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The Public Spirit of the Corporation

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1. DR. FAUST'S STRADIVARI

Imagine yourself sitting in the Berlin Philharmonic Hall, listening to a concert given by the Berlin Philharmonic Orchestra. On the stage-bill is the Second Piano Concerto by Johannes Brahms. I especially like this concerto because it comes as a nice double pack: Hidden in the third movement is a wonderful cello concert. Therefore, you can be sure that this important cello-solo will be played by Dr. Faust, the first solo-cellist of the Berlin Philharmonic, on an original

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I dedicate this paper to JOACHIM MESTMÄCKER on the occasion of his 75th birthday. For helpful comments on earlier versions I thank the interdisciplinary working group "*Gemeinwohl und Gemeinsinn*" (chair: Herfried Münkler) of the Berlin-Brandenburg Academy of Science, and colleagues from the University of California, Berkeley, and Cornell Schools of Law, especially Richard M. Buxbaum and Melvin A. Eisenberg at Berkeley.

Stradivari from 1798. Dr. Faust discovered this extraordinary instrument on one of the many tours of the Orchestra. His enthusiasm, however, was immediately dampened as he realized that neither he personally, nor the Orchestra, nor the Association of the Friends of the Orchestra, could afford to buy it. But then, Dr. Faust recalled a recent conversation with Hilmar Kopper, at that time CEO of Deutsche Bank AG. The Deutsche Bank, a public stock corporation, showed public spirit and financed the cello.[1]

Now, where is the problem? Perhaps JOCHEN MESTMÄCKER doesn't like Brahms or cello music. But, given his long standing interest in and powerful contributions to understanding the delicate interplay of private initiative and government intervention, he may find the following remarks entertaining. Private initiative is not limited to individuals; the "corporate citizen" as well constitutes an important part of the private sector. My example raises questions familiar to corporation lawyers from various jurisdictions: A bank is a bank and not a dealer in antique musical instruments. Can a CEO make this kind of decision by himself according to his personal preferences? The workforce would probably prefer the money to go to a certain soccer team. What did the workers' representatives on the supervisory board think about it, what the customers paying charges for their checking accounts? Under a German perspective, financing of cultural events and institutions still is predominantly a responsibility of the government and should be under democratic control. The extension of corporate power into the realm of cultural life is seen with some reservations.[2]

2. SOME CLASSICAL CASES AND CURRENT DISCUSSIONS

2.1 *Evans* v. *Brunner, Mond & Company*[3]

In this older English case, the directors of a chemical manufacturing corporation had passed a resolution to distribute £100,000 to universities for the furtherance of scientific research without further restrictions. A shareholder challenged the resolution, arguing that the money might be used for scientific education in astronomy or some other branch not useful to the chemical trade and that, besides, the benefit if any was too remote; in fact, even competitors might get the benefit. At the time of the gift, scientists and chemists in particular

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[1] I am grateful to Dr. Georg Faust for personal communications in this matter.

[2] The problems of contributions to political parties and campaign funding will not be discussed in this paper.

[3] Ch. 359, 90 L.J. Ch.Div. 294 (1921) after Lattin, *The Law of Corporations*, 2nd ed. (Mineola, NY: Foundation 1971) p. 210.

were in short supply. The court applied the rule that the contribution must be one that can fairly be regarded as incidental or conducive to the purposes for which the company was formed. This rule was construed rather generously. The court found that persons trained in other sciences would be useful in the chemical branch as well by virtue of their knowledge of scientific methods and procedures. While the donor corporation might not acquire any of the sponsored scientists, it had the opportunity of acquiring them and given the shortage of scientifically trained people this was the best way to relieve the shortage.

2.2 *A.P. Smith Manufacturing Company* v. *Barlow*[4]

In this case, a gift of $1500 to the trustees of Princeton University was challenged as a waste of corporate assets since it resulted in no direct economic benefit of the corporation. The court used an interesting analogy between individuals and legal persons: "When the wealth of the nation was primarily in the hands of individuals they discharged their responsibilities as citizens by donating freely for charitable purposes. With the transfer of most of the wealth to corporate hands and the imposition of heavy burdens of individual taxation, they have been unable to keep pace with increased philanthropic needs. They have therefore, with justification, turned to corporations to assume the modern obligations of good citizenship in the same manner as humans do." So there is room for a public spirit of corporations, but how much and who decides on the recipient? In the case at hand, the gift was seen appropriate as in furtherance of the free enterprise system on which the corporation's success was dependent. Moreover, "there was no showing that the gift in question was made to a *pet charity* in furtherance of personal rather than corporate ends."

Nowadays, in the US state legislation, the Model Business Corporation Act, the ALI Principles on corporate governance, and state courts generally recognize the corporate power to make donations. Still controversial are the limits to such generosity. To varying degrees, additional tests apply as to some connection of the gift to the corporation's business and as to the amount being reasonable in relation to the business' size and earnings. Reference is also made to the treatment of such gifts under tax law.

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[4] N.J. 145, 98 A.2d 581, 39 A.L.R.2d 1179 (1953), appeal dismissed, 346 US 861, 74 S.Ct. 107, 98 L.Ed. 373; see also discussion in Cox/Hazen/O'Neal, *Corporations* (New York: Aspen Law & Business 1997) p. 64; Jennings and Buxbaum, *Corporations, Cases and Materials*, 5th ed. (St. Paul, Minn.: West 1979) p. 124; O'Kelley and Thompson, *Corporations and Other Business Associations, Cases and Materials*, 3rd ed. (New York: Aspen Law & Business 1999) pp. 269-270.

2.3 *Dodge* v. *Ford Motor Co.*[5]

This case is usually quoted in support of the theory that corporations should be run exclusively in the interest of shareholders.[6] Henry Ford owned 58 % of the company's stock, the Dodge brothers held 10 %. The company yielded large profits and paid generous dividends. Mr. Ford, the dominant force in the business, pursued a plan to cut dividends; the selling price of the cars should be reduced, the capacity of the plant should be increased. "My ambition", said Mr. Ford, "is to employ still more men, to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes. To do this we are putting the greatest share of our profits back in the business." The Dodge brothers challenged this plan and contended that the apparent immediate effect will be to diminish the value of shares and the returns to shareholders. The court agreed with the plaintiffs. "There should be no confusion (of which there is evidence) of the duties which Mr. Ford conceives that he and the stockholders owe to the general public and the duties which in law he and his co-directors owe to the protesting minority stockholders. A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of directors are to be exercised for that end. The discretion of directors is to be exercised in the choice of means to attain that end and does not extend to a change in the end itself, to the reduction of profits or to the non-distribution of profits among stockholders in order to devote them to other purposes."

An older English case may be quoted as well as a more recent Alabama case in the same line of argument. Lord Bowen argued 1883 that "Charity has no business to sit at boards of directors qua charity". A railroad company wanted to offer, after its winding up, its unemployed workers severance pay.[7] The Alabama Supreme Court held in 1963 that gifts to the widows of former corporate officers were an invalid waste of corporate assets.[8] These cases show

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[5] N.W. 668 (Mich. 1919).

[6] See e.g. Margaret M. Blair, *Ownership and Control: Rethinking Corporate Governance*, (Brookings Institution 1995) p. 202, reprinted in: Clarkson [ed.], *The Corporation and its Stakeholders. Classic and Contemporary Readings*, (Toronto: University of Toronto Press, 1998) p. 47, 51: point . . . made crystal clear; E. Merrick Dodd Jr., "For Whom Are Corporate Managers Trustees?", 45 *Harv.L.Rev.* (1932) 1145, reprinted in: Clarkson [ed.], ibid., pp. 31, 43 n. 3: a vigorous assertion of this view; O'Kelley/Thompson, *supra* n. 4, p. 267: a classic example of shareholder litigation seeking to change or obtain redress for corporate policies that are intended to bestow significant benefit on non-shareholder constituencies.

[7] Wiethölter, *Interessen und Organisation der Aktiengesellschaft im amerikanischen und deutschen Recht* (Karlsruhe: Müller 1961) p. 5.

[8] *Adams* v. *Smith*, 153 So.2d 221 (Ala. 1963).

that benefits for employees and their families fall, in some people's view, within the scope of donations or charity.

2.4 An example from a recent German discussion: slave labor claims

We all know of the intricate problem of compensation for forced and slave labor during Nazi Germany. Such compensation is now being arranged by a foundation funded partly by German businesses, partly by the German Government, i.e., tax money. A German lawyer named Philipp argued in an article that contributions of German stock corporations to the foundation were illegal under current stock corporation law, void, even unconstitutional.[9] No payments were owed in terms of actually existing claims and, therefore, expenditures towards the foundation were detrimental to the rights and interests of the current shareholders. The moral aspect – ethical responsibility for misdeeds in the past –, so goes the argument advances, applies only to individuals, not to legal persons. Threats of boycott in foreign markets (i.e. the US) against businesses unwilling to join the foundation were illegal, even criminal actions.

The legal position just described certainly is an extreme exception. The general opinion among corporate lawyers is that the managing board is entitled to contribute to the Foundation "Remembrance, Responsibility and the Future".[10] This is especially important as the call to join the foundation covers all German businesses including those that were founded only after the war. The author's contention that no payments are owed is true at least for those new enterprises. However, there is involuntary irony in the Philipp's philippic. He complains that the treatment of the World War II forced labor issue shows a blatant attempt of the US to exert hegemony over European and German private law. The German legal tradition, however, is much more open to a civic spirit of legal persons, expressed by contributions for non-business causes, than the American line of argument in *Dodge* v. *Ford* or the so called finance model that calls for management of the corporation exclusively in the interest of shareholders, or even the more moderate view that requires at least some distant benefit of donations for the corporation. This needs further elaboration (4.2.2).

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[9] Philipp, "Darf der Vorstand zahlen? Die Zwangsarbeiter und das Aktienrecht", *AG* (2000) 62.

[10] Mertens, "Der Vorstand darf zahlen", *AG* (2000) 157.

3. LEGAL ISSUES

All the given examples have something in common. They share the premise that the corporation is to be run for the profit of its shareholders according to its stated business purpose. Nobody denies that. The controversies arise around additional or competing corporate goals and other constituencies' than the shareholders' interests.

In corporate law, three sets of issues can be distinguished. First, we have the more technical question as to whether the corporation has the power to show "public spirit". Second, we have the corporate governance problem of the decision making process and its control. Last but not least come the substantive issues as to which goals and interests are legitimately forged into the spirit of the corporation.

3.1 Ultra vires acts and the powers of the corporation

The limits of the powers of a corporation based on common law, its charter, or its articles of incorporation are well discussed and lost much of their original impact. Generous interpretation of implied powers and the application of agency law, with apparent authority to fall back on, enlarged the scope of authorized business. Therefore, cases based on *ultra vires* will be extremely rare nowadays. The emphasis shifted to the business judgment rule and whether directors acted reasonably in what they believed advanced the corporation's best interest.

The German legal tradition from early on followed a different concept. Legal persons incorporated according to private law enjoy full legal capacity.[11] Limitations of authority of managing directors are of interest only within the internal relationship between the director and the corporation but not towards third parties. The notion of unlimited representative power is well established in commercial law. It facilitates commercial transactions in an environment of complicated organizations.

As a result, we can assume that the cello mentioned in the introduction can stay where it is and serve its wonderful purpose. Even *Philipp*, the outspoken advocate of strict profit maximization, has to resort to collusion in order to make void contributions to the Foundation "Remembrance, Responsibility and the Future". His argument goes: if the Foundation is aware (i.e., read his article) that contributions are illegal under German law, acceptance of gifts amounts to

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[11] For discussion whether the concept of legal entity includes constitutional rights under the First and Fourteenth Amendments see Buxbaum and Hopt, *Legal Harmonization and the Business Enterprise. Corporate and Capital Market Law Harmonization Policy in Europe and the U.S.A.* (Berlin: de Gruyter 1988) pp. 155 et seq.; for the respective dispute in German law see commentaries on Art. 19 GG.

intentional collaboration with the management to the detriment of the corporation, one of the very few exceptions to the unrestricted representative power of managing directors.

The ultra-vires problem taken care of by modeling the legal person in analogy to the individual, there still is the question of the decision-making process within the corporation and the foundation as well as the legitimization of a "public spirit".

3.2 The decision making process and its control

The impact of a business purpose statement in the articles of incorporation and the scope of the management's decision-making powers are closely related. The perspective taken depends to a large extent on the legal culture and environment. German lawyers love abstract discussions. They fill books and articles with reasoned definitions of the "*Unternehmensinteresse*", i.e. the interest of the enterprise as an abstract concept, and whether or not there is a difference between the interest of the enterprise or the corporation and the interest of it's shareholders, and what the interest of "the shareholders" might be given the diversity of the shareholder population.[12] A scholar coming from the common law tradition, I assume, would not bother so much about definitions but would rather ask who is empowered to decide which interests will guide the decisions. The limits to such powers then will be discussed in terms of fiduciary duties and to what extent the business judgment rule protects the management. Despite the differences in focus, the decision-making process is an important issue in the international corporate governance discussion. Here, we find the shareholders' and other constituencies' interests addressed as well as which decisions should go to the shareholders' meeting.[13]

Coming back to my cello-example, the decision-making issues are whether the CEO needed a resolution of the managing board or the approval of the supervisory board or even of the shareholders' meeting, and whether it made a difference whether the articles of incorporation of the Deutsche Bank or some other internal rules say something about business purpose and gifts.

Interestingly enough, all cases and examples deal with decisions made by the management or the board of directors. That the shareholders' meeting could be

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[12] Peter O. Mülbert, "Shareholder Value aus rechtlicher Sicht", *ZGR* (1997) 129, 142 with further references.

[13] See, e.g., OECD Principles of Corporate Governance, <http://www.oecd.org/daf/governance/principles.htm> [last visited 31 August 2001]; German Panel on Corporate Governance, Code of Best Practice, <http://www.corgov.de> [last visited 31 August 2001]; DVFA Deutsche Vereinigung für Finanzanalyse und Asset Management e.V., Corporate Governance Scorecard©, <http://www.dvfa.de/pdf/scorecard.pdf> [last visited 31 August 2001].

involved is mentioned only as a possibility.[14] No case or example actually gave jurisdiction to the shareholders' meeting. Practically speaking, this is very sensible. Shareholders' meetings are expensive, usually held only once a year, and burdened with many technicalities. Whoever once attended the Annual General Meeting of a large corporation (I take my students every year to such an event, and they are always shocked) will be well aware of the limits of this device as a decision-making body. Not only practically but legally as well we are dealing with decisions within the powers of the board of directors. The board is certainly free to submit issues to the shareholders; in our cases, though, it will rarely do so. The division of powers within the corporation seems to be rather similar in all the jurisdictions mentioned.

3.3 Which interests are to be served?

Whoever has the power to decide upon corporate activities he, she, or it will be bound by some substantive criteria. Usually, these are defined negatively as the issue turns up whenever a transgression is alleged. The furtherance of a "pet charity" by the chairman of the board as it was mentioned in *A.P. Smith* would constitute such a transgression. However, is it enough to meet the criterion "pet charity" when the CEO of the Deutsche Bank happens to like cello music or old instruments? Probably not. As positive tests whether contributions are within the powers of the management are mentioned in the examples: Tax law, quantitative criteria, i.e. the relation of the amount donated to capital or earnings, secondary benefits for the corporation like positive publicity, etc. Still, this leaves plenty of interests mentioned in *Dodge* v. *Ford* and other cases – the workforce, consumers, education, art, sports, etc. – that may or may not be served by more or less inspired corporate officers. As this is one of the topics of the ongoing corporate governance debate – shortly, the shareholder v. stakeholder debate – I will present a short comparative overview over some aspects of German and American law.

4. Shareholder value, codetermination, and public interest in a comparative perspective

4.1 Internal and external governance

There is one feature common to all jurisdictions although rarely presented with prominence. That is the distinction between internal and external governance.

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[14] *A.P. Smith Mfg. Co.* v. *Barlow*, *supra* n. 4.

External governance of the corporation involves, e.g., tax law, regulations of the industry, consumer protection laws, restrictive contract law concerning standard terms, labor and employment law. External governance is everything that regulates the behavior of a legal person as well as of an individual conducting a business with respect to third parties. Internal governance comprises all the rules that govern the internal decision-making processes within the corporation, be they procedural or substantive, based on contract (articles of incorporation), regulation, or default rules.

To illustrate the distinction just made, I would like to go back to the old English case where the board wanted to offer severance pay to laid off workers. As of 1883, such payments were purely voluntary; they were labeled as "charity" and discussed under the heading whether the directors of a corporation were allowed to use corporate funds for charitable contributions - a question of internal governance. Under current German law, severance payments accompanying plant closings are mandatory – "*Sozialplan*" according to § 112 *Betriebsverfassungsgesetz*, in other jurisdictions such plans are agreed upon in collective bargaining. In all cases, based on contract with third parties, collective agreement, or statute, we are dealing with external governance. The management has to take such costs into account when calculating whether the closing of a plant makes economic sense or not. This is not a question of "charity" anymore. Whether a bank is willing to finance a cello is the result of an internal decision making process and, therefore, only subject to internal governance rules.

As an aside I may add that, in German legal analysis, benefits or other payments not included in employees' individual contract or owed on the basis of a collective agreement are still considered "wages" or "salary" in a broad sense. That is, such payments are not gifts but compensation for work done within a long term, relational and necessarily incomplete contract. The underlying theory is quite different from the doctrine of "employment at will".[15] As already pointed out, there are many faces of labor and employment law – completely independent from corporate law – in the comparatist's world. Therefore, discussions based on employment at will look path-dependent to me.

More homogenous is another aspect of external governance by regulation. General laws apply to all corporations (and businesses conducted in various forms). At least within the respective jurisdiction, such laws have a so-called cartel effect, i.e. competition in the specifically regulated area is excluded. Internal governance, however, shapes the standing of the corporation in the market where it faces other corporations with their outcomes of their internal

[15] Katherine Van Wezel Stone, "Policing Employment Contracts Within the Nexus-of-Contracts Firm", 43 *U.of Toronto L.J.* 353 (1993).

decision-making process.[16] In this respect, human resources management can be a source of competitive advantage. This line of argument comes easily to someone used to thinking in categories of competition and the market process. In academic circles, however, fields of interest are often painstakingly kept separate. The company law professor does not venture into labor law or antitrust. It takes someone like JOCHEN MESTMÄCKER to overcome such limitations. He would take up the discussion and navigate into deeper waters of social philosophy. I rely on his generosity and understanding for the topicality of this paper.

Many interests – I don't want to go into the question of the definition of "stakeholders" in this context – are protected by external governance, be it contractual or by regulation. Therefore, it would be a big mistake to surmise that stakeholders' interests are neglected if they are not included in the scope of the substantive criteria of management decisions.[17] When it comes to shareholders, we see another picture.[18] Aside from their position defined by corporation law (which is "regulation", too, as far as mandatory provisions are concerned), there is very little in terms of external governance. We could think of capital markets law. However, there, the shareholder is protected as an investor in general. She should be well and fairly informed in order to follow the "Wall Street rule", i.e. buy, sell, or hold her stock. But this has little or no relation to the internal functioning of the corporation. Seen from the internal governance side, shareholders have, e.g., voting rights. Also important are articles of incorporation, by-laws, and mandatory or default corporation law provisions. These are the rules to

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[16] Eisenberg strikes a similar note applying the prisoner's dilemma: Melvin A. Eisenberg, "Corporate Conduct That Does Not Maximize Shareholder Gain: Legal Conduct, Ethical Conduct, the Penumbra Effect, Reciprocity, the Prisoner's Dilemma, Sheep's Clothing, Social Conduct, and Disclosure", 28 *Stetson L.Rev.* (1998) 1, 10 et seq. See also Sadowski/Junkes/Lindenthal, "Labour Co-Determination and Corporate Governance in Germany: The Economic Impact of Marginal and Symbolic Rights", in: Schwalbach [ed.], *Corporate Governance* (Berlin: Springer 2001) p. 146; Schuler/Turnheim/Jackson, "Human Resource Management: Past, Present, Future", in: Blanpain/Engels [eds.], *Comparative Labour Law and Industrial Relations in Industrial Market Economies*, 6th ed. (The Hague: Kluwer 1998) 181, at p. 207.

[17] Clark, *Corporate Law* (Boston: Little, Brown 1986) pp. 17 et seq., 678: many obligations to non-shareholders.

[18] This is well discussed especially in the economic literature; shareholders are considered recipients of the residual, and this serves as a premium for the risk they assume. Cheffins, *Company Law: Theory, Structure, and Operation* (Oxford: Clarendon 1997) p. 54; for a critical assessment see also Jonathan R. Macey, "An Economic Analysis of the Various Rationale for Making Shareholders the Exclusive Beneficiaries of Corporate Duties", 21 *Stetson L.Rev.* 23 (1991).

which the shareholders subjected their investment.[19] From a German point of view, I would add the "membership" component: the stock corporation is a variation of the "*Verein*", the basic form of association in a separate legal entity where members have administrative rights and privileges as to the pursuit of the purposes of the association. The creation of the separate legal entity is undoubtedly based on some kind of "contract" or private ordering; the nature of such "contracts", however, is organizational and distinct from other kinds of market exchanges. Rights emanating from the organizational or membership side of the corporation are found on the internal side of governance and show that shareholders are dependent on internal than on external governance to a much larger extent than other stakeholders.

There is another approach to analyze the firm (sometimes seen as the equivalent of the corporation, sometimes not), the nexus-of-contract theory. It didn't take hold in the courts' jurisprudence, and only to a limited extent in the legal literature. It is popular, however, among business and law-and-economics scholars and serves several valuable purposes. As a lawyer, though, I don't like to talk about "nexus of contracts" without a caveat: the concept of what constitutes "contract" is not the same in law and in economics.[20] And even in law, the concept of "contract" varies from country to country according to varying legal traditions.[21] So, this kind of economic analysis transplanted into legal reasoning very quickly hits fatal snags.[22] If you define the corporation according to Jensen and Meckling as a cluster of contracts, "*the private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold*

[19] A similar line of argument provides Macey, ibid., at pp. 36-39: shareholders as residual claimants face severe contracting problems with respect to defining the nature and the extent of obligations owed to them by officers and directors of the corporation whereas other constituencies, at least theoretically, have less contracting problems. They are further protected through gap-filling by courts in context with pre-existing contracts. The local communities should resort to the political process.

[20] Melvin A. Eisenberg, "The Conception that the corporation is a Nexus of Contracts, and the Dual Nature of the Firm", 24 *J.Corp.L.* (1999) 819, 822 et seq.

[21] The above-mentioned construction of employment contracts as "employment at will" (i.e. a series of discrete transactions) or long-term, relational and incomplete contracts gives a taste of such differences.

[22] Windbichler, Vor § 15 in: *Großkommentar zum AktG* (Hopt and Wiedemann [eds.]), 4th ed. (Berlin: de Gruyter 1999) note 19; Cheffins, *supra* n. 18, pp. 31 et seq.

without permission of the other contracting individuals".[23] Clark, one of the early critics of this theory, comments: "*This extreme contractualist viewpoint is almost perverse.*"[24] I don't want to discuss this controversy in detail but single out some aspects. I think that an undiscriminating efficiency analysis according to agency-theory – that is what many contractualists do – gives short shrift to the inside-outside perspective germane to legal analysis of legal entities. And, as already mentioned, a lawyer will find it difficult to deal with an highly abstract definition of "contract" that glosses over our (continental) differentiation between contract and organization, if not the concept of the legal person in general.[25] These legal perceptions – or constructions, if you like that better – are more or less well established, according to the legal system at hand,[26] and useful. And they are not foreign to economic thinking. The distinction between contract and organization reflects the distinction between market and hierarchy.[27] Moreover, they offer a better understanding of the mechanisms of regulation, default laws, and actual contracts.

The "nexus-of-contract" approach is intriguing for another reason, though. Given the strong emphasis of American law on the role of directors as trustees for the shareholders, the "nexus-of-contract"-theory allows the extension of fiduciary duties to other constituencies.[28] The effect is an increase of managers' discretion in decision-making. Therefore, the argumentative role of the appeal to the "common weal" or "public spirit" is just the opposite in law as is its role in political theory. There, it usually describes constraints of decision-making power. Another powerful incentive to engage in a nexus-of-contract analysis is the conundrum of the doctrine of employment at will.[29]

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[23] Michael Jensen and William Meckling, "The Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", 3 *J.Fin.Econ.* (1976) 305, reprinted in: Putterman and Kroszner [eds.], *The Economic Nature of the Firm*, 2nd ed. (Cambridge: Cambridge University Press 1997) p. 315; see also Easterbrook and Fischel, *The Economic Structure of Corporate Law* (Cambridge, Mass.: Harvard University Press 1991) pp. 40 et seq.

[24] Clark, *supra* n. 17, p. 60; see also Melvin A. Eisenberg, *supra* n. 20, 819.

[25] Eisenberg, *supra* n. 20, criticizes that the nexus-of-contract theory fails to explain where the "nexus" begins and where ordinary contractual relationships with the corporations start.

[26] The concept of organizational contracts is known in the common law tradition as well as in the code law traditions; the extent to which it is emphasized and analyzed varies, however. Law and economics scholars seem to have an inclination for exchange-type contracts and only gradually engage in organizational perspectives.

[27] Ronald Coase, "The Nature of the Firm", 4 *Economica* (1937) 386, reprinted in: Putterman and Kroszner [eds.], *The Economic Nature of the Firm*, 2nd ed. (Cambridge: Cambridge University Press 1997) p. 89; Williamson, *The Economic Institutions of Capitalism: Firms, Markets, and Relational Contracting* (New York: The Free Press 1985).

[28] Eisenberg, *supra* n. 20, p. 833.

[29] See, e.g., Stone, *supra* n. 15; Margaret M. Blair and Lynn Stout, "A Team Production Theory of Corporate Law", 85 *Virginia L.Rev.* (1999) 101.

Other theories to the same effect, that is freeing the management from its obligation to further only shareholders' interests, tried to avoid the shortcomings of the nexus-of-contract-theory. I don't want to engage in a detailed discussion of these well-written about endeavors.[30] Some of them I will mention in the context of coping with the separation of ownership and control, and some of them you will recognize in earlier European ideas. Especially intriguing is the similarity between social responsibility and team-production[31] arguments and the German discussion in the 1920s and later in the 1960s and 1970s that included many constituencies but led to the current workers' co-determination model.

4.2 Separation of ownership and control

All the theoretical concepts I mentioned have in common that the interests of the shareholders have to be considered; there is no controversy about that. The controversy begins with the role of other constituencies. To raise the question whether management should consider interests other than the shareholders' is possible only in the light of separation of ownership and control. The fact of this separation is undisputed. Dysfunctional AGMs of large corporations with a population of many small shareholders rendered managements quite independent. This is all too familiar. However, the historical context and the factual developments that brought about the analysis of the separation of ownership and control vary considerably from country to country. I hope that the following comparative aspects will take away a little bit the *déja-vu* sensation.

4.2.1 *The American approach*

I will make this very short. Starting with the predominant role of the board to manage the corporation,[32] a logical reaction to the separation of ownership and control was the imposition of fiduciary duties to the benefit of shareholders. As the law of trust, the ultimate source of fiduciary duties is germane to the Anglo-American legal system, this approach is path-dependent, and so are the attempts to extend fiduciary duties to other constituencies, even if construed in a contractual environment.[33] The ways to increase management's discretion beyond straight profit maximization were shown above in the sample cases. The business purpose was generously construed to include concepts like corporate

[30] See e.g. the collection Clarkson [ed.], *supra* n. 6.

[31] Blair/Stout, *supra* n. 29; Sadowski/Junkes/Lindenthal, *supra* n. 16, p. 146.

[32] Lattin, *supra* n. 3, p. 239.

[33] Cf. Eric. L. Talley, "Fiduciary Duties and Industrial Developments", *U.C. Davis L.Rev.* (2001) (forthcoming).

identity, corporate citizenship, and investment in human resources, and everything and everybody is now enchanted by the spell of the "long-term perspective".

The more recent shareholder-value discussion was ignited by spectacular, highly leveraged take-over cases that generated huge profits for some managers, investment bankers, and lawyers to the detriment of the shareholders. I think that the contention that shareholders enriched themselves to the detriment of employees, small suppliers, communities, consumers, etc. cannot be generalized and is untrue in many instances, especially when shareholders were hurt by economically unsound financing. Multi-constituency arguments and even statutes can be traced to defense mechanisms of endangered managers.[34] Whether a take-over is hostile or friendly is an issue of perspective, usually the perspective of the incumbent management and therefore not beyond doubt. "Other constituency statutes" should not be overrated. Many authors do not consider them a genuine shift in the definition of fiduciary duties.[35] Moreover, the states that enacted them do not seem to be the major incorporation venues (Indiana, Iowa, and Pennsylvania as opposed to Delaware).

4.2.2 *The German approach*

I would like to spend a little more time on the German legal development. The emphasis in legal analysis from the 19th century on imparted much more on the phenomenon of the legal entity. Early in the 20th century, the dysfunctionality of the shareholders' meeting was evident. At best, it ratified management's decisions. The reaction was the introduction of a constitution-like system of checks and balances between shareholders' meeting, supervisory board and managing board (in the two-tier system). This organizational solution included further separation of management from the shareholders. The business, firm, or enterprise undertaken by the corporation became a major subject of interest and legal research. At the same time, that is during the 1920s, the term "*Aktienanstalt*" (difficult to translate, probably "business institution") emerged, and Walter Rathenau wrote his essay on the "enterprise in and of itself" ("*Das*

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[34] Cox/Hazen/O'Neal, *supra* n. 4, pp. 69 et seq.; O'Kelley/Thompson, *supra* n. 4, p. 266; cf. also *Revlon, Inc.* v. *MacAndrews & Forbes Holdings, Inc.*, Del. Supr., 506 A.2d 173 (1986).

[35] O'Kelley/Thompson, *supra* n. 4, p. 267; for a comparative view of the older German discussion of a multi-constituency representing board see Vagts, "Reforming the 'Modern' Corporation: Perspectives from the German", 80 *Harv.L.Rev.* (1966) 23, partly reprinted in Jennings/Buxbaum, *supra* n. 4, p. 164.

Unternehmen an sich").[36] A pluralistic approach came almost naturally with this perception of the phenomenon of the large public corporation, and the idea of shareholder supremacy faded more and more. The then new corporate governance ideas were transformed into law by an amendment to the commercial code that took out the stock corporation law of the code and created a separate statute, the *Aktiengesetz* of 1937, especially its famous § 70 subsec. 1. As the year indicates, this development coincided with National-Socialist ideology covering more and more areas of political, cultural, and economic life. This coincidence, however, led to misunderstandings pertaining to the structure of the German stock corporation law.[37]

The law provided that the managing board shall manage the corporation on its own authority with respect to the best interest of the enterprise and the workforce, and the common weal of the people and the country (. . . *wie das Wohl des Betriebs und seiner Gefolgschaft und der gemeine Nutzen von Volk und Reich es fordern*). The wording was in the style of the times, certainly, but the major substantive statement was the mandatory division of power between management and shareholders' meeting. The shareholders' meeting was not the supreme instance anymore; its remaining powers, however, were mandatory by law and could not be taken away by articles of incorporation, the management, or shareholders' resolutions. The current provision on the managing board, § 76 subsec. 1 *Aktiengesetz* 1965, does not contain the express pluralistic description of goals anymore. It simply states that the managing board shall manage the corporation on its own authority. Jurisprudence and legal scholars concur in general that this includes the power to take multiple constituencies' interests

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[36] Laux, *Die Lehre vom Unternehmen an sich. Walther Rathenau und die aktienrechtliche Diskussion in der Weimarer Republik*, (Berlin: Duncker & Humblot 1998) pp. 59 et seq., Riechers, *Das >Unternehmen an sich<. Die Entwicklung eines Begriffes in der Aktienrechtsdiskussion des 20. Jahrhunderts* (Tübingen: Mohr Siebeck 1990); Wiedemann, *Gesellschaftsrecht, Band I: Grundlagen*, (München: Beck 1980) pp. 301 et seq. – The notion of the large corporation as an institution of public interest moves corporation law away from private law and closer to public law, an approach now taken by some "progressive" American scholars; see, e.g., Kent Greenfield, "Using Behavioral Economics to Show the Power and Efficiency of Corporate Law as Regulatory Tool", *U.C. Davis L.Rev.* (2001) (forthcoming). Again, the definitions of public law and private law may vary considerably between legal systems. In civil law jurisdictions, public law refers to the involvement of government in relation to the citizen; private law may very well be shaped according to public policy as, for instance, forced by EU Directives on consumer contracts.

[37] For instance, it is said that the new law incorporated the « Führer-principle » by giving the chairman of the managing board a tie-breaking vote. Compared with other stock corporation laws, this rule seems only mildly hierarchical. The position of the president-directeur-général (PDG) in French law has always been much stronger. Until 1965 in Germany and, with slight changes, until now in Austria, the 1937 statute was/is in force and does not present exceptional governance problems.

into account.[38] Further reaching theories claiming an obligation of the management to pursue such pluralistic goals didn't take hold either academically or practically.[39] Especially the problems of who should monitor a management owing multiple-constituency duties and which remedies should be available to whom were never resolved.

Given the German historical context it is not surprising to find workers' representatives on supervisory boards, first without voting rights but with the right to participate and speak according to the *Betriebsrätegesetz* of 1920.[40] This statute about *Betriebsverfassung* (statutory framework for employees' rights in enterprises) was a generalization of rules promulgated to entice special industries into extraordinary war efforts (*Gesetz über den vaterländischen Hilfsdienst* 1916).[41] After the Second World War, the Allied Forces in the western part of occupied Germany fell back on the - rather modern – 1920s model of co-determination. On the board level, the co-determination law for the coal and steel industry set a prominent example for an even farther reaching concept. It provides for an equal number of workers' and shareholders' representatives on the supervisory board plus on neutral person co-opted by both groups. This law was enacted in 1951 and was supposed to assist in the pacification of potentially war relevant industries.[42] However, the procedural involvement of workers representatives on the supervisory board doesn't change the substantive powers and responsibilities of management.[43] Nowadays, it's mainly of symbolic value.[44] But note the historical irony in

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[38] Hueck, *Gesellschaftsrecht*, 19th ed. (München: Beck 1991) § 23, VII; Hüffer, *Aktiengesetz*, 4th ed. (München: Beck 1999) § 76 note 12.

[39] A prominent advocate of the mandatory pluralist approach – based on Art. 14 of the German constitution – is Schmidt-Leithoff, *Die Verantwortung der Unternehmensleitung* (Tübingen: Mohr Siebeck 1989) pp. 155 et seq., pp. 214 et seq; for a discussion why marginal or symbolic rights are not meaningless cf. Sadowski/Junkes/Lindenthal, *supra* n. 16.

[40] As the term Betriebs*verfassung* (constitution) suggests, this body of law was considered at the outset as public law. The discussion about its legal character has been settled much later (1970s); now, *Betriebsverfassung* is firmly grounded in private law. Cf. Reichold, *Betriebsverfassung als Sozialprivatrecht. Historisch-dogmatische Grundlagen von 1848 bis zur Gegenwart* (München: Beck 1995).

[41] Reichold, *supra* n. 40, pp. 185 et seq.

[42] Mertens, in: Zöllner [ed.], *Kölner Kommentar zum Aktiengesetz*, Vol. 2, 2nd. ed. (Köln: Heymanns 1996) Anh. § 117 C MontanMitbestG note 2.

[43] Hueck, *supra* n. 38, § 24, II, 1 c); Hüffer, *supra* n. 38, § 116 notes 2, 7; Kraft/Kreutz, *Gesellschaftsrecht*, 11th ed. (Neuwied: Luchterhand 2000). Practically, however, the institutional setting ensures the inclusion of employees' interests in the decision-making process.

[44] Christine Windbichler and Gregor Bachmann, "Corporate Governance und Mitbestimmung als 'wirtschaftsrechtlicher ordre public'", in: *Festschrift für Gerold Bezzenberger*, (Westermann/Mock [eds.]) (Berlin: de Gruyter 2000), p. 797. For an overview over theoretical frameworks regarding human resources management see Schuler/Turnheim/Jackson, *supra* n. 16, p. 181 at pp. 199–205. Empirical research stayed rather inconclusive, cf. Gerum, *Mitbestimmung und Corporate Governance* (Gütersloh: Bertelsmann Stiftung 1998) with further references.

the fact that a governance model established to further a war effort was later used to democratize heavy industry in the name of peace-keeping. Be that as it may, the historical development, together with a different understanding of the employment contract, account for path-dependency in the specific field of labor relations.

There's another interesting structural detail. According to the co-determination law for the coal and steel industry, the workers' representatives are elected by the shareholders' meeting upon binding proposals by the works councils. This shows how deeply entrenched in corporate law models the way of thinking was in 1950. Who else but the shareholders' meeting could possibly elect board members, even if it is bound by another body's decision. The fact that later co-determination laws, starting with the *Betriebsverfassungsgesetz* 1952, provide for either direct elections or, according to the size of the corporation, elections by electors indicates a significant change from pure corporation law to enterprise or enterprise-constitution law. This German background to the pluralistic approach, together with the financing traditions – bank loans, banks as stockholders, retained profits and lean dividends –, led to sleepy stock markets and a low percentage of the general population that owned stock. Shareholders were almost forgotten. If they were thought of at all, they were considered stupid and impertinent. Stupid because they gave money to a corporation, and impertinent because they expected dividends.

The scenario changed dramatically with the opening-up of capital markets, first within the EU, then worldwide. Financial globalization brought the shareholders back into focus. Starting roughly with the 1990s, the term "shareholder value" attracted more and more attention. The international corporate governance debate as well as the American discussion and European developments focus on shareholder value vs. other constituencies or stakeholder value. The incentives to do so, however, differ considerably. In Germany, the shareholder virtually had to be reinvented.[45] Especially business administration scholars' endeavors in this direction lead to overreactions and the promotion of rigid profit-maximizing standards.[46]

[45] This is the course of the German Governments commission on Corporate Governance; a summary of its report is available on <http://www.bundesregierung.de/dokumente/Artikel/ix_48101_1400.htm> [last visited 31 August 2001].

[46] See e.g. Theodor Siegel, Peter Bareis and Dieter Rückle, "Stille Reserven und aktienrechtliche Informationspflichten", *ZIP* (1999) 2077.

5. CONCLUSION

To draw a conclusion: In a worldwide comparison including the OECD Principles of Corporate governance[47], or the DVFA Corporate Governance Scorecard©,[48] or the German Panel on Corporate Governance's suggested best practices[49], we find the common trait of "enlightened shareholder value", or, "TQM" (total quality management). The term "enlightened shareholder value" is used, for instance, by The Company Steering Group of the British Department of Trade.[50] Eisenberg speaks of "enlightened corporate self-interest".[51] The construction of the current sections of the German corporation law (§§ 76, 93 *Aktiengesetz*) pertaining to the powers and duties of the managing board is very similar to the American fiduciary duties of directors in the light of other constituency statutes and the more generous jurisprudence. An obligation to act with "social responsibility" beyond compliance with the law, however, is harder to find, especially when it comes to full-fledged control mechanisms and actionable positions.[52]

An exclusive philosophy that the board of directors' one and only duty is to maximize profits is common only among those authors who write against this position. At least in law, no one really argues strongly for such an attitude. This may be different in finance and business administration.[53] When it comes to other constituencies' interests, first and foremost the Principles, Guidelines,

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[47] *Supra* n. 13, Section III. The role of stakeholders in corporate governance: The corporate governance framework should recognise the rights of stakeholders as established by law and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

[48] *Supra* n. 13.

[49] *Supra* n. 13.

[50] "Modern Company Law for a Competitive Economy" <http://www.dti.gov.uk/cld/final report> [last visited 31 August 2001].

[51] Eisenberg, *supra* n. 16, especially pp. 5 et seq. for the "ethical-conduct principle".

[52] A major argument against the empowerment of management to include non-shareholder interests in the business perspective is that, by this empowerment, management is protected against control. There will always be a respectable interest management can claim to have protected when a decision is challenged by shareholders. Vice versa, if substantive claims could be made as to other constituencies' interests, they would be hopelessly tangled with conflicting but equally valuable interests. Remedies are sought in disclosure and more subtle reputational sanctions; see, e.g., Cynthia Williams, "Corporate Social Responsibility in an Era of Economic Globalization", *U.C. Davis L.Rev.* (2001) (forthcoming).

[53] Cf. *supra* n. 46; there are voices, however, that advocate management induced forms of workers' participation, e.g. Sadowski/Junkes/Lindenthal, *supra* n. 16; Schuler/Turnheim/Jackson, *supra* n. 16, at p. 207 (there is no "one-best-way approach"); see also Biagi, "Forms of Employee Representational Participation", in: (Blanpain/Engels [eds.]), *Comparative Labour Law and Industrial Relations in Industrial Market Economies*, *supra* n. 16, 341, at pp. 379-381.

and Best Practices, and whatever soft law may be around, call for compliance with the existing laws, i.e. compliance with what I called external governance. An argument in favor of regulation needs to pay specific attention to the legal positioning of such regulation; an imposition of fiduciary duties, e.g. owed to consumers, would be regulation of the internal decision making process, whereas laws calling for information of consumers, warranties, or liability would be external governance. Moreover, a civic spirit that manifests itself in donations and contributions and the general policy of the corporation is well received everywhere and by no means illegal from a corporate law perspective. Tax law bears witness to that. Taxation belongs to what I called external governance but gives incentives for the internal decision-making process. Benefits for the workforce are not given as charity but as an investment in human capital.

This substantive notion does not include the path-dependent procedures via co-determination, extension of management discretion or fiduciary duties. Executives of union-managed pension-funds have to deliver conflict of interest-prone duties: investing money profitably for their clients and, at the same time, staying loyal to union goals. They resort to the magic formula of "long-term goals", the point in the infinite distance where parallels intersect. In this last area – relations to the workforce – however, my convergence-model does not apply to the same extent. Here, we find a distinct "path-dependency", that is approaches and attitudes follow different paths according to legal culture and historical development. When looking at other jurisdictions' conflict resolution tools, path-dependent and functional analysis is required. An analysis of German co-determination will show that its function on the enterprise level is, to a large extent, external governance.[54] Both, establishedment-level and board-level co-determination, shall ensure compliance with protective regulation.[55]

Certainly, there will always be cases and applications that rise controversy about whether and to what extent management can invoke non-shareholders' interests. One example from the European legal development is the never ending discussion of the management's rights, privileges, and duties when facing a so-called hostile takeover. How "neutral" are managers supposed to

[54] The works council (*Betriebsrat*) enters into collective agreements with the employer, i.e. the corporation represented by management. This collective contract can, therefore, not be a constituting element of the corporation that is a party to the contract. If not the corporation but the "firm" is considered as the phenomenon constituted by a nexus of contracts, we leave legal analysis and find ourselves in the realm of economics or sociology where the term "contract" obviously does not have the same meaning as in law. Cf. Eisenberg, *supra* n. 20. Internal governance is called upon when management is obliged by law to inform the *Betriebsrat* and discuss decisions in advance. For this kind of co-determination, procedural in its nature, only procedural remedies are available whereas in the field of substantive mandatory co-determination (§ 87 *Betriebsverfassungsgesetz*) a tie-breaking arbitration process is provided (*Einigungsstelle*).

[55] See especially § 80 I 1 *Betriebsverfassungsgesetz*.

be? The history of the 13th EU Directive on take-over bids is full of this controversy.

I don't want to take up this very specific topic but come back to some of my sample cases. First, the German example of the Foundation "Remembrance, Responsibility and the Future". Can a legal person have moral sentiments and take ethical responsibility? What about those businesses that were founded only after World War II? Or merged with foreign corporations (DaimlerChrysler, Aventis [Hoechst/RhônePoulenc]? It should be noted that the Foundation is funded by the whole of the German business sector, not only corporations subject to potential claims. Giving money to this special initiative constitutes an act to improve the business climate, an act of corporate citizenship, of public spirit. This is acceptable as long as the overriding goal to make profits is not given up, the contributions keep within reasonable proportion to the businesses size and earnings, and the corporation is not morphed into a non-profit organization.[56] I happen to infer from a personal conversation that DaimlerChrysler pays its share out of the marketing budget.

Last but not least *Dodge* v. *Ford*. Henry Ford's attitude is sometimes interpreted as ahead of its time. profit sharing may nowadays be a sound business strategy to increase the good will of the company and benefit long-term perspectives.[57] However, I find another bit of information quite interesting. The judge in Dodge warned in strong words that the corporation is to be run in the best interest of its shareholders, and that there is no room for personal generosity. Judicial review of management decisions should not interfere with a certain leeway business judgment needs, though. "*The judges are not business experts. It is recognized that plans must often be made for a long future, for expected competition, for a continuing as well as an immediately profitable venture. The experience of the Ford Motor Company is evidence of capable management of its affairs.*" The mentioning of future competition was especially delicate in the case at hand. The brothers Dodge were planning, as they later did, to set up their own business of manufacturing cars. The profits from their investment in Ford was contributing to their capital. Decreasing dividends meant lack of funds for the new enterprise. Lower car prices would have made the market entry more difficult; they would have had to meet the lowered Ford prices. Why did Henry Ford take refuge to the eleemosynary disguise? Saying openly that his business purpose was to fend off future competition from the Dodge brothers would have been a clear-cut violation of Sec. 1 Sherman Act. This probably explains why the attempted "public spirit" was not discussed as

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[56] Mertens, *supra* n. 10, p. 158.

[57] Lattin, *supra* n. 3, pp. 211 et seq.

to its merits for the reputation of the corporation, furtherance of long-term goals, legitimacy of large and profitable corporations etc.

Again, the comparative, intra-, and interdisciplinary approach that I always associate with JOCHEN MESTMÄCKER's work brings about the larger picture. This permits me a more personal observation. One of my capital expenditures as a student was the acquisition of MESTMÄCKER's "*Europäisches Wettbewerbsrecht*"; it still produces dividends.

The public corporation is without any doubt entitled to ventilate a public spirit. Shareholders cannot object to that. The limits for expenditures made for such civility vary from case to case and jurisdiction to jurisdiction but are not at variance in principle. This convergence in dogmatic structure ends where significant path-dependency is encountered; the practical outcomes, however, may still be in confluence. But when explaining and justifying outcomes we always need to pay proper attention to the dynamic interchanges of internal and external governance. And there should be no confusion of contract with "contract". Here, I would like to borrow from a famous line by Gertrude Stein: A contract is not a contract is not a contract. So we can sit back leisurely and listen to Dr. Faust's Stradivari, or is it Deutsche Bank in a cello-case for sheep's clothing?[58]

[58] Eisenberg, *supra* n. 16, p. 14.