002b; Lütz 1996)

Corporate managers and the leadership of organized labor were divided over corporate governance reform and the development of finance capitalism. Managers of many large German corporations, such as Daimler Benz and Siemens, backed much of the reform agenda. These firms now had global operations and were increasingly interested in tapping foreign credit and securities markets that were out of reach so long as the German financial and corporate governance model remained insular and dominated by domestic insiders. Union leaders, including those of IG Metall, Germany's leading industrial union, realized that the German economy had slipped into a structural crisis and required reform to boost competitiveness. Despite some skepticism, labor leaders were largely willing to accept financial system and corporate governance reforms so long as they did not disturb codetermination and collective bargaining arrangements, and did not shift the costs of restructuring onto employees.¹⁹ Shareholders, however, played virtually no political role in the reform of securities and company law—even though these reforms were ostensibly undertaken on their behalf. Quite simply, given Germany's historically undeveloped securities markets and lack of an equity culture of mass shareholding, shareholders were too few

¹⁹ In this sense, German welfare state policy has helped facilitate reform and corporate restructuring. The SPD government accommodated organized labor by extending generous unemployment and early retirement pension benefits to ease the impact of restructuring on the workforce. This helped to shore up the support of its base constituencies and to deflect criticism of pro-finance and pro-shareholder policies. Germany has effectively socialized the risk and costs of restructuring, but at increasingly enormous costs in terms of pension outlays and structural unemployment. (See Streeck 2003)

and too poorly organized to wield significant influence in policy debates. Reforms were almost entirely a top-down process.

The reform of securities law and regulation became a consensual policy among German political and economic elites, and it has proceeded apace since the mid-1990s. The landmark Second Financial Market Promotion Act of 1994 transformed securities regulation and the legal and institutional foundations of German finance.²⁰ The Act replaced the decentralized system of state-level exchange regulators and largely self-regulating stock exchanges with a centralized federal regulator, German Federal Securities Supervisory Office (*Bundesaufsichtsamt für den Wertpapierhandel*, or “BAWe”). Over the remainder of the 1990s further legislation and regulatory rulemaking steadily expanded the agency’s powers and jurisdiction and increased the stringency of disclosure rules and other regulatory standards.²¹ In April 2002, following the election of Schröder’s SPD-Green coalition in late 1998, the process of regulatory centralization reached its peak as the German Parliament consolidated all financial market and services regulation, including the regulation of securities markets, banking, and insurance, and folded the BAWe within one massive agency, the German Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, “BAFin”).²²

²⁰ Second Financial Market Promotion Act (Gesetz über den Wertpapierhandel und zur Änderung börsenrechtlicher und wertpapierrechtlicher Vorschriften, Zweites Finanzmarktförderungsgesetz) of 26 July 1994, Federal Law Gazette, Part I, p. 1749.

²¹ From late 1997 through 1998, another series of Financial Market Promotion Laws and other legislative changes markedly expanded the agency’s role in regulating and policing German securities markets. The BAWe came to oversee the filing of prospectuses, the financial disclosure by public companies, insider trading, and the reporting of voting rights and ownership stakes. It now also supervises financial services providers, stock brokers, the stock exchanges, and cooperates with other national securities regulators. (See Cioffi, 2002b)

²² Law on Integrated Financial Services Supervision (Gesetz über die integrierte Finanzaufsicht (“FinDAG”)), April 22, 2002 (effective May 1, 2002).

With this reform, Germany surpassed the United States in the centralized administration of financial services regulation.

Consensus was far harder to find when policy debate turned to company law reform. The CDU-CSU led coalition balked at more substantial corporate governance reform. Corporate managers were—and remain—both a core constituency of the center-right Christian Democrats. They had been willing to acquiesce in securities law reform, but, nestled within the protective network structure of “German Inc.,” many rejected company law reforms that would more directly reduce their autonomy from shareholders. Opposition was particularly intense among owners and managers of many small and medium sized firms within the *Mittelstand*, often referred to as the backbone of the German economy, who feared that further reforms would threaten family control of firms and their stable sources of credit within the established bank-centered financial system. The Free Democratic Party (FDP) was hamstrung: it was part of a CDU-CSU led coalition that declined to press for reform, but the leadership of Germany’s sole liberal party with historically close links to major banks, favored corporate governance reform.

The center-left Social Democratic Party took up this reform agenda, first in opposition in the Bundestag and then as the governing party under Chancellor Gerhard Schröder. Since the late 1990s, the SPD has used corporate governance reform as the centerpiece of its own policy agenda of economic modernization and to cast the CDU-CSU conservative alliance as the defender of insular managerial elites in an increasingly outmoded and dysfunctional economic model.²³ The SPD claimed a strategic centrist policy position on corporate governance reform that complemented the pursuit of financial system modernization and internationalization by many large banks. The party sought and

²³ See Cioffi 2002b, Höpner 2003. For an excellent account and analysis of the ways in which the Schröder government sought to create a shareholding culture in Germany during the late 1990s, see Ziegler, 2000.

obtained the support of major financial institutions. This placed the conservative CDU-CSU and their neo-liberal allies in the FDP in a difficult position. They had long relied upon the support of business and financial elites, which were now splitting over financial market and corporate governance reform.

Schröder's centrists were able to overcome—for a time—objections from segments of organized labor (particularly the rank-and-file) and traditionalist left-wing factions who were suspicious of Anglo-American "casino capitalism."²⁴ In part, the centrists prevailed because the corporate governance policy agenda appealed to long-standing ideological concerns of the German left. Both the SPD and Green parties have opposed the traditional insularity of Germany's conservative and hierarchical economic elite.²⁵ Corporate governance reform by the SPD leadership appealed to the Greens' ideological preferences for economic decentralization and devolution even though this necessitated regulatory centralization. (Cioffi, 2002b, Höpner, 2003)

In 1998, the SPD, then still in the opposition, took advantage of shifting policy preferences among interest groups to engineer the first major overhaul of company law since 1965. This successful campaign played upon popular resentment of "bank power" among core SPD constituents while casting the party as led by business-friendly pragmatists.²⁶ The proposed legislation put the CDU on the defensive and forced the Kohl government to support a compromise version of the Control and Transparency Act ("KonTraG"), which moderated the anti-bank provisions while

²⁴ Indeed, Schröder's rise within the SPD and his victory in this policy debate indicates the decline of these traditional powers within German social democracy.

²⁵ For an excellent account of this ideological aspect of German social democracy in historical perspective, *see* Höpner 2003.

²⁶ For a detailed discussion of the SPD's pseudo-populist strategy to gain left-wing support for governance reform, *see* Cioffi 2002b.

retaining more important governance reforms.²⁷ The SPD leadership claimed credit as modernizing reformers, maintained credibility with their left wing, painted the CDU as beholden to corporate interests, and cultivated closer relations with the financial sector.

The KonTraG complemented the prior massive overhaul of securities law by addressing issues of bank power, the function of the supervisory board, auditing, share voting rights, stock options, and litigation rules. The law sought to reduce the power of Germany's banks in voting shares and supervisory board representation while strengthening their disclosure and fiduciary obligations to shareholders.²⁸ However, these restrictions were acceptable to the larger financial institutions and fit with their abandonment of the post-war relational banking model. More than four years *before* the passage of the Sarbanes-Oxley Act, German law required the supervisory boards of listed firms to hire and oversee the external auditor instead of the management board.²⁹

²⁷ Corporate Control and Transparency Act (*Gesetz zur Kontrolle und Transparenz im Unternehmensbereich*, "KonTraG") of 27 April 1998, Federal Law Gazette, Part I, p. 786 (Gesetz vom 27.4.1998, BGBl. I, S. 786 vom 30.4.1998). For a political analysis of the KonTraG, see Cioffi 2002b.

²⁸ If the bank's holdings in a listed firm exceed 5% of the corporation's stock, it can vote their own equity stakes *or* vote the proxy votes of the shares deposited by its brokerage customers—but not both. The rules on the voting of shares by banks in corporate decision making were designed to use the traditional bank-centered proxy voting system while allowing alternative mechanisms of proxy voting to emerge (*e.g.*, shareholders' associations). The KonTraG also required banks to disclose all board mandates held by their representatives, their ownership stakes in firms, and alternative ways for their share depositors to exercise their votes. (Seibert, 1998; Cioffi 2002b)

²⁹ The law contains additional auditing reforms to ensure the independence and reliability of auditors. An auditor may not audit a firm if it has earned more than 30% of its revenues from the client over the past five years and must change the signatory of the audit if the same person has signed the report more than six times in ten years. The KonTraG also raised the limitation on auditor

The KonTraG also imposed a “one share, one vote rule” that mandates equal voting rights and abolishes voting caps among shares of common stock, while prohibiting the voting of cross-shareholding stakes above 25% (a blocking minority under German company law) in supervisory board elections. These provisions were designed to prevent managers and minority shareholders from wresting control from the majority. However, by weakening their defensive ownership structures, this new structure of voting rights exposed some German firms to unprecedented threats of hostile takeover—a fact underappreciated at the time but one that would soon prove politically contentious.

Corporate governance reform took an additional leap forward in July 2000 when the Schröder government pushed through a major tax reform law (*Steuerreform*), over strenuous opposition from the Christian Democrats, that *abolished* capital gains taxes on the sale of cross-shareholdings. The reform simultaneously accomplished three goals. First, it further cultivated support of the financial services sector which held a large share of these cross-shareholdings. Second, it provided a means to improve the liquidity of domestic stock markets by increasing the proportion of shares actively traded. And third, it fit within a longer-term strategy of using capital market pressures to force firms to restructure and improve efficiency, both by encouraging the development of securities markets and by undermining the ownership networks that had insulated German corporations from takeovers. (*See Holloway, 2001*)

The takeover vulnerability created by the company and tax law reforms, along with the fear instilled in managers by Vodafone’s hostile takeover of Mannesmann in early 2000, triggered a backlash against the further liberalization of German corporate

liability from 500,000 DM to 8 million DM for listed corporations (2 million DM for unlisted companies). (*Cioffi 2002b*)

governance.³⁰ The growing domestic political conflict over takeovers spilled over into the EU's attempt to adopt Takeover Directive that would have liberalized Europe's market for corporate control. German managers, unionists, conservatives, and left-wing Social Democrats alike mobilized and blocked the directive in the European Parliament in July 2001. This was the first major defeat suffered by the European Commission in pursuit of a single EU market.³¹ A week after the rejection of the EU Takeover Directive, the German cabinet approved Germany's first takeover law, the Securities Acquisition and Takeover Act, designed to facilitate takeovers and a market for corporate control. The same disparate coalition mobilized against the Act.³² The government ultimately diffused the controversy surrounding the Takeover Act by diluting the shareholder-centered approach to takeover regulation in the draft law and the Bundestag passed it in November 2001.³³

³⁰ At the time Mannesmann was taken over, prior to the enactment of the July 2000 tax reform law, corporate Germany appeared unruffled. Interviews conducted by the author, as well as journalistic accounts, indicate that the fears of German managers grew when they considered the cumulative takeover vulnerability created by the KonTraG and tax reform in the absence of alternative anti-takeover defenses. For an excellent analysis of the Mannesmann takeover, *see* Höpner and Jackson, 2001.

³¹ For an extended discussion of the relation between the politics of German corporate governance and the failure of the EU Takeover Directive, *see* Cioffi, 2002b.

³² *See* Braude, 2000a, 2000b; Braude and Hong, 2001, Barbier, 2001; Williamson, 2001; Wood, 2001

³³ Securities Acquisition and Takeover Act (Wertpapierwerbs- und Übernahmegesetzvom) of December 20, 2001, BGBl. 1, 2001, 3822 (effective January 1, 2002); *see also* Ashurst Morris Crisp, 2002 (translation). Rather than enshrining the primacy of shareholder interests in law, the Takeover Act obliges both the offeror and the target's management to disclose information concerning the offer to either the works council or directly to the employees, and it entitles organized labor to two representatives on the government's thirteen-member takeover "advisory board."

After these bitter political conflicts over the basic character of the German economy and the balance of managerial, financial, and labor power, the SPD government retrenched and adopted a corporate governance policy that sought to maintain the balance among contending stakeholder interests. To compensate the unions and left-wing Social Democrats that had supported or acquiesced in pro-shareholder reforms, codetermination legislation passed with government support in 2001 marginally expanded the powers of works councils and makes them somewhat easier for employees to form. This careful balance of stakeholder power with increased shareholder protections was displayed again as the government appointed two successive corporate governance commissions.³⁴ The first, under the chairmanship of law professor Theodor Baums, drew representatives from major interest groups and was charged with drafting a comprehensive code of best practices in German corporate governance. The second commission, the *permanent* Government Commission on Corporate Governance (known as the Cromme Commission) was also largely comprised of peak association and interest group representatives. It adopted a Code of Best Practices and made over 150 recommendations to improve disclosure and transparency; strengthen the role, obligations, and independence of corporate boards; improve external auditing; and modernize corporate finance rules. Most important was a “comply or explain” rule,

³⁴ Much of this account is based on an interview with Theodor Baums, July 9, 2003, Frankfurt. See also Baums Commission Report (*Bericht der Regierungskommission Corporate Governance*), July 10, 2001 (complete official German version available at www.otto-schmidt.de/corporate_governance.htm, English summary available at http://www.shearman.com/publications/cm_pubs.html); Government Commission of the German Corporate Governance Code (Cromme Commission), *German Corporate Governance Code*, adopted February 26, 2002, as amended May 21, 2003 (information and official German version and English translation available at <http://www.corporate-governance-code.de/index-e.html>).

since enacted by Parliament³⁵, that requires firms to comply with the Code of Best Practice or file a public disclosure statement explaining its reasons for not doing so. Tellingly, the politically explosive subject of codetermination was excluded from both commissions' mandates for fear of destroying consensus on all other issues.

The SPD-Green coalition has been forced to confront the political constraints on corporate governance reform. The Schröder government has been fighting an increasingly tense two-front battle, not only against the CDU, FDP, and corporate managers, but also against the SPD left wing and industrial unions opposed to further liberalization of corporate governance and the neo-liberal tendencies of finance capitalism. As in the American case, political conflict intensified and reform slowed when policy began to impinge on the basic allocation of economic power in society. But the serious erosion of the government's left-wing support and sagging SPD electoral fortunes even in core strongholds forced a retrenchment of its reform agenda. As a result, corporate governance reform has fallen off since 2002.

IV. THE COMPARATIVE REGULATORY POLITICS OF CORPORATE GOVERNANCE REFORM

The narrative accounts of corporate governance reform detailed above show that regulatory intervention in the structure and operation of firms and financial markets has undergone remarkable change since 1990. (See Tables 3 & 4) They also highlight a number of important common structural trends in the United States and Germany: (1) regulatory centralization and institutionalization, (2) the displacement of self-regulation by

³⁵ See Transparency and Disclosure Act (TraPuG) (Gesetz zur weiteren Reform des Aktien- und Bilanzrechts, zu Transparenz und Publizität (Transparenz- und Publizitätsgesetz) of July 19, 2002, BGBl. I 2002, 2681.

formal legal rules, (3) the expansion of market facilitating disclosure and transparency regulation, and (4) the use of structural regulation to protect shareholders by altering the corporation's internal form and power relations. These trends demonstrate a significant expansion of state power in the economy and its active reshaping of the private sphere in the age of finance capitalism. They also underscore the decisive importance of the state and the role of the center-left in the politics of reform.

TABLE 3: MODIFIED GOVERNANCE MODELS AND THE EFFECTS OF REFORM IN THE UNITED STATES (1990-2005)

UNITED STATES	
SECURITIES LAW	<ul style="list-style-type: none"> • Institutional investors' governance role strengthened by proxy rules deregulation (1992). • Securities litigation reform limits shareholder fraud suits, empowers institutional investors as "lead plaintiffs" (1995, 1998). • Transparency regulation strengthened by Regulation FD and other more stringent disclosure, risk management, & certification rules (2000, 2002-2004). • Creation of the PCAOB and assertion of greater federal regulatory control over accounting rules (2002-present). • Enhanced statutory civil & criminal penalties, extension of securities fraud statute of limitations (2002). • Increased SEC enforcement actions (2001-2005).
COMPANY LAW	<ul style="list-style-type: none"> • Spread of state anti-takeover laws (1980s-early 1990s). • Federal law encroaches on state corporate law by requiring greater board independence & control over external auditing, and empowering board to hire own professional staff (2002). • Improved risk management & internal monitoring procedures, certification of accounts and monitoring by CEO & CFO (2002).
LABOR LAW	<ul style="list-style-type: none"> • No significant change.

TABLE 4: MODIFIED GOVERNANCE MODELS AND THE EFFECTS OF REFORM IN THE GERMANY (1990-2005)

GERMANY		
SECURITIES LAW	<ul style="list-style-type: none"> • Centralization and increased stringency of securities regulation under jurisdiction of a single federal regulatory agency. • Creation and steady strengthening of disclosure rules. 	<ul style="list-style-type: none"> • Increased transparency & financial reporting by public firms. • Banks increasingly focused on securities markets & financial services.
COMPANY LAW	<ul style="list-style-type: none"> • Restructuring of supervisory board responsibilities for auditing and risk management. • Institution of one share-one vote rule. • Takeover law allows some anti-takeover defenses. 	<ul style="list-style-type: none"> • Strengthens transparency & rights of small shareholders. • Bars golden and shares and voting caps—empowers both minority and controlling shareholders. • Stakeholder system of representation & governance preserved.
LABOR LAW	<ul style="list-style-type: none"> • Works council codetermination modestly strengthened by making election easier & expanding consultation rights. 	<ul style="list-style-type: none"> • Too early to tell effect; likely to be marginal.
ENFORCEMENT MECHANISMS	<ul style="list-style-type: none"> • Securities regulator given formal investigative powers. • Marginal strengthening of private litigation rules. 	<ul style="list-style-type: none"> • Increased regulatory enforcement of securities regulation. • No significant change in private litigation (though more suits filed after stock market crash of 2000).

Corporate governance reform in these very different political economies highlights the central role of state actors in institutional change and the restoration of systemic legitimacy. State actors play central coordinating and policy formulation roles in the development of institutional and regulatory structures on which sophisticated modern markets depend. Internal division, uncertainty, and loss of legitimacy under crisis conditions prevented interest groups from blocking reform but also from proposing coherent policy solutions. Shareholders were simply too weak to drive reform politics and policymaking. These conditions of economic crisis and uncertainty gave political actors greater autonomy in articulating and imposing reform agendas that made use of new regulatory approaches, mechanisms, and institutions to engineer institutional change and regulatory innovation.

The primary political proponents of reform in both the United States and Germany came from the center-left—the Democratic Party in the United States and Germany’s SPD and Green Party. The more conservative Republicans and CDU were generally far more resistant to pro-shareholder reforms. The logic of the political left advancing the cause of shareholders and finance capital appears counterintuitive, but is quite straightforward. (Cioffi, 2002b, 2005; Höpner, 2003; Cioffi and Höpner, 2004) Reform threatened the interests, power, and positions of established managerial elites closely allied with conservative parties. In both countries, conservative parties were the defenders of the managerial elite and the corporate status quo—but circumstances had brought the status quo into disrepute.

Crises opened strategic political avenues to reformist center-left parties. Center-left policymakers embraced corporate governance reform as a means of appealing to middle class voters resentful of economic elites while claiming the banner of reform and economic modernization. The Democratic Party in the United States took this opportunity to attack the Republican’s anti-regulation and pro-manager stance, while appealing to middle class voters and investors who believed in free but *fair* markets. Reform was

popular, consistent with the Democrats' historical support for the expansion of the regulatory state, and put the Republicans on the defensive. In Germany, the SPD's corporate governance reforms satisfied left-wing and populist constituencies by targeting managerial (and to some extent banking) elites, yet also attracted support from the middle class, financial sector, and portions of the managerial elite by promoting policies that promised higher returns to savings and financial capital, more efficient capital allocation and corporate restructuring, and increased rates of growth and innovation.

In both the United States and Germany, governance reform fit surprisingly well with the center-left's ideological and programmatic attempts to reconcile state intervention in the economy with market economics. The Democratic Party and the SPD have both championed the regulatory state to ameliorate market failures and as a counterweight to concentrated corporate and managerial power. Both have an interest in protecting private pension assets on which the middle and working classes increasingly depend for retirement income. The German Greens were likewise attracted to the cause of corporate governance reform and even more driven by the prospect of decentralizing economic power within domestic corporate and financial networks. Governance and securities law reform thus appealed to the center-left's egalitarian ideology and policy agenda. (Höpner 2003; *cf.* Cioffi 2002b) This is a highly simplified sketch of complex party political dynamics. Even so, the general point holds: corporate governance reform—a crucial institutional foundation of finance capitalism—is largely a project of the political left, rather than the ostensibly pro-business or neo-liberal right.

Despite these similarities, however, the Democrats and the SPD advanced their legislative agendas under starkly different institutional and political conditions that yielded fundamental differences in the process and substance of corporate governance reform. The fragmentation of American political institutions and interest groups makes deliberative and sustained reform programs

difficult, if not impossible. These characteristics favor rapid legislative responses and convulsive episodic reforms under crisis conditions. Consequently, the severity of the post-Enron American corporate governance crisis triggered a sudden—and relatively short—episode of reform politics (c. 2002-2004). Reformist Democrats pursued a more activist regulatory agenda as interest groups splintered under economic and political pressure and most Republicans retreated to distance themselves from corruption and misconduct. The reformers' political weakness became evident from their inability to withstand the anti-reform backlash by a resurgent as political alliance of political conservatives and corporate managers against reform as these crisis conditions dissipated. In Germany, "politics as usual" is also often characterized by policy paralysis within a political system that demands consensus. However, shifting policy preferences and the centralization of representation within peak associations, against background conditions of European economic integration and legal harmonization, produced new interest group alignments and party strategies that sustained corporate governance reform for over a decade (c. 1993 to present).³⁶

As the politics of reform differed between the United States and Germany, so did the significance and substance of the policy outcomes. The reforms adopted in these two country cases served fundamentally different ends. The American reforms tended to *reinforce* the shareholder-centered and market-driven characteristics of the established American regime. The innovations of structural regulation were left deeply flawed and incomplete after the defeat of the SEC attempt to reform of shareholder voting and board elections. Though it *may* prove to be a point of departure in a new developmental trajectory away

³⁶ Commitment to European integration played an important role in promoting financial market and corporate governance reform, but support for EU legal harmonization and the Single Market Program did not extend to takeover and company law reform. As shown above, *domestic* politics governed the outcome of these policy debates.

from managerialism, Sarbanes-Oxley does not represent a fundamental break with the established institutional arrangements and power relations of American corporate governance as did the New Deal reforms of the 1930s.

In contrast, the German reforms were *transformative* and fundamentally altered the domestic corporate governance regime. Financial system and corporate governance reform constitutes a major episode of institution building and structural change that reflects a fundamental realignment of domestic political forces.³⁷ German elites sought to systematically restructure their financial and company law systems in response to pressing economic problems. American politicians had no such systemic reform agenda and merely sought an immediate response to the political and economic threats posed by pervasive corporate scandals. If the American corporate governance model has remained more resilient, it is because Germany's had to go through a more substantial transformation to develop the framework of law and regulation necessary for finance capitalism.

The position of labor and employees as stakeholders the most striking difference between the American and German corporate governance regimes. The exclusion of employees and labor interests from the American corporate governance was not even discussed, let alone challenged, in the political debate over reform. Consequently, American corporate governance reform has taken a *shareholder*-centered form. In contrast, German works council reform and the refusal of the government's corporate governance commissions to even address codetermination has preserved Germany's *stakeholder* model. Indeed, these most recent developments reflect the increased importance of firm-level stakeholder governance as a forum for the negotiation of economic conflict. The more consensual and coordinated policy process in

³⁷ The prospect of labor market, pension, and social welfare reforms in Germany under the SPD's "Agenda 2010" further reinforce the impression that the German social market economy is now at a critical juncture.

Germany promoted this more thoroughgoing and longer-term systemic reform, but also required continued accommodation of labor interests. Germany remains a stakeholder model of corporate governance in important ways. Finance capitalism is not the same as shareholder capitalism.

Current political developments point to continued and intensifying political conflict over corporate governance. The erosion of the SPD's base of political support due to struggles over economic reform and economic performance herald increasing conflict over the basic structure and character of German capitalism. The incorporation of pro-shareholder securities regulation and corporate law principles poses a potential threat to the consensual German corporate governance regime and social market economy. These conflicts would threaten the vaunted institutional complementarities of the German model—high-skill, high-wage labor, and high-value added production financed by supplies of “patient capital”—and the comparative economic advantages they confer. Germany's adoption of transparency regulation and company law rules favoring shareholder interests may sharpen conflicts among managers, shareholders, and employees that post-war institutional arrangements ameliorated.

In the American case, the expansion of federal regulatory authority into the traditionally non-federal areas of accounting and corporate law has already intensified political conflict over corporate governance policy. (Cioffi, 2005) Managers, financial institutions, and political conservatives have already begun to attack the Sarbanes-Oxley Act and related SEC rulemaking as excessively costly and damaging to American business. (*Id.*) A backlash against corporate governance reform has gathered force. The fierce battle over shareholder proxy voting, mounting political attacks on other reforms, and the resignation of two successive SEC Chairmen under political pressure indicate that the corporate governance reforms of 2002-2004 established new points of conflict, not a new policy consensus.

Corporate governance reform has become a front in broader political battles over the future of the regulatory state and political economic change. If the 1990s was the decade of faith in financial markets, the turn of the 21st century has ushered in a more sober but also more contentious era of regulatory politics embedded in domestic regulatory politics and legal institutions. This suggests that finance capitalism is less likely than ever to take a single homogenizing form and more likely to develop in nationally distinctive forms. Corporate governance reform has redrawn the political battle lines over regulation, corporate power, and the future of finance capitalism in the United States and Germany. They have not brought a lasting peace.

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