3

The Basic Governance Structure: The Interests of Shareholders as a Class

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The law of corporate governance establishes the 'rules of the game'[1] among corporate constituencies. As we observed in Chapter 2, corporate law must address three fundamental agency problems: the conflict between managers (directors and senior executives) and shareholders, the conflict between controlling and minority shareholders, and the conflict between shareholders and non-shareholder constituencies. This chapter examines how the corporate governance structure mitigates the manager-shareholder conflict; Chapter 4 explores the role of governance in safeguarding minority shareholder and non-shareholder interests. Both chapters focus on publicly traded firms, although much of our discussion applies equally well to companies that are not actively traded.

Corporate governance builds largely on the appointment rights and trusteeship strategies detailed in Table 2–1. We begin by dilating on these strategies, which are *self*-enforcing in the limited sense that they empower a principal, or a disinterested trustee, to safeguard the principal's interests. Thus we focus less on enforcement in Chapters 3 and 4 than in subsequent chapters. We must note, however, that basic shareholder rights are *not* always enforced. Russia's negative experience during the mid-1990s is a cautionary reminder that 'self-enforcing' governance strategies still require an honest judiciary and a strong securities regulator to be effective.[2] Indeed, even in the U.S., there is discomforting evidence of shortcomings in the mechanics of shareholder voting.[3]

[1] Lucian A. Bebchuk, *Letting Shareholder Set the Rules*, 119 Harvard Law Review 1784 (2006).

[2] See Bernard Black, Reinier Kraakman, and Anna Tarassova, *Russian Privatization and Corporate Governance: What Went Wrong?*, 52 Stanford Law Review 1731 (2000).

[3] See Marcel Kahan and Edward B. Rock, *The Hanging Chads of Corporate Voting*, 96 Georgetown Law Journal 1227 (2008). While no one suggests that U.S. voting contests are rigged, incumbents often seem to enjoy an edge in closely-matched contests. See e.g. Yair Listokin, *Management Always Wins the Close Ones*, 10 American Law and Economics Review 159 (2008). See also *Hewlett v. Hewlett-Packard Co.*, 2002 WL 818091 (Del. Ch. 2002) (reviewing irregularities in the HP-Compaq proxy contest). The law in some other core jurisdictions appears to do more to allay

3.1 Appointment Rights and Shareholder Interests

Two features of the corporate form underlie corporate governance. The first is investor ownership, which, given the breadth of contemporary capital markets, implies that ultimate control over the firm often lies partly or entirely in the hands of shareholders far removed from the firm's day-to-day operations. The second is delegated management, which implies that shareholder influence is usually exercised indirectly, by electing directors.[4] Thus, a canonical feature of the corporation is a multi-member board—selected (largely or entirely) by shareholders—that is distinct from both the general meeting of shareholders and the firm's managing officers. The law addresses the shareholder-manager agency problem in the first instance by establishing and reinforcing the right of shareholders to appoint the members of the board. The effectiveness of this strategy depends, in turn, on the board's powers and resources, and on the capacity of shareholders to engage in collective action. In addition to this appointment strategy, many jurisdictions rely increasingly on the trusteeship role of independent directors as pillars of corporate governance.

3.1.1 Managerial power and corporate boards

The governance law of public or 'open' corporations is broadly similar in all of our core jurisdictions. It reserves certain fundamental decisions to the general shareholders meeting, while assigning much decision-making power to one- or two-tier boards of directors.

In single-tier jurisdictions such as the U.S., UK, and Japan, one board exercises the legal power to supervise *and* manage a corporation, either directly or through its committees.[5] By contrast, in two-tier jurisdictions, monitoring powers are allocated to elected supervisory boards of non-executive directors, which then appoint and supervise management boards that include the principal executive officers who design and implement business strategy. Germany and the Netherlands mandate two-tier boards for open domestic companies, while Italy and France permit domestic companies to choose between one- and two-tier boards, and firms in every EU jurisdiction may choose between one- and two-tier

concerns about voting irregularities. See, e.g., §§ 342–351 UK Companies Act 2006 (requiring an independent report on shareholder polling upon request of a qualified minority of shareholders).

[4] An exception to this generalization proves the rule. From 1971 until 2004, company law in the Netherlands placed certain large domestic corporations under a so-called *structuur* regime, in which new directors were selected by incumbent directors, subject to review by the commercial court to ensure adequate representation of shareholder and employee interests. For further discussion of the *structuur* regime and its replacement, see *infra* 4.1.3.1.

[5] East Asian jurisdictions heavily influenced by German law and Italy retain vestigial supervisory boards such as the board of auditors (Japan and Italy) or the board of supervisors (China). The powers of these secondary boards are generally limited, however.

boards by opting into the *Societas Europaea* (or SE), which allows either board structure.[6] Although the supervisory and management boards are in a semi-hierarchical legal relationship in the two-tier structure, the management board may be the more powerful of the two in fact. The management board enjoys independent legal status. Under German law, for example, the supervisory board cannot oust the management board without cause, cannot make business decisions reserved to the management board, and—on certain matters—may even be overruled if a recalcitrant management board can obtain the support of a super-majority shareholder vote.[7] In practice, a company's most influential single actor can be the chair of either its supervisory or its management board, depending upon ownership structure and the personalities involved.[8]

In theory, single-tier boards concentrate decision-making power, while two-tier boards favor collective decision-making. For example, a single-tier board permits firms to combine the roles of board chairman and chief executive officer ('CEO'), as commonly happens in the U.S. and France.[9] By contrast, two-tier jurisdictions such as Germany bar supervisory boards from making managerial decisions, and, as a statutory default, requires that management boards make decisions by majority vote.[10] Both approaches to the management of large firms have potential advantages.[11] But two considerations caution against generalizing about these advantages in our core jurisdictions. First, the extent of the distinction between the two board structures is often unclear. Informal leadership coalitions can cross-cut the legal separation between management and supervisory boards;[12] while supermajorities of independent directors and an independent chairman can give single-tier boards a quasi-supervisory flavor.

[6] For France see Art. L. 225–57 Code de commerce. For Italy see Art. 2409–8 to 2409–15 Civil Code. For the SE, see Art. 38 Council Regulation (EC) No 2157/2001 of 8 October 2001, 2001 O.J. (L 294) 1.

[7] §§ 111 IV and 119 II Aktiengesetz (AktG).

[8] For example, a controlling shareholder who chairs a firm's supervisory board is likely to be its dominant actor. In addition, past German practice has sometimes blurred the separation between the two boards by elevating retired members of the management board, and particularly its chair, to the supervisory board. Recently, the non-binding German Corporate Governance Code has limited the number of former management board members on the supervisory board to two, and required 'special reasons' for the election of a former management board member as chairman of the supervisory board (Art. 5.4.2 and 5.4.4).

[9] The UK is the exception among single-tier jurisdictions: Art. A.2.1 of the Combined Code of Best Practices calls for a clear division of responsibility between a company's chairman and chief executive officer.

[10] § 77 Aktiengesetz.

[11] An extensive literature in social psychology explores the systematic differences in group versus individual decision-making and problem-solving. See, e.g., Samuel N. Fraidin, *When Is One Head Better Than Two? Interdependent Information in Group Decision Making*, 93 Organizational Behavior and Human Decision Processes 102 (2004); Norbert L. Kerr and R. Scott Tindale, *Group Performance and Decision Makingg*, 56 Annual Review of Psychology 623 (2004).

[12] Often, in German companies with no controlling shareholders, the management board de facto picks the supervisory board. See Klaus J. Hopt and Patrick C. Leyens, *Board Models in Europe—Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France and Italy*, 1 European Company and Financial Law Review 135, 141 (2004).

Second, labor codetermination in Germany, the most prominent two-tier jurisdiction, weakens the supervisory board as a governance organ devoted exclusively to the interests of the shareholder class. We address the governance features of codetermination further in Chapter 4. Here we merely note that the two-tier board structure facilitates strong labor participation in corporate governance in part because full access to sensitive information and business decision-making can remain with the management board, thereby mitigating potential conflicts of interest on the supervisory board.

3.1.2 Nominating directors and the mechanics of voting

In addition to board architecture, the legal aspects of corporate governance include a wide variety of rules governing director nomination and shareholder voting.

All of our core jurisdictions apart from the U.S. allow shareholders to nominate directors. Ordinarily the board proposes the company's slate of nominees,[13] which is rarely opposed at the annual shareholders meeting. But in most jurisdictions, a qualified minority (usually a small percentage) of shareholders can contest the board's slate by adding additional nominees to the agenda of the shareholders' meeting.[14] Insurgent candidates who are nominated in this fashion face the same up-or-down vote as the company's own nominees. In contrast to this model, however, insurgent shareholders in the U.S. cannot place nominees on the company's proxy or on the agenda of the shareholders' meeting as of right, but must instead solicit their *own* proxies and distribute their own solicitations—i.e., ballots, registration statements (subject to SEC review), and supporting materials—to contest the company's slate of nominees.[15]

Voting rules for board seats at the annual meeting follow a similar pattern. Our core jurisdictions other than the U.S. follow a majority voting rule, under which directors are elected by a majority of the votes cast at the shareholders'

[13] In Italian listed companies, the incumbents' slate of candidates is formally presented by dominant shareholders, usually in coordination with the managers.

[14] In the UK the default rule is that any shareholder can present her own board candidates in advance of the meeting (Art. 76, Table A). Similarly, in German companies any shareholder can add her own candidates up to two weeks before the meeting (§ 127 AktG). In Japan a qualified minority (1% of votes or 300 votes) may propose its own slate of candidates, which the company must include in its mail voting/proxy documents. Art. 303 and 305 Companies Act. In Italy the quorum for the proposal of a slate of candidates varies from 0.5% for the largest companies (by capitalization) to 4.5% for the smaller ones. Art. 144–4 Consob Regulation on Issuers.

[15] 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, 746 (2005). U.S. securities law allows shareholders to append certain proposals to the company's proxy, but it expressly excludes resolutions relating to the election of directors. 17 C.F.R. § 240.14a–8 (2008). See also *infra* 3.1.4. The management community has fiercely resisted reform efforts to allow a qualified minority of shareholders to place their own nominees on the company's proxy.

meeting. By contrast, the statutory default in the U.S. is a 'plurality' voting rule, under which any number of votes suffices to elect a nominee to a board seat.[16] Under this rule, even few favorable votes can elect an entire slate of nominees because dissidents cannot vote *against* the company's nominees: they can only vote a competing slate of nominees, when there is one.[17] Thus, U.S. shareholders cannot block a company's nominees without waging a costly proxy contest. However, U.S. voting practices are currently in flux. Delaware has undertaken a modest statutory reform,[18] and institutional investors have prompted some U.S. companies to opt into majority voting.[19]

Another important aspect of the voting system comprises the rules that regulate—or fail to regulate—the distribution of voting power among classes of shareholders and between nominal and beneficial shareholders. Corporate laws generally embrace the default rule that each stock carries one vote. But all jurisdictions permit some deviations from this one-share/one-vote norm, even while they prohibit or limit others. Thus, all of our core jurisdictions limit circular voting structures[20] and vote buying by parties antagonistic to the interests of shareholders as a class. Germany, Italy, and Japan ban voting caps (i.e., limits on the number of votes a single shareholder may cast) and place limits on dual-class shares that allow controlling shareholders to maintain control while ratcheting down their economic stakes.[21] By contrast, however, all of our jurisdictions

[16] See, e.g., § 216(3) Delaware General Corporation Law.

[17] However, U.S. dissidents can withhold favorable votes for board nominees to express dissatisfaction with company policies. Shareholder activists often wage withhold-the-vote campaigns to bring pressure on the board even if they cannot change its composition. Contested elections for U.S. companies' boards are rare. See Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 Virginia Law Review 675, 688 (2007).

[18] See § 216(4) Delaware General Corporation Law (barring the board from revoking a stockholder bylaw requiring a majority vote for directors).

[19] See Jay W. Verret, *Pandora's Ballot Box, or a Proxy with Moxie? Majority Voting, Ballot Access, and the Legend of Martin Lipton Re-Examined*, 62 The Business Lawyer 1007, 1043 (2007).

[20] Most jurisdictions forbid subsidiaries from voting the shares of their parent companies. Art. L. 233–31 Code de commerce (France); Art. 2359–2 Civil Code (Italy); Art. 308(1) Companies Act (Japan); § 160(c) Delaware General Corporation Law; § 135 Companies Act 2006 (UK). German law bars subsidiaries from owning shares of their parents except in special circumstances (§71d AktG). A number of countries also ban voting in the case of cross-shareholdings by companies that are in no parent-subsidiary relationship. In Italy the relevant threshold (for listed companies only) is 2%, while it is 10% in France, and 25% in Germany. 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.

[21] For Germany see § 134(1) (voting caps allowed only in non-listed companies), § 12(1) and § 139 (non-voting shares allowed only up to one half of the share capital), and § 12(2) (multiple voting rights banned) Aktiengesetz. For Japan, see Art. 115 Companies Act (shares with restricted voting rights cannot exceed half of the total issued shares); as far as voting caps are concerned, the law is not clear but the Tokyo Stock Exchange is likely to delist companies where ceilings result in an unreasonable restriction of shareholders rights (see Shearman & Sterling, LLP, Proportionality between Ownership and Control in EU Listed Companies: Comparative Legal Study—Exhibit C, Part 2, 357 (2007) at http://www.ecgi.de/osov/final_report.php. For Italy see Art. 2351(2) (non-voting shares cannot exceed half of the outstanding capital), 2351(3) (voting caps allowed only in non-listed companies) and 2351(4) (multiple voting

permit share ownership structures that have effects identical to those of dual-class shares, such as corporate pyramids.[22]

Why is there such disparate treatment of the separation of control from economic interest in shares, both among jurisdictions and within them? One answer is that there is no convincing theoretical or empirical support for a one-share/one-vote rule.[23] Another is that many strategies for separating votes from shares are difficult to regulate. The traditional corporate pyramid illustrates both points. It is arguably efficient insofar as it permits talented controlling shareholders to leverage their own capital by inviting public participation in their enterprises (and it is widely used to finance family-owned businesses throughout the world). In addition, it cannot be banned outright without crippling the partially-held subsidiary as a viable ownership structure.[24]

A less traditional example of separating control rights from cash-flow rights is so-called 'empty voting', in which activists use stock lending, equity swaps, and other derivatives to acquire naked votes in corporations in which they may even hold a net short position.[25] Empty voting is difficult to detect (at least without disclosure reform), and, like vote buying, it can be used to undermine shareholder welfare. Needless to add, it has also attracted the focused attention of corporate lawmakers.[26]

3.1.3 The power to remove directors

Removal rights follow appointment rights. Indeed, one might say that directors are normally 'removed' by dropping their names from the company's slate or by failing to reelect them. It follows that the length of directorial terms can be critical. Longer terms provide insulation from proxy contests, temporary shareholder

rights banned) Civil Code. Note also that voting caps can entrench managers as well as protect minority shareholder interests, while circular voting structures and cross-holdings can entrench controlling minority shareholders as well as managers.

[22] 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).

[23] See e.g. Mike Burkart and Samuel Lee, *The One Share-One Vote Debate: A Theoretical Perspective*, (2007), at http://www.ssrn.com; Renée Adams and Daniel Ferreira, *One Share, One Vote: The Empirical Evidence*, 12 REVIEW OF FINANCE 51 (2008).

[24] Such structures are extremely common but difficult to regulate except, perhaps, through tax law. See, e.g., Randall K. Morck, *How to Eliminate Pyramidal Business Groups: The Double Taxation of Intracorporate Dividends and Other Incisive Uses of Tax Policy*, in TAX POLICY AND THE ECONOMY 135 (James M. Porterba (ed.), 2005). See generally TAX AND CORPORATE GOVERNANCE (Wolfgang Schön (ed.), 2008).

[25] 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).

[26] Rule 8.3 of the UK Takeover Code, as amended in May 2006, requires 'contracts for differences' (i.e., equity swaps) and similar derivative contracts held during an offer period to be disclosed if they affect more than 1% of the underlying securities.

majorities, and even powerful CEOs. Among our core jurisdictions, directorial terms range from two in the case of Japan, to no limits at all in the case of the UK (where private companies occasionally appoint directors for life).[27] U.S. terms fall somewhere in the middle, with a default of one year and a maximum in most cases of three or four years for staggered or classified boards.[28] By contrast, corporations in Germany and France usually elect directors for five- or six-year terms respectively, the maximum that their statutes permit.[29]

A second aspect of removal rights is the power to remove directors *before* the end of their terms. British, French, Italian, and Japanese law all accord shareholder majorities a non-waivable right to remove directors mid-term without cause.[30] Our remaining jurisdictions provide weaker removal rights. The German default rule allows three-quarters of voting shares to remove a shareholder-elected supervisory board member without cause.[31] The most important U.S. jurisdictions treat the right to remove directors without cause as a statutory default subject to reversal, either by a charter provision on point,[32] or by disallowing removal without cause for classified boards.[33] In addition, Delaware indirectly cabins removal rights by denying shareholders the power to call a special shareholders' meeting unless the company's charter expressly so provides.[34]

Thus, removal rights generally track appointment rights. Jurisdictions with 'shareholder-centric' laws on the books—the UK, France, Japan, and Italy—provide shareholders with non-waivable removal powers as well as robust nomination powers. 'Board-centric' Delaware—the dominant U.S. jurisdiction—weakens removal powers by allowing staggered boards and discouraging special shareholders' meetings. The correlation between appointment and removal powers breaks down principally for German companies, whose shareholders have strong appointment rights (for 'their' supervisory board seats)

[27] Art. 332(1) Companies Act (Japan); Paul L. Davies, GOWER AND DAVIES' PRINCIPLES OF MODERN COMPANY LAW 389 (8th ed., 2008) (UK). The maximum term for directors of Italian companies is 3 years. Art. 2383, Civil Code.

[28] In a staggered or classified board, only a fraction of the board is elected each year. For example, Delaware General Corporation Law requires that at least one third of the directors be elected annually (§141(d)) where there is a single class of voting stock. Longer terms are possible, however, where corporate charters provide for multiple classes of voting stock.

[29] § 102 I AktG (Germany); Art. L. 225–18 Code de commerce (France).

[30] § 168 and §303 Companies Act 2006 (UK), Art. L. 225–18 Code de commerce and 225–103 (France); Art. 2383 and 2367, Civil Code and Art. 126–2, Consolidated Act on Financial Intermediation (Italy) (all providing for removal within term and setting minimum thresholds to call special meetings in publicly traded companies). Art. 339(1) Companies Act (Japan) (simple majority required for removal without cause).

[31] § 103 I AktG (Germany).

[32] See § 8.08(a) Revised Model Business Corporation Act.

[33] See § 141(k) Delaware General Corporation Law.

[34] See §§ 211(b) and 211(d) Delaware General Corporation Law. Note that the majority of Delaware companies now going public opt into staggered boards as well as other charter provisions that make the removal of directors difficult. See Lucian A. Bebchuk, John C. Coates, and Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STANFORD LAW REVIEW 887 (2002).

but can only oust directors from lengthy terms by means of a supermajority vote.[35] (Indeed, German law favors stability on the management board as well, by insulating its members from abrupt removal by the supervisory board.[36])

3.1.4 Facilitating collective action

A final aspect of governance rules is the extent to which they empower dispersed shareholders. Diffuse stock ownership presents shareholders with formidable collective action problems in attempting to exercise their control rights. All of our target jurisdictions address this problem—up to a point.

Voting mechanisms are a conspicuous example. Small shareholders everywhere can exercise their voice at shareholder meetings through one of three mechanisms: mail (or distance) voting, proxy solicitation by corporate partisans, and proxy voting through custodial institutions or other agents. For example, Japanese law allows mid-size and large firms to choose either proxy or mail voting.[37] Mail voting requires the distribution of 'universal ballots', which permit shareholders to vote on all board nominees in lieu of giving proxies to partisan agents who ultimately vote at shareholders' meetings. Likewise, France, Germany, and Italy allow corporations to opt for distance voting,[38] which also enables shareholders to submit universal ballots.[39] By contrast, only the U.S. and the UK rely exclusively on proxy voting among our core jurisdictions.[40] In the UK proxy fights are relatively rare, since prior negotiation among institutional investors often resolves conflicts.[41] It matters in the U.S., however, where shareholders exercise relatively less influence over managers and the costs to insurgents of nominating candidates and soliciting proxies are high.[42]

[35] § 103 AktG. [36] § 84 AktG.

[37] Japanese firms with 1000 or more shareholders must make this choice. Art. 298(1)(iii), 298(2) and 301 Companies Act. Mail voting is also optional for smaller companies, and voting by electronic means is optional for all Japanese companies. Art. 298(1)(iv) Companies Act. In practice most large public Japanese firms adopt mail voting rather than proxy voting.

[38] Art. L. 225–107 Code de commerce (France); Art. 2370(4) Civil Code and Art. 127 Consolidated Act on Financial Intermediation (Italy). For Germany, see the 2001 law on registered shares and on facilitating the exercise of the right to vote (NaStraG).

[39] See Ulrich Noack and Michael Beurskens, *Internet-Influence on Corporate Governance—Progress or Standstill?*, 3 European Business Organization Law Review 129, 146 (2002).

[40] The NYSE mandates proxy solicitation for 'operating' listed U.S. firms except where solicitation would be impossible (Rule 402.04(A) Listed Company Manual). See also Rules 4350(g) and 4360(g) NASDAQ Marketplace Rules (same). No such law or listing requirement exists in Germany, France, Italy, the UK, or Japan. Note that Art. 12 of the Shareholders' Rights Directive (Directive 2007/36/EC, 2007 O.J. (L 184) 17) will require also the UK to grant all 'traded companies' the right to opt for distance voting, though whether this will change UK corporate practice remains to be seen.

[41] Julian R. Franks, Colin Mayer, and Stefano Rossi, *Ownership: Evolution and Regulation*, The Review of Financial Studies (forthcoming 2009) at http://www.ssrn.com.

[42] Heavy regulation of proxy solicitation was a major obstacle to insurgent shareholder action in the U.S. until 1992, when the SEC relaxed many of its filing and disclosure requirements. Regulation of Communication Among Shareholders, Exchange Act Release No. 34–31326 (1992).

Broadly speaking, all institutions that invest in the market on behalf of multiple beneficiaries can be seen as aggregating control rights, and therefore reducing the collective action problems of disaggregated investors. Indeed, many institutions with financial obligations to their beneficiaries or customers—including pension funds, mutual funds, unit trusts, and insurance companies—have long championed shareholder interests in the UK and the U.S.[43] By contrast, purely custodial institutions have no financial interest in the shares they hold, and have traditionally favored company nominees to the extent that they have been empowered to vote custodial shares. For example, U.S. brokerage houses vote their custodial shares in favor of uncontested company nominees,[44] while continental European custodians, such as banks and foundations, traditionally played an even stronger, pro-incumbents role in corporate governance.[45] In Germany, for example, where supervisory boards could not (or did not) engage in partisan proxy solicitation,[46] banks served as depositories for shares, and customarily voted these shares for company nominees by implicit consent.[47] After financial pressures[48] and legal reform[49] largely curbed this practice in the 1990s, voting outcomes in widely held German companies have occasionally become less predictably pro-management.[50]

Indeed, significant barriers to shareholder collective action still remain, including registration and disclosure requirements for any 5% 'group' of shareholders whose members agree to coordinate their votes. See SEC Rule 13d–5 (17 C.F.R. § 240.13d–5 (2008)). Regulation today is not entirely unfavorable for U.S. insurgents, however. The law also benefits them by, for example, forcing extensive corporate disclosure, ensuring that insurgent proxy materials actually reach shareholders, and often allowing small shareholders to piggyback shareholder proposals onto a company's proxy form. Finally, the U.S. is our only core jurisdiction to allow *ex post* compensation of successful insurgents for their campaign expenses. See, e.g., *Rosenfeld v. Fairchild Engine & Airplane Corp.*, 128 N.E. 2d 291 (N.Y. 1955).

[43] See Geof P. Stapledon, Institutional Shareholders and Corporate Governance (1996).

[44] A proposal to ban this is still pending. See NYSE proposed amendment to Rule 452 (Giving Proxies by Member Organization), at http://www.nyse.com/press/1161166307645.html.

[45] Italy is an exception, because proxy voting by banks was prohibited in 1974 and only became legal again in 1998. There is no evidence today of banks' involvement in shareholder meetings.

[46] See Karsten Schmidt, Gesellschaftsrecht 854 (4th ed., 2002).

[47] Small shareholders could always instruct their banks as to how to vote their shares. See § 128 Aktiengesetz. But they rarely gave explicit instructions. Mark J. Roe, *Some Differences in Corporate Structure in Germany, Japan, and the United States*, 102 Yale Law Journal 1927, 1942 (1993).

[48] See Dirk Zetzsche, *Die Aktionärslegitimation durch Berechtigungsnachweis—von der Verkörperungs- zur Registertheorie (Teil 2)*, 4 Der Konzern 251, 251–2 (2007).

[49] See Eric Nowak, *Investor Protection and Capital Market Regulation in Germany*, in The German Financial System 425, 436 (Jan P. Krahnen and Reinhard H. Schmidt (eds.), 2004), which reviews new curbs on proxy voting by banks. Another law reform was the provision for companies to appoint independent shareholder representatives empowered to exercise the proxies of shareholders wishing to vote. § 134(3) AktG.

[50] Anecdotal evidence includes the resignation of Deutsche Börse's Chairmen of the supervisory and management boards after activist investors' pressure made it clear that they would have faced a vote of dismissal at the general meeting. See Norma Cohen and Patrick Jenkins, *D Börse Chiefs Agree to Step Down*, Financial Times (Europe), 10 May 2005, at 1. For evidence of the decline in bank influence in Germany see Dirk Zetzsche, *Explicit and Implicit System of Corporate*

3.2 The Trusteeship Strategy: Independent Directors

Among our core jurisdictions, the principal trusteeship strategy today for protecting the interests of disaggregated shareholders—as well as minority shareholders and non-shareholder corporate constituencies—is the addition of 'independent' directors to the board. Of course, 'independence' (and trusteeship) is a matter of degree. At minimum, lawmakers create a measure of trusteeship simply by defining a subset of the firm's managers as 'directors', who are equipped with unique powers and face unique liabilities. Such manager-directors assume more of the credit or blame for company performance than other managers, and are therefore likely to have greater allegiance than other managers to the welfare of the company and its shareholders. At the other extreme, corporate law might rely entirely upon the trusteeship strategy, and entirely abandon the appointment strategy, by mandating that the board be self-appointing with no dependence on, or duty to represent, any constituency other than the corporation in its entirety. While the latter approach is not taken today by any of our leading jurisdictions—or by any others that we know of—it was until recently approximated by the *structuur* regime in the Netherlands.[51] It is, moreover, the form of governance characteristic of large nonprofit corporations,[52] and the one adopted by the many—generally quite successful—business firms in northern Europe that have been (re)organized as industrial foundations.[53]

The increasingly common requirement that some or all members of a corporation's board of directors not be senior executives of the firm reflects the trusteeship strategy in that it removes one conspicuous high-powered incentive for directors to favor the interests of the firm's management at the expense of other constituencies. If, however, such non-executive directors are directly appointed by managers, shareholders, or other stakeholders as constituency representatives, their independence may be little more than token. For example, although

Control—A Convergence Theory of Shareholder Rights, Working Paper (2004), at http://www.ssrn.com. Until recently, the Netherlands went further than any other European jurisdiction in allowing a particular kind of custodial intermediary to strip shareholders of their vote. This intermediary, which was in place in many of the largest Dutch listed companies, was the specialized voting trust (*administratie Kantoor*), authorized by statute and established by the corporation itself, which held and voted the corporation's stock and issued the beneficial owners of this stock non-voting trust certificates in its place. A recent law reform restored some voting power to beneficial owners: except in certain circumstances (e.g., when a hostile takeover is imminent), holders of trust certificates in publicly-held corporations now have the statutory right to obtain a proxy to exercise the voting rights on the underlying shares. See e.g. Peter Van Schilfgaarde and Jaap Winter, Van de NV en de BV 198 (2006).

[51] See *supra* note 4.

[52] See Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 Yale Law Journal 835–901 (1980).

[53] See Steen Thomsen and Caspar Rose, *Foundation Ownership and Financial Performance: Do Companies Need Owners?*, 18 European Journal of Law and Economics 343 (2004).

German law excludes top managers from the supervisory board, it reflects a dual appointment strategy rather than a trusteeship strategy to the extent that the board is comprised of shareholder members who depend, financially or otherwise, on shareholder interests, and of labor members similarly dependent on labor interests. France limits the number of employees (and hence managers) on the boards of public companies to one third,[54] but this rule too reflects trusteeship only to the extent that the remaining two-thirds of the board are free of strong ties to large blockholders.

Truly independent directors are board members who are not strongly tied by high-powered financial incentives to any of the company's constituencies but who are motivated principally by ethical and reputational concerns. That is, of course, our definition of a trustee. As noted earlier in this chapter, all of our core jurisdictions including Japan[55] now recognize a class of 'independent' directors in this sense, and most jurisdictions actively support at least some participation by these directors on key board committees. The U.S. is the originator of this form of trusteeship and still its most enthusiastic proponent. U.S. case law generally encourages independent and non-employee directors, while U.S. exchange rules now require that company boards include a majority of independent directors and that key board committees be composed by a majority of independent directors or entirely of them.[56] In addition, the U.S. Sarbanes-Oxley Act requires publicly traded companies to have wholly independent audit committees with the power and the duty to select outside auditors.[57]

Our EU jurisdictions promote independent directors through the less compulsory 'codes of best practices', which we address in Section 3.3 below, except that the EC Audit Directive now requires listed companies (and other 'public-interest entities' such as banks) to have at least one independent director with financial sophistication.[58]

[54] See Art. L. 225–22 Code de commerce. See also *infra* 4.2.1.

[55] Japanese law now provides for the trusteeship strategy in the form of a choice between statutory auditors, at least half of whom must be independent, or a tripartite structure of board committees staffed by majorities of independent directors. See *infra* text accompanying notes 85–92. As of this writing, the vast majority of Japanese firms prefer the traditional statutory auditor system over the Western-style system of committees dominated by independent directors.

[56] See Rules 303A.01 (listed companies must have a majority of independent directors) and 303A.04–05 (nominating/corporate governance and compensation committees composed entirely of independent directors) NYSE Listed Company Manual; Rule 4350(c)(1) (majority of independent directors required) and Rules 4350(c)(3)–(4) (compensation and nominations committees comprised solely of independent directors; one out of three members may lack of independence provided that she is not an officer or a family member of an officer) NASDAQ Marketplace Rules. Audit committees must comply with Section 10A, Securities Exchange Act of 1934, 15 U.S.C. § 78a (2008) (each audit committee member shall be independent): see Rule 303A.06 NYSE Listed Company Manual and Rule 4350(d) NASDAQ Marketplace Rules. For Japan, see Art. 2(15) Companies Act (definition of outside director).

[57] Sarbanes-Oxley Act of 2002 [SOX] § 301.

[58] Art. 41(1). Companies may opt to appoint the independent accounting or auditing expert as a member of a separate body (such as the Italian board of auditors) instead of qualifying her as a director.

Thus, trustee-like directors are widely considered to be a key element of good governance. In the U.S., they are most often seen as monitors of managers or controlling shareholders (although this task might be better performed by directors who were *dependent* on shareholder—or minority shareholder—interests[59]). In EU jurisdictions with concentrated ownership structures, independent directors are more likely to be seen as champions of minority shareholders or non-shareholder constituencies.[60] Put differently, trustee-like directors are a wide-spectrum prophylactic. They are potentially valuable for treating all agency problems, but not exclusively dedicated to treating any. Moreover, they come at a price, since there is an inevitable tradeoff between a director's independence and her knowledge about the company.[61] It is, then, not so surprising that the empirical literature has yet to find a significant correlation between independent directors as a percentage of board members and corporate performance.[62]

3.3 Board Structure and International Best Practices

Since both the appointment and trusteeship strategies operate through the board, their success depends in no small part on the board's capabilities—or, more particularly, on its incentives, professionalism, legal powers, committee structure, size, and resources. From the mid-1980s onwards, efforts at governance reform have attempted to increase the board's efficacy along one or more of these dimensions. In particular, commentators tie good governance to a range of so-called

[59] See, e.g., Ronald J. Gilson and Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 Stanford Law Review 863 (1991).

[60] The NYSE definition of independence excludes large blockholders (Rule 303A.02 NYSE Listed Company Manual); most EU jurisdictions consider large shareholders or their appointees 'dependent' (UK: Art. A.3.1 Combined Code of Best Practices; Italy: Art. 3.C.1 Corporate Governance Code; in France, a stricter evaluation of independence is required for shareholders holding more than 10% of votes or outstanding capital, see AFEP and MEDEF, The Corporate Governance of Listed Corporations, § 8.5 (2003)); Japan considers holding company appointees to operating company boards to be independent (see Art. 2(15) Companies Act and Tokyo Stock Exchange, Principles of Corporate Governance for Listed Companies 18 (2004)).

[61] For discussion of the tradeoffs between independence and information on the board, see Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of shareholders Value and Stock Market Prices*, 59 Stanford Law Review 1465, 1506–7 (2007). Gordon's important article argues that increasingly informed share prices in the U.S. permit increasingly less informed but more independent outside directors. See *id.* at 1541–63. But see Enrichetta Ravina and Paola Sapienza, *What do Independent Directors Know? Evidence From Their Trading* (2006), at http://www.ssrn.com (finding that independent directors do almost as well as insiders in trading company stock, which suggests that they are well informed).

[62] For an extensive review of the literature on independent directors in the U.S., see Gordon, *supra* note 61, at 1500–9. For evidence that firms with more outside directors do not outperform those with fewer in Japan, see Yoshiro Miwa and J. Mark Ramseyer, *Who Appoints Them, What Do they Do? Evidence on Outside Directors from Japan*, 14 Journal of Economics, Management & Strategy 299 (2005).

'best practices'. Chief among these are size (small is better); committee structure (independent audit, compensation, and nominating committees are good); independence from management, controlling shareholders, or both (more is better); and separation of the roles of board chairman and CEO (independent chairmen are good).

3.3.1 National codes of best practices

Before reviewing these practices in detail, however, we detour slightly to address the remarkable efflorescence of 'soft law' in the form of codes of best practice, which now does much of the work in shaping board structure in European companies.

Following the UK's lead, all EU jurisdictions have now adopted a 'corporate governance code',[63] i.e., guidelines for listed companies that address board composition, structure, and operation, and are drafted by market participants under the aegis of an exchange or regulatory authority. Listed companies are not legally bound to follow these guidelines. Instead, they have an obligation—under listing rules, as in the UK, or under corporate law, as in Germany—to report annually whether they comply with code provisions and, if they do not comply, the reasons for their noncompliance.[64] This device is intended to enlist reputation, shareholder voice, and market pressure to push companies toward best practices, while simultaneously avoiding rigid rules in an area where one size clearly does not fit all.[65]

In general, voluntary codes of best practice seem to be most influential in countries such as the UK, where institutional shareholders are powerful and the financial press is sensitive to governance issues.[66] To be sure, *reported* compliance rates are high and increasing in all jurisdictions that have adopted corporate governance codes.[67] But reported rates may be misleading. Companies may

[63] In the wake of several corporate scandals and a consequent fear of direct government intervention the City of London first issued a corporate governance code in 1992 (Sir Adrian Cadbury, Report of the Committee on the Financial Aspects of Corporate Governance (1992)).

[64] See LR 9.8.6 UK Listing Rules; for Germany, § 161 AktG.

[65] As one of the coauthors of this book has noticed, however, even corporate governance codes may have a '*de facto* one-size-fits-all' effect, because market participants may prefer standardization to tailor-made solutions and hence punish deviations from codes recommendations with lower stock prices even when these would be in shareholders' interest. See Gérard Hertig, *On-Going Board Reforms: One Size Fits All and Regulatory Capture*, 21 Oxford Review of Economic Policy 269, 273–4 (2005).

[66] Formal enforcement of codes is of secondary importance everywhere. See Eddy Wymeersch, *The Enforcement of Corporate Governance Codes*, 6 Journal of Corporate Law Studies 113 (2006).

[67] For the UK see e.g. Sridhar Arcot and Valentina Bruno, *In Letter but not in Spirit: An Analysis of Corporate Governance in the UK* (2006), at http://www.ssrn.com; for France see AMF, *AMF 2008 Report on Corporate Governance and Internal Control* (2009) at http://www.amf-france.org; for Italy and Germany see Eddy Wymeersch, *The Corporate Governance 'Codes of Conduct' Between State and Private Law*, 26–7 (2007), at http://www.ssrn.com.

claim to comply when, in fact, they behave strategically to avoid the 'spirit' or even the letter of national codes. The debacle surrounding the Italian listed company Parmalat provides an illustration. A few months before its collapse, Parmalat declared (among other things) its full compliance with the Italian code principle requiring 'an adequate number' of independent directors—a statement whose obvious inaccuracy went entirely unnoticed at the time.[68] Even in the case of the UK, where full compliance with the combined code hovers in excess of 50% of listed companies, almost 10% choose not to comply and fail to give a reason, in flagrant breach of the FSA's listing rules.[69]

National codes of best practices enforced by the 'comply-or-explain' rule are in place outside the EU as well.[70] Yet, two of our core jurisdictions lack such a code, the U.S. and Japan. In the U.S., the lack of a soft national code of best practices is not particularly puzzling. U.S. 'hard law' has already done much of the work: that is, listing rules, federal law, or the quasi-legislative opinions of the Delaware courts have *already* forced large companies to adopt most of the best practices that the EU codes recommend. Outside directors formed a majority in most U.S. boards from the 1970s onwards; and as early as 1978, the NYSE required listed companies to appoint audit committees staffed by independent directors.[71] Delaware courts and U.S. federal tax law have also encouraged publicly traded companies to increase the numbers and responsibilities of independent directors in the last few decades.[72] And governance requirements were further tightened by the changes in law and listing rules that followed in the wake of the Enron and WorldCom debacles.

In Japan, the Tokyo Stock Exchange has promulgated a limited set of voluntary governance recommendations that do not include a comply-or-explain mandate. These recommendations accommodate both the Western-style independent director model of the board and the traditional Japanese model, in which the board is dominated by inside managers who are monitored by a board of auditors (or a recent variant of this model). Thus, Japan is an outlier among our core jurisdictions to the extent that its norms of best practices do not implicitly encourage

[68] The corporate governance statement candidly reported that the board included *three* 'independent' directors out of 13: one the personal accountant (and schoolmate) of the dominant shareholder and CEO; a second a personal lawyer to the CEO; and the third a director in a banking group closely associated with Parmalat. See Guido Ferrarini and Paolo Giudici, *Financial Scandal and the Role of Private Enforcement: The Parmalat Case*, in AFTER ENRON 159, 174 (John Armour and Joseph A. McCahery (eds.), 2006).

[69] See Arcot and Bruno, *supra* note 67, at 3.

[70] For a comprehensive list of corporate governance codes around the world, including codes that are not backed by a 'comply or explain' strategy, see http://www.ecgi.org/codes/all_codes.php.

[71] See e.g. Mark S. Beasley, *An Empirical Analysis of the Relation Between the Board of Director Composition and Financial Statement Fraud*, 71 THE ACCOUNTING REVIEW 447 (1996).

[72] For example, approval by independent directors earns U.S. managers more relaxed judicial review of self-interested decisions, greater leverage over the dismissal of shareholder suits, and even eligibility for favorable tax treatment of management compensation plans. See Gordon, *supra* note 61, at 1480–3.

the large-scale appointment of independent directors.[73] In practice, however, many companies that follow the traditional Japanese model of board composition include independent directors on their boards.

3.3.2 Best practices and board structure

Japan aside, the canon of best practices in corporate governance is remarkably similar across our jurisdictions, whether it is embodied in hard law or semi-voluntary codes. Jurisdictions differ more in the 'severity' of their best practices rather than in the direction of their concerns. One example is international convergence on the standard U.S. triptych of an audit, nomination, and compensation committee within the board, to be staffed—entirely or in part—by independent directors. Here the motivation is clearly to keep control over these crucial functions out of the hands of corporate insiders. As noted above, U.S. listing rules and the Sarbanes-Oxley Act make this board structure mandatory for U.S. listed companies.[74] Somewhat less forcefully, the UK's *Combined Code of Corporate Governance* recommends that independent directors compose one-half of the membership of the board as a whole, that the board's chair be independent on appointment, and that the company's audit committee be entirely independent.[75] France, Germany, and Italy follow suit, albeit with less emphasis on independence.[76] Thus, with the exception of Japan, the composition and committee structure of the boards in our core jurisdictions appear to be converging.

In contrast to directorial independence and committee structure, board size has received less attention in our core jurisdictions, despite its salience in the

[73] Bear in mind that very little evidence links most metrics of good governance to corporate performance. See Sanjai Bhagat, Brian J. Bolton, and Roberta Romano, *The Promise and Peril of Corporate Governance Indices*, Working Paper (2007), at http://www.ssrn.com. Note too that the traditional Japanese governance structure retains an elected board of 'statutory auditors', at least half of whom must be from outside the firm.

[74] Only the NYSE requires firms to have nomination and compensation committees composed exclusively of independent directors.

[75] Provision C.3.1 Combined Code of Best Practices. Provision B.2.1. of the most recent, June 2008 Combined Code also requires that the Remuneration Committee be entirely independent, except that it may include the Chairman if she was independent on appointment.

[76] The French code (Principle 8.2) distinguishes between widely held companies (recommending independence for half of the board) and companies with a controlling shareholder (recommending independence for one-third), while the German and Italian codes only recommend an 'adequate number' of independent directors, leaving broad discretion to individual companies. See Recommendation 5.4.2 German Corporate Governance Code; Principle 3.P.1 Italian Corporate Governance Code. The case of independent directors in Germany is particularly delicate, as shareholders may fear that directors who are 'independent' of shareholders might side with labor representatives on a divided board. All three countries recommend an audit committee, and France and Italy a remuneration committee as well. In Germany, 'the majority of the larger listed companies has already installed [nomination and remuneration committees as well].' Klaus J. Hopt and Patrick C. Leyens, *Board Models in Europe—Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy*, 1 EUROPEAN COMPANY AND FINANCIAL LAW REVIEW 135, 141 (2004).

literature on effective governance.[77] No code of best practices limits board size, and only France mandates a maximum size of 18 directors in its company law.[78] Nevertheless, as Table 3–1 illustrates, board size—like committee structure—appears to be converging to the Anglo-American norm of small boards with between nine and twelve directors in all core jurisdictions except Germany.

Table 3–1[79]

	U.S.	UK	Germany	France	Italy	Japan
Average board size	10.7	10.8	≥ 20 for largest companies	10.3	11	13.8
Average per cent of independent directors	81%	59% (excluding chairman)	28%	46%	46%	Between 0%–10%

To be sure, the numbers in Table 3–1 require qualification. To begin, the unusually large size of German boards is an artifact of German codetermination law.[80] Without this constraint, German companies would undoubtedly have supervisory boards in line with international averages—and indeed several major German companies such as Allianz, BASF, and Porsche have converted into the EU-wide SE form expressly in order to reduce the size of their boards to the SE minimum of 12 directors.[81] Similarly, the extent to which 'independent' directors are actually independent differs by jurisdiction. French law, for example, still emphasizes the role of the *président-directeur général* (PDG), a combined chairman of the board and CEO, who typically dominates the board

[77] See e.g. David Yermack, *Higher Market Valuation of Companies with a Small Board of Directors*, 40 Journal of Financial Economics 185 (1996); Jeffrey L. Coles, Naveen D. Daniel, and Lalitha Naveen, *Boards: Does One Size Fit All?*, 87 Journal of Financial Economics 329 (2008).

[78] Art. L. 225–17 Code de Commerce.

[79] Sources: Spencer Stuart, 2006 UK Board Index (2006) at http://www.spencerstuart.com; Spencer Stuart, The Changing Profile of Directors (2006) at http://www.spencerstuart.com (U.S.); *id.*, Italia 2006 Spencer Stuart Board Index (2006) at http://www.spencerstuart.com; Heidrick & Struggles, Corporate governance in Europe: Raising the Bar (2007) at http://www.heidrick.com; Tokyo Stock Exchange, TSE-Listed Companies White Paper of Corporate Governance 2007 (2007) at http://www.tse.or.jp (for large companies with 300 or more consolidated subsidiaries—Chart 20; for all listed companies the average is nine). While all of these sources are relatively current as of our writing, the criteria they employ for selecting firms and defining the independence of directors varies. Nevertheless, we believe the table gives a rough idea of actual practice as to board size and independence in each of our jurisdictions.

[80] The supervisory boards of Firms with more than 20,000 employees must contain at least 20 directors. See § 7 Mitbestimmungsgesetz (Codetermination Law).

[81] See Jochem Reichert, *Experience with the SE in Germany*, 4 Utrecht Law Review 22, 27–8 (2008). Available data show a growing interest in the SE form. See also ETUI-REHS, *European Company (SE) Factsheets* (2008) at http://ecdb.worker-participation.eu (listing both established and planned SEs with an indication of the reason for the adoption of the SE statute).

and may even select independent directors with the aid of a controlling shareholder.[82] In Italy, also, blockholders often secure their influence by inflating the board with friendly outside directors.[83]

Finally, the puzzle of Japanese boards is not that they average more directors than other jurisdictions, but that they seem to have so few relative to past decades.[84] Japanese practice traditionally dictated that boards should be large, chiefly in order to create positions for aging but loyal senior executives.[85] But this tradition appears to have changed. Table 3–1 may exaggerate the magnitude of the change because it is based on the average board size of larger companies listed on the Tokyo Stock Exchange, many of which are nonetheless smaller than the same category of companies listed two decades ago (because the number of listed companies has more than doubled during this period). But other factors are also at work. One is that Japanese companies can now adopt a US-style, tripartite committee structure.[86] Another is that innovation has also occurred *within* the traditional Japanese model of the board. Under the so-called *Shikkou-yakuin* system, some Japanese companies now separate strategic decision-making from tactical business decisions by delegating the latter to a new level of corporate officers who might otherwise have served as second-tier directors on a traditional Japanese board.[87] This innovation offers the option of smaller boards without altering the number of honorific positions at the company's apex. (i.e., the sum of directors and executives who serve as *shikkou-yakuin*).

Put differently, in both Germany and Japan, large boards of directors serve organizational functions other than monitoring and managing on behalf of shareholders. This does not mean that traditional Japanese and German companies

[82] Eddy Wymeersch, *A Status Report on Corporate Governance Rules and Practices in Some Continental European States*, in Comparative Corporate Governance: The State of the Art and Emerging Research 1045, 1113–14 (Klaus J. Hopt et al. (eds.), 1998). The *Loi relative aux Nouvelles Régulations Economiques* (NRE) of 15 May 2001 allows French open companies to separate the offices of *président* and *directeur général* in order to align themselves with the international 'good governance' prescription of separating the CEO role from that of chairman of the board. Art. L. 225–51-1 Code de commerce. 15 out the 40 largest French listed companies have done so: see Spencer Stuart, Corporate Governance in France (2007) (http://www.spencerstuart.co.uk/).

[83] Cf. Assonime and Emittenti Titoli SpA, *An Analysis of the Compliance with the Italian Corporate Governance Code (Year 2007)* 24 (2008) at http://www.assonime.it) (non-executive, non-independent directors hold on average one-third of board seats in Italian listed companies).

[84] See The Anatomy of Corporate Law 40 note 32 (1st ed., 2004) (listed Japanese firms averaged between 19 and 25 directors in the 1990s and earlier).

[85] See Curtis J. Milhaupt, *Creative Norm Destruction: The Evolution of Nonlegal Rules in Japanese Corporate Governance*, 149 University of Pennsylvania Law Review 2083, 2092 (2001).

[86] Sony reduced its board size and began to recruit independent directors in 1997. Soon thereafter some other Japanese multinational companies followed suit, ostensibly to enhance efficiency by separating the formulation of policy from its implementation. See, e.g., Ronald J. Gilson and Curtis J. Milhaupt, *Choice As Regulatory Reform: The Case of Japanese Corporate Governance*, 53 American Journal of Comparative Law 343, 349 (2005).

[87] See Hideki Kanda, *Understanding Recent Trends Regarding the Liability of Managers and Directors in Japanese Corporate Law*, 17 Zeitschrift für Japanisches Recht 29, 32 (2004).

lack effective governance, however. Arguably, real governance in many German companies occurs within the management board,[88] or within supervisory board committees,[89] while the supervisory board as a whole functions mainly to disclose management policy to labor representatives and arbitrate potential labor disputes. Similarly, in Japan, de facto decision-making power traditionally resides not in the board as a whole, but in the hands of informal management committees or a single 'representative' director, who is also the firm's CEO.[90] The separate board of statutory auditors, which monitors management in collaboration with a company's outside auditors,[91] is generally perceived to be relatively ineffective in Japan, as it is in other jurisdictions that maintain this atrophied form of supervisory board.[92]

3.4 Decision Rights and Shareholder Interests

Since the corporate form exists in part to facilitate delegated decision-making,[93] corporate law is sparing in mandating direct decision rights for shareholders. As we explain in later chapters, shareholders obtain mandatory decision rights principally when directors (or their equivalents) have conflicted interests (Chapter 6) or, even more often, when decisions call for basic changes in governance structure or fundamental transactions that potentially restructure the firm (Chapter 7). Moreover, although the law generally discourages shareholders from directly participating in business decisions, there are exceptions. At the level of the individual shareholder, many jurisdictions permit derivative actions, which are not only a species of enforcement device but also a right

[88] Thus, German law provides that it is the responsibility of the management board, and the management board alone, to manage the AG. § 76 I AktG. The supervisory board can veto some transactions but—in contrast to a U.S., UK, or French board—cannot instruct the management board to take any action with a minor exception necessary to implement the Co-determination Act. German Stock Corporation Act and Co-Determination Act 10 (Martin Peltzer and Anthony G. Hickinbotham (eds. & trans.), 1999).

[89] German supervisory boards, as the Corporate Governance Code itself recommends, may set up committees to which its main tasks, and especially the audit function, can be delegated (§ 5.3 German Corporate Governance Code).

[90] See Gilson and Milhaupt, *supra* note 86, at 349.

[91] Japanese statutory auditors (*kansayaku*) conduct both a financial audit of the company's books and a 'compliance audit' of whether managers are complying with the applicable laws, the company's charter, and their fiduciary duties.

[92] See Gilson and Milhaupt, *supra* note 86, at 348. The board of statutory auditors is also held to have performed poorly in Italy, where it was mandatory until 2003. See Ferrarini and Giudici, *supra* note 68, at 186. Italian publicly traded companies may now choose among a default single-tier structure with a board of statutory auditors, a two-tier structure, and a single-tier board with an audit committee composed of independent directors. See Art. 2380 and 2409–18(2) Civil Code.

[93] Governance costs might be defined as the costs of informing and forging a majority preference among multiple shareholders, as well as the costs of taking mistaken decisions because shareholders are relatively uninformed. These costs are identical to what one of us terms 'ownership costs'. See Henry Hansmann, The Ownership of Enterprise 35 (1996).

granted to individual shareholders to manage a corporate cause of action. We discuss derivative suits further in Chapter 6. Suffice to say here that even in the U.S., the jurisdiction most friendly to derivative suits, courts allow them to proceed only when boards are demonstrably too conflicted or incompetent to manage their corporations' legal claims, especially seemingly plausible claims against corporate insiders.

Jurisdictions also differ at the level of the shareholders meeting. Some jurisdictions allow company charters to authorize the direct participation of the shareholders meeting in making operational business decisions, and all jurisdictions allow shareholders to manage closely held corporations directly. Jurisdictions differ, then, chiefly in the extent to which they accord mandatory or optional decision rights to shareholders of open corporations.

At one end of the spectrum, the UK statutory default permits a qualified majority of shareholders to overrule the board on *any* matter within the board's competence.[94] Thus, shareholders can sell the company or amend the charter even if the board disagrees, provided that the issue is properly noticed and is approved by more than 75% of voting shares.[95] Of course, shareholders seldom overrule a board in this way. A supermajority vote is hard to come by; and, more to the point, a simple majority is generally enough to remove the board. Nevertheless, the latent power to make all business decisions, even in public companies, enhances the UK's position as the most shareholder-centric of our core jurisdictions.

In jurisdictions other than the UK, the shareholders' meeting has less autonomous power. Routine business decisions generally fall within the exclusive competence of the management board or within the single-tier board's exclusive authority to 'manage' the corporation.[96] Nevertheless, continental European jurisdictions and Japan still allow qualified percentages of shareholders to initiate and approve resolutions on a wide range of matters including questions that may have fundamental importance to the company's management and strategic direction, such as amendments to the corporate charter.[97] By contrast, the U.S.—or at least Delaware—law is again the least shareholder-centric jurisdiction. As we discuss in Chapter 7, U.S. shareholders must ratify fundamental corporate

[94] See Schedule 3, Art. 4, Model Articles for Public Companies, Companies (Model Articles) Regulations 2008 No. 3229. Because the shareholders can fire the entire board with a simple majority resolution (§ 168 Companies Act 2006), this is of course irrelevant in practice.

[95] See §§ 314 and 338 (companies are required to circulate shareholder statements and proposed resolutions whenever asked by shareholders representing 5% of voting rights or by 100 shareholders) as well as § 283 (75% consent needed for special resolution to pass) UK Companies Act 2006.

[96] E.g., § 141(a) Delaware General Corporation Law. In Germany, routine business decisions would fall within the exclusive competence of the managerial (rather than supervisory) board (§ 76 Aktiengesetz).

[97] See Dirk Zetzsche, *Shareholder Interaction Preceding Shareholder Meetings of Public Corporations—A Six Country Comparison*, 2 European Company and Financial Law Review 107, 120–8 (2005) (France and Germany). For Italy see Art. 2367 Civil Code and Art. 126–2 Consolidated Act on Financial Intermediation. For Japan, see Art. 303 and 305 Companies Act.

decisions such as mergers and charter amendments but lack the power to initiate them.[98]

Almost all jurisdictions require shareholders to ratify a broader range of corporate decisions than they allow shareholders to initiate. Nevertheless, the pattern of decision rights among jurisdictions is similar at both levels. In general, U.S. law mandates shareholder ratification for a relatively narrow range of decisions, while our other core jurisdictions require shareholder approval for a wider range, including certain routine but important decisions. For example, France, Germany, Italy, the UK, and Japan require the general shareholders' meeting to approve the distribution of the company's earnings.[99] For UK listed companies, the law mandates an advisory shareholder vote on directors' compensation, while the Listing Rules require shareholder approval of a number of 'significant transactions', including substantial sales of corporate assets.[100] Equally important, all EU member states give shareholders the right to appoint and dismiss the auditors of listed and publicly traded companies,[101] while shareholders also elect the 'statutory auditors'—as well as the directors—of Japanese and Italian companies.[102]

Finally, even though shareholder decision rights diverge across jurisdictions in public companies, they converge on flexible and extensive shareholder decision rights in closely held companies. A good example is the closed German limited liability company (GmbH), which may be very large in capitalization and number of shareholders. The GmbH not only mandates shareholder approval of financial statements and dividends, but also authorizes the general shareholders' meeting to instruct the company's board (or general director) on all aspects of company policy.[103] The GmbH form, then, allows shareholders complete authority to manage business by direct voting—unless the company is subject to codetermination law by virtue of the size of its workforce.[104] Similarly, although legal regimes for close companies in France, Italy, Japan, and the U.S. generally

[98] See *infra* 7.2 and 7.4.

[99] §§ 58 and 174 AktG (Germany) (the power to decide on the distribution lies with shareholders, but management and supervisory board may limit distributable profit); Art. L. 232–12 Code de commerce (France); Art. 2434 Civil Code (Italy); Art. 454(1) Companies Act (Japan). In the UK, the law does not allocate the power to approve distributions, but the model articles require shareholder approval (Art. 30 Schedule 1, Model Articles for Private Companies Limited by Shares and Art. 70 Schedule 3, Model Articles for Public Companies, Companies (Model Articles) Regulations 2008 No. 3229).

[100] See 6.2.3 (voting on compensation); Ch. 10, UK Listing Rules.

[101] See European Commission, *Green Paper, The Role, the Position and the Liability of the Statutory Auditor within the European Union* 23 (1996), at http://www.europa.eu. However, in most listed companies shareholders merely ratify the choice made by the board (*id.*, 23).

[102] Art. 329(1) Companies Act (directors as well as statutory auditors appointed by general meeting of shareholders) (Japan); Art. 2400 Civil Code (Italy).

[103] Schmidt, *supra* note 46, at 1068; § 46 Gesetz betreffend die Gesellschaften mit beschränkter Haftung (GmbHG) (financial statements, profit distribution), §§ 37, 38, 46 GmbHG (shareholder instructions).

[104] A GmbH subject to codetermination must have a two-tier board and is subject to AG rules on the division of functions between the boards, and between boards and shareholders. Schmidt, *supra* note 46, at 482–3.

identify directors (Italy, the U.S., the UK, and Japan)—or 'managers' (French SARL)—as the default decision-makers, all of these jurisdictions permit closely held companies to opt into full shareholder management.[105]

3.5 The Reward Strategy

Corporate law gives the *well-organized* shareholder majority ample power to protect its interests through appointment and decision rights, which, among other things, allows the shareholder majority to strongly influence management's monetary incentives. But the reward strategy, like the trusteeship of independent directors, is sometimes also said to substitute for direct shareholder monitoring when shareholders are dispersed. The theory, of course, is that optimally-structured pay packages can align the interests of managers with those of shareholders as a class.

The law generally plays into the reward device indirectly, by regulating how, and when, companies can compensate their managers in order to advance the interests of the firm.[106] And the most important reward for managers of publicly traded firms today is one of the many forms of equity compensation—e.g., stock options, restricted stock, and stock appreciation rights—which now comprise major (albeit varying) portions of total compensation for top managers in all of our core jurisdictions.[107]

The U.S. best illustrates the law's role in facilitating—and then curbing—high-powered equity incentives. Although the Delaware courts initially regarded

[105] The French non-publicly traded corporation form, the SARL, vests power to manage the SARL in one or more 'managers', absent a charter provision to the contrary. Art. L. 221–4 and 223–18 Code de commerce. While American non-publicly traded corporation statutes and Italian and UK law generally permit direct shareholder management of the company, this requires a specialized corporate form—the *société par actions simplifiée*—in France. See Art. L. 227–5 and 227–6 Code de commerce. In Japan, non-publicly traded companies are permitted not to have statutory auditors and in that case each shareholder has the same rights as statutory auditors.

[106] The instances in which the law actually mandates equity incentives for directors are largely symbolic, as when French law requires directors to hold at least one share in their companies. Art. L. 225–25 and L. 225–72 Code de commerce.

[107] Even today, however, significant differences remain across countries in the proportion of total remuneration for CEOs that takes the form of long-term equity compensation, annual bonuses, and salary. For example, in the largest U.S. companies between 2002 and 2006, 60% of total direct compensation was equity compensation, slightly over 20% took the form of bonuses, and less than 20% took the form of salary. See Mercer's *2006 CEO Compensation Survey* (covering top U.S. firms) (http://www.mercer.com/pressrelease/details.jhtml/dynamic/idContent/1263210). Curiously, these figures are similar to those for German DAX 30 management boards in 2006, admittedly only the very largest German companies (equity compensation 60%, annual bonuses 25%, salary 15%). Deutsche Börse AG, Remuneration Report 2006, at http://www.deutsche-boerse.com. A broader sample of publicly traded British firms, however, offered much lower levels of long-term equity compensation (equity 28%, annual bonuses 22%, and salary 44%). Martin J. Conyon, John E. Core, and Wayne R. Guay, *How High is US CEO Pay? A Comparison with UK CEO Pay* (2006), at http://www.ssrn.com.

stock options with suspicion,[108] they soon made their peace with option compensation, aided by the wide discretion that U.S. firms enjoy to issue rights and repurchase shares.[109] In addition, a 1994 change in U.S. tax law[110] gave options an enormous (if unintentional) boost by barring corporations from expensing compensation in excess of $1 million per year that was not tied to firm performance. More recently, however, legal reform turned against equity incentives. First, the Sarbanes-Oxley Act of 2002 marginally restricted equity pay by banning corporate loans for top managers to use in acquiring stock or exercising options (a formerly common practice[111]), and by requiring CEOs and CFOs to disgorge returns on equity compensation arising from artificially inflated share prices.[112] Second, just as this chapter is being revised, the U.S. Federal Government has radically restricted the equity compensation of the top executives of all companies that have accepted, or will accept, government capital in order to survive the current financial crisis.[113] These restrictions will persist until the government's investment is redeemed.

Other jurisdictions have taken longer to embrace equity pay and expand board discretion to make incentive awards. In the case of equity compensation, for example, Germany only recently allowed publicly traded companies to repurchase up to 10% of their outstanding shares in order to underwrite stock option compensation plans.[114]

As to board discretion over pay, differences among our jurisdictions are best seen in a comparison of the roughly contemporaneous Delaware civil litigation against Michael Eisner, Disney, Inc.'s former CEO, and other Disney directors, for a termination settlement that awarded $140 million to Disney's President,[115] and the criminal prosecution of Josef Ackermann, Deutsche Bank's CEO and a Mannesmann AG director, and two other members of Mannesmann supervisory board, for paying Mannesmann's CEO, and members of his executive team, 'appreciation awards' (of approximately $20 million for Mannesmann's CEO), for having extracted an extraordinarily high premium from a hostile acquirer (Vodafone) after a drawn-out takeover battle.[116]

The two cases differed importantly on their facts. In *Disney*, the amount at issue was contractually fixed ex ante, and the dispute turned on whether Disney's

[108] See e.g. *Krebs v. California Eastern Airways*, 90 A.2d 562 (Del. Ch. 1952).

[109] E.g., § 157 Delaware General Corporation Law.

[110] Internal Revenue Code § 162(m).

[111] See e.g. Kuldeep Shastri and Kathleen M. Khale, *Executive Loans*, 39 Journal of Financial and Quantitative Analysis 791 (2004).

[112] SOX § 304(a).

[113] See American Recovery and Reinvestment Tax Act of 2009 (enacted 13 Feb. 2009) (barring, *inter alia*, all forms of equity pay for the top five officers and top 20 most highly paid employees below the top five officers in large firms, with the exception of long-term restricted stock valued less than one-third of a covered recipient's ordinary salary).

[114] § 71 Aktiengesetz. Prior rules restricting buy-backs and new share issues had severely restricted equity-based compensation.

[115] *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27 (Del. 2006).

[116] See e.g. Curtis J. Milhaupt and Katharina Pistor, Law and Capitalism 69–86 (2008).

directors had been so grossly negligent as to have acted in bad faith, either in negotiating the original contract or in not contesting a 'no fault termination clause' that triggered the $140 million payment to Disney's ex-president, even though shareholders argued that the former president had indeed been at fault. In *Mannesmann*, the payments at issue were gratuitous (*ex post* bonuses granted by Ackermann and one other member of the compensation committee), but made with the full approval of Vodafone—which, by the time of the payout, held 98.66% of Mannesmann's shares.

Despite these factual differences, however, the differing outcomes of the two cases are revealing. The Delaware court deployed the business judgment rule to exonerate Eisner and the Disney board from civil liability despite evidence of negligence and an odor of conflict of interest (the discharged manager had been a close personal friend of the CEO). By contrast, the German Supreme Court, the BGH, ruled that Ackermann might be criminally liable for breach of trust in the form of dissipating corporate assets.[117] From the perspective of Delaware law, it is nearly inconceivable that a disinterested director (Ackermann) would face civil liability for approving a gratuitous bonus ratified by a 98% disinterested shareholder, let alone face criminal liability.[118] Delaware has long permitted disinterested boards to reward departing executives with compensation in excess of their contractual entitlements.[119] For the BHG, criminal liability followed as a matter of course from the penal code, the fact that Mannesmann's independent existence was ending, and the absence of a pre-negotiated golden parachute.

Clearly, the U.S. constrains managerial pay less than Germany does, even if executive pay is controversial in both countries. One issue, then, is whether relatively low-paying jurisdictions such as Germany can compete for top managerial talent in a global market without relaxing constraints on compensation,[120] especially when bordering Switzerland offers U.S.-level compensation.[121] The converse issue, however, is whether U.S. companies (or companies in other high-paying jurisdictions) can continue to offer unprecedented pay packages without

[117] BGH, Decision of 21 December 2005, 3 StR 470/04. Unlike the lower court, the BGH relied on criminal law alone (the criminal equivalent of common law corporate waste doctrine: see § 266 Strafgesetzbuch (Criminal Code)), and, unlike the lower court, did not pin its holding to § 87 AktG, which requires managerial compensation to be reasonable. After the BHG holding, the *Mannesmann* defendants reached a monetary settlement with the public prosecutor.

[118] See Franklin A. Gevurtz, Disney *in a Comparative Light*, 55 American Journal of Comparative Law 453, 484 (2007). Under Delaware law, shareholder ratification would also have protected the second member of the Mannesmann executive committee, who, unlike Ackermann, stood to benefit monetarily from the ex post bonuses as a former Mannnesmann officer.

[119] See *Zupnick v. Goizueta*, 698 A.2d 384 (Del. Ch. 1997) (upholding options granted for past services at the end of tenure) and *Blish v. Thompson Automatic Arms Corporation*, Del.Supr., 64 A.2d 581 (1948) (retroactive compensation is not made without consideration where an implied contract is shown to exist or where the amount awarded is not unreasonable in view of the services rendered).

[120] Brian R. Cheffins and Randall S. Thomas, *The Globalization (Americanization?) of Executive Pay*, 1 Berkeley Business Law Journal 233 (2004).

[121] *Schweizer Topverdiener*, Börsen-Zeitung, Nov. 22, 2007, at 6 (reviewing study of management compensation in 100 largest Swiss listed companies).

triggering a shareholder revolt or political intervention, particularly during periods of economic stress. As noted above, the UK now mandates a shareholder advisory vote on all executive directors' compensation for listed companies; one wonders whether the U.S. might soon follow suit.[122]

A different question is whether high-powered equity compensation as it is now structured actually motivates managers to maximize long-term corporate value. The empirical literature is again inconclusive.[123] Well-known critics argue that U.S.-style compensation is best explained as low-visibility managerial rents extracted from shareholders rather than as finely-tuned incentives crafted in the course of arms-length bargaining.[124] By contrast, supporters of U.S. pay practices argue that its critics underestimate its incentive properties and misunderstand the bargaining context in which CEO pay must inevitably be set.[125] At bottom, the question is whether incentive compensation is, or might be, a partial substitute for close monitoring by powerful shareholders (or an active market for corporate control), or whether, alternatively, current levels of compensation *result* from insufficient monitoring by shareholders and the market.[126]

3.6 Legal Constraints and Affiliation Rights

Legal constraints and affiliation rights serve as supporting actors rather than as leading players in the structure of corporate governance, at least with respect to protecting the interests of shareholders as a class. All managerial and board decisions are constrained by general fiduciary norms, such as the duties of loyalty and care. Moreover, affiliation rights in the form of mandatory disclosure inform both shareholders and boards of directors by providing a metric for evaluating managerial performance in the form of well-informed share prices.[127] By

[122] For evidence that the UK 'say on pay' provision has enhanced sensitivity of CEO cash compensation to negative operating performance see Fabrizio Ferri and David Maber, *Solving the Executive Compensation Problem Through Shareholder Votes? Evidence from the U.K.*, Working Paper (2007), at http://www.ssrn.com. The U.S. has already adopted its own 'say on pay' requirement for firms receiving government capital in the wake of the financial crisis. See *supra* note 113 (2009 Act regulating executive compensation in firms that accept TARP funding).

[123] Compare, e.g., Lucian A. Bebchuk, Martijn Cremers, and Urs. C. Peyer, *Pay Distribution in the Top Executive Team* (2007), at http://www.ssrn.com, with Bhagat, Bolton, and Romano, *supra* note 73, at 54, 56.

[124] See, e.g., Lucian A. Bebchuk and Jesse M. Fried, Pay Without Performance: The Unfulfilled Promise of Executive Compensation (2004).

[125] See e.g. John E. Core, Wayne R. Guay, and Randall S. Thomas, *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 Michigan Law Review 1142 (2005).

[126] See, e.g., Marcel Kahan and Edward Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 University of Chicago Law Review 871 (2002) (option compensation as a substitute for takeover pressure). But see, e.g., Lucian Bebchuk, Jesse Fried, and David Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 University of Chicago Law Review 751 (2002).

[127] See Gordon, *supra* note 61.

contrast, exit rights are not important to general corporate governance by and large. Corporate law makes use of them only in specialized circumstances that are detailed in later chapters: for example, as a remedy for minority shareholder abuse or as a check on certain fundamental transactions such as mergers.

3.6.1 The constraints strategy

As with exit rights, hard-edged rules and fiduciary standards are poorly suited to protecting the interests of the shareholder majority. Shareholders who can appoint and remove managers have no need to hobble managerial discretion with legal constraints—except, perhaps, in the context of related party transactions, which we address in Chapter 6. Yet, all of our core jurisdictions impose a very broad duty on corporate directors and officers to take reasonable care in the exercise of their offices (duty of care). This duty, while difficult to enforce, is truly part of the wider corporate governance system, and intended to benefit shareholders as a class insofar as their interests are identified with the corporation's interests.

It is tempting to view violations of the director's or officer's duty of care as a kind of corporate 'malpractice', analogous to malpractice committed by other professionals such as doctors or auditors. But the analogy is weak because defining 'reasonable care' is far more difficult for directors than, say, for doctors. The misconduct that violates the duty of care is nominally described as 'negligence' or 'gross negligence'. Yet most jurisdictions recognize a second principle of corporate law, the business judgment rule,[128] which effectively insulates from legal challenge business decisions taken in good faith (that is, without intent to harm the company). This low standard of liability has two principal justifications. The first is that judges are poorly equipped to evaluate highly contextual business decisions. In particular, absent clear standards, hindsight bias can make even the most reasonable managerial decision seem reckless *ex post*. The second is that, given hazy standards and hindsight bias, the risk of legal error associated with aggressively enforcing the duty of care would inevitably lead corporate decision-makers to prefer safe projects with lower returns over risky projects with higher expected returns.[129] Ultimately, shareholders may stand to lose more from such 'defensive management' than they stand to gain from deterring occasional negligence.

[128] In Germany, the business judgment rule is embodied in statute law rather than being solely a creation of the courts. § 93(1) para. 2 (AktG) (added in 2005). In the UK, the rule is not stated explicitly but seems to emerge from the courts' lack of willingness to review manager's business decisions in the absence of any conflict of interest: see, e.g., *Howard Smith Ltd v. Ampol Petroleum Ltd* [1974] AC 821, 832. The Companies Act of 2006 introduces an objective standard of due care, but few believe that this will lead UK courts to second-guess business decisions.

[129] See, e.g., William T. Allen, Reinier Kraakman, and Guhan Subramanian, Commentaries and Cases on the Law of Business Organization (2nd ed., 2007) Ch. 8.

At least in the U.S., the rare cases in which courts hold directors personally liable for gross negligence in decision-making tend to involve unusual circumstances, such as a merger or sale of the entire company or the onset of insolvency.[130] Moreover, even in these cases, the courts often hint at something more than negligence—bad faith or a conflict of interest that is difficult to prove—as the real basis for liability.[131] The law-on-the-books in continental European jurisdictions such as Germany appears to offer negligent directors less protection from liability than U.S. case law, statutory law, and ancillary institutions such as comprehensive D&O insurance.[132] The offset, however, is that the probability of a suit seeking to impose liability is far higher in the U.S. than in our other core jurisdictions.

In addition to the global duty of care, many jurisdictions impose specialized monitoring duties on corporate officers and directors, which play into corporate governance and serve in part to protect shareholder interests. For example, case law in Delaware and UK holds that the duty of care extends to creating 'information and reporting systems' that can allow the board to assess corporate compliance with all applicable laws.[133] Similarly, EU and Japanese law task supervisory boards, audit committees, and statutory auditors with ensuring that publicly traded companies have adequate auditing checks and risk management controls in place.[134] Section 404 of the U.S. Sarbanes-Oxley Act, a milder version of which was adopted in the EU, requires CEOs and CFOs of U.S. firms to report on the effectiveness of their firms' internal financial control.[135] However,

[130] See *infra* 5.3.1.1.

[131] The famous Delaware example is *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), in which the Delaware Supreme Court clearly believed that a retiring CEO had a strong personal interest in selling his company, which added an element of disloyalty to the arguably negligent process followed by the board in consummating the sale.

[132] Thus, § 93(1) para. 2 AktG, the German business judgment rule, appears to protect *non-negligent* business decisions from legal attack. By contrast, the U.S. rule protects negligent decisions that were made in good faith from judicial review. Allen, Kraakman, and Subramanian, *supra* note 129, at 252. For similar case law developments in Japan, see Kanda, *supra* note 87, at 30.

[133] See *In re Caremark Int'l Inc. Derivitive Litigation*, 698 A.2d. 959 (Del. Ch. 1996). The *Caremark* duty of oversight was recently reaffirmed by the Del. Supreme Court in *Stone v. Ritter*, 911 A.2d 362 (Del. 2006). Similarly in the UK, *Re Barings plc (No.5)* [1999] 1 BCLC 433, esp. at 486–9.

[134] See FSA Disclosure Rules and Transparency Rules DTR 7.1 (UK); § 91(2) AktG (Germany); Art. L. 225–235 Code de Commerce (France); Art. 149 Consolidated Act on Financial intermediation (Italy). For Japan, auditing requirements are established by Art .328(1), 390(2) and 404(2) of the Companies Act, while internal control requirements are set by Art. 362(4)(iv) and Art. 362(5) of the Companies Act; see also Arts. 24–4–4(1) and 193–2(2) of the Financial Instruments and Exchange Act. The EC directive on statutory audits (Directive 2006/43/EC, 2006 O.J. (L 157) 87) requires companies to have an audit committee (comprised of directors or established as a separate body under national law) that shall 'monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems'. Art. 41(2)(b).

[135] SOX § 404. On the costs and benefits of § 404, see e.g. Robert A. Prentice, *Sarbanes-Oxley: The Evidence Regarding the Impact of Section 404*, 29 Cardozo Law Review 703 (2007). Japan has also adopted a similar provision. See Art. 24–4–4 Financial Instruments and Exchange Act (effective from April 2008). In the EU, the directive on company reporting (Directive 2006/46/EC, 2006 O.J. (L 224) 1) requires that the annual corporate governance statement of listed companies contain a 'description of the main features of the company's internal control and risk management systems in relation to the financial reporting process'. Art. 1(7). However, no assessment of the effectiveness of the internal control structure and procedure has to be made nor, *a fortiori*, have auditors to report on it.

with the exception of Section 404 and its Japanese analogue, which are enforced by outside auditor attestation,[136] we are unaware of evidence indicating that these narrower monitoring duties are enforced more rigorously than the broader duty of care itself.

3.6.2 Corporate governance-related disclosure

While mandatory disclosure is not itself one of the legal strategies that we defined in Chapter 2, it plays a critical supporting role in the functioning of all legal strategies, and in all aspects of corporate law—at least for publicly traded companies. The structure of the corporate governance system is no exception.

All of our core jurisdictions mandate extensive public disclosure as a condition for allowing companies into the public markets. Firms must make timely disclosure, both periodically and prior to shareholder meetings. Moreover, there is considerable convergence on the content of this disclosure, much of which is governance-related. For example, all of our core jurisdictions require firms to disclose their ownership structure (significant shareholdings and voting trust agreements), executive compensation, and the details of board composition and functioning.[137]

It is quite plausible that such extensive disclosure makes a large contribution to the quality of corporate governance directly, by informing shareholders, and indirectly, by enlisting market prices in evaluating the performance of corporate

[136] SOX § 404(b). Art. 193–2(2) Financial Instruments and Exchange Act (Japan).

[137] For ownership disclosure requirements, see Art. 9–15, Transparency Directive; US: Section 13d, Securities Exchange Act of 1934; Japan: Art. 27–23 Financial Instruments and Exchange Act. U.S. Regulation S-K, 17 C.F.R. Part 229 Item 601(b)(3)(i)-(ii), requires filing the corporate charter and bylaws as exhibits in Form 10Q (quarterly report) and Form 10K (annual report). In addition, any voting trust agreement or corporate code of ethics must be filed in Form 10Q. See Item 601(b) Exhibit Table. Disclosure of voting trust agreements is also required by the EC Takeover Bids Directive (Art. 10 Directive 2004/25/EC, 2004 O.J. (L 142) 12). As for executive compensation see SEC Executive Compensation and Related Person Disclosure, Exchange Act Release No. 33–8732 (11 Aug. 2006); for EU, see EC Commission, *Fostering an appropriate regime for the remuneration of directors of listed companies* (Recommendation 2004/913/EC, 2004 O.J. (L 385) 55) and the International Accounting Standard No. 24 (Commission Regulation (EC) No 2238/2004 of 29 December 2004, 2004 O.J. (L 394) 1) (disclosure on an aggregate basis). Executive compensation disclosure is required in Japan on an aggregate basis in the annual securities report (to be filed under Art. 24 Financial Instruments and Exchange Act; see Akinobu Shuto, *Executive Compensation and Earnings Management: Empirical Evidence from Japan*, 16 Journal of International Accounting, Auditing and Taxation 1 (2007)) but the annual corporate governance report to be filed under the Tokyo Stock Exchange Securities Listing Regulation requires companies to split the data among categories of beneficiaries (Tokyo Stock Exchange, TSE-Listed Companies White Paper, *supra* note 79).

insiders. Moreover, it is particularly important in firms without powerful inside shareholders, where mandatory disclosure may be the basis on which the shareholder majority can exercise its appointment and decision rights. Arguably the comprehensive nature of U.S. proxy statements, and the large potential liability that attaches to misrepresentations, builds on this assumption. Another indication is the shareholder's right in continental European jurisdictions to void shareholder resolutions if the company withheld material information bearing on the vote at the shareholders' meeting. Litigation of this sort is particularly common in Germany, where courts take voting-related disclosure very seriously, both in publicly traded and privately-held companies.[138]

3.7 Explaining Jurisdictional Similarities and Differences

A review of major jurisdictions reveals that they often use the same strategies to shape corporate governance in fundamentally similar ways. For example, all of our sample jurisdictions mandate that shareholders elect the decisive majority of directors on the board (or of the managers who serve as director equivalents in non publicly traded corporations); and all require a qualified shareholder majority to approve fundamental changes in the company's legal personality, such as a merger, dissolution, or material change in the company's charter. To a greater or lesser extent, all of our jurisdictions have adopted elements of the now-global norms of good corporate governance. For example, all jurisdictions now require (in their stock exchange listing rules), recommend (in their corporate governance codes) or (in the case of Japan) at least allow companies to opt for the tripartite committee structure—audit, compensation, and nomination committees.[139] Moreover, all single-tier jurisdictions except Japan now require or recommend a significant complement of independent directors on corporate boards and on key board committees (thus embracing the trusteeship device). All major jurisdictions impose a duty of care or prudent management as a legal norm (although nowhere is it rigorously enforced); and all jurisdictions rely on mandatory disclosure to enlist the market as a monitor of the performance of public companies and aid disaggregated shareholders in exercising their appointment rights.

Despite these global similarities, however, there are significant differences in the extent to which the governance *law* of our target jurisdictions is structured to protect shareholder interests against managerial opportunism. Moreover, the law-on-the-books, whether hard or soft, only imperfectly reflects each jurisdiction's distinctive balance of power among shareholders, managers, labor, and the state.

[138] See e.g.Ulrick Noack and Dirk Zetzsche, *Corporate Governance Reform in Germany: The Second Decade*, 15 European Business Law Review 1033, 1044 (2005).

[139] See *supra* 3.3.2.

Consider the law-on-the-books first. If we were to ask a knowledgeable observer to array our six core jurisdictions on a spectrum from the most to the least empowering for shareholders vis-à-vis managers in publicly traded companies, she would most likely list the UK at one extreme and the U.S. at the other. Despite their common legal heritage, the two Anglo-Saxon jurisdictions mark the ends of the governance continuum. Filling in the middle is trickier. Italy, Germany, and France accord shareholders significant rights that Delaware does not, such as the non-waivable minority right to initiate a shareholder meeting, to initiate a resolution to amend the corporate charter, to place board nominees on the agenda of shareholders' meeting, and to remove directors without cause by a qualified majority vote. However, Japan also has a plausible claim to equally shareholder-friendly law on the basis of its short director terms, easy removal rights, and user-friendly mail and internet voting regimes. The sticking point for Japanese law is that it supports large, insider-dominated corporate boards. This leaves Germany and the U.S. in a dead heat for having the least shareholder-friendly governance law, at least on the books. Delaware law is unmistakably board-centric, while Germany's codetermination statute mandates labor directors on the board with interests that are, on the surface at least, opposed to those of the shareholder class.

In some respects, this legal spectrum accurately depicts the power of shareholders as a class to safeguard their interests vis-à-vis managers. Despite the fact that shareholdings in the U.K. are diffuse, governance in the U.K. is significantly influenced by institutional shareholders, who are well equipped to represent the interests of shareholders as a class.[140] Moreover, one of the most important arbiters of corporate disputes in the UK—the Takeover Panel—developed largely in accordance with the wishes of institutional shareholders.[141] In contrast, the U.S. governance system relies heavily on independent directors, trusteeship, and state courts, none of which are specifically targeted to protect the interests of shareholders as a class. In recent years, however, U.S institutional shareholders—and especially hedge funds—have become increasingly assertive, and U.S. boards have become increasingly attentive to share price.[142] There has been, in other words, a perceptible shift in favor of shareholder interests over board autonomy—albeit it has occurred without major changes in underlying law. Thus, U.S. governance in

[140] For discussion of the political economy of the power of institutional investors in the UK, relative to those in the U.S., see Geoffrey Miller, *Political Structure and Corporate Governance: Some Points of Contrast Between the United States and England*, 1998 Columbia Business Law Review 51; Ronald J. Gilson, *The Political Ecology of Takeovers: Thoughts on Harmonizing the European Corporate Governance Environment*, in European Takeovers: Law and Practice 49 (Klaus J. Hopt and Eddy Wymeersch (eds.), 1992).

[141] See John Armour and David A. Skeel, Jr., *Who Writes the Rules for Hostile Takeovers, and Why?—The Peculiar Divergence of U.S. and U.K. Takeover Regulation*, 95 Georgetown Law Journal 1727, 1767–76 (2007).

[142] See Alon Brav, Wei Jiang, Frank Partnoy, and Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 Journal of Finance 1729 (2008); Gordon, *supra* note 61, at 1526–35.