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Corporate Governance After Enron and Global Crossing: Comparative Lessons for Cross-National Improvement

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Corporate Governance After Enron and Global Crossing: Comparative Lessons for Cross-National Improvement

EDWARD S. ADAMS*

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I. INTRODUCTION

Throughout the 1980s and into the early 1990s, stakeholder capitalism was held up by many commentators as the future of American capitalism. In stakeholder capitalism, a broad array of people and groups impacted by a corporation's activities, from employees to the people living in the local community, are considered when making corporate decisions.¹ The type of capitalism practiced in the United States, by contrast, is traditionally termed shareholder capitalism, as the interests of shareholders are the primary concern of corporate decisionmaking.²

Countries such as Japan, Germany, and France were often cited as examples of more "humane" versions of capitalism, usually termed stakeholder capitalism. Often, the ostensible humanity of these systems was argued to also lead to more efficient and productive economies. Germany's legendary *Wirtschaftswunder* ("Economic Miracle"), Japan's similarly extraordinary economic recovery following World War II, and the apparent success of France's centralized management convinced many Americans that they should be looking across the oceans to solve their economic problems. Many American commentators also concluded that Japan, Germany, and France had successfully combined strong economies with job security, healthy wages, and a tight social net. Apparently, it was possible to have your cake and eat it too.

Calls for reform in American corporate governance were especially strong in the early 1980s and the early 1990s when the American economy languished in recession or slow growth, and foreign countries often appeared to be out-performing the U.S.³ In the latter part of the 1990s, however, the situation reversed sharply and criticism subsided as the U.S. experienced strong, sustained economic growth driven by

1. See, e.g., *From Squares to Pyramids: The Best Hope for Japanese Companies Is to Change the Way They Are Run*, *ECONOMIST*, Nov. 27, 1999, at Supp. 11 (discussing the stakeholder capitalism of Japan).

2. See Robert Sobel, *Our Man Flint: Flamboyant Dealmaker Pioneered Big Corporate Combines*, *BARRON'S*, Jan. 12, 1998, at 37 (presenting a colorful history of shareholder capitalism in the United States).

3. See, e.g., ROBERT B. REICH, *THE NEXT AMERICAN FRONTIER* (Penguin Books 1984) (1983).

technology and the growth of Internet commerce. By contrast, Japan's economy has been stagnant for a decade, postunification Germany has experienced its highest unemployment rates since before World War II, and France's economy has languished in similar doldrums. More recently, however, the spectacular wave of dot com bankruptcies and questionable activities surrounding the high-profile Enron and Global Crossing bankruptcies have renewed attention to corporate governance problems in the U.S.

This Article outlines and compares the corporate governance structures of the United States, Japan, Germany, and France. This outline and comparison is made with respect to past, present, and future characteristics and trends. As a cross-national study, it recognizes that the varying natures of differing legal, business, social, and cultural structures significantly affect the degree to which a country can implement changes to its corporate governance systems. This study includes the possibility that one country's corporate model might be inapplicable to another country. Some aspects of American capitalism, nevertheless, are slowly being adopted as improvements in Germany, France, and Japan. Likewise, the U.S. is importing, to some extent, features of other countries' systems.

This Article also analyzes the strengths and weaknesses of corporate governance systems in Japan, Germany, and France. By doing so, a better understanding can be gained of the nature and limitations of America's corporate governance system, its potential for exportation, and its capacity for importing foreign improvements. Likewise, a better grasp can be gained of the nature and limitations of other countries' corporate governance systems, their potentials for exportation, and their capacities for importing foreign improvements. The recent bankruptcies of Enron and Global Crossing are used to illustrate these points.

II. THE HISTORY OF CORPORATE GOVERNANCE IN THE UNITED STATES

A. Combining Large Enterprise, Concentrated Management, and Dispersed Shareholders to Form Large Public Firms

During the formative years of the American corporation in the 1800s, most businesses were local and were funded by a cohesive group of concerned shareholders whom either managed the business themselves or held managers responsible for their duties.⁴ Initially, most states restricted the size and scope of the corporation.⁵ During the last quarter of the 1800s, states began to remove the limitations on incorporation so that businesses could incorporate "for any lawful purpose."⁶ As a result, corporations grew in size and complexity. The first quarter of the 1900s was marked by growth in American business and a separation of ownership from control. In 1930, the corporate paradigm in the United States was described by economists Berle and Means: "[T]he

4. See Robert Charles Clark, *The Four Stages of Capitalism: Reflections on Investment Management Treatises*, 94 HARV. L. REV. 561, 562 (1981).

5. See EDWIN MERRICK DODD, *AMERICAN BUSINESS CORPORATIONS UNTIL 1860 WITH SPECIAL REFERENCE TO MASSACHUSETTS* 269 (1954).

6. Clark, *supra* note 4, at 562 n.4; see also William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 664 (1974).

central mass of the twentieth century American economic revolution [is a] massive collectivization of property devoted to production, with [an] accompanying decline of individual decision-making and control, [and a] massive dissociation of wealth from active management."⁷

Berle and Means "argued that a clear separation had developed between shareholders and management, with shareholders [the individual investor] no longer having any real voice in how the corporation is run [on a day-to-day basis] and with management only theoretically accountable to the board of directors."⁸

The consequence, they argued, is that this separation of ownership and control created the potential for a divergence of interests. Managers may not always work to maximize corporate profit. Instead, they may seek their own pecuniary gain at the expense of shareholders. According to Berle and Means, the effect of this problem of divergent interests is gauged in terms of agency costs, or those costs incurred to fashion institutions and mechanisms that align manager incentives with shareholder preferences.⁹

In an effort to reduce shareholder risk, Berle and Means theorized that an assortment of institutions and mechanisms, both internal and external, could mitigate managerial agency-cost problems and align manager goals with those of shareholders. Internally, for example, the board of directors monitors management's activities. There are also managerial self-oversight programs, incentive programs tying manager compensation to stock price, and a proxy voting system, through which shareholders can challenge managerial initiatives.¹⁰

Externally, the stock market is the principal disciplinary force.¹¹ Corporations are required to disclose corporate financial data;¹² if the public likes what it sees, the stock increases in value and the price goes up. On the other hand, if shareholders are dissatisfied with the corporation's performance, they sell their shares and the stock price falls. In this way, share price acts as a sort of public approval rating.¹³ If the stock

7. Mark J. Roe, *German "Populism" and the Large Public Corporation*, INT'L REV. L. ECON. 187, 188 (1994) (quoting ADOLF A. BERLE & GARINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 129 (rev. ed. 1968)). The model of corporate governance described by Berle and Means has been referred to by one commentator as the "managed corporation." John Pound, *The Promise of the Governed Corporation*, HARV. BUS. REV., Mar.-Apr. 1995, at 89-90.

8. Martin Lipton & Jay W. Lorsch, *A Modest Proposal for Improved Corporate Governance*, 48 BUS. LAW. 59, 60 (1992).

9. See BERLE & MEANS, *supra* note 7, at 129.

10. See Securities Exchange Act of 1934, 15 U.S.C. § 78n (2000) (authorizing the Securities Exchange Commission ("SEC") to develop rules governing the solicitation of proxies). Congress hoped that better disclosure would protect shareholders from management overreaching. See *id.* § 78b.

11. There are also managerial labor markets and capital markets that deny credit to poor managers. The threat of bankruptcy is a further management motivator, but realistically this is not of much consolation to shareholders. By the time management is concerned about bankruptcy, millions of dollars of their money have already been lost.

12. Under the Securities Exchange Act of 1934 a public corporation is required to periodically disclose its finances. The basic forms to be filed with the SEC are Form 10-K, Form 10-Q, Form 8-K, Form 10-C, Form SR. See 15 U.S.C. § 78a (2000).

13. It should be noted, however, that shareholders sell their shares for a variety of reasons.

price falls to a point where a corporate raider believes the company is undervalued and would be more profitable under different management, the raider might attempt a hostile takeover. If so, the raider will offer to purchase from shareholders, at a premium, a controlling majority of the corporation's stock. If the raider is successful in acquiring control, the incumbent managers are usually soon replaced. Hostile takeovers, therefore, tend to give management incentive to keep the company profitable, share price high, and shareholders happy.

In sum, the large American public firm evolved, and prospered as an efficient response to the economics of large-scale organization during the first half of the 1900s. By minimizing agency-cost problems attendant to a separation of ownership and control, corporations in the first half of the 1900s were able to meet the huge capital requirements of modern technology.

This description of the corporation was accurate for most of the 1900s; however, in the 1960s, 1970s, and 1980s, the downfall of the managed corporate governance system became apparent. The model's weaknesses resulted in poor corporate performance; and shareholders, officers, and directors began to demand changes to better equip corporations for the intense competition in the global market.

This discontent with the managed corporation model was founded upon the flood of evidence documenting manager waste and excess despite monitoring devices designed to safeguard shareholder interests. The 1990's best-seller *Barbarians at the Gate*,¹⁴ for example, chronicled the twenty-five billion dollar leveraged buyout of RJR Nabisco ("RJR") and highlighted numerous instances of lavish corporate extravagance at shareholder expense. In addition to an air force of plush corporate jets and dozens of country club memberships for CEO Ross Johnson,¹⁵ RJR's management engaged in more fundamental forms of mismanagement.¹⁶ RJR's own executives conceded before the buyout that with better management, RJR's operation income could be increased "40% in a single year if necessary. Profit margins could be taken to 15 percent from 11. Cash flow . . . could be taken to \$1.1 billion a year from \$816 million."¹⁷ The RJR

Dissatisfaction with a corporation's current management may be one of many reasons for any shareholder's decision to sell.

14. BRYAN BURROUGH & JOHN HELYAR, *BARBARIANS AT THE GATE* (1990).

15. MICHAEL JACOBS, *SHORT-TERM AMERICA* 64 (1991).

16. For example, a trade loading practice caused cigarette wholesalers to carry more product than they could resell promptly. See Carol Loomis, *The \$600 Million Cigarette Scam*, *FORTUNE*, Dec. 4, 1989, at 89, 92. The purpose was to bolster RJR's market share measured at the production level and to accelerate the reporting of operating profits. See *id.* The result, however, was expensive peakloading in the production process and a backlog of stale cigarettes that would eventually reduce RJR's long run profits as consumers switched to better-quality brands. See *id.*

17. BURROUGH & HELYAR, *supra* note 14, at 370-71. Interestingly, after a lengthy bidding war, the leveraged buyout firm of Kohlberg, Kravis Roberts & Co. ("KKR") acquired RJR, installed new management, and dramatically improved RJR's operating performance. Within three years after the buyout, RJR halved its debt, received an investment grade rating for much of its formerly junk-rated bonds, added substantial revenues from new product lines, and received an award for "most improved" company on the 1992 *Fortune* list of "most admired" companies. See Kate Ballen, *America's Most Admired Corporations*, *FORTUNE*, Feb. 10, 1992, at 40, 43.

experience may seem particularly outrageous, but unfortunately, it is not unique.¹⁸

Trends indicate, however, that wealth and management are coming together. A powerful motivating force for the reformation in corporate management styles is the institutional investor.¹⁹ During the 1970s and 1980s, institutional investors amassed large pools of capital for maximizing stock performance for their beneficiaries. As a result, institutional investors' holdings have increased significantly, and have become more concentrated in corporations.²⁰ Institutional investors have the capability to bridge the gap that developed throughout the 1900s between ownership and corporate control.²¹

The presence of these large institutional investors appears to provide the greater impetus and resources needed to monitor directors and ensure management's accountability for its strategies and policies.²² In effect, the increasing presence of

18. For example,

in 1989, the board of Occidental Petroleum voted to spend \$86 million of the company's money to build a museum to house the personal art collection of its chief executive, Armand Hammer. Some of the art was also paid for with corporate money. A substantial amount of the shareholder's money had already been spent on some of Hammer's hobbies, such as Arabian horse breeding, cattle farming, and film production.

JACOBS, *supra* note 15, at 64.

19. There are a number of different types of institutional investors. Public and private pension funds, which invest the retirement savings of America's workers, comprise the largest segment. The second-largest is insurance companies, which invest the vast sums received from premiums so that they will have the money to pay future claims and benefits. . . .

Investment companies, most of which are known as mutual funds, are an increasingly popular mechanism for individuals to purchase stocks. By pooling resources, individuals are theoretically able to attain much of the power available to larger investors.

Id. at 42. Bank trust departments, mentioned earlier, are the banks' remaining direct contact with the securities market. Bank trust funds "manage investments for both individuals and institutional customers, but they do not invest the bank's own capital. Finally, foundations and endowments affiliated with universities and other tax-exempt entities comprise the smallest segment of institutional investors." *Id.*

20. Institutional investors now control about 60% of the stock in the 1,000 largest U.S. corporations, and the control is concentrated among the largest twenty-five institutional investors. See Lorene Yue, *Large Investors Control Market*, DETROIT FREE PRESS, Aug. 20, 1998. "Those 25 largest investors controlled 19.7 percent of total outstanding stock in 1997, up from 16.7 percent in 1996." *Id.* Older reports show that institutional investors are steadily gaining power: Institutional investors went from holding 39% of U.S. public stock holdings in 1976 to 60% in 2002. See John C. Bogle, Remarks Before the 25th Annual Conference of the Association of Investment Management Sales Executives 1 (April 29, 2002), at http://www.vanguard.com/bogle_site/sp20020429.html (last visited April 18, 2003).

21. Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1, 6 (1987).

22. In fact, commentators are acknowledging institutional investor power as one of two factors likely to have the greatest influence on the development of corporate governance. See, e.g., BOARD DIRECTORS AND CORPORATE GOVERNANCE: TRENDS IN THE G-7 COUNTRIES OVER THE NEXT TEN YEARS (1992) [hereinafter BOARD DIRECTORS].

these institutional investors as major shareholders in corporations is causing an evolution in corporate governance, where the board of directors is truly an independent oversight entity that can effectively monitor management. Although mergers and acquisitions are a permanent characteristic in the American capital market, the frequency of these takeovers as a means for shareholders to ensure management discipline is increasingly being replaced by the safeguards that can be exercised by a more vigilant and proactive board of directors. Shareholders are regaining the substantial control they once had over their investment by ensuring that their corporate representatives (the board of directors) are doing their job. However, only the future will tell whether institutional investors will be capable of fulfilling the challenge of being proactive shareholders and energizing boards of directors to achieve greater profitability, stability, and competitiveness within the corporations.

B. Corporate Players and Their Respective Responsibilities

The corporate structure consists of three bodies: shareholders, a board of directors, and officers. A distinctive characteristic of American corporations, as compared to other countries, is that corporate ownership and control are dispersed across a relatively large number of shareholders.²³ One recent study shows, for example, that the mean average percentage of outstanding shares owned by the five largest shareholders in the United States, Japan, and Germany, are 25.4%, 33.1%, and 41.5%, respectively.²⁴

1. Board of Directors

The role of the American board of directors, as in Germany, France, and Japan, is to monitor "management on behalf of shareholders."²⁵ In a majority of state statutes, "the business and affairs of every corporation . . . shall be managed by or under the direction of the board," which is elected by the shareholders.²⁶ Given the complexities of a corporation's day-to-day activities and the infrequency with which boards gather to discuss corporate policy and strategy, top management (led by the CEO), manages the day-to-day and month-to-month affairs. In practice, therefore, the board of directors' primary function has been to select and replace officers.²⁷

Theoretically, directors oversee management's decisions, which includes regularly evaluating its performance and monitoring the strategy and policies the officers seek to

23. Of the top one hundred companies in the United States: seventy-three are widely held and publicly traded; another 25% are closely held and publicly traded; only 2% are privately owned; and, none are owned by the government. *See id.* at 6.

24. *See* Stephen Prowse, *Corporate Governance in an International Perspective: A Survey of Corporate Control Mechanisms Among Large Firms in the U.S., U.K., Japan and Germany*, 4 FIN. MARKETS, INSTITUTIONS & INSTRUMENTS 1, 25 tbl.9 (1995).

25. *Id.* at 28.

26. DEL. CODE ANN. tit. 8, § 141 (2001).

27. U.S. boards have become more directly involved with management succession than at any time in the past. Nearly 75% of U.S. companies recently reported that they have a management succession plan in place and two-thirds of those companies report that their plan was developed by or with the board of directors. *See* BOARD DIRECTORS, *supra* note 22, at 18.

employ for the growth and performance in the corporation. The composition of the board, however, prevents the board from being a critical or contributing force in the formation of policy and strategy. On average, a corporate board in the United States is composed of twelve directors.²⁸ In the past thirty years, inside directors (the management team) have dominated the board, who are chosen by the CEO in the absence of informed shareholder nomination and voting power.²⁹ Even when a board has outside directors, these directors are usually not truly independent because they are in some way affiliated with management as former employees, acquaintances, or relatives. Thus, management's interests on the board have had a significant impact on the functioning of the board.

Qualitative evidence over the years indicates the predominance of inside directors has been the primary cause of ineffective monitoring by boards.³⁰ Even the imperfect independent director is better than a nonindependent director.³¹ The composition of the board, therefore, is a crucial factor for its effectiveness.

In recognition of this fact, more boards are becoming composed of a majority of outside directors with the aim of increasing a board's effectiveness and curtailing management predominance.³² This is occurring primarily because corporations are increasingly realizing that a board's success in performing its roles and responsibilities is largely dependent on its composition.³³ The quest for truly independent and qualified boards of directors will continue to achieve the ultimate goal of safeguarding the interests of stockholders.³⁴

A director's tenure on a board varies depending on the corporation. The longer a director sits on a board, the more knowledge he or she will have. As a result, a longer-term director may become more critical and informed in his or her evaluation of management and strategic policies. Although familiarity may breed contempt, the Harvard University Survey of G-7 country boards indicates that longer board tenures produce higher returns.³⁵

28. Investor Responsibility Research Center, *Study Finds Dot-Com Boards Are Less Independent, in Conflict with Governance Principles*, at http://www.irrc.org/press_releases/01102000dotcom.html (Jan. 10, 2000). In 1991, 77% of the CEOs were also chairmen of the board of their companies. See BOARD DIRECTORS, *supra* note 22, at 10.

29. See Prowse, *supra* note 24, at 29.

30. Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895, 899 (1992).

31. *Id.* at 900.

32. A 1999 study found that 67% of the directors serving on boards of S&P 500 companies are considered independent. Investor Responsibility Research Center, *supra* note 28. See generally *Redraw the Line Between the Board and the CEO*, HARV. BUS. REV., Mar.-Apr. 1995, at 153 [hereinafter *Redraw the Line*].

33. See Black, *supra* note 30, at 900.

34. As of 1995, only 5% of boards reported being actively involved in day-to-day management issues. Boards' involvement is likely to increase, however, over the next decade as a result of growing shareholder activism and the adoption of board policies involving management reviews. See *id.*

35. The Harvard study indicates that an extra five years in average tenure of board members is associated with a 3.9% increase in annual shareholder return over an average ten-year period, which is attributed to the greater experience and the longer-term perspective of directors who have served on boards for a longer period of time. See BOARD DIRECTORS, *supra* note 22, at 23.

Board compensation in the United States is usually based on an annual fee, a per-meeting fee, or an annual fee plus a per-meeting fee.³⁶ The latter was used by 83.1% of companies in 1990.³⁷ Of the top quartile of firms, the average board salary was \$47,187 in 1990.³⁸ From 1987 to 1992, director salaries increased 27%.³⁹ In addition, corporations commonly extend other benefits such as liability insurance, pensions, and medical insurance.⁴⁰

To perform its fiduciary duty to shareholders, a board must have a good understanding of the company's business environment, and it should be informed of corporate operating strategies. Although the primary source of information is the firm's own management, 70% of American firms do rely on outside sources of information.⁴¹

In addition, a director owes shareholders the fiduciary duties of due care, loyalty, candor, and obedience. Although subject to personal liability for a breach of their fiduciary duties, directors have been insulated from liability through the judicially created "business judgment rule," which creates a presumption that a director exercises due care when making business decisions, unless proven otherwise.⁴² Therefore, the board of directors has essentially been insulated from liability absent some egregious error⁴³ or the lack of due care with respect to the decisionmaking process.⁴⁴

2. Shareholders

Shareholders are the owners of the corporation, making them primarily responsible for electing the directors. Theoretically, because shareholders exercise ultimate control over the board of directors through board elections, shareholders also control management. In reality, however, individual shareholders have often been unable to perform the role of monitor and final decisionmaker because of collective action problems.

The twentieth-century managed corporation model amassed corporate wealth in the hands of shareholders. Shareholders, however, have typically been merely passive investors whose economic success or failure depends upon the officers who managed and controlled the corporation.⁴⁵ Individual shareholders of many large corporations owned too few shares to act independently and were so dispersed that the costs of attempting to gather and discuss corporate strategy and policy were too high for a private, individual stockholder to incur. An individual with modest share ownership will be more inclined to sell his or her shares than get involved with the costs of communication and negotiation between a body of diverse and dispersed shareholders. Therefore, the representation of shareholder interests on boards dramatically declined

36. *See id.* at 34.

37. *See id.*

38. *See id.* at 35.

39. *See id.*

40. *See id.*

41. Trends indicate that the use of outside information sources is likely to increase with external pressures and the rapidly changing business environment. *See id.* at 21.

42. *Aronson v. Lewis*, 473 A.2d 805, 813 (Del. 1984).

43. *See Litwin v. Allen*, 25 N.Y.S.2d 667, 699 (N.Y. Sup. Ct. 1940).

44. *See Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

45. *See Pound*, *supra* note 7, at 90.

in the last thirty years.⁴⁶

With the increasing concentration of the institutional investors' holdings, however, stockholders may be gaining a renewed influence. Ostensibly, management should be more perceptive to shareholder interests aggregated in large units.⁴⁷ If institutional investors can group their shares together and more frequently reach common interests and goals, shareholders should have more power to impact the corporation, influence its direction, and improve its performance.⁴⁸ To facilitate this trend, many practitioners and commentators are looking abroad for alternative models of corporate ownership and control.

3. Officers

Officers of a corporation are elected by the board of directors. Typically, they include a chief executive officer ("CEO") and a chief financial officer ("CFO"). Since the first quarter of the twentieth century, the power of the corporation has been concentrated in the officers of the corporation. The CEO's dominance is a key characteristic of large American firms, especially compared to foreign corporations.⁴⁹ The American CEO dominates the internal organization of the firm, as well as the board of directors.⁵⁰

Evidence of management's shortcomings under the managed corporation model is scattered throughout academic journals and contemporary business literature.⁵¹ In *Business Week's* 1992 review of executive salaries, one commentator complained that:

To get into 1992's Top 10, a chief executive had to make more than \$22.8 million. For all the talk of boards of directors cracking down on excesses, for all the prodding of activist shareholders, for all the disclosure rules passed by the Securities & Exchange Commission, CEO pay continues to climb to ridiculous heights. Just how many tens of millions of dollars are needed to motivate CEOs to do their jobs properly?⁵²

46. In 1986, for example, major shareholders were directly represented on the boards of only 31% of the large U.S. corporations, and individual investors were directly represented on the boards of 8%. See BOARD DIRECTORS, *supra* note 22, at 10.

47. In a recently published survey, 61% of CEOs reported that they now "regularly hold meetings with their institutional investors." *CEOs Don't Seek Shareholder Input*, INVESTOR REL. BUS., Nov. 1, 1999, available at 1999 WL 5954481. However, the survey also reported that only "45% of the respondents have an 'active' shareholder relations program, down from 55% in 1997." *Id.*

48. A 1999 study revealed that CEOs are becoming responsive to interested shareholders. On four key issues, most CEOs agree with corporate-governance reforms being pushed by shareholder activists. There is agreement on increasing outside directors, formalizing evaluations of both CEO and board performance, and limiting the number of boards on which directors can serve. See *Meeting of Minds*, INDUSTRY WEEK, Nov. 15, 1999, at 10.

49. See Roe, *supra* note 7, at 188.

50. See Pound, *supra* note 7, at 90.

51. See, e.g., Black, *supra* note 30, at 895.

52. *Executive Pay: It Doesn't Add Up*, BUS. WK., Apr. 26, 1993, at 122. CEO salaries continue to grow at an incredible rate. See *id.* The 1992 average salary of a large U.S.

The justification offered for these sums, which are even larger today, is that CEOs are delivering great value to their shareholders. Indeed, some are. Often, however, high executive salaries "bear[] no relationship to the performance of the companies they run" ⁵³ Moreover, the disparity between the executive suite and the shop floor continues to widen. Today, the average American CEO makes over four hundred times the average worker's salary, and the disparity continues to grow. ⁵⁴

Theoretically, the board of directors and shareholders should check management's powers and activities. In reality, however, they have typically failed. Board members elected at the direction of the management by passive shareholders feel beholden to management and too frequently see no problems, shy away from tough questions, and, in some cases, just do not work very hard. ⁵⁵ Shareholders similarly exercise little protection from abusive management. Historically, the sole means to directly alter the management of a firm involved the use of the proxy fight. The collective action problems attendant to mobilizing a vast number of shareholders for such a contest, however, is well documented. ⁵⁶ Moreover, the proxy rules promulgated by the SEC are complex and frequently expensive. ⁵⁷ The ineffectiveness of proxy contests as a monitoring device is evidenced by the fact that approximately "99.65% of corporate boards are elected in uncontested proxy solicitations." ⁵⁸

The external pressure of the capital market has also failed to distinguish itself as an effective disciplinary mechanism. While executives do worry about their firm's stock price, this concern does not always lead to long-term excellence. In fact, the reverse is

corporation CEO was nearly four million dollars. *See id.* In 1998, the average salary was over ten million dollars. *See* Tim Smart, *Worker-Executive Pay Gap Growing with Economy*, ARIZ. REPUBLIC, Aug. 30, 1999, at A1. Gains in stock value accounted for many of the biggest annual payouts in 1998, such as the \$575 million paid to Disney's Michael Eisner, or the \$167 million paid to Citigroup's Sanford Weill. *Id.*

53. Steve Lohr, *Recession Puts a Harsh Spotlight on Hefty Pay of Top Executives*, N.Y. TIMES, Jan. 20, 1992, at A1.

54. *See* Robin Goldwyn Blumenthal, *Review & Preview*, BARRON'S, Sept. 6, 1999, at 10. "CEOs at major companies brought home average compensation packages of \$10.6 million in 1998, up 36% from 1997. Worker pay, meanwhile, averaged a paltry \$29,267, only 2.7% more than in 1997." *Id.* "[T]he ratio of top executive to factory worker pay has exploded this decade from 42 to 1 in 1980 to 419 to 1 [in 1998]." Smart, *supra* note 52, at A1.

55. *See* JAY W. LORSCH & ELIZABETH MACIVER, *PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS* (1989). For example, where was the board during RJR Nabisco's dark years? For all practical purposes, nowhere. The board played a passive, rubber stamp role at RJR Nabisco—a role made more comfortable by generous perquisites granted by management. *See* Daniel Wise, *The Ethics of 'Barbarians': Should Dual Roles be More Closely Scrutinized?*, N.Y.L.J., Aug. 30, 1990, at 5. CEO Johnson extended lucrative consulting and service contracts to several directors, and sent company business to a bank run by another. *See id.* Although such arrangements are generally legal, and can even benefit a corporation, they are also frequently subject to the discretion of the CEO. *See id.* In the case of RJR, the perquisites may have pacified board members and made them less critical of managements' behavior.

56. Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 862-63 (1993); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 543-44 (1990).

57. *See* Black, *supra* note 56, at 531-32.

58. Grundfest, *supra* note 56, at 862.

often the case.⁵⁹ Often, capital market signals are unclear, and arrive too late to have any meaningful effect. Ironically, management's reaction to falling share price may be precisely the wrong one. One common erroneous response is to cut back on investment or research and development in the hope of artificially improving the next quarter's earnings. In addition, despite the ostensible construction of "Chinese walls" between analyst and investment banking operations in large financial institutions, the threat of losing investment banking revenues due to less than glowing analyst reports persists.

From the 1960s through the early 1980s, the only real check on management power came in the form of threats of corporate takeovers.⁶⁰ The 1980s takeovers, however, only exacerbated the untouchability of most corporate management.⁶¹ As Professor Grundfest states: "The takeover wars are over. Management won."⁶² Since the 1980s takeover wave, managements have constructed innovative judicial and legislative roadblocks to hostile tender offers.

On the judicial front, the courts upheld the use of shareholder rights plans and poison pills by incumbent management to fend off takeover attempts.⁶³ The American courts affirmed the right of officers to defend against the hostile takeovers even though the actions necessary to prevent a takeover were contrary to the shareholders' pecuniary interests.⁶⁴ In effect, officers are permitted to protect their own positions with the corporation and personal careers at the expense of the shareholders' financial gain—contrary to the stated objective of enhancing shareholder gain espoused by many state corporation statutes. One commentator, for instance, notes that this broad grant of discretionary power to management was far greater than what many people thought was appropriate.⁶⁵

59. See Jonathan Charkham, *The American Corporation and the Institutional Investor: Are There Lessons from Abroad?*, 1988 COLUM. BUS. L. REV. 765, 768-69. Current data suggests that CEOs who use slash and burn techniques are rewarded well, regardless of their strategy's long-term consequences. See Sarah Anderson & John Cavanagh, *CEOs Win, Workers Lose; How Wall Street Rewards Job Destroyers*, at <http://www.corpwatch.org/corner/glob/ips/ceo.html> (accessed on Mar. 25, 1999).

60. See Lipton & Lorsch, *supra* note 8, at 59.

61. See Norma M. Sharara & Anne E. Hoke-Witherspoon, *The Evolution of the 1992 Shareholder Communication Proxy Rules and Their Impact on Corporate Governance*, 49 BUS. LAW. 327, 330-31 (1993).

62. Grundfest, *supra* note 56, at 858. The takeover-threat has, however, begun to resurface. "Surprisingly, 64% of CEOs [in 1999], up from 59% and 47% in 1997 and 1995 respectively, saw an increased threat of hostile takeover attempts." *CEOs Don't Seek Shareholder Input*, *supra* note 47.

63. See *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1153-54 (Del. 1989), *aff'g* 1989 Fed. Sec. L. Rep. (CCH) ¶ 94,514 (Del. Ch. July 14, 1989). In *Paramount*, the Delaware Court of Chancery held that even an adequately priced, noncoercive tender offer can constitute a threat warranting the defensive use of a poison pill. *Id.* In one of its many manifestations, a poison pill is a threat by the target corporation that "if any bidder acquires a certain percentage of its shares," the target will sell new shares at half-price "to dilute the bidder's financial interest and voting power and deter it from raising its stock holding" percentage for as long as the poison pill is in effect. Edmund Kelly, *Rx for Corporate Directors This Proxy Season*, LEGAL TIMES, Mar. 30, 1992, at 27.

64. See *Paramount*, 571 A.2d at 1140.

65. Rob Norton, *Who Owns this Company, Anyhow?*, FORTUNE, July 29, 1991, at 132

Legislatively, corporations were successful in lobbying for stronger state antitakeover statutes to further insulate management from accountability.⁶⁶ In effect, these statutes obstruct a company's owners from protecting their investments by preventing efforts to replace incompetent and ineffective management.⁶⁷ Although they differ in their details, all antitakeover statutes afford management added discretion when choosing to resist an unwelcome tender offer. While some observers may applaud the diminished importance of takeovers on the corporate governance scene,⁶⁸ their exit leaves managers largely impervious to shareholder or outside investor challenges. It appears that "the walls around the corporate castle are higher now, and the moat wider, than ever before."⁶⁹

Finally, the demise of the junk bond market "further insulated corporate management" from challenges.⁷⁰ These instruments had served as the primary financing vehicle used for takeovers. Moreover, the 1987 stock market plummet associated with "Black Monday" added instability to a corporate America that was already precipitously indebted from a wave of highly leveraged acquisitions.⁷¹ As a result, the CEO presently retains full control over a corporation's destiny, with only superficial checks on his or her power in the widely dispersed, passive shareholders and the pro-CEO board of directors.

C. Four Decades of Impact on Corporate Governance in the United States

1. From the Nineteenth Century to the "Takeover Era"

The separation of management from investors in the early 1900s began moving American corporate governance down a path that was eventually "eclipsed by the hostile takeovers and the transaction-based market for corporate control."⁷² Starting in the 1960s, shareholders unable to exert influence on unresponsive management used takeover bids as a powerful instrument of displacement.⁷³ These takeover mechanisms

(quoting professor of law at Stanford and former SEC Commissioner Joseph A. Grundfest).

66. See Brett Duval Fromson, *The Big Owners Roar*, FORTUNE, July 30, 1990, at 66.

67. According to Robert Monks, the former ERISA chief at the Department of Labor who advises institutional investors, "These decisions make you sick to your stomach. They essentially strip away the rights of the shareholder and turn common stock into junk stock." *Id.* at 67 (quotations omitted).

68. See John C. Coffee Jr., *The Uncertain Case for Take Over Reform: An Essay on Stockholders, Stakeholders and Bust-Ups*, 1988 WIS. L. REV. 435, 441-43 (1988); Steven A. Rosenblum, *Proxy Reform, Takeovers, and Corporate Control: The Need for a New Orientation*, 17 J. CORP. L. 185, 187-92 (1991).

69. Chancellor William Allen, *Corporate Directors in the Dawning Age of Post-Managerialism*, Address Before Stanford University Center for Economic Policy Research Conference on Corporate Governance: New Problems and Solutions 10 (May 1, 1992).

70. Sharara & Hoke-Witherspoon, *supra* note 61, at 331.

71. See Fromson, *supra* note 66.

72. John Pound, *The Rise of the Political Model of Corporate Governance and Corporate Control*, 68 N.Y.U. L. REV. 1003, 1008 (1993) (quotations omitted).

73. Walter Werner, *Management, Stock Market and Corporate Reform: Berle and Means Reconsidered*, 77 COLUM. L. REV. 388, 403 (1977).

became viable as dissatisfied shareholders drove stocks downward by selling off their shares of stock.

Although the ostensible central objective of corporations is to enhance corporate profit and shareholder gain, the defensive posture adopted by corporations in the later half of the 1900s influenced boards to emphasize maintaining the life of the corporation. Moreover, the focus on the single event transaction deemphasized long-term investment and, consequently, diminished future earnings. Consequently, this period of fixation on takeover defenses and short-term profit maximization was dubbed simply as the "takeover era."⁷⁴

2. From Decline to Renewal in Corporate Governance?

Economic indicators show that American competitiveness in the last fifteen years has either stagnated or declined relative to other countries.⁷⁵ Throughout the 1980s, the United States lost market share in virtually all industries, from mature industries such as automobile manufacturing to high-technology sectors "that will define the information age."⁷⁶ Correspondingly, the quality of life for many Americans has also declined, resulting in far-reaching societal effects. In the face of declining profits, layoffs, shrinking wages, rising health care costs, and degenerating neighborhoods, news of corporate opulence and astronomical executive compensation is not only unseemly, it points to a deeper structural pathology.

Management, as a constituency interested in its own welfare, appears to have grown too powerful.⁷⁷ The existing institutions and mechanisms developed to protect shareholders against managerial abuse have proven largely ineffective. Too often, boards of directors are simply figureheads that rubber-stamp management initiatives. The evidence of reckless corporate behavior characteristic of the managed corporation is difficult to digest in an increasingly competitive global economy, especially during economic downturns.

As a result of these aggregate trends, American corporations in the 1990s are in search of new corporate governance models to improve performance in the face of

74. See James M. Tobin, *The Squeeze on Directors—Inside Is Out*, 49 BUS. LAW. 1707 (1994). Also, for purposes of comparison, the frequency of takeovers that are motivated by managerial failure is one of the starkest differences between the U.S. financial system and Germany and Japan. See Prowse, *supra* note 24, at 46. Empirical evidence supports the claim that mergers and acquisitions in Japan and Germany are significantly lower than in the United States. See *id.* at 46-47. In a 1993 study, "just over [two percent] of large Japanese firms [were] taken over or merged between 1980 [and] 1989, in contrast to over [twenty-two] percent of large U.S. firms." See *id.* at 33. With respect to Germany, United States takeover rates are between fifteen and twenty times more frequent than in Germany. See *id.* at 33. As of 1993, "since [World War II], there have only been four successful hostile takeovers in Germany [and] they appear to be almost as rare in Japan." See *id.* at 35.

75. U.S. DEPARTMENT OF COMMERCE, TECHNOLOGY ADMINISTRATION, U.S. REPORT CARD TRENDS, EMERGING TECHNOLOGIES: A SURVEY OF TECHNICAL AND ECONOMIC OPPORTUNITY xiii (1990).

76. JACOBS, *supra* note 15, at 3.

77. See JOSEPH GRUNDFEST, *THE SUBORDINATION OF AMERICAN CAPITAL 1* (John M. Olin Program in Law and Economics Working Paper Series, 1990).

international competition and merger and acquisition activity.⁷⁸ Some commentators, however, still believe that the inability of a dominant entity to control a large enough portion of a corporation will continue to make takeovers a crucial disciplining device.⁷⁹ These commentators believe the status quo will be challenged. The impetus for change is the increased activism of institutional shareholders with a greater concentration of ownership and reenergized, independent boards.

New corporate governance schemes, however, are just beginning to focus on the increased role of the board of directors, which must take a proactive role in fulfilling its responsibilities. Ideally, the board should more closely monitor managers and oversee strategy and policy. Through increased activism, internal corporate control mechanisms can be strengthened, in turn vitiating the historical purpose of takeovers. New corporate governance structures are, in fact, more like the ones envisioned in statutory models.⁸⁰

Lessons of repeatedly failed corporate undertakings point to four main conclusions that should guide the formulation of a new American governance model.⁸¹ First, past failures teach the importance of a strong, independent, and informed board capable of evaluating management performance.⁸² Second, boards must actively participate in the development of long-term corporate strategy.⁸³ Third, management must strictly comply with codes of conduct. But this compliance must not deter the degree of flexibility and risk-taking necessary for peak management performance.⁸⁴ Fourth, it must be remembered that corporate performance is not a function of corporate governance alone.⁸⁵

The following discussion outlines a current proposed model for corporate governance designed to deal with the global market of the twenty-first century. In this model, institutional investors stand as the shareholders who can make directors accountable, as well as strengthen their role as a check and balance against management decisions.⁸⁶ The competitive success of German and Japanese firms lends credence to the notion that the American corporate governance system of strong

78. See, e.g., Michael C. Jensen, *Eclipse of the Public Corporation*, 67 HARV. BUS. REV. 61, 61 (Sept.-Oct. 1989) (discussing the virtues of the takeover era for corporate America's health).

79. See MICHAEL C. JENSEN, *Takeovers: Their Causes and Consequences*, in FOUNDATIONS OF CORPORATE LAW 234 (Roberta Romano ed., 1993); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1169 (1981).

80. See Pound, *supra* note 72, at 1006.

81. See BOARD DIRECTORS, *supra* note 22, at 29-30.

82. See *id.* at 29.

83. See *id.* at 30.

84. See *id.*

85. See *id.*

86. Professor John Pound of Harvard University proposed a corporate governance paradigm called the political model. See Pound, *supra* note 72, at 1007. He analogized this model with the model of governance found in the public sector. *Id.* In the political model "active investors seek to change corporate policy by developing voting support from disperse shareholders, rather than by simply purchasing voting power or control" through a takeover. *Id.* Moreover, within this model, "[i]nsurgents use public processes to educate voters and to propose alternatives to the policies of incumbents" thereby engendering and promoting "an informed, participatory, and substantive approach to oversight of management." *Id.*

management and weak shareholders can be improved.⁸⁷ Moreover, evidence suggests that institutional oversight of management can add significant value.⁸⁸

D. Moving From a Managed Corporation to a Governed Corporation

From the time of Berle and Means' commentary through the 1980s, corporate America was governed by a system referred to as "the managed corporation."⁸⁹ The managed corporation model focused on the power of management, and its ultimate responsibility if the corporation succeeded or failed.⁹⁰ It was the board of director's duty to hire the best officers and then submit to their strategies and policies without providing objective analysis or critiques.⁹¹ Shareholders were merely silent partners who were expected not to handle corporate affairs.⁹²

As a result, this model allowed mistakes or improper policies or strategies to go uncorrected until major damage was caused. Therefore, this model fostered "an unstable cycle of silence and crisis,"⁹³ as there were no checks on the management's decisionmaking.⁹⁴ One commentator argues that this model is outdated for handling today's business environment, where competition is so fierce that major mistakes in corporate strategy can be devastating.⁹⁵ Absent from the managed corporate model was a system to ensure that decisions are made effectively.

The governed corporation offers significant advantages over the managed corporation system. Principally, and unlike the managed governance system, it focuses on maintaining an effective and accountable decisionmaking process. The governed corporation requires management and a truly independent board featuring a strong presence of outside directors to collaborate on strategy and policy, and to actively seek input from shareholders.⁹⁶ SEC chairman Richard Breeden aptly refers to an empowered board as "the linchpin of our system of corporate governance, and the foundation for the legitimacy of actions taken by management in the name of the shareholders."⁹⁷ It should be noted, however, that corporate governance and the board's role affect corporate performance only insofar as they actually influence management decisions. Therefore, corporate performance is enhanced "by a proactive board that cooperatively and constructively works along with management to formulate and implement strategic corporate plans."⁹⁸

Because the governed system theoretically mandates open lines of communication

87. Black, *supra* note 30, at 896.

88. *See id.* at 898.

89. *See* Pound, *supra* note 7, at 90.

90. *See id.*

91. *See id.*

92. *See id.*

93. *Id.* at 91.

94. *See generally* Pound, *supra* note 7.

95. *See id.*

96. *See id.*

97. Lipton & Lorsch, *supra* note 8, at 62 (quoting Richard C. Breeden, Chairman, Securities and Exchange Commission, Corporate Governance and Compensation, presented at Town Hall of California, Los Angeles, California (June 1992)).

98. BOARD DIRECTORS, *supra* note 22, at 27.

between informed bodies, it should be able to address specific problems internally without imposing changes in control, changes in management, or the enormous transaction costs underlying takeover control mechanisms.⁹⁹ Instead of blaming the CEO or other officers, this system seeks to work together to find solutions. By acting early and effectively, directors may prevent a small problem from turning into a major crisis. Moreover, because the board of directors has expertise and knowledge to contribute to the corporation's performance, the governed model is potentially less disruptive and possibly more specialized.¹⁰⁰ Perhaps most importantly, this corporate system can increase a corporation's long-term sustainability.¹⁰¹

To implement this governance strategy, corporations must redefine the roles and responsibilities of the corporate entities so that they use the informed involvement of all three bodies. To the extent possible, directors should be empowered to help managers make the best possible decisions and be proactive and effective in the policy making process. As Chancellor William T. Allen, Delaware Court of Chancery, notes:

The conventional perception is that boards should select senior management, create incentive compensation schemes and then step back and watch the organization prosper

This view . . . is, in my opinion, badly deficient. It ignores a most basic responsibility: the duty to monitor the performance of senior management in an informed way. Outside directors should function as active monitors of corporate management, not just in crisis, but continually; they should have an active role in the formulation of the long-term strategic . . . goals; they should as well engage in the periodic review of the short and long-term performance according to plan and be prepared to press for correction when in their judgment there is need.¹⁰²

Many scholars are positing that major shareholders may fulfill the idealized role of the true authorities that are able to speak directly to management and directors about their critique of corporate policies and strategies. By redefining shareholder and director responsibilities and duties along these lines, the governance scheme should foster debate, bring in better information, offer new perspectives, and reduce false consensus and insularity.¹⁰³

The evolution of American corporations in the 1990s makes the reformation to a governed corporation possible. Ownership has become more concentrated into the control of large institutional investors, which have the motivation to protect their interests by influencing corporate policy. In sum, "[t]he board will function as a team,

99. *See id.*

100. *See id.*

101. *See* Pound, *supra* note 72, at 1009 (stating that the new corporate governance is politically sustainable because it "accords with American values about how major institutions in our society should be governed, emphasizing due process, substantive debate, and the use of formal voting referenda").

102. Chancellor William T. Allen, Delaware Court of Chancery, *Redefining the Role of Outside Directors in an Age of Global Competition*, presented at Ray Garrett, Jr., Corporate Securities Law Institute, Northwestern University, Chicago (Apr. 1992), *quoted in* Lipton & Lorsch, *supra* note 8, at 62

103. Pound, *supra* note 7, at 94.

shareholders will have input, and the company that can make quick and relatively painless midcourse corrections rather than suffering decline and crisis" in the new corporate paradigm.¹⁰⁴

1. The Case for the Role of the Institutional Investor in the Governed Corporation

Many commentators now look to the institutional investor to lead the way in the move to a governed corporate system of corporate control. As mentioned above, institutional investors have increased both their overall holdings and the concentration thereof, especially in specific blue chip companies.¹⁰⁵ Not only do many institutional investors own enough stock to have some controlling influence in their roles as shareholders, they have business and financial incentive to be critical shareholders looking out for the corporation's best interest. With the increased holdings of trillions of dollars in debt and equity investments, institutional investors are less flexible in their ability to divest from large equity interests.¹⁰⁶ Institutional investor funds are, therefore, locked into holdings on a longer-term basis.¹⁰⁷

Proponents for change in corporate governance view this development as crucial. Concentrated ownership allows the few institutional investors (as opposed to the scattered, thousands of relatively uninformed individuals) to take a more active interest in corporate governance as a means of exerting pressure on management to improve performance.¹⁰⁸ Moreover, given the size of institutional investor holdings and their ability to organize shareholder activism, management and directors should be more responsive to "outsiders who circulate alternative policy proposals to major investors, make informal suggestions for new director nominees . . . or solicit votes for a shareholder proposal" concerning specific policy reforms.¹⁰⁹

Corporations are, in fact, already implementing some of the governed corporation's characteristics of increased board and shareholder involvement.¹¹⁰ There are increased instances of "private negotiations between major corporate managements and private

104. *Id.* at 96.

105. *See* Yue, *supra* note 20.

106. *See* BOARD DIRECTORS, *supra* note 22, at 9.

107. The average institutional investor is likely to hold stock for a period of more than three to five years. *See id.* at 22.

108. Shareholder activism has been the impetus for change in the following corporations: XTRA Corporation; Honeywell; Lockheed; Avon; Sears, Roebuck and Co.; Diversified Industries; and U.S.X. *See id.* at 11-13.

109. Pound, *supra* note 72, at 1008.

110. Specifically, General Motors, Home Depot, IBM, Westinghouse, Lockheed, Beckman Instruments, Time Warner, and Ceridian Corp. have instituted some of the governed corporation characteristics with increasing recognition of the role of the board and increased shareholder participation. *See* Pound, *supra* note 7, at 96-97. Ceridian Corp. is an interesting case study. At the end of the 1980s Ceridian, then Control Data, was the epitome of the managed corporation, with William Norris in command. *Id.* at 97. In the early 1990s, however, shareholders exerted major pressure on the board due to poor stock performance, and the board replaced Norris with Lawrence Perlman, who has a management approach similar to the structure of the governed corporation. *Id.* Directors were moved to the forefront of decisionmaking, and Perlman started seeking dialogue with Ceridian's major stockholders. *Id.* Since Perlman's arrival, Ceridian added more than one billion dollars of market value for its stockholders. *Id.* at 98.

and public institutions about executive compensation, corporate structure and strategy, and board effectiveness."¹¹¹ As one commentator states, "[I]t is clear that they [institutional investors] are in the corporate governance business to stay."¹¹² Comprehensive surveys during the 1990s reported both increased involvement of institutional investors in board rooms and positive responses from directors.¹¹³ Moreover, because institutional investors own more than a majority of shares in most major public companies, it is realistic to expect that they will continue to insist on accountability for poor performance. A likely consequence of the increased activism, therefore, is a renewed and increased sense of director responsibility to shareholder interests.¹¹⁴ Institutional investors will likely continue to focus on strengthening the independence and fiduciary responsibilities of boards vis-à-vis management to improve long-term financial performance.¹¹⁵

Against the benefits which accrue from increasing investor input, drawbacks are certain to arise.¹¹⁶ Many of the problems institutional investors will face are endemic to being an institutional investor. First, the institutional investor might arguably be unable to expend the time and resources necessary to monitor the well-being of every company in which it invests.¹¹⁷ Because an individual portfolio is typically benchmarked by comparing to a market average or index rather than by focusing on individual companies, the institutional investor's investment strategy may prevent a thorough evaluation of individual companies.¹¹⁸ An institutional investor may also face real conflicts of interest between its fiduciary responsibility to beneficiaries and the role of an active owner.¹¹⁹ Institutional investors are in the business of achieving gains for their clients. This provides a temptation to liquidate holdings in one corporation and then transfer funds to a more successful corporation.

Given the benefits to be derived from performing a baseline ownership role and the competitiveness of the marketplace, it is arguable that institutional investors will want, and may feel compelled, to make sure that the corporations in which they invest are

111. Pound, *supra* note 72, at 1009. Shareholder proposals related to corporate governance increased from thirty in 1987 to 101 in 1991. The majority of shareholder resolutions requested corporations to appoint a majority of independent outside directors, to opt out of antitakeover legislation, and adopt confidential voting procedures in shareholder meetings. See BOARD DIRECTORS, *supra* note 22, at 10.

112. Lipton & Lorsch, *supra* note 8, at 61.

113. "Some 61% of CEOs said they regularly hold meetings with their institutional investors; 51% of CEOs said they meet more than twice a year; 38% meet twice a year and 11% said they meet once a year." See *CEOs Don't Seek Shareholder Input*, *supra* note 47. "Relationships with institutional investors were described as positive by 96% of CEOs. . . . Overall, the negative view of institutional investors has steadily declined from the first survey in 1992 . . ." *Id.*

114. A 1999 survey reported that most CEOs agree with corporate governance reforms being pushed by shareholder activists, such as increasing the number of independent directors, formalizing evaluations of both CEO and board performance, and limiting the number of boards on which directors can serve. See *Meeting of Minds*, *supra* note 48.

115. See BOARD DIRECTORS, *supra* note 22, at 12.

116. See Lipton & Lorsch, *supra* note 8, at 60-61.

117. See *id.* at 60.

118. See *id.* at 61.

119. *Id.*

performing at a profitable level and avoid any disastrous losses to the funds they create. As past lessons indicate, the institutional investor, as well as corporations and the public, cannot look to gain in only the short term. A corporation's success must be managed in terms of the long term.

As noted above, one of the pivotal roles institutional investors can play is to ensure the selection of a board of directors that has integrity, expertise, and independence from the officers and management of the corporation. Thus, the composition of boards is changing dramatically and will likely continue to do so.

2. The New and Improved Board of Directors

To function most effectively, the governed corporation model requires independent, outside boards of directors who are experts in the complexities of the company and its industry, in finance and the corporation's financial structures, and in the relevant law and regulations. If increasing the number of independent, outside directors continues,¹²⁰ boards will soon become driven by a majority of independent, outside directors.¹²¹

Not only will corporations turn to outside directors for increased effectiveness, they will also turn to independent and specialized directors out of necessity. With the increasing responsibilities of boards to monitor management activities and review financial and operation audits, and directors' increased exposure to personal liability, boards will likely see a greater representation of lawyers, auditors, academics, international experts,¹²² and engineers.¹²³ Directors with political connections will also be an asset to corporate boards.¹²⁴ In the end, it is likely that the new boards will be composed of people more demographically representative of the American population with commensurately diverse expertise and skills.¹²⁵ Public image will likely be the

120. "Virtually all major public corporations now acknowledge that they have no choice but to make their managements more accountable to their shareholders and that . . . strengthening the hand of the outside directors is the logical way to do so." *Redraw the Line*, *supra* note 32, at 153. For example, at Home Depot, six of the ten directors are activist outside board members. *Id.* at 162. A recent study revealed that Home Depot's board philosophy is the subject of widespread admiration and imitation. See John A. Byrne, *The Best & Worst Boards*, *BUS. WK.*, Jan. 24, 2000, at 150.

121. David W. Johnson, the Chairman, President, and CEO of Campbell Soup, stated that the board should include no more than two members of the management. See *Redraw the Line*, *supra* note 32, at 165.

122. Among U.S. firms with five billion dollars and over in sales, 21% report that they have established international advisory boards. In addition, 12% of the largest U.S. companies have some representation by non-U.S. citizens, although two-thirds of CEOs believe a director with international experience would be an asset to a board. See BOARD DIRECTORS, *supra* note 22, at 32.

123. See *id.*

124. See *id.*

125. See *id.* at 31. Most boards (58%) are still composed entirely of men; by contrast, racial diversity levels have increased. Respondents to a comprehensive study said their boards have one (17%) or two (6%) minority board members, up from the previous years. See NATIONAL ASSOCIATION OF CORPORATE DIRECTORS, PRESS RELEASE: NACD RELEASES 1999-2000 PUBLIC COMPANY GOVERNANCE SURVEY, at <http://www.nacdonline.org/> (Oct. 13, 1999).

most important selection criteria, followed by professional experience and reputation.¹²⁶ The fact that most of the major corporations today are revamping their boards is evidence of the importance of the board's composition.¹²⁷

The corporation and its shareholders should increasingly utilize the board "to act as an independent monitor of management . . ." and to ask the tough questions management might otherwise avoid.¹²⁸ Boards should meet more frequently and should focus on debating new decisions, strategies, and policies—not just on reviewing past performance.¹²⁹ To effectively debate and evaluate policy and strategy, the board must have access to the relevant information, including access to free exchanges between directors and managers below the CEO.¹³⁰

Director compensation will also likely need to increase to account for these increased demands and to obtain qualified directors.¹³¹ But, a director's compensation must be sufficiently linked to the company's performance to provide an appropriate performance incentive.¹³² As one chairman of a large American corporation stated, "There is no substitute for directors who have a personal stake in the ultimate performance of a company's shares."¹³³ The most important form of compensation in the governed corporation model will be the performance-related incentives, primarily in the form of stock options and stock payments.¹³⁴

Although a board of directors must feature a strong cadre of independent outside

126. *See id.*

127. *See* Pound, *supra* note 72, at 1005 n.2. *See also* Byrne, *supra* note 120 (reporting on a study that shows investors demand independence in corporate boards).

128. John G. Smale, Nonexecutive Chairman of the Board of General Motors Corporation describes GMC's view of the role of their board of directors in this way. *See Redraw the Line, supra* note 32, at 154.

129. Lipton & Lorsch, *supra* note 8, at 69. "[B]oards at most U.S. companies meet an average of eight times per year . . ." Investor Responsibility Research Center, *supra* note 28.

130. *See* Pound, *supra* note 7; *Redraw the Line, supra* note 32 (interviewing Alan J. Patricof, Chairman and founder of Patricof, and Bernard Marus, Chairman of Home Depot, who stated that directors at Home Depot are provided with information regarding every phase of Home Depot's operation and are required to visit stores to talk with employees and customers).

131. *See* Pound, *supra* note 7, at 95.

132. *Id.* A 1994 report by the National Association of Corporate Directors ("NACD") recommended that directors receive at least 50%, and up to 100%, of their compensation in stock. Robin Goldwyn Blumenthal, *Directors' Cut: Study Links Corporate Performance to Boards' Equity Stakes*, BARRON'S, Aug. 2, 1999 at 22. "The primary responsibility of directors is to enhance shareholder value, so why shouldn't their compensation be tied to it?" *Id.* (quoting Roger W. Raber, president and CEO of the NACD).

133. *Redraw the Line, supra* note 32, at 160 (statement of Alan J. Patricof, Chairman and founder of Patricof). At Home Depot, to ensure that outside directors are willing to make the commitment, outside directors are required to "make a personal and serious financial investment in Home Depot either by purchasing stock or by investing in an options program . . ." *Id.* at 163 (statement of Bernard Marus, Chairman of Home Depot). Home Depot wants directors to invest enough so that each person "feel[s] that they have plenty to gain financially if the company succeeds and an equal amount to lose if it doesn't." *Id.*

134. In 1990 75% of CEOs reported that their directors own stock and just over 13% were given stock options. *See id.* In 1998, equity comprised more than 50% of outside directors' total compensation. *See* Blumenthal, *supra* note 132, at 32.

directors, inside directors will continue to be valuable.¹³⁵ First, the participation of the management on the board permits the board to observe and evaluate the decisionmaking process, as well as the outcome.¹³⁶ The directors' interaction with management facilitates the observation and evaluation of the management's competence, which is helpful for effectively fulfilling its role in selecting officers to run the corporation.¹³⁷ Second, candid and interactive participation by management in decisionmaking (rather than simply conducting a formal presentation) concerning investment and strategy will facilitate more informed decisionmaking. Finally, management can provide an essential communication link between the employees of the corporation and the governing body of the corporation.¹³⁸

3. Distributing Roles and Responsibilities Between Management and Directors

The corporate governance model requires CEOs and directors to redefine their relationship. With increased director involvement in strategy and policy of corporations, the division of roles and responsibilities can become unclear. The new corporate governance requires directors to take an active role in strategic policy-making in addition to overseeing the management. In theory, the division between management and the board should emphasize that the board deals with strategic long-term strategizing and the management handles the formulation, implementation, and supervision of that strategy. To make the governed corporation work, the management and the board must work together as a team, but with mutual respect and an awareness of the parameters of each other's duties.¹³⁹ Therefore, as some commentators suggest, an attempt to make bright-line, one-size-fits-all demarcation between these two spheres' responsibilities is neither necessary nor helpful.¹⁴⁰ Instead, the lines of authority should be drawn according to each company's respective needs and structure.¹⁴¹

Directors' responsibilities are increasing beyond what was previously thought as a board's duty. Directors will likely continue to engage in new activities to enforce their role as the body that best represents a corporation's owners. These activities include overseeing management—including selecting, evaluating, and dismissing officers who fail to perform—and overseeing the conduct of the corporation's business—such as reviewing financial objectives, approving corporate actions, providing advice to management, and ensuring that the corporation conducts itself according to the law.¹⁴² Constraints on board authority such as limited time, knowledge, and expertise with respect to day-to-day matters, however, will continue to exist. Therefore, hard and fast rules of board and management responsibilities are not necessary. Instead, what likely

135. See Oliver Williamson, *Boards of Directors and Fiduciary Duties*, in FOUNDATIONS OF CORPORATE LAW 157, 163 (Roberta Romano ed. 1993).

136. See *id.*

137. See *id.*

138. See *id.*

139. See Jay W. Lorsch, *Empowering the Board*, HARV. BUS. REV., Jan.-Feb. 1995, at 107-08.

140. See BOARD DIRECTORS, *supra* note 22, at 16.

141. See *id.*

142. See *id.*

will develop is that each company will evaluate its own needs according to its size, activities, structure of ownership, and business objectives to determine what responsibilities each should perform.

Boards can require performance-linked compensation schemes to encourage executive performance.¹⁴³ This can also ameliorate the outrage of the public and shareholders over increasingly exorbitant executive salaries.¹⁴⁴ Although Japan has followed the American lead in instituting performance-based compensation plans, for example, overall American compensation remains significantly higher than in Japan¹⁴⁵ and elsewhere. Further, making it known that a board will not condone unearned, exorbitant salaries increases directors' trust with its shareholders. It is imperative, nonetheless, that the portion of compensation tied directly to performance be large enough to serve as a genuine performance incentive. Historically, the link has often been insufficient.¹⁴⁶

Most firms use salary as the largest proportion of executive compensation. Linking a percentage of pay to performance, arguably, increases the likelihood that a corporation will turn in a profitable performance. This conclusion is based on the assumption that an officer will have a greater incentive to make his or her corporation as profitable as possible if he or she must forego greater personal financial gain if the corporation performs poorly.¹⁴⁷

Other innovative incentives include giving a CEO stock options that carry an exercise price of 40% over the stock's current trading price.¹⁴⁸ Corporations such as

143. See Clifford W. Smith, Jr. & Ross L. Watts, *Incentive and Tax Effects of Executive Compensation Plans*, in FOUNDATIONS OF CORPORATE LAW 164 (Roberta Romano ed., 1993).

144. *Executive Pay*, *supra* note 52, at 122 (noting the "astonishing" salaries of CEOs and the failure of a link between pay and performance).

145. See Steven N. Kaplan, TOP EXECUTIVE REWARDS AND FIRM PERFORMANCE: A COMPARISON OF JAPAN AND THE U.S. 30-37 (Nat'l Bureau of Econ. Research, Working Paper No. 4965, 1993). Note, however, that such differences may be culturally based. See *infra*, Part VI.

146. A recent study of the largest 250 NYSE listed firms found "that the median CEO's wealth increased by only \$3.25 for every \$1000 increase in shareholder value." See Prowse, *supra* note 24, at 45. Put in everyday terms, it costs the median CEO just \$32,500 for a ten million dollar loss in shareholder value. *Id.* at 45 n.58 (referring to a study documented in Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225, 226-27 (1990)).

147. A recent study corroborated what many had already guessed: "[t]he more stock directors hold, the better the [company's] performance." Blumenthal, *supra* note 132, at 22. "Specifically, for the average company, every 1% increase in the share ownership of the average outside director corresponds with a 1.52% rise in operating income." *Id.* The study also found that stock-holding directors are more likely to make a change in management when the company falters. *Id.*

Compensation in the form of stock awards and/or option grants is standard at more than two-thirds of companies. Stock has replaced pensions during the 1990s, with fewer than 10% of all companies currently providing directors with retirement income. The proportion of director pay delivered in stock—including retainer stock, stock awards, and options—averages 48%. See NATIONAL ASSOCIATION OF CORPORATE DIRECTORS, *supra* note 125.

148. See *Executive Pay*, *supra* note 52 (illustrating Colgate's new incentive program for CEO performance).

Colgate, Palmolive, and AT&T include setting triggers for stock option rewards at higher stock price levels in their incentive programs.¹⁴⁹ Other compensation schemes include performance units and performance shares; these link the proportion of units or shares to the extent performance goals are achieved over a designated period, usually four to five years.

In the transition period, CEOs must recognize that increasingly empowered directors can help them and their company, and should not be viewed as a threat.¹⁵⁰ CEOs who resist reforming their corporate structure will lose, as will the corporation as a whole.¹⁵¹

The foregoing discussion illustrates the problems faced by American corporations and their system of corporate governance. A means of remedying these problems by shifting corporate control from a managed to a governed system has also been posited. This remedy implies the prospect of increased participation by institutional shareholders.

The following discussion compares the corporate governance models of Japan, Germany, and France. Given these nations' increased reliance on the participation of large shareholders (particularly banks), many commentators view these foreign systems as a potential blueprint for changing the American corporate governance system.

III. CORPORATE GOVERNANCE IN JAPAN

A. The Historical Development of Japanese Corporations

Japanese stock exchanges were first established in 1878 in Osaka and Tokyo.¹⁵² Despite the existence of these exchanges, Japanese corporations have relied predominantly on banks and government funding for financing.¹⁵³ This contrasts sharply with their American counterparts, which historically have been financed in large part through public offerings on liquid stock exchanges.¹⁵⁴ In fact, in the early stages of Japan's industrialization, during the later half of the 1800s and early 1900s, those companies that were forced to turn to public financing were perceived to be inferior.¹⁵⁵

To obtain financing, Japanese corporations relied on their connections with *zaibatsu*, industrial conglomerations which controlled economic growth prior to World War I by dominating particular sectors of the economy through self-financing.¹⁵⁶ Under the *zaibatsu*, Japan's economy grew rapidly through World War I.¹⁵⁷

After World War II the United States was instrumental in reforming the Japanese

149. *See id.*

150. *See* Lorsch, *supra* note 139, at 107.

151. *See id.*

152. *See* Christopher Lee Hefel, *Corporate Governance in Japan: The Position of Shareholders in Publicly Held Corporations*, 5 U. HAW. L. REV. 135, 141 (1983).

153. *See id.* at 140.

154. *See id.* at 141.

155. *See id.*

156. *See id.*

157. *See id.*

corporate structure during the Allied occupation of Japan.¹⁵⁸ By incorporating provisions of American corporate governance structure, the United States sought to promote corporate democracy and redistribute corporate stock ownership.¹⁵⁹ The American-style "Securities Democratization" program resulted in a mass release of securities and the implementation of antimonopoly laws that increased individual share holding and expanded the Japanese stock market.¹⁶⁰ With Allied occupation, therefore, came the birth of the Japanese public corporation.

The imposition of the American model into the Japanese business culture was not successful, however. Without understanding and taking into account the differences of the societies and business cultures, the unmodified American structure never had a real chance in Japan. With only limited exposure to a social structure that was founded on democratic principles, Japanese society had no working knowledge of the principles upon which the American structure was formed. More importantly, it did not share the history from which this structure arose. As a result, the imposition of a foreign mode of corporate governance without regard to fundamental cultural differences inevitably led to ineffective management and corruption.¹⁶¹

New international events precipitated further changes in Japan's corporate structure. With the advent of the Cold War, the United States shifted its attention away from monitoring Japan's corporate democratization movement, and the Allied occupation ended. In the absence of American monitoring and Allied supervision, the Japanese government amended the commercial code to accommodate business practices similar to those which existed before World War II. Along with these changes, Japanese corporations quickly began to expand their productivity and accelerate economic growth.¹⁶² Because economic recovery was believed to be the only deterrent to a complete communist takeover of the Far East, the United States did not object when it became apparent that the amendments, which hearkened back to the era of the *zaibatsu*, strengthened the Japanese economy. The new provisions facilitated mergers, acquisitions, and intercorporate shareholding.¹⁶³ The new Japanese business structure consisted of enterprise groups called *keiretsu*.

Japanese business owners today form themselves into *keiretsu* in a manner true to the spirit of the *zaibatsus* that existed prior to World War II.¹⁶⁴ Each *keiretsu* (larger than a *zaibatsu*) usually represents an industry and consists of a number of companies which cooperate with one another and use each other's services and support. Each group is then dependent upon a core of related banks.¹⁶⁵

The financial structures of Japanese corporations come primarily from banks, trust

158. *See id.*

159. The reforms sought to redistribute corporate authority among shareholders, directors, and management. *See id.* In order to redistribute the power, the *zaibatsu* and other holding companies were dissolved or reorganized. *See id.* In addition, in 1948 the Japanese Security Exchange Act was enacted, which like the U.S. mold, mandated disclosure of corporate information. *Id.* at 141 n.17.

160. *See id.* at 141-42.

161. *See id.* at 144 n.27.

162. *See id.* at 145.

163. *See id.*

164. *See id.*

165. *Id.*

banks, insurance companies, independent institutions, and government sources.¹⁶⁶ The banks of enterprise groups provide the most substantial source of funds and act as coordinating centers for business within the groups.¹⁶⁷ The bank-company relationship "is considered permanent and is an integral part of the company's existence."¹⁶⁸ Because of the banks' significant ownership interests in the corporations they fund and, in some cases, their presence on the corporation's board of directors, banks have incentive to ensure the corporation performs well and has the necessary resources.¹⁶⁹

Japan's government is characterized as having a probusiness bias, and indeed, business-government relations are close and amicable. The government enforces laws through informal administrative guidance. In fact, the government is seen "not as an impartial regulator, but as a promoter and protector of domestic industry."¹⁷⁰ Japanese laws and programs substantively are probusiness.¹⁷¹

B. The Japanese Corporate Structure

Japan's corporate governance structure in its large stock corporations (*kabushiki kaisha*) borrows from the nominal structure of American corporations. It consists of a board of directors, shareholders, and executives. Theoretically, shareholders elect directors, who in turn set overall corporate policies and direction. The directors also appoint and monitor the executives who implement the directors' plan. In practice, however, Japanese shareholders have been virtually powerless with respect to performing any meaningful function within the corporation. Moreover, the board of directors is merely an extension of the executives, since the executives constitute a majority of the directors.¹⁷² In 1981, Japan revised its commercial code in the area of corporate governance; the amendments became effective October 1, 1982.¹⁷³ The purposes behind the changes were to require greater accountability of the management, disperse stock ownership, and encourage greater shareholder participation in decisionmaking.¹⁷⁴

1. Board of Directors

Similar to the American structure, Japanese boards of directors are elected by shareholders. In reality, however, the CEO and the CEO's operating committee choose the directors with perhaps some consultation from large shareholders.¹⁷⁵ The shareholders finalize the nominations with the formality of a vote.¹⁷⁶ Shareholders also

166. See BOARD DIRECTORS, *supra* note 22, at 141.

167. See Heftel, *supra* note 152, at 149.

168. *Id.*

169. See *id.*

170. BOARD DIRECTORS, *supra* note 22, at 130.

171. See *id.*

172. See *id.* at 129.

173. See Heftel, *supra* note 152, at 136.

174. See *id.* at 136-37.

175. See BOARD DIRECTORS, *supra* note 22, at 131.

176. See *id.* A clapping of the shareholders' hands at a shareholders' meeting suffices as a shareholder vote. See *id.*

have the power to remove directors with or without cause.¹⁷⁷ Corporations are required by law to have, at a minimum, three directors—with each director serving a maximum term of two years.¹⁷⁸ The corporate statute grants powers to the board to “manage” the corporation.¹⁷⁹

In practice, the board represents the interests of the corporation and employees, rather than the shareholders.¹⁸⁰ The two primary reasons for this representation are, first, nearly all directors are senior managers or former company employees,¹⁸¹ and second, Japanese shareholders are passive.¹⁸² Therefore, the board is, in essence, an extension of the management whose interests are inseparable. Because of the corporate success Japanese firms experience, the existing system of governance has gone unchallenged.¹⁸³

Most major corporations have ten to twenty executives on the board, whose presence is based on seniority and personal service to the corporation. The directors are arranged hierarchically based on those criteria.¹⁸⁴ Because of the board's size and differences with respect to the working demands each director faces (usually reflecting seniority), boards are often divided up into working groups.¹⁸⁵ The most senior working groups perform most board functions and senior executives are elected as representative directors.

The Japanese corporation code requires board members to appoint representative directors to act on behalf of the corporation when dealing with third parties.¹⁸⁶ Representative directors implement shareholder and board decisions.¹⁸⁷ In an effort to control the representative directors' power, however, the 1981 amendments require certain important decisions to be made by the board as a whole.¹⁸⁸

The board's primary responsibility is the health and growth of the company as a whole, instead of shareholder profit maximization.¹⁸⁹ Company growth is the most important objective because “it maximizes the welfare of shareholders (through capital gains), management (through steadily increasing opportunities for promotion), employees (through job security and wage growth), the government (through growing tax revenues) and the community (through growing employment).”¹⁹⁰ Although the directors hold formal authority, directors' meetings are characteristically infrequent

177. *See id.* at 179.

178. *See Heftel, supra* note 152, at 153-54.

179. *Id.* at 154.

180. *See* BOARD DIRECTORS, *supra* note 22, at 129.

181. *See id.*

182. *See id.* at 130.

183. *See id.* at 1.

184. *See id.* at 131.

185. *See Heftel, supra* note 152, at 154.

186. *See id.*

187. *See id.* at 155.

188. The following four topics are reserved for consideration and action by the whole board: (1) disposal or acquisition of substantial assets; (2) borrowing in substantial amount; (3) appointment or removal of a manager or other senior employees; and (4) substantial organizational changes. *Id.* at 155 n.115.

189. *See id.* at 129.

190. *Id.* at 129-30.

and "decisions are rubber stamped."¹⁹¹ Corporate authority is vested in the president, who works with an operating committee.¹⁹²

The composition of the board consists of very few, if any, outside directors. Almost 80% of the boards have no outside directors and just 15% of the corporations have one or two outside directors, representing lender banks, retired government officials or top business partners of the corporation.¹⁹³ The domination of insiders on Japanese boards is one of the main reasons boards are seen as "hollow shells" and are ineffective in overseeing the affairs of the company.¹⁹⁴

The chairman of the board is usually a retired CEO of the corporation or a retired government official.¹⁹⁵ The chairman's duties involve maintaining the various personal relationships with businesses and government officials to ensure that business will run smoothly from the exterior.¹⁹⁶ Therefore, the chairman's role in actual business decisions of the corporation is limited.¹⁹⁷ With respect to the other executive directors, depending upon the executive director's seniority, only a few of the top-level executives will have the time to deal with director-type issues because the other executives will be dealing with the corporation's day-to-day affairs.

The necessity of having an exhaustive and timely formal information source for directors is obviated by the fact that Japanese directors are predominantly insiders who have direct knowledge of corporate information. For those few outside directors, weekly or monthly meetings are held to keep those directors abreast of corporate information.¹⁹⁸ When and if truly outside directors are appointed to the boards, they will probably be already well informed with corporate policy.

Japanese firms are particularly active in pursuing external information within the *keiretsu*. As a result, board directors are connected with information concerning other Japanese companies and financial institutions in the particular industry. The information is obtained through the monthly meetings between the directors and managers of the *keiretsu*.¹⁹⁹ Directors are also expected to be well versed with respect to domestic and foreign market trends.²⁰⁰

The decisionmaking process of the board of directors follows the consensus-style method of decisionmaking that is pervasive throughout Japanese corporations.²⁰¹ The chief characteristics of this type of decisionmaking are the board's debating of matters and the reaching of decisions through consensus. Therefore, board decisionmaking, as

191. *Id.* at 131.

192. *See id.*

193. Christina L. Ahmadjian, *Changing Japanese Corporate Governance*, JAPANESE ECON., Nov.-Dec. 2000, at 59, 70.

194. *See* Heftel, *supra* note 152, at 158.

195. *See* BOARD DIRECTORS, *supra* note 22, at 131.

196. *See id.*

197. *See id.*

198. *See id.* at 132.

199. *See id.*

200. Most large multinational firms maintain a significant business intelligence-gathering network to monitor markets. *See id.*

201. This decisionmaking style has been termed "bottom up" consensus decisionmaking. Decisions start at the bottom and work their way up with each employee agreeing or disagreeing with the proposal. *See id.* at 134.

with any other corporate decision, can often be a lengthy process.

The compensation of Japanese directors is below their American and European counterparts.²⁰² The limit on earning differential between company positions is based on the idea of the company as a social group, which in turn keeps the wages of directors and other management and employees relatively close.²⁰³ In addition to director salary, an executive salary, and generous entertainment expense accounts, a director also receives nonmonetary rewards of respect and prestige that have great value in Japanese society.²⁰⁴ Directors also receive medical benefits.²⁰⁵

In short, the capability of Japanese boards to monitor critically and support corporate management is severely curtailed by the domination of inside directors. The Japanese corporations, however, have thrived on a different approach that, as will be discussed below, entails intercorporate shareholding and the watchful eye and support of *keiretsu* members. The large financial institutions and creditors have a strong incentive to protect their holdings and investments in the firms by monitoring and influencing the management and gathering information.

2. Shareholders

Japanese stock ownership has two distinctive characteristics. First, corporate ownership is heavily concentrated in the control of a relatively small number of institutions and individuals. Second, there is cross-shareholding between companies who are affiliated in the *keiretsu*. Referred to as "safe shareholders," banks, other members of the *keiretsu*, board directors, employees, business customers, and associates hold a high proportion of stock.²⁰⁶ Most corporations believe that having a controlling portion of shares owned by safe shareholders is essential.²⁰⁷ The main reason for this view is that Japanese companies believe "insider control strengthens enterprise group relations, reinforces management control and ensures that shareholder meetings proceed harmoniously."²⁰⁸ Safe shareholding is also believed to prevent foreign takeover attempts.²⁰⁹ Banks and associated businesses, therefore, have ownership in most major corporations, which is in contrast to the United States, where banks are prohibited from directly owning stock and very few companies have an industrial company as top shareholder.²¹⁰ Bank ownership has leveled off with the amendments to the Antimonopoly Act, a piece of legislation limiting bank ownership to 5% of a corporation's holdings.²¹¹ The purpose of the amendments was to disperse

202. *Id.* at 140.

203. *See id.*

204. *See id.*

205. *See id.*

206. *See* Heftel, *supra* note 152, at 146-47. Between 60% and 80% of corporate stock is owned by banks, trust and pension funds, insurance firms, and business partners. *See* Prowse, *supra* note 24, at 15-16.

207. Heftel, *supra* note 152, at 147. In a 1982 survey, 660 out of 661 companies stated they thought it was necessary to have a stable level of safe shareholders. *See id.* at 147 n.46.

208. *Id.* at 147.

209. *See id.*

210. *See id.*

211. *See id.* at 150. However, 5% still constitutes a majority interest in many corporations.

ownership and increase individual outside ownership by limiting the percentage of cross-shareholdings between companies and their subsidiaries.²¹²

The cross-shareholding among affiliated businesses is common among Japanese firms because it symbolizes sincerity and commitment. Although the amount of stock exchanged is small, in the aggregate the amount of shares owned by companies in the industry make up a significant share of stock ownership.²¹³ Thus, in the Japanese business culture, cross-shareholding is believed to be in the best interest of corporations, because it solidifies business relationships.²¹⁴ The intercompany stock is very stable and rarely sold, because it is procured for business relations, not profit maximization.²¹⁵ Therefore, the corporate structure buttresses the interconnectedness of the *keiretsu*. Some commentators, however, believe that cross-shareholding is detrimental to outside shareholders and is thus the major cause for a steady decline in individual ownership.²¹⁶

With regard to individual investors, the cross-shareholding among companies affiliated in the same enterprise group has substantially lessened the holdings of individual investors.²¹⁷ Only 20 to 30% of shares are in general circulation. As minority shareholders, Japanese investors, like their American counterparts, are passive investors. Despite the lack of control over corporate affairs, individual investing is profitable and a steady source of income.²¹⁸ With no capital gain tax, investors turn over stock frequently. The stock market, however, is still seen culturally as a gamble. As a result, a relatively smaller portion of personal assets is invested in stocks.²¹⁹

This small percentage of outstanding shares and outside ownership contributes to Japanese corporate security and stability. These mainstream shareholders, individually as well as in the aggregate, have no meaningful power with respect to the corporation. As a result, management typically ignores initiatives or inquiries from remaining stockholders, and can afford to do so because of its insulation from outside challenges.²²⁰ Consequently, the annual shareholder meetings are largely a formality in corporate governance.²²¹ The 1981 amendments, however, do require directors to attend shareholder meetings to discuss any question posed by a shareholder in written form prior to the meeting and to field those questions that arise during the meeting.²²² Moreover, since the 1981 amendments, greater shareholder attendance has been

See id.

212. *See id.* at 150.

213. *See* BOARD DIRECTORS, *supra* note 22, at 130.

214. *See* Heftel, *supra* note 152, at 147.

215. Dividends are minuscule because stock is valued at the par value rather than market value, which often leads to the stock dividends amounting to just a few yen per share. *See id.* at 147-48.

216. *See id.* at 150.

217. *See id.*

218. *See id.* at 167-68.

219. *See id.*

220. *See id.*

221. One commentator notes that companies have been known to compete with each other to have the shortest shareholder meeting. *See* BOARD DIRECTORS, *supra* note 22, at 130.

222. *See* Heftel, *supra* note 152, at 172.

recorded, and management and directors are providing more information to familiarize shareholders with the corporation.²²³

Although shareholder membership on the board of directors is scarce, large institutional shareholders are not passive in their ownership interest. In addition to their influence in the accounting and audit divisions of corporations, institutions and financial lenders have preferred to meet informally in monthly meetings called "President's Club meetings."²²⁴ Here, shareholders and lenders of many different corporations in the *keiretsu* gather to discuss general corporate policy and strategy.²²⁵ In essence, although these meetings are not a part of Japan's formal corporate governance structure, they do serve as a second board that checks the progress and policy of the corporation.²²⁶

As noted above, shareholders must possess at least one unit before they can vote.²²⁷ Although the commercial code expressly limits the issues on which shareholders can vote at shareholder meetings, a corporation's articles of incorporation can be amended to authorize shareholders to vote on other issues.²²⁸ A quorum of a majority of the outstanding voting shares and affirmative votes of a majority of the shareholders present at the meeting is required for passage.²²⁹

Shareholders are required to appoint at least two auditors who supervise the management's progress.²³⁰ During their two-year term, auditors investigate corporate affairs and documents, make reports to the directors, and—at shareholder meetings—enjoin directors' illegal acts and bring suits on behalf of the corporation.²³¹ Even though auditors are subject to joint and several liability for failure to perform their role, their effectiveness as a monitoring entity has been questionable.²³²

3. Executives

In a Japanese corporation, the president and his or her executives wield the most real power in the corporation.²³³ The corporation's president and the operating committee set policy and strategy, and make the long-term and daily goals for the corporation.²³⁴ They also perform the monitoring function of the company's performance, which in the United States is performed by the board of directors.²³⁵

223. *See id.* at 174-75.

224. *See* Prowse, *supra* note 24, at 30.

225. *See id.* at 30.

226. The informal President's Club meetings resemble Germany's supervisory board, the *Aufsichtsrat*. *See id.*

227. A stock unit generally consists of 1000 shares of stock. *See* Hefel, *supra* note 152, at 162.

228. *See id.* at 163. Shareholders can make resolutions concerning the following examples of topics: declaration of cash dividends, declaration of stock dividends, approval of financial statements, and the election of auditors and accounting auditors. *Id.* at 163-64.

229. *See id.* at 164.

230. *See id.* at 159.

231. *Id.*

232. *See id.*

233. *See* BOARD DIRECTORS, *supra* note 22, at 131.

234. *See id.*

235. *See id.*

Therefore, the president is free from shareholder accountability, especially given that all board members are allies. However, social group mores and "his dedication to the overall health and growth of the company" check the president's power.²³⁶

Management's first loyalty is to its employees, which is a manifestation of the lifetime employment system.²³⁷ In Japanese society, an individual's identity conforms to the company for which one works, because employees usually stay with one company their entire lives.²³⁸ Therefore, corporate success is essential for an individual's security. As one commentator stated: "To the Japanese way of thinking, company employees have more 'ownership' interest in the company than do shareholders who merely are investing in the company."²³⁹ Also, the lifetime employment system makes management turnover relatively rare.²⁴⁰ Transfers, however, do take place between companies within a *keiretsu*.²⁴¹

The selection of the president is a critical time for a Japanese corporation.²⁴² Although corporations have mandatory retirement age policies, corporations do not always follow them.²⁴³ Depending upon the personality of a president and quality of replacements, a president's resignation, or stepping down, is a common means for replacing a president.²⁴⁴ Very rarely are presidents forced out of office. A president may be forced to resign, however, if the board, the managers, labor leaders, and shareholders all agree that removal is necessary.²⁴⁵

Because of the cultural importance of growth and health of the corporation, executive compensation is not tied to profits to the extent it is in the United States, even though one-third of the compensation comes in the form of semiannual bonuses derived from profit performance.²⁴⁶ Salaries among Japanese executives, managers, and the average worker remain relatively in the same range.²⁴⁷ The trend, nonetheless, is toward further performance-linked incentives.²⁴⁸

C. Japanese Corporate Control Mechanisms

In Japan, corporate governance takes the form of an interconnected web of

236. *Id.* The company is viewed by the president and its employees as a family, an integrated social unit. *See id.*

237. *See* Heftel, *supra* note 152, at 148.

238. *See id.*

239. *Id.* at 167.

240. *See* BOARD DIRECTORS, *supra* note 22, at 139.

241. *See id.*

242. *See id.* at 132.

243. *See id.*

244. *See id.*

245. *See id.*

246. *See id.* at 129.

247. In a 1992 survey, the average salaries and bonuses were as follows: company presidents receive 1.647 million yen per month and 6.27 in annual bonuses; vice presidents and senior managing directors receive 1.1 million yen per month and 3.55 million yen in annual bonuses; managing directors received 1.05 million yen per month and 3.12 million yen in annual bonuses; and the average worker received 260,000 yen per month and 1.11 million yen in annual bonuses. Salary growth was relatively commensurate between the levels. *See id.* at 140.

248. *See id.*

enterprise groups called *keiretsu*. The nonfinancial companies are bound by product market links and small equity interests in each other. All nonfinancial firms have strong, although not exclusive, borrowing links with the financial institutions in the *keiretsu*, which also take large equity stakes in the corporation.²⁴⁹ Therefore, banks are the most important large shareholders and have, until recently, been the exclusive source of external financing.²⁵⁰ Through this interconnectedness, these shareholders exert control over the management of corporations.

The corporation's major lenders monitor the corporation's progress and stability. They also supplant the American role of shareholders and directors by providing an impetus for change if something needs to be changed or someone needs to be removed.²⁵¹ Given their access to the relevant information through the *keiretsu*, a corporation's lender and closest business acquaintance is better informed to make these decisions than directors or shareholders.

Japan's perspective on methods of obtaining corporate control is different than that of the United States. Although friendly mergers and acquisitions are commonplace, hostile takeovers, which are prevalent in the United States, are very unusual.²⁵² Japan's takeover laws regulate only foreign investors and were relaxed in the 1980s. Thus, with respect to domestic transactions, Japan—much like Germany—has almost no legal barriers.²⁵³

The significant impediments to takeover activity in Japan are corporate ownership and cultural norms.²⁵⁴ Japan's high concentration of ownership and the large number of cross-shareholding arrangements with friendly firms make it exceedingly difficult for a prospective bidder to attain a sufficiently large stake in a firm to take it over.²⁵⁵

Moreover, unlike the American firm that had in the past relied on takeovers as a corporate control mechanism to handle defunct management, Japanese firms (and German firms) do not need this mechanism. As one commentator noted, "[t]he structure of corporate ownership after all is an endogenous response by investors to the costs and benefits of maintaining managerial discipline weighed along with other factors."²⁵⁶ Therefore, Japan's corporate governance structure—through direct shareholder monitoring—underscores the reasons for American shareholders' reliance on takeovers as a corporate control mechanism.²⁵⁷

It is noteworthy, however, that most friendly mergers begin as unsolicited offers. It is through the support of the target corporation's shareholders and board that a successful merger can take place.²⁵⁸ Also, Japanese mergers and acquisitions usually involve a struggling corporation that sees the merger as being a more favorable option than bankruptcy.²⁵⁹

249. See Prowse, *supra* note 24, at 41.

250. See BOARD DIRECTORS, *supra* note 22, at 140.

251. See *id.* at 130.

252. See *id.* at 132.

253. See Prowse, *supra* note 24, at 36.

254. See *id.* at 37.

255. See *id.*

256. *Id.*

257. See *id.* at 37, 41-42, 51.

258. See BOARD DIRECTORS, *supra* note 22, at 132.

259. Yoshiro Miwa & J. Mark Ramseyer, *The Myth of the Main Bank: Japan and*

1. Positive Aspects of the Japanese Corporate Structure

Empirical evidence indicates corporations with financial institutions holding large debt and equity positions in the firm "experience fewer liquidity effects on investment" and have better transmission of information to shareholders than corporations operating under external finance and governance systems.²⁶⁰ Closely tied financial shareholders are in a better position to be proactive in monitoring the activities of the corporation and its management than are diffuse shareholders. Japanese corporate monitoring involves continuous direct monitoring rather than intervention in the firm's business only after the firm is experiencing financial difficulties.²⁶¹ Continuous monitoring allows problems to be dealt with at a symptomatic level rather than after the firm encounters systemic problems too severe to fix. Evidence indicates "Japanese firms with high financial institution ownership show higher levels of productivity and profitability than other Japanese firms."²⁶² Moreover, trends indicate "that high financial institution ownership reduces both the frequency and severity of lapses from efficiency and profitability."²⁶³

The deregulation of public offerings and securities in the 1980s has, however, caused many firms with entrenched managers to seek external financing apart from banks.²⁶⁴ The main reasons for this change are the high costs associated with the monitoring of banks and the higher costs of bank financing.²⁶⁵

A majority block of safe shareholders provides directors with a working environment that is advantageous to corporate performance. First, the support of the safe shareholders allows directors the freedom to pursue long-term planning and reduces pressure on management to produce short-term corporate profits.²⁶⁶ Second, by having the majority of shares controlled by safe shareholders, corporations have a defense against hostile takeovers. In fact, many cross-shareholding agreements include assistance to help defend against unsolicited acquisition bids.²⁶⁷ Third, management and directors can pursue whatever course of business they feel will be beneficial to the corporation, and the implementation of the plan is relatively quick and not questioned.²⁶⁸

Proponents of the Japanese governance system view the fact that Japanese management typically states its principal objective as long-term growth, and not profits, as another positive aspect.²⁶⁹ Ostensibly, greater corporate wealth benefits management, shareholders, and employees equally. As long as growth is steady, profits

Comparative Corporate Governance, 27 L. & SOC. INQUIRY 401, 404 (2002) (book review) (citing Paul Milgrom & John Roberts, *Complementarities and Systems: Understanding Japanese Economic Organization*, 9 ESTUDIOS ECONOMICOS 3 (1994)).

260. Prowse, *supra* note 24, at 44.

261. *Id.* at 37-38.

262. *See id.*

263. *Id.* at 44.

264. *Id.* at 45.

265. *See id.*

266. *See* BOARD DIRECTORS, *supra* note 22, at 135.

267. *See id.*

268. *See id.*

269. *See id.*

and stock prices will increase accordingly.²⁷⁰ By pursuing corporate growth as the primary goal instead of short-term profits, Japanese corporations believe they increase their long-term stability and, therefore, success.

2. Negative Aspects of the Japanese Corporate Structure

This model of control has its problems as well. Principally, majority stock ownership by safe shareholders insulates management from outside pressures, which perpetuates management's unresponsiveness to corporate change. Therefore, management is not accountable to anyone, and no entity in the Japanese corporate structure can check management's progress, with the exception of financial institutions.²⁷¹ Although high financial institution ownership has typically been deemed a positive attribute of Japanese corporation ownership, the continued existence of widespread economic politicking and moral hazard issues causes some observers to doubt that even diffusely held banks are truly efficient and effective monitors of a corporation.²⁷² Also, evidence indicates that high cross-shareholding between nonfinancial corporations "lowers the profitability and productivity of a firm."²⁷³ As *Business Week* puts it:

The web of personal connections in [Japanese] politics is reproduced in corporate practices. In the . . . keiretsu system of cross-shareholdings, related companies hold shares in each other, propping up stock values. Banks belonging to the keiretsu keep lending to weak members. Letting these banks fail would cause such a shock that the [Ministry of Finance] is terrified of letting that happen.²⁷⁴

Some commentators, however, continue to view the intercorporate holdings as essential to cementing business relationships and believe their associated costs are justified.²⁷⁵

A further limitation to Japanese corporate governance is that the consensus-style decisionmaking process can be a cumbersome and laborious process. Japanese corporations abroad may be hurt in highly competitive markets where quick decisionmaking is critical.²⁷⁶ Detrimentally, the quality and innovation of corporate strategy may also be limited to the current ideas of management, which perpetuates the status quo.²⁷⁷

D. Future Trends and Challenges in Japanese Corporate Governance

Although Japanese corporations will continue to be run according to the general

270. See *id.*

271. See *id.* at 136.

272. See Prowse, *supra* note 24, at 46.

273. *Id.* at 45.

274. Robert Neff, *Commentary: Why Japan Won't Act to Save Itself*, BUS. WK., May 18, 1998, at 144, available at <http://www.businessweek.com/datedtoc/1998/980518.htm>.

275. See Miwa & Ramseyer, *supra* note 259.

276. See BOARD DIRECTORS, *supra* note 22, at 136.

277. See *id.*

scheme of management-dominated boards, the realities of increasingly global competition in the 1990s will prompt some changes. The following are likely impetuses for change to the structure and functioning of the board of directors: the need to make quick decisions to compete in foreign markets, the necessity of having directors of foreign subsidiaries in the decisionmaking process of the Japanese parent corporation, and the need to increase director accountability to satisfy shareholders.²⁷⁸ These phenomena will, in turn, influence the entire corporate scheme. Japanese corporate governance is adopting some western corporate governance characteristics. Substantial manifestations of the western-type structure will be slow to develop.²⁷⁹ The dilemma for Japan, as in all countries, is to determine how to improve its own management cultures internally, and to import elements of other countries' corporate structures.

1. Multinationalism

Japanese firms are transforming themselves (including their subsidiaries) into multinational corporations.²⁸⁰ Further internationalization makes the current corporate structure vulnerable to situations where quick decisions are required to deal with other countries. The traditional consensual decisionmaking is inefficient for handling mergers and acquisitions internationally because the traditional decisionmaking process is slow and the potential risks with a body untrained or unequipped to make such decisions are high.²⁸¹ Therefore, as corporations continue to feel the paralyzing effects of the consensual decisionmaking method, they will continue to streamline the decisionmaking process to achieve more informed decisions at a faster pace.²⁸²

Because most successful multinational firms require integration of local management of subsidiaries into the parent firm, Japanese corporate structure may not be able to accommodate this need as sufficiently as local management would prefer or in some cases demand. The subsidiaries of some Japanese multinational corporations are beginning to act independently and demand management control.²⁸³

For the success of Japanese domestic and multinational firms, the presence of outside directors on boards to give a foreign perspective may become essential.²⁸⁴ Demands by subsidiaries for localized management will likely make the current system of a tightly controlled management increasingly unable to satisfy these foreign needs or ensure the subsidiaries continued success in the foreign country. The Japanese corporate structure, however, is inherently biased against the presence of outside directors, given the tradition of the board members having longstanding, close personal relationships, and common company experiences among management.

This tension creates a dilemma for the Japanese corporation, as the best foreign manager may not want or be able to participate in the traditional Japanese business

278. *See id.* at 141.

279. *See id.*

280. *See id.* at 134.

281. *See id.*

282. Honda Motor Corp., NEC Corp., and several other corporations are beginning to reorganize operations and delegating decisionmaking power to divisions. *See id.* at 134.

283. *See id.* at 141.

284. *See id.*

operations.²⁸⁵ One commentator notes that this arguable glass ceiling will deter the most competent foreign manager from joining a Japanese subsidiary.²⁸⁶ Some top Japanese executives have recognized this limitation. They also agree that, to become true multinationals, Japanese boards must accept outside directors—even if these outside directors do not fit their traditional conception of what a board member should be.²⁸⁷

As one commentator claims, it is arguable that outside directors will have no real influence until the structure of the Japanese board of directors becomes more defined and separated from management, and the duties of outside directors are given substance.²⁸⁸ Change, however, will likely be slow until Japanese corporations see their performance decline due to the absence of outside insights. Even then, the question of how the culture can accommodate such change remains unanswered.

2. Composition of the Board of Directors

Trends indicate that Japanese corporations will continue to run business under the status quo, pursue growth, and maintain the nature of their boards in the traditional business style.²⁸⁹ Unlike future boards of directors in the United States, Japanese boards will continue, for the most part, with the same management and male-dominated boards, although other views on women, minorities, foreigners, and consumers will be more liberal.²⁹⁰ However, at least one commentator predicts that once the post-1960 generation comes into power, real changes will take place in how Japanese corporations conduct business.²⁹¹

For the most part, however, the composition will remain the same and the pool of candidates will continue to come from the management ranks of the corporation. Because Japanese boards of directors are insulated from outside pressures, there is little pressure for board diversity.²⁹² Compounding that phenomenon is Japanese society's view that corporate promotion should be based purely on merit.²⁹³ Foreign directors, however, may start to be considered for corporations that conduct extensive international business and have foreign subsidiaries.²⁹⁴

Some relatively revolutionary corporations (such as Sony Corp., which was founded after World War II) now see a need for change as Japanese corporations move into the twenty-first century. Sony Corp.'s chairman, Akio Morita, believes "Japan's economic post-War success has mainly been due to business practices—low wages and low

285. *See id.*

286. *See id.* at 133.

287. *See id.*

288. *See id.*

289. *See id.* at 137.

290. *See id.*

291. These post-1960 directors will likely be more aggressive and assertive in their business dealings. Some examples of this behavior are already being seen in corporations such as Minabea Co., Ltd. and Kyocera Corp. *See id.*

292. *See id.* at 139.

293. *See id.*

294. *See id.*

dividends—which are now unacceptable.”²⁹⁵ Mr. Morita believes that shorter hours, higher wages, increased dividends, and greater consideration to nonbusiness issues—such as the environment—will be necessary to be successful internationally.²⁹⁶

3. Changes in the Japanese Economy

With the deregulation of securities law in Japan, corporate dependence on financial institutions is decreasing. This movement will dramatically influence the functioning of the Japanese system of corporate governance, given financial institutions' key role in the Japanese corporation.²⁹⁷ Moreover, firms will have a greater appreciation for high returns and efficiency maximization as they will be forced to become more attentive to profitability and efficiency in the face of intensified domestic and international competition.

Therefore, the economic realities of the Japanese business environment may make extensive cross-shareholding and the open communication and expansive cooperation among rivals may cause an inefficient allocation of resources and suboptimal corporate profitability.²⁹⁸ As one commentator notes, “[t]he deregulation of domestic financial markets and intensifying competition are weakening the web of cross-share holding that has insulated directors and management from outside pressures.”²⁹⁹ Moreover, Japanese corporations will likely turn away from the traditional financing sources of banks and look to nonfinancial institutional financing because the costs are typically lower.³⁰⁰ This will expose corporations to greater dependence on outside investors, whose rights should strengthen and expand.³⁰¹

Therefore, the safe shareholder block of stock, which insulated directors and management from outside challenges in the past, may be dissipating. The crumbling of these intercorporate relations may subject the directors and management to greater accountability from the increased presence of outside shareholders.³⁰² With decreasing intercorporate share holdings, the *keiretsu* likely will weaken.³⁰³ This weakening will impact the current corporate governance structure with respect to the structure's reliance on the *keiretsu* for monitoring and informing board members, management, lenders, and business associations.³⁰⁴ While it is expected that boards will retain a great deal of their power, directors will be exposed to greater accountability to shareholders, and will be forced to consider outside influences when making business decisions and forming corporate strategy.³⁰⁵ True accountability and independence of boards, however, will develop only when management, shareholders, and government agree it

295. *Id.* at 138.

296. *See id.*

297. *See id.* at 134.

298. *See id.*

299. *Id.*

300. *See* Prowse, *supra* note 24, at 45.

301. *See* BOARD DIRECTORS, *supra* note 22, at 135.

302. *See id.*

303. *See id.* at 134.

304. *See id.*

305. *See id.*

is in the best interests of the corporations.³⁰⁶

IV. CORPORATE GOVERNANCE IN GERMANY

A. Corporate Structure of German Corporations

1. Shareholders

The structure of the German firm and the securities market of Germany differ considerably from American counterparts. American, Japanese, and French stock markets starkly contrast with the German stock markets. In particular, Germany's securities market is largely underdeveloped. Of the approximately two million companies in Germany, only about 4600 are stock corporations ("AG").³⁰⁷ Of those stock corporations, 825 are truly publicly traded, mainly because they lack a long-term controlling shareholder or shareholder group.³⁰⁸ Limited publicly traded stock ownership in German corporations makes hostile takeovers rare. Friendly mergers and acquisitions are, however, a recognizable feature of the German economy.³⁰⁹

German shareholders are relatively small in number, own large voting blocks of stock in corporations, and have long-term interests in the corporation. The majority of these shareholders are large financial institutions. For example, the top five shareholders in Daimler-Benz (the largest German conglomerate) own nearly 79% of the corporation's stock, whereas the top five shareholders in General Motors own only 5.74%.³¹⁰ The voting power of German banks comes from direct ownership of stock, from control over investment companies, and—most importantly—from authority to

306. *See id.* at 141.

307. THE CONCISE OXFORD-DUDEN GERMAN DICTIONARY 17 (2d ed. 1998) (AG is an abbreviation for *Aktiengesellschaft*, which is "stock company" in German).

308. *See* Theodor Baums, *Corporate Governance in Germany: The Role of the Banks*, 40 AM. J. COMP. L. 503, 504 (1992); John C. Coffee Jr., *Comparative Corporate Governance*, N.Y.L.J., Mar. 26, 1992, at 5.

309. *See* Friedrich K. Kübler, *Institutional Owners and Corporate Managers: A German Dilemma*, 57 BROOK. L. REV. 97, 102 (1991).

310. Five top voting blocks in Daimler-Benz as of 1986 and GM as of 1990.

Daimler-Benz		General Motors	
Shareholder	% of Total	Shareholder	% of Total
Deutsche Bank	41.80	Mich. St. Treas.	1.42
Dresdner Bank	18.78	Stanford	1.28
Commerzbank	12.24	Wells Fargo	1.20
Sonst. Kredit	4.41	CREF	0.96
Bayerische L-Bank	1.16	Bankers Trust NY	0.88
Top Five	78.39	Top Five	5.74

This table combines the German banks' votes from brokerage stock, directly owned stock, and mutual fund stock. Mark J. Roe, *Some Differences in Corporate Structure in Germany, Japan, and the United States*, 102 YALE L.J. 1927, 1938 (1993).

vote stock that the bank's brokerage customers own but deposit with the bank. Therefore, as a result of these concentrated holdings (which typically amount to more than half of a corporation's stock), these shareholders possess considerable power over the actions of German CEOs.

2. Board of Directors

The board of directors of German corporations is typically structured into a two-tier system. Unlike the unitary board of directors present in American, Japanese, and majority of French corporations, German corporate governance operates on two separate, but related levels: the supervisory board (*Aufsichtsrat*) and the management board (*Vorstand*). In firms with over 2000 employees, shareholders are entitled to elect half the supervisory board.³¹¹ The firm's employees elect the other half, but under German law, the chair of the supervisory board must come from the shareholder side, and is usually a senior executive with the company's lead bank.³¹² In addition to appointing the management board, the supervisory board must also approve all major corporate decisions and inspect all major financial documents.³¹³

Control of the corporation is ultimately in the hands of the managerial board. They are responsible for the day-to-day administration of the corporation. However, as supervisors, banks wield considerable influence concerning corporate policy. Unlike the traditional American inside board of directors, bank representatives on the supervisory board are largely independent of the CEO's influence. The CEO is neither a member of the supervisory board nor responsible for the members' positions on the board. Board members owe their allegiance to their home institutions. Consequently, board members see it as their task to closely scrutinize all information and vigorously object to reckless or wrong-headed corporate policy.

3. Management

Because of the dominant position that bank shareholders maintain in German corporations, German executives are highly cognizant of these shareholders' demands and recommendations on strategy and policy. Unlike the American executive, who has been relatively free to pursue whatever course of business he or she deemed desirable, while being insulated from shareholder or director control, German executives are subject to strict control and influence by banks. As a result, German corporate strategy and policy truly are products of both the executives and shareholders. Through this cooperative effort, German managers need not concern themselves with a falling stock price or marauding corporate raiders looking to take over an undervalued firm.

B. Corporate Governance

The German model's principal advantage, just as in Japan, is management accountability. Because German banks are permitted to hold large blocks of stock, and

311. See Kübler, *supra* note 309, at 98.

312. See Roe, *supra* note 310, at 1942.

313. See Baums, *supra* note 308, at 509-10.

thereby place their representatives on a corporation's governing board, they are able to exert direct influence on corporate decisionmaking. Bank representatives on the supervisory board develop a continuing relationship with management; management comes to view shareholders not as an anonymous monolith with little loyalty to the firm, but as representatives of institutions expecting a profit and interested in the firm's long-term health.³¹⁴

In addition to management accountability, the German model has the added benefit of bringing more expertise to the decisionmaking process. In a modern, complex economic system, information is too widely dispersed. A person or staff from a single organization may not be able to assimilate all relevant information needed to make critical decisions. By including banks on the governing board, German corporations are given access to an abundance of additional information that better positions them to react to technology-driven and rapidly changing markets.³¹⁵

Commentators argue further that the cost of debt capital is less under the German model. Because banks (as shareholders) have influence over corporate policy, they are more amenable than American banks to make new loans or restructure existing loan agreements.³¹⁶ Moreover, "as a result of their relative indifference to the stock market, German . . . firms tend to have much lower dividend payout ratios."³¹⁷ This money can instead be used for research and development, factory improvements, equipment, or employee training.

Though the German model does have weaknesses,³¹⁸ it appears to remedy the management accountability problem that plagues American corporate governance. The question then becomes, to what extent can or should the United States borrow from Germany? Although the German model promotes managerial accountability, it cannot be an exact blueprint for the United States, since the American cultural ethic and legal regime prevents large concentrations of financial power.

C. Applying the German Model to U.S. Corporations

American corporate structure and business philosophy prevent the direct application of the German model to American corporations as they presently exist.

314. See Roe, *supra* note 310, at 1984-85. Banks are concerned with total return on their investment. That is, being both shareholder and creditor, they think in terms of long-term maximization for their equity and commercial loans together. See *id.*

315. See *id.* at 1931-33, 1985-86.

316. See David P. Hale, *Learning from Germany and Japan*, WALL ST. J., Feb. 4, 1991, at A10. In Germany, as in the United States, interest payments on debt are tax deductible. See *id.*

317. *Id.*

318. The major disadvantage of a bank-dominated capitalist system is its lack of venture capital markets. Start-up entrepreneurs have a difficult time obtaining risk capital from equity investors. Also, with banks serving on a number of supervisory boards, the potential arises for a crippling array of conflicts of interest. Finally, agency problems may simply shift from the firm to the banks. Who is watching the banks, insuring that they that they are properly watching management? For example, in 1994, questions were raised concerning the supervisory board of Metallgesellschaft, Germany's fourteenth largest company, which missed a string of poor investment decisions made by the Metallgesellschaft's CEO. As a result, the company's leading banks had to make a DM 3.4 billion (\$2.2 billion) emergency infusion of debt and equity. See *Banks Pull Metall Back from Brink*, DAILY TELEGRAPH, Feb. 7, 1994, at 25.

Philosophically, the United States has historically distrusted governmental concentrations of power.³¹⁹ This is seen in the very foundations of our democracy: public representation; individual rights; a system of checks and balances among the legislative, judicial, and executive branches; and the fragmentation of power between state and federal government. Private economic concentrations have been equally suspect. The Populists of the 1890s and Theodore Roosevelt's Progressive Movement of the early twentieth century gave political voice to the widespread attitude that large financial institutions and central accumulations of economic power are inherently undesirable and should be reduced, even if the concentration serves a useful productive function. Historian Richard Hofstadter, reviewing this issue, summarized that: "the ordinary American's ideas of what . . . economic life ought to be like had long taken form under the conditions of a preponderantly rural society with a broad diffusion of property and power. In that society large aggregates had played a minor role."³²⁰

It is not surprising, then, that the American corporate structure—sculpted according to a regulatory regime that discourages, if not prohibits, powerful accumulations of wealth—also prevents the German model's direct application. Indeed, a traditional objective of American antitrust law is to break up monopolies and promote competition among smaller, fragmented groups. Today, if American banks were to imitate their German counterparts and acquire large voting blocks of American corporations, they would violate nearly every financial regulation in the United States.³²¹

Interestingly, in the early twentieth century, American banks were evolving toward a form somewhat similar to that of German banks today. Though American banks could not own stock, they did have the power to underwrite and distribute securities through affiliates.³²²

Some large banks, such as J.P. Morgan, also played a major role in restructuring troubled industries and promoting corporate mergers. The Morgan Bank supervised the reorganization of the American railway industry after the depression of the mid-1890s, and sponsored the creation of U.S. Steel. During its height, Morgan Bank partners sat on the boards of 112 public companies,³²³ and "companies that had a close affiliation with the Morgan Bank often sold at a premium . . . because of investors' confidence in Morgan management."³²⁴ A study by the National Bureau of Economic Research found that before 1914, America's leading banks, including Morgan, had a system of cross-directorships on the boards of many of the major railway and manufacturing companies.³²⁵

In 1933, however, in response to numerous bank failures after the stock market crash of 1929, Congress passed the Glass-Steagall Act,³²⁶ which prohibited bank

319. See Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 *COL. L. REV.* 10, 32 (1991).

320. RICHARD HOFSTADTER, *THE AGE OF REFORM: FROM BRYAN TO F.D.R.* 65 (1955).

321. See Roe, *supra* note 319, at 16-31.

322. See National Currency Act of Feb. 25, 1863, § 11, 12 U.S.C. § 24 Seventh (1988), *Cal. Bank v. Kennedy*, 167 U.S. 362, 366-67 (1897); Hale, *supra* note 316, at A10.

323. See RON CHERNOW, *THE HOUSE OF MORGAN* (1990) 152.

324. Hale, *supra* note 316, at A12.

325. See Hale, *supra* note 316, at A12.

326. See Banking Act of 1933, §16, 12 U.S.C. § 24 Seventh (1988).

affiliates from dealing in securities. According to proponents, keeping bank affiliates out of stocks reduced the risk of bank failure. Moreover, by severing banks' access to the securities market and limiting their business, Congress successfully decentralized a portion of American finance.³²⁷ In 1956, Congress further restricted banks by passing the Bank Holding Company Act,³²⁸ which limited bank holding companies to no more than 5% of the voting stock of any nonbanking company. Other laws restricted banks to a presence in only one state³²⁹ and capped the level of equity that bank trust funds could hold in any single corporation;³³⁰ bank trust funds are the only remaining link that banks have with the securities market.

While there have been calls for banking deregulation (in areas such as bank sponsorship of mutual funds), restrictions on banks are eroding,³³¹ and the bulk of American banking law would have to be repealed to accommodate German-style banking in the United States. The likelihood of this happening anytime soon is, at best, low.

Notwithstanding its twentieth century fragmentation, a curious phenomenon has been taking shape on the American securities landscape. For the past decade, economic power has been slowly consolidating in the hands of institutional investors.³³² These institutional investors may spur the increased internal control characterizing the German model. The evolving American corporate governance structure may, therefore, make particular attributes of the German model viable in the American corporate governance. The inherent cultural differences between the two systems, though, will continue to limit such adoptions.

327. See Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 41-42 (1991).

328. See Bank Holding Company Act of 1956, § 4(c)(4)-(5), 12 U.S.C. § 1843(c)(5)-(6) (2000).

329. See McFadden Act, ch. 191, § 1, 44 Stat. 1224 (1927) (codified as amended at 12 U.S.C. § 36 (1988)).

330. See 12 C.F.R. § 9.18 (b)(9)(ii) (2002).

331. Roe, *supra* note 310, at 1949 n.50.

332. Yet, the growth of institutional investors has not gone unchecked. Both the Congress and the states, ever suspicious of concentrated power, have restricted the extent to which any one institutional investor can hold securities in a single corporation. For example, the Investment Company Act of 1940 prohibits a diversified mutual fund from holding over 10% of the stock of one company. Investment Company Act of 1940 § 5(b), 15 U.S.C. § 80a-5(b) (2000). The Employee Retirement Income Security Act of 1974 ("ERISA") discourages pension funds from holding large blocks of stock by requiring that they diversify their portfolios. ERISA § 404, 29 U.S.C. § 1404 (2000). The State of New York has limited the percentage of a New York insurer's assets invested in stock to 25%. New York life insurers cannot put more than 2% of the insurance company's assets into the stock of a single issuer, and property and casualty insurers cannot control a non-insurance company. New York Insurance Law § 1405(a)(6)(8), 1405(a)(6)(i), 1705(a)(1)-(2), 107(a)(40), 1403(c), 1404(a)(13)(B)(i), 1407(a)(4) (McKinney 1985 & Supp. 1990). Additionally, there is an array of SEC rules, requiring expensive and time-consuming disclosure, should a shareholder, individually or as a member of a group, own more than a specified percentage of a corporation. See 15 U.S.C. § 78m(d) (2000); Regulation 13D, 17 C.F.R. §§ 240.13d-1 to -7 (2002).

V. THE CORPORATE GOVERNANCE STRUCTURE IN FRANCE

A. Shareholders

From the beginning of French industry until today, French corporations have been owned either by individuals³³³ or the State.³³⁴ In the early stages of industrialization, equity financing was limited due to the general societal fear of outsiders as shareholders. As a result, French corporations relied primarily on banks for financing.³³⁵ Times have changed dramatically as now the "Paris capital market . . . is the most modernized and sophisticated [stock exchange] in the world."³³⁶ The Paris stock exchange ranks fourth in the world behind Tokyo, New York, and London, with a total capitalization reaching 4,333 billion francs in 1991.³³⁷ France also has the largest number of individual shareholders among all the European countries.³³⁸

In major French companies, stock holdings are relatively concentrated.³³⁹ Typically, four primary groups hold corporations listed on the French Stock Exchange:³⁴⁰ households,³⁴¹ institutional investors,³⁴² companies,³⁴³ and foreign investors.³⁴⁴ In

333. In smaller firms, it is not uncommon that the managers of their family owned a substantial portion of the company. See ASH AHMAD ET AL., FORMAL AND INFORMAL INVESTMENT BARRIERS IN THE G-7 COUNTRIES: THE COUNTRY CHAPTERS 28 (1994).

334. However, a number of major firms formally owned by the State have been privatized in recent years, or are in the process of being privatized. See *Loi de Privatization (Privatization Act) No. 86-912 of July 2, 1986, JO Aug. 7, 1986 at 9695, as amended by the Act No. 93-923, of July 19, 1993, JO July 21, 1993, at 10255*. Twenty-one enterprises will be privatized under the Act. See *id.*

335. See Keith Dill Nunes et al., *French & SEC Securities Regulation: The Search for Transparency and Openness in Decisionmaking*, 26 VAND. J. TRANSNAT'L L. 217, 219-20 (1993).

336. *Id.* at 220.

337. *Id.*

338. *Id.*

339. In contrast to the United States, French company shareholding usually follows the structure of UAP (a French insurance company), although Air Liquide and Lafarge are exceptions to the concentrated holdings. In UAP, 85% of UAP's equity investments are in twenty shares. See JONATHAN P. CHARKHAM, KEEPING GOOD COMPANY: A STUDY OF CORPORATE GOVERNANCE IN FIVE COUNTRIES 126, 127 (1994).

340. There are about 630 *Sociétés Anonymes* ("SA") quoted on the Stock Exchange. See *id.* at 130.

341. Of the 4.5 million direct investors, 3.2 million investors hold their stock through the "OPCVM." The OPCVM (*Organismes de Placement Collectif en Valeurs Mobilières*) are either Mutual Fund Investment Corporations (referred to as "SICAV," *Société d'Investissement à Capital Variable*), or Unit Trusts (*Fonds Communs de Placement*). OPCVM investors generally keep their shares for about four years, and are therefore relatively stable. Individual investors are interested in the yield from their investment rather than in the actual control or management in the corporation. See Catherine Levi, *Les Actionnaires, Qui Sont-ils?*, LE MONDE, Dec. 14, 1993.

342. See *id.* Institutional investors are insurance companies, pension funds (that industry is heavily dominated by the State, but has started to move towards the equity market), OPCVM, the *Caisse des Dépôts* (National Deposit and Consignment Office), and a number of banks and other credit institutions. Although some of these investors are dependable (notably those who

addition, it is common to have a large portion of a corporation's shares (30 to 50%) held by friendly shareholders who have an interest in the corporation and are referred to as partners or *noyau dur* ("hardcore" shareholders).³⁴⁵ Remaining shares are floating ones that are available on the market.

Similar to Japan and Germany, French banks³⁴⁶ are the dominant stockholders in French corporations, giving them considerable power within French corporations through their membership on corporate boards and the heavy corporate reliance on debt financing.³⁴⁷ The position of banks within corporations is typically viewed as an asset, based on French industry's general perception that banks provide strong protection against takeovers. There is some disagreement, however, on whether the banks are effective monitors, given the potential conflict of interests inherent in the banks' roles as managers of mutual funds and suppliers of credit.³⁴⁸ It is generally accepted, however, that banks' presence on boards improves boards' management oversight capabilities.³⁴⁹

With respect to corporate control, shareholders are virtually powerless in controlling corporate affairs, with the exception of banks. This is primarily due to the

constitute the hardcore of the shareholding), on average they do not hold their shares for more than eleven months. See REPORTS OF THE COMMISSION DES OPERATIONS DE BOURSE, QUELS ACTIONNAIRES POUR L'ENTREPRISE? (1993); REPORTS OF THE COMMISSION DES OPERATIONS DE BOURSE, RELATIONS DES GRANDES ENTERPRISES COTEES AVEC LEUR ACTIONNAIRES (1993). The *Commission des Operations de Bourse* is the French equivalent to the U.S. Securities and Exchange Commission.

343. Corporations, however, usually take participation in other firms to support external growth operations, and retain their shares for longer periods of time (an average of thirteen years). See *id.* QUELS ACTIONNAIRES POUR L'ENTREPRISE?, *supra* note 342; RELATIONS DES GRANDES ENTERPRISES COTEES AVEC LEUR ACTIONNAIRES, *supra* note 342.

344. See CHARKHAM *supra* note 339, at 127.

345. The Privatization Act of 1986 "expressly provided for the creation of such holdings and insisted on five-year, 'no-sell agreements' (since cancelled)." *Id.* at 126-27.

346.

These alliances can include significant cross-shareholdings, or the issuance of stock warrants or options to allies which can be converted to common (or even super-voting) stock in the event that a takeover offer for the issuer company is announced.

A variation of this cross-holding technique is a company's use of a subsidiary as a holding company to hold up to ten percent of the parent company's stock.

This practice, termed *auto-contrôle* is widely used in France by such well-known companies as Pernot-Ricard, Paribas, and CGE. . . .

David J. Berger, *Guidelines for Mergers and Acquisitions in France*, 11 NW. J. INT'L L. & BUS. 484, 504 (1991).

347. "The five big [French] banks now hold between them FF 104 billion in industrial investments, excluding the insurance sector (Société Générale (18), Paribas (25), Suez (25), Crédit Lyonnais (18), BNP (18))." CHARKHAM, *supra* note 339, at 145. The role of institutional shareholders is likely to increase in the coming years. Therefore, the relative importance of the banks will decrease. See BOARD DIRECTORS, *supra* note 22, at 12.

348. The question is whether the bank as a member of the board of an industrial company will give preference to the interests of the company, or to the interests of the bank itself. See CHARKHAM, *supra* note 339, at 145.

349. See BOARD DIRECTORS, *supra* note 22, at 12.

substantial holdings of friendly shareholders and management's power to insulate itself from dissatisfied shareholders. Government shareholding, hardcore shareholding, and cross-shareholding have protected a substantial number of privatized companies from takeover attempts and contested bids.³⁵⁰ In addition, if the articles of incorporation provide for the increase of voting rights to long-term shareholders, who generally are friendly to management, the management is also protected from hostile shareholder actions. Management also has the ability to further insulate itself from shareholders by issuing up to 25% of the capital in the form of nonvoting preferred stock, or investment certificates, where the voting rights associated with these certificates are issued separately to existing shareholders and are subject to significant transfer restrictions.³⁵¹

Shareholders, however, are not voiceless. Bad management, once recognized, can ultimately be sanctioned by the shareholders through the dismissal of the board of directors, or the supervisory board directors at a general meeting. The shareholders may vote in person, through a proxy vote, or by instructing the chairman to vote in a specific way. Still, proxy battles are unlikely to occur over most management issues, because the people who sit on the board of directors are very often the same people holding large shares in the corporation.

Shareholders have the ability to scrutinize corporate finances and management every year.³⁵² They may also enter into control agreements between the corporation and the management.³⁵³ Shareholders with at least 5% of the corporation's capital have the ability to request the appointment of a management expert by a judicial court.³⁵⁴ The *Commission des Opérations de Bourse* ("COB") may do the same if the corporation is publicly traded.³⁵⁵ Such an expert has the duty to investigate management decisions and operations.³⁵⁶ The expert's report is then communicated to the shareholders, the board of directors, or the supervisory board, and eventually, to the COB.³⁵⁷

Finally, shareholders of an SA are required to appoint an auditor,³⁵⁸ whose role is to control the financial statements of the corporation³⁵⁹ and assess the legality of the corporation's operations. The reports prepared by the auditor are transmitted to the board of directors or supervisory board for review, as well as to the shareholders.³⁶⁰

350. This stability will probably erode to a degree in the future, however, as the State is tending to become less involved in the industrial and financial sectors. *See id.* at 10.

351. *See generally* CODE DE COMMERCE [C. COM.] L228-12 (Fr.), available at <http://www.legifrance.gouv.fr> (the French version of this official government website lists this code as the Code de Commerce, the English version lists it as the Nouveau Code de Commerce).

352. *See id.* at L225-100.

353. *See id.* at L225-38, -86.

354. *See generally id.* at L225-231.

355. *Id.*

356. *Id.*

357. *Id.* The COB, the French equivalent to the Securities and Exchange Commission, exercises an external control over the corporation operations, notably insider trading, and since 1984, over the activities of the management. *See id.*

358. *See id.* at L225-238. The term of the appointment is six fiscal years. *See id.* at L225-229. This provision ensures the auditor's independence.

359. *See id.* at L225-237.

360. *See id.*

Audit reports are a critical checking device to monitor the management's integrity.

Therefore, the concentrated shareholding in French corporations, and the actual presence of these shareholders on corporate boards or supervisory boards,³⁶¹ imposes executive accountability, which facilitates effective oversight of executives.³⁶² Therefore, the control exercised over management is likely to be internal rather than external in a French company.

B. Management

In France, there is a tradition of "strong centralized leadership which goes back through de Gaulle and Napoleon to Louis XIV."³⁶³ The French social preference for concentrated power is also prevalent in the area of corporate governance.

[French managers perceive] . . . the organization . . . as a collectivity of persons to be managed. . . . The French see the company as a system of persons organized in a social hierarchy. Authority is distributed vertically, with each actor having the authority necessary for him or her to make the required contribution to the system. . . . [As a result] the French manager . . . considers it very important to have precise answers to the majority of questions he might be asked by subordinates concerning the work they are doing. Implicitly, he bases his authority more on a superior degree of knowledge and competence than on his talent for coordination of management. This attitude leads to a greater degree of centralization of authority and responsibility in the company.³⁶⁴

This conception of the executive role is reflected in the French corporation's form of management. The board of directors elects the president of the SA. Theoretically, the board of directors controls French managers; however, the president of the SA selects the board members (in French as "conseil d'administration" or "management directeurs généraux"), with consultation from the SA's major shareholders. Therefore, executive power is curtailed through the power of the board.

The level of compensation received by French officers is similar to that of their German counterparts.³⁶⁵ In 1992, for example, French CEOs received on average \$217,333, versus \$230,950 and \$313,375 for their German and American counterparts,

361. The supervisory board plays a key role in determining the strategic direction of the firm. *See id.*

362. The management is in fact accountable to banks, family interests, and eventually the State. *See* BOARD DIRECTORS, *supra* note 22; Oxford Analytica, Ltd., EXECUTIVE REPORT TO BOARD DIRECTORS AND CORPORATE GOVERNANCE: TRENDS IN THE G7 COUNTRIES OVER THE NEXT TEN YEARS 7, 20 (1992).

363. CHARKHAM, *supra* note 339, at 119. State interventionism in commercial matters can be traced back to the early seventeenth century. For example, the choice of the shareholders in the New Guinea Company, established in 1684, was reserved to the king. *See* KHORSHED D.P. MADON, MANAGEMENT OF CORPORATIONS: A MULTI-NATIONAL STUDY OF CORPORATE LAW AND MANAGEMENT 113 (1971).

364. Gilles Amado et al., *Organizational Change and Cultural Realities: Franco-American Contrasts*, 21 INT'L STUD. MGMT. & ORG. 62, 80-83 (1991).

365. GRAEF S. CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES 209 (1991).

respectively.³⁶⁶ Although their base salaries are not drastically different, the average total remuneration of chief executives in the United States recently amounted to \$747,539, versus \$493,625 in France and \$432,602 in Germany.³⁶⁷ The difference is even more striking with top executives in the largest corporations. Chief executives of America's biggest companies recently averaged \$3.2 million,³⁶⁸ while their German counterparts averaged one million deutsche Marks (\$735,000), and the French a mere three million francs (\$600,000).³⁶⁹

The gaps are partly explained by different business practices, and most significantly by what Steve Lohr of the *New York Times* refers to as the "showering of [American] executives with stock options."³⁷⁰ Additionally, staff representatives in the French corporations may prevent exorbitant executive salaries, since they are able to appoint their own financial expert with power to examine the accounts of the company. The payment of excessive sums would probably come under harsh scrutiny.

C. Board of Directors

The traditional French governance system, similar to the American system, is a one-tier system led by a board of directors.³⁷¹ A board of directors must consist of at least three but no more than eighteen members.³⁷² Each director must be a stockholder with the minimum number of shares specified in the bylaws.³⁷³ A board chairman (*président du conseil d'administration*)³⁷⁴ is typically the managing director of the corporation. Directors may serve a term that lasts up to six years with the option of renewal.³⁷⁵

Directors are elected by shareholders at shareholder meetings.³⁷⁶ In practice,

366. Michael A. Verespej, *Pay-For-Skills: Its Time Has Come*, *INDUSTRY WEEK*, June 15, 1992, at 22, 23.

367. *Id.* However, unlike Germany, such representation does not amount to codetermination. See CHARKHAM, *supra* note 339, at 144; BOARD DIRECTORS, *supra* note 22, at 9.

368. See Lohr, *supra* note 53.

369. See CRYSTAL, *supra* note 365, at 207-09.

370. Lohr, *supra* note 53. Stock options are relatively cheap for U.S. companies because of "accounting conventions in the United States."

371. See C. COM. L225-17.

372. *Id.* The articles of incorporation may also provide that the employees elect additional directors. *Id.* at L225-27. A maximum of four salaried executives may also serve on the board, which is in addition to the twelve allowed by law. See *id.* The executive directors, however, cannot represent more than one-third of the entire board. *Id.*

373. *Id.* at L225-25.

374. The board of directors elects the chairman, who must be a member of the board. See *id.* at L225-47. The chairman may also be the *directeur général* (also known as the "PDG") of the corporation. *Id.* at 225-51-1. The board of directors may remove the PDG at any time. *Id.* at L225-55. The removal of the PDG without cause will subject a corporation to liability unless the PDG is also the chairman of the board. *Id.* This can be a useful tool to control the activities of the PDG (although seldom used), but presents the disadvantage of potential instability, since the shareholding may change, and with it personal preferences.

375. *Id.* at L225-18. The average director term is five years with reelection automatic in most instances. See BOARD DIRECTORS, *supra* note 22, at 97.

376. *Id.* The directors may be dismissed at any time by an ordinary general meeting of the shareholders. *Id.*

however, the PDG appoints the board, and the shareholder vote is merely a formality in the ratification of the PDG's selection. Therefore, although the shareholders are technically responsible for the designation of the board members, the PDG may actually be the one who makes the decision, or at least influences the shareholders' choice in a substantial way. The directors are usually appointed as representatives for the largest shareholders. PDGs, therefore, usually choose those shareholders who have significant holdings within the corporation to facilitate efficient management.³⁷⁷

Finally, because legal entities may be directors of an SA,³⁷⁸ major institutions with significant shareholdings, such as banks, may appoint nominees to the board. Doing so, however, has a major drawback. Because they become insiders of the corporation, they restrict their ability to place bids on the equity market, which eventually restricts their potential control of management through the equity market.

The board of directors has extended powers to act on behalf of the company under all circumstances, provided the acts are consistent with the corporate purpose and are not expressly reserved for the shareholders' meetings.³⁷⁹ Board action requires the physical presence of at least half of the board.³⁸⁰ Most decisions can be made by a simple majority vote.³⁸¹

The PDG may perform any act on behalf of the company that is necessary in the course of management, so long as he or she does not impinge upon acts specifically reserved for the shareholders or the board of directors as a whole.³⁸² Up to five assistant general managers (*directeurs généraux délégués*) elected by the board upon PDG's request may assist the PDG.³⁸³ The actions of the PDG or the directors are constrained to an extent given the presence of large shareholder representation on the board. A PDG's failure to respect these limitations will in all likelihood result in his or her termination. Therefore, the kind of recklessness observed in the similar one-tier system in the United States is unlikely to occur in France. The success of this structure is the primary reason why the vast majority of the firms in France have maintained a one-tier system.

Some French corporations, however, have adopted a two-tier system inspired by the German model of corporate governance. In this system, the shareholders of the corporation appoint a supervisory board of three to eighteen members³⁸⁴ who must

377. JEREMY BACON, CONFERENCE BOARDS AND CORPORATE GOVERNANCE 33 (1993). A result of this type of board membership of directors who control the majority of share in the corporation is that management has the power to refuse unwanted takeover offers. *See id.*

378. *See* C. COM. L225-20. But the entities elected as directors must designate permanent representatives who are subject to the same liabilities as the other directors, as if they were sitting on the board in their personal capacity. *See id.*

379. *See id.* at L225-35. Note that the company may nevertheless in certain circumstances be bound by acts engaged in violation of limitations on the board's powers as being in violation of the company's corporate purpose. *See id.*

380. *See id.* at L225-37.

381. *See id.*

382. *Id.* at L225-56.

383. *See id.* at L225-53. The board of directors, in consultation with the PDG, determines the powers of the assistant general managers. *See id.* at L225-56. However, the general managers are deemed to have all the powers the PDG have vis-a-vis third parties. *Id.* The board of directors can remove the general managers at any time. *See id.* at L225-55.

384. *Id.* at L225-69.

each hold a minimum of qualifying shares,³⁸⁵ as specified in the company's bylaws.³⁸⁶ The supervisory board, in turn, appoints³⁸⁷ and supervises³⁸⁸ a directorate consisting of one to five members³⁸⁹ who do not need to hold shares in the corporation.³⁹⁰

Board compensation, like executive compensation, is a barometer of the accountability of the board to shareholders. Under French law, members of both kinds of boards receive attendance payments (*jetons de présence*), fixed by the shareholders as a global amount divided by the board.³⁹¹ To limit double salaries within the two-tiered corporations, not more than one third of the members of the supervisory board can be employees of the SA,³⁹² and the members of either kind of board cannot sit on more than five supervisory boards.³⁹³

Although directors wield considerable power, director liability provides another check on director activities in addition to the presence of large shareholder representation on the board. Even though the company is bound by all acts of the directors,³⁹⁴ directors are jointly and severally liable to the corporation and third parties for any damages or losses resulting from such actions.³⁹⁵ A shareholder may bring an action either individually or derivatively, on behalf of the corporation.³⁹⁶ The officers and directors may also be subject to criminal liability with a penalty of up to five years imprisonment, for example, if they create fraudulent financial statements or make false declarations concerning dividends.³⁹⁷ In practice, however, it seems that the liability of the directors or the PDG is seldom triggered because of the performance of their duties.³⁹⁸

385. *Id.* at L225-72.

386. *Id.* at L225-72.

387. *Id.* at L225-59.

388. *Id.* at L225-68. In doing so, the supervisory board has the power to make such controls and examinations as it deems advisable and has access to all documents. *Id.* In addition, every three months, the directorate must submit a report on the situation of the company to the supervisory board and prepare and submit the financial statements of the company to the supervisory board once a year, which then makes its comments based on its review of the documents. *Id.*

389. *See id.* at L225-58.

390. *Id.* at L225-59.

391. *Id.* at L225-83.

392. *Id.* at L225-85.

393. *Id.* at L225-77.

394. *See id.* at L225-64. The directorate is empowered to act on behalf of the company, provided the acts performed are not among those reserved to the supervisory board or the shareholders, and are within the purpose of the corporation. *See id.*

395. *Id.* at L225-251.

396. *See id.* at L225-252. Any shareholders' vote attempting to limit or remove director liability is void. *Id.* at L225-253. The members of the supervisory board are liable only to the extent that they failed to properly supervise the management or to disclose to shareholders, any crime or serious management of which they had personal knowledge. *See id.* at L225-257.

397. *See id.* at L242-6.

398. *See* BOARD DIRECTORS, *supra* note 22; EXECUTIVE REPORT, *supra* note 362, at 10.

VI. LESSONS FOR CROSS-NATIONAL IMPROVEMENT

A. BERLE AND MEANS IN THE GLOBAL TWENTY-FIRST CENTURY

Understandably, the bulk of the subsequent literature on American shareholder governance following Berle and Means has focused on the relationship between those management and shareholders, with boards of directors and external actors serving largely as adjunct forces. Conversely, foreign stakeholder governance systems have continued to focus highly on the relationship between management and external actors, largely due to history and inertia if nothing else. Each of these organizational perspectives has strengths and weaknesses. This Article argues that the strengths of each system can be imported into the other to effect improved corporate governance.

B. What Shareholder Governance Can Learn from Stakeholder Governance

The flexibility and decisiveness of American-style shareholder governance can be improved by importing the external disciplines of the Japanese, German, and French systems. Certainly, the U.S. can benefit by recognizing that some concentration of ownership through institutions can benefit corporate performance by linking it more closely to the disciplining effects of the capital market. The trend toward, and advantages of, increased institutional participation on boards of directors are already apparent.

Increased concentration, although it will help overcome the collective action problem of dispersed shareholders, is not an unqualified benefit to corporate governance. Institutional investors face real conflicts of interest between their fiduciary responsibility to beneficiaries and their role as active investors. Institutional investors' conflicts are further complicated to the extent that they offer differing financial services to customers with divergent fiduciary goals. As institutional investors grow more influential on boards of directors, their temptations will be the same as those of the Japanese *keiretsu* banks and their counterparts in Germany and France. In particular, this includes the opportunity to bail out one corporation and transfer funds to a more successful corporation. An institution with large positions in an individual corporation may also be reluctant to reveal problems that show its investments were unwise and call into question the competence of its own management. Also, banks directly supplying a corporation with capital potentially face the moral hazard of being reluctant to reveal internal problems for fear of setting off a chain reaction that would make it harder for the company to repay its debts, access capital markets or, at worst case, cause it to fail.

A larger role for institutional investors is gaining cultural acceptance in American corporate governance. More fully integrating this facet of stakeholder governance appears to be mainly a matter of time. Importantly, however, corporations and institutional investors alike must be careful not to confuse their respective roles. Turning institutional "outsiders" into "insiders" is likely only to generate the same paralysis that sometimes accompanies consensual decisionmaking in stakeholder-governed companies.

C. What Stakeholder Governance Can Learn from Shareholder Governance

The system of external disciplines in the Japanese, German, and French styles of

stakeholder governance can be improved by importing the management flexibility and decisiveness allowed (at times to a fault) in the American shareholder system. Certainly, stakeholder countries benefit from outside influence on their boards of directors. Often, however, stakeholder "outsiders" and, to some extent, the capital market itself, become so close to the corporations they are supposed to monitor that they effectively become "insiders," complete with their aligned interests.

More than a benefit, such a generalized institutional transition may, in fact, be an outright necessity as these countries continue to deregulate and refine their securities and capital markets. As this process continues on a global scope, stakeholder corporations will likely find themselves less insulated from *Barbarians at the Gates*-type hostile takeovers designed to check internal management inefficiencies. For example, even though Japanese domestic and export success is often attributed to the concentration of ownership and debt claims held by banks and *keiretsu* corporations, compatibility with multinational firms via merger, acquisition, or partnership will almost certainly require reforms, given the differences in cultural norms.³⁹⁹ Similarly, the organizational decentralization spurred by the information technology revolution undercuts the rationale of the centralized, hierarchical governance of Japanese, German, and French corporations.

Improved mobility and a "natural" deconcentration in ownership can promote this flexibility and decisiveness. Principally, achieving a more diverse and noninstitutional ownership is a cultural issue that requires stakeholder countries to deemphasize hierarchy, disentangle personal aspects of cross-corporate relations, and become more comfortable with what Joseph A. Schumpeter impersonally termed the "perennial gale of creative destruction"⁴⁰⁰ of fully dynamic capitalism. Additionally, stressing neutral rules that place individual investors on equal footing with institutional investors is a continued baseline requirement for such a long-term project. Notably, the principal disadvantage of shareholder governance, atomization of shareholder interests, is a distant prospect in stakeholder countries.

D. Enron and Global Crossing: "See No Evil" in the Two Faces of the Corporate Janus?

Ideally, management and the board of directors should serve as the principal disciplinarians of the corporate structure and give shareholders a 360-degree view of its activities. Thus, their dual functions are much like the two faces of the Roman god Janus. Although the smoke surrounding the high profile Enron and Global Crossing bankruptcies is unlikely to clear for quite some time, some of the initial puzzle pieces of their failures can be put together. It is imperative that comparative corporate governance scholarship both analyzes and draws lessons from these massive downfalls.

1. Enron—The Greatest Management Sham in Corporate History?

The collapse of Enron into Chapter 11 during late 2001 and early 2002 made it the largest ever public bankruptcy in U.S. history. This dramatic and unexpected implosion

399. *See supra* Part IV.

400. JOSEPH A. SCHUMPETER, *CAPITALISM, SOCIALISM, AND DEMOCRACY* 83-86 (3d ed. 1950).

is especially shocking when contrasted to the public reputation of a model corporate citizen it had developed during a transformation from a staid gas pipeline founded in 1985 into a high-flying energy trader. *Fortune* magazine had named Enron to its list of "100 Best Companies in America to Work For,"⁴⁰¹ Harvard Business School wrote a flattering case study hailing "Enron's transformation: From gas pipelines to New Economy powerhouse,"⁴⁰² and—most ironically—*CFO* magazine honored Chief Financial Officer Andy Fastow in 1999 for his innovative work on "unique financing techniques."⁴⁰³ Right up to its implosion, external financial analysts were either similarly fooled or succumbed to the ever-present threat of reduced access to management or cuts in investment banking fees.⁴⁰⁴

Even at its collapse, Enron featured an apparently ideal blue chip board of directors of only two insiders, Kenneth Lay and Jeffrey Skilling, and fifteen highly distinguished and diverse outsiders from business, institutional finance, government, academia, and the U.S. Olympic Committee. By all appearances, board members had nothing to gain and much to lose from being associated with such a business catastrophe.⁴⁰⁵ Indeed, "[a] growing body of evidence does . . . suggest that Enron was a peculiarly egregious case of bad management, misleading accounts, shoddy accounting and, quite probably, outright fraud."⁴⁰⁶ Sherron Watkins, the company whistleblower who first pointed out

401. Curtis C. Vershooor, *Were Enron's Ethical Missteps a Major Cause of Its Downfall?*, STRATEGIC FINANCE (Feb. 2002), at 22.

402. John A. Byrne et al., *The Environment was Ripe for Abuse*, BUS. WK., Feb. 25, 2002, at 118, 118.

403. Evan Thomas, *Every Man for Himself: They Used to Be on Top of the World, But Now Enron's Fallen Elite Are Trying to Duck Blame for Their Empire's Ruin. How They May Try to Hang Together—Or Hang Separately*, NEWSWEEK Feb. 18, 2002, at 22.

404. Jerry Knight, *Analysis' Plea of Ignorance Undermines Market*, WASH. POST, Mar. 4, 2002, at E1.

405. The list of board members included: Robert A. Belfer, Chairman, Belco Oil & Gas Corp.; Norman P. Blake, Jr., Chairman, President and CEO, Comdisco, Inc., and Former CEO and Secretary General, U.S. Olympic Committee; Ronnie C. Chan, Chairman, Hang Lung Group; John H. Duncan, Former Chairman of the Executive Committee, Gulf & Western Industries, Inc.; Wendy L. Gramm, Director, Regulatory Studies Program of the Mercatus Center at George Mason University, and Former Chairwoman, U.S. Commodity Futures Trading Commission; Ken L. Harrison, Former Chairman and CEO, Portland General Electric Co.; Robert K. Jaedicke, Professor of Accounting (Emeritus) and Former Dean, Graduate School of Business, Stanford University; Kenneth L. Lay, Chairman, Enron Corp.; Charles A. Lemaistre, President Emeritus, University of Texas, M.D., Anderson Cancer Center; John Mendelsohn, President, University of Texas, M.D., Anderson Cancer Center; Jerome J. Meyer, Chairman, Tektronix, Inc.; Paulo V. Ferraz Pereira, Executive Vice President, Group Bozano, Former President and COO, Meridional Financial Group, and Former President and CEO, State Bank of Rio de Janeiro; Frank Savage, Chairman, Alliance Capital Management International; Jeffrey K. Skilling, President and CEO, Enron Corp.; John A. Urquhart, Senior Advisor to the Chairman, Enron Corp., President, John A. Urquhart Associates, and Former Senior Vice President of Industrial and Power Systems, General Electric Co.; John Wakeham, Former U.K. Secretary of State for Energy, and Leader of the Houses of Lords and Commons; and Herbert S. Winokur, Jr., President, Winokur Holdings, Inc., and Former Executive Vice President, Penn Central Corp. Enron Corp., *Board of Directors*, at <http://www.enron.com> (last visited Mar. 5, 2002).

406. *The Lessons from Enron*, ECONOMIST, Feb. 9, 2002, at 9.

questionable accounting practices, testified before Congress that even former CEO Kenneth Lay was “duped” by lower management and accounting fraud⁴⁰⁷ involving off-balance-sheet transactions and private, special-purpose entities. Whether or not this is ultimately shown to be true, both Lay and the board of directors deserve appropriate, if perhaps somewhat different, scrutiny.

Ultimately, though, Enron appears to be largely another case of “the cult of the all-powerful chief executive, armed with sackfuls of stock options . . .” again “push[ing] . . . checks [and balances] aside.”⁴⁰⁸ Principally, Enron suffered from an overly flexible and hyper-incentivized management structure that could not be kept in check by a decentralized in-house legal staff or a captured accounting firm. *Business Week* explains:

Lynda R. Clemmons, a French and history major from Southern Methodist University, was supposed to be emblematic of the rebels in Enron’s freewheeling culture. In 1997, as a 27-year-old gas-and-power trader, she launched an esoteric enterprise in weather derivatives. Within two years, her startup had written \$1 billion in weather hedges to protect companies against short-term spikes in the price of power during heat waves and cold snaps.

Layers of management were wiped out. . . . The company abolished seniority-based salaries in favor of more highly leveraged compensation that offered huge cash bonuses and stock option grants to top performers. Young people, many just out of undergraduate or MBA programs, were handed extraordinary authority, able to make \$5 million decisions without higher approval.

. . . Another essential “check and balance” in the culture—Enron’s in-house legal staff—was also compromised because of its reporting relationships. Instead of being centralized at headquarters, it was spread throughout the business units, where it could more easily be co-opted by hard-driving executives. . . .

. . . In practice, the system bred a culture in which people were afraid to get crossways with someone who could screw up their reviews. . . . “You don’t object to anything,” says one former Enron executive. “The whole culture at the vice-president level and above just became a yes-man culture.”

[According to another insider,] anyone who questioned suspect deals quickly learned to accept assurances of outside lawyers and accountants.⁴⁰⁹

“[J]ust from the evidence that has emerged so far, the trio of Lay, Skilling and Fastow will be remembered for their ability to fool a lot of people, including some very smart ones, for a long time.”⁴¹⁰ In chief, then, Enron is a provocative case study in the shortcomings of management unaccountability in stakeholder governance. Although Enron need not have adopted the full trappings of French or Japanese centralization, it

407. Daren Fonda & Adam Zagorin, *The Scandal That Keeps on Giving*, TIME, Feb. 25, 2002, at 17.

408. *The Lessons from Enron*, *supra* note 406, at 10.

409. Byrne et al., *supra* note 402, at 118, 118-20.

410. Thomas, *supra* note 403, at 24.

acutely demonstrates the peril of diminishing or forgoing the requisite level of ultimate central control, both in management and the legal division.

Amazingly, CFO Fastow was able to pass off the Enron-Arthur Andersen accounting techniques by saying, "we're very conservative in our accounting approach."⁴¹¹ The subsequent shredding of accounting documents by outside auditor Arthur Andersen proves otherwise. Thus, Enron's long-standing close relationship with Arthur Andersen also demonstrates the clear and present dangers of "too close" stakeholder-type relationships with external institutions.

2. Global Crossing—Siren Song of a Musical Board of Directors?

The collapse of Global Crossing into Chapter 11 in January of 2002 made it the fourth largest public bankruptcy in U.S. history.⁴¹² Launched in 1997 by former junk bond trader Gary Winnick, Global Crossing rapidly built a preeminent global high-speed fiber optic communications network.⁴¹³ The entrance of a flurry of competitors and a sharp drop in demand for broadband capacity, however, combined to make it impossible for the company to pay off its \$12 billion in debt.⁴¹⁴ At bankruptcy, company assets were listed at \$22 billion, although the company was once valued at more than \$40 billion.⁴¹⁵ Nonetheless, a number of industry analysts now conclude that Global Crossing's massive investment was inherently impossible to recoup in the face of overcapacity.⁴¹⁶ That, however, does not itself explain how financial markets and investors were misled into thinking otherwise.⁴¹⁷

In contrast to Enron, Global Crossing's problems appear to have their beginnings in its board of directors. Winnick was firmly rooted in Global's board as its chairman. In stark contrast, the rest of the board had been composed of thirty different directors since 1998, with the board's size ranging between eight and seventeen members during that time.⁴¹⁸ On its face, the presence of significant outside investors on the board should have been an important disciplinary force. Outside directors from Softbank Capital Partners,⁴¹⁹ which had invested \$340 million in Global's Asian subsidiary in 2000 and 2001, and the Carlyle Group,⁴²⁰ which held 2.2 million shares until April 2000, had an obvious incentive to protect their investments. But, "[o]f great concern to

411. Ronald Fink, *Beyond Enron: The Fate of Andrew Fastow and the Company Casts a Harsh Light on Off-Balance-Sheet Financing*, CFO, Feb. 2002, at 34, 39.

412. *Global Crossing Director Resigns, Third in Month*, REUTERS ENGLISH NEWS SERV., Mar. 4, 2002 [hereinafter *Global Crossing Director Resigns*].

413. Mark Harrington, *Global Crossing Files Chapter 11*, NEWSDAY, Jan. 29, 2002, at A43.

414. *Id.*

415. *Id.*

416. *Id.*

417. *See id.*

418. Harrington, *supra* note 413.

419. Henry Sender & Dennis K. Berman, *Global Crossing Panel Mixed Interests: Audit Committee Reflects Crisscrossing Involvement, Spurs Questions*, ASIAN WALL ST. J., Mar. 4, 2002, at M1. One member of Global Crossing's audit committee was Eric Hippeau, "managing director, Softbank Capital Partners, a unit of Tokyo-based Softbank Corp." *Id.*

420. "William Conway, a managing director of Carlyle Group, a Washington private investment firm, served on the audit committee from the spring of 1999 until five months ago [from March 2002]." *Id.*

some shareholders is the now-apparent fact that Mr. Winnick's personal friends, big shareholders and business clients numbered large on Global Crossing's board, and its audit committee in particular.⁴²¹ Notably, Winnick's own private banker Maria Elena Lagomasino, co-head of J. P. Morgan Private Bank, sat on the board at Winnick's appointment from April 2001 until her resignation in December of that year.⁴²² Lagomasino, though, was more than a regular adviser. In Winnick's own words, she was also his personal financial "shrink."⁴²³ Likewise, Winnick serves on the national board of advisers of J. P. Morgan Chase,⁴²⁴ making for an obvious potential conflict of interest. "Also serving on the board was Mr. Winnick's longtime friend Norman Brownstein, a Washington lobbyist, who had contracts with Global Crossing."⁴²⁵ Former U.S. Secretary of Defense William Cohen was added to the board in April 2001, as the company sought a \$450 million Pentagon contract.⁴²⁶ Cohen's personal advisory firm, the Cohen Group, says it had no business relationships with Global Crossing.⁴²⁷ "However, several attorneys. . . which formed a 'strategic alliance agreement' with Cohen Group in January 2001, were hired to lobby for the Pentagon contract."⁴²⁸

Apparently, the problem of a musical board of directors also spilled over into management. With a personal stake in Global Crossing of \$4 billion at one point, Winnick governed with what *Fortune* magazine called an "imperial style."⁴²⁹ Indicative of this behavior is the fact that, "[h]e bought the old Hilton estate in Bel Air, Calif., for a reported \$40 million—the highest price ever paid in the U.S. for a single-family residence. His workspace is a replica of the White House Oval Office."⁴³⁰ Evidently, "Global Crossing compounded its woes with a fast-money corporate culture and a chairman who hired [five] high-profile CEOs [in four years] but wouldn't relinquish control. 'It's the CEO-of-the-Month Club over there,' jokes one Wall Street analyst."⁴³¹ Amazingly, at one point in 2000, three CEOs were on the company's payroll at the same time.⁴³² Although the downstream effects of ineffectual top-level controls remain to be determined, it seems impossible that a continually shuffling board of directors and a dominant chairman did not contribute substantially to Global Crossing's downfall. Even more so than Enron, the full details of Global Crossing's demise will likely not be discovered for some time. But it provides a complementary case study in the dangers of allowing a board of directors to be co-opted from within, allowing outsiders to effectively have "inside" interests, and the limits of outside

421. *Id.*

422. *Id.*

423. *Id.*

424. *Id.*

425. *Id.*

426. *Id.*

427. *Id.*

428. *Id.*

429. Julie Creswell, *Global Flameout; Chairman Gary Winnick Spent Like a Roman Emperor. But the Fall of Much-Hyped Global Crossing Spells Trouble for Other Telcos Too*, *FORTUNE*, Dec. 24, 2001, at 109; *Id.*

430. *Id.*

431. *Id.*

432. *Id.*

institutional investors to assert themselves in the current system.

Remarkably, Arthur Andersen also served as Global's outside accountant.⁴³³ Again, a whistleblower raised questions about Andersen's accounting practices.⁴³⁴ According to Roy Olofson, a former vice president of finance, he was subsequently fired by Joseph Perrone, Andersen's lead auditor of Global Crossing, before taking an executive position with the company.⁴³⁵ Like Enron, the closeness of this relationship shows the perils of entrenched stakeholder-type relationships, as do the potentially conflicting *keiretsu*-style interlocking relationships that some board members possessed.

E. Creating the Tension of Competing Interests

The flexibility and decisiveness of shareholder corporate governance and the external discipline of stakeholder corporate governance both yield important benefits. Neither system, however, produces these benefits in an unqualified manner. At the extremes, each system suffers serious flaws that are detrimental to all interested parties. The task for countries seeking to improve their corporate governance systems—like so many other things in law and organizational behavior—is to create a beneficial tension between the competing interests that each system stresses. For example, the shortcomings of the American system reveal the benefits of having outside directors on the board. Conversely, the Japanese system epitomizes the pitfalls of overreliance on them. The conceptual key for cross-national improvement is to recognize that optimum corporate performance is a function of the individual firm's internal knowledge and a requisite level of external discipline from individual shareholders, institutional investors, and capital markets.

As a matter of economic ecology, a diverse set of organizational genetics will enable a corporation to best achieve its goals. In particular, an "ideal" corporate ownership and board of directors will be made up of a diverse combination of knowledgeable and incentivized insiders, independent outsiders with complementary knowledge and skill sets, and institutional outsiders tied to disciplining capital markets. No single composition or particular concentration of each group is a universal good. The best order will depend on the facts and circumstances of each case. For the latter group, however, the ideal arrangement is often likely to be one with multiple institutional investors, but an absence of any rigid concert of interests among them. In many instances, separation of the position of CEO and chairman of the board will also be beneficial. Financial markets have just begun to respond to these points. For example, grading products to help investors evaluate the independence of corporate boards are only now being developed along the lines of bond rating systems.⁴³⁶ It is

433. Jeremy Kahn, *Global Crossing: How Telecom's Bad Boy Did It*, FORTUNE, Mar. 4, 2002, at 36.

434. James Rosen, *Global Crossing's Quiet Crash*, NEWS AND OBSERVER, Mar. 4, 2002, at A1.

435. *Id.*

436. Ron Orol, *Critics: Time to Overhaul Corporate Boards*, DAILY DEAL, Feb. 6, 2002. Institutional Shareholder Services, a Rockville, Maryland-based proxy advisory firm, has begun to develop a grading system for corporate board independence. According to Caroline Brancato, director of the Global Corporate Governance Research Center, "It's similar to the way Moody's

equally important that board members be compensated with more than just the prestige of holding an influential "rubber stamp" position to entice substantial participation and their bona fide constructive criticism of management.

Likewise, management must be incentivized to actively pursue the corporation's best interests without being hyper-incentivized in way that rewards overly competitive behavior and discourages the sharing of power, authority, and information.⁴³⁷ Conversely, however, legal departments and internal auditors must remain largely centralized and somewhat insulated from the day-to-day pressures of the bottom line.

Stakeholder relationships must be well-defined and completely transparent. In particular, boards should require mandatory rotations every four years or so of both audit partners and audit firms themselves,⁴³⁸ and self-impose an end to audit firms doing both accounting and consulting work for the corporation. Also, boards must make total disclosure of analyst and banking conflicts nonnegotiable. Ideally, analysts should not be paid for attracting clients, but for the long-term performance of their picks, even if compensation is delayed.⁴³⁹

Far from being contradictory, if harnessed through an appropriate tension, these competing interests should focus and discipline each other to the benefit of all interested parties. The appropriate analogy is that of cross-cutting beams in a skyscraper. Individual beams may be aligned at different angles intersecting each other's path, but they have a common purpose in maintaining the integrity of the whole. The trick in execution, of course, is to prevent such arrangements from creating the dysfunctional paralysis of abject consensual decisionmaking that characterizes many stakeholder governance relationships. If orchestrated correctly, genuine and significant cross-national improvement is possible. Such improvements are, of course, constrained by the existing institutional and cultural norms of a particular country. In the long-term, though, even incremental changes are likely to spur self-reinforcing feedback. The future of global corporate governance, therefore, is likely to be a general convergence between shareholder and stakeholder governance, subject to the particular needs and existing institutional limitations of individual countries.

VII. CONCLUSION

The comparison of corporate governance structures of the United States, Japan, Germany, and France reveals many of the benefits and shortcomings of each country's respective system. This analysis is useful because it provides scholars, legislators, and practitioners, who are contemplating change, insight into alternative approaches to corporate governance. However, any effective proposal for improving corporate governance in the United States must take into consideration the fact that a country's particular choice of corporate governance is largely influenced by its history, social practices, and cultural mores. As such, it may not be possible to adopt certain aspects of German, Japanese, or French corporate governance systems in the United States.

rates a country's financial institutions—this program rates the level of independence at a corporation. . . . And institutional investors can look at the board independence rating and decide whether they want to invest or not." *Id.*

437. See Byrne et al., *supra* note 402, at 118.

438. *The Lessons from Enron*, *supra* note 406, at 9.

439. Knight, *supra* note 404, at E1.

Nonetheless, Japan, Germany, and France have adopted aspects of American capitalism to the improvement of each of these nations' economy. As well, U.S. corporate stakeholders might realize similar improvements by embracing certain features of corporate governance employed in other countries.

