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The Basic Governance Structure: Minority Shareholders and Non-Shareholder Constituencies

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The corporate governance system principally supports the interests of shareholders as a class. Nevertheless, corporate law can—and to some degree must—also address the agency conflicts jeopardizing the interests of minority shareholder and non-shareholder contractual constituencies. And herein lies the rub. To mitigate either the minority shareholder or the non-shareholder agency problems, a governance regime must necessarily constrain the power of the shareholder majority and thereby aggravate the managerial agency problem. Conversely, governance arrangements that reduce managerial agency costs by empowering the shareholder majority are likely to exacerbate the agency problems faced by minority shareholders and non-shareholders at the hands of controlling shareholders.

In this chapter, we first address the protection of minority shareholders, and then turn to governance arrangements that protect the firm's employees—the principal non-shareholder constituency to enjoy such protections as a matter of right in some jurisdictions. In Chapter 5, we address the protections granted to corporate creditors.

While corporate law mostly deals with the relationship between the corporation and its contractual counterparties, it is sometimes called upon to protect the interests of constituencies external to the corporate form as well.[1] The final part of this chapter explores how the legal strategies of corporate law can also be directed to serve the interests of non-contractual stakeholders.

4.1 Protecting Minority Shareholders

It is well-documented by empirical research that dominant shareholders enjoy "private benefits of control"—that is, disproportionate returns—often at the expense of minority shareholders.[2] These benefits are impounded in the control premia charged for controlling blocks and in the price differentials that obtain between publicly traded

[1] See Chapter 1.5.

[2] See Tatiana Nenova, *The Value of Corporate Voting Rights and Control: A Cross-Country Analysis*, 68 Journal of Financial Economics 325, 336 (2003) (employing share price differentials for dual class firms to calculate private benefits); Alexander Dyck and Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 Journal of Finance 537, 551 (2004) (employing control premia in sales of control blocks to calculate private benefits).

high- and low-vote shares in the same companies. Both measures are often assumed to be rough indicators of the extent of minority shareholder expropriation.[3] The varying degrees of protection accorded to minority shareholders by differing corporate governance systems explain at least some of the variation in these indicators.

4.1.1 Shareholder appointment rights and deviations from one-share–one-vote

One way to protect minority shareholders is by granting them the right to appoint one or more directors. Specifically, company law can enhance minority appointment rights by reserving board seats for minority shareholders or over-weighting minority votes in the election of directors. Even if they only select a fraction of the board, a minority can still benefit from access to information and, in some cases, the opportunity to form coalitions with independent directors. Of course, shareholder agreements or charters can—and sometimes do—require the appointment of minority directors for individual firms. The law can achieve a similar result on a broader scale by mandating cumulative or proportional voting, which allow relatively large blocks of minority shares to elect one or more directors. Moreover, lawmakers can further increase the power of minority directors by assigning them key committee roles or by permitting them to exercise veto powers over certain classes of board decisions.[4]

Significantly, however, general corporate law rules granting minority board representation are relatively *un*common among our core jurisdictions. Italy mandates board representation for minority shareholders in listed companies.[5] Brazil grants minority shareholders who hold more than a 10 or 15 percent stake (of preferred or common stock, respectively) the right to appoint a board member, as well as cumulative voting at the request of shareholders representing at least 10 percent of voting capital.[6] However, the high coordination costs associated with these thresholds mean that generally only blockholders, rather than dispersed minority shareholders, benefit from the associated rights. Cumulative voting is the statutory default in Japan,[7] but it is routinely avoided by charter provisions. In France, the UK, and the U.S. firms may adopt a cumulative voting rule, but publicly traded firms rarely do so;[8] and in Germany, commentators dispute whether cumulative voting is permissible at all in public corporations.[9] In the

[3] See note 136 and accompanying text.

[4] For example, Art. 78 Russian Joint-Stock Companies Law requires that major transactions, including those that implicate the interests of controlling shareholders, be unanimously approved by directors. Consequently, "disinterested" minority directors can block major transactions between the company and its controlling shareholders or managers. In Brazil, directors elected by minority shareholders have veto rights over the appointment and removal of independent auditors: Art. 142, § 2º Lei das Sociedades por Ações.

[5] Art. 147-3 Consolidated Act on Financial Intermediation (requiring that at least one director be elected by minority shareholders).

[6] Art. 141 Lei das Sociedades por Ações. If neither group satisfies the relevant threshold, they may pool votes to make a joint board appointment. See also Art. 239 (granting minority shareholders the right to elect one board member in government-controlled firms).

[7] Art. 342 Companies Act.

[8] At the turn of the twentieth century, cumulative voting was common in the U.S. See e.g. Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 Columbia Law Review 124 (1994); cf. §§ 708(a) and 301.5(a) California Corporation Code (respectively mandating cumulative voting and authorizing opt-out from cumulative voting for listed companies).

[9] See Mathias Siems, Convergence in Shareholder Law 172 (2008). Even though the majority agrees that proportional voting is permissible, no important German corporation has included such a charter provision. See also Paul L. Davies and Klaus J. Hopt, *Boards in Europe—Accountability and*

UK, the new premium listing rules for companies with controlling shareholders grant minority investors what may be called an "expressive" veto on the appointment of independent directors. Their appointment is initially subject to separate approval by all shareholders and minority shareholders. If such approval is not obtained, then the shareholder majority can determine the election after a "cooling-off" period, between 90 and 120 days later.[10]

While the use of appointment rights directly to protect minorities is rare, all jurisdictions regulate the apportionment of voting rights in relation to share ownership—a central mechanism that affects both the appointment and decision rights of shareholders. Corporate laws generally embrace a default rule that each share carries one vote. Awarding voting rights in direct proportion to share ownership has the benefit of aligning economic exposure and control within the firm, but may leave minority shareholders vulnerable to opportunistic behavior by controlling shareholders. At the same time, where the value of incumbents' control is high—whether because the law fails to restrict dominant shareholders' opportunism or because, in the absence of a dominant shareholder, managerial agency costs would be high—proportionality between cash-flow and voting rights may impair a company's ability to raise further equity finance and secure profitable investment opportunities.[11] Consequently, our jurisdictions often contemplate adjustments to shareholder appointment and decision rights in both directions, that is, both by limiting the power of dominant shareholders and by allowing them to enhance it in various ways.

All jurisdictions permit at least some deviations from the one-share–one-vote norm to let dominant shareholders enhance their control over the corporation. These mechanisms include dual-class equity structures with disparate voting rights, circular shareholdings, and pyramidal ownership structures. While our core jurisdictions universally restrict circular shareholding schemes[12] and vote-buying by parties antagonistic to the interests of shareholders as a class,[13] they diverge with respect to the availability and use of other similar devices.

Germany and Brazil go furthest in limiting deviations from one-share–one-vote that increase the power of controlling shareholders: both countries ban shares with multiple

Convergence, 61 American Journal of Comparative Law 301 (2013) (noting that cumulative voting has failed to gain much traction in Europe).

[10] UK Listing Rules, 9.2.2E and 9.2.2F.

[11] See e.g. Kristian Rydkvist, *Dual-class Shares: A Review*, 8 Oxford Review of Economic Policy 45 (1992).

[12] Most jurisdictions forbid subsidiaries from voting the shares of their parent companies: Art. L. 233–31 Code de commerce (France); Art. 2359–II Civil Code (Italy); Art. 308(1) Companies Act (Japan); § 160(c) Delaware General Corporation Law; § 135 Companies Act 2006 (UK). German, Brazilian, and Japanese laws bar subsidiaries from owning shares of their parents except in special circumstances (§71d AktG; Art. 244 Lei das Sociedades por Ações; Art. 135 Companies Act). A number of countries, such as Italy, France, and Germany, also ban voting in the case of cross-shareholdings by companies that are in no parent-subsidiary relationship. See Shearman & Sterling, LLP, Proportionality Between Ownership and Control in EU Listed Companies: Comparative Legal Study 17 (2007) at http://www.ecgi.de/osov/final_report.php.

[13] A less traditional example of separating control rights from cash-flow rights is so-called "empty voting," in which investors use stock lending, equity swaps, or other derivatives to acquire "naked" votes in corporations in which they may even hold a negative economic interest (i.e. gain if the stock price goes down rather than up). See Henry T.C. Hu and Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 Southern California Law Review 811 (2006). Empty voting, like vote buying, can be used to undermine shareholder welfare. Despite efforts at increasing transparency over economic interests, as opposed to formal ownership rights, no jurisdiction provides for ownership disclosure rules that are geared for disclosure of empty voting per se. See Wolf-Georg Ringe, The Deconstruction of Equity 162–99 (2016).

votes and cap the issuance of non-voting or limited-voting preference shares to 50 percent of outstanding shares.[14] In Brazil, where dual-class firms were historically common, non-voting shares are prohibited outright in the *Novo Mercado*, the premium corporate governance segment of the São Paulo Stock Exchange.[15] Even these jurisdictions, however, do not regulate pyramidal ownership structures (where company A owns a majority of the voting shares of company B, which in turn owns a majority of the voting shares of company C, and so on),[16] which have identical effects to dual-class shares in separating cash flow and voting rights.[17] The U.S., by contrast, goes furthest in banning or discouraging the use of pyramidal structures through holding company regulations and the taxation of inter-corporate distributions.[18]

Similarly, some European jurisdictions permit the issuance of so-called fidelity shares, which condition the award of additional voting rights on a minimum holding period as a shareholder. For instance, Italian law recently enabled corporations to award double voting rights to shareholders who have held onto their shares for at least two years.[19] This mechanism had long been available in France on an opt-in basis, but in 2014, as part of an openly protectionist law on takeovers, it became the default rule for listed companies. Unless such companies opt out, their shares spawn double voting rights after two years in the same hands.[20] Although such "tenure voting" systems are usually justified as protecting the interests of long-term over short-term shareholders,[21] they tend also to embed the power of controlling shareholders relative to outside investors.

The U.S. and UK permit different classes of shares to carry any combination of cash flow and voting rights, but U.S. and Japanese exchange listing rules bar recapitalizations that dilute the voting rights of outstanding shares.[22] While the New York Stock

[14] See §§ 12 II and 139 II Aktiengesetz AktG (Germany); and Arts. 15, § 2º, and 110, § 2º, Lei das Sociedades por Ações (Brazil). In Brazil, however, companies have recently circumvented the ban on multi-voting stock by adopting a functionally equivalent dual-class structure where the public float carries *economic* rights that are a multiple of those granted to insiders. Brazil's Securities Commission (CVM) blessed this structure in the *Azul* case in 2013. France caps the issue of non-voting shares by listed companies at 25 percent of all outstanding shares. Arts. L. 228–11 to L. 228–20 Code de commerce. In 2014, Italy partially repealed the ban on multiple voting shares: it now allows non-listed companies to issue shares with up to three votes. Such companies may later go public, but cannot subsequently increase the proportion of multiple voting shares. The 50 percent cap on non-voting and limited voting shares has, instead, been maintained. See Art. 2351 Civil Code, as amended (Italy). Similarly to Germany and Brazil, Japan imposes a 50 percent cap on non-voting and limited voting shares: Arts. 108(1)(iii) and 115 Companies Act.

[15] For a discussion, see Ronald J. Gilson, Henry Hansmann, and Mariana Pargendler, *Regulatory Dualism as a Development Strategy: Corporate Reform in Brazil, the United States, and the European Union*, 63 Stanford Law Review 475, 489–90 (2011).

[16] As a result, pyramidal firms have emerged in Brazil's Novo Mercado, as elsewhere.

[17] See e.g. Lucian A. Bebchuk, Reinier Kraakman, and George Triantis, *Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, in Concentrated Corporate Ownership 445 (Randall K. Morck ed., 2000).

[18] See Steven A. Bank and Brian R. Cheffins, *The Corporate Pyramid Fable*, 84 Business History Review 435 (2010); Eugene Kandel, Konstantin Kosenko, Randall Morck, and Yishay Yafeh, *The Great Pyramids of America: A Revised History of US Business Groups, Corporate Ownership and Regulation, 1930–1950*, NBER Working Paper No w19691 (2015).

[19] Art. 129-V Consolidated Act on Financial Intermediation, as amended in 2014. This mechanism may actually serve to enhance the power of the state as shareholder.

[20] Art. L. 225-123 Code de commerce, as amended by Loi. No. 2014-384 of 29 March 2014 (known as the "Loi Florange"). See also Chapter 8.2.3.

[21] See Chapter 3.2.

[22] See Rule 313 NYSE Listed Company Manual and Rule 4351 NASDAQ Marketplace Rules (voting rights of existing shareholders of publicly traded common stock cannot be disparately reduced or restricted through any corporate action or issuance). See also Tokyo Stock Exchange, Securities

Exchange (NYSE) listing rules banned deviations from proportional voting for most of the twentieth century, dual-class shares have recently enjoyed something of a renaissance in media and hi-tech corporations.[23] The U.S. has even attracted high profile dual-class companies from abroad: for instance, Chinese e-commerce giant Alibaba opted to go public on the NYSE after being unable to list on the Hong Kong Stock Exchange, which still adheres to a strict one-share–one-vote rule. In the UK, where institutional investors had successfully discouraged dual-class shares altogether,[24] the Premium market segment is now exclusively for companies listing classes of shares with proportionate voting rights.[25] Thus, although legal support for a one-share–one-vote norm is limited, all our core jurisdictions restrict some ways of leveraging voting rights that are regarded as particularly harmful.

Much rarer than devices that *empower* a certain group of shareholders are legal devices that simply *dilute* the voting power of large shareholders, to benefit small shareholders. Perhaps the best known technique of this sort is "vote capping," that is, imposing a ceiling on the control rights of large shareholders and correlatively inflating the voting power of small shareholders. For example, a stipulation that no shareholder may cast more than 5 percent of the votes reallocates 75 percent of the control rights that a 20 percent shareholder would otherwise exercise to shareholders with stakes of less than 5 percent.

Except for Germany and Japan,[26] all our core jurisdictions permit publicly traded corporations to opt into voting caps by charter provision. Today, however, the real motivation for voting caps is more likely to be the deterrence of takeovers than the protection of minority investors. They are more commonly adopted where no controlling block exists, to dissuade the building of one, rather than to constrain the voting power of an existing block-holder. Voting caps survive today chiefly in France and, to a lesser extent, in Italy and Brazil.[27]

Listing Regulations, Rule 601(1)(xvii) and Enforcement Rules for Securities Listing Regulations, Rule 601(4)(xiv) (prohibiting unreasonable *ex post* restrictions on shareholder voting rights).

[23] Prominent examples include News Corporation, Google (now Alphabet), Facebook, and LinkedIn, where the use of "super-voting" shares has allowed the founding shareholders, who arguably have a strategic role in the value of the company, to keep control of the corporation without holding the majority of the share capital.

[24] See Julian Franks, Colin Mayer, and Stefano Rossi, *Spending Less Time with the Family: The Decline of Family Ownership in the United Kingdom*, in A History of Corporate Governance Around the World 581, 604 (Randall K. Morck ed., 2005).

[25] UK Listing Rule 7.2.1A, Premium Listing Principle 4.

[26] Voting caps were banned for German publicly traded (listed) companies in 1998. See § 134 I Aktiengesetz (AktG) (as amended by KonTraG). Still, there was one important exception: Volkswagen AG, which is regulated by a special law, was subject to a 20 percent voting cap. The European Court of Justice ruled that the voting cap (together with other provisions of the VW Act) impeded the free movement of capital which was guaranteed by Art. 56(1) EC Treaty (now Art. 63 TFEU); see Case C-112/05, *Commission v. Germany*, Judgment of 23 October 2007, European Court Reports [2007] I-8995. Japan adopts the rule of one-share, one-vote and does not allow voting caps. See Art. 308(1) Companies Act. Italy banned voting caps from 2003 to 2014 (other than for privatized companies). See Art. 2351 Civil Code, as amended (Italy).

[27] For France see Art. L. 225-125 Code de commerce; Art. 231-54 Règlement Général de l'AMF (declaring, however, voting caps ineffective at the first general meeting after a bidder has acquired two thirds or more of the voting shares). For Brazil, see Art. 110, § 1º Lei das Sociedades por Ações, (permitting voting caps); Novo Mercado Regulations, Art. 3.1.1 (prohibiting voting caps below 5 percent, except as required by privatization laws or industry regulations). Although extremely rare in the UK and the U.S. today, voting caps were common in the nineteenth century in the U.S., Europe, and Brazil. See Mariana Pargendler and Henry Hansmann, *A New View of Shareholder Voting in the Nineteenth Century*, 55 Business History 585 (2013).

4.1.2 Minority shareholder decision rights

As in the case of appointment rights, the law sometimes protects minority shareholders by enhancing their direct decision rights. Minority decision rights are strongest when the law entrusts individual shareholders (or a small minority of them) with the power to make a corporate decision. Such is the case for instance when the law allows individual shareholders, or a small shareholder minority, to bring suit in the corporation's name against directors or other parties against whom the corporation may have a cause of action.[28] Granting decision rights to a majority of minority shareholders is also an effective governance strategy. For this reason, corporate laws sometimes impose a majority-of-the-minority approval requirement on transactions between controlling shareholders and their corporations.[29]

In addition, all our core jurisdictions fortify minority decision rights over fundamental corporate decisions by imposing special majority or supermajority approval requirements. As we discuss in Chapter 7, the range of significant decisions subject to shareholder voting varies, as does the particular voting threshold required for approval.[30] As a practical matter, however, the relevant threshold is almost always higher than the simple majority of the votes cast at a general shareholders' meeting. Arguably, then, most jurisdictions use decision rights to protect large blocks of minority shares against expropriation effected via major transactions such as mergers.

Several European jurisdictions pursue this end explicitly by awarding the holders of a sufficient percentage of minority shares (25 percent or more of voting shares) a statutory blocking right—to prevent a "bare" majority from trumping the will of a "near" majority.[31] Most U.S. states and Brazil require a majority of the outstanding shares to approve fundamental transactions such as mergers, which implies a supermajority of the votes that are actually cast.[32] The size of the supermajority in this case depends on the percentage of shares represented at the meeting, which, in turn, reflects the salience of the transaction for minority shareholders. Nevertheless, requirement of approval by a majority of the outstanding shares is no protection for minority investors if the controlling shareholder enjoys such a majority.[33]

4.1.3 The incentive strategy: Trusteeship and equal treatment

The incentive strategy for protecting minority shareholders takes two forms. One is the familiar device of populating boards and key board committees with independent directors. As noted in Chapter 3, lawmakers seem to view independent directors as a kind of broad-spectrum prophylactic, suitable for treating both the agency problems of minority shareholders and those of shareholders as a class. The second mode of protecting minority shareholders is strong enforcement of the equal treatment norm, particularly with respect to distribution and voting rights. This norm applies to both closely held and publicly traded firms, and blurs into an aspect of the constraints strategy: a fiduciary duty of loyalty to the corporation that implicitly extends towards minority shareholders and perhaps other corporate constituencies as well.

[28] See Chapter 3.2.3 and Chapter 6.2.5.4.
[29] See Chapter 6.2.3 and Chapter 7.4.2.3.
[30] See Chapter 7.7.
[31] See Chapter 7.2 and 7.4.
[32] See e.g. § 251 Delaware General Corporation Law (merger); § 242 (charter amendment); Art. 136 Lei das Sociedades por Ações.
[33] Such levels of control are common in Brazil, for example.

4.1.3.1 *The trusteeship strategy and independent directors*

The addition of independent directors to the board is a popular device, not only as a solution to shareholder–manager agency problems,[34] but also for protecting minority shareholders and non-shareholder constituencies. Lawmakers implicitly assume that independent directors—motivated by "low-powered incentives"—namely, morality, professionalism, and personal reputation—will stand up to controlling shareholders in the interest of the enterprise as a whole,[35] including its minority shareholders and, to varying degrees, its non-shareholder constituencies. Strong forms of trusteeship reduce the possibility of controlling the board by shareholders (or by anyone else). In the extreme case, no constituency, including shareholders, can directly appoint representatives to the company's board. This was the core principle of the Netherlands' old "structure regime,"[36] under which the boards of some large companies became self-appointing organs, much like the boards of many nonprofit corporations or foundations. Alternatively, investors themselves may contract to give one or more mutually selected independent directors the decisive voice on the board as a governance solution to intra-shareholder opportunism. This pattern is common in venture capital-backed firms.[37]

In our core jurisdictions, however, most "independent" directors are neither self-appointing nor rigorously screened for independence by savvy investors. Instead, director "independence" typically means at most financial and familial independence from controlling shareholders (as well as from the company and its top corporate officers).[38] A director qualifies as independent under such a definition even if she is vetted and approved by the company's controlling shareholder—and even if she has social ties to the controller—as long as she has no close family or financial ties, such as an employment position or a consulting relationship, with the controller. A conventional example is that an officer of an unrelated, third-party company qualifies as an independent director of the corporation, but an officer of a holding company with a controlling block of stock in the corporation does not. Moreover, the fact that in many jurisdictions shareholders have the right to remove directors (including independent directors) at any time further exacerbates concerns about the lack of actual independence in controlled firms.

Finally, the most modest and basic form of a director-based trusteeship strategy abandons all pretense to independence and simply requires board approval for important company decisions. For example, the authority to initiate proposals to merge the company can be vested exclusively in the board of directors under U.S. and Italian law.[39] Alternatively, shareholders may be barred from directly making any decisions

[34] See Chapter 3.3.1.

[35] For a critical assessment, see Wolf-Georg Ringe, *Independent Directors: After the Crisis*, 14 European Business Organization Law Review 401 (2013).

[36] See e.g. Edo Groenewald, *Corporate Governance in the Netherlands: From the Verdam Report of 1964 to the Tabaksblat Code of 2003*, 6 European Business Organization Law Review 291 (2005).

[37] See Jesse M. Fried and Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 New York University Law Review 967, 988 (2006).

[38] And, according to the listing rules of U.S. stock exchanges, not even that: they only require independence from the company and top management. Jurisdictions with concentrated ownership structures, however, usually impose some form of independence from controlling shareholders. For a comprehensive survey, see Dan W. Puchniak and Luh Luh Lan, *Independent Directors in Singapore: Puzzling Compliance Requiring Explanation*, American Journal of Comparative Law (forthcoming).

[39] See § 251 (b) Delaware General Corporation Law; Chapter 3.4; Art. 2367 Civil Code (Italy).

about the company's business without the board's invitation, as under German law.[40] These measures constrain the controlling shareholder to pursue her policies through directors who, although appointed by her, nevertheless face different responsibilities, incentives, and potential liabilities from controlling shareholders.

Of course, how well the director-based trusteeship strategy works, even when some or most directors are financially independent of controlling shareholders, remains an open question. We have already expressed our skepticism about the efficacy of these directors as trustees for minority shareholders.[41] Nevertheless, U.S. case law provides anecdotal evidence that independent boards or committees can make a difference in cash-out mergers,[42] or when controlling shareholders egregiously overreach.[43]

4.1.3.2 The equal treatment norm

The equal treatment of shares (and shareholders) of the same class is a fundamental norm of corporate law. Although this norm can be viewed as a rule-based constraint on corporate controllers, it can also be seen as a species of the incentive strategy. To the extent that it effectively binds the controlling shareholder, it motivates her to act in the interests of shareholders as a class, which includes the interests of minority shareholders. As with all abstract norms, however, its functioning is subject to at least two important qualifications. The first concerns the range of corporate decisions or shareholder actions that trigger this norm. The second qualification concerns the meaning of the norm itself. For example, are two shareholders treated equally when a corporate decision has the same formal implications for each, even though it favors the distribution or the risk preferences of the controlling shareholder over those of the minority shareholder? Insofar as shareholder preferences are heterogeneous and controlling shareholders have legitimate power to shape corporate policy, some level of unequal treatment seems endemic to the corporate form.[44]

Our core jurisdictions differ with respect to these qualifications of the equal treatment norm. In general, civil law jurisdictions—and particularly those that have been

[40] § 119 II AktG (shareholders may only vote on management issues if asked by the management board). But see Chapter 7.6 for the case law on implicit shareholders' meeting prerogatives (the so-called *Holzmüller* doctrine).

[41] See Chapter 3.3.1. See also Ringe, note 35. For a broad discussion of the value of independent directors in U.S. family controlled listed companies see Deborah A. DeMott, *Guests at the Table: Independent Directors in Family-Influenced Public Companies*, 33 Journal of Corporation Law 819 (2008).

[42] See Chapter 7.4.2.

[43] An example is the Hollinger case, in which the Delaware Chancery Court backed a majority of independent directors who ousted the dominant shareholder from the board, and prevented him from disposing of his controlling stake in the company as he wished. See *Hollinger Int'l, Inc. v. Black*, 844 Atlantic Reporter 2d 1022 (Del. Ch. 2004). The independent directors in Hollinger acted, however, only after the controlling shareholder's misdeeds were already under investigation by the Securities and Exchange Commission (SEC), and the controller had openly violated a contract with the board as a whole to promote the sale of the company in a fashion that would benefit all shareholders rather than the controller alone. See also Chapter 8.4.

[44] For an instructive U.S. example on the point, compare *Donahue v. Rodd Electrotype Co.*, 328 North Eastern Reporter 2d 505 (Mass. 1975), in which the court mandates that closely held corporations must purchase shares pro rata from minority and controlling shareholders, with *Wilkes v. Springside Nursing Home, Inc.*, 353 North Eastern Reporter 2d 637 (Mass. 1976), in which the same court recognizes that controlling shareholders may pursue their right of "selfish ownership" at a cost to minority shareholders as long as they have a legitimate business purpose.

heavily influenced by German law—tend to view equal treatment as a broad principle (or source of law) that suffuses all aspects of corporate law. Germany and Japan also frame the principle of equal treatment as a general statutory provision.[45] By contrast, the common law jurisdictions—the U.S. and UK—specify equal treatment by case law or statute in particular contexts, but are less inclined to embrace a general legal standard of equal treatment as distinct from constraint-like standards such as the controlling shareholder's duty to act fairly vis-à-vis minority shareholders.[46]

These jurisdictional differences in the deference accorded to equal treatment have important consequences in a number of corporate law areas. As we discuss in Chapter 8, respect for equal treatment makes American-style poison pills more difficult to implement in jurisdictions that discourage companies from distinguishing among shareholders in awarding benefits, including stock purchase rights.[47] Indeed, it is arguable that the law in the U.S.—or at least Delaware—accords the widest latitude for *un*equal treatment of identical shares among all of our core jurisdictions, though there are some isolated areas in which it enforces the equal treatment norm with exceptional vigor. Although most jurisdictions enforce the equal treatment norm most strongly in the area of corporate distributions (that is, dividends and share repurchases) and share issues, U.S. law in practice limits categorical enforcement only to the payment of dividends. In general, targeted share repurchases, even at prices above market, are permissible in the U.S., and companies may issue shares to third parties without providing preemption rights to incumbent shareholders.

Another area in which deference to the equal treatment norm has important implications is the law of corporate groups (i.e. groups of companies under the common control of another company, often managed as a single, integrated business). As we discuss in Chapters 5 and 6, some jurisdictions—such as Germany, France, Italy, and Brazil—provide for special regulation in this area, permitting judicial evaluation of intra-group transactions in aggregate.[48] Equal treatment is thus interpreted as applying not to individual transactions, but to aggregates of transactions.

To conclude, the reach of the equality norm varies greatly, both within and between jurisdictions. However, all our jurisdictions rely on this device, in at least some circumstances, to align the incentives of controlling and minority shareholders.

[45] § 53a Aktiengesetz (Germany) and Art. 109(1) Companies Act (Japan). There is also a gray area in German law when it comes to the preferential provision of information to blockholders vis-à-vis other shareholders. A number of EU directives provisions more or less broadly impose the equal treatment principle upon EU publicly traded companies as well. See Art. 46 Directive 2012/30/EU, 2012 O.J. (L 315) 74; Art. 3(1)(a) Directive 2004/25/EC, 2004 O.J. (L 345) 64; Art. 17(1) Directive 2004/109/EC, 2004 O.J. (L 390) 38; Art. 4 Directive 2007/36/EC, 2007 O.J. (L 184) 17.

[46] Under Delaware law, equal treatment of minority shareholders determines whether a given transaction is conceived as self-dealing and scrutinized as such. Insofar as minority shareholders have received formally equal treatment (i.e. controlling shareholders have not benefited at the minority's expense), the business judgment rule applies. *Sinclair Oil Corp. v. Levien*, 280 Atlantic Reporter 2d 717 (Del 1971). On the treatment of related-party transactions by controlling shareholders, see Chapter 6.2.2 and 6.2.5.

[47] Given Japan's strong statutory provision enshrining the equal treatment norm, the evolving Japanese case law on warrant-based takeover defenses is particularly interesting in this regard. See *Bull-dog Sauce v. Steel Partners*, Minshu 61–5-2215 (Japan. S. Ct. 2007) (permitting a discriminatory distribution of warrants where the warrant plan, overwhelmingly approved by an informed shareholder vote, provided compensation for discriminatory treatment to the defeated tender offeror). See Chapter 8.2.3.

[48] See Chapter 5.2.1.3 and 5.3.1.2, and Chapter 6.2.5.3.

4.1.4 Constraints and affiliation rights

We group together the remaining strategies for protecting minority shareholders because there is less to say about them in a chapter devoted to the governance system. Legal constraints—principally in the form of standards such as the duty of loyalty, the oppression standard, and abuse of majority voting—are widely used to protect the interests of minority shareholders. In fact, these standards are often specific applications of the equal treatment norm, as when courts allow only "fair" transactions between companies and their controllers—meaning, in effect, that controlling shareholders cannot accept unauthorized distributions from the corporate treasury at the expense of the firm's minority shareholders. We examine these standards more closely in Chapters 6 and 7, although we must stress here that they may help minority shareholders in settings involving neither a related-party transaction nor a fundamental change.[49]

Finally, the affiliation strategy, in the guise of mandatory disclosure, is at least as important for protecting minority shareholders as it is for protecting shareholders as a class. To the extent that disclosure, as a condition for entering and trading in the public markets, reveals controlling shareholder structures and conflicted transactions, market prices may bring home to controllers the costs of their opportunism.[50] Moreover, mandatory disclosure provides the information necessary to protect minority shareholders through other mechanisms, such as voting or litigation.[51]

By contrast, the exit strategy goes only so far in protecting minority shareholders. On the one hand, free transferability of shares, one of the five key elements of the business corporation, is helpful but incomplete as a minority protection tool. It permits dissatisfied minority shareholders to sell their shares on the market, but only if there is a market for the company's shares, and even then, usually at a price that already reflects the controlling shareholder's abuses.[52] On the other hand, minority shareholders are generally unable to exit the firm by taking with them their proportional share of the corporation's assets. After all, permanency of investment is a hallmark of the corporate form. As we address in Chapters 6, 7, and 8, corporate law sometimes does provide stronger exit rights, in particular for closely held companies, but usually only upon egregious abuse of power by a controlling shareholder or in conjunction with a major transformation of the enterprise. Examples include the availability of appraisal rights (essentially, a put option) upon the occurrence of a fundamental transaction in many jurisdictions;[53] or the mandatory bid rule triggered by a sale of control and sell-out rights in Europe and Brazil.[54]

[49] For instance, in some jurisdictions a minority shareholder in a closely held firm may challenge as oppressive or abusive a controlling shareholder's decision to discharge the minority shareholder as an employee or to remove her from the board when all of the company's distributions to shareholders take the form of employee or director compensation.

[50] See Chapter 6.2.1.1.

[51] See Chapter 9.1.2.3.

[52] Informed blockholders can also use the threat of exit, and its impact on stock price, to discipline managers, thereby improving firm governance *ex ante*—although this mechanism is likely to be more effective in firms lacking a controlling shareholder. See Alex Edmans, *Blockholders and Corporate Governance*, 6 Annual Review of Financial Economics 23 (2014) (reviewing the use of exit by blockholders as a governance device).

[53] See Chapter 7.2.2 and 7.4.1.2.

[54] See Chapter 8.3.4.

4.2 Protecting Employees

In addition to protecting minority shareholders, the corporate governance system extends important protections to non-shareholder constituencies in a contractual relationship with the corporation. Corporate law in all jurisdictions provides specialized protections to corporate creditors, which we consider separately in Chapter 5. Here we focus principally on the governance protections accorded to employees.

As contractual counterparties to the corporation, employees may deserve the protection of corporate law insofar as they are particularly susceptible to exploitation by the firm—and labor law regulations are held to be insufficient to protect workers or costlier to implement. From an economic perspective, this vulnerability emerges from the specific nature of the human capital investments that workers may make in their employer's business, such as by learning to use the firm's technology or relocating to a remote region where a particular facility is located.[55] When these investments are firm-specific (in the sense that they are useful only in the context of this employment), a profit-seeking corporation may subsequently exploit an employee's lack of outside options to "hold up" the employee.[56] This could be done by renegotiating the employment contract to transfer surplus from the worker to the firm, for example by decreasing wages and benefits, or worsening working conditions. To the extent that employees are able to foresee the prospect of such opportunistic behavior by the firm, they will be less willing to undertake firm-specific investments to begin with, thus ultimately harming profits.[57]

Our core jurisdictions differ profoundly in the extent to which they rely on corporate law for the protection of employees. Where they do, appointment rights, decision rights, and incentives are the principal strategies of choice. Of course, employees may also benefit indirectly from strategies designed to protect shareholders and creditors. For instance, mandated financial disclosures can assist employees, as well as investors, in their affiliation decisions. Disclosure rules have recently been harnessed to protect employees in a different way: labor unions in the U.S. have pushed for a rule requiring companies to disclose the "pay ratio" between the CEO and the median worker, a figure that might arguably help their bargaining position in wage negotiations.[58] Finally, a recent legal change in the UK also purports to rely on corporate law as a substitute for the labor law protections by permitting the elimination of various labor rights for "employee shareholders" having received a grant of at least £2,000 in company stock.[59]

[55] Moreover, employees may also have firm-specific financial investments in the form of unfunded defined-benefit pension obligations, which are more common in Germany and Japan. See Martin Gelter, *The Pension System and the Rise of Shareholder Primacy*, 43 Seton Hall Law Review 909, 966 (2013).

[56] See generally Margaret M. Blair, Ownership and Control: Rethinking Corporate Governance for the Twenty-first Century (1995); Paul L. Davies, *Efficiency Arguments for the Collective Representation of Workers: A Sketch*, in The Autonomy of Labour Law 367 (Alan Bogg et al. eds., 2015).

[57] For a thorough articulation of the view that corporate law should protect parties making specific investments in the firm, see Margaret Blair and Lynn Stout, *A Team Production Theory of Corporate Law*, 85 Virginia Law Review 247 (1999); Martin Gelter, *The Dark Side of Shareholder Influence: Managerial Autonomy and Stakeholder Orientation in Comparative Corporate Governance*, 50 Harvard International Law Journal 129 (2009).

[58] On the "pay ratio" rule, see Section 4.3.1.

[59] See s. 205A, Employment Rights Act 1996, as introduced by the Growth and Infrastructure Act 2013 (s. 31).

A minority shareholding in the employer is, however, an implausible substitute: an undiversified position only compounds workers' vulnerability to firm-specific risks and opportunism.

4.2.1 Appointment and decision rights strategies

The widespread introduction of employee-appointed directors to the boards of large European corporations is one of the most remarkable experiments in corporate governance of the twentieth century. Many European countries now mandate employee-appointed directors in at least some large companies,[60] although our core jurisdictions are not fully representative in this respect. The U.S., UK, Italy, and Japan do not mandate employee board participation. Even French requirements are tame by the standards of most other countries imposing worker participation, which typically require that employee representatives constitute one-third of the board.[61] France requires some employee board representation for listed companies in which employees own more than 3 percent of the shares.[62] Since 2013, large companies must also stipulate in their articles of association that one or two directors will be appointed as employee representatives.[63] However, in the majority of French companies (with over 50 employees) employees may only select two (sometimes four) non-voting representatives to attend board meetings.[64] Employee participation requirements are also mild in Brazil: they apply solely to firms controlled by the federal government and mandate the appointment of only one employee representative, who is not permitted to vote on labor-related matters.[65]

By contrast, German law establishes "quasi-parity codetermination," in which employee directors comprise half the members of supervisory boards in German companies with over 2,000 (German-based) employees.[66] Just as importantly, some of these labor directors must be union nominees, who generally come from outside the enterprise.[67] Moreover, only German-based employees and German trade unions have a right to appoint labor directors—though such differential treatment of foreign employees has recently become questionable under EU law.[68]

Although shareholders and workers appoint equal numbers of directors to the supervisory boards of large German companies (as the term "quasi-parity" denotes), this does not mean that they share power equally as a formal legal matter, since the supervisory board's

[60] The only EU countries that have *not* introduced any significant form of worker board representation are Belgium, Bulgaria, Cyprus, Estonia, Italy, Latvia, Lithuania, Malta, Romania, and the UK. Many countries, however, provide for employee board representation only in state-owned companies. See www.worker-participation.eu/.

[61] This is the case for instance in Austria, Denmark, Luxembourg, and Hungary. See Aline Conchon, *Board-level Employee Representation Rights in Europe: Facts and Trends*, European Trade Union Institute Report No. 121 (2011), www.etui.org.

[62] Arts. L. 225-23 and L. 225-71 Code de commerce (for a one-tier board and a supervisory board respectively).

[63] Arts. L. 225-27-1 and L. 225-79-2 Code de commerce (for one-tier boards and supervisory boards respectively), introduced by Loi No. 2013-504 of 14 June 2013.

[64] Art. L. 432-6 Code du travail.

[65] Lei 12.353, de 28 de dezembro de 2010 (Braz.).

[66] §§ 1 and 7 Mitbestimmungsgesetz. German companies with between 500 and 2,000 employees must grant one-third of their board seats to employees. §§ 1 and 4 Drittelbeteiligungsgesetz.

[67] In the largest companies seven members are elected by employees and three are appointed by trade unions. § 7 II Mitbestimmungsgesetz.

[68] See Kammergericht, decision of 16 October 2015, 14 W 89/15, Zeitschrift für Wirtschaftsrecht 2172 (2015) (requesting a preliminary ruling by the Court of Justice of the European Union on the issue. As of our writing, the case is still pending).

chairman, who is elected from among the shareholder representatives, has the statutory right to cast a tie-breaking vote in a second round of balloting in case of deadlock.[69] Nevertheless, employee representatives retain considerable power, formally through a statutory right to veto nominees to the management board,[70] and informally, because they are in a position to disrupt the proceedings of the supervisory board. In addition, the German codetermination statute allocates one seat on the management board to a "human resources director," who often has close ties with unions and employees.[71] Thus, German codetermination gives labor significant leverage over corporate policy by according it influence over the composition of the management board, access to information, and the power to withhold consent from contentious company decisions. This latter point is especially critical, because the usual practice of supervisory boards is to take decisions by consensus and because the shareholder bench of the supervisory board may not act monolithically, owing to the presence of independent board members.[72]

With the exception of Germany, whose laws permit works councils to co-decide (with management) on a number of employee-sensitive matters,[73] corporate laws never confer direct decision-making rights on workers. EU directives on works councils do provide employee information and consultation (but not decision) rights on matters of particular employee concern, such as the prospective trend of employment, any substantial change in a firm's organization, collective redundancies or sales of undertakings.[74] Such rights give labor lead time to organize resistance, make its case, or otherwise protect employees' interests. Even if works councils cannot influence major corporate decisions, the information flow that they provide, from top management to the shop floor and vice versa, arguably creates as much trust between companies and their employees as mandatory employee representation on the board, especially since labor representatives on works councils are typically the firm's own employees rather than outside union appointees.[75]

4.2.2 The incentives and constraints strategies

Incentive devices are less important in protecting employees than they are in protecting minority shareholders. Consider the trusteeship strategy first. Of course independent directors appointed by shareholders may function as weak trustees on behalf of employees, just as they do for minority shareholders, if law and local business culture motivate them to do so. And to some extent the law does facilitate such weak trusteeship even in the U.S., where many states other than Delaware permit—but do not

[69] § 29 II Mitbestimmungsgesetz.

[70] Election to the management board is by a two-thirds majority vote of the supervisory board (§ 31 II Mitbestimmungsgesetz). If there is no two-thirds majority for a candidate, lengthy proceedings are instituted which finally award the tie-breaking vote in a simple majority vote to the chairman of the supervisory board.

[71] § 33 Mitbestimmungsgesetz. (Germany).

[72] See Chapter 3.3.1.

[73] §§ 87 *et seq.* Betriebsverfassungsgesetz (Germany).

[74] See European Works Council Directive (Recast Directive 2009/38/EC, 2009 O.J. (L 122) 28); Art. 4 General Framework Directive (Directive 2002/14/EC, 2002 O.J. (L 80) 29); Art. 2 Collective Redundancies Directive (Council Directive 98/59/EC, 1998 O.J. (L 224) 16); Art. 7 Sale of Undertakings Directive (Council Directive 2001/23/EC, 2001 O.J. (L 82) 16).

[75] Works councils can provide a better framework for information-sharing than the supervisory board also because, unlike trade unions, they are usually not involved in negotiations of employment terms: see Annette Van Den Berg, *The Contribution of Work Representation to Solving the Governance Structure Problem*, 8 Journal of Management and Governance 129 (2004). See also Davies, note 56.

require—directors to consider the interests of employees and other non-shareholder constituencies in making important decisions, especially in the context of a hostile takeover.[76]

Unlike minority shareholders, non-shareholder contractual constituencies do not—and usually cannot—enjoy the protection of the equal sharing norm. Employees, lenders, and suppliers generally receive the bulk of their compensation as fixed payments rather than volatile claims on the net income of the firm as a whole. Where employees invest in developing firm-specific human capital, such fixed payments may be the firm's dominant risk-sharing arrangement, as the stockholders are generally able to diversify their financial investments across firms.

Employee stock ownership might seem to be a weak variant of the equal sharing device. Some jurisdictions encourage firms to share equity ownership with employees, on the theory that this will improve corporate governance and diminish tensions within the firm.[77] Yet share ownership entails different, and less satisfactory, consequences for employees than for outside investors with diversified portfolios. For employees, ownership of their firm's shares increases the already large—and largely undiversified—firm-specific risk that they bear. Moreover, it is unclear whether employee share ownership serves to protect the interests of employees as a class, as employee-shareholders generally remain a minority, without significant governance rights. Nevertheless, the grant of stock options to lower-level employees is surprisingly frequent in practice, especially in high-tech industries: stock options can help alleviate financing and capital constraints facing the firm, as well as promote retention and the sorting of optimistic employees.[78]

Finally, the constraints strategy for protecting employees is largely embodied in dedicated regulatory structures, such as labor law, which, for reasons of space, we exclude from the purview of this book except in the context of fundamental corporate decisions, addressed in Chapter 7 below.[79] Otherwise, the laws that permit or mandate corporate directors to have regard to non-shareholder constituencies typically encompass the interests of employees as well.[80] Nevertheless, these other corporate law constraints for protecting non-shareholder constituencies are usually toothless or narrowly targeted, as discussed further below.

4.3 Protecting External Constituencies

Corporate laws everywhere focus primarily on the relationships between the corporation and its contractual constituencies—notably, managers and shareholders, but also creditors and employees. Yet there is no doubt that the corporation's economic relevance and impact go well beyond its relationships with contractual counterparties.

[76] See Chapter 8.1.2.3. For a trustee-like analysis of the U.S. board, see Blair and Stout, note 57.

[77] There are also instances of the reward strategy in the form of legally sanctioned sharing regimes. For example, the U.S. has tax-favored employee stock ownership plans: see Henry Hansmann, The Ownership of Enterprise 87 (1996). France mandates both extensive information and limited employee profit-sharing rights in all firms with more than 50 workers. See Arts. L. 2322-1, 2323-6 to 2323-23-60, 3322-2, 3324-1 and 3324-10 Code du travail.

[78] See e.g. John E. Core and Wayne R. Guay, *Stock Option Plans for Non-executive Employees*, 61 Journal of Financial Economics 253 (2001) (finding an association between the use of stock options and financing and capital constraints); Paul Oyer and Scott Schaefer, *Why Do Some Firms Give Stock Options to All Employees? An Empirical Examination of Alternative Theories*, 76 Journal of Financial Economics 99 (2005) (attributing the widespread use of stock options to sorting and retention goals, rather than incentives).

[79] See Chapter 7.4.3.2. [80] See Section 4.3.3.

Left unchecked, corporations may engage in socially harmful behavior, such as environmental degradation, violations of human rights, anticompetitive behavior, or practices that pose systemic risk to the economy. The recent scandal involving German car manufacturer Volkswagen—which designed its cars' software to cheat emissions tests—illustrates this concern. The company's relentless pursuit of growth, which initially benefited both shareholders and workers, encouraged managerial choices that clearly conflicted with the wider interests of society.

Of course, corporations have no monopoly on socially harmful activities: individuals and other organizational forms engage in them as well. Yet because the corporate form is particularly conducive to large-scale enterprise, the social harms it engenders are correspondingly large-scale. Moreover, limited liability—an essential feature of the corporate form—serves to compound the problem, by permitting shareholders to bear only a fraction of the costs their companies' activities cause for third parties.[81] And precisely because they cannot protect themselves through contract, the corporation's non-contractual stakeholders have a greater need for legal protection than do its contractual constituencies.

The crucial question is not whether the corporation's non-contractual stakeholders deserve legal protection of some sort—they clearly do—but whether corporate law is the proper channel through which to deliver this. A simple answer is that protection of interests extraneous to the firm should come from other areas of law, such as environmental law, human rights law, antitrust law, or financial regulation. Indeed, the use of legal rules and standards—the constraints strategy—to promote interests extraneous to the corporate form is, almost by definition, *not* corporate law, but the application to corporations—as legal persons—of norms from other fields of law.

On occasion, however, regulators from our core jurisdictions resort to the same governance strategies and incentive strategies outlined in Chapter 2, not (only) to mitigate agency problems within the firm, but (also) to achieve broader societal objectives. Such an approach may be necessitated when—owing to regulators' information gaps or to successful industry lobbying—more direct regulatory responses to externalities and other social problems are not feasible.[82] On the other hand, corporate law may become an easy target of populist or misguided reform efforts that can easily decrease the efficiency of its regime without generating any meaningful gains for other constituencies.

The use of corporate law to protect external constituencies is by no means new. Historically, the very availability of incorporation was conditioned on the showing of a specific public benefit resulting from the enterprise. Other features of early corporate laws were specifically devised to mitigate monopoly problems or otherwise protect the interests of consumers.[83] In fact, the historical and contemporary uses of corporate law to protect non-contractual stakeholders are too numerous to describe in full.[84] It is worth noting, however, that in recent years—and in particular, in the wake of the recent financial crisis—there has been a visible resurgence in the use of legal strategies that shape the internal governance of business corporations, in particular in the financial sector, to tackle broader social and economic problems.

[81] See Chapter 1.2.2 and Chapter 5.1.2.3.

[82] See Mariana Pargendler, *The Corporate Governance Obsession*, 42 Journal of Corporation Law 101 (2016).

[83] Henry Hansmann and Mariana Pargendler, *The Evolution of Shareholder Voting Rights: Separation of Ownership and Consumption*, 123 Yale Law Journal 948 (2014).

[84] This is particularly conspicuous with respect to takeover regulation, which is often shaped by the interests of labor, local communities, and the national economy. For examples, see Chapter 8.

Before proceeding, one caveat is necessary. Most attempts to protect external interests—from gender equality in the boardroom to the reduction of systemic risk and the protection of human rights—can be, and have been, rationalized in terms of promoting long-term shareholder value. Nevertheless, while the long-term interests of shareholders may at times coincide with those of society at large, perfect alignment in all circumstances is implausible. In the following discussion, we consider instances in which the legal strategies of corporate law are deployed with the interests of external constituencies in mind, without taking a firm stance on the extent to which they also benefit investors.

4.3.1 Affiliation strategies

The vast majority of the disclosure requirements imposed on publicly traded companies concern factual matters that assist investors in evaluating the corporation's financial condition and, to a lesser extent, in exercising their governance rights.[85] By increasing the quality and quantity of information available to the public, mandating such disclosures enhances the efficiency of stock prices and supports financially motivated affiliation (and, to a lesser extent, voting) decisions by shareholders as a class.

In recent years, however, there has been a rise in the use of "non-financial" or "social" disclosure requirements.[86] These new obligations relate to information that, while arguably valuable from a social standpoint, may not always be relevant for shareholder affiliation decisions motivated solely by financial considerations. Rather, their goal is to facilitate entry and exit decisions by shareholders (and consumers) on socially minded criteria and, where such decisions are taken on a sufficiently large scale, to shape substantive corporate conduct. For instance, the U.S. Dodd-Frank Act of 2010 requires publicly traded companies to disclose their use of conflict minerals from the Democratic Republic of the Congo—a rule intended ultimately to discourage the use of such minerals and thereby alleviate the humanitarian crisis in the region.[87] Similarly, a new SEC requirement that U.S. public companies must disclose the extent to which they consider diversity in director nominations is at least partly motivated by fairness concerns towards women and minorities.

The Dodd-Frank Act also includes a provision mandating disclosure of the ratio of CEO compensation to that of their company's median employee. This rule is best understood as a response to growing apprehension about inequality, rather than as a metric for evaluating corporate financial performance. In Japan, too, new executive compensation disclosure obligations in part reflect growing unease about pay gaps between CEOs and their average employees.[88] For the first time, Japan now requires individualized reporting of executive compensation packages, but only for those executives whose annual pay exceeds ¥100 million (approximately US$1 million)—a high threshold that is not met in most Japanese companies.[89]

[85] See Chapter 3.4.2 and Chapter 9.

[86] See e.g. Donald C. Langevoort and Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation after the JOBS Act*, 101 Georgetown Law Journal 337 (2013).

[87] The D.C. Circuit has found that the portion of such a rule requiring a company to report that its products have not been found to be "DRC conflict free" violates freedom of speech under the U.S. Constitution: *Nat'l Ass'n of Mfrs. v. SEC*, 2014 Westlaw 1408274 (D.C. Cir., Apr. 14, 2014).

[88] See Robert J. Jackson, Jr. and Curtis J. Milhaupt, *Corporate Governance and Executive Compensation: Evidence from Japan*, 2014 Columbia Business Law Review 111, 129.

[89] Cabinet Office Ordinance on Disclosure of Corporate Affairs, Form 2 (Precautions for Recording (57)d) and Form 3 (Precautions for Recording (37)).

Non-financial disclosure has also gained particular traction in the EU. The Accounting Directive now requires companies that operate in extractive industries to publish details on payments they make to local governments in the countries in which they operate.[90] Moreover, a 2014 directive mandates disclosure of non-financial information in management reports, including the company's policy and performance with respect to "environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters."[91] These new reporting requirements have a broad footprint: they apply to all large "public interest entities," a category which includes not only listed companies, but also large closely held banks and insurance firms with more than 500 employees. The goal is presumably to focus pressure from shareholders, consumers, and civil society at large so as to steer corporations towards socially desirable outcomes. In Japan, there is relatively little mandatory disclosure of non-financial information to protect external constituencies, although the Tokyo Stock Exchange requires companies to describe how they respect the interests of various stakeholders in their governance reports.

Whether disclosure is an appropriate means to accomplish these ambitious goals remains an open question, which we consider further below.

4.3.2 Appointment and decision rights strategies

The interests of external constituencies could in theory also be advanced through the allocation of appointment and decision rights. Although reformers have argued for "constituency directors" at various points in time (especially in the 1970s),[92] none of our core jurisdictions confers general appointment rights on non-shareholder constituencies other than employees. The only exception is the appointment rights conferred by certain "golden shares"—such as France's *action spécifique*—which permit governments to appoint board representatives in privatized firms.[93]

Yet most jurisdictions have director qualification requirements that constrain shareholders' choice of appointees in view of broader economic or social purposes. A classical example is the prohibition, in countries such as the U.S., Germany, and Italy, of interlocking directorates across financial institutions, which aims to preserve competition by preventing directors from simultaneously serving on the boards of rival firms.[94]

More recently, Germany, Italy, and France and other countries have instituted mandatory minimum quotas on corporate boards,[95] and Japan has concurrently introduced voluntary targets. Gender quotas are best viewed as a constraint on the exercise of

[90] See Arts. 41–8 Directive 2013/34/EU, 2013 O.J. (L 182) 19. "Extractive industries" encompass the exploration and extraction of minerals, oil, natural gas deposits, or other materials. The disclosure provisions also apply to firms engaged in logging activity in primary forests (Art. 41).

[91] Directive 2014/95/EU, 2014 O.J. (L 330) 4, which inserted Art. 19A to Directive 2013/34/EU.

[92] See e.g. Ralph Nader, Mark Green, and Joel Seligman, Taming the Giant Corporation 125 (1976) (advocating the presence of an informed representative on the board for each public concern, such as environmental matters, consumer interests, compliance, among others).

[93] Art. 31-1 Ordonnance No. 2014-948 of 20 August 2014, inserted by Loi No. 2015-990 of 6 August 2015.

[94] Section 8 of the Clayton Act (U.S.); § 100 section 2 No. 3 AktG (Germany); Art. 36, Decree-Law 6 December 2011, No. 201 (Italy).

[95] Aktiengesetz § 96(2) (30 percent of supervisory board seats for the largest companies with employee board representation); Arts. 225-18-1 and 225-69-1 Code de commerce (in force, respectively, as of 1 January 2017 and 2020); Art. 147-III Consolidated Act on Financial Intermediation (Italy) (one-third of board seats). The Italian law on gender quota only applies to three board elections following its entry into force in 2012.

appointment rights that seeks to further more than simply the interests of shareholders. The empirical literature does not evidence any clear link between board diversity and corporate performance.[96] While a similar absence of evidence has not stopped independent directors being promoted as a means of securing shareholders' interests,[97] a likely alternative motivation for these new quota requirements is the political desire to promote gender fairness. Perhaps also, they may seek to further the interests of non-shareholder constituencies, as some studies suggest that female directors exhibit different preferences from male directors with respect to risk-taking and the protection of stakeholders.[98]

Decision rights are also occasionally used to protect the interests of non-shareholder constituencies. This is not done directly, at least in our core jurisdictions, but indirectly, by conferring decision rights on the state. An example is the retention by governments of "golden shares" in privatized firms. These first emerged in the UK during privatizations in the 1980s, and then spread to Brazil, France, Germany, and Italy.[99] Golden shares grant the state veto rights over certain fundamental corporate decisions (such as mergers, dissolutions, and sales of assets) disproportionately to, or sometimes irrespective of, any ownership interest in the firm. Governments with golden shares can be "shareholders" in name only—they are not necessarily investors in, or beneficial owners of, the firm.[100] The rationale for awarding such outsize decision rights to governments is presumably to protect the public interest at large.[101]

Golden shares are not the only instrument by which governments can exercise direct corporate power to promote social objectives. Another is direct state ownership of enterprise, either via majority stakes or significant blockholdings.[102] Despite waves of

[96] See e.g. Deborah H. Rhode and Amanda Packel, *Diversity on Boards: How Much Difference Does Difference Make?* 39 Delaware Journal of Corporate Law 363 (2014) (reviewing the empirical literature on female participation on boards and concluding that "the relationship between diversity and financial performance has not been convincingly established"); Renee B. Adams, *Women on Boards: The Superheroes of Tomorrow?*, ECGI Finance WP No 466/2016 (2016) (similar).

[97] See Chapter 3.2.

[98] See e.g. George R. Franke, Deborah F. Crown, and Deborah F. Spake, *Gender Differences in Ethical Perceptions of Business Practices*, 82 Journal of Applied Psychology 920 (1997) (women more likely than men to perceive certain business practices unethical); Renée B. Adams and Daniel Ferreira, *Women in the Boardroom and Their Impact on Governance and Performance*, 94 Journal of Financial Economics 291 (2009) (diverse boards devote more effort to monitoring); David A. Matsa and Amalia R. Miller, *A Female Style in Corporate Leadership? Evidence from Quotas*, 5 American Economic Journal: Applied Economics 136 (2013) (boards subject to gender quotas increased relative labor costs and made fewer workforce reductions). But see Renée B. Adams and Vanitha Ragunathan, *Lehman Sisters*, Working Paper (2015), at ssrn.com (banks with more women directors no less prone to risk-taking).

[99] However, golden shares have been successfully challenged in the EU as an impediment to the free movement of capital. See e.g. Wolf-Georg Ringe, *Company Law and Free Movement of Capital*, 69 Cambridge Law Journal 378 (2010).

[100] Whether golden shares entitle governments to cash-flow rights varies by jurisdiction. Even where they do, the associated decision rights are disproportionately powerful.

[101] However, corporate income taxation makes the government a residual claimant of sorts in *all* firms in a way that serves to align the interests of the government with those of shareholders. Indeed, a high rate of tax compliance is associated with lower private benefits of control. See Dyck and Zingales, note 2.

[102] Bernardo Bortolotti and Mara Faccio, *Government Control of Privatized Firms*, 22 Review of Financial Studies 2907, 2924 (2009) (common law governments resort to golden shares more frequently; civil law governments relying more on continued equity ownership in privatized firms); Aldo Musacchio and Sergio G. Lazzarini, Leviathan in Business, Brazil and Beyond (2014) (examining different varieties of state capitalism).

privatizations, significant state ownership persists in several of our core jurisdictions—most conspicuously in France, Germany, Italy, and Brazil.[103] By exercising appointment and voting rights through its role as shareholder, the state may steer the firm to achieve political objectives, even at the expense of financial returns. State-owned enterprises (SOEs) are usually subject to the same corporate law regime applicable to private firms, which generally affords the state as controlling shareholder wide discretion to pursue public goals.[104] For example, Brazil's corporations statute applies to the state the same fiduciary duties applicable to private controlling shareholders, but otherwise specifically authorizes it to pursue the public interest that justified an SOE's creation.[105]

Finally, scholars and policymakers have at times expressed hope that shareholders themselves might exercise decision rights in ways that promote the interests of society at large. The basic premise is that the rise in institutional investors pursuing indexing strategies entailing economy-wide exposure, together with the broader spread of equity ownership across various segments of society in some jurisdictions (especially the U.S.), created a natural alignment between the interests of these "universal owners" and the public interest.[106] The expansion of shareholder rights following the 2008 financial crisis—as exemplified by the rise of "say on pay" around the globe—is at least partly premised on this assumption.[107]

4.3.3 The incentives and constraints strategies

As discussed above, the widespread use of the constraints strategy to protect the interests of external constituencies is usually thought to happen beyond the perimeter of "corporate law." There are, however, limited exceptions to this. First, other areas of law can harness the mechanisms and enforcement tools of corporate law to pursue their goals, which can make disciplinary boundaries more porous. For example, the U.S. Foreign Corrupt Practices Act of 1977 (FCPA) on accounting and internal control rules, on the one hand, and on SEC enforcement against public issuers, on the other, in the pursuit of corruption.

Another exception is the imposition on directors of duties to consider the interests of constituencies other than shareholders—an expression of the standards strategy. The corporate laws of many jurisdictions provide that directors owe their duty of loyalty to the company rather than to any of its constituencies.[108] Such a duty is most naturally understood as an exhortation to maximize the net aggregate returns (pecuniary and non-pecuniary) of all corporate constituencies.

[103] See Mariana Pargendler, *State Ownership and Corporate Governance*, 80 Fordham Law Review 2917 (2012).

[104] Marcel Kahan and Edward Rock, *When the Government is the Controlling Shareholder*, 89 Texas Law Review 1293 (2011); Mariana Pargendler, *Governing State Capitalism: The Case of Brazil*, *in* Chinese State Capitalism and Institutional Change: Domestic and Global Implications 385 (Curtis J. Milhaupt and Benjamin Liebman eds., 2015).

[105] Art. 4º § 1º Lei 10.303, de 30 de junho de 2016 (Braz.).

[106] See e.g. Robert A. G. Monks and Nell Minow, Watching the Watchers 121 (1996); James P. Hawley and Andrew T. Williams, The Rise of Fiduciary Capitalism (2000); Gelter, *The Pension System*, note 55.

[107] The same idea has inspired recent proposals to employ the constraints strategy to impose more stringent liability standards on managers of systemically important firms. See John Armour and Jeffrey N. Gordon, *Systemic Harms and Shareholder Value*, 6 Journal of Legal Analysis 35 (2014) (suggesting diversified shareholders would act "as a proxy for society" in enforcing such liability).

[108] E.g. Germany: §§ 76 I and 93 I 2 AktG; Japan: Art. 355 Companies Act.

In theory, implementing this obligation might (or might not) require division of company surplus between shareholders and non-shareholder constituencies such as employees, in order to maximize the aggregate private welfare of all corporate constituencies.[109] In practice, however, courts are not well-placed to determine which policies maximize aggregate private welfare. This explains why, even where it is spelt out, a duty to pursue the corporation's interest (in this broad sense) is unenforceable. Even fair-minded directors are unlikely to know how best to distribute surplus among multiple corporate constituencies. Thus, the exhortation to boards to pursue their corporations' interests is less an equal sharing norm than, at best, a vague counsel of virtue, and, at worst, a smokescreen for board pursuit of their own interests. For instance, the UK Companies Act 2006 requires directors to seek to promote "the benefit of [the company's] members as a whole, *and in doing so [to] have regard* (amongst other matters) to … the interests of the company's employees, … [and] the impact of the company's operations on the community and the environment."[110] However, the obligation is framed subjectively, extending only to "act[ing] in the way *he considers, in good faith*" would bring about that result, which encourages judicial deference to directors. Moreover, third parties have no standing to enforce the duty. Similarly, Brazil's corporations statute provides that directors should act in the best interests of the company, "subject to the exigencies of public good and the social function of enterprise"; controlling shareholders, in turn, have duties and responsibilities towards "the remaining shareholders, workers, and the community in which [the company] operates."[111] Yet this type of language appears to have no constraining force, much like similar language in the typical American constituency statute.[112]

None of our core jurisdictions deploy duties to advance the interests of non-shareholder constituencies with quite such ambition as the new regime introduced by India's Companies Act of 2013. This requires companies to create a corporate social responsibility committee and spend at least 2 percent of average net profits on promoting their "corporate social responsibility policy"—preferably in local areas—or to explain their reasons for noncompliance. The Indian statute's definition of "corporate social responsibility" is particularly broad, encompassing not only social objectives closely related to the firms' primary activities, but also general humanitarian goals such as the eradication of extreme hunger and poverty, reducing child mortality, and combating various diseases.[113] Unsurprisingly, given its ambition, the effectiveness of this regime remains very much open to question.

Yet while our core jurisdictions do not compel spending on social causes, they do not prohibit it, either. A number of them explicitly sanction corporations' ability to make reasonable charitable contributions.[114] Legal systems may also encourage corporate charitable contributions through various tax deductions. And even in the United States, where fiduciary duties to shareholders are formally perhaps the strongest,[115]

[109] Note that maximizing the private welfare of all of the firm's current constituencies is not equivalent to maximizing overall social welfare, which would include, for example, the welfare of potential employees who are never hired because the high wages of current employees limit firm expansion.

[110] § 172 Companies Act 2006 (UK).

[111] Arts. 164 and 116 Lei das Sociedades por Ações.

[112] See Chapter 8.5.

[113] Companies Act 2013 (India), Art. 135 and Schedule VII.

[114] See e.g. § 122(9) Delaware General Corporation Law; Art. 154, § 4º Lei das Sociedades por Ações.

[115] The most famous articulation of the shareholder primacy ideal comes from the case of *Dodge v. Ford Motor Company*, 170 NW 668 (Mich. 1919) ("it is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of

in practice directors enjoy wide latitude to further the interests of non-shareholder constituencies so long as the decision is framed in terms of promoting long-term shareholder value.[116]

Corporate law may also indirectly protect non-shareholder constituencies through the imposition of oversight liability on directors for failures to implement and monitor internal systems of compliance against illegal activity. By making it likelier that illegal activities will be detected and their effects contained, such oversight obligations, which we touched upon briefly in Section 3.4.1, can also protect external constituencies.[117] Some jurisdictions also impose liability for damages caused to third parties by the directors' negligence (or gross negligence) in breaching a duty to the corporation.[118] In practice, however, this duty is principally read to protect the creditors of closely held corporations.[119]

Finally, another (blunt) use of the constraints strategy to protect the interests of external constituencies is through the imposition of personal liability on directors and officers—or even shareholders—for violations of law.[120] All of our core jurisdictions occasionally deviate from the general rule that only the corporation—as a distinct legal person—is liable for its actions to accommodate the deterrence and compensation goals of other branches of law, such as product liability, social securities law, tax law, patent law, environmental law, labor law, antitrust law, and financial regulation.[121] These include both direct sanctions for intentional or reckless violations of law and secondary liability to pay damages to third parties if the firm becomes insolvent.

Irrespective of the scope and content of corporate fiduciary duties, the trusteeship strategy in the form of independent directors—as the "broad-spectrum prophylactic" previously mentioned—is also used to protect both contractual constituencies and stakeholders external to the firm.[122] For instance, the New York Stock Exchange first required the inclusion of independent directors in audit committees in the late 1970s as a response to the corruption scandals of that era, even though corporate corruption can easily serve the financial interests of investors (if to the detriment of society at large). Indeed, one may argue that such ambiguity with respect to the function served by independent directors—the protection of shareholders as a class, of minority shareholders, of non-shareholder contractual constituencies, or of external

shareholders and for the primary purpose of benefiting others"). See, more recently, *eBay Domestic Holdings, Inc. v. Newmark*, 16 Atlantic Reporter 3d 1, 33 (Del. Ch. 2010) ("Promoting, protecting, or pursuing non-stockholder considerations must lead at some point to value for stockholders").

[116] Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 New York University Law Review 733 (2005) (business judgment rule deference entails significant managerial discretion to sacrifice profits in the public interest).

[117] Claire Hill and Brett McDonnell, *Reconsidering Board Oversight Duties after the Financial Crisis*, University of Illinois Law Review 859, 866–7 (2013).

[118] Art. 429(1) Companies Act (Japan); Art. 2395 Civil Code (Italy); Art. L. 225-251 Code de commerce (France). However, French courts virtually never impose liability on directors on behalf of third parties as long as the company is solvent. See Maurice Cozian et al., Droit des sociétés 179 (28th edn., 2015).

[119] See Chapter 5.3.1.1.

[120] See Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 Yale Law Journal 857 (1984).

[121] See e.g. Klaus J. Hopt and Markus Roth, *Sorgfaltspflicht und Verantwortlichkeit der Vorstandsmitglieder*, in Aktiengesetz: Grosskommentar (Heribert Hirte et al. eds., 5th edn., 2015), § 93 comments 656 et seq (discussing controversial imposition of personal liability on corporate directors in Germany for product liability cases).

[122] See e.g. Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?* 95 Harvard Law Review 597, 597 (1981–2) ("Numerous observers have argued that the addition of independent directors to corporate boards would solve the problem of corporate social responsibility without incurring the costs of external regulation").

stakeholders—has in fact facilitated political consensus and contributed to the spread of this mechanism in our core jurisdictions over time.[123] The reward strategy has also been increasingly deployed to protect the interests of non-shareholder constituencies. Rather than attempting to tie executive remuneration to benefits conferred by the corporation on society as a whole—which would clearly be impractical—the reward strategy has rather been used to discourage certain practices considered to be especially harmful from a social standpoint.

In the wake of the financial crisis, there has been considerable concern that, by tying executive remuneration to short-term returns, compensation packages in financial institutions contributed to the system's collapse by encouraging managers to take risks that were excessive from a social standpoint.[124] In systemically important financial institutions, the interests of undiversified shareholders conflict with those of society as a whole—both because financial crises have disastrous macroeconomic consequences and because taxpayers are left to pick up the bill to bail out failing banks.

Yet, given the countervailing advantages of equity-based compensation, none of our core jurisdictions has completely banned its use in financial institutions, though the EU has capped the variable component at twice fixed pay.[125] Nor has there been any permanent imposition of ceilings on the level of compensation, notwithstanding populist demands and growing concern about inequality. Except for the EU's cap on variable pay, most reforms in this area took the form of decision strategies, as in the global spread of the "say on pay" rule,[126] of trusteeship strategies, as in the most stringent independence requirements for members of compensation committees imposed in the U.S,[127] and of affiliation strategies, as in the greater disclosure requirements in the U.S. and Japan.[128]

4.4 Explaining Jurisdictional Differences and Similarities

As with our discussion of the primary manager–shareholder agency problem in Chapter 3, we first assess our core jurisdictions according to the protection that substantive law offers to minority shareholders, employees, and external stakeholders, respectively, and then according to the protection that these constituencies enjoy in practice, considering not only corporate law but also societal and legal institutions more generally.

4.4.1 The law-on-the-books

The substantive law-on-the-books gives little guidance as to which jurisdictions place more emphasis on protecting minority shareholders and external constituencies. It does, however, provide an indication of which countries go furthest to protect employees through corporate law.

[123] Pargendler, note 82.

[124] See e.g. Lucian A. Bebchuk and Holger Spamann, *Regulating Bankers' Pay*, 98 Georgetown Law Journal 247 (2010).

[125] Art. 94(1)(g) Capital Requirements Directive IV, 2013 O.J. (L 176) 338. The basic cap is set at 100 percent of fixed pay, which may be increased to 200 percent with shareholder approval. See generally John Armour et al., Principles of Financial Regulation 380–8 (2016). Moreover, the supervisory board members of most large German firms no longer receive stock options, though their fixed salary has increased considerably.

[126] See Section 4.3.2 and Chapter 6.2.3.

[127] See Chapter 3.3.1.

[128] See Section 4.3.1.

Consider minority shareholders first. Our analysis has shown that only Brazil and Italy among our core jurisdictions rely on appointment rights, in the form of minority-elected board members, to protect minority shareholders. Elsewhere the long-term trend is in the opposite direction—namely, *away* from minority empowerment through devices such as cumulative voting and strong supermajority voting rules.[129]

Why do so few jurisdictions mandate minority-friendly appointment rights for listed companies? One answer is that "partisan" representation of minority shareholders in controlled companies can be costly, by introducing conflict in board meetings, discouraging candid business discussions, and, at its worst, providing competitors with access to sensitive information.[130] Another answer is that minority shareholders in publicly traded corporations are a heterogeneous group. On the one hand, retail investors are the most vulnerable minority but, as a consequence of collective action problems, are also the group least able to pursue their interests effectively through appointment and decision rights. This is especially so under the high ownership percentage thresholds required for the exercise of such rights in Brazil and Italy. On the other hand, the minority shareholders best able to use appointment rights are large-block investors, who are also best able to contract for governance protections (e.g. in a shareholder agreement) even without the addition of mandatory terms in the law.

Board representation for minority shareholders might make more sense if, as is relatively often the case in Brazil and Italy for the largest companies,[131] institutional investors, as opposed to other blockholders, nominate minority directors. At least in the U.S., however, stringent laws on insider trading and onerous ownership disclosure rules that prevent coordination among shareholders[132] historically discouraged most institutional investors from exercising appointment rights, making this strategy less appealing. For activist investors such as hedge funds, however, board representation for minority investors has proved to be a potent tool, even in the U.S.—especially in light of the growing collaboration between hedge funds and traditional institutional investors.[133]

What, then, of other legal strategies for protecting minority investors? Among our core jurisdictions the U.S., followed by the UK, appears to rely most extensively on independent directors (in publicly traded companies), even more so after the Sarbanes-Oxley and Dodd-Frank Acts enhanced their role. But since independent directors may be appointed by controlling shareholders, even in the U.S. and the UK, their allegiance is always suspect unless their interest in maintaining a good reputation among outside shareholders at large is greater than their desire to be re-elected in a particular firm (or in other firms with controlling shareholders). The U.S., however, complements the trusteeship strategy with the strongest mandatory disclosure system of all our core jurisdictions.[134]

[129] See Chapter 3.2.1 and Chapter 4.1.1.

[130] See e.g. Gordon, note 8, at 167 (discussing traditional critiques of cumulative voting).

[131] Institutional investors nominate around one-third of the minority-appointed directors in companies voluntarily providing such information. See Assonime, Corporate Governance in Italy: Compliance with the CG Code and Directors' remuneration (Year 2012) 62–70 (2013), at http://www.assonime.it.

[132] See Mark J. Roe, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance 273 (1994).

[133] See Kobi Kastiel, *Against All Odds: Shareholder Activism in Controlled Companies*, 2016 Columbia Business Law Review 60.

[134] See Chapter 6.2.1.1 and Chapter 9.

Alternatively, consider the equal treatment norm as a minority safeguard. Here, Japan—followed by continental European jurisdictions and Brazil—is the country with the most stringent standards, at least on-the-books. The UK also gives substance to the equal treatment norm in the form of preemption rights and minority-protective takeover rules, while Delaware appears to rely on it the least. Put differently, all we know from reviewing the law-on-the-books is that jurisdictions pursue different strategies to protect minority interests. How well these strategies work in practice is a totally different story.

When it comes to governance strategies that protect labor's interest, Germany's system of quasi-parity codetermination, coupled with works council co-decision rights, clearly stands out.[135] France follows, a considerable distance behind Germany, by mandating a far more attenuated labor presence on company boards and, for companies with more than fifty employees, a works council with mere information and consultation rights.[136] But France, like Japan, Germany, Italy, and Brazil, has strong labor law rules governing basic employee interests, ranging from pension rights to terms of dismissal.[137] The U.S., followed by the UK, is the least protective of our core jurisdictions, both in direct regulation of employee rights and in structuring the corporate governance system to reflect employee interests. Overall, the observed pattern seems consistent with the view that the presence of powerful shareholders increases the risk of exploitation of workers.[138]

Conversely, different jurisdictions embrace a variety of strategies with respect to the protection of external constituencies, making it difficult to establish a clear pecking order. The use of the affiliation strategy through mandatory disclosure of non-financial information is currently most extensive in EU countries, and least so in Brazil. Whether explicitly or implicitly, all jurisdictions require or at least permit the board to take into account the interests of non-shareholder constituencies.[139]

State influence through ownership or golden shares is strongest in Brazil, France, and Italy, and again weakest in the U.S., with other jurisdictions falling somewhere in between. On the other hand, the decision rights of shareholders are weakest in the U.S., thus arguably insulating boards from shareholder pressure and enabling them, if only *de facto*, to promote a broader set of interests.[140]

4.4.2 The law in practice

As we argue above, the law-on-the-books provides an imperfect measure of the protection accorded to corporate constituencies. This is particularly the case for minority shareholders.

[135] For reviews of the empirical literature on these mechanisms, see John T. Addison and Claus Schnabel, *Worker Directors: A German Product that Did Not Export*, 50 Industrial Relations 354, 354 (2011); Davies, note 56.

[136] See Rebecca Gumbrell-McCormick and Richard Hyman, *Embedded Collectivism? Workplace Representation in France and Germany*, 37 Industrial Relations Journal 473, 482 (2006).

[137] See e.g. Juan C. Botero, Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, *The Regulation of Labor*, 119 Quarterly Journal of Economics 1339 (2004) (France's labor law is most restrictive among our jurisdictions).

[138] Gelter, *The Dark Side*, note 57. But see Mark J. Roe, *Political Preconditions to Separating Ownership from Control*, 53 Stanford Law Review 539 (2000) (for the different view that social democracies induce concentrated ownership in order to counterbalance the influence of labor in firm management).

[139] See notes 111–12 and accompanying text.

[140] See Chapter 3.4. See also Christopher M. Bruner, Corporate Governance in the Common Law World 105 (2013).

4.4.2.1 *Minority shareholders*

Two prominent empirical papers, applying different methodologies to data from the 1990s, suggest that controlling shareholders obtained private benefits that ranged from small to negligible in the UK, U.S., and Japan respectively, through moderately larger in Germany (approximately 10 percent), very large in Italy (30 percent or more) and France (28 percent), to extraordinarily large (65 percent) in Brazil.[141] Thus, to the extent that private benefits of control measure the severity of the majority–minority shareholder agency problem, our core jurisdictions differed dramatically in the extent of protection that they offered to minority shareholders, even if these differences were not evident a priori from the law-on-the-books.[142]

Moreover, these variations followed a clear pattern. The three jurisdictions in which large corporations ordinarily have dispersed ownership also had low private benefits of control, while the three countries in which concentrated ownership dominates had moderate to large private benefits.

This association between dispersed ownership and low private benefits of control is not accidental. In fact, widely held firms can only thrive in contexts where private benefits of control are relatively small. Whenever private benefits of control are sufficiently large, dispersed ownership becomes inherently unstable, since a potential raider would have much to gain from acquiring a controlling block and expropriating the remaining minority.[143]

Nevertheless, the numerous corporate reforms implemented in our core jurisdictions since the 1990s, combined with the modest rise in ownership dispersion in some contexts (Brazil)[144] and the reduction of the wedge between ownership and control in others (Italy),[145] cast doubt on the continued accuracy of these earlier measurements of private benefits of control. Strikingly, there are no cross-country studies that update the earlier estimates of private benefits of control—which would be a critical element in assessing whether and how the recent wave of corporate law reforms mattered.

In any case, the data from the 1990s suggest that the award of appointment rights to minority shareholders in Italy and Brazil was a response—albeit not necessarily a solution—to the mistreatment of minority shareholders. Moreover, it indicates that the strong equal treatment norms found in civil law jurisdictions did not necessarily protect minority shareholders, nor did a relatively low percentage of independent directors (as in Japan) necessarily inflate private benefits of control. Even domination by a controlling shareholder is not a reliable predictor, since Scandinavian jurisdictions

[141] The two papers are Nenova, note 2, at 336 (employing share price differentials for dual-class firms to calculate private benefits) and Dyck and Zingales, note 2 (employing control premia in sales of control blocks to calculate private benefits). Although these two papers present similar results across all other jurisdictions, they differ sharply for France (2 percent vs. 28 percent). Here Nenova's finding of 28 percent is more plausible because it is based on nine observations of French firms, while Dyck and Zingales have only four observations of French control transactions.

[142] But see Sofie Cools, *The Real Difference in Corporate Law Between the United States and Continental Europe: Distribution of Powers*, 30 Delaware Journal of Corporate Law 697, 760–1 (2005) (the sizeable difference in scope of shareholder voting rights across jurisdictions may lead to different values of control, even without private benefits).

[143] See e.g. Lucian Bebchuk and Mark Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 Stanford Law Review 127 (1999).

[144] Érica Gorga, *Changing the Paradigm of Stock Ownership from Concentrated Towards Dispersed Ownership? Evidence from Brazil and Consequences for Emerging Countries*, 29 Northwestern Journal of International Law and Business 439 (2009).

[145] Massimo Belcredi and Luca Enriques, in Research Handbook on Shareholder Power 383, 385 (Jennifer G. Hill and Randall S. Thomas eds., 2015).

generally manifested low levels of private benefits despite concentrated ownership structures.[146]

What, then, predicts the efficacy of minority shareholder protections and, by implication, the extent of private benefits of control? The literature suggests that many disparate factors matter, including legal rules, the general business culture, and even the competitiveness of the product markets.[147]

In line with the analysis of Chapter 3, we suggest that ownership structures, on the one hand, and legal protection of minority shareholders, on the other, are mutually reinforcing.[148] In jurisdictions where concentrated ownership prevails, controlling shareholders tend to block the enactment of laws that could curb their private benefits. By contrast, in jurisdictions where ownership is dispersed, institutions and the investing public are likely to have greater political clout in pushing for reforms that reduce minority expropriation. Our core jurisdictions seem to confirm this pattern.

In the UK, the interests of institutional shareholders dominate the institutions of lawmaking and enforcement, such as the Financial Conduct Authority (as UK Listing Authority), the Financial Reporting Council and the Takeover Panel. Large institutional investors are normally hands-off shareholders with every reason to oppose any form of suspected favoritism toward corporate controllers.

In the U.S., political influence is more evenly balanced between institutional investors and professional managers. But again, neither managers and institutional investors nor state courts and the SEC have reason to treat controlling shareholders with kid gloves. Stringent U.S. disclosure requirements, holding company regulations,[149] and taxation of intra-corporate distributions[150] are all indications of the comparative weakness of controlling shareholders under U.S. law. Delaware courts also take a tougher stance toward self-dealing by controlling shareholders than by officers and directors.[151] Finally, shareholder class actions and enforcement by the SEC are, respectively, very common and increasingly severe.

The case of Japan would seem to be similar in one respect. As we argue in Chapter 3, while a large percentage of shares of listed companies still lies in the hands of stable corporate shareholders, the amount held by each is usually small. As there is no controlling shareholder in these companies, the equal treatment norm is accepted without much opposition.[152]

By contrast, in jurisdictions such as France, Italy, and Brazil, where large shareholders control most listed companies, one assumes that controlling shareholders are a potent political influence. The fact that the state is a major shareholder in many companies in these countries—and is often a member of the controlling coalition in the companies in which it holds a non-controlling stake—further compounds the influence of

[146] See Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 Harvard Law Review 1641 (2006).

[147] See Dyck and Zingales, note 2. [148] See also Bebchuk and Roe, note 143.

[149] Roe, Strong Managers, Weak Owners, note 132, at 98.

[150] Randall Morck and Bernard Yeung, *Dividend Taxation and Corporate Governance*, 19 Journal of Economic Perspectives 163 (2005).

[151] See Chapter 6.2.5.

[152] Note, however, that managers who dominate listed companies do have an interest in providing benefits to friendly shareholders in order to maintain their support. For example, a company may financially assist employees' purchases of the company's shares. Provided there is a reasonable motivation (such as promotion of employees' welfare), this is not prevented by the equal treatment norm. Also, once hostile acquirers become a significant threat despite friendly shareholder support, managers gain an interest in discriminating among shareholders in order to facilitate warrant or rights-based takeover defenses. See Chapter 8.2.3.2.

controlling shareholders, as we noted in Chapter 3. Anecdotal evidence concords with the existing (albeit dated) empirical evidence to suggest that the minority–majority agency problem remains severe in these jurisdictions, despite legal efforts to mitigate it through increased mandatory disclosure, appointment rights for minority shareholders in Italy and Brazil, and pressure to add independent directors arising from listing standards or codes of best practice.[153]

4.4.2.2 Employee protection

In contrast to the weak correlation between formal law and minority shareholder protection, the correlation between law and employee protection is strong. German company law does, in fact, reallocate corporate power to unions and works councils through quasi-parity codetermination and co-decision rights.

The question then becomes: how effective is codetermination as an employee protection tool? In other words, what exactly can labor directors accomplish apart from the narrow goal of enhancing labor's bargaining power? In Germany they can influence business policies.[154] There is also evidence that codetermination may provide valuable insurance to skilled workers, protecting them against layoffs due to external shocks in exchange for lower wages.[155] But in addition to this, labor directors may also play an important informational role, at least in theory. Mutually wasteful bargaining behavior such as strikes and lock-outs result in part from distrust between firms and employees.[156] By credibly informing employees, labor directors might limit such costly bargaining behavior. Likewise, by revealing the firm's intentions, labor directors can alert workers about possible future plant closings and related layoffs. Whether employee representation at the board level actually improves industrial relations based on trust between labor and shareholders is impossible to say in the absence of econometric studies on the issue.

An alternative theory, with some empirical support in the literature, argues that codetermination *can* provide German supervisory boards with "valuable first-hand operational knowledge" that improves board decision-making and increases firm value in the subset of firms in which the need for intra-firm coordination is greatest.[157] Yet there is also evidence that quasi-parity codetermination in larger German firms reduces firm value[158]—and still other, non-comparable, studies finding that codetermination increases employee productivity or firm profitability.[159]

[153] See Chapter 3.3.1, and Sections 4.1.1 and 4.1.3.1.

[154] See Chapter 3.5.

[155] E. Han Kim, Ernst Maug, and Christoph Schneider, *Labor Representation in Governance as an Insurance Mechanism*, Working Paper (2016), at ssrn.com (skilled workers in German firms with quasi-parity codetermination receive wages that are 3.5 percent lower in exchange for protection against layoffs).

[156] See R.B. Freeman and E.P. Lazear, *An Economic Analysis of Works Councils*, in Works Councils: Consultation, Representation and Cooperation in Industrial Relations 27 (J. Roger and W. Streek eds., 1995). See generally John Kennan and Robert Wilson, *Bargaining with Incomplete Information*, 31 Journal of Economic Literature 45 (1993).

[157] Larry Fauver and Michael E. Fuerst, *Does Good Corporate Governance Include Employee Representation? Evidence from German Corporate Boards*, 82 Journal of Financial Economics 673, 679 (2006).

[158] See ibid. at 698–701; Gary Gorton and Frank A. Schmid, *Capital, Labor, and the Firm: A Study of German Codetermination*, 2 Journal of the European Economic Association 863 (2004).

[159] For a useful if partisan review, see Simon Renaud, *Dynamic Efficiency of Supervisory Board Codetermination in Germany*, 21 Labour 689 (2007). Renaud's strongly positive findings about the effects of quasi-parity codetermination on profitability and productivity are suspect because they rely on balance sheet data and fail to include the range of control variables found in the finance-oriented literature such as Fauver and Fuerst, note 157.

Moreover, the question remains: if large efficiencies result from codetermination, why do the parties fail to contract for labor directors voluntarily and divide the surplus? Why do we seldom see labor directors where they are not mandated by law? And if mandatory law is needed to overcome collective action problems associated with the introduction of voluntary codetermination, why is mandatory regulation necessary to sustain codetermination once it has been introduced? Although commentators have offered speculative economic answers to these questions,[160] the empirical literature again remains sparse.

There may also be ideological or cultural explanations for the dearth of employee directors outside of continental Europe. But a competing explanation is that the costs of labor representation exceed its benefits, or at least are feared to do so. One source of concern is the difficulty of bridging the sharply divergent interests of the board's constituent groups of employees and shareholders, or even among employees themselves, in framing policy or supervising management. Voting is a highly imperfect way of making decisions in the presence of such conflicts. Majority decision-making by a divided board risks opportunistic outcomes that diminish the value of the firm as a whole,[161] and is also likely to make for a costly and cumbersome decision-making process.[162]

In addition, strong labor representation on the board may exacerbate the agency conflict between managers and shareholders as a class. Managerial discretion plausibly increases if shareholder and labor directors split over corporate policy, or if large and divided supervisory boards lack the institutional capacity to monitor managers closely.[163] Indeed, managers may withhold information from boards with the acquiescence of shareholders to limit leaks to employees and competitors.[164] Strong labor may benefit managers, just as strong managers have proven to be loyal protectors of labor's interests in large Japanese companies, even without a regime of codetermination.[165]

[160] See e.g. Fauver and Fuerst, note 157, at 679 (proposing that firms may be deterred from adopting codetermination voluntarily by adverse selection in recruiting employees and managers, even if codetermination would increase firm value).

[161] Perhaps for this reason, the double voting right of the chairman of the supervisory board of codetermined corporations in Germany is very rarely used (its use is thought to undermine labor relations).

[162] It is nearly always the case that, in any given firm (whether investor-, employee-, customer-, or supplier-owned), the group of persons sharing ownership is remarkable for its homogeneity of interest. Even within investor-owned firms, for example, it is highly unusual for both preferred and common shareholders to share significant voting rights. Likewise, within entirely employee-owned firms it is rare for both managerial and line employees to share control (and voting rights are often given to the line employees, who tend to be more homogeneous). See Hansmann, note 75, at 62–4 and 91–2. This suggests that the appointment strategy is not easily adapted to resolve significant conflicts of interest.

[163] But see Fauver and Fuerst, note 157 (in some instances employee board representation may increase supervisory boards' monitoring capacity and thereby *reduce* agency costs).

[164] See Katharina Pistor, *Co-Determination in Germany: A Socio Political Model with Governance Externalities*, in Employees and Corporate Governance 163, 188–91 (Margaret M. Blair and Mark J. Roe eds., 1999). Pistor also provides an illuminating account of the practice of codetermination in German firms as forcing segmentation of the supervisory board into employee and management "benches," which meet separately prior to board meetings (a practice that the German Corporate Governance Code, in the one and only provision addressing codetermination, endorses) and always present a common front in formal meetings of the supervisory board. The common practice of forcing supervisory boards to review the auditor's report *at the board meeting*, but not permitting board members to receive a copy for close review, is emblematic of the informational restrictions placed by the management board on the supervisory board (ibid, 191).

[165] See Masahiko Aoki, *Toward an Economic Model of the Japanese Firm*, 28 Journal of Economic Literature 1 (1990).

Most directors in Japanese firms are managers who were promoted from within the ranks of the companies, and they tend to take the interests of core employees to heart.

So which side of the ledger dominates, the costs or the benefits of codetermination? At least in the case of German-style codetermination, the empirical literature is, as hinted, surprisingly mixed. Certainly large German firms survive and even flourish under the quasi-parity regime of employee representation, and it seems intuitively likely that codetermination has contributed to the heavy orientation of the German economy toward manufacturing exports. Nevertheless, it is difficult to tease out the opportunity costs suffered by the German economy as a result of strong-form codetermination.

4.4.2.3 External constituencies

Evaluating the correlation between formal law and the actual protection of non-contractual constituencies is exceedingly difficult. The interests of different stakeholders might conflict with one another, and measuring the impact of various strategies on overall social welfare is simply impossible. Moreover, the desirability of using corporate law to protect non-contractual constituencies hinges not only on its ability to protect stakeholders, but also on how it fares compared with regulation by other fields of law. As a result, any normative assessment of existing approaches to corporate law in different jurisdictions will be tentative at best.

There is good reason to be cautious about the use of corporate law to tackle broad social problems. Sometimes such attempts simply lack teeth. When fiduciary duties are enlarged to encompass non-contractual constituencies, they are usually unenforceable by those constituencies. Not only are there procedural constraints to enforceability (non-shareholders usually lack standing to sue), but even determining what general social welfare requires at any point in time is an insurmountable task even for directors—let alone for courts.

By contrast, state influence in corporate governance (by means of state ownership and, to a lesser extent, golden shares) is far more consequential. SOEs often pursue social (usually political) objectives that conflict with shareholder wealth maximization. Yet the effects of state ownership on overall social welfare are dubious, especially when regulatory alternatives are taken into account.[166]

More recently, policymakers have hoped that institutional investors, as "universal owners" exposed to the entire market, will act as stewards of the public good.[167] The new non-financial disclosure requirements, as well as recent reforms leading to greater shareholder empowerment in executive compensation decisions and otherwise, are at least partly premised (or at least gained further political traction based) on this assumption. However, diversified institutional shareholders usually lack both the knowledge and the incentives necessary for such interventions. And the undiversified shareholders

[166] See e.g. World Bank, Bureaucrats in Business: The Economics and Politics of Government Ownership (1995) (finding that state-owned factories pollute more than private factories); Andrei Shleifer, *State Versus Private Ownership*, 34 Journal of Economic Perspectives 133 (1998) (arguing that social goals are usually best addressed by government contracting and regulation).

[167] See e.g. European Commission, Green Paper: The EU Corporate Governance Framework (2011); http://ec.europa.eu; John Kay, The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report 74 (2012) ("institutional investors acting in the best interest of their clients should consider the environmental and social impact of companies' activities and associated risks among a range of factors which might impact on the performance of a company, or the wider interests of savers, in the long-term").

who are more likely to be influential, such as hedge funds, are usually uninterested in promoting goals other than financial returns.[168] In fact, a study on the reputational consequences for firms found liable of financial regulation violations in the UK found that breaches of rules designed to protect third parties actually resulted in a positive stock market reaction for the companies, suggesting the shareholders like firms to push the boundaries.[169]

Nevertheless, there seems to be a clear recent trend toward employing the legal strategies of corporate law to tackle broad social problems. Whether this is a functional response to government failures in addressing externalities, or merely window-dressing to deflect more fundamental regulatory reforms, remains an open question.[170] There is, however, reason to be skeptical about the ability of corporate law to significantly tackle concerns which reach far beyond the agency problems that form its core competency.

[168] Edward B. Rock, *Institutional Investors in Corporate Governance*, in Oxford Handbook of Corporate Law and Governance (Jeffrey N. Gordon and Wolf-Georg Ringe eds., 2016).

[169] John Armour, Colin Mayer, and Andrea Polo, *Regulatory Sanctions and Reputational Damage in Financial Markets*, Working Paper (2015), at ssrn.com.

[170] Pargendler, note 82.