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THE DARK SIDE OF SHAREHOLDER INFLUENCE: TOWARD A HOLDUP THEORY OF STAKEHOLDERS IN COMPARATIVE CORPORATE GOVERNANCE

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The Dark Side of Shareholder Influence: Toward a Holdup Theory of Stakeholders in Comparative Corporate Governance

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Abstract

Most comparative corporate governance scholarship is preoccupied with the protection of shareholders against illicit self-dealing by managers and controlling shareholders, and the problem of agency cost. Differences in the role of stakeholders such as employees are acknowledged in the literature, but usually not explained in functional terms. At the same time, US legal scholars are increasingly debating the strong insulation of the board of directors from shareholders in the United States, and are seeking to find an explanation for it. Proponents of a stakeholder view of corporate law have argued that the insulation of the board of directors in the United States from shareholders mitigates the risk of holdup of members of nonshareholder constituencies by shareholders, thus encouraging specific investment by these groups. The most hotly debated type of specific investment is the human capital of employees. However, US corporate law is unusual in the large degree of autonomy enjoyed by managers vis-à-vis shareholders. Since holdup of stakeholders typically takes place within what is considered legitimate managerial business judgment, but shareholders are the primary financial beneficiary of this type of ex-post opportunism, comparative corporate governance needs to take into account the degree to which managers are shielded against shareholder influence, an issue that is quite unrelated to shareholder protection. I argue that concentrated ownership, as it is typical for Continental Europe, is conducive to holdup problems because it implies strong shareholder influence on management decision-making. Given their costs, laws aiming at the protection of stakeholders (such as codetermination or restrictive employment law) are therefore normatively more desirable in the presence of stronger shareholder influence, particularly under concentrated ownership. Without postulating that each corporate governance system of the "Wealthy West" has an optimal level of such laws, the theory is corroborated by the observation that they tend to be more strongly developed in corporate governance systems with stronger shareholder influence. Thus, I provide a new explanation for institutional complementarities in different corporate governance systems. The United Kingdom, which (in spite of dispersed ownership) has both stronger shareholder influence than the US and stronger employment law, is classified as an intermediate case.

Keywords: corporate law, shareholder influence, corporate governance,

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1. Introduction

The predominant academic view of corporate law today rests on the principal-agent paradigm. In the United States, where economic analysis dominates the scene, most corporate law scholarship continues to analyze the law in terms of agency relationships, including both the classic Berle-Means-type separation of ownership and control under a dispersed ownership structure, and the agency conflict between controlling and minority shareholders under concentrated ownership. The interests of stakeholders other than shareholders are usually left on the sidelines, descriptively and sometimes even normatively. However, based on developments in economic theory, corporate law theory is increasingly debating the significance of firm-specific investment by other constituencies, the most prominently discussed case being specific investment in human capital by employees. While specific investment is said to enhance the firm's productivity and competitiveness, it also exposes workers to holdup, which in turn creates a disincentive against making specific investments in the first place.[1] This has led to reinterpretation of US corporate law by some scholars, notably by Margaret Blair and Lynn Stout, who developed a "team production" theory of corporate law.[2]

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[1] In economic theory, the holdup problem describes a situation where one party makes an investment that is specific to the investment with another one. Since this investment cannot be used to gain the same benefits in a relationship with a third party, the party having made the investment can be threatened with opportunistic renegotiation of the contract, resulting in the loss of the rent on the investment, if contractual protection is incomplete. Benjamin Klein, *Hold-up problem,* in 2 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 241 (Peter Newman ed. 1998). For details in the context of employees, *see infra* section 2.2. The paradigmatic example is the Fisher Body-General Motors case, where Fisher was producing car bodies for general motors. Following an unexpected surge in the demand for cars, Fisher was able to charge General Motors a supracompetitive price since it could not obtain car bodies from another supplier. Ultimately, the two firms merged in 1926, which eliminated this inefficiency. *See* Benjamin Klein, Robert G. Crawford & Armen A. Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process,* 21 J. L. & ECON. 308-310 (1978).

[2] *Infra* notes 48-50 and accompanying text.

The comparative corporate governance literature continues to be dominated by the agency paradigm[3] and puts a strong emphasis on the difference between dispersed ownership, predominating in the US and the UK, and concentrated ownership of shares, which characterizes, among others, continental European corporate governance systems:[4] The two prototypical structures struggle with different types of agency problems, namely the managerial agency problem under dispersed ownership and intra-shareholder agency problems under concentrated ownership. The latter type of agency conflict is of particular significance in the comparative corporate governance literature, given the predominance of concentrated ownership outside the US and the UK. Scholarship tends to emphasize the importance of the protection of shareholders against self-dealing by managers and large shareholders.

By contrast, the role of specific investments in general and the team production approach specifically seem not to have had a significant impact on the debate on comparative corporate governance so far. This paper attempts to bridge this gap by proposing a theory of how capital structure and asset specificity are connected. The crucial factor in my analysis is what I call *shareholder influence.* Whether nonshareholder constituencies such as employees are subject to holdup risks depends on what decisions are taken by managers within the scope of their legitimate business judgment (e.g. whether a plant is closed). Since shareholders are the financial beneficiaries of holdup, it is important whether they can influence these decisions directly, or whether managers otherwise have an incentive to pursue ex post shareholder wealth maximization. Specifically, I hypothesize that, all else being equal, concentrated

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[3] However, Blair and Stout's team production theory has been applied to Canadian corporate law. *See* Stephanie Ben-Ishai, *A Team Production Theory of Canadian Corporate Law,* 44 ALBERTA L. REV. 299 (2006).

[4] *See* Randall K. Morck, *Introduction,* in CONCENTRATED OWNERSHIP STRUCTURE 1, 1 (Randall K. Morck ed. 2000); Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Corporate Taxonomy,* 119 HARV. L. REV. 1641, 1645-1650 (2006) (both summarizing cross-country evidence).

ownership exacerbates holdup problems regarding stakeholders, because shareholder influence is much greater than in a classical Berle-Means firm.[5] *Shareholder protection* against illicit self-dealing by managers and large shareholders, which is usually studied by the comparative literature, is an entirely different issue.

Shareholder influence may help to explain differences we observe in regard to pro-stakeholder laws in different countries of the „wealthy west". Continental European corporate governance systems, which are characterized by strong shareholder influence due to concentrated ownership, have pro-stakeholder institutions in their corporate governance systems and much more rigid employment laws than the US, which protects employees against holdup to some degree. Since pro-stakeholder laws come at considerable cost, such as friction in codetermined boards of directors and the difficult of adapting employment in times of crisis, they may be more or less desirable depending on the respective degree of shareholder influence. Thus, I suggest that both the US and Continental European systems may be close to their respective local optimum given their respective ownership structures. This paper provides a functional explanation for pro-stakeholder laws and institutional complementarities in corporate governance.

Most of the article focuses on the opposition between US-style dispersed ownership and continental European concentrated ownership, and how it affects holdup problems. However, I also emphasize that the *shareholder influence* variable also varies between the US and the UK: US corporate and securities law is highly unusual in the

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[5] It has occasionally been mentioned that large shareholders may expropriate stakeholders with relative ease, but the issue seems not to have been analyzed in detail or studied from a comparative perspective so far. *See* Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance,* 52 J. FIN. 737, 758 (1997); Gérard Charreaux & Philippe Desbrières, *Corporate Governance: Stakeholder Value versus Shareholder Value*, 5 J. MGMT. & GOV. 107, 116 (2001); Gregory Jackson, *Employee Representation on the Board Compared: A Fuzzy Sets Analysis of Corporate Governance, Unionism and Political Institutions,* 12 INDUSTRIELLE BEZIEHUNGEN 1, 7 (2005). For a mathematical model in the context of LBOs, *see* Michel A. Habib, *Monitoring, Implicit Contracting, and the Lack of Permanence of Leveraged Buyouts,* 1 EUR. FIN. REV. 139 (1997).

extent to which it disenfranchises shareholders from any explicit or implicit influence. I argue that the UK constitutes an intermediate case, standing between the US and Continental Europe, both regarding shareholder influence and legal protection of employees against holdup.[6]

The paper proceeds as follows: Section 2 sets the scene, first by reiterating the "agency" and "specific assets" perspectives of the firm in sections 2.1 and 2.2, and then by describing how stakeholder interests are usually dealt with in comparative corporate governance theories (section 2.3). Section 3 outlines the core thesis of the paper. I first define the concept of *shareholder influence* in section 3.1 and then proceed to how it comes to bear under US-style dispersed ownership and under continental European concentrated ownership in sections 3.2 and 3.3. Section 4 relaxes the ceteris paribus assumption and points out that the protection of employees is more strongly developed in corporate governance systems characterized by concentrated ownership. Section 5 attempts to put the pieces of the puzzle together by suggesting that the respective combinations of shareholder influence and stakeholder protection in the US and continental Europe possibly constitute two different local optima – in other words, strong stakeholder protection should be seen as a complementary element to shareholder influence. My theory thus provides the obverse to

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[6] While I focus on employees in this paper, the analysis might conceivably be extended to other groups of stakeholders, particularly creditors. Economically orientated legal scholars have previously suggested that a strong position of managers may have the consequence that actions that hurt creditors, but benefit shareholders, may not be taken. *See* Mark J. Roe, *Corporate Strategic Reaction to Mass Tort,* 2 VA. L. REV. 1, 17-30 (1986) (describing how institutions generally thought to advance the interests of shareholders do not have these incentive effects in a mass-tort-induced crisis); Lynn M. LoPucki, *The Death of Liability,* 106 YALE L. J. 1, 42-43 (1996) (arguing that managers will resist shareholders attempts to externalize risks by crediting highly leveraged legal entities). More recently, a debate about the (so far not entirely clear) implications of corporate governance for the cost of debt has emerged in financial economics. *See* Hollis Ashbaugh-Skaife, Daniel W. Collins & Ryan B. LaFond, *The effects of corporate governance on firms' credit ratings,* 42 J. ACCT. & ECON. 203 (2006) *also see* Roman Inderst & Holger Müller, Ownership Concentration, Monitoring, and the Agency Cost of Debt, WORKING PAPER (1999), available at http://ssrn.com/abstract=190497; Michael Bradley, Dong Chen, George Dallas & Elisabeth Snyderwine, *The Relation between Corporate Governance and Credit Risk, Bond Yields and Firm Valuation,* WORKING PAPER (2007), available at http://ssrn.com/abstract=1078463.

Mark Roe's suggestion that pro-stakeholder laws are the reason for the persistence of concentrated ownership in Continental Europe[7] (although the two theories are not incompatible). In section 6, I also incorporate the UK into the theory, which is lumped into one group with the US in most comparative corporate governance theories, but is actually an intermediate case located between the US and Continental Europe both regarding shareholder influence and pro-stakeholder laws. Section 7 summarizes and concludes.

2. Foundations

2.1. The agency perspective

Most discussion of policy issues of corporate law today is based on the economic theory of the firm. Regardless of its complexities, most of corporate law scholarship, and almost all of comparative scholarship, is dominated by the agency view. With antecedents such as Berle and Means,[8] agency theory was formalized and achieved its breakthrough with Jensen and Meckling's seminal 1976 article.[9] While these authors emphasize the nature of the firm as a nexus of contracts, i.e. as a focal point of

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[7] *Infra* note 71 and accompanying text.

[8] ADOLPH A. BERLE & GARDNER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932). However, other authors, most famously Adam Smith, have recognized the problem long before Berle and Means. A less well known example is the almost forgotten work of Erwin Steinitzer, who, writing in German in 1908, pinpointed the agency problem more than twenty years before Berle and Means and described the corporation in very similar terms as what became later known as the „nexus of contracts" almost 70 years before Jensen & Meckling and Alchian & Demsetz (both *infra* note 9) coined that metaphor. *See* ERWIN STEINITZER, ÖKONOMISCHE THEORIE DER AKTIENGESELLSCHAFT (1908) (describing the firm as a network of contracts on pp. 48-49 and discussing agency problems on p. 55 et seq.). Interestingly, Berle and Means cited the German industrialist, politician and scholar Walter Rathenau (WALTHER RATHENAU, VON KOMMENDEN DINGEN [1917]) for the argument that corporations were increasingly developing an "objective existence comparable only to the state" among corporations. *See* BERLE & MEANS, *id.* at 352; ARNDT RIECHERS, DAS "UNTERNEHMEN AN SICH" 183-184 (1996) (pointing out Rathenau's influence on Berle and Means).

[9] *Cf.* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Cost and Ownership Structure,* 3 J. FIN. ECON. 305 (1976). The nexus of contracts metaphor is usually attributed to Armen A. Alchian & Harold Demsetz, *Production, Information Costs and Economic Organization,* 62 AM. ECON. REV. 777 (1972).

coordination of productive factors consisting of explicit and implicit contracts,[10] the nature of the firm as a legal entity as such remains irrelevant under the terms of the theory.[11]

While it is normatively recognized that corporate law should maximize the aggregate welfare of all corporate constituencies,[12] the interests of constituencies other than shareholders remain on the sidelines of the debate, as these are usually thought to be sufficiently protected by contract.[13] The design of the respective corporate law and corporate governance environment will therefore not (normally) affect the incentives of groups such as creditors, employees, suppliers and others enter into relationships with it under specified contractual rights and obligations.

By contrast, shareholders are not given such rights, but are left with residual cash flows,[14] which is why their relationship to the management of the firm is said to be of primary importance. As residual risk-bearers, shareholders are said to have the best incentives to monitor other constituencies, maximize the total value of the firm and thus social welfare; thus, residual risk-bearing should be aligned with residual control and the power to change the arrangement of the use of production factors.[15] If managers are incentivized to maximize shareholder value, it follows logically that all other constituencies, whose rights are fixed contractually, receive the full maximum value

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[10] *E.g.* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991) 12.

[11] *E.g.* Oscar Couwenberg, *Corporate Architecture and Limited Liability,* UNIVERSITY OF GRONINGEN FACULTY OF LAW WORKING PAPER SERIES IN LAW AND ECONOMICS 5, http://ssrn.com/abstract=934329.

[12] Henry Hansmann & Reinier Kraakman, *What is Corporate Law?* in THE ANATOMY OF CORPORATE LAW 1, 18 (Reinier Kraakman, Paul Davies, Henry Hansmann, Gerard Hertig, Klaus J. Hopt, Hideki Kanda & Edward B. Rock 2004). However, as pointed out by these authors and others, the ultimate goal is to maximize the total social welfare of society. *See generally* LOUIS KAPLOW & STEVEN SHAVELL, FAIRNESS VS. WELFARE (2002). Anyone whose utility is affected by corporate conduct can be understood as a member of a constituency or as a stakeholder of the firm. *See* Janice Dean, *Stakeholding and Company Law,* 22 COMPANY LAW. 66, 69-71 (2001); *see also* Jean Tirole, *Corporate Governance,* 69 ECONOMETRICA 1, 23-25 (2001) (implying that anyone affected by the firm's externalities is a stakeholder).

[13] EASTERBROOK & FISCHEL, *supra* note 10, at 11.

[14] EASTERBROOK & FISCHEL, *id.*, at 11.

[15] Alchian & Demsetz, *supra* note 9, at 781-783.

as well. From this stems the notion of shareholder primacy and the fact that shareholders are said to be the beneficiaries of managers' fiduciary duties. Furthermore, in the ideal case, shareholders are presumed to be diversified as predicted by portfolio theory[16] and thus risk-neutral and in the best position to bear the firm's residual risk. Only creditors are sometimes considered to be an exception,[17] as they become residual risk-bearers when the company approaches bankruptcy.[18]

2.2. The specific investments perspective

Without doubt, the agency perspective has an important function in the analysis of the relationship between shareholders, managers, and creditors. However, it can be criticized as being focused too strongly (or in practice even exclusively) on the financial structure of firms, while leaving out the important aspect of bundling of various resources into a joint endeavor whose combined value is greater than that of the sum of its parts'.[19]

While Coase pointed out the importance of transaction costs to the organization of economic activity in 1937[20], the challenge to the agency paradigm has its roots in the theory of transaction costs and incomplete contracts theory. Oliver Williamson emphasized that there were important impediments to complete contingent contracting,

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[16] Harry Markowitz, *Portfolio Selection,* 7 J. FIN. 77 (1952) (article considered the beginning of portfolio theory). *See generally* RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 153 et seq. (7th ed. 2003).

[17] Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law,* 89 GEO. L. J. 438, 443 (2001).

[18] Stewart C. Myers, *Determinants of Corporate Borrowing,* 5 J. FIN. ECON. 147 (1977). *See* West Mercia Safetywear Ltd v Dodd and Another, [1988] B.C.L.C. 250; Credit Lyonnais Bank Netherlands, N.V. v. Pathe Communications Corporation, 1991 Del. Ch. LEXIS 215 at n. 55 (Dec. 30, 1991); *also see* Geyer v. Ingersoll Publications Co., 621 A.2d 784 (Del. Ch. 1992); Angelo, Gordon & Co., L.P. v. Allied Riser Communs. Corp., 805 A.2d 221 (Del. Ch. 2002) (all suggesting that directors have duties towards creditors in the vicinity of insolvency); *but see* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 2007 Del. LEXIS 227 (denying *direct* fiduciary claims against directors by creditors).

[19] *E.g.* Bernd Frick, Gerhard Speckbacher & Paul Wentges, *Arbeitnehmermitbestimmung und moderne Theorie der Unternehmung,* 69 ZEITSCHRIFT FÜR BETRIEBSWIRTSCHAFT 745, 748 (1999). *See also* id. at 750 (suggesting that the older, principal-agent based perspective remains common only in finance textbooks).

[20] Ronald H. Coase, *The Nature of the Firm,* 4 ECONOMICA 386 (1937).

such as information asymmetry, opportunism and bounded rationality.[21] These factors essentially eliminate a crucial assumption implicit in the agency-theoretical perspective of corporate law. Oliver Hart and his coauthors developed the "property rights" or "incomplete contracts" approach, which attempts to explain the assignment of property rights by reference to specific assets of various parties to the corporate nexus. This theory emphasizes the importance of who "owns" an asset, i.e. who has residual control over it. In those states of the world not specified by contract, decisions will be made by the owner, which implies a potential to put pressure on other parties who made such investments in order to appropriate their rents.[22]

In fact, there seems to be widespread agreement today that workers make investments by acquiring skills that are only useful in the particular employment relationship.[23] For the productive process of the firm, firm-specific investments may be beneficial, as workers with specialized human capital may be able to do their jobs more quickly, make fewer mistakes, and create higher-quality products. Overall, specific investment may make the firm more competitive and therefore able to succeed in the market. Those investments may originally be costly for workers to acquire, but it allows them to gain quasi-rents in the course of the relationship with the firm. For example, employees may agree to accept a wage below their outside earning capacity during the training period, but expect to receive wages above their marginal product once they have acquired experience and have achieved a senior status within the

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[21] OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 43 et seq. (1985); *cf.* OLIVER HART, FIRMS, CONTRACTS AND FINANCIAL STRUCTURE 23 (1995).

[22] HART, id. at 29-33.

[23] *See e.g.* HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 26 (1996); Stewart J. Schwab, *Life-Cycle Justice: Accommodating Just Cause and Employment at Will,* 92 MICH. L. REV. 8, 13 (1993); James M. Malcolmson, *Individual Employment Contracts,* in 3 HANDBOOK OF LABOR ECONOMICS 2291, 2311-2337 (Orley Aschenfelter & David Card eds. 1999) (reviewing the labor economics literature on contractual protection of specific investment); Larry Fauver & Michael E. Fuerst, *Does good corporate governance include employee representation? Evidence from German corporate boards,* 82 J. FIN. ECON. 673, 679 (2006).

firm.[24] While wages are normally fixed claims, other rewards are not, such as certain types of retirement benefits, expectations regarding job security and advancement within the corporate hierarchy, and the safety of working conditions.[25]

Note that firm-specific human capital can be understood quite broadly: Labor economist Edward Lazear argues that, while few skills actually are specifically useful within one employment relationship only, idiosyncratic combinations of skills may be;[26] for example, a combination of knowledge in tax law, economics and JAVA programming, required in a (monopolist) firm producing tax optimization software,[27] will normally not be useful outside that particular employment relationship, although each of these individual skills will certainly be (but not all of them in a single new professional opportunity).[28] In the case of a job change, the employee will lose part of his investment and possible need to reinvest.[29] A related factor is motivating potential employees to relocate to an area near the place of employment and to make arrangements to live there, including the reorganization of their social life. These costs cannot be fully recovered.[30] The employee may not necessarily be "locked in" with the particular employer, but with his employment options in the region where he lives. The effect is the same if the line of work in which the employee is trained is only demanded by one employer in the region. Even if other employment opportunities are available, he will not be able to make the same wage in a line of work for which he has no special qua-

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[24] *E.g.* Schwab, *supra* note 23, at 13; Thomas Eger, *Opportunistic termination of employment contracts and legal protection against dismissal in Germany and the USA,* 23 INT'L REV. L. & ECON. 381, 383-384 (2004).

[25] Kent Greenfield, *The Place of Workers in Corporate Law,* 39 B. C. L. REV. 283, 305-307 (1998).

[26] Edward P. Lazear, *Firm-Specific Human Capital: A Skill-Weights Approach*, IZA DISCUSSION PAPER NO. 813 (June 2003), at http://ssrn.com/abstract=422562.

[27] This example is given by Lazear, *id.* at 2.

[28] *But see* HANSMANN, *supra* note 23, at 71 (suggesting that it is rather middle- and upper-level managers than operative personnel who specifically invest).

[29] However, an employee's flexibility for retraining may also decrease over the years. *E.g.* HANSMANN, *id.*, at 26.

[30] *See e.g.* HANSMANN, *id.*; EIRIK G. FURUBOTN & RUDOLF RICHTER, INSTITUTIONS AND ECONOMIC THEORY 232 (2000). In the European context, language barriers and cultural differences making relocation costly may also play a role.

lification. Other corporate stakeholders may suffer in a similarly precarious position, e.g. suppliers who tailor their production to the needs of a particular purchaser or who set up their production site near the purchaser's one.[31] Stakeholders will make such investments only if they can expect to gain a rent or quasi-rent at a later time, e.g. payment above marginal cost.

The predominant view in the economics analysis of corporate law still assumes that contracts with members of nonshareholder constituencies are complete, protecting these from opportunism by shareholders or managers. However, real-life contracts are normally not complete contingent ones, which exhibit the highly theoretical characteristic of determining payoffs for all parties for each possible state of the world (to put it in the language of economic modeling).[32] For many states of the world, the transaction cost necessary would exceed the potential welfare gains from incorporating such a provision into the contract, because each state's probability is very small. Humans are boundedly rational, meaning that the parties are unable to foresee certain possible contingencies because of cognitive limitations (or because the costs of considering them exceed the benefits ex ante).[33] Other terms are not included in contracts because they cannot be observed by the parties ex post or verified by courts. It is, for example, hard to objectively anticipate and measure "the demand for cars, or

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[31] Lynn Stout mentions two further interesting examples. First, in the case of PeopleSoft's takeover by Oracle, companies relying on PeopleSoft's products apparently would have suffered from its integration into Oracle. Second, the move of a factory from the US to Mexico may hurt those who purchased real property in the town where the factory is located. Lynn A. Stout, *Takeovers in the Ivory Tower: How Academics Are Learning Martin Lipton May Be Right,* 60 BUS. LAW. 1435, 1448 (2005).

[32] *See e.g.* Alan Schwartz, *Incomplete Contracts,* in 2 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 277 (PETER NEWMAN ed. 1999). Complete contingent contracts would have to include payoffs for all parties involved depending on numerous exogenous factors, such as market demand, actions of competitors, legal regulation and many others.

[33] The term is attributed to Herbert Simon, *A Behavioral Model of Rational Choice,* 69 Q.J. ECON. 99 (1955); *see generally* WILLIAMSON, *supra* note 21, at 45-46; HART, *supra* note 21, at 80-82; Christine Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics,* 50 STAN. L. REV. 1471, 1477 (1998).

the degree of innovation, the extent of government regulation, or the actions of competitors."[34]

As a result of the incompleteness of contractual protection, stakeholders can be subject to holdup by the group in control. If e.g. employees are locked into the employment relationship, the employer may e.g. engage in opportunistic wage negotiations by threatening dismissal unless employees agree to a reduction of wages to marginal revenue products,[35] or default on mere implicit expectations regarding the employment relationship such as career advancement prospect. Shareholders would be the ex post beneficiaries, as they would capture the firm's increased profits available for distribution.[36] Ex ante, they may suffer if they cannot commit not to hold up stakeholders.

In many cases, human capital investments will be beneficial for the promotion of the total welfare of both shareholders and employees.[37] Depending on the productive processes employed, these may shift a company's production function, thus allowing for larger output for the same amount of inputs. In the terminology of the theory of incomplete contracts, those investments will frequently not be verifiable by a third party, sometimes maybe not even ex post observable by the parties involved. By the very nature of human capital, such investments cannot be made the part of an enfor-

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[34] HART, *supra* note 21, at 24.

[35] Eger, *supra* note 24, at 384-385.

[36] Another reason for holdup could be off-work related capital of stakeholders, such as relocating near the site of employment, but also family and social relations. *See* Tirole, *supra* note 12, at 23.

[37] *E.g.* Charreaux & Desbrières, *supra* note 5; Andreas Engert, *Eine juristische Theorie des Unternehmens,* in FESTSCHRIFT FÜR ANDREAS HELDRICH ZUM 70. GEBURTSTAG 87 (Stephan Lorenz, Alexander Trunk, Horst Eidenmüller, Christiane Wendehorst & Johannes Adolff eds. 2005) (both arguing that the sum of rents received from all stakeholder groups within a company should be maximized). This conforms to the general objective of normative (law and) economics to maximize total utility. *See* ANDREU MAS-COLLELL, MICHAEL D. WHINSTON & JERRY R. GREEN, MICROECONOMIC THEORY 825-831 (1995); LOUIS KAPLOW & STEVEN SHAVELL, FAIRNESS VERSUS WELFARE 15-38 (2002); STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 595-598 (2004); *but see* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 12-17 (5th ed. 1998).

ceable contract, as a third party like a court will not be able to tell whether an employee has made the specified amount of relationship-specific investments.[38]

However, if investments can at least be observed by the firm's management or inferred (with at least some degree of certainty) from output, management will be able to reward employees for having invested. The prospect of a reward may constitute part of an implicit contract with the person or group in charge, which is necessary to induce employees to make such investments ex ante.[39] For example, workers may be paid below their marginal product early in their careers for incentive reasons, having the legitimate expectation of being rewarded with higher wages later; a supplier may expect to do business with the firm again if his performance was good and he built a plant tailored to the need of producing for the firm. [40] Ex post, it may pay for shareholders to renege on these implicit deals. However, members of non-constituency groups can be expected to make firm-specific investments only if their investments can be protected, either by a complete contract or an implicit arrangement.

If such long-term implicit contractual arrangements are not possible, because they cannot be verified by courts, constituencies such as employees will fail to make firm-specific investments (where they can avoid it) unless they enjoy some protection. This may work to the detriment of other constituencies, including shareholders, as the "total pie" of the company will be smaller. In that situation, holdup risk is not simply an external effect of the agency relationship between shareholders and managers borne by employees, but the result may be that ultimately all constituencies are worse off.

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[38] *Cf.* HART, *supra* note 21, at 37-38, n15 (defining the terms "verifiable" and "observable"); *also see* FURUBOTN & RICHTER, *supra* note 30, at 233.

[39] Andrei Shleifer & Lawrence Summers, *Breach of Trust in Hostile Takeovers,* in CORPORATE TAKEOVERS. CAUSES AND CONSEQUENCES 33, 37 (ALAN J. AUERBACH ed. 1988).

[40] Shleifer & Summers, *supra* note 39, at 37.

Shareholders may not always benefit from the elimination of holdup possibilities. In some cases, the interests of shareholders and stakeholders will coincide, i.e. catering to the interests of nonshareholder constituencies will also increase long-term shareholder value because long-term relations are essential for a firm's success. In other cases, the gain in welfare to nonshareholder constituencies may exceed losses to shareholders,[41] or the losses incurred by nonshareholder constituencies in a transaction are smaller than the gains to shareholders.[42] However, from a welfare perspective, furthering stakeholders' interests will be desirable. This does not mean that shareholders should be entirely stripped of their power over corporations (or large firms for that matter). Their contribution to the firm may still be of crucial importance to the corporate nexus, as the aggregate of a firm's shareholders cannot withdraw its contribution to the corporation without liquidating it.[43] Individual shareholders selling will typically not be able to so without incurring losses, which may explain why some residual control rests with shareholders in every Western corporate governance system. However, there are limits to its descriptive and normative explanatory power. Hart and Moore's "property rights" solution to the specific investment problem was the suggestion that an agent "is more likely to own an asset if his action is sensitive to whether he has access to that asset and is important to the generation of the surplus, or if he is a crucial trading partner for others whose actions are sensitive to whether they have access to the asset and are important in the generation of surplus."[44]

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[41] *Cf. e.g.* Colin Mayer, *Financial Systems and Corporate Governance: A Review of the International Evidence,* 154 J. INSTITUTIONAL & THEORETICAL ECON. 144, 146 (1998).
[42] E.g. the possible liquidation and subsequent sale of Rover to Phoenix by BMW, as described by John Armour, Simon Deakin & Suzanne J. Konzelmann, *Shareholder Primacy and the Trajectory of UK Corporate Governance,* 41 BRITISH J. INDUS. REL. 531, 543-545 (2003).
[43] *Cf.* WILLIAMSON, *supra* note 21, at 304-305.
[44] Oliver Hart & John Moore, *Property Rights and the Nature of the Firm,* 98 J. POL. ECON. 1119, 1149 (1990).

Rajan and Zingales have developed a theory of the firm based on the property rights approach, but replaced ownership with the concepts of power and access to a resource.[45] These authors suggest that there are two risks associated with specific investment. First, any party not in control of the "nexus of specific assets" has an incentive to underinvest in firm-specific assets to avoid being subject to holdup by the controlling party (as under the Hart approach). Second, there is an additional underinvestment problem that is the result of being assigned ownership: Firm-specific investments may make it less lucrative to sell the property right to a third party and more difficult to hold up others, since the owner will also expect a quasi-rent from the asset.[46] As the party in control should not have an incentive against specializing the asset, it may therefore by more efficient to assign ownership rights to a party that does not specifically invest at all if the firm requires large and multiple firm-specific investments by particular groups.[47]

In a series of articles, Margaret Blair and Lynn Stout have developed a "team production" approach to corporate law in which they expand on these models and suggest that the US solution to this problem is to give control over the firm to the board of directors. Building on incomplete contracts theory and, more specifically, the Rajan and Zingales model, they suggest that the fiction of a corporation's legal personality independent from its members may be a solution to the contracting problems of specific investment. In this view, corporate stakeholders, including shareholders, yield control over their specific investments to the board of directors, making it impossible for them to control how the specific investment is used, while exit from the firm is made hard

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[45] Raghuram G. Rajan & Luigi Zingales, *Power in a Theory of the Firm,* 113 Q. J. ECON. 387 (1998).
[46] In essence, Rajan & Zingales relax the assumption that the value of an asset for other uses increases with specific investment, which need not necessarily be true.
[47] Rajan & Zingales, *id.,* at 422-423.

by the fact that it would result in the loss of their investment.[48] Crucially, control over the firm's assets is not actually given to shareholders, but to the fictional legal entity of the firm itself.[49] Team members submit to hierarchy and ownership on their own, as it works for their own benefit.[50] Blair and Stout assert that shareholders are not the only residual risk bearers in a corporation.[51] Of course, they are in the traditional sense as the group whose financial claims are satisfied with what remains when everyone else got what was his due. But on the other hand, other corporate constituencies frequently make firm-specific investments (e.g. employees specialize their human capital). Directors thus act a "mediating hierarchy" standing between all constituencies, including shareholders, whose task it is to balance countervailing interests, and to rearrange production factors if necessary. Thus, they interpret the board's duty to serve the interest of the corporation not as shareholder interest, but as the aggregate welfare function.[52]

This view is supported by the large degree of autonomy US corporate law typically assigns to the board. The picture of directors acting as shareholders' agent seems incomplete when you consider shareholders' inability to command directors. Fiduciary duties to shareholders are not enough to ensure that directors will pursue shareholder primacy, and directors have broad discretion to adopt takeover defenses, which allows them to promote other constituencies' interests over short-term

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[48] Margaret M. Blair & Lynn Stout, *Specific Investment and Corporate Law,* 7 EUR. BUS. ORG. L. REV. 473, 492 (2006).
[49] Margaret Blair & Lynn Stout, *A Team Production Theory of Corporate Law,* 85 VA. L. REV. 247, 274 n. 57 (1999).
[50] Blair & Stout, *id.,* at 274.
[51] *Also see* Charreaux & Desbrières, *supra* note 5, at 124 ([stakeholders] assume a part of the residual risk).
[52] Blair & Stout, *id.,* at 288-9. The team production theory has been extended to Chapter 11 bankruptcy reorganization (*see* Lynn M. LoPucki, *A Team Production Theory of Bankruptcy Reorganization,* 57 VAND. L. REV. 741 (2004)) and to Canadian corporate law (*see* Ben-Ishai, *supra* note 3).

shareholder value maximization.[53] Shareholders' voting rights may be overrated as well and are considered to be largely a fig leaf by some;[54] the fact that such rights exist can be put down to the necessity of someone actually voting for directors, and shareholders are likely to exhibit more homogeneous objectives than other groups, which makes the voting process less costly.[55] It has also been suggested that, while the residual risk-bearers argument for shareholder primacy is inconclusive, enforceable fiduciary duties are normally restricted to shareholders because their interests are not well-protected by other mechanisms relative to those of other constituencies, who usually have more effective means at their disposal than judicial lawmaking.[56]

While proponents of the shareholder primacy view often denounce the absence of influence shareholders in the US as inefficient, the team production approach provides a possible explanation why the attenuation of shareholder influence may be efficient.[57] However, they do of course acknowledge that board autonomy may be a second-best solution, as it worsens the classic agency problem.[58]

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[53] Blair & Stout, *id.,* at 290-315. *Also see* D. Gordon Smith, *The Shareholder Primacy Norm,* 23 J. CORP. L. 277 (1998) (arguing that the shareholder primacy norm of the famous opinion of Dodge v. Ford Motors, 170 N.W. 668 (Mich. 1919), is overrated, as the case actually dealt with a minority-majority conflict for which corporate law has found other doctrinal mechanisms in the meantime). *Also see* Jill E. Fisch, *Measuring Efficiency in Corporate Law,* 31 J. CORP. L. 637, 651 (2006) (pointing out that under Delaware takeover case law, permits directors to consider the interests of stakeholders unless the company has been put up for sale by the board).

[54] *See* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise,* 93 VA. L. REV. 675 (2007).

[55] Blair & Stout, *id.,* at 309-313. In fact, a major factor in Henry Hansmann's theory why it is providers of capital rather than employees who "own" most firms is the lower cost of collective decision-making resulting from the greater homogeneity of interests among shareholders. *See* HANSMANN, *supra* note 23, at 44, 62-64, 89-119.

[56] Fisch, *supra* note 53, at 667-668.

[57] Other explanations have emerged in the literature in recent years. Einer Elhauge suggests that a corporation's dispersed shareholders are not subject to moral and social pressure with respect to the corporation's policies in the way a sole entrepreneur would be, e.g. with respect to the preservation of the environment. Thus, social pressures cannot fill up the gaps left by public enforcement to their full extent if managers must unconditionally maximize shareholder value. The large autonomy of boards apparently allows them to react to the pressure of moral and social sanctions in the same way as a sole entrepreneur would. This mechanism may thus approximate a degree of promotion of the public interest that maximizes social welfare. *See* Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest,* 80 N.Y.U. L. REV. 733 (2005). In Stephan Bainbridge's view, shareholder primacy prevails as the normative corporate objective, but he argues that the dissociation between shareholders and managers ultimately works to the benefit of shareholders, as it facilitates collective decision-making. *See* Stephen M. Bainbridge, *The Board of Directors as Nexus of Contract*s, 88 IOWA L REV. 1 (2002);

2.3. Stakeholders in comparative corporate governance literature

The dominance of the agency perspective has been carried over from domestic US scholarship to the international context. The comparative corporate governance generally focuses on agency problems, and usually juxtaposes two types of corporate governance systems. One the one side, arm's length or outsider systems (mainly the US and the UK) are said to be characterized by dispersed ownership, strong securities markets, and agency problems between shareholders and managers that are held in check by market mechanisms, most of all the market for corporate control. On the other hand, control-oriented or insider systems (such as those of Continental European countries) have concentrated ownership, less developed securities markets, with the managerial agency problem being mitigated by the monitoring function of large shareholders (and sometimes creditors), which, however, in turn creates another agency problem because of large shareholders' private benefits of control.[59] On a related note, it is one of the staple narratives of comparative corporate governance that Continental systems take stakeholder interests into account, while Anglo-Saxon systems do not (or to a much smaller degree).[60] Some commentators suggest

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Stephen M. Bainbridge, *Director v. Shareholder Primacy in the Convergence Debat*e, 16 TRANSNAT'L L. 45 (2002); Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers: Preliminary Reflection*s, 55 STAN L. REV. 791 (2002); Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governanc*e, 97 NW. U. L. REV. 547 (2003).

[58] Blair & Stout, *supra* note 48, at 493.

[59] *See e.g.* Erik Berglöf, *A Note on the Typology of Financial Systems,* in COMPARATIVE CORPORATE GOVERNANCE, 151, 159-164 (Klaus J. Hopt & Eddy Wymeersch eds. 1997); Brian R. Cheffins, *Does Law Matter? The Separation of Ownership and Control in the United Kingdom,* 30 J. LEGAL STUD. 459, 465 (2001); John C. Coffee, Jr. *The Rise of Dispersed Ownership: The Role of Law and the Separation of Ownership and Control,* 111 YALE L. J. 1, 3 (2001).

[60] *E.g.* Hansmann & Kraakman, *supra* note 17, at 443-447; Brian R. Cheffins, *The Metamorphosis of "Germany Inc.": The Case of Executive Pay,* 49 AM. J. COMP. L. 497, 500-501 (2001); Amir N. Licht, *The Maximands of Corporate Governance: A Theory of Values and Cognitive Style,* 29 DEL. J. CORP. L. 649, 733 (2004); *also see* Klaus J. Hopt, *Labor Representation on Corporate Boards: Impact and Problems for Corporate Governance and Economic Integration in Europe,* 14 INT'L REV. L. & ECON. 203, 208-209 (1994); Jennifer Cook & Simon Deakin, *Stakeholding and Corporate Governance: Theory and Evidence on Economic Performance* 3 ERSC CENTRE FOR BUSINESS RESEARCH WORKING PAPER (1999).

that this is rather a cliché, while actual practice does not differ too much altogether.[61] Others have observed a shift towards stakeholder rhetoric in business practice since the early 2000s.[62] Nevertheless, it is probably the majority opinion that Anglo-Saxon shareholder primacy is the economically efficient corporate objective, and that the Anglo-Saxon model of corporate law will ultimately prevail in a Darwinian struggle.[63] Regard to the interests of other constituencies is usually thought to be counterproductive, as long as it cannot be explained by "enlightened shareholder value", meaning that it is in the long-run interest of shareholder wealth.[64] US corporate law – hardened by regulatory competition and free markets – is presumed to deviate from this principle only in exceptional circumstances (if it ever does), and – focusing on the agency problem – much of the literature emphasizes that deviations from the "standard" model must be inefficient.[65]

While the corporate governance literature is very much concerned with the reasons for dispersed and concentrated ownership structures, reasons why the stakeholder influence on corporate governance varies between countries seem to be a less researched concern.[66] Amir Licht suggests that differences are due to cultural norms, with Anglo-Saxons, and Americans in particular, being more prone to cognitive closure and individualism, which are associated with a greater acceptance or even desire to have a maximand consisting of a single variable such as shareholder wealth.[67]

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[61] *See* MATHIAS SIEMS, CONVERGENCE IN SHAREHOLDER LAW 175-190 (2007) (reviewing the literature in detail).
[62] Lisa M. Fairfax, *The Rhetoric of Corporate Law: The Impact of Rhetoric on Corporate Norms*, 31 J. CORP. L. 675 (2006).
[63] *E.g.* Hansmann & Kraakman, *supra* note 17.
[64] *See e.g.* Armour et al., *supra* note 42, at 537.
[65] Hansmann & Kraakman, *supra* note 17.
[66] *See e.g.* Mark J. Roe, *Political Preconditions to Separating Ownership from Corporate Control,* 53 STAN. L. REV. 539, 542 (2000) ("Most corporate governance analyzes ignore employees."); PETER A. GOUREVITCH & JAMES SHINN, POLITICAL POWER AND CORPORATE CONTROL 8 (2005) ("[Employees] are often left out of models of corporate governance.").
[67] Licht, *supra* note 60, at 667-686, 733-739. One could of course question Licht's analysis as it regards to American takeover law.

Dirk Zetzsche emphasizes the predominant religious background of corporate governance systems, and proposes that Catholic and Lutheran ethical values were historically more conducive to a stakeholder-oriented corporate governance system than Calvinist and Anglican ones.[68]

Applying an economic perspective, Mark Roe has suggested that shareholder primacy could be inefficient when an industry is concentrated, because the shareholders of a monopolist will gain part of the consumer surplus, while, according to standard microeconomic theory, another part of it will be completely lost to society.[69] If managers deviate from primacy and sacrifice profits by employing a larger number of workers, the actual productive output could be closer to the social optimum. In Continental Europe, the weakness of pro-shareholder institutions could therefore be seen as a complement to noncompetitive product markets.[70] While Roe's theory is an innovative combination of industrial economics and comparative corporate governance, it rests firmly within the agency paradigm. Hence, once abnormal barriers to free markets are removed, it would be efficient for shareholder primacy to prevail as well. In his more famous body of work, Mark Roe argues that political pressure has been the reason for the strong position of stakeholder interests in many countries. The argument is that social democratic politics and legislation makes it hard for managers to pursue shareholder interest and lay off workers, close plants or change the firm's line of production for legal and practical reasons (which is important in times of economic contraction), and in some cases (most of all in the presence of codetermination) impedes monitoring of managers. In that theory, stakeholder policies are in turn the raison d'être for concentrated ownership, which allows some degree of preservation of

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[68] Dirk A. Zetzsche, *An Ethical Theory of Corporate Governance History,* CBC WORKING PAPER No. 0006 (2007).
[69] Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization,* 149 U. PA. L. REV. 2063, 2066 (2001).
[70] Roe, *id.* at 2080-2081.

shareholder influence, as it will keep managers (and employees) under control and may make it easier for managers to overcome pro-employee pressures.[71] Similarly, Gourevitch and Shinn suggest that corporate governance structures, including labor influence, are the result of complex political interactions depending on which coalitions among the three interest groups of owners, managers and workers are formed, and which coalition succeeds in achieving long-term dominance over the third group that remains outside of the coalition.[72] Pagano and Volpin propose an alternative political theory explaining corporate governance structures with differences between voting systems: While majority voting systems favor strong shareholder protection and weak employment protection, proportional voting systems tend to result in weak shareholder protection and strong employment protection.[73]

In this paper, I attempt to endogenize the role of stakeholders into an economic framework, relying on the specific investments perspective of corporate law. It is not intended to deny the significance of cultural and political factors, which certainly influence corporate governance laws, as it is hard to conceive that every aspect of a country's corporate governance system is determined by economic efficiency. However, it is only reasonable to believe that relatively successful economic systems, such as the ones of the US and of most Western European states are not too far away from an economic local optimum regarding corporate governance. Hence, if

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[71] Roe, *supra* note 66; ROE, *supra* note 90.
[72] GOUREVITCH & SHINN, *supra* note 66.
[73] Marco Pagano & Paolo F. Volpin, *The Political Economy of Corporate Governance,* 95 AM. ECON. REV. 1005 (2005). The reason for this result is that in majoritarian systems parties must compete for swing voters, who in Pagano & Volpin's model are those who are neither strongly committed to the employees' nor the entrepreneur's cause and therefore favor strong shareholder protection (as employees do, but entrepreneurs do not) and weak employment protection (as entrepreneurs do, but employees do not). By contrast, proportional election systems tend to result in a corporatist compromise between those strongly opposed to shareholder protection (entrepreneurs) and those strongly committed to employee protection (workers).

specific investments by stakeholders, most of all human capital are important, it is likely that they are taken into account in one way or the other in each of these.

3. The stakeholder perspective in dispersed and concentrated ownership systems

This part of the paper outlines the theory that it is *shareholder influence* that acts as the potential cause of holdup of nonshareholder constituencies, and that stronger shareholder influence, particularly in the case of concentrated ownership, implies a greater risk of expropriation of stakeholder such as employees. Section 3.1 defines the term shareholder influence. Section 3.2 describes the situation in the US and argues that holdup risk is (in general) comparatively small. Section 3.3 provides the contrary picture of Continental European corporate governance systems, which are characterized by concentrated ownership. In both cases we can see that aspects of corporate law reinforce the respective stance towards shareholder influence.

3.1. Shareholder influence delineated

By the term *shareholder influence*, I refer to explicit or implicit influence shareholders on managerial decision-making within managers' legitimate business judgment. *Shareholder influence* must not be confused with *shareholder protection* against illicit activity by managers or controlling shareholders, which is the subject of an important share of the literature on agency problems in large corporations.[74] The distinction roughly depends corresponds to the traditional dichotomy between the duties of

[74] *See e.g.* Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *The Law and Economics of Self-Dealing,* December 2005, available at http://ssrn.com/abstract=864645; Priya P. Lele & Mathias Siems, *Shareholder Protection: A Leximetric Approach,* 7 J. CORP. L. STUDIES 17 (2007). Note that the definition of shareholder influence differs from the one espoused by Zetzsche, who focuses mostly on legal mechanisms of shareholder protection. *See* Dirk Zetzsche, *Explicit and Implicit Systems of Corporate Control – A Convergence Theory of Shareholder Rights* 23*,* CBC WORKING PAPER No. 0001, at http://ssrn.com/abstract=600722.

loyalty and care to which directors are subject under US corporate law.[75] The duty of loyalty is, at its core, concerned with self-dealing transactions, and requires a manager to act fairly to the company when she is self-interested.[76] By extension, it also applies to controlling shareholders.[77] The duty of loyalty usually is thought to be vigorously enforced by the courts and essentially addresses the misappropriation of corporate assets by directors, managers, or large shareholders *to their own personal benefit*.[78] One might think that the ideal to which directors and managers are held should be shareholder value maximization.[79] However, it is rather doubtful whether the "shareholder primacy norm" is good law at all. For example, Gordon Smith argues that the famous shareholder primacy argument of Ford Motor[80] and even older case law did not arise in the context of actual shareholder-stakeholder conflicts, but was used to resolve conflicts of interest between controlling shareholders and minority investors.[81] In fact, more than half of US states have introduced constituency statutes, which allow or require directors to take employee interests into account, particularly when responding to hostile takeovers,[82] whereas in others, most of all Dela-

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[75] *See e.g.* WILLIAM T. ALLEN & REINIER KRAAKMAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATIONS 239 (2003).

[76] *See e.g.* ROBERT C. CLARK, CORPORATE LAW 166-171 (1986); Melvin Aron Eisenberg, *Self-Interested Transactions n Corporate Law,* 13 J. CORP. L 997 (1988); Melvin A. Eisenberg, *The Duty of Good Faith in American Corporate Law,* 3. EUR. COMPANY & FIN. L. REV 1, 14 (2006). DGCL § 144. For a comparative overview regarding the law and director's self-dealing including the US, the UK, France, Germany and Italy, *see* Luca Enriques, *The Law of Company Directors' Self-Dealing: A Comparative Analysis,* 2 INT'L & COMP. CORP. L. J. 297 (2000); *also see* Gerard Hertig & Hideki Kanda, *Related Party Transactions,* in THE ANATOMY OF CORPORATE LAW 101, 114-118 (Reinier Kraakman, Paul Davies, Henry Hansmann, Gerard Hertig, Klaus J. Hopt, Hideki Kanda & Edward B. Rock 2004).

[77] Sinclair Oil Cop v. Levien, 280 A.2d 717 (Del. 1971); Donahue v. Rodd Electrotype, 328 N.E.2d 505 (Mass. 1975); ALLEN & KRAAKMAN, *supra* note 75, at 297-299.

[78] Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board,* 79 WASH. U. L. Q. 403, 427 (2001).

[79] Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919).

[80] *Id.*

[81] Smith, *supra* note 53*,* at 306-309.

[82] Jonathan D. Springer, *Corporate Constituency Statutes: Hollow Hopes and High Fears,* 1999 ANN. SURV. AM. L. 85, 125-128 (listing a total of 32 statutes, among those 30 constituency statutes and 2 statutes explicitly allowing to consider the directors to consider the corporation's continued independence as optimally serving the corporation's and shareholder interest). However, Nebraska's statute was repealed in 1995. Springer, *id.* at 95.

ware, takeover case law has required directors to take into account "the impact on "constituencies" other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally)."[83] While there is a good case to say that the shareholder primacy norm is not good law in the US at all,[84] there appears to be agreement even among scholars stopping short of following that view that the shareholder primacy norm is enforced only very rarely.[85]

The duty of care is a much looser constraint to managerial conduct. The crucial delineation of the duty of care is of course the business judgment rule, according to which directors are given plenty of rope in daily decision-making, unless they fail to gather the relevant information before deciding, act in good faith and stay clear of self-interest.[86] The prominent provision of DGCL § 102(b)(7) even allows firms to entirely preclude liability for violations of the duty of care, and most Delaware firms have made use of this option.[87] While doctrinal structures vary and the business judgment rule is not universal,[88] it appears to be recognized across jurisdictions that directors should be not constrained to narrowly by a standard of care.[89] Mark Roe summarizes

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[83] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985).

[84] *See* Lynn A. Stout, *Why We Should Stop Teaching Dodge v. Ford,* UCLA LAW & ECON RESEARCH PAPER SERIES NO. 07-11 (2007) (arguing that the Dodge vs. Ford case, *supra* note 53, which is typically cited for shareholder primacy, is not good law and hardly ever used as a precedent).

[85] ALLEN & KRAAKMAN, *supra* note 75, at 287. Whether a managerial decision promotes shareholder primacy or not is typically a question about which courts are likely to defer to directors under the business judgment rule. *See e.g.* Shlensky v. Wrigley, 237 N.E. 2d. 776, 778 (Ill. App. 1968).

[86] ALI PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(c).

[87] Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis,* 39 EMORY L. J. 1155, 1160-1161 (1990) (reporting that 90% in a sample of 180 publicly traded Delaware firms had a provision after the introduction of DGCL § 102(b)(7)). More recently, the Delaware courts have established an (additional) duty of good faith which is not affected by a statutory clause precluding recovery under the duty of care. *See* In re the Walt Disney Company Derivative Litigation, 906, A.2d 27 (Del.); Steven A. Ramirez, *The Special Interest Race to CEO Primacy and the End of Corporate Governance Law,* 32 DEL. J. CORP. L. 345, 379 n. 197 (2007); *see generally* Eisenberg, *Good Faith,* supra note 76; Hillary Sale, *Delaware's Good Faith,* 89 CORNELL L. REV. 456 (2004).

[88] For example, there is no business judgment rule under UK law. *See e.g.* PAUL L. DAVIES, GOWER AND DAVIES' PRINCIPLES OF MODERN COMPANY LAW 436-437 (7th ed. 2003); Brian R. Cheffins & Bernard S. Black, Outside Director Liability Across Countries, 84 TEX. L. REV. 1385, 1401 (2006). This has not changed with the Companies Act of 2006, which codified directors' duties in §§ 170-181.

[89] Regarding the UK, *see* DAVIES, *id.* at 436; Cheffins & Black, *id.*; regarding France, *see* YVES GUYON, DROIT DES AFFAIRES, vol.1, nº 459 (12th ed. 2003); regarding Italy, *see* Giuseppe Campana, *La responsibilità civile degli amministratori delle società di capitali,* 2000 NUOVA GIURISPRUDENZA CIVILE COM-

this by stating that "[c]orporate law does not even try to directly control the cost of managerial mismanagement or non-conflicted disloyalty, from managers not working hard enough for shareholders."[90] It does "little, or nothing, to directly reduce shirking, mistakes and bad business decisions that squander shareholder value."[91] Roe claims to describe not only the US situation, but a general principle that can be observed across jurisdictions.

In short, as long as managers do not steal, it is mostly in their discretion how to run a business within what is generally considered their legitimate business judgment. Day-to-day business decisions, but typically even fundamental decisions of the firm, are taken by top management, although the more significant they may sometimes require approval by shareholders.[92] Managerial decisions of this kind may have considerable impact on the wealth or well-being of shareholders and other stakeholders, and even pitch these interests against each other, e.g. when management considers the closure of a plant or negotiates a collective bargain with union representatives. How managers will use their discretion will depend on their personal interest and incentives.

With this distinction in mind, it is obvious that *shareholder protection* against self-dealing either by managers or by controlling shareholders can be well-developed,

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MENTATA II, 215, 224-226; Antonio Rossi, *Art. 2392: Responsabilità verso la società,* in IL NUOVO DIRITTO DELLE SOCIETÀ 790, 796-803 (Alberto Maffei Alberti ed. 2005). German law even adopted a provision modeled on the US business judgment rule (§ 93 I 2 AktG, as amended by UMAG, September 22, 2005, BGBl I S 2802), but only after a broad managerial latitude had been already recognized by in the case law [BGH 21.4.2004, II ZR 175/95, "ARAG/Garmenbeck". Regarding the decision, *see e.g.* Erich Schanze*, Directors' Duties in Germany,* 3 COMPANY & FIN. INS. L. REV. 286, 291 (1999)].

[90] MARK J. ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE 162 (2003).

[91] Mark J. Roe, *Corporate Law's Limits,* 31 J. LEGAL STUD. 233, 244 (2002).

[92] Shareholder approval requirements are more common in continental Europe than in the US. *e.g. See e.g.* Sofie Cools, *The Real Difference in Corporate Law between the United States and Continental Europe: Distribution of Powers,* 30 DEL. J. CORP. L. 697, 739-741 (2005). *See also* Lele and Siems' shareholder protection index, at http://www.cbr.cam.ac.uk/pdf/Lele-Siems-Shareholder-Index-Final1.pdf (analyzing the powers of the shareholder meeting in France, Germany, the UK, the US, and India following a leximetric approach); Henry Hansmann & Reinier Kraakman, *The Basic Governance Structure,* in THE ANATOMY OF CORPORATE LAW 33, 57-58 n. 107 (Reinier Kraakman, Paul Davies, Henry Hansmann, Gerard Hertig, Klaus J. Hopt, Hideki Kanda & Edward B. Rock 2004).

while at the same time, the *shareholder influence* may remain small. Legal remedies against illicit private benefits of control may be an effective deterrent without any shareholder influence on regular decision-making, and without any incentives aligning managerial conduct with shareholder primacy. US corporate law is generally thought to provide good shareholder protection against managerial self-dealing, while the strong role of the board of directors in corporate governance is evident. For example, Stephen Bainbridge, an ardent academic supporter of shareholder primacy (both in its normative and descriptive dimensions), claims that US law provides a strong shareholder wealth maximization objective, but emphasizes that it does not grant any significant degree of control to shareholders.[93]

Within what is considered business judgment, there are various ways how shareholder influence can be created, but effectively there are two broad types. First and foremost, shareholder influence can be created by the presence of a *controlling shareholder*, or even a number of cooperating large shareholders that directly influence important business decisions; this type of influence is most relevant under concentrated ownership. Second, incentives created by the institutional framework might force managers to act as if shareholders were directing business. The concept of shareholder influence is broader than direct control and, beside explicit control, also includes a strong presence of markets mechanisms that implicitly force managers to pursue shareholder interests;[94] the second type most important in a system characterized by dispersed ownership. It may therefore be convenient to distinguish *explicit* and *implicit shareholder influence.* Shareholder influence thus describes all institu-

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[93] Bainbridge, *supra* note 57, at 573. This is of course a highly contentious notion. Many other scholars argue that US corporate governance would benefit from increased shareholder influence. The argument has been brought forward powerfully by Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power,* 118 HARV. L. REV. 833 (2005).

[94] *Cf.* Zetzsche, *supra* note 74, at 17-21 (suggesting that Continental corporate governance systems should be characterized as explicit systems with direct shareholder influence, whereas Anglo-Saxon systems tend to be implicit systems of corporate control).

tional factors that determine whether managers are forced or incentivized to pursue shareholder interests within the discretion assigned to them by corporate law.[95]

Section 3.2 and 3.3, focusing on the US and continental Europe respectively, describe why the European ownership structure is more conducive to holdup problems.

3.2. Separation of ownership and control: An American advantage?

3.2.1. Insulation of managers from shareholder influence

As described above, alternative economic interpretations of US corporate law and governance, in particular team production theory,[96] emphasize the large degree of autonomy managers enjoy in the US. Regarding the theory that shareholder influence on managerial business judgment exacerbates holdup problems, it is evident that this factor is less significant under the typical US corporate governance structure than elsewhere.

First, consider *explicit shareholder influence*. Dispersed shareholders are of course subject to collective action problems caused by rational apathy and the free-rider phenomenon.[97] Notably, explicit shareholder influence is reinforced by certain requirements of corporate and securities law. While the Delaware courts are generally protective of the voting process as such[98] and have considered the possibility of ousting managers as a safety valve for discontent shareholders,[99] proxy contests remain quite rare. Lucian Bebchuk reports that the number of contested proxy solicitations per year never exceeded 40 in the period between 1996 and 2004, during which pe-

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[95] In other words, explicit influence is most important in control-oriented systems, while implicit influence is most important in arm's length systems. On the distinction, *see supra* note 59 and accompanying text.
[96] See section 2.2.
[97] *See* Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law,* 26 J. L. & ECON. 395, 398-408 (1983); CLARK, *supra* note 76, at 390-393.
[98] Schnell v. Chris-Craft Industries, Inc., 285 A.2d 437 (Del. 1971); Blasius Industries, Inc., v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988).
[99] *See e.g.* Unocal Corp. v. Mesa Petroleum Co., 493 A.3d 946 (Del. 1985).

riod there were about 300 contested solicitations in total.[100] Some of the reasons mentioned are staggered boards and the costs of electoral challenges.[101] While incumbents can be sure to finance their proxy costs out of the corporate cashbox, challengers only have a chance to be reimbursed if their assault on the corporate fortress succeeds.[102] In an environment of dispersed ownership, coordination between shareholders is a prerequisite to *explicit shareholder influence*. However, some of the most severe impediments are established by federal securities law. Under § 13(d) of the Securities Exchange Act, anyone directly or indirectly acquiring beneficial ownership of 5% of any class of equity security must submit a 13D filing with the SEC within 10 days. One important aspect is SEC Rule 13d-5(1), under which persons acting together "for the purpose of acquiring, holding, voting or disposing of equity securities" are deemed a group for purposes of § 13(d), and are thus required to submit a 13D filing if they jointly surpass the 5% threshold. This requirement is generally thought to inhibit, if not entirely prevent coordination between shareholders, as proponents run the risk of a lawsuit by the company or other shareholders on the basis that they may have failed to disclose their plans completely.[103] Another impediment to coordination is the danger of communication between security holders triggering the (costly) duty to file a proxy statement under § 14 of the Securities Exchange Act if it is "reasonably calculated to result in the procurement, withholding or solicitation of

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[100] Bebchuk, *supra* note 54, at 682-683. Not all of these were electoral challenges, and less than half of them were successful. Bebchuk, *id.* at 686-687.
[101] Bebchuk, *id.* at 688-691, 694.
[102] The leading case is Rosenfeld v. Fairchield Engine & Airplaine Corp., 128 N.E.2d 291 (N.Y. 1955) (establishing the "Froessel rule" named after Judge Charles Froessel). For a more thorough description and a deeper analysis *see* Lucian Arye Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests,* 78 CAL. L. REV. 1073, 1106-1126 (1990).
[103] John C. Coffee, Jr., *The SEC and the Institutional Investor: A Half-Time Report,* 15 CARDOZO L. REV. 837, 842, 877-882 (1994); Bernard S. Black, *Shareholder Activism and Corporate Governance in the United States,* in 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 459, 461 (vol. 3, Peter Newman ed. 1998).

a proxy."[104] Most shareholder proposals are therefore made under Rule 14a-8, which allows a proposal to be included in the company's proxy statement. However, this option is limited to specific subject matters and requires submission six months before the shareholder meeting.[105]

Implicit shareholder influence could be created by incentives for managers to act in the interest of shareholders, most of all hostile takeovers. Before the backdrop of the US takeover wave of the 1980s, Shleifer and Summers famously suggested that hostile takeovers can create a possibility for shareholders to renege on implicit contracts with employees by selling out to a raider who will break up the firm.[106] However, while it would be an overstatement to say that takeovers were a fad that passed with the 1980s, takeovers have become considerably harder as a consequence of the development of Delaware case law during the 1990s. With the narrowing of the *Unocal*[107] standard in *Unitrin*[108], and the restriction of *Revlon*[109] duties under the two *Paramount*[110] cases, managers are essentially able to "just say no" to a hostile bid.[111] The second element of an anti-takeover bulwark is, of course, the staggered board. Under the regime of DGCL § 141(d), if permitted by the charter or bylaws, a board of directors may be classified into three groups, each of which is elected only every three years, meaning that only a third of directors is elected each year. By default, in

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[104] Securities Act § 14; SEC Rule 14a-1(l)(iii).

[105] Black, *supra* note 103, at 459; *see also* Coffee, *supra* note 103, at 884. Regarding impediments against institutional shareholder such as banks and insurers *see* MARK J. ROE, STRONG MANAGERS – WEAK OWNERS (1994) (developing a theory how banking regulation and other New Deal era laws prevented institutional investors from taking a greater role in US corporate governance).

[106] Shleifer & Summers, *supra* note 39; *see also* Julian Franks & Colin Mayer, *Capital markets and corporate control: a study of France, Germany and the UK,* 10 ECON. POL'Y 189, 213-214 (1990) ("[c]hanges in ownership undermine the ability of firms to sustain a reputation for long-term relationships").

[107] Unocal Corp. v. Mesa Petroleum Co., 493 A. 3d 946 (Del. 1985).

[108] Unitrin, Inc. v. American General Corp., 651 A.2d 1361 (Del. 1995).

[109] Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 179 (1986).

[110] Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1153 (1989); Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 47 (Del. 1993).

[111] *E.g.* Jeffrey N. Gordon, *"Just Say Never": Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffet,* 19 CARDOZO L. REV. 511, 516 (1997).

the case of a classified board, directors may be removed by shareholders only for cause.[112] Thus, a takeover bidder or someone launching a proxy contest needs to sustain his attack over two subsequent elections in order to obtain a majority in the board. In the case of what Lucian Bebchuk, John Coates and Guhan Subramanian have defined as an "effective staggered board",[113] where this type of board structure has been implemented in the company's charter, dismantling it requires approval by the board itself,[114] meaning that the bidder cannot simply take control of the shareholder meeting and subsequently destagger the board. These authors provide strong empirical evidence that,[115] due to the combination of staggered boards and poison pills[116] and the cost of committing to an offer price over two elections,[117] US boards can effectively shield themselves, rendering hostile takeovers almost impossible in many cases.[118] Thus, the current regime of takeover law offers powerful defenses to managers, further attenuating possible implicit shareholder influence through market forces.[119]

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[112] DGCL § 141(k)(i). Most states other than Delaware allow staggered boards. *See* Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy,* 54 STAN. L. REV. 887, 893-894 (2002).

[113] Bebchuk et al, *supra* note 112, at 894.

[114] The reason is that an amendment of the charter requires approval of both the board of directors and shareholders. *See* DGCL § 242(b).

[115] Bebchuk et al, *supra* note 112, at 925-939.

[116] In Moran v. Household International, Inc. 500 A.2d 1346 (Del. 1985), the Delaware Supreme Court accepted that the board of directors has the authority to adopt a "shareholder rights plan" (i.e. a poison pill).

[117] Bebchuk et al, *id.* at 922-923.

[118] Lucian Bebchuk and Alma Cohen have provided empirical evidence that charter-based staggered boards correlate with a reduction of shareholder value, measured in Tobin's Q. *See* Lucian A. Bebchuk & Alma Cohen, *The cost of entrenched boards,* 78 J. FIN. ECON. 409-433 (2005); *also see* Michael D. Frakes, Classified boards and firm value, 32 DEL. J. CORP. L. 113 (2007). This could mean that these rents are collected by other constituencies and leaves out other components of overall social welfare that are harder to measure. *See also* Lynn A. Stout, *supra* note 31, at 1436 ("the board of directors enjoys at least as much authority to decide whether or not the company will sell itself as […] in 1979").

[119] To be sure, holdup situations could also be the result of a friendly takeover in a firm with dispersed ownership. In fact, overall M&A has by no means decreased. *See e.g.* Mergerstat, *M&A Activity U.S. and U.S. Cross-Border Transactions,* available at http://www.mergerstat.com (visited January 30, 2008); *see also* Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law,* 69 U. CHI. L. REV. 871, 880 (2002). However, whether managers have an incentive to let a takeover go forward that results in a holdup situation depends on execu-

3.2.2. Does insulation of managers from shareholders help stakeholders?

A seemingly forceful argument against the idea that the insulation of managers from shareholder influence is that managers or directors are by no means required to pursue the interests of employees and other stakeholders, and their interests are not necessarily aligned with these groups.[120] While this may be seen as one of the weak points of team production theory of corporate law, its proponents have brought forward reasons why this is most likely the case, which need not be reiterated in detail here. Directors have to keep corporate constituents well if they do want to keep their jobs,[121] while social norms – reinforced by corporate law – expect them not to engage in self-dealing, but to act fairly and impartially to the firm's constituents.[122] Part of the argument is that managers often behave in a way that would be considered economically rational in a narrow sense, but need to enter into relationships of trustworthiness with stakeholders in order to further the joint goals of the corporate coalition.[123]

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tive compensation. In fact, it has been suggested that performance-based executive compensation schemes such as stock options have increased in the US as a response to Delaware takeover law, thereby giving managers an incentive to obtain a high price from the bidder for shareholders. *See* Kahan & Rock, *id.* at 884, 896-899; Jeffrey N. Gordon, *An American Perspective on Anti-Takeover Laws in the EU: The German Example,* in REFORMING COMPANY AND TAKEOVER LAW IN EUROPE 541, 553-554 (Guido Ferrarini, Klaus J. Hopt, Jaap Winter & Eddy Wymeersch eds. 2004). On the other hand, in recent years, executive compensation contingent on stock performance, at least as it has been implemented in the US in practice, has come under criticism for allowing managers to draw rents from the firm instead of aligned their interests with shareholders'. *See e.g.* Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem,* 17 J. ECON. PERSP. 71 (2003); Lucian A. Bebchuk & Jesse M. Fried, *Pay without Performance: Overview of the Issues,* 30 J. CORP. L. 647 (2005); *also see* Bruno S. Frey & Margit Osterloh, *Yes, Managers Should Be Paid Like Bureaucrats,* CESIFO WORKING PAPER NO. 1379, at http://ssrn.com/abstract=555697 (suggesting that, from the perspective of team production, managers should receive fixed compensation); Tirole, *supra* note 12, at 26. It is particularly interesting to compare the takeover activity in the US to the UK, which, as will be discussed in section 6, has a higher degree of implicit shareholder influence. The UK does not only have a larger proportion of hostile takeovers, but also considerably larger amount of total M&A activity when set in relation to the two countries' total GDPs. For figures on UK and US takeover activity *see* John Armour & David A. Skeel, jr., *Who Writes the Rules for Hostile Takeovers, and Why? The Peculiar Divergence of US and UK Takeover Regulation,* 95 GEO. L. J. 1727, 1738 (2007).

[120] Bebchuk, *supra* note 93, at 909-911.

[121] Blair & Stout, *supra* note 49, at 315.

[122] Blair & Stout, *id.* at 315-316.

[123] Blair & Stout, *supra* note 78, at 438-441.

In fact, there is empirical evidence supporting the notion that workers benefit from entrenched management. While entrenched management is associated with a low Tobin's Q[124] (a measure of shareholder wealth), takeovers seem to correlate with reductions in wages (of varying degree).[125] Antitakeover statutes are associated with higher ones.[126] Similarly, takeover defenses seem to be associated with lower cost of debt, suggesting an advantage for creditors.[127] Behavioral theory suggests that managers, when they are subject only to loose constraints, generally do not try to maximize profits, but to "profit-satisfice" by determining what payoff would be acceptable for providers of equity.[128] Profits made by the firm cannot be verified by outside shareholders and therefore need to necessarily be disgorged to shareholders in their full extent.[129] Empirical findings suggest that managers tend to prefer a "quiet life", where closing down plants is avoided,[130] which will typically be in the interest of employees.

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[124] Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards,* 78 J. FIN. 409 (2005) (finding an association between staggered boards and relatively lower Tobin's Q).

[125] Joshua G. Rosett, *Do union wealth concessions explain takeover premiums?* 27 J. FIN. ECON. 263 (1990); Frank R. Lichtenberg & Donald Siegel, *The Effect of Ownership Changes on the Employment and Wages of Central Office and Other Personnel,* 33 J. L. & ECON. 383 (1990); Jagadeesh Gokhale, Erica L. Groshen & David Neumark, *Do Hostile Takeovers Reduce Extramarginal Wage Payments?* 77 REV. ECON. & STAT. 470 (1995) (finding a reduction of extramarginal payments to senior workers after a hostile takeover); *but see* David Neumark & Steven A. Sharpe, Rents and Quasi-Rents in the Wage-Structure: Evidence from Hostile Takeovers, 35 INDUS. REL. 145 (1995) (finding no higher likelihood of firms with extramarginal wage payments being more likely to be subject to a hostile takeover). Similarly, bondholders with little contractual protection tend to lose wealth following takeovers. Paul Asquith & Thierry A. Wizman, *Event risk, covenants, and bondholder returns in leveraged buyouts*, 27 J. FIN. ECON. 195 (1990); *also see* Gilles Chemla, *Hold-up, stakeholders and takeover threats,* 14 J. FIN. INTERMEDIATION 376, 379 (2005) (summarizing the literature).

[126] Marianne Bertrand & Sendhil Mullianathan, Is there discretion in wage setting? A test using takeover legislation, 30 RAND J. ECON. 535 (1999); Marianne Bertrand & Sendhil Mullianathan, *Enjoying the Quiet Life? Corporate Governance and Managerial Preferences,* 111 J. POL. ECON. 1043 (2003) (finding higher wages for workers following antitakeover statutes, but, however, suggesting that these did not lead to higher productivity). *Also see* Henrik Cronquist, Fredrik Heyman, Mattias Nilsson, Helena Svaleryd & Jonas Vlachos, *Do Entrenched Managers Pay Their Workers More?* CEPR WORKING PAPER NO. 5371, available at http://ssrn.com/abstract=883717 (reporting data for Sweden).

[127] Ashbaugh-Skaiffe et al, *supra* note 6; *but see* Bradley et al, *supra* note 6 (suggesting that this result holds only for investment grade firms).

[128] John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web,* 85 MICH. L. REV. 1, 29 (1986); JESSE H. CHOPER, JOHN C. COFFEE, JR. & RONALD J. GILSON, CASES AND MATERIALS ON CORPORATIONS 29-30 (6th ed. 2004); Elhauge, *supra* note 57, at 804. The theory of "satisficing" can be traced to Herbert Simon, *A Behavioral Model of Rational Choice,* 69 Q. J. ECON. 99 (1955).

[129] *E.g.* M. Pagano & P.F. Volpin, *Managers, Workers, and Corporate Control,* 40 J. FIN. 841, 842 (2005).

[130] Bertrand & Mullianathan, *supra* note 126, at 1066-1067.

More generally, a preference for the continuation of operations without any fundamental changes should also imply avoiding job cuts and antagonizing unions. Under certain circumstances, such as when facing hostile takeovers, employees and top management are therefore natural allies.[131]

The insulation of managers exacerbates the agency problem with respect to shareholders, which is a legitimate concern. No interest group apart from managers themselves benefits from illicit self-dealing, as it is addressed by the duty of loyalty. Furthermore, there is of course the potential problem of insufficient effort by managers and employees. Hence, the creation of an optimal corporate governance regime should be seen as an exercise of striking the right balance between the minimization of agency cost and holdup to the benefit of shareholders. In some situations, however, the beneficiaries of holdup may be managers themselves.

For the comparative objective of this paper, the crucial aspect of the analysis is the comparison of the US situation to a system with pervasive shareholder influence. Holdup will take place only if there are beneficiaries to whose interest managers are aligned. In the absence of shareholder influence, managers will weigh costs and benefits against each other when deciding to put pressure on other stakeholders, as long as they are the exclusive beneficiaries. When managers have to share benefits with shareholders, their incentive to engage in holdup is reduced and more likely to be outweighed by other factors. Hence, to rule out the possibility that stakeholders benefit from insulation of managers, one would either have to show that there are no

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[131] *See e.g.* Roberta Romano, *The Political Economy of Takeover Statutes,* 73 VA. L. REV. 111, 120-122 (1987) (arguing that managers and workers tend to form coalitions against hostile takeovers on the political level); Martin Hellwig, *On the Economics and Politics of Corporate Finance and Corporate Control,* in CORPORATE GOVERNANCE: THEORETICAL AND EMPIRICAL PERSPECTIVES 95, 122-125 (Xavier Vives ed. 2000) (describing the alignment of managerial and stakeholder interests); Pagano & Volpin, *supra* note 129, at 865 ("managers and workers are natural allies against a takeover threat").

significant firm-specific investments by stakeholders, or that managers are the exclusive beneficiaries of holdup, which are very strong assumptions.

3.3. Concentrated ownership and holdup in Continental Europe

3.3.1. How ownership blocks create potential for holdup

The situation regarding holdup risk described in previous sections does not apply in the presence of a controlling shareholder. Concentrated ownership of shares even of large, listed corporations prevails virtually in every country except the US and the UK, and most of all, in the large Western European corporate governance systems.[132] It is equally obvious that the team production theory does not apply, at least not without modification.[133]

In an idealized version of a concentrated ownership corporate governance structure, a large shareholder of a corporation holds voting power equivalent to cash-flow rights. The well-known advantage of concentrated ownership is that a large or controlling shareholder with extensive cash-flow rights has a strong incentive to monitor managerial misconduct.[134] The classic Berle-Means and Jensen-Meckling type managerial agency problem of the separation between ownership and control may be eliminated by monitoring.[135] However, as a negative side-effect and another agency problem, the controlling shareholder or even another substantial large shareholder

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[132] Raphael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate ownership around the world,* 54 J. FIN. 471 (1999); Marco Becht & Alisa Roëll, *Blockholdings in Europe: An international comparison,* 43 EUR. ECON. REV. 1049 (1999); Mara Faccio & Larry H.P. Lang, *The ultimate ownership of Western European Corporations,* 65 J. FIN. ECON. 365 (2002); Gilson, *supra* note 4, at 1645 (summarizing the empirical evidence); *but see* Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States,* forthcoming REV. FIN. STUD., *available at* http://ssrn.com/abstract=991363 (arguing that, contrary to the conventional wisdom and most other empirical evidence, dispersed ownership is not more prevalent in the US than elsewhere).

[133] *Cf.* Bebchuk, *supra* note 93, at 909.

[134] *E.g.* Shleifer & Vishny, *supra* note 5, at 754-755.

[135] *See generally* Andrei Shleifer & Robert W. Vishny, *Large Shareholders and Corporate Control,* 94 J. POL. ECON. 461 (1986).

obtains the opportunity to obtain private benefits of control.[136] Large shareholders are typically able to siphon money out of the firm by entering into non-arm's-length deal with the firm or by exploiting corporate opportunities on their own.[137] It follows that the most important shareholder-related policy goal in corporate governance systems with large shareholders is to keep their opportunities to abuse their position in check. Without disregarding these factors, the exacerbation of holdup-problem vis-à-vis other constituencies resulting from concentrated ownership may be another issue affecting the taxonomy of comparative corporate governance.[138] In a firm with a controlling shareholder, managers are at risk of being replaced by that person. Charreaux and Desbrières suggest that, in a situation of crisis were the firm's value drops substantially, management will find it beneficial to reduce the share assigned to nonshareholder constituencies (in particular employees), but "to maintain that of the dominant shareholder so that this one may obtain at least the normal market return" in order to avoid eviction. In this situation, nonshareholder constituencies, in particular employees will be the firm's residual risk-bearers instead of shareholders.[139] As a matter of theory, the controlling shareholder is in the position to induce managers to pressurize other constituencies into giving up quasi-rents and rents on their specific investment. Naturally, it would be in the ex post interest of shareholders to have managers do so irrespective of capital structure, but under dispersed ownership collective

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[136] *See generally* Shleifer & Vishny, *supra* note 5, at 758-761; Mark J. Roe, *The Institutions of Corporate Governance,* in HANDBOOK OF NEW INSTITUTIONAL ECONOMICS 371, 374-375 (Claude Menard & Mary M. Shirley eds. 2005); *cf.* John C. Coffee, jr., *A Theory of Corporate Scandals: Why the USA and Europe Differ,* 21 OX. REV. ECON. POL'Y 198, 200-208 (2005) (suggesting that financial fraud in Continental Europe will typically involve participation of controlling shareholders because of the differences in ownership structure).

[137] *Also see* Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Tunneling,* 90 AM. ECON. REV. (PAPERS & PROC.) 22 (2000).

[138] In this context it is interesting to note that the presence of blockholders seems to be associated with a higher cost of debt, which might be attributed to a similar relationship. *See* Ashbaugh-Skaife et al, *supra* note 6.

[139] Charreaux & Desbrières, *supra* note 5, at 116.

action problems impede the required coordination.[140] This factor is reinforced by certain aspects of US corporate law described above.[141]

The controlling shareholder's incentive to expropriate nonshareholder constituencies is financial, as a large share of holdup profits will end up in his pockets. If the shareholder has both a controlling interest (or the possibility to control the company in concerted action with other large shareholders) and a large claim to cash flow, she has both a monetary incentive and the opportunity. It follows that, keeping other factors constant, the possibility to hold up other constituencies will increase with a higher degree of explicit shareholder influence, which will typically increase with a higher share held by the controller. Likewise, the holdup incentive will increase with the monetary share in the firm.

As we have seen, the theory that holdup problems are small in the US compared to other jurisdictions rests on the insulation of managers from shareholder influence. In a (hypothetical) extreme version of a Berle-Means firm, insulation would be complete in the sense that shareholders would not be able to influence managers, and managers would also have little reason to promote shareholder interests in decisions where there are tradeoffs with the interests of other constituencies.[142] Managers and direc-

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[140] Habib, *supra* note 5, at 146-148.

[141] *Supra* section 3.2.1.; *see generally* Hansmann & Kraakman, *supra* note 92; Bebchuk, *supra* note 93, at 848.

[142] Habib, *supra* note 5, at 147 ("not being a shareholder, he has nothing to gain from doing so"). The situation in a Berle-Means firm approximates that in a Non-Profit Organization, which is characterized by a non-distribution constraint, i.e. there is not even an interest group with financial incentives to monitor management and interfere in decision-making. The usually accepted explanation for the existence of the non-distribution constraint is that the NPO's stakeholder would object to an owner receiving profits; because the quality of NPO's product is subject to information asymmetries (Henry Hansmann, *The Role of Nonprofit Enterprise,* 89 YALE L. J. 835, 846-848 (1980)) or is not a contractible property that could be verified by a court (Edward L. Glaeser & Andrei Shleifer, *Not-for-profit entrepreneurs,* 81 J. PUB. ECON. 99 (2001)), which is why the possibility of distributions would create an incentive to reduce quality. The flipside of the coin is that managerial accountability is thought to be particularly great in NPOs. *E.g.* Edward L. Glaeser, *The Governance of Not-for-profit Firms,* NBER WORKING PAPER NR. 8921, 3 (2002) ("[…] managers of non-profit firms […] enjoy a degree of autonomy almost unparalleled in the economy"). The nonprofit form may even be chosen where human capital investment is particularly important. *See* Glaeser & Shleifer, *id.* at 101-102 (suggesting that private universities might be such a case).

tors would have no incentives to extract rents from nonshareholder constituencies any more than to divert funds that shareholders should receive. In other words, managers would be able to use their position to gain advantages from all constituencies, whenever opportunities arise, without favoring one over the other. As the result of controlling the firm's business activities on a day-to-day basis, managers may feel socially attached to employees and even long-term business partners.[143] In all likelihood, classical moral hazard, as analyzed by the principal-agent paradigm of corporate governance, will most likely be more severe than expropriation of other constituencies' rents. Dispersed shareholders, who are quite distant from management in day-to-day decision-making and, as a group, cannot exit the company,[144] may therefore be in the weakest position of all. Consequently, in such an extreme version of a Berle-Means firm, stakeholder problems may be almost irrelevant.

3.3.2. Explicit shareholder influence in Continental Europe

It is easy to see that controlling shareholders in Continental Europe typically do have the strong influence on management assumed by the theory. French law,[145] for example, allows shareholders to revoke the appointment of members of the *conseil d'administration* (board of directors) at any time,[146] without the necessity to give a reason.[147] The rule is considered to be mandatory.[148] Similarly, the CEO of the com-

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[143] *See e.g.* ROE, *supra* note 90, at 34 ("these managerial tendencies fit well with employees' goals").
[144] WILLIAMSON, *supra* note 21, at 304-305.
[145] This section describes only the predominant one-tier structure. Since the 1966 reforms, French corporate law has alternatively offered a German-style two-tier structure with a *directoire* and a *conseil de surveillance*. As of 2002, 6491 among 150,000 *sociétés anonymes* had a dualistic structure, but about 25% of the CAC 40 stock index. *See* PHILIPPE MERLE & ANNE FAUCHON, DROIT COMMERCIAL. SOCIETES COMMERCIALES 417 n.2 (10th ed. 2005).
[146] Art. L. 225-18 al. 2 C. com.
[147] Cass. Com., Octobre 26, 1959, JURISCLASSEUR PERIODIQUE 1960.2.11696; Cass. com. January 3 1985, DEFRENOIS 1987, p. 620, note J. Honorat; *cf.* MICHEL GERMAIN, TRAITE DE DROIT COMMERCIAL, TOME 1 – VOLUME 2, note 1653 (G. Ripert & R. Roblot eds, 18th ed. 2001).
[148] MERLE & FAUCHON, *supra* note 145, at note 386; GERMAIN, *id.*

pany (*directeur général*), who is appointed by the *conseil*[149], can be removed by it at any time.[150] Assistant general managers (*directeurs délégués*), who are appointed upon proposal by the CEO,[151] can by removed upon his proposal as well.[152] While some commentators emphasize the strong position of the PDG (*président directeur général*, i.e. a person being both president of the *conseil* and CEO),[153] it is obvious that his power is constrained by the large shareholders and the potential threat of replacement.[154] Before the NRE Act of 2001,[155] shareholders were even able to directly remove the PDG by revoking his appointment to the *conseil*, as the CEO was legally required to be one of its members.[156] The NRE Act may also have slightly strengthened the position of management by making the company liable for damages if the dismissal of the *directeur général* or of *directeurs délégués*) was not based on good cause (unless the *directeur général* was at the same time a member of the *conseil*.[157]

Similarly, in Italy, under the traditional system of board organization[158] the appointment of a director (member of the *consiglio di amministrazione*) can be revoked at

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[149] Art. L. 225-51-1. Before the NRE law of 2001 (Loi du 15 mai 2001 sur les nouvelles régulations économiques, J.O. du 16 mai), the *directeur général* had to be a member of the *conseil d'administration*.

[150] Art. L. 225-55 C. com.

[151] Art. L. 225-53 C. com.

[152] Art. L. 225-55 C. com.

[153] *E.g.* Christiane Alcouffe, *Judges and CEOs: French Aspects of Corporate Governance,* 9 EUR. J. L. & ECON. 127, 129 (2000).

[154] Hansmann & Kraakman, *supra* note 92, at 41 ("the shareholder majority nevertheless holds the PDG at the end of a short leash by virtue of the majority's removal power"). French commentators do not fail to point out that not the board, but the general shareholder meeting of shareholders is the "supreme organ" of the company. *See e.g.* Yves Guyon, *L'évolution récente des assemblées d'actionnaires en droit français,* in MELANGES GUY FLATTET 39 (Bernard Dutoit, Josef Hofstetter & Paul Piotet eds. 1985); YVES GUYON, DROIT D'AFFAIRES, TOME 1: DROIT COMMERCIAL GENERAL ET SOCIETES n° 289 (12th ed. 2003).

[155] *Supra* note 149.

[156] GERMAIN, *supra* note 147, at 453.

[157] Art. L. 225-55 C. com. One might hypothesize that the exception might strengthen the practice of making the *directeur général* the president of the board.

[158] Since 2004, Italian firms can choose between three different types of organization structure of the firm (Riforma organica della disciplina delle società di capitali e società cooperative, decreto legislativo 17. 01. 2003 n. 6; Gazz. Uff. 22. 01. 2003, n. 1, 7, suppl. ord. 8/L; for an overview on recent Italian corporate law reforms, *see* Guido Ferrarini, Paolo Guidici & Mario Stella Richter, *Company Law*

any time by shareholders; however, the firm may have to pay damages to the director if it happened without cause.[159] This provision is also considered mandatory law: shareholders cannot waive the right to recall directors (neither in the charter nor otherwise).[160]

In countries such as France and Italy, where management is thus kept on a short leash by large shareholders, the potential for holdup of stakeholders is high. Large shareholders either control the board through direct representation, or they can directly threaten the firm's senior managers with removal from their position.[161]

By contrast, German law provides a structure that would indicate to the reader of the *Aktiengesetz* that German boards are even more insulated from shareholder influence than their American counterparts. German *Aktiengesellschaften* have a mandatory two-tier board structure, i.e. there is a management board (*Vorstand*) taking care of the operations of the company, while the supervisory board (*Aufsichtsrat*) is ex-

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Reform in Italy: Real Progress? 69 RABELS ZEITSCHRIFT FÜR AUSLÄNDISCHES UND INTERNATIONALES PRIVATRECHT 658, 659-661 (2005)). Besides the traditional structure discussed in the text (*consiglio di amministrazione* and *collegio sindacale,* as discussed here), firms may choose an English-style monistic and a German style dualistic structure. The power of shareholders to elect and revoke the appointment of directors is identical in the newly introduced purely monistic system (where there is no board of auditors, but only an audit committee of the board of directors with similar tasks). Codice Civile Art. 2409noviesdecies refers to Art. 2383, among others. In the dualistic model, which is based on German law, the members of the management board (*consiglio di gestione*) are elected by the members of the supervisory board *(consiglio di sorveglianza*). However, other than in Germany, the supervisory board can revoke the appointment of the managing directors at any time. Codice Civile Art. 2409novies(3), (5). Members of the supervisory board can be removed by a majority vote. Codice Civile Art. 2409duodecies(5) referring to Art. 2393(4).

[159] Codice Civile Art. 2383(3).

[160] GUIDO CAPOZZI, LE SOCIETÀ DI CAPITALI, LE SOCIETÀ COOPERATIVE E LE MUTUE ASSICURATRICI 679 (vol. 1, 2005). The board of auditors (*collegio sindacale*), which is also elected by shareholders, is of less interest here. Its members are elected by shareholders, but can only be removed for cause (Codice Civile Art. 2400(1), (2)). It is less concerned with involved with individual business decisions and strategy than the German supervisory board. *See e.g.* Ferrarini et al, *supra* note 158, at 676-677 (describing that the monitoring function of the board of auditors focuses on compliance with the law, "standards of good management and the adequacy and functioning" of the firm's organizational structure); Klaus J. Hopt & Patrick C. Leyens, *Board Models in Europe – Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy,* 1 EUR. COMPANY & FIN. L. REV. 135, 158-159 (2004) ("its control duties do not include business strategy"). The duties of the board of auditors are set out in Codice Civile art. 2403(1); *see also* Eugenio Ruggiero, *Italy,* in THE LEGAL BASIS OF CORPORATE GOVERNANCE IN PUBLICLY HELD CORPORATIONS 79, 106 (Arthur R. Pinto & Gustavo Visentini eds. 1998) (describing the pre-2004 law. under which monitoring was limited to the legality of management decisions except in cases of manifestly negligent decisions).

[161] *See e.g.* Ruggiero, *id* at 83-84 (describing the influence of controlling shareholders and coalitions of large shareholders on listed Italian firms).

pected to monitor it. § 76 AktG, which resembles DGCL § 141, explicitly charges the management board with managing the company and declares that this task is its exclusive responsibility[162], with instructions either from the supervisory board or shareholders being invalid.[163] The provision is mandatory.[164] The management board's independence is supposedly guaranteed by procedural safeguards concerning its appointment and dismissal. The responsible body is the supervisory board, which can only dismiss members of the management board prematurely for cause, including a shareholder vote of no confidence that is not obviously frivolous.[165] Thus, dismissal requires consent between major shareholders and the supervisory board. Supervisory board members that are elected by shareholders[166] have a period of office of up to about five years[167] and normally can only be dismissed prematurely by a supermajority of three quarters.[168] This structure was first introduced in the *Aktienge-*

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[162] § 76(1) AktG.

[163] Hans Joachim Mertens, *in* KÖLNER KOMMENTAR ZUM AKTIENGESETZ, § 76, comment 42 (vol. 2, 2nd ed., Wolfang Zöllner ed. 1988/1996); Wolfgang Hefermehl & Gerald Spindler, *in* MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ, § 76, comment 21 (vol. 3, 2nd ed., Bruno Kropff & Johannes Semler eds., 2003); UWE HÜFFER, AKTIENGESETZ § 76, comment 10 (7th ed. 2006) (also pointing out that there is no *direct* fiduciary relationship between either management board and individual shareholder or a management board and the shareholder meeting); *also see* BGH 30.3.1967, II ZR 245/63, 1967 NEUE JURISTISCHE WOCHENSCHRIFT 1462.

[164] HÜFFER, *supra* note 163, § 23, comment 36; *also see* Andreas Pentz, *in* MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ, BAND 1, § 23, comment 156, (2nd ed. Bruno Kropff & Johannes Semler eds., 2000). However, corporations may enter into control agreements under § 291(1) AktG, which gives the controlling entity, which must be an "enterprise" (e.g. a parent company) the right to control the firm, but also triggers the protective duties of the law of contractual corporate groups. *See generally* Peter Hommelhoff, *Protection of Minority Shareholders, Investors and Creditors in Corporate Groups: the Strengths and Weaknesses of German Corporate Group Law,* 2 EUR. BUS. ORG. L. REV. 61, 64-66 (2001); Gerard Hertig & Hideki Kanda, *Creditor Protection,* in THE ANATOMY OF CORPORATE LAW 71, 86 (Reinier Kraakman, Paul Davies, Henry Hansmann, Gerard Hertig, Klaus J. Hopt, Hideki Kanda & Edward B. Rock 2004); Hertig & Kanda, *supra* note 76, at 124-125.

[165] § 84(3) AktG.

[166] § 101(1) AktG. Half of the board members are employee representatives, but in the case of a tie the vote of the chairman (who is one of the shareholder-appointed members) is decisive. On codetermination, *see infra* section 4.1.2.

[167] The rule in § 102(1) AktG on the term of office is somewhat more complicated and depends on when the annual general meetings is held, but effectively results in a maximum period of about five years. *See* HÜFFER, *supra* note 163, § 102, note 2.

[168] § 103(1) AktG. The charter may entitle the owners of registered shares (with restricted transferability) to appoint up to one third of the board members appointed by shareholders; the respective shareholder also has the right to revoke the appointment at any time (§§ 101(2), 103(2) AktG). There are special rules regarding the removal of supervisory board members for cause by a court (§ 103(3) AktG).

setz of 1937, whereas previous enactments had been based on the premises that the meeting of shareholders was the supreme controlling body of the firm.[169] Most interestingly, the motivational report accompanying the act states:

> "Under current law, the shareholder meeting is the supreme body of the corporation; the authority of management board and supervisory board is derived from it. Fundamental decisions regarding the fate of the corporation are made by the majority of the providers of funds, who are personally not responsible, who usually lack precise and competent insight into business and the firm's operations, and who typically emphasize the concerns of capital."[170]

The report goes on to explain that the law is intended to limit the role of the shareholder meeting. The text quoted above discusses several concerns explicit shareholder influence may raise, but the last part seems to be motivated by the ones addressed by team production theory, as a lopsided focus on capital is apparently seen as harmful. Besides the structural isolation of management from shareholders, the act concurrently introduced § 70(1), which required directors "to manage the corporation as the good of the enterprise and its retinue and the common wealth of folk and realm demand".[171] The provision codified the doctrine of the *Unternehmensinteresse,* i.e. the institutional interest of the firm that transcends the interests of specific interest groups, including shareholders. Although the provision was introduced in 1937 and has linguistically been influenced by Nazism,[172] it was not exclusively an item of that ideology, the doctrine had been developed by earlier writers such as Rathenau and

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[169] On the historic development *see e.g.* Wolfgang Hefermehl & Johannes Semler, *Verfassung der Aktiengesellschaft: Vorbemerkung,* comments 10-20, *in* 3 MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ (2nd ed., Bruno Kropff & Johannes Semler eds., 2003).

[170] FRIEDRICH KLAUSING, GESETZ ÜBER DIE AKTIENGESELLSCHAFTEN UND KOMMANDITGESELLSCHAFTEN AUF AKTIEN 56 (1937) (own translation).

[171] The translation follows Detlev F. Vagts, *Reforming the "Modern" Corporation: Perspectives from the German,* 80 HARV. L. REV. 23, 40 (1966)].

[172] *See* Vagts, *id.* at 40 (using the term "retinue" to translate the German "Gefolgschaft", which "Nazism claimed to find in the teutonic past" and describes a pseudo-feudal relationship between the firm and its employees).

Haussmann[173] and reflected a broader trend in both politics and economic theory in the Germany of the 1920s and 1930s.[174] When the requirement to promote the "good of the enterprise" was dropped in the 1965 reform, the reason given was that it was self-evident that the interests of employees and of the public had to be taken into consideration.[175] The doctrine continues to play a role in German corporate law until today.[176] However, it is no longer seen as the metaphysical interest of the business "as such", but as a proxy for the interests of various groups that must be reconciled.[177]

Nevertheless, law in books that attempts to insulate the management from shareholders is overruled by the actual practice of German corporate governance. Large German firms are often controlled by single large shareholders, and sometimes by medium sized-ones[178] who exercise control by forming coalitions, and are able to elect confidants to the supervisory board, including management board members

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[173] WALTHER RATHENAU, VOM AKTIENWESEN. EINE GESCHÄFTLICHE BETRACHTUNG (1917); FRITZ HAUSSMANN, VOM AKTIENWESEN UND VOM AKTIENRECHT (1928). Notably, Rathenau was an industrialist and a moderate liberal politician, who was serving as German foreign minister when he was assassinated by nationalists in 1922. However, Friedrich Klausing, the editor of the motivational report accompanying the 1937 Aktiengesetz (*supra* note 170), was most likely a Nazi. He committed suicide after being dismissed as the rector of the University of Prague in 1944, when his son had been identified as one of the conspirators in the assassination attempt on Hitler of July 20. *See* Bernd Rüthers, *Spiegelbild einer Verschwörung: Zwei Abschiedsbriefe zum 20. Juli 1944,* 60 JURISTENZEITUNG 689-698 (2005). For a detailed review of Rathenau's and Haussmann's (partly contradicting) ideas *see* RIECHERS, *supra* note 8, at 7-25.

[174] *See* RIECHERS, *id.* at 26-42.

[175] BRUNO KROPFF, AKTIENGESETZ 97 (1965).

[176] Most recently, the *Bundesgerichtshof* referred to the *Unternehmensinteresse* in its Mannesmann opinion (BGH 21.5.2005, 3 StR 470/04, 2006 JURISTENZEITUNG 560). *See e.g.* the critical appraisal by Gerald Spindler, *Vorstandsvergütungen und Abfindungen auf dem aktienrechtlichen Prüfstand,* 27 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT 349, 252 (2006). Recent scholarship influenced by law and economics tends to attack the doctrine. *See e.g.* Holger Fleischer, in KOMMENTAR ZUM AKTIENGESETZ, § 76, comments 30-31 (Gerald Spindler & Eberhard Stilz eds. 2007).

[177] HÜFFER, *supra* note 163, § 76, comment 15.

[178] *See* Jeremy Edwards & Marcus Nibler, *Corporate governance in Germany: the role of banks and ownership concentration,* 15 ECON. POL'Y 239, 246-251 (2000); F. Jens Köke, *New Evidence on Ownership Structures in Germany*, 34 KREDIT UND KAPITAL 257, 268-272 (2001); Ekkehard Boehmer, *Who Controls German Corporations,* in CORPORATE GOVERNANCE REGIMES 268 (Joseph A. McCahery, Piet Moerland, Theo Raaijmakers & Luc Renneboog eds. 2002); Marco Becht & Ekkehart Boehmer, *Voting control in German corporations,* 23 INT'L REV. L. & ECON. 1 (2003); Dariusz Wójcik, *Change in the German model of corporate governance: evidence from blockholdings 1997-2001,* 35 ENV'T & PLAN. A 1431 (2003).

and senior employees of the controlling firm and lawyers, accountants and other professionals. The managers' formal independence from shareholders is undermined by various factors. First, members of the management boards have to face reelection after a period of at most five years,[179] when they have to face the scrutiny of these persons and de facto of the core shareholders.[180] Second, the requirement of a cause to remove board members prematurely can be met by a vote of no confidence. Due to the close connection between large shareholders and supervisory board members, and due to the fact that supervisory board members themselves can be removed by a supermajority of 75% in the shareholder meeting, managers no longer enjoying the confidence of the controlling shareholder or the ruling coalition will typically be unable to maintain their position.[181]

Controlling shareholders and coalitions are therefore typically able to impose their will on the firm, up to the point of replacing managers. Employee representatives on the board are typically not in the position to object, as the vote of the president of the supervisory board (a shareholder representative) is decisive in the case of a tie.[182] An exception would be the case where groups of shareholders fall out among each other, in which case employees my case the decisive vote. However, as a general matter, even under German corporate law, shareholder influence as such would by strong enough to extract rents and quasi-rents from stakeholders.[183]

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[179] § 84 I AktG.

[180] Peter Doralt, *Die Unabhängigkeit des Vorstands nach österreichischem und deutschen Aktienrecht – Schein und Wirklichkeit,* in DIE GESTALTUNG DER ORGANISATIONSDYNAMIK. FESTSCHRIFT FÜR OSKAR GRÜN 31, 47 (Werner H. Hoffmann ed. 2003); Jean du Plessis & Claus Luttermann, *The Dominant Role of the German Banks and New Players in the German Financial Sector,* in GERMAN CORPORATE GOVERNANCE IN INTERNATIONAL AND EUROPEAN CONTEXT 203, 209-210 (Jean J. Du Plessis, Bernhard Großfeld, Claus Luttermann, Ingo Saenger & Otto Sandrock 2007).

[181] Doralt, *id.* at 47-48.

[182] § 29(2) MitbestG; *see* Hansmann & Kraakman, *supra* note 92, at 36.

[183] Regarding countervailing factors in the legal system, *see* section 4.

3.3.3. Absence of holdup incentives in pyramid structures?

One might object that the incentives of large shareholders described in section 3.3.1 in concentrated ownership structures do not exist because of the often significant divergence between ownership and control. Such a divergence may by created by various deviations from the one-share one-vote principle, which is normally thought to create optimal incentives for efficient shareholder decisions,[184] such as differential voting rights (including voting caps), cross-ownership of shares, and most strongly, stock pyramids.[185] Pyramidal structures, if carried out to the extreme, may allow a controller to vote the majority of the stock of a publicly traded firm while at the same time owning only a minimum of capital and cash-flow rights. For example, if shareholder A owns 50% of the shares of company B, which in turn holds 30% of publicly traded firm C, A will effectively vote 30% of C's shares (which will in most cases suffice to control a publicly traded firm) while only holding 15% of cash flow rights.[186] Luca Enriques and Paolo Volpin describe the case of Telecom Italia, where, in 2005, one person held 18% of TI's voting power with only 0.7% of capital by means of a chain of four intermediary firms (two of them publicly traded).[187]

With regard to agency problems, pyramidal structures and other divergences from one-share-one-vote are usually considered problematic, as they allow the controller

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[184] Sanford J. Grossman & Oliver D. Hart, *One Share-One Vote and the market for Corporate Control,* 20 J. FIN. ECON. 175-202 (1988); HART, *supra* note 21, at 186-209; EASTERBROOK & FISCHEL, *supra* note 10, at 72-74.

[185] *See e.g.* Lucian Arye Bebchuk, Reinier Kraakman & George Triantis, *Stock Pyramids, Cross-Ownership, and Dual-Class Equity,* in CONCENTRATED CORPORATE OWNERSHIP 295, 297-301 (Randall K. Morck ed. 2000).

[186] *See e.g.* Randall K. Morck & Lloyd Steier, *The Global History of Corporate Governance. An Introduction,* in A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD 1, 4 (Randall K. Morck ed. 2005).

[187] Luca Enriques & Paolo Volpin, *Corporate Governance Reforms in Continental Europe,* 117 J. ECON. PERSP. 117, 119-121 (2007); *also see* Julian Franks & Colin Mayer, *Ownership and Control of German Corporations,* 14 REV. ECON. STUD. 943, 948-949 (2001) (giving the example of a closely-held entity formerly holding 1.2% of cash flow rights in Daimler Benz, which apparently was not connected by exclusive control of the firm, as it was cancelled out by other firms holding similar voting rights on several levels of the pyramid).

to externalize his decisions on minority shareholders.[188] The extreme type of pyramidal structure just described approximates a Berle-Means corporation in important respects: The manager is almost totally in control of the firm and hardly accountable to minority shareholders, without owning a significant stake himself. A hostile takeover is largely ruled out. Thus, pyramids combine the worst of both dispersed and concentrated ownership.[189]

With regard to shareholder influence and the potential holdup problem resulting from it, one might think that the controller of such a firm could function as a "meditating hierarch", as under the Blair and Stout theory, which would apply by analogue. The holdup problem incidental to concentrated ownership might be largely eliminated, because the monetary incentive to holdup nonshareholder constituencies is greatly reduced or even eliminated by the pyramid.[190] However, a closer look reveals that even if the controller of the firm only has a nominal entitlement to the firm's cash flow, holdup is not ruled out in firms on the "bottom" of the pyramid, i.e. in subsidiaries.

First, benefits that can be squeezed out of the firm on the bottom of the pyramid by reneging on implicit deals with nonshareholder constituencies could be used for projects at another level of the pyramid. Assume that X, through a chain of subsidiaries, owns 10% of the cash flow rights of company A, but controls 50% of votes. In turn, A owns 50% of operative company B, which is thus also controlled by X. Possible examples of holdup would include the sale of a plant operated by a subsidiary of B to a third party (resulting in the loss of jobs), or pressuring B's employees into accepting lower wages, which may result in higher profit available for distribution to

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[188] Guido Ferrarini, *One Share – One Vote: A European Rule?* 3 EUR. COMPANY & FIN. L. REV. 147, 160 (2006).

[189] Bebchuk et al, *supra* note 185, at 295.

[190] Regarding agency cost, it is often said that pyramidal structures eliminate the large shareholder's incentive to monitor managers. *See* Bebchuk et al, *supra* note 185, at 301, 305 (suggesting an increase in agency costs); Köke, *supra* note 178, at 264.

shareholders over the coming years. In theory, X's financial holdup incentive should be only 5% compared to a situation where he is the sole owner of B.

However, as the controller, X may be able to engage in activity that would allow him to obtain a share exceeding 5% at the cost of other shareholders. The techniques are the ones well known from the discussion regarding agency conflicts in a concentrated ownership structure, i.e. tunneling[191] through transactions between B and A, or between B and X that are entered into under terms unfavorable to B, or stock dilution.[192] After holdup, B could be merged into an entity controlled by X or A under an exchange ratio that benefits X at the expense of A's other shareholders.[193] If either of the two possibilities exists, X will be able to increase the ratio from 5% to a higher amount. The degree to which the controlling shareholder benefits depends on how much must be given to minority shareholders. If there are good tunneling opportunities, or if the controller can merge the two firms and dilute the minority's stock, he may have a greater incentive to use the funds there than otherwise, because his share in the subsidiary is greater. By contrast, if X cannot increase her share in holdup gains by these means, but these need to be distributed either through a dividend or an inflated share price, minority shareholders receive a fair share of the prey. Reduced monetary incentives may mean that the controlling shareholder will not engage in holdup in marginal cases, as his gains are outweighed by disadvantages or idiosyncratic reasons such as reputational commitments to good relations with stake-

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[191] *See* Johnson et al, *supra* note 137.

[192] For a definition and discussion of techniques, *see e.g.* Pierre-Henri Conac, Luca Enriques & Martin Gelter, *Constraining Dominant Shareholders' Self-Dealing: The Legal Framework in France, Germany, and Italy,* 4 EUR. COMPANY & FIN. L. REV. 491, 496, 523-524 (2007); Vladimir Atanasov, Bernard Black & Conrad S. Cicotello, *Unbundling and Measuring Tunneling,* U. TEX. L. & ECON. RES. PAPER NO. 117 (2007), at http://ssrn.com/abstract=1030529 (distinguishing between asset tunneling, cash flow tunneling, and equity tunneling); for a discussion of possibly justified dilution, *see* Kristoffel Grechenig, *Discriminating Shareholders through the Exclusion of Pre-emption Rights?* 4 EUR. COMPANY & FIN. L. REV. 571, 575-576 (2007).

[193] The controlled entity could either be within the pyramid at a level where X's financial stake is higher, outside of the pyramid, or even within another pyramid controlled by X.

holders.[194] Stakeholders may therefore benefit from improved protection of minority shareholders.

Second, even if extreme types of pyramids greatly reduce or rule out the controller's holdup incentive, it may resurface under circumstances where funds are needed at a higher level of the pyramid. In the above example, firm A might experience financially constrained circumstances and need additional liquidity, where short-term holdup gains in firm B may help to resolve the situation. Besides an exogenously induced crisis, one situation where this might happen is an LBO of the parent firm. While X's personal advantage may not be all that big because her cashflow rights in both A and B are relatively small, the requirement to make interest payments in A creates a joint interest by all of A's shareholders, its creditors and even its employees (and other stakeholders) may trigger pressure to extrude all financial means from its subsidiary firm B. This may sometimes by achieved by initiating holdup regarding B's stakeholders, e.g. by reducing wages in order to generate larger financial distributions to A. In spite of the personal financial incentive of X, the controller of both firms, is reduced in comparison to a situation where she directly owns a large share of B, the joint pressure from A's stakeholders may make up for that difference. X is unlikely to resist, as her financial share in A is still bigger than in B. Hence, it will be more important to her to assure the survival and long-term prosperity of the parent firm and to satisfy the demands of its stakeholders than to maintain friendly relations with stakeholders on the subsidiary level. Such a situation, triggered by a crisis or an LBO, may even pitch stakeholders against stakeholders, as nonshareholder constituencies on the parent level may benefit from holdup of stakeholders of the subsidiary.

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[194] For a discussion of long-term commitment by large shareholders, *see infra* section 3.3.4.

Third, the controller can sell his share of the company at any time.[195] A sale can of course happen at any level of the pyramid, and might be particularly lucrative if the pyramidal separation between ownership and control is removed, i.e. when the purchaser holds the share directly after the transaction, while the purchaser was only the recipient of minimal cashflow rights while fully controlling it. The new controller would then have a much greater financial incentive in favor of holding up stakeholders. Hence, even if there is no current holdup risk, there is always a potential one, which should also discourage specific investment.

Given all of this, there are good reasons to believe that pyramids do not eliminate holdup risk, even though the controller's incentives may be temporarily reduced.

Finally, it should be emphasized that pyramids, where the controller actually holds a substantial chunk of equity in the bottom subsidiary, seem to be more the rule than the extreme form described by Enriques and Volpin.[196] For example, if the controlling entity owns 20% of cash flow rights, but 40% of votes, the financial interest is certainly significant and distinguishable from ownership stakes of managers of American companies. In an empirical study of ownership structures in the German manufactur-

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[195] For example, in Germany, while there is little hostile takeover activity, there is a thriving market of controlling blocks. *See* Franks & Mayer, *supra* note 187, at 955.

[196] *See e.g.* the empirical evidence and its interpretation by La Porta et al, *supra* note 132, at 498-500, 511 (concluding that, while pyramids are common, the magnitude of deviations from the one-share-one-vote ideal tends to be small); Stijn Claessens, Simeon Djankov & Larry H.P. Lang, *The separation of ownership and control in East Asian corporations,* 58 J. FIN. ECON. 81, 100 (2000) (reporting mean ratios of cash-flow rights to control rights between 0.602 and 0.941 for East Asian economies); Franks & Mayer, *supra* note 187, at 950-951 (reporting an average ratio between voting and cash flow rights of 1.6 in a sample of 38 German firms with a pyramidal ownership structure); Köke, *supra* note 178, at 280-281 (reporting that in only 10% of a sample of 5788 German manufacturing firms with a pyramidal structure in only 10% of them the ratio of cash flow rights to voting rights was less than 75%); Faccio & Lang, *supra* note 132, at 392 (reporting mean ratios of cash flow to control rights between .740 and .941 for 13 Western European countries); Roberto Barontini & Lorenzo Caprio, *The Effect of Family Control on Firm Value and Performance. Evidence from Continental Europe,* ECGI FINANCE WORKING PAPER N° 88/2005, at 43 (reporting a wedge between cash flow and control rights of more than 20% in only 11.6% of firms). A theoretical explanation of the existence of pyramids and their respective structures (which entails varying degrees of separation of ownership and control) is provided by Heitor Almeida & Daniel Wolfenzon, *A Theory of Pyramidal Ownership and Family Business Groups* (May 2005), available at http://ssrn.com/abstract=721801 (suggesting an influence of the degree of investor protection and profitability of the firm).

ing industry, Köke concludes that the agency problem resulting from pyramidal structures "is probably irrelevant for most German firms."[197]

3.3.4. Large ownership blocks as a commitment device?

Before this paper, a few scholars have already pointed out that holdup of nonshareholder constituencies may be facilitated by large shareholders.[198] By contrast, it is sometimes suggested that the long-term horizon of large financial investors in the firm may facilitate specific investment by managers, who are not so easily ousted by a takeover as, say, in the UK.[199] Equivalently, it is sometimes claimed that a large shareholder may facilitate implicit contractual relationships and commitment by other nonshareholder constituencies because of his longer time horizon in the firm.[200]

This claim is quite puzzling. While it is commonly thought that large shareholders in control-oriented finance systems hold shares for extended periods of time,[201] it is doubtful that the existence of a large shareholder *as such* should facilitate specific investment. The assumption underlying this claim is that under a dispersed ownership there is a constant takeover threat of a hostile takeover, which would be a doubtful proposition in the US context. It is of course true that managers, employees and other stakeholders are shielded from hostile takeovers by large shareholders

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[197] Köke*, id.* at 285.

[198] Shleifer & Vishny, *supra* note 5*, at* 758; Charreaux & Desbrières, *supra* note 5*,* at 116; *see* Habib, *supra* note 5 (mathematical model in the LBO context); *also see* Pagano & Volpin, *supra* note 129, at 841 (providing a model in which managers have an incentive to provide employees with strong protection to make the firm unattractive as a target of takeovers; however, this incentive rests on managers having only a small stake in equity).

[199] Julian Franks & Colin Mayer, *Ownership and Control in Europe,* in 2 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 722, 728-729 (Peter E. Newman ed. 1998); William W. Bratton & Joseph A. McCahery, *Comparative Corporate Governance and Barriers to Global Cross Reference,* in CORPORATE GOVERNANCE REGIMES 23, 27 (Joseph A. McCahery, Piet Moerland, Theo Raaijmakers & Luc Renneborg eds. 2002). Regarding the interpretation of UK corporate governance under the hypothesis of this paper, *see* section 6.

[200] *E.g.* Stephan Woolcock, *Competition among Forms of Corporate Governance in the European Community: The Case of Britain,* in NATIONAL DIVERSITY AND GLOBAL CAPITALISM 179, 183 (Suzanne Berger & Ronald Dore eds. 1996); Ruth V. Aguilera & Gregory Jackson, *The Cross-National Diversity of Corporate Governance: Dimensions and Determinants,* 28 ACAD. MGMT. REV. 447, 451 (2003).

[201] *E.g.* Bratton & McCahery, *supra* note 199, at 27.

under concentrated ownership. However, holdup can take place for two reasons: First, large shareholders themselves can obtain financial benefits; second, large shareholders refraining from ex post opportunism may sell to a third party (even when they are unwilling to hold up stakeholders themselves).

With regard to managers (distinct from shareholders), economic theory already tends to emphasize that specific investment is discouraged by concentrated ownership, as a manager only retains his position in the firm at the whim of the dominating shareholder or coalition of shareholders. Burkart, Gromb and Panunzi suggest that the choice of ownership structure implies a tradeoff between the reduction of agency cost through monitoring by large shareholders on one hand and managerial initiative on the other, which is stifled by tight constraints imposed by blockholders. Managerial initiative, which is interpreted as a form of specific investment, is avoided ex ante if managers cannot be certain to receive the private benefit of being able to retain full control of the firm ex post.[202]

The same reasoning applies nonshareholder constituencies such as employees,[203] where the presence of a large or controlling shareholder *as such* cannot signal commitment not to engage in holdup. To compare, consider a fully entrenched manager not subject to explicit or implicit shareholder influence and a controlling shareholder with full control over the firm's crucial business decisions, both considering whether to attempt to threaten employees with redundancy to increase profits. For reasons discussed above, the entrenched manager's interest may to some degree be aligned with employees (sections 2.2 and 3.2.2). Similar reasons might apply to the control-

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[202] Mike Burkart, Denis Gromb & Fausto Panunzi, *Large Shareholders, Monitoring, and the Value of the Firm,* 112 Q. J. ECON. 693 (1997). Without addressing specific investment, a similar point is made by Philippe Aghion & Jean Tirole, *Formal and Real Authority in Organizations,* 105 J. POL. ECON. 1 (1997).

[203] The point is alluded to by Burkart et al., *id.* at 702; *also see* Marco Becht, Patrick Bolton & Alisa Roëll, *Corporate Law and Governance,* in 2 HANDBOOK OF LAW AND ECONOMICS 829, 855 (A. Mitchell Polinsky & Steven Shavell eds. 2007) (extending this reasoning to stakeholders).

ling shareholder if he is indeed in charge of managing the firm's operations. However, while the entrenched manager draws no personal benefit from holdup, the controlling shareholder reaps a big chunk of ex post financial gains. Thus, assuming that the same countervailing incentives apply both to the manager and the controlling shareholder, the latter will be more eager to expropriate nonshareholder constituencies. Naturally, the manager's incentives may be different because of what I have described as *implicit shareholder influence*, i.e. when the threat of a hostile takeover is considerable, or managerial incentives are otherwise closely aligned with shareholders (which is much less the case in the US than in the UK, which will be discussed in section 6).

One reason why concentrated ownership is sometimes thought to facilitate specific investment by stakeholders is the difficulty of selling a large share in a publicly held firm.[204] However, opportunism vis-à-vis nonshareholder constituencies does not necessarily imply a sale of the share or even the threat of liquidating of the firm, in which case a large shareholder will indeed typically incur losses. In fact, the assertion that holdup is easier under dispersed ownership is often made with regard to the possibility of a *hostile* takeover,[205] i.e. when a dispersed ownership structure is replaced by a dominating shareholder.

From the perspective of stakeholders fearing holdup, the counterpart to a hostile takeover in a controlled firm is a voluntary sale of control.[206] Unlike hostile takeovers, such sales are unlikely to change managerial incentives, as managers in a controlled

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[204] Aguilera & Jackson, *supra* note 200, at 451.
[205] *E.g.* Franks & Mayer, *supra* note 199, at 729.
[206] *See e.g.* BMW's sale of Rover to Phoenix described by Armour et al, *supra* note 42, at 543-545. BMW would have liquidated the firm if it had not found a buyer. The acquirer (Phoenix) pressurized unions into making some concessions, in spite of labor law strengthening their negotiating position; *also see* Martin J. Conyon, Sourafel Girma, Steve Thompson & Peter W. Wright, *Do hostile mergers destroy jobs?* 45 J. ECON. BEHAV. & ORG. 427 (2001) (finding a similar decrease in demand for labor for firms that were acquired through a hostile takeover and a voluntary sale).

firm are under constant supervision by the controlling shareholder.[207] However, they may influence stakeholders' incentives whether to specifically invest. As a holdup decision is that of the current shareholder, so is the decision whether to sell the firm. If the current shareholder is unwilling to hold up stakeholders, a purchaser may be able to do so. If short-term shareholder value can be increased through holdup, a buyer will be able to offer a price to the current shareholder in excess of the current value of the firm. Thus, the protection of stakeholders hinges on whether the controlling shareholder is (1) both unable *and* unwilling to expropriate nonshareholder constituencies himself, but (2) also not susceptible to a lucrative offer from a third party (which will inevitably come if holdup benefits are sufficiently large). For the second condition to be met, the controlling shareholder must draw what is known as a *non-pecuniary private benefit*.[208]

For a typological perspective, the reasons for such benefits depend on who the shareholder is. First, the controlling shareholder may be a government entity, whose agents have to bear a political cost if they e.g. act against workers' interests and to cut jobs. However, whether a government entity fosters specific investments, depends on the stability of political preferences. The political process may at times lead to the predominance of the view that state-controlled enterprises should be run in a more efficient way in order to save taxpayer's money.

The second possibility is family ownership. Members of founding families may feel personally attached to the business they or their ancestors created, and they may sometimes even have a personal commitment to the firm and its employees that will

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[207] *Cf.* Klaus Gugler & B. Burcin Yurtoglu, *The effects of mergers on company employment in the USA and Europe,* 22 INT'L J. INDUS. REL. 481, 497 (2004) (summarizing the empirical finding that in the US, only tender offers, but not other deals have a significant negative effect on employment).

[208] *See* Gilson, *supra* note 4, at 1663-1664 (defining non-pecuniary benefits as "forms of psychic and other benefits that, without more, involve no transfer of real company resources and do not disproportionately dilute the company's stock to a diversified investor").

make it hard to close production sites. Particularly in small countries, the position as a founding family may confer additional benefits in political and social life.[209] However, not all of such benefits are necessarily passed on to subsequent generations.[210] Members of later generations of a founding family may lose their interest in the firm or lack the entrepreneurial skills of their forefathers. Non-pecuniary benefits may thus result in a slow deterioration of the firm's position over time,[211] thus making sale of control to a more effective controller more lucrative. Thus, while such non-contractible private benefits may create a temporary shield against holdup,[212] at some point the combination of efficiency and holdup gains is likely to become a too great incentive. Even in countries with a longstanding tradition of family control in many important firms such as France, family influence is not always seen as positive in politics:[213] While not providing impeccable evidence about the effects of family control, this supports the intuition there may be considerable conflicts of interest between family owners and workers.

The third possibility is the controlling shareholders' ability to enter into transactions with the firm on unfavorable terms.[214] The ability to do this can be idiosyncratic if another business run by the controlling shareholder complements that of the firm. Take the example of firm A producing motors and firm B producing cars. As the con-

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[209] *See* Mike Burkart, Fausto Panunzi & Andrei Shleifer, *Family Firms,* 58 J. FIN. 2167, 2168 (2003) ("A founder may derive pleasure from having his child run the company that bears the family name"); Gilson, *supra* note 4, at 1666.

[210] *See* Sandy Klasa, *Why do Controlling Families of Public Firms Sell Their Remaining Stake?* 42 J. FIN. & QUANTITATIVE ANALYSIS 339 (2007).

[211] Gilson, *supra* note 4, at 1669.

[212] *See* Burkart et al, *supra* note 209, at 2178 (modeling the conditions under which a founding family retains control because of non-pecuniary benefits in spite of superior abilities of an outside manager).

[213] *See e.g.* Antoin E. Murphy, *Corporate Ownership in France,* in A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD 185, 188 (Randall K. Morck ed. 2005) (referring to prime minister Edouard Daladier's famous criticism of the alleged two hundred "grandes familles" in 1930); *see also* Marie-Laure Djelic & Rolv Petter Amdam, *Americanization in Comparative Perspective: The Managerial Revolution in France and Norway, 1940-1990,* 49 BUS. HIST. 483, 493-493 (2007) (discussing the replacement of family ownership by state ownership in France).

[214] So-called "tunneling", *see* Johnson et al, *supra* note 137.

trolling shareholder of A, B could gain from buying motors below the usual market price. Not every potential purchaser of the share in A would be able to obtain the same benefit. However, corporate law theory generally disdains this kind of private benefit, as it hurts minority investors.[215] As minority shareholder protection gets better, this potential shield against holdup will also diminish.[216]

Summing up, it is safe to say that concentrated ownership *as such* cannot serve as a commitment mechanism facilitating specific investment by stakeholders. Even when holdup is not a current threat, potential holdup by a friendly acquirer may create a deterrent against firm-specific investment by nonshareholder constituencies, similar to the threat of a hostile takeover.

4. Legal and regulatory responses to holdup

Given the proposition outlined in the previous sections, it seems reasonable to assume that reasonably successful corporate governance should have developed responses to the danger of holdup resulting from concentrated ownership. The intuitive answer is that legal deviations from shareholder primacy could be seen as a response. Thus, I outline in section 4.1 which laws are relevant, focusing on employees. Legal strategies intended to protect employees from holdup mirror those available to protect shareholders against the classical agency problem[217] and can take the form of standards, rules, and decision rights.[218] I emphasize that, in general, stronger legal protections against holdup can be observed in corporate governance systems with concentrated ownership. In section 4.2 I deal with the question why such laws are normally mandatory.

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[215] *E.g.* Djankov et al, *supra* note 74.

[216] The evidence suggests that this kind of shareholder protection has been strengthened over the past years in several major jurisdictions. *See* Lele & Siems, *supra* note 74, at 31.

[217] *See* Henry Hansmann & Reinier Kraakman, *Agency Problems and Legal Strategies,* in THE ANATOMY OF CORPORATE LAW 21, 23 (Reinier Kraakman, Paul Davies, Henry Hansmann, Gerard Hertig, Klaus J. Hopt, Hideki Kanda & Edward B. Rock 2004).

[218] I discuss the three strategies in what I consider the ascending order of importance.

4.1. Legal strategies to contain shareholder influence

4.1.1. Standards: corporate objective norms

In many corporate law systems, the standard of conduct to which managers are subject takes stakeholders into account. For example, both German and French law are generally thought not to adhere to the ideal of shareholder primacy, but to director's obligation to promote the *Unternehmensinteresse*[219] (the interest of the business) or *intérêt social*[220] (the interest of the association) respectively, both of which are usually understood to entail a broader corporate objective than mere shareholder value maximization. However, the practical impact of these provisions, and the difference from Anglo-Saxon jurisdictions should not be overestimated. As described above, US corporate law has its constituency statutes,[221] as the UK has a statutory provision requiring directors to "have regard" to the interests of employees and other stakeholders.[222] Enforcement mechanisms that could be used e.g. by employees are ab-

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[219] *Supra* note 171-177 and accompanying text.

[220] It appears to be the majority opinion that the "social interest" of the firm transcends the mere common interest of shareholders. *See* Alcouffe, *supra* note 153, at 133-135; *E.g.* C. DUCOULOUX-FAVARD, SOCIETE ANONYME, AKTIEN GESELLSCHAFT [sic], SOCIETA PER AZIONI 182 (1992); SABINE DANA-DEMARET & YVES REINHARD, LEXIQUE DE DROIT DES SOCIETES ET DES GROUPEMENTS D'AFFAIRES 54 (1993); Claude Ducouloux-Favard, *Trente Années d'influence du droit communautaire sûr le droit français des sociétés,* 1995 REVUE DES SOCIETES 649, 657; Jean Paillusseau, *La modernisation du droit des sociétés commerciales,* 1996 RECUEIL DALLOZ SIREY c287, c289; Jean Paillusseau, *Entreprise, société, actionnaires, salariés, quels rapports ? (1),* 1999 RECUEIL DALLOZ, c157, c164-5; Philippe Bissara, *L'intérêt social,* 1999 REVUE DES SOCIETES 5, 14; Jacques Delga, *Éthique, éthique d'entreprise, éthique du gouvernement d'entreprise,* 1999 LE DALLOZ c397 (pointing out that "corporate ethics" in Latin countries are different from Anglo-Saxon ones); J. Simon, *L'évolution du gouvernement d'entreprise en France,* 77 REVUE DE DROIT INTERNATIONAL ET DE DROIT COMPARE 368, 373 (2000); Didier Poraccchia, *La rôle de l'intérêt social dans la société par actions simplifiée*, 2000 REVUE DES SOCIETES 223, 224; Didier Danet, *Crony capitalism et gouvernement d'entreprise,* 14 REVUE INTERNATIONALE DE DROIT ECONOMIQUE 247, 273 (2000). Some scholars, notably Professor Dominique Schmidt, have tried to reinterpret *intérêt sociale* to correspond to the interest of shareholders during the 1990s. *See* Dominique Schmidt, *Considération des intérêts des actionnaires dans les prises de décisions et le contrôle du juge,* 1997 REVUE DE JURISPRUDENCE COMMERCIALE 257, 259 ; Dominique Schmidt, *De l'intérêt social,* 1995 SEMAINE JURIDIQUE (JCP) ED. E., I, no. 488; DOMINIQUE SCHMIDT, LES CONFLITS D'INTERETS DANS LA SOCIETE ANONYME 10-16 (1999). *See* Antoine Pirovano, *La "boussole" de la société. Intérêt commun, intérêt social, intérêt d'entreprise ?* 1997 RECUEIL DALLOZ 189, 194.

[221] Regarding shareholder primacy in the US, *see* section 3.1. Constituency statutes allow or permit directors to take the interests of corporate constituencies into accounting in their decision whether to resist a takeover. *See supra* note 82.

[222] § 309 (1) of the Companies Act of 1985 stated: "The matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company's employees in general, as well as the interests of its members." The provision was originally introduced in

sent in all of these countries, including the continental European ones.[223] Hence, in a situation of strong explicit shareholder influence, it is unlikely to be meaningful.

4.1.2. Decision rights: Codetermination

The decision rights strategy is more interesting, and is probably of considerable significance. The paradigmatic case is codetermination in Germany, which assigns up to half of the seats on the supervisory board to employees (increasing in the number of the firm's employees) and thus gives limited, but explicit influence to this group.[224] For example, more moderate employee participation systems exist in Austria[225], the Czech Republic, Slovenia, Slovakia, and Hungary.[226] Even states with one-tier boards, such as Luxemburg, Denmark, Sweden and Finland have employee participation systems.[227] In the Dutch system, firms exceeding a certain size are required to have a supervisory board, whose members are appointed under a system of cooptation and include employee and shareholder representatives.[228]

1980, when a proposal to grant standing to unions eligible to represent employees in collective bargaining was rejected by the recently elected conservative majority. Regarding the legislative history, *see* D.D. Prentice, *A Company and its Employees: The Companies Act 1980*, 10 INDUS. L. J. 1 (1981); Lord Wedderburn of Charlton*, Employees, Partnership and Company Law,* 31 INDUS. L. J. 99, 103-108 (2002). For the current law, *see* § 172 of the Companies Act 2006, which mentions a number of stakeholders whose interests should be regarded.

[223] For the US, *see* John C. Coates IV, *Note: State Takeover Statutes and Corporate Theory: The Revival of an Old Debate,* 64 N.Y.U. L. REV. 806, 855 (1989); Springer, *supra* note 221, at 108, 121; for the UK, *see* Prentice, *id.* at 4-5; *also see* L.S. Sealy, *Directors' "Wider" Responsibilities – Problems Conceptual, Practical and Procedural,* 13 MONASH U. L. REV. 164, 177 (1987); J. E. PARKINSON, CORPORATE POWER AND RESPONSIBILITY 83 (1993).

[224] *See e.g.* Katharina Pistor, *Codetermination: A Sociopolitical Model with Governance Externalities,* in EMPLOYEES AND CORPORATE GOVERNANCE 163 (Margaret M. Blair & Mark J. Roe eds. 1999); Henry Hansmann & Reinier Kraakman, *supra* note 92, at 63-64.

[225] For Austria, *see* § 110 Arbeitsverfassungsgesetz (ArbVG).

[226] THOMAS RAISER, UNTERNEHMENSMITBESTIMMUNG VOR DEM HINTERGRUND EUROPARECHTLICHER ENTWICKLUNGEN, GUTACHTEN B FÜR DEN 66. DEUTSCHEN JURISTENTAG, B 42 (2006). Slovenia, which initially adopted the German version of codetermination after independence [*see* Rado Bohinc & Stephan M. Bainbridge *Corporate Governance in Post-Privitized Slovenia,* 49 AM. J. COMP. L. 49, 58-60 (2001)], has in the meantime abandoned it after its constitutional court declared it unconstitutional (RAISER, *id.* at B 42-B 43).

[227] RAISER, *id.* at B 43-B 44; *also see* Hansmann & Kraakman, *supra* note 92, at 62 (noting that, among EU countries, only Portugal, Belgium, Italy and the UK have no employee participation systems, whereas Ireland, Spain and Greece mandate employee directors only for state-owned firms).

[228] *See* STEVEN R. SCHUIT, BARBARA BIER, LEONARD G. VERBURG & JAN A. TER WISCH, CORPORATE LAW AND PRACTICE OF THE NETHERLANDS 111-117 (2002); Edo Groenewald, *Corporate Governance in the Netherlands: From the Verdam Report of 1964 to the Tabaksblat Code of 2003,* 6 EUR. BUS. ORG. L.

In most cases, the impact on decisions may actually be quite limited except in cases of significant conflicts between different groups of shareholders. Even under German "quasi-parity", the decisive vote is cast by the chairman, who is one of the directors elected by shareholders.[229] However, codetermination may serve as a channel transmitting crucial information to employee representatives,[230] which puts employees in the position to act early and improves their bargaining position. While the debate on whether (and what extent of) codetermination is efficient has not reached a final conclusion, the existing evidence allows some preliminary conclusions: A study by Gorton and Schmid found that equal codetermination (50% of seats held by employees) was linked to a 31% discount on the value of the firm's share in the stock make compared to firms where employees only held one third of the seats on the board;[231] however, Fauver and Fuerst found a positive effect of "moderate" codetermination (1/3), depending on the industry, in a more recent paper: It appears that shareholder value, measured in Tobin's Q actually increases the value of German trade, transportation and manufacturing firms.[232] Finally, according to FitzRoy and Kraft, the introduction of codetermination in 1976 was correlated with slight gains in productivity.[233] While it is yet too early for a final verdict, taken these together, some, but not excessive employee decision rights may improve the firm's productivity and competitiveness; mitigating holdup problems may be one of the reasons.

REV. 291, 294-295 (2005); Abe de Jong & Alisa Roëll, *Financing and Control in the Netherlands,* in A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD 467, 473 (Randell K. Morck ed. 2005).

[229] §§ 27(2), 29(2) MitbestG.

[230] *See* Gérard Hertig, *Codetermination as a (Partial) Substitute for Mandatory Disclosure,* 7 EUR. BUS. ORG. L. REV. 123, 128-130 (2006).

[231] Gary Gorton & Frank A. Schmid, *Capital, Labor and the Firm: A Study of German Codetermination*, 2 J. EUR. ECON. ASS'N 863 (2004).

[232] Fauver & Fuerst, *supra* note 23. These results do not hold when the employee representatives do not actually work in the firm, but are sent by unions.

[233] Felix FitzRoy & Kornelius Kraft, *Co-determination, Efficiency and Productivity,* 43 BRIT. J. INDUS. REL. 233 (2005).

4.1.3. Rules: Employment law

Most likely, the legal strategy with the greatest impact is the rules approach of employment law, whose instruments make layoffs of workers more difficult and costly, and eliminates some of the threat potential that may result in a holdup-type renegotiation.

Generally, countries characterized by ownership concentration tend to be those with strong legal job protection.[234] The contrast between the US and continental Europe could hardly be more striking. In comparative indices of labor flexibility, the US usually is found to be one of the industrial countries with the smallest degree of employment protection.[235] In fact, the baseline default rule in virtually all US states is employment at will,[236] meaning that both the employee and, more importantly, the employer can end the employment relationship at any time without any notice period if no specific term is stated in the contract of employment, without a requirement to show cause.[237] Estimates about the percentage of the population subject to the at-

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[234] For empirical evidence, *see* Roe, *supra* note 91, at 263-264; ROE, *supra* note 90, at 51-52 (both finding a negative correlation between the number of medium-sized firms without a blockholder and the OECD Employment Law Index); Beth Ahlering & Simon Deakin, *Labour Regulation, Corporate Governance and Legal Origin: A Case of Institutional Complementarity* 26, ECGI LAW WORKING PAPER N° 72/2006, at http://ssrn.com/abstract=898184 (finding a correlation between the employment law index and blockholder size, but not between either collective industrial relations or social security and blockholder size); *also see* Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *The Economic Consequences of Legal Origins* 55 (2nd draft, Mimeo, Harvard Department of Economics) ("countries that have strong shareholder protections indeed have weak protections of labor").

[235] ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, THE OECD JOBS STUDY: EVIDENCE AND EXPLANATIONS, PT. II: THE ADJUSTMENT POTENTIAL OF THE LABOUR MARKET 74 (1994); *also see* Juan C. Botero, Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *The Regulation of Labor,* 2004 Q. J. ECON. 1139.

[236] *Cf.* J. Hoult Verkerke, *An Empirical Perspective on Indefinite Term Employment Contracts: Resolving the Just Cause Debate,* 1995 WIS. L. REV. 837, 839 (pointing out that, in spite of advocacy by the proponents of the Model Employment Termination Act, only one state – Montana – had abrogated the common law rule by statute). On the Montana statute *see* DOUGLAS E. RAY, CALVIN WILLIAM SHARPE & ROBERT N. STRASSFELD, UNDERSTANDING LABOR LAW 65-66 (1999); MARK A. ROTHSTEIN, CHARLES B. CRAVER, ELINOR P. SCHROEDER & ELAINE W. SHOBEN, EMPLOYMENT LAW 723 (2nd ed. 1999).

[237] *E.g.* Jay M. Feinman, *The Development of the Employment at Will Rule,* 20 AM. J. LEGAL HIST. 118, 118 (1976); Payne v. Western & Atlantic Railroad, 81 Tenn. 507 [1884] at 518-519; Demasse v. ITT Corp., 984 P.2d 1138 (Ariz. 1999) (en banc).

will rule range between 60 Million[238] and 70 and 75% of the US' 100 million private-sector, non-agricultural workforce.[239]

To be sure, the rule has increasingly been encroached upon by state courts in the second half of the 20th century, when courts gradually adopted a number of exceptions.[240] However, US courts generally require the employee to show that the dismissal was impermissible for reasons of public policy,[241] such as an inacceptable motive.[242] By contrast, in Germany and France the employer typically has this burden of proof.

For example, in Germany, redundancies of employment relationships that lasted more than six months are legally invalid if they are "socially unjustified."[243] Social justification can be established on various grounds, including reasons relating to the person of the employee (such as inability to perform the job), his conduct, but also compelling operational requirements opposed to continued employment. A dismissal is "socially unjustified" when it violates selection criteria for redundancies agreed upon with the works council (a mandatory representative body of employees) and the employee could be deployed within the company. This applies even where the em-

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[238] Jack Stieber, *Recent Developments in Employment-At-Will,* 36 LABOR L. J. 557, 558 (1989).

[239] William L. Mauk, *Wrongful Discharge: The Erosion of 100 Years of Employer Privilege,* 21 IDAHO L. REV. 201, 204 (1985); Cindy Barber, *Note: Comparison of International and U.S. Employment Termination Procedures: How Far have we come? – A Step in the Right Direction,* 19 SYRACUSE J. INT'L & COM. 165, 165 (1993); INTERNATIONAL LABOR ORGANIZATION, TERMINATION OF EMPLOYMENT DIGEST 356 n.2 (2000).

[240] Peter Linzer, *The Decline of Assent: At-Will Employment as a Case-Study of the Breakdown of Private Law Theory,* 20 GA. L. REV. 325, 339-344 (1986); ROTHSTEIN ET AL., *supra* note 236, at 672.

[241] Novosel v. Nationwide Insurance Co. 721 F.2d 894 (3d Cir. 1983); Lucas v. Brown & Root, Inc. 736 F.2d 1202 (8th Cir. 1984); Wagenseller v. Scottsdale Mem. Hosp., 710 P.2d 1025 (Ariz. 1985); Nees v. Hocks 536 P.2d 512 (Or. 1975) (jury duty); Belline v. K-Mart. Corp, 940 F.2d 184 ((7th Cir. 1991) (whistleblowing).

[242] *Cf.* ROTHSTEIN ET AL., *supra* note 236, at 698 et seq.; Petermann v. Int'l Brotherhood of Teamsters, Local 396, 344 P.2d 24 (Cal. App. 2d 1959) (refusal to commit perjury); Delaney v. Taco Time International inc., 681 P.2d 114 (Or. 1984) (refusal to sign defamatory statement); Sabine Pilot Serv. v. Hauck, 687 S.W. 2d 733 (Tex. 1985).

[243] § 1(1) KSchG. Legal protection against dismissal applies only to firms with more than five employees (§ 23(1) KSchG). The threshold was subject to some legislative variations during the past years. *See* Wilhelm Moll, in GROSSKOMMENTAR ZUM KÜNDIGUNGSRECHT, § 23, comment 3 (Reiner Ascheid, Ulrich Preis & Ingrid Schmidt eds. 2000).

ployee could be retained after undergoing a reasonable amount of (re)training.[244] In this case, the works council can object to dismissal. Generally, the termination of the employment relationship (even when tied to a new offer) must be a measure of last resort.[245]

The works council must be heard before dismissals[246] and may raise objections against dismissals not for cause; more specifically, it can object that the employer failed to adequately consider social criteria,[247] or when the employer violated selection criteria stipulated in collective bargaining agreements,[248] when the employee could be transferred to another position within the company[249] or when he could be retrained for a different position.[250] Such an objection considerably improves the employee's procedural position,[251] as he is entitled to remain in employment until the court has decided the case;[252] and can enforce this by preliminary injunction.[253]

An operative reorganization (*Betriebsänderung*), which includes plant closures, relocations, mergers and new manufacturing processes, triggers additional duties for employers of more than twenty employees. Besides the requirement to consult the works council,[254] the employer and the works council must agree on a "social plan" (*Sozialplan*).[255] Typically, the social plan would include severance payments to em-

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[244] § 1(2) KSchG.
[245] BAG 27.9.1984, 2 AZR 62/83 (finding such an offer must take precedence over an outright termination).
[246] § 102(1) BetrVG.
[247] § 102(3)(1) BetrVG.
[248] § 102(3)(2) BetrVG.
[249] § 102(3)(3) BetrVG.
[250] § 102(3)(4) BetrVG.
[251] § 1(2) KSchG, sentences 2 and 3. *See e.g.* Michael Kittner, in KÜNDIGUNGSSCHUTZRECHT, § 102 BetrVG, comment 233, (Wolfgang Däubler, Michael Kittner & Bertram Zwanziger eds, 5th ed. 2001); Michael Kittner & Thomas C. Kohler, *Conditioning Expectations: The Protection of the Employment Bond in German and American Law,* 21 COMP. LABOR L. & POL'Y. J. 263, 317 (2000).
[252] § 102(5) BetrVG.
[253] Kittner, *supra* note 251, at note 266.
[254] § 111 BetrVG
[255] § 112 BetrVG. A notable decision of the federal labor court in 1979 explicitly stated that mere reductions of personnel also required social plans (BAG 1 ABR 17/77, May 22, 1979, 1980 NEUE JURISTISCHE WOCHENSCHRIFT 83).

ployees or the creation of a trust fund from which additional payments to dismissed employees would be made if these fail to find employment for a considerable length of time.[256]

While the roots of modern German employment protection law can be traced to the early days of the Weimar Republic[257] and the modern Employment Protection Act was passed in 1951,[258] its French equivalent has more recent origins. While a 1926 court decision[259] and a 1928 statute[260] introduced damages for "abusive" dismissals, the protection resulting from this seems to have been comparatively weak.[261] Only a 1967 law introduced mandatory severance payment for employees who had been with the same employer for two years and were dismissed not for cause.[262] Restrictions on the employer's right to dismiss along the lines of German law were only enacted in 1973.[263] Besides cumbersome procedural requirements the employer has

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[256] *Cf.* Wolfgang Däubler, in KÜNDIGUNGSSCHUTZRECHT KOMMENTAR FÜR DIE PRAXIS, §§ 111-113 BetrVG*,* comment 62, (Wolfgang Däubler, Michael Kittner & Bertram Zwanziger eds, 5th ed. 2001). § 112a BetrVG sets out minimum thresholds of affected employees. A study covering the early 80s found that social plans typically required employers to make considerable payments to employees. Those were usually calculated by using formulas based on age, length of employment and annual salary, with upper limits expressed in terms of a certain number of monthly salaries (varying between 3 and 24). The financial impact on firms was considerable, exceeding 14% of annual profits and 7% of equity for half of the firms. *See* EDMUND HEMMER, SOZIALPLANPRAXIS IN DER BUNDESREPUBLIK 43, 66, 78 (1988).

[257] A law of 1921 first allowed employees to challenge "socially unacceptable" dismissals in court if the works council supported their complaint. *See* Stefan Fiebig, in KÜNDIGUNGSSCHUTZGESETZ HANDKOMMENTAR, *Einleitung,* comment 104 (Stefan Fiebig, Inken Gallner, Jürgen Griebelnig, Wilhelm Mestwerdt, Stefan Nägele & Gerhard Pfeiffer eds., 2nd ed. 2004); Ulrich Preis, in GROSSKOMMENTAR ZUM KÜNDIGUNGSRECHT, *Grundlagen A,* comment 8 (Reiner Ascheid, Ulrich Preis & Ingrid Schmidt eds. 2000). This law was only applicable in businesses which were large enough to require a works council (more than 20 employees). Also, the employer could "pay off" the employee.

[258] Fiebig, *id.* at note 108 et seq.; *see* the official grounds at 4 RECHT DER ARBEIT 61-63 (1951).

[259] Madeleine M. Plasencia, *Employment-At-Will: The French Experience as a Basis for Reform,* 9 COMP. LAB. L. J. 294, 299 (1988).

[260] Loi du 19 Juillet 1928; *see* Plasencia., *id.;* JEAN PELISSIER, ALAIN SUPIOT & ANTOINE JEAMMAUD, DROIT DU TRAVAIL, note 406 (20th ed. 2000)

[261] *See* PÉLISSIER ET AL., *id.*

[262] Ordonnance du 13 juillet 1967. The provision was subsequently codified in modified form in Code du travail Art. L. 122-9. *See* PELISSIER ET AL., *supra* note 260, at note 489. A regulation dating to 1974 fixed the amount of payments. Code du travail Art. R. 122-2, Décr. n° 74-808 du 19 sept. 1974.

[263] *See e.g.* Roland Voize-Valayre, *The French Law of Unjust Dismissals,* 23 NYU J. INT'L. L. & POL'Y 519, 523 (1991).

to meet in order to dismiss an employee,[264] the employer must show a *cause réelle et sérieuse,* which may be scrutinized by a court.[265] However, such cause could also be provided by a reorganization of the enterprise.[266]

In addition to this, French employment law also includes special provisions on dismissals "for economic reasons",[267] under which the employer is required to obtain authorization from the local labor office to dismiss employees. While the original regulation of 1945[268] never obtained great importance,[269] this apparently changed with the incorporation of a modified version into the *Code du Travail* in 1975.[270] The new law gave dismissed employees the right to damages.[271] Even though the administrative authorization to dismiss employees was refused only rarely,[272] the procedure apparently exerted a prohibitive effect against dismissals.[273] While the authorization requirement was repealed in 1986,[274] the role of the works council was increased.[275] The employer is required to inform the director of the labor office after effecting a dismissal.[276] If an employer wants to dismiss more than ten employees within a period of thirty days, employee representatives have to be convened and informed

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[264] Code du travail Art. L. 122-14. Failure to comply with the procedures may result in damages, *see* Code du travail Art. L. 122-14-4.
[265] Code du travail Art. L. 122-14-3. *See* PÉLISSIER ET AL., *supra* note 260, at note 407.
[266] PÉLISSIER ET AL., *supra* note 260, at note 411.
[267] Code du travail Art. L. 321-1. The definition also includes substantial modifications of the contract of employment.
[268] Ordonnance du 24 mai 1945; décret du 23 août 1945; arrête du 6 oct. 1945.
[269] *See* Jean Pélissier, *Les licenciements pour motif économique,* 1975 RECUEIL DALLOZ SIREY c135, c136 (pointing out that employees could not obtain damages for dismissals in violation of the regulation); JEAN-EMMANUEL RAY, DROIT DU TRAVAIL DROIT VIVANT 228 (9th ed. 2000) (indicating that the regulation was never respected).
[270] Loi du 3 janv. 1975. *See* FRANCK MODERNE, LE CONTROLE ADMINISTRATIF DES LICENCIEMENTS ECONOMIQUES 16 (1983).
[271] JEAN RIVERO & JEAN SAVATIER, DROIT DU TRAVAIL 534 (11th ed. 1989)
[272] RIVERO & SAVATIER, *id*, at 535 (giving the number of 90% of acceptances).
[273] RIVERO & SAVATIER, *id.*.
[274] Loi du 3 juillet 1986; loi du 30 décembre 1986.
[275] *Cf.* RAY, *supra* note 269, at 229.
[276] Code du travail Art. R. 321-1 (Regulation).

about the plan (i.e. the *comité d'entreprise* if the firm has typically more than fifty employees).[277] The employees have to be selected according to "social" criteria.[278]

Since 1974, employers with fifty employees or more may be required to arrange for a social plan, similar to German law, if ten employees or more are dismissed within a period of 30 days.[279] The plan should include measures to avoid layoffs and measures to reassign employees inside or outside the firm.[280] Frequently severance payments are made in the course of the plan.[281] The courts have taken quite a strict stance and stated that the employer has to take all possible measures within the means of the firm to continue to employ the employees or to facilitate their reassignment to another job.[282]

Employment protection law in other Continental European countries resembles the situation in Germany and France. It is often costly to lay off employees, because mandatory severance payments have to be made, and "social plans" have to be prepared. Further costs are created by procedural hassle. For example, a survey among German firms found that 76% of firms had had difficulty pursuing dismissals "for compelling operational reasons" in the past, often because of the standard proof to establish operational reasons demanded by the courts or the difficulty of correctly applying the social criteria of selecting employees for dismissal. [283] Lawsuits against

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[277] Code du travail Art. L. 321-3; *cf.* PÉLISSIER ET AL., *supra* note 260, at note 435.
[278] Code du travail Art L. 321-1-1.
[279] Code du travail Art. L. 321-4-1. Originally, the provision was not part of the law, but a collective bargaining agreement on the national level (*accord national interprofessionnel du 21 novembre 1974*). *See* Gérard Couturier, *Le plan social : aspects juridiques,* 1985 DROIT SOCIAL 643, 643. The social law became part of the labor code only in 1986. Loi du 30 décembre 1986, n° 86-1320 subsequently amended by the lois du 2 août 1989, n° 89-549 and du 27 janvier 1993, n° 93-121. *Cf.* PELISSIER ET AL., *supra* note 260, at 497-8.
[280] Loi 27 janvier 1993; *see* PÉLISSIER ET AL., *supra* note 260, at note 446.
[281] *Cf.* Robert Rebhahn, *Abfindung statt Kündigungsschutz? Rechtsvergleich und Regelungsmodelle,* 2002 RECHT DER ARBEIT 272, 278.
[282] Soc. 28 mars 2000, RJS 5/2000, n° 520; *see* PÉLISSIER ET AL., *supra* note 260, at note 448.
[283] Heide Pfarr, Silke Bothfeld, Lutz C. Kaiser, Martin Kimmich, Andreas Peuker & Karen Ullmann, *REGAM-Studie: Die Kündigungs-, Klage- und Abfindungspraxis in den Betrieben,* 59 BETRIEBS-BERATER 106, 109-110 (2004).

dismissals are prevalent; studies covering the periods of September 1999 to November 2000 and the years 1998 to 2003 found concluded that lawsuits were brought in 11.1% and 15.3% of dismissals respectively.[284] There are slightly lower numbers for dismissals "for compelling operational reasons" only, with estimates ranging between 8% and 10%.[285]

The effect of all these mechanisms is twofold. First, judicial review of dismissal decisions, severance payments and procedural hurdles all make dismissal more costly to employers and hence reduce the credibility of a holdup theat.[286] Second, explicit and implicit costs borne by the employer, most of all payments made in consequence of a social plan, can be interpreted as a mechanism to internalize the harm incurred by employees with shareholders as a result of a dismissal: As a result, there will only be an incentive to close a plant if the gain to shareholders exceeds the loss to employees.[287] In fact, some of the labor economics literature suggests that rules making dismissals more expensive, such as severance payments, are associated with greater incentives to invest in specific human capital.[288] Thus, while these legal mechanisms may be responsible for inflexibility in the labor market, they have the upside of protecting employees' specific investment against holdup. To be sure, individual and collective protection *by law* is not the only relevant factor. Collective bargaining agreements may have similar effects, and unions may help workers to police implicit

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[284] Pfarr et al., *id.* at 106.

[285] Harald Bielinski, Josef Hartmann, Heide Pfarr & Hartmut Seifert, *Die Beendigung von Arbeitsverhältnissen: Wahrnehmung und Wirklichkeit,* 51 ARBEIT UND RECHT 81, 87 (2003) (8%); Pfarr et al., *id.* at 108 (10%).

[286] Eger, *supra* note 24, at 387.

[287] Engert, *supra* note 37, at 109; for a similar argument regarding the UK *see* John Armour & Simon Deakin, *Insolvency and employment Protection: the mixed effects of the Acquired Rights Directive,* 22 INT'L REV. L. & ECON. 443, 445-446 (2003).

[288] Alison Booth & Monojit Chatterji, *Redundancy Payments and Firm-specific Training,* 56 ECONOMICA 505 (1989); Susan N. Houseman, *The Equity and Efficiency of Job Security: Contrasting Perspectives on Collective Dismissal Laws in Western Europe,* in NEW DEVELOPMENTS IN THE LABOR MARKET 185, 187-188 (Katharine G. Abraham & Robert. B. McKersie eds. 1990); Jens Suedekum & Peter Ruehman, *Severance Payments and Firm-Specific Human Capital,* 17 LAB. 47 (2003); Alison L. Booth & Gylfi Zoega, *On the Welfare Implications of Firing Costs,* 19 EUR. J. POL. ECON. 759 (2003).

commitments by firms.[289] The bargaining power of unions depends in large parts on the law in the shadow of which bargains are struck. Unions may be better able to help workers to protect their rents when the background law is more worker-friendly. According to Mark Roe, employee power, as the consequence of certain political preconditions in the respective country, is the cause of ownership concentration, which is needed to provide increased monitoring in view of agency cost exacerbated through stakeholder influence.[290] The hypothesis of this paper reverses the direction of causality: Given a high level of ownership concentration – and therefore a significant danger of holdup – it may be desirable to develop strong legal and institutional tools of stakeholder, particularly employee protection. However, these two explanations need not necessarily be incompatible, but could recursively reinforcing each other.[291]

4.2. Why mandatory law?

An objection to the theory might be that employment protection and codetermination provisions are all mandatory law, and such just provisions might be introduced voluntarily if they improve a firm's corporate governance and competitiveness.[292] Whereas voluntary codetermination is only observed extremely rarely in practice (if ever), individual employment contracts sometimes provide some direct protection against dis-

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[289] *See* Chad Hogan, *Enforcement of Implicit Employment Contracts through Unionization,* 19 J. LAB. ECON. 171 (2001).
[290] *Supra* section 2.3.
[291] *But see* Holger M. Mueller & Thomas Philippon, *Concentrated Ownership and Labor Relations,* CENTRE FOR ECONOMIC POLICY DISCUSSION PAPER SERIES NO. 5776, at http://ssrn.com/abstract=933094 (finding no support for an interaction between labor law and concentrated ownership, but suggesting hostile labor relations as the proximate cause for concentrated ownership, without ruling out the possibility of a feedback loop between the two factors). Under this paper's holdup theory, hostile labor relations could well be an alternative consequence of concentrated ownership.
[292] Michael C. Jensen & William H. Meckling, *Rights and Production Functions: An Application to Labor-managed Firms and Codetermination,* 52 J. BUS. 469, 472-475 (1979) (arguing that the burden of proof lies with the proponents of codetermination); Richard A. Epstein, *In Defense of the Contract at Will,* 51 U. CHI. L. REV. 947, 956 (suggesting that [parties to an employment contract] "as a general matter know how to govern their own lives).

missal (such as in the case of tenure for university professors) or severance payments that internalize some of the harm inflicted on the dismissed employee with the firm by making dismissal more costly.[293]

There are various arguments why either codetermination or employment protection should be mandatory. Regarding codetermination, adverse selection is probably cited most frequently. Fauver and Fuerst suggest that if a single firm introduced codetermination voluntarily, the increased bargaining power of workers would reduce the wage differential between senior management and workers, while job security within the firm would increase. The result would most likely be that the firm would lose the best managerial talent to competitors and attract the least productive workers, who presumable have the strongest preference for job security.[294] Similarly, it is often suggested that firms offering generous redundancy entitlements within an environment without employment protection may attract poor employees; for an employee, it may be irrational to bargain for job protection as it may signal the absence of a commitment to work hard.[295] Armour and Deakin further suggest that the appropriate matching of individual redundancy entitlements may be excessively costly to contract for, both because of the difficulty to specify outputs in individual states of the world and because specific investment is hard to observe.[296] Of course, any job protection law (both on the individual and collective level) is less tailored to the individual situa-

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[293] *See e.g.* J. Hoult Verkerke, *An Empirical Perspective on Indefinite Term Employment Contracts: Resolving the Just Cause Debate,* 1995 WIS. L. REV. 837, 867 (reporting empirical findings on the prevalence of employment at will and voluntary restrictions of dismissals to "just cause").

[294] Fauver & Fuerst, *supra* note 23, at 679.

[295] David I. Levine, *Just-Cause Employment Policies in the Presence of Worker Selection,* 9 J. LAB. ECON. 293 (1991); Cass R. Sunstein, *Human Behavior and the Law of Work,* 87 VA. L. REV. 205, 225-6 (2001); Armour & Deakin, *supra* note 287, at 447-448; *but see* Verkerke, *supra* note 293, at 902-905.

[296] Armour & Deakin, *id.* at 447-448; *also see* Margit Osterloh & Bruno S. Frey, *Shareholders Should Welcome Knowledge Workers as Directors,* 10 J. MGMT. & GOV. 325, 328 (2006) (pointing out the high transaction cost of protecting specific investment by contract).

tion than a private contract; however, the point is that they increase workers' bargaining power, particularly on the collective level.[297]

Furthermore, Sunstein also points out that successful bargaining for employment protection may be ruled out by an endowment effect, i.e. the existence of a difference between the amount someone is willing to pay for a right she does not possess and the amount for which she is willing to sell if she has the entitlement.[298] A sense of entitlement similar to the one associated with endowment effects may make the voluntary provision of codetermination very difficult in practice: The introduction of a mandatory codetermination scheme may be particularly hard to "sell" to investors. While the "traditional" justification of shareholder primacy resting on shareholders ownership[299] of the firm has become obsolete in academic circles with the development of the contractarian model, it is most certainly still preeminent in the public consciousness. Considering themselves the "owners" of the firm, investors may feel naturally entitled to control its governance structure and hence be unwilling to partly cede control,[300] even if any influence of small shareholders is in practice ruled out by the presence of a controlling shareholder. According to a related behavioral explanation, employer representatives may fear an increased sense of entitlement among workers due to job protection laws which may affect what bargains employees con-

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[297] Collective bargaining agreements may sometimes make it possible to overcome these problems, e.g. an industry-wide agreement with a union could eliminate the adverse selection problem. On the related possibility of unions policing implicit commitments by firms to workers *see* Hogan, *supra* note 289.

[298] Sunstein, *supra* note 295, at 220-224. On the endowment effect, *see generally* Daniel Kahnemann, Jack L. Knetsch & Richard H. Thaler, *Experimental Tests of the Endowment Effect and the Coase Theorem,* 98 J. POL. ECON. 1325 (1990); Thomas S. Ulen, *Rational Choice Theory in Law and Economics,* in 0710 INTERNATIONAL ENCYCLOPEDIA OF LAW AND ECONOMICS, 790, 804-806 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000).

[299] *E.g.* Milton Friedman, *The social responsibility of business is to increase its profits,* NEW YORK TIMES MAGAZINE, Sept. 13, 1970, 32.

[300] *Also see* Margaret M. Blair, *Corporate "Ownership",* BROOKINGS REV., Winter 1995, 16 (criticizing the concept of "ownership" of the firm as misleading and a reason for distortions in corporate law policy debates).

sider as fair, thus hurting the employer side's bargaining position.[301] Furthermore, it has been suggested that benefits that are hard to describe in terms of financial figures may often not be understood by investors.[302]

Finally, note that mandatory law may not always be binding in practice. For example, mandatory severance payments are often said to have the effect of turning full-time jobs into part-time employment (where legal rules often do not apply to their full extent), resulting in an outsourcing of work to atypical employment relationships.[303] With some effort to contract around the law, mandatory rules may effectively become default rules for at least some jobs; apparently, low skilled workers are more frequently affected by this phenomenon,[304] which may imply that employers are in fact able to differentiate between workers where some employment protection is desirable and others.[305]

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[301] Houseman, *supra* note 288, at 191-192.
[302] Frick et al., *supra* note 19, at 751-753.
[303] Edward P. Lazear, *Job Security Provisions and Employment,* 105 Q. J. ECON. 699, 724-725 (1990); David H. Autor, *Outsourcing at Will: The Contribution of Unjust Dismissal Doctrine to the Growth of Employment Outsourcing,* 21 J. LAB. ECON. 1 (2003).
[304] *See e.g.* Bernhard Boockmann & Tobias Hagen, *The Use of Flexible Working Contracts in West Germany: Evidence from an Establishment Panel,* ZEW DISCUSSION PAPER NO. 01-33, 9-10, available at http://ssrn.com/abstract=358341 (finding that temporarily employed workers have comparatively less education).
[305] Furthermore, even German codetermination has always been non-mandatory to the extent that shareholders can decide to break up a large firm into smaller, non-affiliated ones, which are subject to a less stringent employee participation regime. However, such split-ups may result in considerable costs. *See* Gorton & Schmid, *supra* note 231, at 895. In recent years, the possibility to set up a European Company (SE) or of a cross-border merger has also created some possibilities to reduce the influence of employees in mainly German firms. Both the creation of an SE and a cross-border merger trigger a negotiation process about the applicable future codetermination regime, in which employees are in a strong bargaining position and allows the effective maintenance of previous structures. *See* Andrew Johnston, *EC Freedom of Establishment, Employee Participation in Corporate Governance and Regulatory Competition,* 7 J. CORP. L. STUD. 71, 109 (2006). However, an SE can be merged into a national legal form (without any employee participation) after two years (Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute of a European Company, 2001 O.J. (L 294) 1, art. 66(1)). Art. 16(7) of the Directive on Transnational Mergers [Directive 2005/56/EC, of the European Parliament and of the Council of 26 October 200 5 on cross-border mergers of limited liability companies, 2005 O.J. (L 310) 1] requires Member States to protect employee participation rights in the event of subsequent domestic mergers for a period of three years. Some authors are therefore speaking of an "erosion" of codetermination. *See* Mathias Habersack, *Grundsatzfragen der Mitbestimmung in SE und SCE sowie bei grenzüberschreitender Verschmelzung,* 171 ZEITSCHRIFT FÜR DAS GESAMTE HANDELS- UND WIRTSCHAFTSRECHT 613, 643 (2007).

5. Re-interpreting comparative corporate governance structures

In this section of the paper I attempt to pull together the elements identified so far – different degrees of shareholder influence and stakeholder protection laws in the US and Continental Europe – into a unitary theory. First, I suggest that the two combinations may constitute different local optima from a normative perspective (section 5.1). Then, I briefly discuss the chronology, which suggests that employment legislation was preceded by strong shareholder influence (section 5.2), and briefly discuss potential consequences for the future (section 5.3).

5.1. Two local optima

We have seen that US corporate governance provides relatively little (explicit or implicit) shareholder influence, in spite of pervasive shareholder primacy rhetoric. By contrast, Continental laws such as these of France and Germany are usually said to have a broader corporate objective and a dearth of shareholder primacy. However, the prevailing concentrated ownership structure creates a considerable degree of explicit shareholder influence, which exacerbates holdup risk for other groups. Even though German corporate law on the books does not provide for strong shareholder influence (other than in France or Italy), the explicit influence of large shareholders in German corporate governance[306] renders the structure of law on the books irrelevant in that respect. However, other than the US, the laws of these states have other mechanisms to make up for it, namely tightly-knit rules designed to protect employees.

In the US context, Lucian Bebchuk criticizes the team production theory,[307] and more generally claims that problems of the holdup of stakeholders are mitigated by mechanisms curbing the influence of dispersed shareholder by pointing out that, if that were a relevant concern, it would be even more important to protect firms against the

[306] *See* Zetzsche, *supra* note 74.
[307] *Supra* section 2.2.

intervention of large shareholders.[308] The comparative discussion in the preceding section shows that he is (partially) right: Mechanisms disempowering protecting employees against shareholder intervention are comparatively weaker in the US than in Continental European countries. Of course, no aspect of a corporate governance system will be optimal for each and every individual firm. We observe both public firms with core shareholders in countries otherwise dominated by dispersed ownership, and widely-held firms in countries with mostly concentrated ownership.[309] However, given that concentrated ownership is much more prevalent in continental Europe than in the US, the analysis of this paper suggests that – other things equal – stronger protection of stakeholders will have stronger benefits in these countries.

In order to show that it is possible that both US and the prototypical Continental European corporate governance systems, without being perfect, may be close to an equilibrium, assume there are two options regarding shareholder influence ("strong" and "weak" shareholders) and two options regarding the protection of employees against opportunism by or on behalf of shareholders ("strong" and "weak" stakeholders referring to the strength of stakeholder protection laws as described in section 4.1). The possible combinations are shown in Table 1. Among these four options, there are only two local optima, from which it will be suboptimal for a corporate governance system to deviate on one axis only.[310]

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[308] Bebchuk, *supra* note 93, at 908-9.

[309] *Cf.* Gilson, *supra* note 4, at 1657-1660 (arguing that dispersed ownership will only be found in concentrated-ownership countries with law effectively preventing self-dealing by large shareholders).

[310] Note that these are not equilibria in the sense of game theory, which would presume the existence of two actors reacting to each others' decisions.

A	weak shareholders weak stakeholders	**B**	strong shareholders weak stakeholders
C	weak shareholders strong stakeholders	**D**	strong shareholders strong stakeholders

Table 1: Local optima of shareholder influence and stakeholder protection

A and D are local optima. Each of A and D outperforms B and C. The US is near or in equilibrium A, Continental European corporate governance systems such as France and Germany may be near or in equilibrium D. The theory of this paper explains primarily why corporate governance systems may be ill-advised to move out of the local optima of A and D along the vertical axis. Regarding the relationship between firms and their employees, there are two types of costs to consider. Most of all, this paper has been concerned with holdup cost, which increases with the degree of shareholder influence (i.e. it is high in the case of the "strong shareholders" option). The "strong stakeholders" option may mitigate holdup cost, but does not come for free. German codetermination, for example, is often criticized on the grounds that it is detrimental to an efficient functioning of the board, as the board of directors grows in size and repeatedly emerging conflicts of interest among heterogeneous groups hamper decision-making.[311] Strong employment protection is a crude instrument that comes at a cost, as it heightens the bargaining power not only of "deserving" employees making valuable specific investment, but also of employees with low productivity, who may be the first to lose their jobs in times of crisis (and who should be the first to be dismissed if the overarching goal is the total welfare of all corporate constituencies).[312]

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[311] *E.g.* HANSMANN, *supra* note 23, at 110-112; Pistor, *supra* note 224, at 178-179.

[312] *See also* Jens Suedekum & Peter Ruehmann, *Severance Payments and Firm-Specific Human Capital,* 17 LAB. 47, 59 (2003) (summarizing the finding that mandatory severance payments may create both incentive effects and lethargy effects with the domination of either depending on the circumstances of the particular case).

The labor economics literature emphasizes how employment protection laws and mandatory severance payments may make it difficult for firms to adjust to modified circumstances.[313] In an environment where "strong shareholders" are taken as given, these costs will typically be outweighed by the benefits of reduced holdup risk, which is why D will be preferable to B. By contrast, for a corporate governance system starting out in a "weak shareholders" world, a "strong stakeholders" strategy would be excessive, as there is little to gain on the holdup front, while the strategy's intrinsic costs are still present, which is why A will outperform C.

It is easy to make a parallel argument regarding the political level in order to explain why either A or D can be stable against moves along the vertical axis (i.e. against weakening or strengthening pro-employee laws respectively): Once human capital investments have been made, employees have a strong incentive to lobby against the abolition of such laws, given the large potential for holdup, which should be smaller under dispersed ownership. Furthermore, once the system is in place it is doubtful whether the incentives of the representatives of "business interests" to lobby for the abolition of pro-employee laws are particularly strong, since making holdup more difficult may be mutually beneficial.

So far the analysis has largely accepted concentrated or dispersed ownership as given. Many comparative corporate governance theories try to explain why dispersed or concentrated ownership persists in a particular country. The theory of this paper is not incompatible with these theories, but the interrelation studied here interacts with these other correlations. To complete the analysis of the local optimality of points A and D in table 1, first consider the persistence of a concentrated ownership structure,

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[313] *E.g.* Lazear, *supra* note 303; John T. Addison & Paulino Texeira, *The Economics of Employment Protection,* 24 J. LAB. RES. 85, 107-115 (2003); David H. Autor, John J. Donohue III & Stewart J. Schwab, *The Costs of Wrongful-Discharge Laws,* 88 REV. ECON. STUD 211 (2006).

i.e. the domination of D over C. The predominant theory of the persistence of concentrated ownership is the "law matters" thesis, according to which large ownership blocks serve as a substitute for adequate legal protection of shareholders.[314] The gist of the theory is that private benefits of control and self-dealing by managers can either be held in check by good corporate law, or failing that, by monitoring by large shareholders. However, the presence of a large shareholder creates other problems, most of all his private benefits. "Law matters" can also be interpreted to mean that bad law creates inadequate protection of the minority against large shareholders, who therefore have an incentive to maintain their position, although it implies an inefficient allocation of risk.[315] Increased holdup risk, as suggested in this paper, joins the ranks of the vices of concentrated ownership.[316] The "law matters" theory is intertwined with the "legal origins theory", according to which common law legal systems are supposedly more protective of minority shareholders than others.[317] It has been argued that civil law systems are more protective of employees than common law countries.[318] If it is true that common law systems are inherently linked to dispersed ownership, the thesis of this paper provides a theoretical basis for a link to employ-

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[314] Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Legal Determinants of External Finance,* 52 J. FIN. 1131 (1997); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Law and Finance,* 106 J. POL. ECON. 1113, 1145-1151 (1998); John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications,* 93 NW. U. L. REV. 641, 647-648 (1999); Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets,* 48 UCLA L. REV. 781, 834-835 (2001); Cheffins, *supra* note 59, at 461-465.

[315] Lucian Arye Bebchuk, *A Rent-Protection Theory of Corporate Ownership and Control,* NBER WORKING PAPER 7203 (1999); William W. Bratton & Joseph A. McCahery, *Incomplete Contracts Theories of the Firm and Comparative Corporate Governance,* 2 THEORETICAL INQUIRIES L. 1, 34-36 (2001); Gilson, *supra* note 4, at 1644, 1654.

[316] Failing adequate legal protection, the possibility to hold up stakeholders might create an additional incentive against selling out the controlling block on the market and allowing ownership to disperse.

[317] La Porta et al., *supra* note 314; Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Investor Protection and Corporate Governance,* 58 J. FIN. ECON. 3 (2000); *see also* Paul G. Mahoney, *The Common Law and Economic Growth: Hayek Might be Right,* 30 J. LEGAL STUD. 503 (2003).

[318] *See* Botero et al, *supra* note 235 (finding that labor markets are more regulated in civil law countries than in common law countries); Pagano & Volpin, *supra* note 73, at 1024 (table showing, among other things, the statistical significance of legal origins for employment protection in OECD countries).

ment law, without needing to take recourse to a view of common law and civil law as proxies for different approaches to government regulation of markets, with "civil law" standing for a greater degree of state intervention to achieve goals of social justice and common law for the protection of property rights.[319]

Alternatively, Roe's political theory could be used to explain why horizontal moves from D to C are difficult. Roe argues that pro-stakeholder laws such as codetermination or employment protection are the consequences of exogenous political factors to which he applies the label "social democracy."[320] Mark Roe also suggests that the ultimate reason for the prevalence of social democracy may have been a history of war and turmoil during the first half of the 20th century in the core civil law countries.[321] Assume a country with strong stakeholders because of historically path-dependent strong employee protection laws. Under the Roe theory, managers are less constrained (to the detriment of the value of firm to stockholders), as stakeholder-oriented laws help them to pursue their own goals. It follows that providers of capital are likely to congregate to amass large ownership stakes in order to improve monitoring of managers.[322] D will therefore result in more competitive firms than C. Combining Roe's theory and that of this paper may help to explain why strong shareholder influence and strong stakeholder influence are complementary factors that reinforce each other. This may be the reason why we are not seeing a rapid move to an

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[319] *See* Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *The Economic Consequences of Legal Origins,* Working Paper, 2007 (attempting to give a unified interpretation of various results of legal origins in different fields); Thorsten Beck, Asli Demirgüç-Kunt & Ross Levine, *Law and finance: why does legal origin matter?* 31 J. COMP. ECON. 653, 657-658 (2003).

[320] *Supra* note 71 and accompanying text.

[321] Mark J. Roe, *Legal Origins, Politics, and Modern Stock Markets,* 120 HARV. L. REV. 462 (2006); Mark J. Roe & Jordan I. Siegel, *Political Instability and Financial Development,* at http://ssrn.com/abstract=963214 (2007).

[322] Roe, *supra* note 66, at 544-560; ROE, *supra* note 90, at 35-36.

end of history for corporate governance along American lines,[323] but – for the time being – the persistence of differences in certain respects.

Quite obviously A, which roughly corresponds to the situation in the US, should normatively dominate B, where weakly protected stakeholders face strong shareholder influence. Concentrated ownership systems are associated with a loss of liquidity and greater difficulty in tapping capital markets for additional finance.[324] At the level of individual firms, a move from A to B corresponds to the "breach of trust" situation famously described by Shleifer and Summers.[325] While the "discovery" of financing a hostile takeover with high-yield debt greatly facilitated or even allowed the takeover wave of the 1980s,[326] the development of the case law up to the mid-1990s ultimately brought US corporate governance back closer to A.[327] As described above,[328] due to the limits on takeovers, it is today again relatively hard for shareholders of individual firms to opt-out of A once ownership has become dispersed. At the level of the corporate governance system as a whole, the theory of this paper adds the potential augmentation of holdup risks to the other vices of concentrated ownership, which is why a move from A to B should not be beneficial, unless such an increase of shareholder influence was accompanied by a strengthening of pro-stakeholder laws.[329]

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[323] *See generally* Hansmann & Kraakman, *supra* note 17.

[324] *E.g.* Patrick Bolton & Ernst-Ludwig von Thadden, *Liquidity and Control: A Dynamic Theory of Corporate Ownership Structure,* 154 J. INSTITUTIONAL & THEORETICAL ECON. 177 (1998); Bratton & McCahery, *supra* note 315, at 12.

[325] Shleifer & Summers, *supra* note 39.

[326] *See e.g.* DAVID SKEEL, ICARUS IN THE BOARDROOM 111-130 (2005); Armour & Skeel, *supra* note 119, at 1755.

[327] The disappearance of the edge in shareholder value (measured in Tobin's Q) Delaware corporation had over firms incorporated elsewhere in the mid-1990s has been attributed to the Delaware case law, most of all the Unitrin case (*supra* note 108). Guhan Subramanian, *The Disappearing Delaware Effect,* 20 J. L. ECON. & ORG, 32, 52-54 (2004).

[328] *Supra* notes 105-119 and accompanying text.

[329] On the political level, the weak position of shareholders in the US is entrenched by the lobbying of other groups. The antitakeover statutes of the 1980s were typically promoted by a broad coalition of interests including managers, organized labor, and others. *See* Roberta Romano, *The Political Economy of Takeover Statutes,* 73 VA. L. REV. 111, 120-128 (1987). The SEC's 2003 shareholder access proposal, which might have facilitated a limited degree of explicit shareholder influence, was success-

5.2. The chronology: Ownership structure before pro-stakeholder laws

The abstract treatment in this section may evoke the question whether the respective enactment of stakeholder protection laws preceded or followed shareholder influence. Mark Roe points out that focusing on the historical sequence may miss the point, since German block ownership and codetermination could be reinforcing each other.[330] However, although he emphasizes the causal connection running *from* pro-employee laws *to* concentrated ownership, he acknowledges that, chronologically, blockholding preceded German codetermination.[331] In fact, as concentrated ownership is the international norm and dispersed ownership the exception, one could speak of concentrated ownership as the primeval state of any corporate governance system.[332] Newly created firms invariable start out as privately held, and only following growth and tapping the stock exchanges they may develop into Berle-Means style corporations. Thus, it is not the persistence of concentrated ownership, but its unraveling in the US and the UK that calls for an explanation. In Germany, in spite of a trend towards concentration of firms and increased ownership dispersion, the majority of large enterprises remained under the control of small groups of owners who took strategic decisions.[333] While there a minority of manager-controlled firms established itself in the 1920s,[334] any nascent movement towards dispersed ownership had come to a halt by years after World War II, when private households exited the stock markets.[335] Similarly, France may have been on the way to a corporate governance system characterized by strong equity markets and dispersed ownership be-

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fully opposed by the Business Roundtable. *See* Mark J. Roe, *Delaware's Politics,* 118 HARV. L. REV. 2491, 2522-2523 (2005).

[330] ROE, *supra* note 90, at 78.

[331] ROE, *id.*

[332] *Supra* note 4 and accompanying text.

[333] Caroline Fohlin, *The History of Ownership and Control in Germany,* in A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD 223, 227-228 (Randall K. Morck ed. 2005).

[334] Fohlin, *id.* at 229.

[335] Fohlin, *id.* at 231-232. Fohlin also points out that evidence on the development of ownership structures during the Nazi period and the years up to 1960 remains scarce.

fore World War I, but "this flirtation [with the stock market], unlike the love affair in the United States and the United Kingdom, did not persist through the twentieth century.[336] Thus, shareholder influence not only came before codetermination, but also before employment law and other pro-stakeholder mechanisms in Europe. Typically, pro-stakeholder legislation in continental Europe often followed a period of labor conflict and/or political instability; earlier precursors to codetermination and employment protection were passed in Germany shortly after World War I.[337] Contemporary employment protection law has its roots in the years after World War II;[338] codetermination was expanded most recently in 1976, following a period of many strikes in the early 1970s.[339] The French and Italian employment laws that characterize the respective labor markets today were passed in that period as well.[340]

The chronology does of course not imply that the holdup problem, upon which the argument of the paper rests, was the only decisive factor or proximate cause bringing pro-employee laws into being. Political preferences are the consequence of highly complex social and historical developments that can hardly be captured by single-

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[336] Murphy, *supra* note 213, at 203 (referring to the data compiled by Rajan & Zingales, according to who France had one of the highest ratios of total market capitalization to GDP in 1913, but only a comparatively small one in later decades); *see* Raghuram G. Rajan & Luigi Zingales, *The great reversals: the politics of financial development in the twentieth century,* 69 J. FIN. ECON. 5, 15 (2003); *also see* Leslie Hannah, *The 'Divorce' of Ownership from Control from 1900 Onwards: Re-calibrating Imagined Global Trends,* 49 BUS. HIST. 404, 406 (2007) (comparing the relative sizes of the New York, London, Paris and Berlin stock markets in 1900).

[337] Betriebsrätegesetz of 1920, RGBl S. 147 (introducing works councils); Gesetz über die Entsendung von Betriebsratsmitgliedern in den Aufsichtsrat of 1922, RGBl S. 209 (introducing employee representatives on the supervisory board for the first time); *see* Thomas Raiser, *The Theory of Enterprise Law in the Federal Republic of Germany,* 36 AM. J. COMP. L. 111, 117-118 (1988); ROE, *supra* note 105, at 213; Thomas Raiser, *Unternehmensmitbestimmung vor dem Hintergrund europarechtlicher Entwicklungen,* in VERHANDLUNGEN DES SECHSUNDSECHZIGSTEN DEUTSCHEN JURISTENTAGES B 1, B 11 (Ständige Deputation des deutschen Juristentages ed. 2006). A law of 1921 first allowed employees to challenge "socially unacceptable" dismissals in court if the works council supported their complaint. *See* Fiebig, *supra* note 257, *Einleitung,* comment 104; Ulrich Preis, *supra* note 257, comment 8.

[338] The *Kündigungsschutzgesetz* (KSchG) was passed in 1951 to reunify laws in the Western zones, *see* Fiebig, *supra* note 257, at note 108 et seq.; *see* the official proposal in 4 RECHT DER ARBEIT 61 (1951).

[339] ROE, *supra* note 105, at 213.

[340] Regarding France, *see supra* notes 263-280 and accompanying text; Alan Hyde, *A Theory of Labor Legislation,* 38 BUFF. L. REV. 398-404 (1990).

factor explanations. However, Roe points out that certain structures of production may not be politically stable and therefore may have induced social democratic policies such as codetermination, whose purpose was to rein in bankers and industrialists.[341] At times, legislation making important changes usually must overcome serious obstacles, but crises, and the discreditation of elites (as in the case of post-war legislation in Germany) may serve as a catalyst. Periods of persistent strikes and social unrest that have often contributed to the passing of pro-stakeholder laws can be interpreted as a symptom of imbalance in corporate governance system.

Regarding the US, it is interesting to note that dispersed ownership was already predominant at the time pro-employee laws surfaced for the first time in Germany in the 1920s. It is generally thought that dispersed ownership began to develop in the last quarter of the 19th century.[342] The first firms to achieve dispersion were the large railroads, whose sheer size made it soon impossible to remain financed solely by entrepreneurial families.[343] The merger wave of the 1890s and early 1900s, which apparently was triggered by the Sherman Act and its prohibition of price-fixing, led to further consolidation and thus generated even more large firms with a dispersed ownership structure.[344] By the time Berle and Means published their famous book in 1932, dispersed ownership was prevalent,[345] and stock ownership had become common in

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[341] ROE, *supra* note 90, at 112-113; *also see* Mark J. Roe, *Backlash,* 98 COLUM. L. REV. 217 (1998).
[342] *E.g.* Coffee, *supra* note 59, at 24.
[343] *Cf.* BERLE & MEANS, *supra* note 8, at 13; ALFRED D. CHANDLER, THE VISIBLE HAND 87 (1977); Coffee, *id.* at 25-26; ROE, *supra* note 105, at 3.
[344] Coffee, *id.* at 33; SKEEL, *supra* note 326, at 59-62; *also see* CHANDLER, *id.* at 331; NAOMI LAMOREAUX, THE GREAT MERGER MOVEMENT IN AMERICAN BUSINESS 1895-1904 2 (1985) (providing empirical data about the period) .
[345] Gardiner C. Means, *The Separation of Ownership and Control in American Industry,* 46 Q. J. ECON. 68, 94 (1931) (summarizing the data); BERLE & MEANS, *supra* note 8; *also see* CHANDLER, *id.* at 451 (describing an increasing distinction between ownership and control in the 1910s); ALFRED D. CHANDLER, SCALE AND SCOPE 85, 191 (1990); Colleen A. Dunlavy, *Social Conceptions of the Corporation: Insights from the History of Shareholder Voting Rights,* 63 WASH. & LEE L. REV. 1347, 1361 (2006) ("[…] by the second decade of the twentieth century, the plutocratic corporation […] was already transformed into the 'modern' corporation that Berle and Means would put in the spotlight of their 1932 book").

the middle class,[346] so that managerial power and atomization of shareholders could become the paradigmatic image on the large American firm.[347] The political reaction to the greatest crisis in US economic history, the Great Depression, included reforms that further strengthened the entrenchment of managers and shielded them against shareholder influence, particularly by further stymieing the growth of financial institutions that might have become important large shareholders as they did elsewhere.[348] Pro-stakeholder legislation (other than antitakeover statutes that likewise have the effect of shielding managers) never made it to the legislative drawing board.[349] Still, the US has been enjoying stable labor relations over most of the 20th century.

5.3. The future: Path dependence and continental European corporate governance reforms

The world keeps turning, and both the law and corporate governance structures are subject to change. Like most comparative corporate governance theories, the basic thesis of this paper may be better at explaining corporate governance structures in the late 20th century than the trends of the late 1990s and 2000s, and the future development. In the US, prominent commentators have identified a decline in the managerialist view of the firm, with one of the contributing factors being increased takeover activity since the 1980s, and a move toward are greater emphasis on shareholder value.[350] Similarly, scholars have remarked that core continental European corporate governance systems such as the German one may be moving closer to

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[346] Gardiner C. Means, *The Diffusion of Stock Ownership in the United States,* 44 Q. J. ECON. 561 (1930).
[347] ROE, *supra* note 105, at 6.
[348] ROE, *supra* note 105, at 95-101.
[349] *See e.g.* Hyde, *supra* note 340, at 392-396.
[350] Hansmann & Kraakman, *supra* note 17, at 444; Jeffrey N. Gordon, *The Rise of Independent Directors in the United States 1950-2005: Of Shareholder Value and Stock Market Prices,* 59 STAN. L. REV. 1465, 1510-1535 (2007). In fact Jeffrey Gordon suggests that Blair & Stout's team production model may rather be a description of the role of the board of US corporations in the 1950s. Gordon, *id.* at 1514 n187.

more dispersed ownership[351] and sliding towards a legal framework and economic structure emphasizing the concerns of dispersed investors to a stronger degree.[352] Maybe more importantly, employment protection laws have been subject to increased scrutiny over the past years. Most obviously, national employee participation systems are being eroded by regulatory arbitrage possibilities created by EU law,[353] while criticism of codetermination is on the rise among German legal scholars.[354]

I have attempted to elucidate the interaction between shareholder influence and the exposure of employees to holdup. Changes with regard to this relationship might be connected to the structure of industrial production, and the amount of specific investment optimal under current circumstances; conceivably, a decrease in the protection of specific investment might coincide with a change in production technology or with e.g. a decline of traditional industries where such investment by employees

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[351] Wójcik, *supra* note 178; *but see* Sigurd Vitols, *Changes in Germany's Bank-Based Financial System: implications for corporate governance,* 13 CORP. GOV. 386 (2005) (suggesting that, while the proportion of banks' holdings in publicly traded has been decreasing, Germany's finance system still remains largely bank-centered).

[352] Cheffins, *supra* note 60, at 501-505; John W. Cioffi, *Restructuring "Germany Inc.": The Politics of Company and Takeover Law Reform in Germany and the European Union,* 24 L. & POL'Y 355 (2002); Enriques & Volpin, *supra* note 187, at 131-134 (summarizing reforms of the past 15 years in France, Germany and Italy aiming at the empowerment of shareholders); *but see* Sigurd Vitols, *Negotiated Shareholder Value: the German Variant of an Anglo-American Practice,* 8 COMPETITION & CHANGE 357 (2004) (arguing that changes have been overestimated and that institutional investors are merely being accepted as additional participants into the compromise between different stakeholder groups).

[353] Both a cross-border merger under the recently enacted Directive [Directive 2005/56/EC, of the European Parliament and of the Council of 26 October 200 5 on cross-border mergers of limited liability companies, 2005 O.J. (L 310) 1 and under the formation of a European Company (Societas Europaea or SE) through a merger [*see* Council Directive 2001/86/EC of 8 October 2001 supplementing the Statute for a European company with regard to the involvement of employees, 2001 O.J. (L 294) 22] trigger a mandatory negotiation with employee representatives about how they are to be represented in the new company, in which they have considerable bargaining power. However, they may lose this influence entirely when the company is subsequently merged into a legal entity fully subject to the law of a Member State without any employee representation after three years. *See* Directive 2005/56/EC, art. 16(7) (requiring Member States to protect the outcome of the negotiations from subsequent mergers for at least three years). The SE Directive 2001/86/EC only prohibits the "misuse" of an SE for the purpose of depriving employees of their collective rights, in which case it is not entirely clear when exactly employee representation could be eradicated by means of a subsequent merger.

[354] *See e.g.* Jean J. Du Plessis & Otto Sandrock, *The Rise and Fall of Supervisory Codetermination in Germany,* 16 INT'L COMM. & COMPANY L. REV. 67, 74-76 (2005) (providing an overview of the critique and evasion strategies by firms); Michael Adams, *Das Ende der Mitbestimmung,* 2006 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT 1561 (harshly criticizing codetermination); *but see* Christine Windbichler, *Cheers and Boos for Employee Involvement: Co-Determination as Corporate Governance Conundrum,* 6 EUR. BUS. ORG. L. REV. 507 (2005) (providing a discussion of pros and cons).

was important. Concurrently, the takeover wave of the 1980s may have left a lasting impression by teaching employees to avoid specific investment and not allowing themselves to be "cheated" again. But even this is correct, the theory of this paper helps to explain why current structures persist, at least in the medium term.

An important effect of the institutional complementarities outlined here is the phenomenon of path dependence: a corporate governance system that has gone down a particular path over the course of history cannot simply ignore these past choices, even when facing the competitive pressures of a globalized economy, which is why a convergence of corporate governance structures is not inevitable, and the present and future remain shaped by the past.[355] While some path dependence theories focus mostly on aspects of legal culture and the persistence of doctrinal categories, the reason given here rests essentially on switching costs.[356] Both the shareholder influence factor and the employee protection factor are partly determined by law, and partly by real-world influences such as ownership concentration, creating a pair of institutional complementarities. Under the assumption of a stable amount of optimal specific investment, changing either of these without the other will create considerable cost. Abolishing strict employment protection law while concentrated ownership is still in place would create considerable holdup cost. Changes with respect to both dimensions may be difficult or costly, if not outright unfeasible in some circumstances. For example, if we knew that the US-style equilibrium A (of section 5.1) was superior to continental-style equilibrium D, it might be hard to get there simply by abolishing pro-employee laws, as this may be not enough to induce the development of dispersed ownership by itself; dispersion may require a combination of several fac-

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[355] Reinhard H. Schmidt & Gerald Spindler, *Path Dependence, Corporate Governance and Complementarity,* 5 INT'L FIN. 311, 312-313 (2002); *see also* Mark J. Roe, *Chaos and Evolution in Law and Economics,* 109 HARV. L. REV. 641, 643-644 (1995).

[356] *See generally* Schmidt & Spindler, *id.* at 314-315.

tors develop only over the course of several decades. Reform-oriented scholars and policymaker should be aware of the risks involved and take institutional complementarities seriously. However, if ownership structures on the European continent are actually moving towards less concentrated ownership, the rationale for pro-employee laws may be subsiding.

6. Putting the UK back on the map

So far, I have focused on the contrast between the US and Continental Europe (concentrating on Germany and France). However, in comparative corporate governance theories, the UK is often considered a peculiar case. Mark Roe notes that in the UK, the prevalence of dispersed ownership is hard to explain under a political theory, as it has had developed securities markets for a long time, but was controlled by the Labour Party in the decisive decades after World War II.[357] He further points out that a theory viewing good corporate law as a prerequisite to dispersed ownership[358] has considerable problems as well, since large British firms remained family-controlled even after World War II.[359] Roe therefore proposes a combined legal-political theory to explain British ownership structures.[360]

While the exact time when the corporate landscape of the UK came to be dominated by dispersed ownership is subject to some dispute,[361] it is important to note that blockholders "unwound" at a later time than in the US, with dispersion only solidifying

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[357] Mark J. Roe, *Political Foundations for Separating Ownership from Control,* in CORPORATE GOVERNANCE REGIMES 113, 129 (Joseph A. McCahery, Piet Moerland, Theo Raaijmakers & Luc Renneboog eds. 2002); ROE, *supra* note 90, at 99.
[358] S*upra* notes 314-319 and accompanying text.
[359] Roe, *supra* note 357, at 129; ROE, *supra* note 90, at 99; *see* CHANDLER, *supra* note 345, at 240.
[360] Roe, *supra* note 357, at 130; ROE, *supra* note 90, at 101-103.
[361] *See e.g.* Brian R. Cheffins, *Law, Economics and the UK's System of Corporate Governance: Lessons from History,* 1. J. CORP. L. STUD. 71, 82 (2001) (citing various authors giving dates ranging from the 1950s to the 1980s).

by the 1980s.[362] However, as we shall see, even today shareholder influence, as defined at the beginning of this paper, is considerably stronger than in the US. In fact, the UK is the reason why the thesis of this paper rests not only on ownership concentration, but on explicit or implicit shareholder influence. While US law moved from a system of explicit shareholder influence to comparatively little shareholder influence on management when ownership dispersed set in, the UK, moved from a system of explicit shareholder influence to one of implicit shareholder influence, which, however, is stronger than in the US. Although implicit shareholder influence may not have a comparable impact on stakeholders as explicit one, the UK qualifies at least as an intermediate case under the thesis of this paper. While ownership dispersion is also the norm in the UK, *both explicit and implicit shareholder influence* are stronger than in the US.[363] On the flipside of the coin, there are also more meaningful stakeholder protection laws.

First, the empirical evidence tells us that dispersion is actually less pronounced than in the US. Individual blocks are bigger, and about 70% of shares are in the hands of institutional investors (as opposed to 50% in the US).[364] In 1994, Bernard Black and John Coffee pointed out that in smaller firms the five biggest investors typically

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[362] *But see* Andrew Johnston, *Takeover Regulation: Historical and Theoretical Perspectives on the City Code,* 66 CAMBRIDGE L. J. 422, 426 (2007) (identifying the merger wave of the 1960s as crucial for dispersed ownership in Britain).

[363] *Also see* Simon Deakin, Richard Hobbs, Suzanne J. Konzelmann and Frank Wilkinson, *Anglo-American corporate governance and the employment relationship: a case to answer?* 4 SOCIO-ECON. REV. 155, 161 (2006) ("Since the late nineteenth century, UK company law, in particular, has largely aimed to protect the autonomy of boards from day-to-day shareholder pressures."); Jennifer Hill, *The Shifting Balance of Power Between Shareholders and the Board: News Corp's Exodus to Delaware and Other Antipodean Tales,* VANDERBILT UNIVERSITY LAW SCHOOL LAW AND ECONOMICS RESEARCH PAPER NO. 08/20, 16, available at http://ssrn.com/abstract=1086477 (suggesting that the paradigm difference between the US and the UK, which provides an example of path dependence, can be traced to the origin of UK company law in unincorporated partnerships, while US corporate law evolved out of state-based charters); *see* L.C.B. Gower, *Some Contrasts Between British and American Corporation Law,* 69 HARV. L. REV. 1369, 1371-1372 (1956).

[364] John Armour, Brian R. Cheffins & David A. Skeel, Jr., *Corporate Ownership Structure and the Evolution of UK Bankruptcy Law: Lessons from the United Kingdom,* 55 VAND. L. REV. 1699, 1750 (2002); *see* Bernard S. Black & John C. Coffee, Jr., *Hail Britannia? Institutional Investor Behavior under Limited Regulation,* 92 MICH. L. REV. 1997, 2002 (1994).

owned more than 30% of shares.[365] Some researchers even expressed doubts that dispersed ownership dominates in the UK, among them the Australian scholar Geof Stapledon.[366] Sociologist John Scott, looking at the period from 1976 to 1988, argued that large British firms were not dominated by managers as a typical Berle-Means firm would be, but were governed by a "constellations of controlling interests" consisting of about 20 shareholders who jointly controlled most listed corporations.[367]

In their seminal article on the impact of bankruptcy law on corporate governance structures, John Armour, Brian Cheffins and David Skeel conclude that Britain should be classified as an outside corporate governance country.[368] However, they mention a number of factors in which it differs from the US: Most to the point, they turn to the fact that British securities law, quite contrary to the situation in the US,[369] does not impede the formation of coalitions between institutional investors regarding particular corporations.[370] Furthermore, in alignment with a number of other commentators, they point out that these investors, while still showing a certain "British reserve", sometimes exercise concerted influence when a firm is in difficulty, for example be requiring a restructuring of management when new shares are issued.[371] Comparing the US and the UK, Bebchuk points out that "the corporate law system of the United States is the one that stands out […] in how far it goes to restrict shareholder initia-

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[365] Black & Coffee, *id.* at 2002.

[366] G. P. STAPLEDON, INSTITUTIONAL SHAREHOLDERS AND CORPORATE GOVERNANCE 10 (1996) (suggesting that the highly diffuse Berle-Means structure was not present in the majority of listed UK firms in the early 1990s).

[367] John Scott, *Corporate Control and Corporate Rule: Britain in an International Perspective,* 41 BRIT. J. SOC. 351, 359-365 (1990). Maybe even more controversially, Scott makes the same claim for the US (*id.* at 369-370). *See* JOHN SCOTT, CORPORATE BUSINESS AND CAPITALIST CLASSES 92 (1997) (making the same claim for both countries, while acknowledging that ownership dispersion is greater in the US than the UK).

[368] Armour et al, *supra* note 364, at 1752.

[369] *Supra* section 3.2.1.

[370] Armour et al, *id.* at 1751.

[371] Black & Coffee, *supra* note 364, at 2037, 2053; Armour et al, *id.* at 1751-1754, 1752; *see* STAPLEDON, *supra* note 366, at 122-129.

tive and intervention.[372] He further explains that changes in the memorandum or articles of association, other than in the US, do not require the initiative of the board of directors, that a qualified minority of ten percent can call a special meeting, and that a majority of shareholders can vote to replace directors at any time.[373]

However, as the UK is usually considered to have a corporate governance system governed by markets rather than explicit control, the more important factor is most likely *implicit shareholder influence.* The most conspicuous difference between the US and the UK in that respect is of course takeover law, where these two countries are situated at two opposing ends of the possible regulatory spectrum. As described above, in the US the board of directors generally has the "just say no defense", i.e. it has broad latitude to thwart hostile takeover bids if it finds a reasonable justification.[374] The British "City Code on Takeovers and Mergers", which has become the model for the EU Takeover Directive,[375] has provided for the mandatory bid rule for several decades, which requires the acquirer of a controlling interest to offer minority shareholders to purchase their shares.[376] More to the point here, the City Code also binds the board of directors to strict neutrality regarding (voluntary or mandatory) takeover bids. While the City Code itself was only promulgated in 1969, the principle of board neutrality had already been established by its (less official and less effec-

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[372] Bebchuk, *supra* note 93, at 848; *also see* Hansmann & Kraakman, *supra* note 92, at 46-47.

[373] Bebchuk, *supra* note 93, at 848-849. The mandatory shareholders' right to remove directors by ordinary resolution, which was previously found in § 303 of the Companies Act 1985, has now been implemented in § 168 of the Companies Act 2006. On the mandatory character of the provision *see* Russell v. Northern Bank Development Corp. Ltd. [1992] 1. W.L.R. 588; Andrew Keay, *Company Directors Behaving Poorly: Disciplinary Options for Shareholders,* 2007 J. BUS. L. 656, 671. The provision was first introduced in the Companies Act 1948. *See* J. Temple Lang, *The Fifth EEC Directive on the Harmonization of Company Law,* 12 COMMON MKT. L. REV. 155, 168 (1975); Keay, *id.*

[374] *Supra* section 3.2.1.

[375] Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids, art. 5, 2004 O.J. (L 142) 12.

[376] The City Code does not actually use the open-ended term "controlling interest", but, as the standard case, requires a bid when someone acquires more than 30% of voting rights. *See* The Takeover Code, Rule 9.1(a). For a comparison of the effects of the American "market rule" and the British "Equal Opportunity Rule" *see* Lucian Arye Bebchuk, *Efficient and Inefficient Sales of Control,* 109 Q. J. ECON. 957 (1994).

tive) predecessor, the "Queensberry Rules" of 1959.[377] During the course of an offer, or even when the board has reason to believe that a bona fide offer is imminent, the board may not "take any action which may result in any offer or bona fide possible offer being frustrated or in shareholders being denied the opportunity to decide on its merits."[378] There are rules that prevent poison pills or similar defensive measures,[379] and the board is required to seek shareholder approval if it wishes to enter into certain types of transactions that may threaten the financial viability of a takeover.[380]

As a result, the discretion of UK boards to act against takeovers is much more curtailed than that of their American counterparts. Once a hostile bid appears on the radar screen, the only workable counter measures are "defence documents", i.e. strong public criticism of the price and terms of the bid, and seeking out an alternative transaction, e.g. by bringing in a "white knight" to defeat the hostile offer or a management buyout.[381] As Paul Davies puts it, "the directors of the target are thrown back on their powers of persuasion."[382]

Similarly, empirical evidence suggests that the threat of a hostile takeover looms more prominently over UK managers than over their American peers. While the US economy is six times as big as the British one, only twice as many hostile takeovers occurred during the 1990s.[383] We learn from John Armour and David Skeel that 85% of takeovers in the UK were hostile between 1990 and 2005, as opposed to 57% in

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[377] BANK OF ENGLAND, NOTES ON THE AMALGAMATION OF BRITISH BUSINESSES (1959); *see* Armour & Skeel, *supra* note 119, at 1759; *also see* Johnston, *supra* note 362, at 432-434.

[378] Rule 21.1.(a). Before the 2006 amendments to the Code, this general clause was not part of Rule 21, but General Principle 7 of the Code. For a discussion of these amendments *see* Geoffrey K. Morse, *Proposed Amendments to the Takeovers Code to Implement the 13th EC Directive,* 2006 J. BUS. L. 242 (2006).

[379] Rule 21.1.(b)(i)-(iii).

[380] Rule 21.1.(b)(iv)-(v).

[381] STEPHEN KENYON-SLADE, MERGERS AND TAKEOVERS IN THE US AND UK para. 10.07 (2004).

[382] PAUL L. DAVIES, GOWER AND DAVIES' PRINCIPLES OF MODERN COMPANY LAW 717 (7th ed. 2003).

[383] Christian Kirchner & Richard W. Painter, *European Takeover Law – Towards a Modified Business Judgment Rule for Takeover Law,* 2 EUR. BUS. ORG. L. REV. 353, 377-379 (2000); Paul Davies & Klaus Hopt, *Control Transactions,* in THE ANATOMY OF CORPORATE LAW 157, 173 (Reinier Kraakman, Paul Davies, Henry Hansmann, Gerard Hertig, Klaus J. Hopt, Hideki Kanda & Edward B. Rock 2004).

the US. While 43% of hostile takeover were successful in the UK, only 24% went through in the US, with the UK actually surpassing the US in the absolute number of successful bids.[384] These numbers may even underestimate the actual effect of US antitakeover regulation and case law, since they do not reflect those takeovers that were deterred in the first place. Armour, Cheffins and Skeel conclude that "the City Code sets up a regime that focuses director attention in the conduct of a bid on the immediate question whether it is in the shareholders' best interest to accept a tender offer."[385]

Takeovers are of course one, if not the most important situation possibly constituting a danger of holdup for employees.[386] Altogether, legal and institutional arrangements in the UK indicate a significantly higher degree of shareholder influence on directors than in the US. The contrast between US and UK could hardly be more striking. Paul Davies and Klaus Hopt point out that this difference is not an idiosyncrasy of takeover law, but rather the reflection of a different general attitude of corporate law towards centralized management.[387] According to John Armour and David Skeel, UK takeover regulation gives directors "a greater incentive to focus on returns to shareholders."[388] In a historical perspective, Franks, Mayer and Rossi claim that the introduction of takeover law – at the behest of financial institutions, and not the interests of the corporate sector – resulted in dispersed ownership in the UK and helped to

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[384] Armour & Skeel, *supra* note 119, at, at 1737-1738; *also see* Julian Franks & Colin Mayer, *Hostile takeovers and the correction of managerial agency failure,* 40 J. FIN. ECON. 163, 164 (1996).
[385] Armour et al., *supra* note 364, at 536; *also see* Deakin et al., *supra* note 363, at 163.
[386] Shleifer & Summers, *supra* note 39, at 41-42; Simon Deakin, Richard Hobbs, David Nash & Giles Slinger, *Implicit Contracts, Takeovers and Corporate Governance: In the Shadow of the City Code,* in IMPLICIT DIMENSIONS OF CONTRACTS 289, 292-295 (David Campbell, High Collins & John Wightman eds. 2003).
[387] Davies & Hopt, *supra* note 383, at 173.
[388] Armour & Skeel, *supra* note 119, at, at 1739.

lead it away from Continental-style corporate governance dominated by large shareholders.[389]

Given the significance of takeovers, one could be led to suspect that UK employees make fewer specific investments than others.[390] In fact, the mere threat of a hostile takeover is said to have made British managers more likely to increase distributions to shareholders.[391] However, on the flipside of the coin, regarding employee protection, it differs from the US in important respects as well. While the UK does not score highly in the OECD employment protection index[392] and other leximetric studies of employment protection,[393] it typically shows up between the US and Continental European countries.[394]

While the UK has never had the employment-at-will doctrine,[395] labor legislation came to the country later than in Continental Europe,[396] but it finally arrived during the 60s and 70s, both under Labor and Conservative governments, who supported a broad consensus on the need to reform during the Sixties.[397] The Contracts of Employment Act 1963 introduced statutory minimum periods of notice.[398] The Industrial

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[389] Julian Franks, Colin Mayer & Stefano Rossi, *Spending Less Time With the Family,* in A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD 581, 604-605 (Randall K. Morck ed. 2005); *also see* Deakin et al., *supra* note 386, at 329-330 (suggesting that the City Code may have reduced the willingness of UK employees to make specific investment).

[390] *See* Deakin et al., *id.* at 329-330; *see also* Johnston, *supra* note 362, at 454.

[391] Johnston, *supra* note 362, at 442.

[392] OECD EMPLOYMENT OUTLOOK 117 (2004).

[393] Botero et al., *supra* note 235, at 1362.

[394] *See* Irene Lynch-Fannon, *Employees as Corporate Stakeholders: Theory and Reality in a Transatlantic Context,* 4 J. CORP. L. STUD. 155, 178 (2004) (assessing the level of labor market regulation in the UK as medium-high, whereas the level in the US is considered to be "low" and the level of some Continental European countries to be "high"); *see also* Gugler & Yurtoglu, *supra* note 207, at 484-485 (summarizing doubts about the conventional wisdom that the UK has a flexible labor markets).

[395] The default common law rule required reasonable notice to be given by either party. GWYNETH PITT, EMPLOYMENT LAW, comment 8–004 (2004).

[396] *Cf.* HUGH COLLINS, JUSTICE IN DISMISSAL 25 (1992) (pointing out that not even the Labour government elected in 1946 had employment protection on its agenda).

[397] PAUL DAVIES & MARK FREEDLAND, LABOUR LEGISLATION AND PUBLIC POLICY 150 (1993).

[398] *Cf.* SIMON DEAKIN, LABOUR LAW 382 (2001). The notice periods can now be found in the Employment Rights Act 1996 (hereinafter: ERA) § 86. Apparently, the practical effect of which was mostly to increase notice periods for low-status employees. *See* HUGH COLLINS, K. D. EWING & AILEEN MCCOLGAN, LABOUR LAW TEXT AND MATERIALS 484 (2001).

Relations Act 1971 superimposed the concept of "unfair dismissal" on the common law; under this test, the employer must show that the employee was dismissed for a "fair reason." Applicable reasons may relate to the employee's capability or qualifications, her conduct, redundancy, and others.[399] This test is not considered ineffectual, as there have been numerous cases where tribunals found dismissals to be unfair,[400] including cases where redundancy was given as the reason for termination.[401] The Redundancy Payments Act of 1965 introduced mandatory redundancy payments,[402] which are not seen merely as unemployment benefits, but as "a recognition of past service, of the worker's stake in and contribution to the enterprise."[403] Finally, at the behest of an EU directive[404], legislation was introduced in 1975[405] under which employers laying of 20 or more employees at one establishment with a period of 90 days", must consult employee representatives.[406]

Beside the aim of implementing EU law, the policy reason behind British employment legislation appears to have been to make the labor market more flexible. Redundancy payments were supposed to facilitate mobility and to overcome resistance against

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[399] ERA 1996 § 98(1), (2).

[400] For an overview on the case law *see* PITT, *supra* note 395, comments 8–030-8–063; *e.g.* Davison v, Kent Meters [1975] I.R.L.R. 145 IT; Weddel & Co. Ltd. v. Tepper [1980] I.R.L.R 96, CA; Polkey v. AE Dayton Services Ltd. [1988] A.C. 344 HL; Scottish Daily Record & Sunday Mail (1986) Ltd. v. Laird, [1996] I.R.L.R. 665; Kent CC v, Mingo, [2000] I.R.L.R. 90 EAT.

[401] Vokes v. Bear [1974] I.C.R: 1, NIRC (failure to consider redeployment); Williams v. Compair Maxam [1982] I.C.R. 156 EAR (unfair process of selecting redundant workers); Polkey v. AE Dayton Services Ltd. [1988] A.C. 344 HL (failure to warn).

[402] DEAKIN, *supra* note 398, at 382. Steven D. Anderman, *The Weakened Edifice of Job Protection Law in Britain,* 20 STAN. J. INT'L. L. 393, 395-399 (1984). The provisions are now found in ERA §§ 135-146. Even though redundancy can also be the basis for an "unfair dismissal claim", it also provides a claim in its own right, which, other than "unfair dismissal", does not require an investigation whether the redundancy was reasonable.

[403] PITT, *supra* note 395, comment 9–001:

[404] The relevant provision of EU law is Art 2 of the Council Directive 98/59/EC of 20 July 1998 on the approximation of the laws of the Members States relating to Collective Redundancies [1998] OJ 1998, L 225/16. The original directive was 75/129/EEC.

[405] *E.g.* Mark Hall & Paul Edwards, Reforming the Statutory Redundancy Consultation Procedure, 28 INDUS. L. J. 299, 300 (1999). For a historical overview of the provisions' development *see* JILL SMITH, PAUL EDWARDS & MARK HALL, REDUNDANCY CONSULTATION: A STUDY OF CURRENT PRACTICE AND THE EFFECTS OF THE REGULATIONS, DTI EMPLOYMENT RELATIONS RESEARCH SERIES NO. 5, 1-2 (1999).

[406] "Appropriate representatives" can be either a recognized union or representatives elected by the employees affected (*e.g.* Hall & Edwards, *id.* at 302). *See* TULCRA [Trade Union and Labour Relations (Consolidation) Act 1992] § 188(1).

change both by individual workers and, more importantly, unions.[407] During the 1950s and 1960s, dismissals without notice were very costly to British employers, as they were often met by spontaneous industrial action.[408] Studies during the years following the reforms showed that these had in fact succeeded in encouraging layoffs[409] and reduced the number of strikes over redundancy issues.[410] Employees were found to be more likely to volunteer to be made redundant.[411] Dismissals legislation lead to the increased implementation of formal dismissal procedures within companies,[412] which made dismissals appear fairer and more legitimate to employees,[413] also resulting in a reduction of the number of strikes.[414]

A plausible interpretation could be that employment legislation brought UK corporate governance into balance. John Armour, Simon Deakin and Suzanne Konzelmann suggest that job protection laws, redundancy payments and consultation requirements giving "voice" to stakeholders, particularly in insolvency, play a role in protecting their quasi-rents.[415] The legislative measures just described reduced resistance by unions and ultimately helped to curb their influence, which help to break up the petrification of the labor market. Union power may have protected employee (quasi-)rents before these laws, but was apparently a very costly response to holdup prob-

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[407] *See e.g.* CYRIL GRUNFELD, THE LAW OF REDUNDANCY 2 (1989).
[408] Ahlering & Deakin, *supra* note 234*,* at 18.
[409] COLLINS ET AL., *supra* note 398, at 1003.
[410] S.R. PARKER, C.G. THOMAS, N.D. ELLIS & W.E.J. MCCARTHY, EFFECTS OF THE REDUNDANCY PAYMENTS ACT 13 (1971).
[411] PARKER ET AL., *id.*, at 62-3; for evidence from the mining industry *see* Victoria Wass, *Who Controls Selection under 'Voluntary' Redundancy? The Case of the Redundant Mineworkers Payments Scheme,* 34 BRIT. J. INDUS. REL. 249, 250-251 (1996).
[412] DAVIES & FREEDLAND, *supra* note 397, at 203; JILL EARNSHAW, JOHN GOODMAN, ROBIN HARRISON & MICK MARCHINGTON, INDUSTRIAL TRIBUNALS, WORKPLACE DISCIPLINARY PROCEDURES AND EMPLOYMENT PRACTICE , DTI EMPLOYMENT RELATIONS RESEARCH SERIES NO. 2, 4-5 (1998); DEAKIN, *supra* note 398, at 388; LINDA DICKENS, MICHAEL JONES, BRIAN WEEKES & MOIRA HART, DISMISSED 235 (1985). The reason appears to be that, e.g. in cases where the employee's conduct is given as the reason for dismissal, employers are more likely to be found within the „band of reasonableness" if a formal investigation are conducted and employees are given the opportunity to defend themselves.
[413] DICKENS ET AL, *id.*, at 230.
[414] COLLINS, *supra* note 396, at 26.
[415] Armour et al, *supra* note 42, at 541-545; Armour & Deakin, *supra* note 287, at 443-463.

lems, as frequent strikes highly counterproductive to the success of the affected firm, or to a corporate governance system as a whole. During the 1960s and 70s, employment protection increased, and strikes correspondingly decreased. While explicit shareholder influence exerted by controlling families was being replaced by implicit shareholder influence by a strong threat of stakeholders, the UK seems to have moved to a local optimum on the employment protection scale by protecting employees against dismissal, although to a smaller degree than on the European continent. Apparently, this allowed ownership dispersion to deepen in the UK, or at least did not impede it.[416]

With respect to the overarching theory of this paper, the UK qualifies as an intermediate case.[417] The UK does not qualify as a "concentrated ownership" country, but its corporate governance systems differs markedly from the US as well, since the degree of implicit shareholder influence is higher, particularly because of the Takeover Code. On the other side of the coin, the respective degree of shareholder influence is countered by an apparently appropriate degree of employment protection as well, since employment law is stronger than in the US, but weaker than on the continent.

7. Conclusion

It is not a new finding that Continental European, UK and US corporate governance differ. This paper discussed the role of shareholder influence on managers, which can either by exerted directly in the case of ownership concentration (as in Continental Europe), or through a set of arrangements that forces managers to pursue shareholder value maximization (as in the UK). US corporate governance is special in that

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[416] On the prevalence of concentrated and dispersed ownership structures over the 20th century, which is a somewhat contentious issue, *see* Cheffins, *supra* note 59, at 466-468; ROE, *supra* note 90, at 100; Franks et al, *supra* note 389.

[417] *Cf.* Lynch-Fannon, *supra* note 394, at 171-172 ("to speak of an Anglo-American model of governance is incorrect").

it largely excludes shareholder influence and grants unusually broad latitude of action to managers and shields from shareholder influence more clearly than in European systems on both sides of the English Channel. The core argument is that increased shareholder influence increases holdup problems regarding other constituencies, in particular employees, at the same time. Hence, a similar degree of safety from holdup may require an entirely different degree of legal protection that needs to be weighed against its cost. Given this, employment protection and other pro-stakeholder laws are (ceteris paribus) therefore more justified in terms of efficiency in systems with concentrated ownership. Continental Europe and the US may be in, or close to, two very different local optima.

Different equilibria have different advantages and disadvantages. Tightly-knit regulation may increase the costs of adapting to changed circumstances, as it will be harder to dismiss employees even in situations where it is imperative or merely desirable for the maximization of total social welfare. The US system is probably more flexible, as managers with broad discretion may more easily respond to changed external circumstances than one-size-fits-all regulatory solutions However, it has other drawbacks. Although shareholder protection against managerial misconduct must be distinguished from shareholder influence (the crucial factor for holdup risk), there are certain links between the two. Most of all, managerial insulation may be the cause of the system's instability and the recurrence of large scandals.[418] The absence of shareholder influence implies that shareholder-stakeholder conflicts are relatively insignificant, while both providers of capital and labor are equally exposed to rent-seeking by managers. The American preoccupation with principal-agent problems

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[418] *See* Mark J. Roe, *The Inevitable Instability of American Corporate Governance* 3-8, HARVARD JOHN M. OLIN CENTER FOR LAW, ECONOMICS AND BUSINESS DISCUSSION PAPER NO. 493, 09/2004, at http://ssrn.com/abstract=615561.

could therefore be explained with a shared threat that (other than in Continental Europe) turns both constituencies into natural allies.[419]

The other lesson we should keep in mind is that institutional complementarities need to be taken seriously. Legal reforms aiming at increased shareholder influence (in the US), shoot be met with caution, as should legal reforms of pro-stakeholder laws in Europe. The intention of this paper is not to claim that the law (e.g. employment law) of each of the corporate governance systems discussed is perfect under the given circumstances. However, reforming only on the two sides of a coin may turn out to be detrimental. One-size-fits-all solutions from the drawing board may be a bad fit in corporate governance other than in ones similar to those they originated in.

[419] *See* GOUREVITCH & SHINN, *supra* note 66, at 65-67 (discussing "transparency coalitions", in which workers and shareholders join forces to constrain managerial agency costs).

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