

## Toward a Single Model of Corporate Law?

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### 1. INTRODUCTION

The history of corporate law is an unfinished story of convergence in two parts. The more important part ended a hundred years ago, when the corporation displaced other entities as the principal legal form of large-scale enterprise in advanced jurisdictions. At the start of the nineteenth century, there were no general corporation statutes anywhere; by its end, the corporation was the dominant mode of organizing large firms throughout North America and Europe. Of course, jurisdictions differed, then as now, in the fine structure of their corporate laws as well as in their corporate governance practices, financing techniques, and reliance on capital markets. These differences persisted—and, in some cases, grew more pronounced—during much of the twentieth century. Over the past two decades, however, the centripetal tendencies at work in corporate governance have reversed, and the second part of the story has begun. Powerful new pressures are pushing corporate law into another phase of convergence. Chief among these pressures is a widespread acceptance of a shareholder-centred ideology of corporate law among international business, government, and legal elites. There is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value. This emergent consensus has already profoundly affected corporate governance practices throughout the world; its influence increasingly conditions the reform of corporate law as well.

### 2. CONVERGENCE PAST: THE RISE OF THE CORPORATE FORM

We must begin with the recognition that the law of business corporations had already achieved a remarkable degree of worldwide convergence at the end of the nineteenth century. By that time, new large-scale enterprises in every major commercial jurisdiction had come to select the corporate form, and the core functional features of that form were essentially identical across these jurisdictions. Those features, which continue to define the form today, are (1) full legal personality, including well-defined authority to bind the firm to contracts and to bond those contracts with assets that are the property of the firm, as distinct from the firm's owners (Hansmann and Kraakman 2001*a*); (2) limited liability for owners and managers; (3) shared ownership by investors of capital; (4) delegated management under a board structure; and (5) transferable shares.

These core characteristics, both individually and in combination, offer important efficiencies in organizing the large firms that have come to dominate developed market economies. We explore those efficiencies in detail elsewhere (Hansmann 1996; Hansmann and Kraakman 2001*b*). What is important to note here is that, while those characteristics and their associated efficiencies are now commonly taken for granted, prior to the beginning of the nineteenth century there existed only a handful of specially chartered companies that combined all five of these characteristics. New York introduced the world's first general corporation statute in 1811. The joint stock company with tradeable shares was not made generally available for business activities in England until 1844, and limited liability was not added to the form until 1855 (Blumberg 1988: 9–20). By around 1900, however, every major commercial jurisdiction appears to have provided for at least one standard-form legal entity with the five characteristics listed above as the default rules, and this has remained the case ever since. Thus, there was already strong convergence a century ago on the basic elements of the law of business corporations. It is, in general, only in the more detailed structure of corporate law that jurisdictions have varied significantly since then.

The five basic characteristics of the corporate form provide, by their nature, for a firm that is strongly responsive to shareholder interests. They do not, however, necessarily dictate how the interests of other participants in the firm—such as employees, creditors, other suppliers, customers, or society at large—will be accommodated. Nor do they dictate the way in which conflicts of interest among shareholders themselves—and particularly between controlling and non-controlling shareholders—will be resolved. The issues have been foci of experimentation and debate throughout most of the last century. At the start of the twenty-first century it is coming to a close.

### 3. THE SHAREHOLDER-ORIENTED (OR 'STANDARD') MODEL

Recent years have brought strong evidence of an emerging consensus on the fundamental issues of corporate governance among the academic, business, and governmental elites in leading jurisdictions. The principal elements of this consensus are that ultimate control over the corporation should reside with the shareholder class; that corporate managers should be charged with managing the corporation in the interests of its shareholders; that other corporate constituencies, such as creditors, employees, suppliers, and customers, should have their interests protected by contractual and regulatory means rather than through participation in corporate governance; that non-controlling shareholders should receive strong protection from exploitation by controlling shareholders; and that the principal measure of the interests of the publicly traded corporation's shareholders is the market value of their shares in the firm. For simplicity, we shall refer to the view of the corporation comprised by these elements as the 'standard shareholder-oriented model' of the corporate form (or, for brevity, simply 'the standard model'). To the extent that corporate law bears on the implementation of this standard model—as to an important degree it does—this consensus on the appropriate conduct of corporate affairs is also a consensus as to the appropriate content of corporate law, and it is likely to have profound effects on the development of that law.

### 3.1. *In Whose Interest?*

As we argue in Section 4, the emerging consensus today on the shareholder-oriented model of corporate governance results in large measure from disenchantment with regimes that have assigned a privileged role to managers, employees, or the state in corporate affairs. This is not to say that there is agreement that corporations should be run in the interests of shareholders alone, much less that the law should sanction that result. All thoughtful people believe that corporate enterprise should be organized and operated to serve the interests of society as a whole, and that the interests of shareholders deserve no greater weight in this social calculus than do the interests of any other members of society. The point is simply that now, as a consequence of both logic and experience, there is convergence on a view that the best means to this end (that is, the pursuit of aggregate social welfare) is to make corporate managers strongly accountable to shareholder interests and, at least in direct terms, only to those interests. It follows that even the extreme proponents of the so-called 'concession theory' of the corporation can embrace the primacy of shareholder interests in good conscience.<sup>2</sup> Even if the legal power to form a corporation is regarded as a privilege conferred by the state for the benefit of all participants in the enterprise, these participants will enjoy the greatest benefits if the firm is governed in the interests of shareholders.

Of course, asserting the primacy of shareholder interests in corporate law does not imply that the interests of corporate stakeholders must or should go unprotected. It merely indicates that the most efficacious legal mechanisms for protecting the interests of non-shareholder constituencies—or at least all constituencies other than creditors—lie outside of corporate law. For workers, this includes the law of labour contracting, pension law, health and safety law, and anti-discrimination law. For consumers, it includes product safety regulation, warranty law, tort law governing product liability, antitrust law, and mandatory disclosure of product contents and characteristics. For the public at large, it includes environmental law and the law of nuisance and mass torts.

Creditors, to be sure, are to some degree an exception. There remains general agreement that corporate law should directly regulate some aspects of the relationship between a business corporation and its creditors. Conspicuous examples include rules governing veil piercing and limits on corporate distributions in the presence of inadequate capital. The reason for these rules, however, is that there are unique problems of creditor contracting that are integral to the corporate form, owing principally to the presence of limited liability as a structural characteristic of that form. These types of rules, however, are modest in scope. Outside of bankruptcy, they do not involve creditors in corporate governance, but rather are confined to limiting shareholders' ability to use the characteristics of the corporate form opportunistically to exploit creditors.

#### 3.1.1. *Which Shareholders?*

The shareholder-oriented model does more than assert the primacy of shareholder interests, however. It asserts the interests of all shareholders, including minority shareholders. More particularly, it is a central tenet in the standard model that minority or non-controlling shareholders should receive strong protection from exploitation at the hands of controlling shareholders. In publicly-traded firms, this means that all shareholders should be assured an essentially equal claim on corporate earnings and assets.

There are two conspicuous reasons for this approach, both of which are rooted in efficiency concerns. One reason is that, absent credible protection for non-controlling shareholders, business corporations will have difficulty raising capital from the equity markets. The second reason is that the devices by which controlling shareholders divert to themselves a disproportionate share of corporate benefits commonly involve inefficient investment choices and management policies.

#### 3.1.2. *The Import of Ownership Structure*

It is sometimes said that the shareholder-oriented model of corporate law is well suited only to those jurisdictions in which one finds large numbers of firms with widely dispersed share ownership, such as the United States of America and the United Kingdom. A different model is appropriate, it is said, for those jurisdictions in which ownership is more concentrated, such as the nations of continental Europe. This view, however, is unconvincing.

Closely-held corporations, like publicly-held corporations, operate most efficiently when the law helps assure that managers are primarily responsive to shareholder interests and that controlling shareholders do not opportunistically exploit non-controlling shareholders. Shareholder primacy does not logically privilege any particular ownership structure. Indeed, both concentrated and dispersed shareholdings have been celebrated, at different times and by different commentators, for their ability to advance shareholder interests in the face of serious agency problems. Thus, the shareholder model is distinct from the conventional opposition of a 'dispersed ownership' system of corporate governance to a 'concentrated ownership' system of governance (Coffee, Chapter 4, this volume). The only point of tangency between the two is the possibility that dispersed share ownership may, as a prerequisite, require shareholder-oriented corporate law—and, in particular, strong legal protection for minority shareholders.<sup>3</sup> But this connection, were it demonstrated, would merely highlight the value of shareholder-oriented law for widely-held firms; it would in no way imply that this law was without value for firms with concentrated ownership.

Still more to the point, differences in ownership structures of corporations among the major commercial jurisdictions are often exaggerated. Every jurisdiction includes a range of ownership structures. While both USA and UK have many large firms with dispersed ownership, both countries also contain a far larger number of corporations that are closely held.<sup>4</sup> Similarly, every major Continental European jurisdiction has at least a handful of firms with dispersed ownership (La Porta *et al.* 1999: 494–5), and the number of such firms is evidently growing. It follows that every jurisdiction should have a corporate law adequate to handle the full range of ownership structures.

Thus, just as the core features of the corporate form rapidly crystallized in the late nineteenth century, we are witnessing rapid convergence on the standard shareholder-oriented model of corporate governance at the beginning of the twenty-first century. This normative consensus will predictably result in substantial convergence in the law and practice of corporate governance as well.

## 4. FORCES OF IDEOLOGICAL CONVERGENCE

There are several principal factors driving consensus on the standard model: the failure of alternative models; the competitive pressures of global commerce; and the shift of interest

group influence in favour of an emerging shareholder class. We consider these developments here in sequence.

#### 4.1. *The Failure of Alternative Models*

The most basic debate and experimentation about corporate law during the twentieth century have centred on the ways in which that law should accommodate the interests of non-shareholder constituencies. In this regard, there are three principal alternatives to a shareholder-oriented model, which we term the manager-oriented, labour-oriented, and state-oriented models of corporate law respectively. Although each of these alternatives has, at various points and in various jurisdictions, achieved some success both in practice and in received opinion, all three have ultimately lost much of their normative appeal.

##### 4.1.1. *The Manager-Oriented Model*

In the United States of America, there existed an important strain of normative thought from the 1930s through the 1960s that extolled the virtues of granting substantial discretion to the managers of large business corporations. Merrick Dodd and John Kenneth Galbraith, for example, were conspicuously identified with this position, and Adolph Berle came to it late in life.<sup>5</sup> At the core of this view was the belief that professional corporate managers could serve as disinterested technocratic fiduciaries who would guide business corporations to perform in ways that would serve the general public interest. The corporate social responsibility literature of the 1950s can be seen as an embodiment of these views.<sup>6</sup>

The normative appeal of this view arguably provided part of the rationale for the various legal developments in USA law in the 1950s and 1960s that tended to reinforce the discretionary authority of corporate managers, such as the Williams Act and amendments to the Securities Exchange Commission's (SEC) proxy rules. The collapse of the conglomerate movement in the 1970s and 1980s, however, largely destroyed the normative appeal of the managerial model. It is now the conventional wisdom that, when managers are given great discretion over corporate investment policies, they tend to serve disproportionately their own interests, however well-intentioned they may be. While managerial firms may be in some ways more efficiently responsive to non-shareholder interests than are firms that are more dedicated to serving their shareholders, the price paid in inefficiency of operations and excessive investment in low-value projects is now considered too great.

##### 4.1.2. *The Labour-Oriented Model*

Large-scale enterprise clearly presents problems of labour contracting. Simple contracts and the basic doctrines of contract law are inadequate in themselves to govern the long-term relationships between workers and the firms that employ them—relationships that may be afflicted by, among other things, substantial transaction-specific investments and asymmetries of information.

Collective bargaining via organized unions has been one approach to those problems, an approach that lies outside corporate law, since it is not dependent on the organizational structure of the firms with which the employees bargain. Another approach, and one that

importantly involves corporate law, has been to involve employees directly in corporate governance by, for example, providing for employee representation on the firm's board of directors. Although serious attention was given to employee participation in corporate governance in Germany as early as the Weimar Republic, unionism was the dominant approach everywhere until the Second World War. Then, after the War, serious experimentation with employee participation in corporate governance began in Europe. The results of this experimentation are most conspicuous in Germany where, under legislation initially adopted for the coal and steel industries in 1951 and extended by stages to the rest of German industry between 1952 and 1976, employees are entitled to elect half of the members of the (upper-tier) board of directors in all large German firms (Pistor 1999). This German form of 'codetermination' has been the most far-reaching experiment with employee participation. It is not unique, however. A number of other European countries have experimented in more modest ways, typically requiring between one and three labour representatives on the boards of large corporations. Moreover, the Dutch have adopted a wholly unique model for larger domestic companies that combines elements of the manager-, labour-, and state-oriented models. Under this Dutch 'structure' regime, supervisory boards are self-appointing, although both labour and shareholders retain their right to object to the board appointments. In the event of an objection, the commercial court decides.

Enthusiasm for employee participation crested in the 1970s with the radical expansion of codetermination in Germany and the drafting of the European Community's proposed Fifth Directive on Company Law,<sup>7</sup> under which German-style codetermination would be extended throughout Europe. Employee participation also attracted considerable attention in the USA during that period, as adversarial unionism began to lose its appeal as a means of dealing with problems of labour contracting and, in fact, began to disappear from the industrial scene. Since then, however, worker participation in corporate governance has steadily lost power as a normative ideal. Despite repeated watering-down, Europe's Fifth Directive has never become law, and it now seems highly unlikely that German-style codetermination will ever be adopted elsewhere.

The growing view today is that meaningful direct worker voting participation in corporate affairs tends to produce inefficient decisions, paralysis, or weak boards, and that these costs are likely to exceed any potential benefits that worker participation might bring. The problem, at root, seems to be one of governance. While direct employee participation in corporate decision-making may mitigate some of the inefficiencies that can beset labour contracting, the workforce in typical firms is too heterogeneous in its interests to form an effective governing body—and the problems are magnified greatly when employees must share governance with investors, as in codetermined firms.<sup>8</sup> In general, contractual devices, whatever their weaknesses, are (when supplemented by appropriate labour market regulation) evidently superior to voting and other collective choice mechanisms in resolving conflicts of interest among and between a corporation's investors and employees.<sup>9</sup>

Today, even inside Germany, few commentators argue for codetermination as a general model for corporate law in other jurisdictions. Rather, codetermination now tends to be defended in Germany as, at most, a workable adaptation to local interests and circumstances or, even more modestly, an experiment that, though of questionable value, would now be politically difficult to undo.<sup>10</sup>

#### 4.1.3. *The State-Oriented Model*

Both before and after the Second World War, there was widespread support for a corporatist system in which the government would play a strong direct role in the affairs of large business firms to provide some assurance that private enterprise would serve the public interest. Technocratic governmental bureaucrats, the theory went, would help to avoid the deficiencies of the market through the direct exercise of influence in corporate affairs. This approach was most extensively realized in post-war France and Japan. In the USA, though there was little actual experimentation with this approach outside of the defence industries, the model attracted considerable intellectual attention. Perhaps the most influential exposition of the state-oriented model in the Anglo-American world was Andrew Shonfield's book, *Modern Capitalism* (1968: 84–5), with its admiring description of French and Japanese style 'indicative planning'. The strong performance of the Japanese economy, and subsequently of other state-guided Asian economies, lent substantial credibility to this model even through the 1980s.

The principal instruments of state control over corporate affairs in corporatist economies generally lie outside of corporate law. They include, for example, substantial discretion in the hands of government bureaucrats over the allocation of credit, foreign exchange, licences, and exemptions from anti-competition rules. Nevertheless, corporate law also plays a role by, for example, weakening shareholder control over corporate managers (to reduce pressures on managers that might operate counter to the preferences of the state) and employing state-administered criminal sanctions rather than shareholder-controlled civil lawsuits as the principal sanction for managerial malfeasance (to give the state strong authority over managers that could be exercised at the government's discretion).

The state-oriented model, however, has now also lost most of its attraction. One reason is the move away from state socialism in general as a popular intellectual and political model. Important landmarks on this path include the rise of Thatcherism in England in the 1970s, Mitterand's abandonment of state ownership in France in the 1980s, and the sudden collapse of communism nearly everywhere in the 1990s. The relatively poor performance of the Japanese corporate sector after 1989, together with the more recent collapse of other Asian economies that were organized on state corporatist lines, has now discredited this model even further. Today, few would assert that giving the state a strong direct hand in corporate affairs has much normative appeal.

#### 4.1.4. *Stakeholder Models*

Over the past decade, the literature on corporate governance and corporate law has sometimes advocated 'stakeholder' models as a normatively attractive alternative to a shareholder-oriented view of the corporation. The stakeholders involved may be employees, creditors, customers, merchants in a firm's local community, or even broader interest groups such as beneficiaries of a well-preserved environment. These stakeholders, it is argued, will be vulnerable to exploitation by the firm and its shareholders if corporate managers are accountable only to the firm's shareholders; corporate law must therefore assure that managers are responsive to the interests of stakeholders as well as to the interests of shareholders. But if stakeholder theories address a single problem of protecting non-shareholder interests in the corporation, they posit at least two distinct solutions to this problem—what

we will label, respectively, the 'trustee' model (Hansmann and Kraakman 2001) and the 'representative' model of stakeholder-oriented corporate governance.

##### (i) *The trustee model*

The trustee model charges a corporation's board of directors and senior managers to act on behalf of the entire enterprise by co-ordinating the contributions and returns of all of its stakeholders. In this model directors do not represent the shareholders that elect them but, rather, the enterprise as a whole as against the parochial interests of all stakeholders. As described by Margaret Blair and Lynn Stout (1999), two of its most sophisticated proponents, the theory that underlies the trustee model (as well as other stakeholder models) envisions the public corporation as a 'team' of stakeholders—shareholders, managers, employees, and perhaps creditors—each of whom must make firm-specific investments for the enterprise to function efficiently (see also Shleifer and Summers 1988; Gordon and Schmid 2000). Since such firm-specific investments expose all team members to the risk of opportunism from other members, all team members prefer a neutral party—an outsider without an interest in the firm—to co-ordinate contributions and allocate rewards among team members (Blair and Stout 1999: 253–4, 273–87). In the case of the public corporation, this outsider is said to be the board of directors, which in the USA typically includes a majority of independent directors who have little or no financial investment in the company.

For Blair and Stout, the trustee model is not only a normative ideal but also a positive depiction of what already exists under the principles of American corporate law.<sup>11</sup> Far from encouraging the single-minded focus on shareholder value that some Europeans fear, USA law, according to Blair and Stout, presses boards to mediate among the interests of all stakeholders. In particular, they point to features of USA law that protect board discretion at the expense of shareholder influence: the severe restrictions on the legal power of shareholders to take management decisions, the discretion apportioned to directors by the business judgement rule, the difficulties faced by shareholders who attempt to exercise their voting rights in a proxy contest, and the so-called 'constituency statutes' that expressly invite boards to consider the interests of non-shareholder constituencies when evaluating takeover proposals (ibid.: 287–319). Outside the USA, moreover, the trustee model remains a topic of active debate.<sup>12</sup>

##### (ii) *The representative model*

Nevertheless, as long as shareholders select directors under the trustee model, the board's power to arbitrate among conflicting stakeholder interests is limited.<sup>13</sup> By contrast, the representative model of stakeholder governance assigns rights to appoint directors directly to stakeholders rather than reserving them for shareholders alone. In this model, then, qualified non-shareholder constituencies appoint their own directors, who together elaborate policies that maximize the joint welfare of all stakeholders, subject to the bargaining leverage that each group brings to the boardroom table. The board, in this model, is the focal point for an unmediated 'coalition of stakeholder groups', which functions as 'an arena for co-operation with respect to the function of monitoring the management', as well as an arena for resolving 'conflicts with respect to the specific interests of different stakeholder groups' (Schmidt and Spindler 1999: 14).

*(iii) Stakeholder models assessed*

In our view, neither the trustee nor the representative model of stakeholder governance is likely to exert much influence on the development of corporate law today, even though both have strong partisans among legal academics. A principal reason is that they have been tried before. At bottom they are simply variants on the manager- and labour-oriented models of corporate governance of earlier decades, despite their novel rhetoric and economic justification.

The trustee model reformulates the manager-oriented model of the 1950s. Where that model depicted managers—and, in particular, chief executive officers—as professionals skilled at balancing the contributions and rewards of other stakeholders, the trustee model turns instead to corporate directors. Thus Blair and Stout see the autonomous power of USA boards as the legal foundation for a neutral trustee, a ‘mediating hierarch’, to superintend the set of long-term contracts among the factors of production (Blair and Stout 1999: 315–19). This move entails a certain loss of realism since CEOs are usually said to exercise far more power than boards in widely-held firms. Thus, the unusual legal autonomy of USA boards is better understood as an expression of the political power of managers rather than as a check on it. But even if boards do act as trustees distinct from managers, the trustee model does not improve on the old-fashioned manager-oriented model. While untethered directors can better serve the interests of some classes of stakeholders, such as a firm’s existing employees and creditors, the director’s own interests will often come to have disproportionate salience in their decision-making, with costs to other interest groups—such as shareholders, customers, and potential new employees and creditors—that outweigh any gains to the stakeholders who are benefited. Moreover, the courts are evidently incapable of formulating and enforcing fiduciary duties of sufficient refinement to assure that managers behave more efficiently and fairly.

Just as the trustee model recycles managerialism, representative stakeholder models repackage yesterday’s labour-oriented model, which they sometimes extend to include non-labour constituencies. But the weaknesses of the labour-oriented regime remain, and in fact they grow more severe as the list of boardroom constituencies grow. The mandatory inclusion of any set of stakeholder representatives on the board is likely to impair corporate decision-making processes with costly consequences that outweigh any gains to the groups that obtain representation. Thus, the same forces that have been discrediting the older models are also undermining the stakeholder model as a viable alternative to the shareholder-oriented model.

*4.2. Competitive Pressure Toward Convergence*

The shareholder-oriented model has emerged as the normative consensus not just because of the failure of the alternatives, but because important economic forces have made the virtues of that model increasingly salient. There are, broadly speaking, three ways in which a model of corporate governance can come to be recognized as superior: by force of logic, by force of example, and by force of competition. The emerging consensus in favour of the standard model has, in recent years, been driven with increasing intensity by each of these forces. We examine them here in turn.

*4.2.1. The Force of Logic*

An important source of the success of the standard model is that, in recent years, scholars and other commentators in law, economics, and business have developed persuasive reasons, which we have already explored above, to believe that this model offers greater efficiencies than the principal alternatives. One of these reasons is that, in most circumstances, the interests of equity investors in the firm—the firm’s residual claimants—cannot be adequately protected by contract. Rather, to protect their interests, they must be given the right to control the firm. A second reason is that, if the control rights granted to the firm’s equity-holders are exclusive and strong, they will have powerful incentives to maximize the value of the firm. A third reason is that the interests of participants in the firm other than shareholders can generally be given substantial protection by contract and regulation, so that maximization of the firm’s value by its shareholders complements the interests of those other participants rather than competing with them. A fourth reason is that, even where contractual and regulatory devices offer only imperfect protection for non-shareholder interests, adapting the firm’s governance structure to make it directly responsible to those interests creates more difficulties than it solves.

This reasoning is today reflected in much of the current literature on corporate finance and the economics of the firm—a literature that is becoming increasingly international. The consequence is to highlight the economic case for the shareholder-oriented model of governance. In addition, the persuasive power of the standard model has been amplified through its acceptance by a worldwide network of corporate intermediaries, including international law firms, the big five accounting firms, and the principal investment banks and consulting firms—a network whose rapidly expanding scale and scope give it exceptional influence in diffusing the standard model of shareholder-centred corporate governance.

*4.2.2. The Force of Example*

The second source of the success of the standard model of corporate governance is the economic performance of jurisdictions in which it predominates. A simple comparison across countries adhering to different models—at least in very recent years—lends credence to the view that adherence to the standard model promotes better economic outcomes. The developed common law jurisdictions have performed well in comparison to the principal East Asian and continental European countries, which are less in alignment with the standard model. The main examples include, of course, the strong performance of the American economy in comparison with the weaker economic performance of the German, Japanese, and French economies.

One might surely object that the success of the shareholder-oriented model is quite recent and will perhaps prove to be ephemeral, and that the apparent normative consensus based on that success will be ephemeral as well. After all, only fifteen years ago, many thought that Japanese and German firms, which were clearly not organized on the shareholder-oriented model, were winning the competition, and that this was because they had adopted a superior form of corporate governance.<sup>14</sup> However, this is probably a mistaken interpretation of the nature of the economic competition in recent decades, and it is surely at odds with today’s prevailing opinion. The competition of the 1960s, 1970s, and early 1980s was in

fact among Japanese state-oriented corporations, German labour-oriented corporations, and American manager-oriented corporations. It was not until the late 1980s that one could speak of widespread international competition from shareholder-oriented firms.

#### 4.2.3. *The Force of Competition*

The increasing internationalization of both product and financial markets has brought individual firms from jurisdictions adhering to different models into direct competition. It is now widely thought that firms organized and operated according to the shareholder-oriented model have had the upper hand in these more direct encounters as well.<sup>15</sup> Such firms can be expected to have important competitive advantages over firms adhering more closely to other models. These advantages include access to equity capital at lower cost (including, conspicuously, start-up capital), more aggressive development of new product markets (Frydman *et al.* 1998), stronger incentives to reorganize along lines that are managerially coherent, and more rapid abandonment of inefficient investments.

These competitive advantages do not always imply that firms governed by the standard model will displace those governed by an alternative model in the course of firm-to-firm competition, for two reasons. First, firms operating under the standard model may be no more efficient than other firms in many respects. For example, state-oriented Japanese and Korean companies have demonstrated great efficiency in the management and expansion of standardized production processes, while German and Dutch firms such as Daimler Benz and Philips (operating under labour- and management-oriented models, respectively) have been widely recognized for engineering prowess and technical innovation. Second, even when firms governed by the standard model are clearly more efficient than their non-standard competitors, the cost-conscious standard-model firms may be forced to abandon particular markets for precisely that reason. Less efficient firms organized under alternative models may over-invest in capacity or accept abnormally low returns on their investments in general, and thereby come to dominate a product market by underpricing their profit-maximizing competitors.

But if the competitive advantages of standard-model firms do not necessarily force the displacement of non-standard firms in established markets, these standard-model firms are likely, for the reasons offered above, to achieve a disproportionate share among start-up firms, in new product markets, and in industries that are in the process of rapid change.<sup>16</sup>

The ability of standard-model firms to expand rapidly in growth industries is magnified, moreover, by access to institutional investors and the international equity markets, which understandably prefer shareholder-oriented governance and are influential advocates of the standard model. Those equity investors, after all, are exclusively interested in maximizing the financial returns on their investments. Over time, then, the standard model is likely to win the competitive struggle on the margins, confining other governance models to older firms and mature product markets. As the pace of technological change continues to quicken, this competitive advantage should continue to increase.

#### 4.2.4. *The Rise of the Shareholder Class*

In tandem with the competitive forces just described, a final source of ideological convergence on the standard model is a fundamental realignment of interest group structures in

developed economies. At the centre of this realignment is the emergence of a public shareholder class as a broad and powerful interest group in both corporate and political affairs across jurisdictions. There are two elements to this realignment. The first is the rapid expansion of the ownership of equity securities within broad segments of society, creating a coherent interest group that presents an increasingly strong countervailing force to the organized interests of managers, employees, and the state. The second is the shift in power, within this expanding shareholder class, in favour of the interests of minority and noncontrolling shareholders over those of inside or controlling shareholders.

##### (i) *The diffusion of equity ownership*

Stock ownership is becoming more pervasive everywhere.<sup>17</sup> No longer is it confined to a small group of wealthy citizens. In the USA, this diffusion of share ownership has been underway since the beginning of the twentieth century. In recent years, however, it has accelerated substantially. Since the Second World War, an ever-increasing number of American workers have had their savings invested in corporate equities through pension funds. Over the same period, the mutual fund industry has also expanded rapidly, becoming the repository of an ever-increasing share of non-pension savings for the population at large (The Conference Board 1997). We have begun to see parallel developments in Europe and Japan, and to some extent elsewhere, as markets for equity securities have become more developed.<sup>18</sup>

The growing wealth of developed societies is a major factor underlying these changes. Even blue collar workers now often have sufficient personal savings to justify investment in equity securities. No longer do labour and capital constitute clearly distinct interest groups in society. Workers, through share ownership, increasingly share the economic interests of other equity-holders. Indeed, in the USA, union pension funds are today quite active in pressing the view that companies must be managed in the best interests of their shareholders (Schwab and Thomas 1998: 341).

##### (ii) *The shift in balance toward public shareholders*

As the example of the activist union pension funds suggests, diffusion of share ownership is only one aspect of the rise of the shareholder class. Another aspect is the new prominence of substantial institutions that have interests coincident with those of public shareholders and that are prepared to articulate and defend those interests. Institutional investors, such as pension funds and mutual funds—which are particularly prominent in the USA and are now rapidly growing elsewhere as well—are the most conspicuous examples of these institutions. Associations of minority investors in European countries provide another example. These institutions not only give effective voice to shareholder interests, but also promote, in particular, the interests of dispersed public shareholders rather than those of controlling shareholders or corporate insiders. The result is that ownership of equity among the public at large, while broader than ever, is at the same time gaining more effective voice in corporate affairs.

Moreover, the new activist shareholder-oriented institutions are today acting increasingly on an international scale. As a consequence, their influence now reaches well beyond their home jurisdictions (Steinmetz and Sesit 1999: A1, A8). We now have not only a common ideology supporting shareholder-oriented corporate law, but also an organized interest

group to press that ideology—an interest group that is broad, diverse, and increasingly international in its membership.

In the USA, the principal effect of the expansion and empowerment of the shareholder class has been to shift interest group power to shareholders from managers. In Europe and Japan, the more important effect has been to shift power away from workers and the state and, increasingly, away from dominant shareholders.<sup>19</sup>

## 5. WEAK FORCES FOR CONVERGENCE

We have spoken here of a number of forces pressing toward international convergence on a relatively uniform standard model of corporate law. Those forces include the internal logic of efficiency, competition, interest group pressure, imitation, and the need for compatibility. We have largely ignored two other potential forces that might also press toward convergence: explicit efforts at cross-border harmonization and competition between jurisdictions for corporate charters.

### 5.1. *Harmonization*

The European Union has been the locus of the most intense efforts to date at self-conscious harmonization of corporate law across jurisdictions. That process, however, has proven a relatively weak force for convergence: where there exists substantial divergence in corporate law across member states, efforts at harmonization have generally borne little fruit. Moreover, harmonization proposals have often been characterized by an effort to impose throughout the EU regulatory measures of questionable efficiency, with the result that harmonization sometimes seems more an effort to avoid the standard model than to further it.

For these reasons, the other pressures toward convergence described above are likely to be much more important forces for convergence than are explicit efforts at harmonization. At most, we expect that, once the consensus for adoption of the standard model has become sufficiently strong, harmonization may serve as a convenient pretext for overriding the objections of entrenched national interest groups that resist reform of corporate law within individual states.

### 5.2. *Competition for Charters*

The USA experience suggests that cross-border competition for corporate charters can be a powerful force for convergence in corporate law and, in particular, for convergence on an efficient model (Romano 1993). It seems quite plausible, however, that the choice of law rules necessary for this form of competition will not be adopted in most jurisdictions until substantial convergence has already taken place. We expect that the most important steps toward convergence can and will be taken with relative rapidity before explicit cross-border competition for charters is permitted in most of the world, and that the latter process will ultimately be used, at most, as a means of working out the fine details of convergence and of ongoing minor experimentation and adjustment thereafter.

## 6. CONVERGENCE OF GOVERNANCE PRACTICES

Thus far we have attempted to explain the sources of ideological convergence on the standard model of corporate governance. Our principal argument is on this normative level: we make the claim that no important competitors to the standard model of corporate governance remain persuasive today. This claim is consistent with significant differences among jurisdictions in corporate practice and law over the short run; ideological convergence does not necessarily mean rapid convergence in practice. There are many potential obstacles to rapid institutional convergence, even when there is general consensus on what constitutes best practice. Nevertheless, we believe that the developing ideological consensus on the standard model will have important implications for the convergence of practice and law over the long run.

We expect that the reform of corporate governance practices will generally precede the reform of corporate law, for the simple reason that governance practice is largely a matter of private ordering that does not require legislative action. Recent events in most developed jurisdictions—and in many developing ones—bear out this prediction. Under the influence of the ideological and interest group changes discussed above, corporate governance reform has already become the watchword not only in North America but also in Europe and Japan. Corporate actors are themselves implementing structural changes to bring their firms closer to the standard model. In the USA, these changes include appointment of larger numbers of independent directors to boards of directors, reduction in overall board size, development of powerful board committees dominated by outsiders (such as audit committees, compensation committees, and nominating committees), closer links between management compensation and the value of the firm's equity securities, and strong communication between board members and institutional shareholders. In Europe and Japan, many of the same changes are taking place, though with a lag. Examples range from the OECD's promulgation of new principles of corporate governance, to recent decisions by Japanese companies to reduce board sizes and include non-executive directors (following the lead of Sony), to the rapid diffusion of stock option compensation plans for top managers in the UK and in the principal commercial jurisdictions of Continental Europe.

## 7. LEGAL CONVERGENCE

Not surprisingly, convergence proceeds more slowly in corporate law than in governance practice. Legal change requires legislative action. Nevertheless, we expect shareholder pressure (and the power of shareholder-oriented ideology) to force gradual legal changes, largely but not entirely in the direction of Anglo-American corporate and securities law. There are already important indications of evolutionary convergence in the realms of board structure, securities regulation, and accounting methodologies, and even in the regulation of takeovers.

### 7.1. *Board Structure*

With respect to board structure, convergence has been in the direction of a legal regime that strongly favours a single-tier board that is relatively small and that contains some insiders

as well as a majority of outside directors. Mandatory two-tier board structures seem a thing of the past; the weaker and less responsive boards that they promote are justified principally as a complement to worker codetermination and thus share—indeed, constitute one of—the weaknesses of the latter institution. The declining fortunes of the two-tier board are reflected in the evolution of the European Union's Proposed Regulation on the Statute for a European Company. When originally drafted in 1970, that Regulation called for a mandatory two-tier board. In 1991, however, the Proposed Regulation was amended to permit member states to prescribe either a two-tier or a single-tier system. Meanwhile, on the practical side, France, which made provision for an optional two-tier board when the concept was more in vogue, has seen few of its corporations adopt the device (Aste 1999: 45).

At the same time, jurisdictions that traditionally favoured the opposite extreme of insider-dominated, single-tier boards have come to accept a significant complement of outside directors. In the USA, the New York Stock Exchange listing rules have long mandated that independent directors serve on the important audit committees of listed firms (NYSE 1998) and, more recently, state law doctrine has created a strong role for outside directors in approving transactions where interests might be conflicted.<sup>20</sup> In Japan, a similar evolution may be foreshadowed by the recent movement among Japanese companies, mentioned above, toward smaller boards and independent directors, and by the recent publication of a code of corporate governance principles advocating these reforms by a committee of leading Japanese managers.<sup>21</sup> The result is convergence from both ends toward the middle: while two-tier boards themselves seem to be on the way out, countries with single-tier board structures are incorporating, in their regimes, one of the strengths of the typical two-tier board regime, namely the substantial role it gives to independent (outside) directors.

### 7.2. *Disclosure and Capital Market Regulation*

Regulation of routine disclosure to shareholders, intended to aid in policing corporate managers, is also converging conspicuously. Without seeking to examine this complex field in detail here, we note that major jurisdictions outside of the USA are reinforcing their disclosure systems, while the USA has been retreating from some of the more inexplicably burdensome of its federal regulations, such as the highly restrictive proxy solicitation rules that until recently crippled communication among American institutional investors. Indeed, the subject matter of mandatory disclosure for public companies is startlingly similar across the major commercial jurisdictions today.<sup>22</sup> Moreover, disclosure practices on the European continent apparently track those of the USA and the UK even more closely than the law requires. American practices in particular set accepted international standards for disclosure, even when securities are issued outside the USA to non-USA investors (Jackson and Pan 2000).

Similarly, uniform accounting standards are rapidly crystallizing out of the Babel of national rules and practices into two well-defined sets of international standards: the Generally Accepted Accounting Principles (GAAP) accounting rules administered by the Financial Auditing Standards Board in the USA and the International Accounting Standards administered by the International Accounting Standards Committee in London. While important differences remain between the competing sets of international standards, these differences

are far smaller than the variations among the national accounting methodologies that preceded GAAP and the new International Standards. The two international standards, moreover, are likely to converge further, if only because of the economic savings that would result from a single set of global accounting standards (MacDonald 1999).

### 7.3. *Shareholder Suits*

Suits initiated by shareholders against directors and managers are now being accommodated in countries that had previously rendered them ineffective. Germany recently reduced the ownership threshold that qualifies shareholders to demand legal action (to be brought by the supervisory board or special company representative) against managing directors, dropping that threshold from a 10 per cent equity stake to the lesser of a 5 per cent stake or a one million DM stake when there is suspicion of dishonesty or illegality (Baums 1999). Japan, in turn, has altered its rules on posting a bond to remove disincentives for litigation. At the same time, USA law is moving toward the centre from the other direction by beginning to rein in the country's strong incentives for potentially opportunistic litigation. At the federal level, there are recently-strengthened pleading requirements upon initiation of shareholder actions, new safe harbours for forward-looking company projections, and recent provision for lead shareholders to take control in class actions.<sup>23</sup> State law rules, meanwhile, are making it easier for a corporation to get a shareholder's suit dismissed.

### 7.4. *Takeovers*

Regulation of takeovers also seems headed for convergence. As it is, current differences in takeover regulation are more apparent than real. Hostile takeovers are rare outside the Anglo-American jurisdictions, principally owing to the more concentrated patterns of shareholdings outside those jurisdictions. As shareholding patterns become more homogeneous (as we expect they will), and as corporate culture everywhere becomes more accommodating of takeovers (as it seems destined to), takeovers will presumably become much more common in Europe, Japan, and elsewhere.<sup>24</sup>

Moreover, where operative legal constraints on takeovers in fact differ, they show signs of convergence. In particular, for several decades USA has been increasing its regulation of takeovers, placing additional constraints both on the ability of acquirers to act opportunistically and on the ability of incumbent managers to entrench themselves or engage in self-dealing. With the widespread diffusion of the 'poison pill' defence, and the accompanying limits that courts have placed on the use of that defence, partial hostile tender offers of a coercive character are a thing of the past—a result similar to that which European jurisdictions have accomplished with a 'mandatory bid rule' requiring acquirers of control to purchase all shares in their target companies at a single price.

To be sure, jurisdictions diverge in other aspects of takeover law where the points of convergence are still uncertain. For example, American directors enjoy far more latitude to defend against hostile takeovers than do directors in most European jurisdictions. Under current Delaware law, incumbent boards have authority to resist hostile offers, although they remain vulnerable to bids that are tied to proxy fights at shareholders' meetings. As the



incidence of hostile takeovers increases in Europe, European jurisdictions may incline toward Delaware by permitting additional defensive tactics.<sup>25</sup> Alternatively, given the dangers of managerial entrenchment, Delaware may move toward European norms by limiting defensive tactics more severely. While we cannot predict where the equilibrium point will lie, it is a reasonable conjecture that the law on both sides of the Atlantic will ultimately converge on a single regime.

### 7.5. *Judicial Discretion*

There remains one very general aspect of corporate law on which one might feel that convergence will be slow to come: the degree of judicial discretion in resolving disputes among corporate actors *ex post*. Such discretion has long been much more conspicuous in the common law jurisdictions, and particularly in the USA, than in the civil law jurisdictions. Even here, though, there is good reason to believe that there will be strong convergence across systems over time. Civil law jurisdictions, whether in the form of court decision-making or arbitration, seem to be moving toward a more discretionary model.<sup>26</sup> The USA securities law is civilian in spirit and elaborated by detailed rules promulgated by the SEC. At the same time, there are signs of growing discomfort with the more extreme forms of unpredictable *ex post* decision-making that have sometimes been characteristic of, say, the Delaware courts. Scholars have begun to suspect the open-ended texture of Delaware case law (Macey and Miller 1987; Branson 1989; Kamar 1998), while the American Law Institute has offered a code-like systemization of the corporate law in the form of the Corporate Governance Project, which includes even the notoriously vague and open-ended USA case law that articulates the fiduciary duties of loyalty and care.

## 8. POTENTIAL OBSTACLES TO CONVERGENCE

To be sure, the movement toward the standard model threatens important interests, which can be expected to serve as a brake on change. We doubt, however, that these interests will be able to stave off for long the reforms called for by the growing ideological consensus focused on the standard model.

Lucian Bebchuk and Mark Roe (1999) make an opposing argument for strong path dependence in corporate law, which proceeds in three steps. First, they suggest that controlling shareholders divert to themselves a disproportionate share of corporate cash flows in jurisdictions with weak minority shareholder protections (most jurisdictions, perhaps). Second, because these controllers presently enjoy large private benefits of control, they have a strong incentive to oppose changes in ownership, governance, or the law. And third, Bebchuk and Roe argue that controlling shareholders can block what they do not like. Controlling shareholders can retain control by refusing to sell their shares; they can manipulate corporate governance through their power to select directors; and, in those societies in which closely-held firms dominate the economy, controlling shareholders have the political influence to block legal reforms that would otherwise reduce their private returns.

To us, however, this pessimistic view seems unwarranted—at least on the consensus assumption that the standard model of corporate law and practice increases firm value.

Consider first the case in which controlling shareholders are financially motivated and care only about maximizing profits. If these controllers can capture the gains of governance reform, they have an obvious interest in efficient governance structures and legal reforms that the standard model can provide. Moreover, it is plausible that they can capture the gains from reform in two ways: either (1) by selling out to buyers who can credibly signal their intention to operate under non-exploitative governance rules; or (2) by squeezing out minority shareholders and restructuring their firm themselves along these same efficient lines. To be sure, law reform might still deny controllers such gains. For example, it might bar controllers from cashing out minority shareholders or taking control premia, which would make it difficult to extract the gains from efficient restructuring. But if controllers have the political influence to block reform altogether, it is reasonable to suppose that they also have the influence to appropriate the returns from reform for themselves.

The more difficult case for convergence arises if controlling shareholders, although mired in inefficient corporate governance, nevertheless prefer reinvesting and presiding over their fading empires to maximizing their economic returns. In theory, such controllers might oppose legal or governance reforms indefinitely. We conjecture, however, that even these controllers cannot stand against the standard model of corporate governance over the long term. By hypothesis, their firms will be disadvantaged relative to the better governed foreign or domestic competition. Moreover, these firms are unlikely to attract new outside capital. Instead, foreign and domestic capital will flow to firms that adopt the shareholder protective measures of the standard model, even if these firms do so outside the domestic legal framework—for example, by subscribing to exchange listing rules that require disclosure and protect minority shareholders, by listing on Exchanges in other jurisdictions to bond their protective intentions (as some Israeli firms now do by listing on NASDAQ) (Coffee 1999), or by voluntarily adopting some of the governance practices that offer the protections of the standard model. Eventually, the result will be to partition off—and grandfather in—the older family-controlled or manager-dominated firms, whose costly governance practices will make them increasingly irrelevant to economic activity even within their local jurisdictions.

## 9. EFFICIENT NON-CONVERGENCE

Not all divergence among corporate law regimes reflects inefficiency. Efficient divergence can arise either through adaptation to local social structures or through fortuity. Neither logic nor competition is likely to create strong pressure for this form of divergence to disappear. Consequently, it could survive for a considerable period of time. Still, though the rate of change may be slower, there is good reason to believe that even the extent of efficient divergence, like the extent of inefficient divergence, will continue to decrease relatively quickly.

### 9.1. *Differences in Institutional Context*

Sometimes jurisdictions choose alternative forms of corporate law because those alternatives complement other national differences in, for example, forms of shareholdings, means for enforcing the law, or related bodies of law such as bankruptcy. A case in point is the new

Russian corporation statute, which deviates self-consciously from the type of statute that the standard model would call for in more developed economies. To take just one example, the Russian statute imposes cumulative voting on all corporations as a mandatory rule, in strong contrast with the corporate law of most developed countries. The reason for this approach was largely to assure some degree of shareholder influence and access to information in the context of the peculiar pattern of shareholdings that has become commonplace in Russia as a result of that country's unique process of mass privatization.<sup>27</sup>

Nevertheless, the efficient degree of divergence in corporate law appears much smaller than the divergence in the other institutions in which corporate activity is embedded. For example, efficient divergence in creditor protection devices is probably much narrower than observed differences in the sources and structure of corporate credit. Similarly, the efficient array of mechanisms for protecting shareholders from managerial opportunism appears much narrower than the observed variety across jurisdictions in patterns of shareholdings.

Moreover, the economic institutions and legal structures in which corporate law must operate are themselves becoming more uniform across jurisdictions. This is conspicuously true, for example, of patterns of shareholdings. All countries are beginning to face, or need to face, the same varied types of shareholders, from controlling blockholders to mutual funds to highly dispersed individual shareholders. Some of this is driven by the converging forces of internal economic development. Thus, privatization of enterprise, increases in personal wealth, and the need for start-up finance (which is aided by a public market that offers an exit for the initial private investors) all promote an increasing incidence of small shareholdings and a consequent need for strong protection for minority shareholders. The globalization of capital markets presses to the same end. Hence Russia, to return to our earlier example, will presumably evolve over time toward the patterns of shareholdings typical of developed economies, and it will ultimately feel the need to conform its shareholder voting rules more closely to the rules found in those economies.

## 9.2. *Harmless Mutations*

In various cases we anticipate that there will be little or no efficiency difference among multiple alternative corporate law rules. In these cases, the pressures for convergence are lessened, although not entirely eliminated (since we still expect global investors to exert pressure to standardize).<sup>28</sup> Accounting standards offer an example. As we noted earlier, there are currently two different accounting methodologies that have achieved prominence among developed nations: the American GAAP and the European-inspired International Accounting Standards. Because these two sets of standards evolved separately, they differ in many significant details. From the best current evidence, however, neither obviously dominates the other in terms of efficiency.

If the economies involved were entirely autarchic, both accounting standards might well survive indefinitely with no sacrifice in efficiency. The increasing globalization of the capital markets, however, imposes strong pressure not only for all countries to adopt one or the other of these regimes, but to select a single common accounting regime. Over time, then, the network efficiencies of a common standard form in global markets are likely to eliminate even this and other forms of fortuitous divergence in corporate law.

## 10. INEFFICIENT CONVERGENCE

Having just recognized that efficiency does not always dictate convergence in corporate law, we must also recognize that the reverse can be true as well: a high degree of convergence need not always reflect efficiency. The most likely sources of such inefficient convergence are flaws in markets or in political institutions that are widely shared by modern economies and that are reinforced rather than mitigated by cross-border competition.

### 10.1. *Third-party Costs: Corporate Torts*

Perhaps the most conspicuous example of inefficient convergence is the rule—already universal, with only minor variations from one jurisdiction to the next—that limits shareholder liability for corporate torts. This rule induces inefficient risk-taking and excessive levels of risky activities—inefficiencies that appear to outweigh by far any offsetting benefits, such as reduced costs of litigation or the smoother functioning of the securities markets. As we have argued elsewhere, a general rule of unlimited pro rata shareholder liability for corporate torts appears to offer far greater overall efficiencies (Hansmann and Kraakman 1991: 1882–3).

Why, then, has there been universal convergence on an inefficient rule? The obvious answer is that neither markets nor politics work well to represent the interests of the persons who bear the direct costs of the rule, namely tort victims. Since, by definition, torts involve injuries to third parties, the parties affected by the rule—corporations and their potential tort victims—cannot contract around the rule to capture and share the gains from its alteration. At the same time, owing to the highly stochastic nature of most corporate torts, tort victims—and particularly the very large class of potential tort victims—do not constitute an easily organized political interest group.<sup>29</sup> Moreover, even if a given jurisdiction were to adopt a rule of shareholder liability for corporate torts, difficulties in enforcement would arise from the ease with which shareholdings or incorporation can today be shifted to other jurisdictions that retain the rule of limited liability.

### 10.2. *Managerialism*

A second example of inefficient conversion, arguably, is the considerable freedom enjoyed by managers in almost all jurisdictions to protect their prerogatives in cases when they might conflict with those of shareholders, including particularly managers' ability to defend their positions against hostile takeover attempts. Again, political and market failures seem responsible. Dispersed public shareholders, who are the persons most likely to be disadvantaged by the power of entrenched managers, face potentially serious problems of collective action in making their voice felt. Managers, whose positions make them a powerful and influential interest group everywhere, can use their political influence to keep the costs of collective action high—for example, by making it hard for a hostile acquirer to purchase an effective control block of shares from current shareholders. Corporate law might therefore converge, not precisely to the shareholder-oriented standard model that represents the ideological consensus, but rather to a variant of that model that has a slight managerial tilt.

### 10.3. *How Big a Problem?*

The problem of inefficient convergence in corporate law appears to be a relatively limited one, however. Tort victims aside, the relations among virtually all actors directly affected by the corporation are heavily contractual, which tends to give those actors a common interest in establishing efficient law. Moreover, as our earlier discussion has emphasized, shareholders, managers, workers, and voluntary creditors either have or are acquiring a powerful interest in efficient corporate law. Indeed, limited liability in tort arguably should not be considered a rule of corporate law at all, but instead should be viewed as a rule of tort law. And even limited liability in tort may come to be abandoned as large-scale tort damage becomes more common and consequently of greater political concern. We already see some movement in this direction in USA environmental law, which pushes aside the corporate veil to a startling degree in particular circumstances.

## 11. CONCLUSION

The triumph of the shareholder-oriented model of the corporation over its principal competitors is now assured, even if it was problematic as recently as twenty-five years ago. Logic alone did not establish the superiority of this standard model or of the prescriptive rules that it implies, which establish a strong corporate management with duties to serve the interests of shareholders alone, as well as strong minority shareholder protections. Rather, the standard model earned its position as the dominant model of the large corporation the hard way, by out-competing during the post-Second World War period the three alternative models of corporate governance: the managerial model, the labour-oriented model, and the state-oriented model.

If the failure of the principal alternatives has established the ideological hegemony of the standard model, though perhaps this should not come as a complete surprise, the standard model has never been questioned for the vast majority of corporations. It dominates the law and governance of closely held corporations in every jurisdiction. Most German companies do not participate in the codetermination regime, and most Dutch companies are not regulated by the managerial 'structure' regime. Similarly, the standard model of shareholder primacy has always been the dominant legal model in the two jurisdictions where the choice of models might be expected to matter most: the USA and the UK. The choice of models matters in these jurisdictions because large companies often have highly fragmented ownership structures. In Continental Europe, where most large companies are controlled by large shareholders (La Porta *et al.* 1999), the interests of controlling shareholders traditionally dominate corporate policy no matter what the prevailing ideology of the corporate form.

We predict, therefore, that as equity markets evolve in Europe and throughout the developed world, the ideological and competitive attractions of the standard model will become indisputable, even among legal academics. And as the goal of shareholder primacy becomes second nature even to politicians, convergence in most aspects of the law and practice of corporate governance is sure to follow.

### Notes

1. An earlier and different version of this essay, entitled 'The End of History for Corporate Law', was published in the proceedings of the Columbia Law School Conference on Convergence in Corporate Governance Systems, and in the *Georgetown Law Journal*.
2. In a hoary debate that cuts across jurisdictional boundaries, proponents of the view that corporations exist by virtue of a state 'concession' or privilege have also been associated with the view that corporations ought to be governed in the interests of society—or all corporate constituencies—rather than in the private interest of shareholders alone (Dodd 1932: 1148–50; Mahoney 2000). Conversely, proponents of the view that the corporation is at bottom a contract among investors have tended to advance the primacy of shareholder interests in corporate governance.  
In our view, the traditional debate between concession and contract theorists is simply confused. On the one hand, corporations—whether 'concessions' or contracts—should be regulated when it is in the public interest to do so. On the other hand, the standard model is, in effect, an assertion that social welfare is best served by encouraging corporate managers to pursue shareholder interests.
3. Raphael La Porta and his colleagues (La Porta *et al.* 1997; 1998; 1999) have pioneered this view in an influential series of articles.
4. Indeed, significant numbers of widely-held USA and UK firms are also controlled firms (La Porta *et al.* 1999: 494–5).
5. Dodd and Berle conducted a classic debate on the subject in the 1930s, in which Dodd pressed the social responsibility of corporate managers while Berle championed shareholder interests (Berle 1932; Dodd 1932: 1145). By the 1950s, Berle seemed to have come around to Dodd's celebration of managerial discretion as a positive virtue that permits managers to act in the interests of society as a whole (Berle 1959: 107–10). John Kenneth Galbraith (1967) takes a similar position.
6. Galbraith (1967) and Berle (1959). For an important collection of essays arguing both sides of the question of managerial responsibility to the broader interests of society, see Mason (1959).
7. Proposal for a Fifth Company Law Directive, 1983 O.J. (C240)2.
8. Pistor (1999) notes that participants in codetermination regimes see earlier employee involvement in decision-making and reduced labour-management conflict as the principal benefit of the system, and a deterioration of firm-level governance—including principally a marked decline in the ability of the supervisory board to monitor and control management—as the cost of the system.
9. (Hansmann 1993a: 589–606; Hansmann 1993b; Hansmann 1996: 89–119). On the weaknesses of German boards, see, for example, Roe (1998: 167). In one of the few quantitative studies of the effects of German codetermination, Gordon and Schmid (2000) find that it reduces shareholder value but hold out hope that there might be an offsetting increase in the protection of the firm-specific human capital of employees.
10. Some commentators, of course, continue to see codetermination as a core element of a unique Northern European form of corporate governance (Albert 1993). Even Albert (*ibid.*: 169–90) concedes, however, the growing ideological power of shareholder-oriented corporate governance.
11. Other academic commentators urge law reform to realize the trustee model (Mitchell 1992).
12. The trustee model has been considered most recently in the ongoing effort to reformulate the duties of directors under UK company law, and has apparently been rejected by the Steering Group in favour of an 'enlightened shareholder interest' model. Compare Company Law Reform

- Steering group (March 1999: 39–46) (contrasting alternatives of a duty to follow enlightened shareholder interest with a ‘pluralist’ duty to all stakeholders to encourage firm-specific investment) with Company Law Reform Steering group (2000: 29–31) (proposing a duty based on shareholder primacy over pluralist duty). Legal formulations of directorial duty on the Continent, however, still generally avoid embracing the norm of shareholder primacy.
13. For this reason the Dutch ‘structure regime’, under which the supervisory boards of larger domestic companies are self-appointing, subject only to the possibility of objection by labour or shareholders, is the most radical existent form of a trustee regime.
  14. To be fair, however, American commentators tended to praise corporate governance in Germany and Japan in the name of the shareholder model. Thus, it was the purported ability of German banks to monitor managers and correctly value long-term business projects that caught the eye of American commentators after the 1970s, not codetermination or the labour-oriented model of the firm (Jacobs 1991: 69–71).
  15. Indirect evidence to this effect comes from international surveys such as a recent poll of top managers conducted by the *Financial Times* to determine the world’s most respected companies. Four of the top five most respected companies were American and hence operated under the shareholder model (the fifth was Daimler-Chrysler, which is ‘almost’ American for these purposes). Similarly, twenty-nine of the top forty firms were either American or British (*Financial Times* Web Site, 17 December 1999).
  16. In this regard it should be noted that small and medium-sized firms in every jurisdiction are organized under legal regimes consistent with the standard model. Thus, shareholders—and shareholders alone—select the members of supervisory boards in the vast majority of (smaller) German and Dutch firms. These jurisdictions impose alternative labour- or manager-oriented regimes only on a minority of comparatively large firms.
  17. Stock market capitalization as a percentage of GDP has risen dramatically in virtually every major jurisdiction over the past twenty years. In most European countries, the increase has been by a factor of three or four (*The Economist*, 13 November 1999: 85–6). The Euro single currency is among the important factors driving the expansion and internationalization of the European capital markets.
  18. Latin America offers a telling example. In 1981, Chile became the first country in the region to set up a system of private pension funds. By 1995, Argentina, Colombia, and Peru had done the same. By 1996, a total of \$108 billion was under management in Latin American pension funds, which by then had come to play an important role in the development of the local equity markets. In 1997, it was estimated that total assets would grow to \$200 billion by 2000 and to \$600 billion by 2011 (*The Economist*, 9 December 1995: S15; Fidler 1997; *Latin Finance*, December 1998: 6).
  19. Of particular interest are signs of change in the cross-ownership networks among major German and Japanese firms. New legislation proposed by the German government would eliminate the heavy (up to 60 per cent) capital gains taxes on corporate sales of stock, which is expected to result in widespread dissolution of block holdings (Simonian 1999: 1). In Japan, keiretsu structures are beginning to unwind as a result of bank mergers and competitive pressure to seek higher returns on capital (Abrahams and Tett 1999: 18).
  20. See, for example, *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).
  21. Corporate Governance Principles: Final Report, Corporate Governance Committee of the Corporate Governance Forum of Japan (26 May 1998).
  22. This can be seen, for example, by comparing the EU’s Listing Particulars Directive with the SEC’s Form S-1 for the registration of securities under the 1933 Act. If USA disclosure requirements remain more aggressive, one must remember that the EU Directives establish minimal

- requirements that member states can and do supplement (Coffee 1999: 668–72). See generally Licht (1998) (discussing convergence in disclosure rules, accounting standards, and corporate governance).
23. See Private Securities Litigation Reform Act of 1995, 109 Stat. 737 (1995).
  24. Already Europe has seen a remarkable wave of takeovers in 1999, culminating in the largest hostile takeover in history: Vodaphone’s acquisition of Mannesmann. In addition, many established jurisdictions are adopting rules to regulate tender offers that bear a family resemblance to the Williams Act or to the rules of the London City Code. See, for example, Brazil’s tender offer regulations, Securities Commission Ruling 69, 8 Sept. 1987, Arts. 1–4, and Italy’s recently adopted reform of takeover regulation, Legislative Decree 58 of 24 February 1999 (the Financial Markets Act or so-called ‘Draghi Reform’).
  25. Already there are signs of pressure in this direction. See Muelbert and Birke (2000: 3) (critiquing recent support for Delaware style defensive tactics by German industry and some academic commentators).
  26. The Holz Müller decision of the German Federal Court, BGH 2, Zivilsenat, II ZR 174/80 (1982). (German case law extension of shareholder right to vote to all fundamental corporate transactions.)
  27. Following Russian voucher privatization in 1993, managers and other employees typically held a majority of shares in large companies. Publicly-held shares were mostly widely dispersed, but there was often at least one substantial outside shareholder with sufficient holdings to exploit a cumulative voting rule to obtain board representation (Black and Kraakman 1996: 1922–3).
  28. Gilson (2000) refers to processes in which facially different governance structures or legal rules develop to solve the same underlying functional problem as ‘functional convergence’. On the assumption that formal law and governance practices are embedded in larger institutional contexts that change only slowly, Gilson conjectures that functional convergence is likely to outpace formal convergence. Such functional convergence, when it occurs, is what we term ‘harmless mutation’. In contrast to Gilson, however, we believe that formal law and governance structures are less contextual and more malleable than is often assumed, once the norm of shareholder primacy is accepted. Functional convergence—rather than straightforward imitation—is thus less necessary than Gilson supposes. We also suspect that close substitutes among alternative governance structures and legal rules are less widespread than Gilson implies.
  29. By way of contrast, the largely non-stochastic tort of environmental pollution has made an easier focus for political organizing in the USA and, as noted in the text below, has led to strong legislation that partially pierces the corporate veil for firms that pollute.

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## Convergence and its Critics: What are the Preconditions to the Separation of Ownership and Control?

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### 1. INTRODUCTION

Contemporary assessments of corporate governance and structure today typically begin at the same point and then diverge. Each opens by noting that Berle and Means (1932) were myopic. When in 1932 they announced the separation of ownership and control, Berle and Means did not recognize that they were describing a largely Anglo-Saxon phenomenon, which did not characterize the corporate governance systems of most of the rest of the world. Next, the commentator typically points out that, like parallel universes, two rival systems of corporate governance exist today: (1) a dispersed ownership model, characterized by strong and liquid securities markets, high disclosure standards, high market transparency, and in which the market for corporate control is the ultimate disciplining mechanism; and (2) a concentrated ownership model, characterized by controlling blockholders, weak securities markets, low transparency, and disclosure standards and possibly a central monitoring role for large banks.<sup>1</sup>

Thus framed, the debate then usually turns to the prospective persistency of this binary division of the corporate universe. Here again, there are two standard positions. One obvious position—hereinafter called the ‘Strong Convergence Thesis’—predicts that competition will force convergence. Thus, as markets globalize and corporations having very different governance systems are compelled to compete head-to-head, both in labour and capital markets, a Darwinian struggle becomes inevitable, out of which the most efficient form should emerge dominant.<sup>2</sup> The rival and newer position—hereinafter called the ‘Path Dependency Thesis’—postulates instead that institutions evolve along path dependent trajectories, which are heavily shaped by initial starting points and pre-existing conditions (Bebchuk and Roe 1999; Licht 2000). In short, history matters, because it constrains the way in which institutions can change, and efficiency does not necessarily triumph.

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