

A Cautionary Note on Drawing Lessons from Comparative Corporate Law

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INTRODUCTION

Mark Roe's article comparing German, Japanese, and U.S. corporate governance extends his important research concerning the effect of political constraints on the organization of U.S. corporations.¹ In this latest publication, Roe painstakingly compares governance arrangements, highlighting the variability in business organization that exists across nations, to obtain guidance for reforming U.S. institutions. This is valuable comparative institutional research, but the lesson to be drawn from the mutability of the corporate form is opaque. As Roe suggests, the legal and institutional differences across the three nations make it difficult to ascertain whether one approach to corporate governance is superior to another and whether a superior organizational form could be successfully transplanted into another setting. Yet without a means to make comparative judgments, the likelihood that helpful lessons can be drawn from other nations' experiences for reforming our own institutions is diminished, and the rationale for making the comparisons in the first place becomes problematic.

Roe does suggest that German and Japanese firms have been subject to less debilitating political constraints on their organization than U.S. firms (because banks were permitted to exercise control over industrial corporations), although he indicates that this may be changing as recent political trends in Germany and Japan seem to resemble U.S. politics. But he does not make clear, at least to my satisfaction, why he reaches this comparative political judgment. Why should we view the corporate organizational form produced by a political process that empowers banks as preferable to a process that does not without evidence of the superiority of the former organizational form?

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1. Mark J. Roe, *Some Differences in Corporate Structure in Germany, Japan, and the United States*, 102 YALE L.J. 1927 [hereafter *Some Differences*]. This thesis was first presented in Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991).

One implication of Roe's thesis that U.S. politics, because it limits the activities of large banks, produces undesirable corporate ownership patterns—patterns that are more politically than economically inspired—compared to that of other nations is that foreign firms' corporate governance arrangements are preferable, and that the United States ought to adjust its laws shaping corporate governance to match those of other nations. Roe expresses considerable ambivalence concerning this implication of his thesis, but he offers two grounds for permitting U.S. firms to adopt non-U.S. institutions: the organization of German and Japanese firms improves decisionmaking and organizational performance, and more choice is better than less.² The implication of the former contention is that German and Japanese firms are more competitive than their U.S. counterparts—how else would we be able to make a comparative assessment of their performance or decisionmaking? Given the data on international competitiveness detailed in this Comment, Roe does not embrace this implication, although he does not draw back on the hypothesized organizational benefits. This creates a muddle, as it is exceedingly difficult to get a fix on the analysis, much less to draw any lessons for corporate law reform. The implication of the latter contention is that U.S. firms would choose to adopt this alternative organizational form were it available. While this implication is also a contestable claim, the core notion that investors ought to be permitted the choice, is, at least in my opinion, less so.

My Comment has one principal, quite simple, point: the central lesson to be drawn from Roe's research in comparative corporate governance is that there is no compelling evidence to support a preference for German or Japanese organizational forms and hence for their adaptation to U.S. firms. First, I review the extensive data indicating that the widely held background assumption of the superior competitiveness of German and Japanese firms over U.S. firms is mistaken. Such an assumption is key for drawing particular lessons from comparative corporate law, such as preferring particular institutions; if German and Japanese firms are not more productive and are in fact less productive than U.S. firms then there is no clear cut reason to emulate their corporate governance arrangements. Second, I provide some anecdotes, for that is all we have now, culled from the history of U.S. corporate finance and current relationships between U.S. firms and banks, to suggest that even were we to alter U.S. banking regulation to permit German- and Japanese-style bank control of industrial corporations, the result may be different from what we see abroad. These data make plain that the most important lesson from examining institutions across time and space is that private parties are quite resourceful in adapting their affairs to minimize the adverse effects of regulation. Third, I address more directly the adequacy of the political

2. Roe, *Some Differences*, *supra* note 1, at 1931-32.

distinctiveness Roe attributes to the United States in producing ineffective institutions of corporate governance by noting that the German and Japanese political systems have intruded on corporate governance on some dimensions of importance to shareholders far more than the U.S. regime of financial regulation. I conclude with a word about Roe's criticism of agency cost theories of corporate organization, which mistakenly views such theories as predicting uniformity, as opposed to variety in the corporate form.

All of this is not to say that U.S. laws restricting bank ownership of corporate stock or separating investment and commercial banking functions should be retained. I believe that they should be rolled back. But the rationale for such a policy reversal cannot be readily found in the study of comparative institutions; it can be located more easily instead in our own corporate law tradition. Namely, it is the policy most consonant with the competitive and enabling approach of U.S. corporate law, which, by permitting experimentation and innovation in the choice of institutions, tends to maximize firm value.³

I. COMPARATIVE PRODUCTIVITY AND DIFFERENCES IN CORPORATE GOVERNANCE

No comparative empirical study has shown that corporate governance arrangements affect productivity. Since no immediate evidence is available, a preference for German and Japanese organizational forms must hinge upon the significance attributed to the fact that those nations have for some time surpassed the United States on a variety of productivity growth measures. For instance, growth in productivity measured by gross domestic product (GDP) per capita, from 1870 to 1979 was 691% for the United States but 1396% for Germany and 1653% for Japan.⁴ As measured by the growth rate in GDP per work-hour from 1970 to 1979, the growth in productivity was 1.92% for the United States, 4.5% for Germany and 5.03% for Japan.⁵ The contention of superiority has to focus on these relative growth rates because in terms of absolute productivity, the United States has retained the lead.

The most comprehensive study of productivity to date, by William Baumol, Sue Anne Batey Blackman, and Edward Wolff, shows that the significance of differences in short-term productivity growth rates has been vastly overstated.⁶ In this study the authors make several important points

3. For an extended discussion of the benefits of competition in the production of corporation laws and an enabling approach to corporate governance, see ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* (forthcoming 1993).

4. WILLIAM J. BAUMOL ET AL., *PRODUCTIVITY AND AMERICAN LEADERSHIP: THE LONG VIEW* 13 (1989).

5. *Id.* at 88.

6. The data and analysis in the following paragraphs are taken entirely from the Baumol, Blackman and Wolff study, especially as reported in *id.* at 14, 65, 68-71, 89-90, 258-260. This study is particularly interesting because it is a reversal of the authors' earlier critical assessment of U.S. productivity

about productivity measures that are critical to understanding their significance. First, productivity growth rates are extremely volatile in the short run and hence are best estimated over long periods. Second, the decline in U.S. productivity growth in recent years is a decline only in comparison to the phenomenal spurt in U.S. productivity in the years following World War II. The current growth rate is, in fact, similar to the United States' historic normal growth rate. The extraordinary increase in U.S. productivity growth in the postwar period equals (and thus can be seen to compensate for) the steep decrease in productivity growth during the Great Depression. Indeed, a growth trendline shows that growth in U.S. productivity has remained constant from 1880 through 1980. Moreover, *all* industrial nations experienced the same temporal pattern of productivity growth rates, an unusual postwar increase and a slowdown during the 1970's.

Third, and most important, differences in short-run productivity growth rates are not indicia of economic decline because of the phenomenon of international convergence. When one nation's productivity is superior to that of other nations, those nations that are not too far behind can catch up as they learn from the leader through the transfer of technology, and so performance levels will converge. The laggard countries have more to learn from the leader than the leader does from them, and consequently, "those who were initially behind *must* advance more rapidly than those who were ahead. Otherwise, the distance between them could not possibly narrow."⁷ Baumol, Blackman, and Wolff exhaustively detail the body of evidence supporting the international convergence conjecture.

More recent works, including an update of productivity measures through 1990 by Baumol and Wolff and a study of productivity in the service sector by McKinsey and Company, reinforce the critical assessment of the significance of comparisons across productivity growth rates in the Baumol, Blackman, and Wolff study and indicate that absolute U.S. productivity has continued to exceed that of Germany and Japan.⁸ Baumol and Wolff's latest data on manufacturing performance indicate that the rate of productivity growth in Germany has, in fact, been lower than that of the United States for over a decade (a decline predating the economic difficulties brought on by reunification). The data also indicate that Japan's productivity growth rate has

performance in PRODUCTIVITY GROWTH AND U.S. COMPETITIVENESS (William J. Baumol & Kenneth McLennan eds., 1985).

7. BAUMOL ET AL., *supra* note 4, at 90. A further fact supporting the convergence hypothesis is that the lag in the rate of U.S. productivity growth compared to other nations is a longstanding phenomenon, going back a century. *Id.* at 87-89.

8. William J. Baumol & Edward N. Wolff, *Comparative U.S. Productivity Performance and the State of Manufacturing: The Latest Data*, 10 CVSTARR NEWSLETTER (Center for Applied Econ., N.Y.U.), 1992, at 1; McKinsey Global Institute, *Service Sector Productivity* (Oct. 1992) (unpublished study, on file with author). The McKinsey study received assistance from several distinguished economists including Martin Baily, Francis Bator, and Robert Solow.

slowed down considerably in recent years and is now not much greater than that of the United States, while the Japanese level of productivity is still far lower than the U.S. level.

The McKinsey study reviews other studies' findings of superior U.S. productivity in the manufacturing sector and then presents five case studies from the service sector (airline, retail banking, restaurant, general merchandise retailing, and telecommunications industries). Because the value of output in a service industry is not always quantifiable, it is difficult to measure the performance of such an industry. The study consequently examines a variety of labor productivity measures to evaluate comparative performance. The findings reveal that, in each of the five industries, labor productivity is higher in the United States than in Europe or Japan. The authors attribute the superior performance of U.S. firms to the greater (domestic) competition that they experience.

The United States' lower rate of productivity growth compared to that of Germany and Japan in the postwar period is therefore best understood as a manifestation of the catch-up from international convergence. We do not need to introduce differences in corporate governance regimes to explain differences in performance. This explanation of changing relative rates of productivity growth does not imply that low relative productivity growth is not a public policy concern. It is. The hard question for public policy is whether another nation will eventually surpass the United States as our long-term historic growth rate may not be sufficient to retain world economic leadership. The answer, in my judgment, will not be found in mimicking other nations' corporate governance arrangements nor in comparative study of such institutions.

While we cannot predict whether the United States will be surpassed as the economic leader, the key factors that economists believe affect absolute productivity performance are the national savings rate (investment), the labor force's education, and the magnitude of efforts devoted to basic and applied research.⁹ There is no theory or evidence relating any of these factors to corporate governance arrangements. It is telling that commentators who are concerned about the effect of corporate governance on comparative economic performance do not mention these key factors; the probable explanation is that it is extremely difficult to relate such fundamental factors to corporate governance patterns.

The difference in corporate structure that Roe details and suggests is significantly related to performance—U.S. firms have dispersed stock ownership that permits managers to run firms without oversight, whereas German and Japanese managers are actively monitored by banks—were all in place considerably before World War II, no later than the Great Depression.

9. BAUMOL ET AL., *supra* note 4, at 258-60.

This is well before the postwar years of the steep relative decline in the U.S. rate of productivity growth; in the prewar years from 1870 to 1929, there is no discernible pattern between form and rate; in fact, the U.S. rate surpassed that of Japan in all years but 1890-1900 and 1913-1929 and that of Germany in all years but 1880-1900.¹⁰ In conjunction with the data on comparative productivity, this indicates that changes in the rate of growth in productivity cannot be readily attributed to differences in corporate governance structure (unless there is a very long lag effect) and strengthens the view that the fruitfulness of studying German and Japanese arrangements for improving U.S. firms' competitive performance, and hence for proposing U.S. corporate governance reforms, is problematic.

II. FURTHER COMPARISONS OF CORPORATE GOVERNANCE, INCLUDING EXAMPLES FROM U.S. HISTORY

The transferability of German and Japanese corporate forms to the United States, as Roe suggests, is a tricky proposition. Evidence of the efficacy of such an approach can be gleaned from examining American corporate financial history, where similar arrangements appeared prior to the twentieth-century financial regulation that Roe identifies as shaping current corporate institutions.

The evidence of the success of German- and Japanese-like corporate governance arrangements in the United States is mixed. As David Teece points out in reviewing the latest work of the distinguished business historian, Alfred Chandler, "U.S. Steel provides one of the very few examples of banker control in American industry."¹¹ As is chronicled by Chandler, U.S. Steel lost its early leading position due to poor management decisions.¹² Teece concludes, "Chandler leaves little doubt that he believes that the financiers and lawyers running U.S. Steel made serious mistakes."¹³

A more hopeful example is provided in a fascinating study by J. Bradford De Long, which indicates that at the turn of the century, adding a Morgan banker to a corporate board increased the value of a firm's stock by 30%.¹⁴ De Long finds no evidence that Morgan exploited the public investors. On the contrary, he finds that companies with a Morgan director sold at higher

10. *Id.* at 88. With the exception of the years surrounding the Great Depression, the rate of U.S. productivity growth remained higher than the international average from 1870 until the postwar period. *Id.*

11. David J. Teece, *The Dynamics of Industrial Capitalism: Perspectives on Alfred Chandler's Scale and Scope*, 31 J. ECON. LIT. 199, 205 n.12 (1993).

12. ALFRED D. CHANDLER, JR., *SCALE AND SCOPE: THE DYNAMICS OF INDUSTRIAL CAPITALISM* 131-40 (1990). After comparing the growth of industrial capitalism in the United States, the United Kingdom, and Germany, Chandler attributes much of the competitive success of firms to professional management. *Id.* at 593-97.

13. Teece, *supra* note 11, at 205 n.12.

14. J. Bradford De Long, *Did J.P. Morgan's Men Add Value? An Economist's Perspective on Financial Capitalism*, in *INSIDE THE BUSINESS ENTERPRISE: HISTORICAL PERSPECTIVES ON THE USE OF INFORMATION* 205, 219 (Peter Temin ed., 1991).

multiples of book value than other companies and that their stock offering prices and subsequent rates of return were comparable to those of non-Morgan companies.¹⁵ Although Morgan was engaged in both commercial and investment banking at the time, De Long's data do not indicate whether Morgan had any position, either as creditor or owner, in the companies on whose boards its partners served. In addition, De Long is not able to determine whether the source of the value added by a Morgan banker was due to effective corporate governance or monopoly rents—whether the market viewed a Morgan appointment as a screen for corporate quality (this assumes Morgan directors actively monitored management so as to protect firm value) or as a signal of future monopoly profits (this assumes the creation of market power through business interconnections established with other Morgan firms).

One would be hard pressed to make predictions from these two contradictory anecdotes concerning the direction of the effect that repealing the Glass-Steagall Act would have on the value of industrial firms. Another interesting study of early American banking by Naomi Lamoreaux further muddies the water. Lamoreaux's research suggests that U.S. banks might not adopt the German and Japanese banks' role of active investors even if the option were made available to them. She finds that New England banks in the late nineteenth century voluntarily exited from arrangements similar to those of German and Japanese banks—ones in which banks lend to insiders with interlocking bank and corporate managerial positions and actively monitor and influence borrowers' behavior—and instead engaged in financial intermediation; the new arrangements were undertaken for efficient risk-reduction reasons.¹⁶ Thus, in at least one region of the United States, the divorce of private bankers and industrialists apparently began long before it was required by federal statute.¹⁷

15. *Id.* at 218-24.

16. Naomi R. Lamoreaux, *Information Problems and Banks' Specialization in Short-Term Commercial Lending: New England in the Nineteenth Century*, in *INSIDE THE BUSINESS ENTERPRISE: HISTORICAL PERSPECTIVES ON THE USE OF INFORMATION* 161 (Peter Temin, ed. 1991).

17. In response to my discussion of Lamoreaux's research on the transformation in New England banking at the turn of the century, Roe suggests that the shift was due to regulation, citing Lance Davis' research, particularly Davis' reference to restrictions on out-of-state lending by Massachusetts banks. Roe, *Some Differences*, *supra* note 1, at 1962-63. Davis' work does not, however, support such a conclusion. Davis' thesis is that capital immobility produces personal financial capitalism (whereby only financiers, for example, Rockefeller and Morgan, can amass pools of capital to finance industry through personal contacts with other financiers and banks); regulation, such as restrictions on national banking, renders capital immobile. Lance E. Davis, *Capital Immobilities and Finance Capitalism: A Study of Economic Evolution in the United States 1820-1920*, 1 *EXPLORATIONS IN ENTREPRENEURIAL HIST.* (2d ser.) 88 (1963). Personal financial capitalism is unnecessary when capital is mobile, as occurs once financial intermediation and capital markets develop. *Id.* The form of banking produced by regulation according to Davis' thesis, then, is exactly the personal form of banking that corresponds to the Japanese and German model that the New England banks were abandoning. It is therefore unlikely that regulation produced the shift by those banks toward financial intermediation. Second, the industries to which the banks were lending in Lamoreaux's example, both before and after the change in practice she details, were typically local firms. Political restrictions on national banking thus cannot explain the evolution in banking practices. Finally, Davis distinguishes between commercial and savings banks throughout his discussion, and the Massachusetts out-

Contemporary comparisons abroad reinforce the view that the behavior of the New England banks might well be the response of U.S. banks today if Glass-Steagall were repealed. As Jack Coffee has noted, U.K. firms are not subject to the same type of ownership restrictions as U.S. firms, yet they have dispersed stock ownership rather than the bank-dominated governance structure of Germany.¹⁸ This difference may be an historical accident; that is, it may be due to disparate industrial development in England and Germany in the late eighteenth and early nineteenth centuries that led to the establishment of different financial institutions.¹⁹ Industrialization occurred considerably later in Germany than in England, at a time when the optimal plant size was much larger and technology was more complex, requiring more capital and more informed entrepreneurial guidance.²⁰ The new German manufacturing firms, in contrast to U.K. manufacturers, were unable to grow by reinvested earnings or relying on small private banks. This necessitated new financial institutions, such as innovative alliances between Rhenish firms and private bankers, joint-stock issue banks, and reliance on government financing.²¹ As a consequence, German banking developed along different lines from British banking. Whatever the significance of fortuities in historical development for explaining contemporary differences between England and Germany, the presence of these differences makes plain that U.S. regulatory barriers are not a sufficient explanation for the differences among U.S., German, and Japanese governance structures.

Moreover, Japanese regulation has prohibited the development of capital markets and forced corporations to rely on bank financing.²² When these restrictions were loosened in the 1980's, there was a significant, dramatic shift away from bank financing: the percentage of corporate debt of public corporations that was bank debt went from 90% in 1975 to under 50% in

of-state lending restrictions to which Davis refers concerned savings banks. *Id.* at 99. The banks Lamoreaux discusses are, however, commercial banks. It is not at all apparent why state regulation of savings banks would have an effect on the financing patterns of the banks that she studied. A difference between the regulation of savings and commercial banks presumably explains what Roe points out as inconsistent with the regulation referred to by Davis, an inability to make out-of-state loans and the holding of national commercial paper by the banks that Lamoreaux discusses.

18. John C. Coffee, Jr., *Liquidity versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991).

19. See RICHARD TILLY, *FINANCIAL INSTITUTIONS AND INDUSTRIALIZATION IN THE RHINELAND, 1815-1870*, 134-35 (1966).

20. HANS-HERMANN FRANCKE & MICHAEL HUDSON, *BANKING AND FINANCE IN WEST GERMANY 4* (1984). This thesis—variation in industrialization is related to a country's economic backwardness at the time of its industrialization—is associated with the German economic historian, Alexander Gerschenkron. See, e.g., ALEXANDER GERSCHENKRON, *ECONOMIC BACKWARDNESS IN HISTORICAL PERSPECTIVE: A BOOK OF ESSAYS* (1962).

21. FRANCKE & HUDSON, *supra* note 20, at 55-63; TILLY, *supra* note 19, at 135.

22. See Takeo Hoshi et. al, *The Choice Between Public and Private Debt: An Analysis of Post-Deregulation Corporate Financing in Japan 4*, 13-15 (Mar. 1993) (unpublished manuscript, on file with author).

1992.²³ It remains to be seen whether the Japanese corporate governance arrangement dependent on financial group ties that Roe emphasizes will continue with the demise of its political (regulatory) support. For example, Takeo Hoshi, Anil Kashyap, and David Scharfstein find that the more successful group firms have lower bank debt after deregulation than the less successful firms, which supports an insurance rationale for the Japanese financial group organization—protecting poor managers—rather than an efficiency explanation.²⁴ The development of Japanese corporate finance and governance arrangements over the next decade will provide a much clearer picture of whether we should be as skeptical of the efficacy (that is, economic as opposed to political viability) of Japanese governance patterns as Roe is of U.S. ones.

It would, therefore, be a mistake to maintain that U.S. corporate governance institutions are better understood as shaped by political, rather than economic, forces and hence are inefficient compared to those of Germany and Japan. A more useful way of characterizing the connection between politics and organizational form, particularly in the contractual context of business firms, is to recognize that private parties are persistent in devising institutions that circumvent, or at least minimize, political constraints on economic activity. For example, Rhenish bankers and entrepreneurs created innovative financial mechanisms that circumvented the Prussian government's restrictions on economic development.²⁵ Closer to home, some large U.S. firms have important relationships with banks, even though banks cannot own corporate stock. Myron Slovin, Marie Sushka, and John Polonchek find, for example, that the impending insolvency of the bank with which firms had their primary lending relationships adversely affected the firms' stock prices.²⁶ In addition, seven of the 1990 Fortune top ten industrial firms had bankers (commercial or investment) on their boards, and two of these corporations had financial relations with the directors' banks of sufficient magnitude to report it in their proxy statements.²⁷ No doubt the relation-specific investments between U.S. firms and banks are far more attenuated than those in Germany and Japan. As in the case of German and Japanese firms, we also do not know if these relationships produce benefits in corporate governance. But we must recognize that even with Glass-Steagall, firms can enter into long-term relationships with

23. *Id.* at 1, 15-17.

24. *Id.* at 23-24.

25. For a detailed discussion of their efforts see TILLY, *supra* note 19, at 134-38.

26. Myron B. Slovin, et al., *The Value of Bank Durability: Borrowers as Bank Stakeholders*, 48 J. FIN. 247 (1993) (reporting that client firms of Continental Illinois Bank experienced negative abnormal returns of -4.2% during bank's impending insolvency).

27. The firms are as follows (with the number of directors affiliated with a bank indicated in parentheses): General Motors (2), Exxon (0), Ford Motor (1), International Business Machines (0), Mobil (0), General Electric (2), Philip Morris (3), Texaco (3), E.I. du Pont de Nemours (1), Chevron (1). The 1990 Fortune rankings of the largest U.S. industrial corporations were obtained from *The Fortune 500*, FORTUNE, Apr. 22, 1991, at 286, and the 1990 SEC proxies from LEXIS, Compny library, Proxy file.

banks. While that statute's repeal will facilitate establishing such relationships, it is far from obvious that U.S. firms will alter their existing banking arrangements to replicate German and Japanese ones more closely.

Given the resourcefulness of private parties in arranging their affairs and the data on comparative productivity, there is no reason to assume that the constrained optimization problem of U.S. firms produces a less efficient corporate structure than that of German and Japanese firms. In fact, the opposite may well be closer to the truth; U.S. firms may be more efficiently organized than their counterparts in other countries. This is because, although Roe emphasizes the shortcomings of American politics, as the next Part describes, the political process in other nations has, along some dimensions, been less favorable for investors than that of the United States. The historical and contemporary examples of the complicated relationship between U.S. firms and banks do not argue for retaining current restrictions on banks' activities. Rather, they highlight the limitations of projecting the impact of U.S. law reform upon its corporate governance institutions from the experience of other countries.

III. COMPARING THE OBJECTIVES OF CORPORATION CODES

In Roe's explanation, politics adversely dominates American corporate organization. The negative effect of politics on firm structure in Germany and Japan, in his analysis, appears to occur only in recent times when they have experienced political pressure to adopt the U.S. pattern of restricting the holding of corporate equity by banks. This perspective is, in my judgment, questionable. As this Comment and Roe's article note, the strength of banks in Germany and Japan is equally a function of their political processes as of economics. Accordingly, to emphasize that one or the other organizational form is politically driven tells us little about the desirability of that form.

Roe appears to suggest that a process that expands the activities of banks is preferable to one that restricts those activities as he expresses some concern over the changing political currents in Germany and Japan. In my view, his concern over these changes is sensible only when shorn from his a priori preference for financial institutions' monitoring of managers and instead related to the nations' particular circumstances. Diminishing the activities of banks in corporate governance in Germany and Japan is likely to be undesirable when we consider the differences in corporation codes and practices concerning the protection of shareholder interests in those countries compared to the United States. Namely, in Germany, the control over managers exercised by banks is a necessary counterweight to nonshareholder interests advanced in that country's corporation code, and in Japan such control may be a constraint on otherwise detrimental corporate group practices. This explanation underscores

that the impact of U.S. financial regulatory reform on corporate governance may not be that significant for U.S. investors.

The German corporation code, for example, in contrast to U.S. corporation law, does not only seek to maximize shareholder welfare but has multiple purposes. It mandates a system of codetermination in which employees elect half of the supervisory board and participate in major corporate decisions, even though their interests are plainly at odds with those of shareholders in many circumstances. For instance, in decisions regarding potential acquisitions, employees will prefer job security to increased share prices, and in the selection of firm projects, as fixed claimants they will prefer less risk than will shareholders. Such an arrangement is therefore not likely to maximize shareholder value because conflicting interests must be reconciled (a firm will be unable to operate effectively as if decisions are undertaken by bare majority split votes).

There is some anecdotal evidence that codetermination is not the ideal arrangement from the shareholders' perspective. First, commentators attribute Volkswagen's financial difficulties to labor's alliance on the supervisory board with the largest shareholder, the state government, which fostered a "politics of jobs" that prevented the firm from cutting costs compared to its international rivals.²⁸ Second, firms do not voluntarily choose such a system. For example, the two-tiered board system is explicitly available to French firms, but virtually none have adopted it.²⁹ Moreover, nothing in U.S. law prohibits the representation of workers on corporate boards. If codetermination were a value-maximizing strategy, we would not only find U.S. firms voluntarily adopting such structures, but we would also see codetermination provisions enacted over time, because the dynamics of state competition tends to lead states to adopt laws that maximize shareholder wealth.³⁰ The absence of the institutions of codetermination in places where they are not legislatively mandated is strong circumstantial evidence that investors do not benefit from them.

28. Ferdinand Protzman, *Volkswagen Sees Need for Shake-Up*, N.Y. TIMES, Mar. 15, 1993, at D1, D8.

29. Klaus J. Hopt, *Directors' Duties to Shareholders, Employees, and Other Creditors: A View from the Continent*, in COMMERCIAL ASPECTS OF TRUSTS AND FIDUCIARY OBLIGATIONS 115, 116 (Ewan McKendrick ed., 1992).

30. ROMANO, *supra* note 3, at ch. 2. There could be some additional organizational costs to adopting codetermination institutions without authorizing legislation, but they are too insubstantial to explain the absence of such corporate forms. For instance, to duplicate the German supervisory board, an employee stock ownership plan could be created and provided with all the shares of one class of stock, which under the charter would elect half of the board, while the publicly-traded common shares would elect the other half. U.S. labor laws do not appear to restrict such employee involvement, as long as the corporate structures are not shams to undermine independent union representation. *Cf. NLRB Ruling on Employee Participation Teams Not Seen as Closing the Door on All Such Efforts*, 8 CORP. COUNSEL WEEKLY (BNA) No. 2, at 8 (Jan. 6, 1993).

Germany is able to maintain a non-value-maximizing corporation code because both the continental corporate law choice of law rule of physical presence, as opposed to statutory domicile, and the corporation code harmonization process of the European Community stifle competition for corporate charters among nations. *See* ROMANO, *supra* note 3, at ch. 6.

Codetermination in all likelihood necessitates the concentration of voting power in banks or some other form of block ownership, compared to U.S. firms where dispersed shareholdings are not subject to an organized and legally mandated opposition. This counterweight is the only clear cut mechanism to protect the shareholders' interest from employees' institutional advantage over dispersed investors to push firm decisions in their favor. But this rationale involves an economic, and not a political, preference for active bank involvement in German firms, which reduces the need for such an arrangement in the United States.

In contrast to the German legal system, Japanese corporate law is not formally at odds with the U.S. shareholder-centered regime, which is not surprising because the United States imposed its legal rules on Japan after World War II. Commentators, however, describe Japanese managers as following objectives other than shareholder value maximization, such as maximization of growth.³¹ Given the corporate group setting, in which the most significant shareholders have dual roles as customers, suppliers, or lenders, such an attitude is also not surprising. There has been little investigation of which economic interest, the equity investment or the related transaction, dominates such shareholders' decisions. Nevertheless, studies find that firms in corporate groups (that is, firms with large corporate cross-holdings other than banks) perform poorly,³² which suggests that the interfirm transactions, and not the equity holdings, involve the more valuable relationship. This finding is not replicated for firms in financial groups (i.e., firms whose largest corporate shareholders are banks).³³ This suggests that banks could play a positive role, from the public investors' perspective, by offsetting the decisional power of the other business-related shareholders, just as German banks counter the employees' role in corporate decisions.

In addition, I am more skeptical than Roe concerning the extent of Japanese shareholder "power" that benefits public investors, particularly given his view that annual meetings are not fractious because management has large shareholders' support. Management uses several tactics to ensure peace at meetings that are not obviously related to promoting investor participation. Most Japanese corporations hold their annual meeting on the same day to prevent shareholder attendance, and some firms pay individuals (called *sokaiya* or professional extortionists) to ensure smooth flowing meetings by, for example, "shouting down and threatening shareholders who question the

31. See, e.g., W. CARL KESTER, JAPANESE TAKEOVERS: THE GLOBAL CONTEST FOR CORPORATE CONTROL 76-77 (1991).

32. FRANK R. LICHTENBERG & GEORGE M. PUSHNER, OWNERSHIP STRUCTURE AND CORPORATE PERFORMANCE IN JAPAN 10, 18, 22-23 (National Bureau of Economic Research Working Paper No. 4092, 1992) (reviewing literature and providing additional confirming evidence).

33. *Id.*

company's management."³⁴ Large shareholders' acquiescence in such tactics may well be another example of the pull of Japanese blockholders' dual roles, casting doubt on whether the group structure unambiguously benefits ordinary shareholders (investors who have no relation with the firm besides their equity capital).

It is puzzling that Roe praises the common German and Japanese institution of corporate governance—bank monitoring—while recognizing that improving corporate governance may not even be its primary purpose. In this regard, the motivation for a comparative study, at least on corporate governance grounds, is ambiguous, for we conventionally understand by that subject institutional arrangements that maximize the value of the firm (i.e., institutions that promote the shareholders' interest). Roe offers no comparative data demonstrating that the public shareholders of German and Japanese firms do better than, or as well as, their U.S. counterparts.³⁵ Yet such comparative information is essential for any lessons to be drawn from comparing corporate governance institutions across nations. As mentioned earlier, it is quite possible that the institutional blockholders in German and Japanese corporations could operate the firms to safeguard or favor their nonshareholder positions at the public shareholders' expense. Roe further notes what other commentators have suggested, that the German and Japanese governance arrangements were adopted to protect incumbent corporate managements from control changes. This is the same explanation that he offers for U.S. laws and regulations preventing such arrangements. It would be helpful to explain why the effort in one but not in the other case may be expected to benefit public investors.

To motivate a monitoring rather than managerialist explanation of the German and Japanese arrangement, Roe emphasizes that, unlike their American counterparts, German and Japanese managers share power. This explanation is not convincing. German and Japanese managers share power with other *managers*, not with shareholders whose personal investments are on the line. A common view in the corporate board literature is that interlocking corporate directors are more accommodating of top management than independent directors as they follow a "golden rule" of directorship: one manager in the role of board member for a second manager's firm does not question the second's decisions and that second manager as a member of the board of

34. James Sterngold, *Head of Big Japan Company Quits in Gangster Payments*, N.Y. TIMES, Oct. 30, 1992, at D3, D3.

35. The separation of commercial and investment banking under the Glass-Steagall Act contributed to the development of U.S. capital markets, as it pushed firms to resort to public markets, as opposed to banks, for capital. See BRUNO SOLNIK, *INTERNATIONAL INVESTMENTS* 101 (2d ed. 1991). Despite Roe's suggestion to the contrary, it is not at all self-evident that investing through bank deposits is preferable to investing in equities directly or through mutual funds. Indeed, one of the most important trends in financing, known as securitization, involves repackaging and reselling bank loans in public capital markets. To determine whether individual investors are disadvantaged by the U.S. situation, we need to compare the returns to individuals investing in the U.S. stock market with the interest earned by German bank depositors, as well as the interest earned by U.S. bank depositors. This is no small task.

directors of the first manager's firm does not question the first's decisions. Roe provides no reason to expect a different scenario in the Japanese group setting, other than the assertion that the stock ownership of the manager's firm makes a difference. But this contention overlooks two important facts that indicate the attenuation of managerial incentives to act in stockholder interests: (1) corporate ownership runs in both directions (the first manager's firm owns the second firm's stock and the second manager's firm owns the first firm's stock) and (2) Japanese managers hold even fewer shares of their own firms than U.S. managers.³⁶ Without more concrete information about the behavior of Japanese firms and managers, it is impossible to conclude that shared authority fosters effective shareholder monitoring rather than mutual accommodation and managerial entrenchment on a par or greater than that present in U.S. firms.

IV. AGENCY COSTS AS "UNIVERSAL THEORY"

In the initial part of his article, Roe sets up as the object of criticism a view of the modern business firm that he terms the "classical economic model," which is principally derived from Michael Jensen and William Meckling's seminal article on agency costs.³⁷ His critique is mistaken, and it is superfluous to his thesis.

In particular, Roe's conceptualization of agency cost theory has it backwards. He contends that agency cost theory predicts the separation of ownership and control. Agency theory predicts that a variety of institutional arrangements will appear to minimize losses arising from agency problems *given* the separation of ownership and control. It does not predict the separation of ownership and control (i.e., dispersed ownership). I am aware of no statement of agency theory suggesting that concentration of share ownership in blocks by banks or other investors is not a possible solution to the problem of organizing a firm in which the managers and owners will not be identical. Indeed, economists working in this area have modeled and empirically investigated such a response.³⁸ I am also not aware of any paper by any agency theorist that makes any of the claims that Roe makes for the theory:

36. Steven N. Kaplan, *Top Executive Rewards and Firm Performance: A Comparison of Japan and the U.S.* (1992) (unpublished manuscript, on file with author) (median holding of Japanese manager is 0.23% compared to U.S. manager's median holding of 1.17%; Japanese managers' average holding is 0.9% compared to U.S. managers' average holding of 5.59%). Similar to the findings of studies of U.S. firms, Lichtenberg and Pushner, *supra* note 32, at 22-23, find that the performance of Japanese firms is positively correlated with insiders' stock ownership.

37. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). Transaction cost economics is also integral to the theory of the firm Roe describes. See, e.g., OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING* (1985).

38. See, e.g., Harold Demsetz & Kenneth Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 J. POL. ECON. 1155 (1985); Andrei Shleifer & Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461 (1986).

that “corporate ownership mediated through securities markets is the highest form of financial development, successfully providing ownership, diversification and liquidity in just the right proportions”;³⁹ that large firms in every economy should develop the same organization; that if there were international differences in corporate organization it would mean that “corporate structure might not matter”; that differences could not exist across firms in their organization; and so forth.⁴⁰ Commentators acquainted with the literature would be astonished to learn that it makes such strange claims. Indeed, scholars have relied on the theory to make comparisons that Roe considers impossible by definition; they have contended that Germany and Japan did not have or need active takeover markets because they resolved agency problems differently from the United States.⁴¹

Of course, in all of the countries that Roe discusses, there are large corporations where ownership is separate from control—neither German banks nor Japanese affiliated companies in corporate groups are 100% shareholders, nor do they directly manage day-to-day operations. Roe shows that firms in Germany and Japan have typically resolved the agency problem differently from U.S. firms, and that U.S. statutes and regulations tend⁴² to restrict the use of such solutions for U.S. firms. But cross-country disparity does not disprove agency theory in the way any of its proponents have used it as opposed to Roe’s conceptualization of it—to explain important features of U.S. corporate law, such as viewing the board of directors as a mechanism to mitigate agency costs.

The impact of the state on corporate organization is not, as Roe implies, a factor incompatible with agency cost explanations of corporate organization. Rather, because models using agency theory are by definition constrained optimization problems—the residual loss is positive and hence the first best equilibrium that eliminates the agency problem cannot be achieved—the political constraints that Roe emphasizes can best be characterized as one reason why the residual loss does not shrink to zero (i.e., firms minimize agency costs subject to constraints, including legal prohibitions on particular organizational forms). Roe would be correct in criticizing agency cost theory, while advancing his view of the predominance of political constraints in shaping corporate organization, were he simply to emphasize that scholars in

39. Roe, *Some Differences*, *supra* note 1, at 1935.

40. Roe, *Some Differences*, *supra* note 1, at 1934. Roe does not provide any attributable quotations or citations to the conceptualization of the position that he is criticizing.

41. E.g., Mike Wright et al., *Corporate Restructuring, Buy-Outs, and Managerial Equity: The European Dimension*, 3 J. APPLIED CORP. FIN., Winter 1991, at 47, 47-48 (Germany); KESTER, *supra* note 31, at 271 (Japan).

42. I use the term “tend” advisedly because, as Roe notes with the Warren Buffet example, it is not impossible for financial institutions to become significant blockholders in U.S. firms, and several studies have found that a majority of U.S. corporations do have significant block owners. See, Demsetz & Lehn, *supra* note 38.

the agency cost tradition have not added regulation as a side constraint. But that omission is not his objection. Roe's position is surely consonant with an agency cost theory of the firm; his critique, which implies that the two are incompatible, is misplaced.

CONCLUSION

Mark Roe has provided in his article important detail on the organization of German and Japanese corporations. This is a valuable contribution to our understanding of corporate law because it emphasizes the great variability in corporate arrangements. It also strengthens the case for relaxing U.S. rules that restrict the choice of organizational form.

While Roe is careful to qualify the conclusions to be drawn from his comparative research, this Comment has emphasized the need for readers to pay close attention to his qualifications, because the most natural implication of such comparative analysis is to assume that German and Japanese corporate governance arrangements should be emulated by U.S. firms and this is a dubious proposition. Not only can no tight connection be demonstrated between corporate governance institutions and international competitiveness, but also, U.S. firms are, in fact, more productive than their German or Japanese counterparts. In addition, there is no evidence that the U.S. political process interferes more in the optimal organization of its corporations than the German or Japanese processes do in theirs. The German code, for instance, is explicitly multi-purpose, interjecting nonshareholder interests into the corporation's objective function. Interfirm equity cross-holdings in Japanese corporate groups, like U.S. restrictions on financial institutions' stock ownership, were instigated, in part, to protect management from control changes, and to serve noncorporate governance functions (protecting business relations across firms). Other regulations promoted the monopoly power of Japanese banks by restricting firms' ability to access public capital markets. It is therefore difficult, as Roe notes, to make comparative assessments concerning the relative superiority of one form or another, or to assume that reforming one nation's laws by copying another's will produce similar arrangements.

Agency cost explanations of the corporate form are not, as Roe contends, incompatible with variety in corporate organization across nations or with his emphasis on the path dependency in organizational form that originates in domestic politics. Rather, agency theory is a theory of constrained optimization that predicts the development of a variety of institutional devices to mitigate the adverse consequences for investors of the separation of ownership and control. It can therefore incorporate political as well as economic constraints on firm organization.

Roe presents the political process as at odds with efficient economic organization. The most useful way to think about the relation between politics and economic organization, however, is to recognize that private parties are persistent in devising institutions that circumvent, or minimize the effect of, political constraints on economic activity. This is, in my opinion, the principal lesson to be learned from doing comparative corporate law.

