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

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Abstract

This paper is the third chapter of the third edition of The Anatomy of Corporate Law: A Comparative and Functional Approach, by Reinier Kraakman, John Armour, Paul Davies, Luca Enriques, Henry Hansmann, Gerard Hertig, Klaus Hopt, Hideki Kanda Mariana Pargendler, Georg Ringe, and Edward Rock (Oxford University Press, 2017). The book as a whole provides a functional analysis of corporate (or company) law in Europe, the U.S., and Japan. Its organization reflects the structure of corporate law across all jurisdictions, while individual chapters explore the diversity of jurisdictional approaches to the common problems of corporate law. In its third edition, the book has been significantly revised and expanded. Chapter 3 examines legal strategies employed in representative "core jurisdictions" to mitigate manager-shareholder conflicts. Agency problems arise from two of the core features of the corporate form: investor ownership, which often results in ultimate control being held by shareholders far removed from the firm's day-to-day operations; and delegated management, which opens up the possibility for opportunistic behavior. This chapter describes how legal strategies outlined in Chapter 2 of the book are utilized to solve the trade-offs resulting from the interaction of investor ownership with delegated management. It describes the use of appointment rights, by which shareholders retain the right to appoint and remove directors. Next, it focuses on core decision rights and how their effectiveness is related to the problem of shareholder coordination costs. It then considers reward strategies and independent directors as a popular trusteeship strategy, while also highlighting differences in and commonalities in the regulation of executive compensation. The chapter briefly reviews legal rules and standards and disclosure as additional tools, before reflecting upon why some divergence in the basic corporate governance structure persists across our sample jurisdictions.

Keywords: shareholder-management conflict, one-tier and two-tier boards, director appointment, directors removal, decision rights, shareholder coordination, independent directors, executive compensation

JEL Classification: D23, G32, G34, G38, K22

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

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Abstract

This paper is the third chapter of the third edition of *The Anatomy of Corporate Law: A Comparative and Functional Approach*, by Reinier Kraakman, John Armour, Paul Davies, Luca Enriques, Henry Hansmann, Gerard Hertig, Klaus Hopt, Hideki Kanda Mariana Pargendler, Georg Ringe, and Edward Rock (Oxford University Press, 2017). The book as a whole provides a functional analysis of corporate (or company) law in Europe, the U.S., and Japan. Its organization reflects the structure of corporate law across all jurisdictions, while individual chapters explore the diversity of jurisdictional approaches to the common problems of corporate law. In its third edition, the book has been significantly revised and expanded.

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Corporate law must address three fundamental agency problems: the conflict between managers (executives and directors) and shareholders, the conflict between controlling and minority shareholders, and the conflict between shareholders and non-shareholder constituencies. This chapter examines how the legal strategies employed in corporate governance mitigate the manager-shareholder conflict in our core jurisdictions; Chapter 4 then explores the role of governance in safeguarding minority shareholder and non-shareholder interests.

Two of the core features of the corporate form underlie corporate governance. The first is investor ownership, which, given the breadth of contemporary capital markets, implies that ultimate control over the firm often lies in the hands of shareholders who are far removed from the firm's day-to-day operations and who face significant information and coordination costs.[1] The second is delegated management, which is functional precisely because of shareholders' information and coordination costs. Such delegation in turn brings with it shareholder-manager agency costs.

Corporate laws address the shareholder-manager agency problem through both governance and regulatory strategies. As this Chapter outlines, however, their deployment and relative efficacy differ according to share ownership patterns. In countries where controlling shareholders are common, *appointment* and *decision rights* are often relatively strong, enabling such shareholders to exert influence directly over the management.[2] At the opposite extreme, where share ownership is dispersed in the hands of passive, uninformed investors, as was the case in the U.S. for much of the twentieth century, appointment and decision rights are less effective, and more work is done by *agent incentives*, in the form of appropriately-calibrated *rewards* for managers and a *trusteeship* role for non-management directors in overseeing executives. Such strategies have been further supported by *standards* of conduct for directors and *affiliation rights*, namely *disclosure rules* to ensure more informed share prices and greater liquidity, which in turn make *exit rights*, including by tendering shares in a hostile takeover bid, more effective. Somewhere between these extremes—and perhaps increasingly commonly—lie ownership patterns where, although controlling shareholders are not the norm, share ownership is concentrated in the portfolios of institutional investors, with collective action being facilitated by both the sheer

[1] Shareholder 'coordination and information costs' can be understood as the costs of actually making decisions among multiple shareholders (that is, of getting informed and forging a majority preference), combined with the costs flowing from such decisions being suboptimal (because shareholders are uninformed or conflicted). See *supra* 2.1 and 2.2. One of us has termed this combination 'ownership costs'. See Henry Hansmann, THE OWNERSHIP OF ENTERPRISE 35 (1996).

[2] These strategies similarly enable non-controlling institutional shareholders in the few companies in these countries that have no dominant shareholder.

size of the largest shareholders' holdings and specialized hedge funds' activism.[3]

Before we describe the extent to which our core jurisdictions make use of the various legal strategies, a few general observations on boards of directors--the key internal governance institution in each of them--will be useful.

3.1 Delegated Management and Corporate Boards

The governance law of public corporations has a similar basic structure in all of our core jurisdictions. Reflecting investor ownership, it reserves certain fundamental decisions to the general shareholders' meeting, while delegated management implies assigning much decision-making power to boards of directors.

We have already seen that delegation of decision-making power in relation to the management of the company's business makes sense as a way of economizing on the information and coordination costs shareholders would face if they tried to make these decisions themselves. So we might see the most basic task of boards as being to manage the company's business. However, many jurisdictions expect boards also to engage in oversight of management, implying a second, trusteeship, role for directors.

Jurisdictions reflect different choices as respects formal board structures: in some countries boards are 'one-tier', whereas in others they are 'two-tier'.[4] In jurisdictions with one-tier boards, such as the U.S., UK, and Japan, a unitary board has legal power both to manage *and* supervise the management of a corporation, either directly or through the board's committees.[5] By contrast, jurisdictions using two-tier board structures prescribe a formal separation between the management and monitoring functions. Monitoring powers are allocated to elected *supervisory* boards of non-management directors,[6] which then appoint and supervise *management* boards that include the principal executive officers in charge of designing and implementing business strategy. Germany and Brazil mandate two-tier boards for public corporations, while Italy and France—as well as the EU for the European Company—offer a choice between one and two-tier boards.[7] In

[3] See Ronald J. Gilson and Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUMBIA LAW REVIEW 863 (2013).

[4] There are also intermediate board structures in other jurisdictions, such as the 'Nordic' board of directors. See Per Lekvall, *A Consolidated Nordic Governance Model*, in THE NORDIC CORPORATE GOVERNANCE MODEL 52, 59-63 (Per Lekvall ed., 2014).

[5] Some jurisdictions—such as Italy, Brazil and East Asian jurisdictions influenced by German law--retain vestigial supervisory boards such as the 'board of auditors' (Japan and Italy) or the 'board of supervisors' (Brazil and China). The powers of these secondary boards, which are functionally similar to those of audit committees on a unitary board, are generally limited, especially in Japan and Italy.

[6] We use 'non-management' in the sense of non-participation in management. Such non-participation in executive decision-making is frequently mandated for supervisory boards in two-tier jurisdictions such as Germany. See §§ 105 and 111 IV Aktiengesetz.

[7] §§ 76-116 Aktiengesetz (Germany); Art. 138 Lei das Sociedades por Ações (Brazil); Art. L. 225–57 Code de commerce (France); Art. 2380 Civil Code (Italy); Art. 38 Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European company (SE).

theory, one-tier boards concentrate decision-making power in the hands of directors, because they combine the managerial and supervisory roles in one group. Thus in some jurisdictions, such as the U.S. and France, it is common to combine the roles of board Chairman and Chief Executive Officer ('CEO') in a single-tier board.[8] By contrast, two-tier jurisdictions such as Germany bar supervisory boards from making managerial decisions.[9]

However, board practices can blur the distinction between the two structures. [10] Informal leadership coalitions can short-circuit the legal separation between management and supervisory boards. In companies with no controlling shareholder, the management board can often *de facto* select the supervisory board.[11] At the same time, hiving out 'supervisory' functions to committees composed exclusively of independent directors gives single-tier boards a quasi-supervisory flavor.

Further, in jurisdictions with labor codetermination—such as Germany, among our core countries—a two-tier board performs an additional function. Here the supervisory board is not devoted exclusively to the interests of the shareholder class, but rather serves the function of lowering the costs of coordination between two different constituencies, namely shareholders and employees. We address the governance features of codetermination further in Chapter 4. At this point we merely note that the two-tier board structure facilitates strong labor participation in corporate governance as full access to sensitive information and business decision-making can remain with the management board, thereby mitigating potential conflicts of interest on the supervisory board.

Codetermination imposes a minimum number of supervisory board members—20 for its largest companies[12]—which makes Germany something of an outlier when it comes to board size. As we documented in the previous edition of this book,[13] most jurisdictions have broadly converged on a similar size for boards, at around 9-12 members. Smaller boards are thought to be more effective in performing their monitoring role.[14] With a view to adapting their board size to the international norm, several major German companies

[8] This is not universally the case. In the UK, Art. A.2.1 of the UK Corporate Governance Code calls for a clear division of responsibility between a company's chairman and chief executive officer, which is by far the most common arrangement in UK listed companies.

[9] See *supra* note 6.

[10] See Paul Davies and Klaus J. Hopt, *Corporate Boards in Europe—Accountability and Convergence*, 61 AMERICAN JOURNAL OF COMPARATIVE LAW 301 (2013).

[11] See Klaus J. Hopt and Patrick C. Leyens, *Board Models in Europe—Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France and Italy*, 1 EUROPEAN COMPANY AND FINANCIAL LAW REVIEW 135, 141 (2004).

[12] See § 7 Mitbestimmungsgesetz (Codetermination Law) (at least 20 directors for supervisory boards of firms with more than 20,000 employees).

[13] At 69-70.

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

such as Allianz, BASF, and Porsche have converted into the EU-wide *Societas Europaea* (SE), which allows for a minimum of only 12 directors.[15]

3.2 Appointment and Decision Rights

The most basic legal strategies implied by investor ownership are *appointment rights*: the shareholders retain powers to appoint (and remove) members of the board of directors. In addition, on matters where delegated management may lead to suboptimal outcomes due to badly aligned incentives, such as conflicted and end-game transactions, corporate laws also grant shareholders *decision rights*. The efficacy of these mechanisms in controlling agency costs are a function of shareholders' information and coordination costs on the one hand, and the severity of managerial agency costs on the other. The easier it is for shareholders to become informed, coordinate among themselves, and make collective choices that maximize their collective welfare, the more efficiently appointment and decision rights will control agency costs. But where shareholder information and coordination costs are high, greater insulation for managers may be in the joint interest of shareholders as well.

In other words, shareholder coordination has two faces: easier coordination can decrease shareholder-manager agency costs—by permitting shareholders to control managers more effectively—while at the same time it might increase shareholder-shareholder agency costs—by permitting a faction to gain control to the detriment of the shareholders as a group. Shareholders as a group may suffer from control by a faction; either because that faction may divert corporate value to itself or because, owing to asymmetric information or distorted incentives, it may wrongly displace a good management team or force it to adopt inappropriate strategies.[16]

When, shares are aggregated in the portfolios of institutional asset managers, as is nowadays the case in most jurisdictions, in addition to the agency problem of delegated management at the firm level, a second tier of agency costs arises between the institutional asset managers and their ultimate clients.[17] Because such asset managers are generally compensated on the basis of relative performance, they are unwilling to invest resources in determining the appropriate exercise of governance rights in individual firms—this would confer a gratuitous benefit on their competitors. However, a lead is often set by 'activist' funds, which compensate their managers on the basis of absolute returns and earn a return by taking significant stakes in the companies in which they invest.[18] Whether such activist hedge funds are in a

[15] See Jochem Reichert, *Experience with the SE in Germany*, 4 UTRECHT LAW REVIEW 22, 27–8 (2008).
[16] See Zohar Goshen and Richard Squire, Principal Costs: A New Theory for Corporate Law and Governance, Working Paper (2016), available at ssrn.com.
[17] Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA LAW REVIEW 811 (1991).
[18] Marcel Kahan and Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 UNIVERSITY OF PENNSYLVANIA LAW REVIEW 1021 (2007); Gilson and Gordon, *supra* note 3; Marco Becht, Julian R. Franks, Jeremy Grant and Hannes F. Wagner, *The*

good position to identify companies with weak strategies and/or disloyal managers, or rather simply target companies that stock markets fail to price adequately, forcing these companies to engage in suboptimal, often 'short-term' business strategies, is one of the most disputed issues in the current corporate governance debate.[19] The empirical evidence about the merits of this new corporate governance paradigm is as yet inconclusive,[20] and the debate will continue on whether the new corporate governance paradigm based on activist hedge funds and institutional shareholders as arbiters of corporate strategy brings net benefits to society.[21]

Before analyzing individual legal strategies across jurisdictions, we should bear in mind that shareholder-centric corporate laws are not *a priori* superior to board-centric ones. Solving the trade-off between managerial agency costs and shareholder information and coordination costs turns out to be one of the hardest challenges for corporate policymakers. Even within a particular jurisdiction and a specific industry, the dynamics between the two constituencies will play out differently due to a number of factors: chief among them is the question of how easily management can convey information about its business strategy without destroying its value. Personalities, including entrepreneurial genius, will also play a role. With this caveat in mind, we can begin our tour of legal strategies used in this area, by considering appointment rights first.

3.2.1 Appointing directors

At the core of appointment rights lies shareholders' power to vote on the selection of directors. The impact of this power is much greater if shareholders also have the power to nominate the candidates for election. The allocation of these entitlements reflects the balance between shareholder information and coordination costs and managerial agency costs. The latter are most tightly controlled by permitting shareholders to select candidates for appointment. However, in the presence of high information and coordination

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Returns to Hedge Fund Activism: An International Study, 21 EUROPEAN FINANCIAL MANAGEMENT 106 (2015).

[19] See e.g. Alon Brav, Wei Jiang, Frank Partnoy, and Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 JOURNAL OF FINANCE 1729 (2008); Gilson and Gordon, *supra* note 3; April Klein and Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 JOURNAL OF FINANCE 187 (2009); Lucian A. Bebchuk, Alon Brav and Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUMBIA LAW REVIEW 1085 (2015); Yvan Allaire and Francois Dauphin, The Game of 'Activist' Hedge Funds: Cui Bono? Working Paper (2015), available at ssrn.com; Emiliano Catan and Marcel Kahan, *The Law and Finance of Antitakeover Statutes* 68 STANFORD LAW REVIEW 629 (2016).

[20] For a comprehensive review see John C. Coffee, Jr. and Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 1 ANNALS OF CORPORATE GOVERNANCE 1 (2016).

[21] It is certainly plausible that the mechanisms employed to disclose information about publicly-traded companies might lead to stock price valuations which are less accurate for some types of business project—'exploratory' innovation for example (see John Armour and Luca Enriques, Financing Disruption, Working Paper (2016)) —but it is unclear whether such effects explain the pattern of activist investing.

costs, it may be preferable to let the board, possibly acting through its independent members, perform the search function that precedes nomination of candidates, and have the shareholders simply vote on them.

This latter approach is common practice in most jurisdictions: the board usually proposes a slate of nominees, which is rarely opposed at the annual shareholders' meeting. The exceptions are Brazil and Italy, where concentrated ownership prevails and formal director nominations by (controlling) shareholders are commonplace.[22]

As a check on agency costs, almost all jurisdictions permit a qualified minority (usually a small percentage) of shareholders to contest the board's slate by adding additional nominees to the agenda of the shareholders' meeting.[23] Insurgent candidates nominated in this fashion face the same up-or-down majority vote as the company's own nominees other than in jurisdictions where shareholders usually vote on the slates as a package, as in Germany and Italy.[24] Finally, special rules apply to allow for minority shareholder representation on the boards of listed companies in Brazil and Italy.[25]

Matters are more complex in the U.S., where board elections have always been a contentious issue attracting policymakers' attention. First of all, the statutory default in Delaware is a 'plurality' voting rule, under which—when an election is uncontested (that is, the number of candidates equals the number of directors to be elected)—any number of votes suffices to elect a nominee to a board seat.[26] Following institutional investors' dismay at reappointment of candidates for whom large numbers of votes had been 'withheld', most large companies have opted out of the default, switching to majority voting.[27] Moreover, Delaware law was amended to facilitate shareholder initiatives to switch to majority voting.[28] And, while plurality

[22] In Italy the law on listed companies itself drives this outcome, by treating shareholder-proposed slates as default. See Art. 147-III Consolidated Act on Financial Supervision.

[23] In the UK the default rule is that any shareholder can present her own board candidates for appointment by ordinary resolution (Schedule 3, Model Articles for Public Companies, Companies (Model Articles) Regulations 2008 No. 3229, Art. 20). In Japan a qualified minority (1 per cent of votes or 300 votes) may propose its own slate of candidates, which the company must include in its mail voting/proxy documents (Art. 303 and 305 Companies Act; see also Gen Goto, *Legally 'Strong' Shareholders of Japan*, 3 MICHIGAN JOURNAL OF PRIVATE EQUITY AND VENTURE CAPITAL 125, 131-136 (2014)). In Italy the quorum for the proposal of a slate of candidates varies from 0.5 per cent for the largest companies (by capitalization) to 4.5 per cent for the smallest. Art. 144–4 Consob Regulation on Issuers. In Brazil, the relevant threshold for proxy access (or reimbursement of expenses) by insurgents in public companies is 0.5 per cent of the total capital. CVM Instruction No. 481 (2009) Arts. 31 and 32.

[24] In German public companies any shareholder can add her own candidates up to two weeks before the meeting (§ 127 AktG). Of course, that applies to German companies subject to codetermination for the subset of supervisory board members appointed by shareholders only.

[25] Art. 147-III, Consolidated Act on Financial Intermediation 1998, as amended in 2005 (Italy); Art. 141, § 4º Lei das Sociedades por Ações (Brazil).

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

[27] Stephen J. Choi, Jill E. Fisch, Marcel Kahan, and Edward B. Rock, *Does Majority Voting Improve Board Accountability?*, UNIVERSITY OF CHICAGO LAW REVIEW (forthcoming 2016).

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

remains relatively common in smaller companies, their boards often yield to 'withholding' campaign demands.[29]

Shareholders in U.S. companies have other tools to obtain representation on the board. One such tool is proxy access—that is, placing nominees on the company's proxy materials so all shareholders will have a choice between the board candidates and the insurgents' ones, without any need for the latter to circulate their own proxy materials. The default in Delaware is against proxy access and federal rules regulating proxies have traditionally refrained from mandating such access. After the Dodd-Frank Act of 2010 explicitly granted the S.E.C. power to make rules facilitating inclusion of shareholder nominations in the corporate proxy form,[30] the S.E.C. adopted a rule to this effect, but the D.C. Circuit struck it down, ostensibly for failing to consider adequately its economic effects.[31] Currently, federal proxy rules allow shareholders to include proposals for proxy access in the company's proxy materials and Delaware law has also eased shareholders' initiatives in favor of proxy access at individual companies.[32] As a consequence, shareholder proposals to adopt proxy access have become increasingly common for U.S. listed companies, and many such companies now provide for it.[33]

Insurgents who wish to obtain control of the board, which is usually the case in connection with a hostile takeover bid,[34] may launch a full-blown proxy contest. In this case, the insurgent bears all the costs of soliciting their *own* proxies and distributing their own materials—that is, ballots, registration statements (subject to SEC review), and supporting materials.[35]

Finally, a popular tool among activists is what is known as a 'short slate' proxy solicitation.[36] Since 1992, when the S.E.C. amended its proxy rules to reduce obstacles to shareholder activism, an insurgent in a proxy contest, typically a hedge fund, may solicit proxies to vote in favor both of its nominees for a minority of directorships and of a majority of the nominees in the company's proxy materials.[37] A 'short slate' makes it easier for a hedge fund activist to persuade institutional investors to support its nominees and to push for a change in the company's strategy from within the board.

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[29] Marcel Kahan and Edward Rock, *Symbolic Corporate Governance Politics*, 94 BOSTON UNIVERSITY LAW REVIEW 1997, 2011 (2014).
[30] § 971, Dodd-Frank Act (2010).
[31] *Business Roundtable v. Securities and Exchange Commission*, 647 FEDERAL REPORTER 3d 1144. According to one study, the DC Circuit's decision itself had a negative impact on the valuation of potentially affected firms: see Bo Becker, Daniel Bergstresser and Guhan Subramanian, *Does Shareholder Proxy Access Improve Firm Value? Evidence from the Business Roundtable's Challenge*, 56 JOURNAL OF LAW & ECONOMICS 127 (2013).
[32] § 112 Delaware General Corporation Law.
[33] See e.g. Howard B. Dicker, 2016 Proxy Season: Engagement, Transparency, Proxy Access, Harvard Law School Forum on Corporate Governance and Financial Regulation, 4 February 2016, available at corpgov.law.harvard.edu.
[34] See *infra* 8.2.3.
[35] See e.g. Sofie Cools, *The Real Difference in Corporate Law Between the United States and Continental Europe: Distribution of Powers*, 30 DELAWARE JOURNAL OF CORPORATE LAW 697, 746 (2005).
[36] See Coffee and Palia, *supra* note 20, at 24–25.
[37] See 17 C.F.R. §240.14a-4(d)(4).

3.2.2 Removing directors

The power to remove directors, if shareholders can exercise it effectively, is a very potent mechanism for controlling agency costs, perhaps even more so than appointment rights. Many jurisdictions—including the UK, France, Italy, Japan, and Brazil—accord shareholder majorities a non-waivable right to remove directors at any time, regardless of cause or the nominal duration of their term.[38] Coupled with powers to requisition a shareholders' meeting—for which the agenda will be circulated at the company's expense—this creates a powerful check on agency costs. Boards recognize the credibility of this threat, and consequently will often accede to shareholder demands for change in the boardroom without the need for a shareholders' meeting actually to be called.[39]

Our other jurisdictions provide weaker removal rights. German law encourages accountability to shareholders of shareholder-elected members of the supervisory board by permitting their removal without cause, although only by a 75 per cent majority.[40] By contrast, shareholders may not remove the labor representatives, nor may the supervisory board remove members of the management board without cause.[41] This latter rule reflects the idea that in the presence of representatives of very different constituencies, making managers (as opposed to supervisors) tightly accountable to their constituency might be counter-productive, undermining effective day-to-day decision-making. In the end, however, the possibility of direct shareholder influence mitigates the limitation on managerial board member dismissal. Where a simple majority of the general meeting approves a 'no confidence' resolution against the management board, this satisfies the 'cause' requirement; in other words, the supervisory board is entitled (and probably obliged) to remove the management board in such a situation.[42]

Many U.S. jurisdictions treat the right to remove directors without cause as a statutory default subject to reversal by a charter provision on point.[43] In Delaware, however, companies may only disallow removal without cause if they choose a staggered (or 'classified') board, that is, a board where only a fraction of the members is elected each year.[44] Staggered boards used to be

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[38] Sections 168 and 303 Companies Act 2006 (UK), Arts. L. 225–18, 225–75 and 225–61 Code de commerce (France); Arts. 2367 and 2383 Civil Code (Italy) (all providing for removal within term and setting minimum thresholds to call special meetings in publicly traded companies). Art. 339(1) Companies Act (Japan) (simple majority required for removal without cause). Art. 140 Lei das Sociedades por Ações (Brazil) (same).

[39] See e.g. Marco Becht, Julian Franks, Colin Mayer, and Stefano Rossi, *Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund*, 23 REVIEW OF FINANCIAL STUDIES 3093 (2010).

[40] § 103 AktG (Germany). Companies' charters may provide for a higher or lower majority (*ibid.*), which they rarely, if ever, do.

[41] Ibid., § 103 and 84(3).

[42] Ibid., § 84(3). In practice the management board member will not wait until the supervisory board votes on the removal, but will step down 'voluntarily.'

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

[44] See § 141(k) Delaware General Corporation Law. For example, Delaware General Corporation Law requires that at least one third of the directors be elected annually (§141(d)) where there is a single class of voting stock. Longer terms are possible, however, where corporate charters provide for multiple classes of voting stock.

common until the mid-2000s. In keeping with the general trend towards greater shareholder appointment rights in the U.S., their use has been in decline for several years,[45] in parallel with a heated scholarly debate over their corporate governance merits.[46] Yet, Delaware indirectly cabins removal rights by denying shareholders the power to call a special shareholders' meeting unless the company's charter expressly so provides.[47]

Especially where removal without cause is not permitted, the standard mode of director 'removal' is dropping their names from the company's slate or failing to reelect them. As a consequence, the length of directorial terms can be critical. Longer terms provide insulation from proxy contests, temporary shareholder majorities, and even powerful CEOs. Among our core jurisdictions, directorial terms are the shortest (one year) in the U.S. (unless the company has a staggered board, in which case the term is typically three years) and, as a matter of practice and corporate governance recommendations for the largest publicly traded companies, in the UK.[48] Terms are short (two years) in Japan as well, while in Italy and Brazil they are three years.[49] At the opposite end of the spectrum lie German and French corporations, which usually elect (supervisory) directors for five- or six-year terms respectively, the maximum that their corporation laws permit.[50]

Thus, removal rights generally track appointment rights: jurisdictions with 'shareholder-centric' laws on the books—the UK, France, Japan, Italy, and Brazil—provide shareholders with non-waivable removal powers as well as robust nomination powers. Delaware—the dominant U.S. jurisdiction—weakens removal powers by allowing staggered boards and discouraging special shareholders' meetings, but has an ever more commonly adopted default directorial term of one year which, together with the recent introduction of more shareholder-friendly rules on appointment,[51] have brought it broadly in line with other jurisdictions.

The correlation between appointment and removal powers does not hold for German companies, whose shareholders have strong appointment rights for 'their' supervisory board members but can only oust them from lengthy terms by means of a supermajority vote. German law favors stability on the management board as well, by insulating its members from removal without cause to some degree.[52]

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[45] Marcel Kahan and Edward Rock, *Embattled CEOs*, 88 TEXAS LAW REVIEW 987, 1007–9 (2009).

[46] Compare, *e.g.*, Lucian A. Bebchuk, John C. Coates IV and Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STANFORD LAW REVIEW 887 (2002) and Lucian A. Bebchuk, Alma Cohen and Allen Ferrell, *What Matters in Corporate Governance?*, 22 REVIEW OF FINANCIAL STUDIES 783 (2009), with Martijn Cremers, Lubomir P. Litov and Simone M. Sepe, Staggered Boards and Firm Value, Revisited, Working Paper (2014), available at ssrn.com.

[47] See §§ 211(b) and 211(d) Delaware General Corporation Law.

[48] UK Corporate Governance Code (2014), B.7.1.

[49] Art. 332(1) Companies Act (Japan); Art. 2383, Civil Code (Italy) (companies may opt for shorter terms, but that is exceedingly rare); Art. 140, III Lei das Sociedades por Ações (Brazil).

[50] § 102 I AktG (Germany); Art. L. 225–18 Code de commerce (France).

[51] See *supra* notes 28 and 32 and accompanying text.

[52] See *supra* text following note 41.

3.2.3 Decision Rights

Since the corporate form seeks to facilitate delegated decision-making, striking the balance between shareholder decision rights and the powers reserved to managers is a delicate exercise for corporate lawmakers. As we explain in later chapters, shareholders obtain mandatory decision rights principally when directors (or their equivalents) have conflicted interests or when decisions call for basic changes in governance structure or fundamental transactions that potentially restructure the firm (Chapters 6 and 7). Further attribution of decision rights closely tracks appointment rights—it depends on the nature of the shareholders and the coordination costs they face.

Almost all jurisdictions require shareholders to approve some corporate actions, whether upon a board proposal or even a shareholder's. Traditionally, U.S. law mandates shareholder ratification for a relatively narrow range of fundamental decisions (in short: charter amendment and mergers), while our other core jurisdictions grant shareholders a broader range of decision rights, including certain routine but important matters. For example, they require the general shareholders' meeting to approve dividend distributions.[53] For UK listed companies, the premium Listing Rules require shareholder approval of so-called 'Class 1' transactions, which exceed a threshold of significance (25 per cent) measured by reference to a range of corporate valuation metrics.[54] Equally important, all EU member states give shareholders the right to appoint and dismiss the auditors of listed and publicly traded companies,[55] while shareholders also elect the 'statutory auditors' or 'supervisors' of Japanese, Italian and Brazilian companies.[56]

On one dimension—shareholder voting on executive pay—convergence is fast approaching, on a rule that permits the shareholders' meeting to cast a vote on managers' compensation packages. We deal with 'say on pay' in Chapter 6.[57]

Jurisdictions also differ in the latitude of the initiation rights they grant shareholders. At one end of the spectrum, the UK and Brazil confer extensive powers on shareholders. The statutory default in the UK permits a 75 per cent majority shareholder vote to overrule the board on any matter, even if it is within the board's competence.[58] Brazil does not contain a similar rule, but

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[53] §§ 58 and 174 AktG (Germany); Art. L. 232–12 Code de commerce (France); Art. 2434 Civil Code (Italy); Art. 454(1) Companies Act (Japan); Art. 132, II Lei das Sociedades por Ações. For the UK, see Art. 70 Schedule 3, Model Articles for Public Companies, Companies (Model Articles) Regulations 2008 No. 3229).

[54] LR 10, UK Listing Rules.

[55] Art. 37(1) EU Audit Directive (Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, 2006 O.J. (L 43) 1, as amended by Directive 2014/56, 2014 O.J. (L 158) 196).

[56] Ibid. See also Art. 329(1) Companies Act (Japan); Art. 2400 Civil Code (Italy); Art. 162 Lei das Sociedades por Ações (Brazil).

[57] See section 6.2.3.

[58] See Schedule 3, Art. 4 Model Articles for Public Companies, note 53. This power's significance is more symbolic than practical. A supermajority is hard to muster, yet a simple majority is enough to remove the board (*supra* note 38) and consequently to induce it to do what the shareholders want.

permits a simple majority of shareholders to make the lion's share of business decisions beyond the very few matters that necessarily require board action.[59] In addition, duly filed shareholder agreements can even bind the vote of corporate directors, to the effect that votes contradicting the agreement are not counted in shareholder and board meetings.[60]

Elsewhere, shareholders have less extensive rights. Routine business decisions generally fall within the (management) board's exclusive authority to 'manage' the corporation.[61] Nevertheless, continental European jurisdictions and Japan allow qualified percentages of shareholders to initiate and approve resolutions on a wide range of matters including questions that may have fundamental importance to the company's management and strategic direction, such as amendments to the corporate charter.[62] By contrast, U.S.—or at least Delaware—law is the least shareholder-centric jurisdiction. As we discuss in Chapter 7, shareholders of Delaware corporations must ratify fundamental corporate decisions such as mergers and charter amendments but lack the power to initiate them.[63]

Even though shareholder decision rights in public companies diverge across jurisdictions, in closely held companies they converge on flexible and extensive shareholder decision rights. A good example is the German limited liability company (GmbH), which may become very large in capitalization and number of shareholders. The GmbH not only mandates shareholder approval of financial statements and dividends, but also authorizes the general shareholders' meeting to instruct the company's board (or general director) on all aspects of company policy.[64] The GmbH form, then, allows shareholders complete authority to manage the business by direct voting—unless the company is subject to codetermination law by virtue of the size of its workforce.[65] Our other core jurisdictions are similarly flexible.

Finally, at the level of the individual shareholder, many jurisdictions permit derivative actions, which are not only an enforcement mechanism but also a right granted to individual shareholders to manage a corporate cause of action. We discuss derivative suits further in Chapter 6 and the directors' duties upon which they are based in section 3.4.1.

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[59] Art. 121 Lei das Sociedades por Ações.

[60] Art. 118 Lei das Sociedades por Ações.

[61] E.g., § 141(a) Delaware General Corporation Law; § 76 Aktiengesetz) (Germany).

[62] See Dirk Zetzsche, *Shareholder Interaction Preceding Shareholder Meetings of Public Corporations—A Six Country Comparison*, 2 EUROPEAN COMPANY AND FINANCIAL LAW REVIEW 107, 120–8 (2005) (France and Germany). For Italy see Art. 2367 Civil Code and Art. 126–II Consolidated Act on Financial Intermediation. For Japan, see Goto, *supra* note 23, at 129-131, 135-136.

[63] See *infra* 7.2 and 7.4. However, shareholders in U.S. corporations do have initiation rights with respect to amendments of corporate bylaws. While some action has taken place in this area, it appears less than one might expect, given the relatively high stakes compared with other contentious areas of corporate governance. See Kahan and Rock, *supra* note 29, at 2019.

[64] §§ 37, 38, 46 GmbHG.

[65] A GmbH subject to codetermination must have a two-tier board and is subject to AG rules on the division of functions between the boards, and between boards and shareholders. Karsten Schmidt, GESELLSCHAFTSRECHT 482–3 (4th ed. 2002).

3.2.4 Shareholder coordination

Closely related to shareholders' appointment and decision rights is the extent to which the law seeks to assist dispersed shareholders in overcoming their collective action problems. All of our target jurisdictions do this, up to a point.

Voting mechanisms are a conspicuous example. Small shareholders everywhere may exercise their voice at shareholders' meetings through attendance in person, which is obviously cumbersome, or through at least one of four mechanisms meant to make voting less costly: voting by mail (or 'distance voting'), proxy solicitation by corporate partisans, proxy voting through custodial institutions or other intermediaries, and participation in an electronic meeting. For example, Japanese law allows firms with significant numbers of shareholders to choose voting either by proxy or by mail.[66] France, Germany, Italy and the UK allow corporations to opt for distance voting.[67] As a consequence of the EU's Shareholder Rights Directive, all of these jurisdictions also now permit electronic meetings and voting.[68] The U.S. traditionally relied on proxy voting,[69] but has also made it possible for companies to establish 'electronic forums' for communication with, and between, shareholders, and for proxy solicitation and appointment to be conducted via the internet (so-called 'e-proxies').[70] Finally, Brazilian law now enables distance voting and permits companies to hold live electronic meetings and voting.[71]

When investors hold shares in individual companies, they usually do so via institutions such as banks (in most jurisdictions) or broker-dealers (in the U.S.) acting as their custodians. As such, these intermediaries have no financial interest in the shares deposited with them. Yet they may face conflicts of interest owing to actual or prospective business relationships with listed companies. For this reason, when they were empowered to vote custodial shares, they generally favored the corporate nominees. This practice was once common among US broker-dealers,[72] and European custodians, such as banks, played an even stronger, pro-incumbent role in

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

[67] Art. L. 225–107 Code de commerce (France); Art. 2370(4) Civil Code and Art. 127 Consolidated Act on Financial Intermediation (Italy). For Germany, see the 2001 law on registered shares and on facilitating the exercise of the right to vote (NaStraG). In the UK, this can be done by inserting a provision in the company's articles: Companies Act (UK) 2006, s 284(4).

[68] Art. 8 Directive 2007/36/EU, 2007 O.J. (L 184) 17.

[69] The NYSE mandates proxy solicitation for 'operating' listed U.S. firms except where solicitation would be impossible (Rule 402.04(A) Listed Company Manual). See also Rules 4350(g) and 4360(g) NASDAQ Marketplace Rules (same). No such law or listing requirement exists in Germany, France, Italy, the UK, or Japan.

[70] SEC Rules 14a-16, 14a-17.

[71] CVM Instruction No. 481 (2009), as amended by CVM Instruction No. 561 (2015).

[72] Since 2009 U.S. brokerage houses have been prohibited from voting shares held as nominees (in 'street name') in directorial elections in the absence of direct instructions from beneficial owners: NYSE Rule 452. The Dodd-Frank Act broadened the prohibition to voting on executive compensation, including say-on-pay (§ 957).

corporate governance.[73] In Germany, for example, where supervisory boards have traditionally not engaged in partisan proxy solicitation,[74] banks serving as custodians for retail investors used to vote the shares in favor of corporate nominees. This custodial exercise of voting rights was justified by reference to investors' 'implicit consent'.[75] After market pressure and legal reform[76] restricted this practice, voting outcomes in widely held German companies have occasionally become less predictably pro-management.[77]

Such outcomes have also been furthered by the increasing internationalization and institutionalization of share ownership in German companies.[78] A similar ownership pattern can be observed in other core jurisdictions: in each of them, shareholdings (or minority shareholdings in companies with a controlling shareholder) are increasingly in the hands of institutions, mostly asset managers acting for pension funds and insurance companies, with the largest among them often holding average stakes around five per cent of the most liquid shares in many markets.[79] Institutions that invest in the market on behalf of multiple beneficiaries can aggregate control rights, thereby reducing the collective action problems faced by disaggregated investors. Indeed, many institutions with financial obligations to their beneficiaries or customers—including pension funds, mutual funds, and insurance companies—have long been champions of shareholder interests in the UK,[80] and are increasingly so in the U.S., especially after policymakers shifted from a legal framework that discouraged shareholder activism and coordination to one which overall favors it.

U.S. federal proxy regulation was historically more concerned with the risk that a faction of shareholders would gain control, to the detriment of the shareholders in general, than with managerial agency costs.[81] That translated

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[73] Italy is an exception, because banks' proxy voting was prohibited (following their prior key role in proxy contests) between 1974 and 1998, after which they failed to resume any active role in companies' shareholders' meetings.

[74] See Schmidt, *supra* note 65, at 854.

[75] The shareholders could always instruct their banks as to how to vote their shares, but rarely gave explicit instructions.

[76] See Wolf-Georg Ringe, *Changing Law and Ownership Patterns in Germany: Corporate Governance and the Erosion of Deutschland AG*, 63 AMERICAN JOURNAL OF COMPARATIVE LAW 493, 506-07 (2015).

[77] For example, the Chairs of Deutsche Börse's supervisory and management boards agreed to resign after activist investor pressure made it clear that they would face a vote of dismissal at the general meeting. See Norma Cohen and Patrick Jenkins, *D Börse Chiefs Agree to Step Down*, FINANCIAL TIMES (Europe), 10 May 2005, at 1. For evidence of the decline in bank influence in Germany see Ringe, *supra* note 76, 522–24. For recent anecdotal evidence of increasingly successful hedge fund activism in Germany, see *Stada and Deliver*, THE ECONOMIST, September 3, 2016, at 58.

[78] Ringe, *supra* note 76, 524–26.

[79] See e.g. Paul Davies, *Shareholders in the United Kingdom*, RESEARCH HANDBOOK ON SHAREHOLDER POWER 355, 357–9 (Jennifer G. Hill and Randall S. Thomas eds., 2015); Edward B. Rock, *Institutional Investors in Corporate Governance*, in OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE (Jeffrey N. Gordon and Wolf-Georg Ringe eds., 2017) (U.S.).

[80] See Geof P. Stapledon, INSTITUTIONAL SHAREHOLDERS AND CORPORATE GOVERNANCE (1996).

[81] See e.g., John Pound, *Proxy Voting and the SEC: Investor Protection Versus Market Efficiency*, 29 JOURNAL OF FINANCIAL ECONOMICS 241 (1991).

into rules that not only discouraged insurgents seeking to gain control via proxy contests, but also chilled coordination attempts among shareholders generally. Along with the advent of ubiquitous institutional investor ownership, the proxy rules' restrictions on inter-shareholder communication were greatly relaxed in 1992.[82] And while barriers to shareholder collective action still remain, including registration and disclosure requirements for any 5 per cent 'group' of shareholders whose members agree to coordinate their votes,[83] hedge fund activists' tactics have shown how favourable the overall framework now is to shareholder engagement. Indeed, the U.S. rules prove looser than those of our other jurisdictions when it comes to treating shareholders as 'acting in concert' with a view to engaging a target company's management. They are also more effective in nudging institutional investors into voting their portfolio shares.

In the U.S., activist hedge funds may alert other hedge fund managers of their intention to start a campaign without falling foul of insider trading laws.[84] And if, as a result, both the initial activist and other hedge funds buy shares in the target company, they need not aggregate their holdings for disclosure purposes.[85] On the contrary, European insider trading rules would treat the intention to start a campaign as price sensitive information, which would prevent those who learn about it from buying additional shares.[86] In addition, hazier definitions of 'acting in concert' for mandatory bid rule purposes, especially in countries such as Germany and France, which have not tried to dissipate doubts via regulatory exemptions or guidance, mean that activists have to beware the risk of jointly crossing the relevant thresholds.[87]

Moreover, since the 1980s, U.S. rules on institutional investors' voting of portfolio shares have proved hospitable to shareholder activism. A rule that first covered pension funds, and was later extended to other asset managers, declared fiduciary duties applicable to decisions regarding the exercise of portfolio shares' voting rights.[88] In addition, since 2003, mutual funds have had to disclose their proxy voting policies.[89] These regulations have helped to

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[82] See Regulation of Communication among Shareholders, Exchange Act Release No. 34–31326 (1992). See SEC Rule 13d–5 (17 C.F.R. § 240.13d–5 (2008)).

[83] See SEC Rule 13d–5 (17 C.F.R. § 240.13d–5 (2008)).

[84] See Coffee and Palia, *supra* note 20, at 35.

[85] See Id. at 28–42.

[86] See Arts. 7–9 Market Abuse Regulation, 2014 O.J. (L 173) 1).

[87] See *infra* 8.3.4. The UK Takeovers Panel issued guidance on acting in concert by active shareholders. See Takeover Panel, Practice Statement No. 26. Shareholder Activism (2009) (available at www.thetakeoverpanel.org). Italy's securities regulator (Consob) similarly clarified which coordinating actions, such as agreement to vote against a given board proposal, are not per se relevant for acting in concert purposes. Art. 44-IV, Consob Regulation on Issuers.

[88] See e.g. Robert B. Thompson, *The Power of Shareholders in the United States,* in RESEARCH HANDBOOK ON SHAREHOLDER POWER, *supra* note 79, 441, 451.

[89] SEC, Proxy Voting by Investment Advisers, Release No. IA-2106, 68 FR 6585 (Feb. 7, 2003). The European Commission is following suit in this area by championing a prescriptive approach along the lines of the SEC rules. See Art. 3f Shareholders Rights Directive, as envisaged by the Proposed Directive amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement, Directive 2013/34/EU as regards certain elements of the corporate governance statement and Directive 2004/109/EC, as approved by the European Parliament on 8 July 2015.

raise participation rates at both U.S. and foreign portfolio companies and to standardize asset managers' views on corporate governance issues, usually in the direction of more pro-shareholder corporate governance policies at the portfolio company level. As importantly, such rules have hugely increased the demand for proxy advisory services and therefore the influence on corporate governance of ISS and Glass Lewis, the two dominant global proxy advisers.

In Europe policymakers have moved much less in the direction of *mandating* institutional investors' involvement in corporate governance, although they have similarly sought to ensure that, as responsible owners, institutions engage with their portfolio companies. The UK, followed by Japan, took the lead in this area by adopting a 'Stewardship Code', which aimed to increase asset managers' accountability as regards their exercise of ownership (mainly voting) rights.[90] The Stewardship Code, however, has no mandatory component: like for Corporate Governance Codes,[91] the only obligation is for UK asset managers to declare whether they comply with it or otherwise explain why they do not. Judging from both mandated statements by UK asset managers and voluntary ones by foreign institutions, the Stewardship Code's principles, perhaps because of their generality, seem broadly shared within the industry.[92]

Harder to tell is whether compliance with the Stewardship Code's principles and, in the U.S., with mandatory voting and voting policies disclosure requirements, also translate into improved governance and/or management and financial performance at portfolio companies.[93] A cause for skepticism is that—unlike Corporate Governance Codes—there are few obvious mechanisms through which the information disclosed will be aggregated and acted upon by the asset managers' ultimate principals, retail investors in institutional investment vehicles.

3.3 Agent Incentives

Within the framework of the law, market forces play an important role in molding corporate agents' behavior. They have levered upon both the low-powered incentives of independent directors within boards tasked with a monitoring role (a trusteeship strategy), and the high-powered incentives created by seeking to align managers' incentives with shareholders' interests through equity-linked compensation (a reward strategy). The law has

[90] Financial Reporting Council (UK), THE UK STEWARDSHIP CODE (2012); Council of Experts Concerning the Japanese Version of Stewardship Code, PRINCIPLES FOR RESPONSIBLE INSTITUTIONAL INVESTORS—JAPAN'S STEWARDSHIP CODE (2014).

[91] See *infra* 3.3.1.

[92] As the time of writing (June 2016), the Financial Reporting Council website lists 306 asset managers, owners, and service providers (such as proxy advisers), including Blackrock, Fidelity, Vanguard, ISS, and Glass Lewis, who have stated their commitment to the Code. See www.frc.org.uk. The Japanese Stewardship Code is a form of pure soft law, in that even Japanese institutional investors are under no obligation to comply or explain. The Financial Services Agency's website lists 207 institutional investors who have undertaken to comply or explain as of end of May 2016.

[93] A review of the empirical evidence by one of this book's authors gives few grounds for optimism. See Rock, *supra* note 79.

intervened in these two areas, sometimes to support and reinforce market practices, and sometimes to curb distortions in their use that might result from the very agency problems such practices seek to ameliorate. Trusteeship and reward strategies have also been used as complements, as where independent directors are charged with the task of ensuring that executive compensation packages genuinely align incentives rather than serving simply as ways for managers to transfer wealth to themselves. While we discuss these two strategies separately below, it is therefore useful to remember that board effectiveness is the outcome of the interaction, *inter alia*, of both rewards and trusteeship: disentangling their separate contributions is one of the many challenges that empirical studies must address in this area.[94]

3.3.1 The Trusteeship Strategy: Independent Directors

Among our core jurisdictions, the principal trusteeship strategy for protecting the interests of disaggregated shareholders is the inclusion of 'independent' directors amongst those comprising the board. Because their compensation packages tend to be less sensitive than managers' to share performance, they are free(r) from high-powered incentives. And because they are not themselves making day-to-day management decisions, they can be expected to identify less with management and to be more willing to be critical.[95] The board – whether one tier or two-tier – then comprises both managers, whose incentives are shaped mainly by the rewards strategy,[96] and non-executives, whose incentives are rather shaped by the trusteeship strategy.[97]

The increasingly common requirement that some or most members of a corporation's board of directors not be executives of the firm reflects the trusteeship strategy in that it removes one conspicuous high-powered incentive for directors to favor the interests of the firm's management at the expense of other constituencies. Truly independent directors are board members who are not strongly tied by high-powered financial incentives to any of the company's constituencies and consequently are motivated principally by ethical and reputational concerns. That is, of course, our definition of a trustee.[98]

All of our core jurisdictions now recognize a class of 'independent' directors in this sense, and most jurisdictions actively support at least some participation by these directors to key board committees (audit, nomination, and compensation). Complementing its traditionally limited reliance on shareholder control rights, the U.S. is the originator of this form of trusteeship and still its most enthusiastic proponent. U.S. case law generally encourages

[94] See also *infra*, end of section 3.3.1.
[95] Melvin A. Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants*, 63 CALIFORNIA LAW REVIEW 375 (1975).
[96] See 3.5.
[97] See Ronald W. Masulis and Shawn Mobbs, *Independent Director Incentives: Where Do Talented Directors Spend Their Limited Time and Energy?*, 111 JOURNAL OF FINANCIAL ECONOMICS 406 (2014).
[98] See 2.2.2.3.

independent directors,[99] while U.S. exchange rules now require that company boards include a majority of independent directors and that key board committees be composed by a majority, or entirely, of independent directors.[100] In addition, the Sarbanes-Oxley Act of 2002 ("SOX") mandated wholly independent audit committees; eight years later, the Dodd-Frank Act mandated wholly independent compensation committees.[101] Similarly, the SOX-inspired EU Audit Directive requires publicly-traded companies to have audit committees with a majority of independent directors, including an independent chair.[102]

Other than that, our EU jurisdictions promote independent directors mainly through soft law, in the form of 'corporate governance codes'. These are guidelines for listed companies that address board composition, structure, and operation, and are drafted by market participants under the aegis of an exchange or a public body. Listed companies are not legally bound to *follow* these guidelines. Instead, they have an obligation—under listing rules, as in the UK, or under corporate law, as in Germany—to report annually whether they comply with code provisions and, if they do not comply, the reasons for their noncompliance—a so-called 'comply or explain' obligation.[103] This device is intended to enlist reputation, shareholder voice, and market pressure to push companies toward best practices, while simultaneously avoiding rigid rules in an area where one size clearly does not fit all.[104]

The UK's code is most enthusiastic in its reliance on independence. It recommends that at least half the board of listed companies (other than smaller ones) be composed of independents,[105] who should also fill the audit and remuneration committees as well as a majority of the nomination committee.[106] France, Germany, and Italy go in the same direction, although they are less whole-hearted in their embrace of independence. The French

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[99] In particular, Delaware courts have repeatedly emphasised the importance of independence as a criterion for review of conflicted transactions or litigation decisions. See 6.2.2.1.

[100] See Rules 303A.01 (listed companies must have a majority of independent directors) and 303A.04–05 (nominating/corporate governance and compensation committees composed entirely of independent directors) NYSE Listed Company Manual; Rule 4350(c)(1) (majority of independent directors required) and Rules 4350(c)(3)–(4) (compensation and nominations committees comprised solely of independent directors; one out of three members may lack of independence provided that she is not an officer or a family member of an officer) NASDAQ Marketplace Rules.

[101] SOX § 301; Dodd-Frank Act of 2010, § 952.

[102] Art. 39(1) Directive 2006/43/EC. However, Art. 39(5) Audit Directive allows member states to opt out of the independence requirements where all members of the audit committee are also members of the supervisory board. Germany has made use of this opt-out. See Abschlussprüfungsreformgesetz of 10 May 2016, Art. 5 Nr. 1, 2.

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

[104] For example, it appears that compliance with code provisions is associated with increased performance in UK firms with dispersed ownership, but has no measurable impact for firms with a controlling shareholder: see Aridhar Arcot and Valentina Bruno, Corporate Governance and Ownership: Evidence from a Non-Mandatory Regulation, working paper (2014), available at ssrn.com. See also Alain Pietrancosta, *Enforcement of Corporate Governance Codes: A Legal Perspective*, in FESTSCHRIFT FÜR KLAUS J. HOPT 1, 1109, 1130 (Stefan Grundmann et al. eds., 2010).

[105] UK CORPORATE GOVERNANCE CODE (2014), Provisions B.1.2.

[106] Ibid, Provisions B.2.1, C.3.1, and D.2.1.

code distinguishes between widely held companies (recommending independence for half of the board) and companies with a controlling shareholder (recommending independence for one-third),[107] while the German and Italian codes only recommend an 'adequate number' of independent directors/members of the supervisory board, leaving broad discretion to individual companies.[108] The case of independent directors in Germany is particularly delicate, as shareholders may fear that directors who are 'independent' of shareholders might side with labor representatives on a divided board. In all three countries the codes recommend an independent audit committee,[109] France and Italy a remuneration committee, and Germany, with France, a nomination committee.[110] Brazilian corporate law does not impose any director independence requirements,[111] but the premium listing segments of the São Paulo stock exchange (such as the Novo Mercado and Level 2) mandate a minimum of 20 per cent independent directors.[112]

As a response to criticisms of the traditional system of insider-dominated boards coupled with a nominally independent but weak board of statutory auditors, the Japanese Companies Act permitted companies to adopt a US-style, tripartite committee structure in 2002. While a few firms with greater international exposure have chosen this new structure,[113] it has not proven particularly popular.[114] However, the reform of the Companies Act in 2014 pushed listed companies, on a comply or explain basis, to appoint at least one outside director. This and a recommendation, in the Corporate Governance Code of 2015,[115] to appoint two independent directors, has triggered a rapid increase in the number of listed companies appointing one or

[107] French Corporate Governance Code, Principle 9.2.

[108] See Recommendation 5.4.2 German Corporate Governance Code; Principle 3.P.1, Italian Corporate Governance Code (for the 40 most traded stock, the recommendation is for one third of independent directors: ibid., criterion 3.C.3).

[109] On EU requirements for an audit committee see *infra* note 160.

[110] See French Corporate Governance Code, Principle 15 and 17; Recommendation 5.3 German Corporate Governance Code; Arts. 5-7 Italian Corporate Governance Code. In Germany, a majority of the larger listed companies has set up remuneration committees as well. See Klaus J. Hopt and Patrick C. Leyens, *Board Models in Europe—Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy*, 1 EUROPEAN COMPANY AND FINANCIAL LAW REVIEW 135, 141 (2004).

[111] There is, however, a modest statutory restriction in that no more than one-third of the members of the board of directors can at the same time serve as corporate officers. Art. 143, §1º Lei das Sociedades por Ações.

[112] Novo Mercado Regulations Art. 4.3; Level 2 Regulations Art. 5.3.

[113] See Ronald J. Gilson and Curtis J. Milhaupt, *Choice As Regulatory Reform: The Case of Japanese Corporate Governance*, 53 AMERICAN JOURNAL OF COMPARATIVE LAW 343, 349 (2005); Amon Chizema and Yoshikatsu Shinozawa, *the 'Company with Committees': Change or Continuity in Japanese Corporate Governance?*, 49 JOURNAL OF MANAGEMENT STUDIES 77 (2012).

[114] As of July 2014, only 58 out of 3414 (or 1.7 per cent of) listed companies at the Tokyo Stock Exchange took the form of company with three committees. See TOKYO STOCK EXCHANGE, TSE-LISTED COMPANIES WHITE PAPER ON CORPORATE GOVERNANCE 2015, at 15 (available at http://www.jpx.co.jp/english/equities/listing/cg/02.html).

[115] The Council of Experts Concerning the Corporate Governance Code, JAPAN'S CORPORATE GOVERNANCE CODE [FINAL PROPOSAL] (2015).

two independent directors.[116] Nevertheless, it remains infrequent for Japanese companies to appoint any more independent directors.[117]

Trustee-like directors are thus increasingly considered to be a key element of good governance in all of our core jurisdictions. In the U.S. and the UK, they are most often seen as monitors of managers (although this task might be better performed by directors who were *dependent* on shareholder interests).[118] In EU jurisdictions with concentrated ownership structures and Brazil, truly independent directors are more likely to be seen as champions of minority shareholders or non-shareholder constituencies.[119] Put differently, trustee-like directors can be seen as a wide-spectrum prophylactic. They are potentially valuable for treating all agency problems (as well as externalities), but not exclusively dedicated to treating any.[120] Nevertheless, it is questionable whether nominally independent directors appointed by a controlling shareholder can properly function as 'trustees' who will protect the interests of minority shareholders, rather than as agents for the controller.[121] Moreover, independent directors come at a price, as there is inevitably a tradeoff between a director's independence and her knowledge about the company.[122] According to many, independent boards, with their limited

[116] For details and analysis of the recent reforms in Japan, see Gen Goto, Manabu Matsunaka and Souichirou Kozuka, *Japan's Gradual Reception of Independent Directors: An Empirical and Political-Economic Analysis*, in INDEPENDENT DIRECTORS IN ASIA (Harald Baum et al. eds.) (forthcoming). The ratio of companies listed in the First Section of the Tokyo Stock Exchange (the top-tier market of Japan) appointing at least one outside director has increased from 30.2 per cent in 2004 to 94.3 per cent in 2015, and the ratio of the same companies appointing at least two independent directors has increased from 12.9 per cent in 2010 to 48.4 per cent in 2015. See Tokyo Stock Exchange, Inc., Appointment of Outside Directors by TSE-Listed Companies [Final Report] (July 29, 2015), available at http://www.jpx.co.jp/english/listing/stocks/ind-executive/index.html.

[117] As of July 2015, the ratio of companies listed in the 1st Section of Tokyo Stock Exchange having one third or more of independent directors was 12.2 per cent, and the ratio of those having a majority of independent directors majority was 2.7 per cent. Ibid.

[118] See, e.g., Ronald J. Gilson and Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STANFORD LAW REVIEW 863 (1991); Jonathan R. Macey, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 90–92 (2008).

[119] The NYSE definition of "independence" does not require independence from large blockholders (Rule 303A.02 NYSE Listed Company Manual), while most EU jurisdictions consider large shareholders or their appointees 'dependent' (UK: UK Corporate Governance Code, Provision B.1.1 (2014); Germany: German Corporate Governance Code, §5.4.2 (2015)*;* Italy: Corporate Governance Code, Art. 3.C.1; in France, a stricter evaluation of independence is required in relation to large shareholders: AFEP/ MEDEF, Corporate Governance Code of Listed Corporations, Arts 9.4-9.5 (2013)); Japan formerly treated holding company appointees to operating company boards as independent, but the 2014 reform of the Companies Act (Art. 2(15)(c)(d)) now denies their independence.

[120] On the use of independent directors to tackle a variety of agency and non-agency problems over time, see Mariana Pargendler, *The Corporate Governance Obsession*, 42 JOURNAL OF CORPORATION LAW 101 (2016).

[121] See Wolf-Georg Ringe, *Independent Directors: After the Crisis*, 14 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW 401 (2013); Arcot and Bruno, *supra* note 104. See also *infra* 4.1.3.1 and 6.2.2.1.

[122] For discussion of tradeoffs between independence and information on the board see Arnoud W.A. Boot and Jonathan R. Macey, *Monitoring Corporate Performance: The Role of Objectivity, Proximity, and Adaptability in Corporate Governance*, 89 CORNELL LAW REVIEW

understanding of risk management and the technicalities of bank management, contributed to the bank failures in 2008-09.[123] As a result, policymakers' emphasis, especially (but not exclusively) for financial institutions, is nowadays as much on competence as independence.[124]

Unfortunately, the crucial empirical question whether independent directors have a positive impact on firm performance is exceptionally difficult to answer.[125] Because board structure is primarily a matter for individual firms to decide, the proportion of independent directors is likely as much a response to, as a cause of, variation in performance. Moreover, the aspects of board structure that affect performance vary by country as much as by firm.[126] Finally, no matter what definition the law or corporate governance codes provide of independence, whether directors labeled as 'independent' will act as such depends on a congeries of factors, such as personal character and the actual remoteness of insiders from the appointment process, which are formidably difficult to measure.

3.3.2 The Reward Strategy: Executive Compensation

The other technique used to modify agent incentives is the reward strategy. Like the trusteeship of independent directors, this strategy is sometimes said to substitute for direct shareholder monitoring and exercise of control rights when shareholders are dispersed and face high coordination costs.[127] The theory is that optimally-structured pay packages can align the interests of managers with those of shareholders as a class. The reality is that managerial rewards can—depending on their terms—be as much a strategy for controlling agency costs as a symptom of them. In addition, if alignment of managers' and shareholders' interests is achieved by taking the stock price

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356 (2003). *Cf* Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of shareholders Value and Stock Market Prices*, 59 STANFORD LAW REVIEW 1465, at 1541–63 (2007) (increasingly informed share prices in the U.S. facilitate monitoring by independent directors); Enrichetta Ravina and Paola Sapienza, *What do Independent Directors Know? Evidence From Their Trading* 23 REVIEW OF FINANCIAL STUDIES 962 (2008) (independent directors do almost as well as insiders in trading company stock, suggesting no lack of information).

[123] See e.g. Jacob de Haan and Razvan Vlahu, *Corporate Governance of Banks: A Survey*, 30 Journal OF ECONOMIC SURVEYS 228 (2016).

[124] See e.g. Art. 91(1) Council Directive 2013/36 of the European Parliament and of the Council of 26 June 2013 on Access to the Activity of Credit Institutions and the Prudential Supervision of Credit Institutions and Investment Firms, 2013 O.J. (L 176) 338: 'Members of the management body shall at all times be of sufficiently good repute and possess sufficient knowledge, skills and experience to perform their duties. The overall composition of the management body shall reflect an adequately broad range of experiences.' For non-financial firms, see e.g. Principle B.1 Corporate Governance Code (2014) (UK).

[125] For a comprehensive review, see Renée B. Adams, Benjamin E. Hermalin and Michael S. Weisbach, *The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey*, 48 JOURNAL OF ECONOMIC LITERATURE 58 (2010).

[126] Bernard S. Black, Antonio Gledson de Carvalho and Érica Gorga, *What Matters and for Which Firms for Corporate Governance in Emerging Markets? Evidence from Brazil (and other BRIK Countries)*, 18 JOURNAL OF CORPORATE FINANCE 934 (2012).

[127] Marcel Kahan and Edward Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law,* 69 UNIVERSITY OF CHICAGO LAW REVIEW 871 (2002).

as a proxy for the latter, deviation from what is optimal even for shareholders may occur at companies for which markets do an imperfect job in reflecting the 'true' value of their investment policies and business strategies, such as in sectors where innovation is more relevant and harder to understand.[128]

Corporate law generally does not stipulate rewards directly, but regulates how companies can compensate their managers in order to advance the interests of the firm. The most important reward for managers of publicly traded firms today is equity-based compensation, which comes in many forms—namely, stock options, restricted stock, and stock appreciation rights—and now comprises large (albeit varying) portions of total compensation for top managers in all of our core jurisdictions.

Consistently with the idea that the rewards strategy may substitute for shareholder decision rights, the U.S.—which has traditionally accorded shareholders the weakest decision rights amongst our core jurisdictions—has embraced high-powered equity incentives most comprehensively. Although Delaware courts initially regarded stock options with suspicion,[129] they soon made their peace, aided by the wide discretion U.S. firms enjoy to issue rights and repurchase shares.[130] Moreover, a 1994 change in U.S. tax law[131] gave options an enormous (if unintentional) boost by barring corporations from expensing executive compensation in excess of $1 million per year that was not tied to firm performance.[132]

For the rewards strategy to operate effectively, compensation must be appropriately calibrated. The U.S. has long relied on disclosure to avoid excessive or incentive-distorting compensation. Nevertheless, objections of miscalibration have repeatedly been voiced, with some cause.[133] As hinted in previous sections, the Dodd-Frank Act of 2010 sought to strengthen the efficacy of the trusteeship strategy's control over reward calibration, by requiring that compensation committees be composed entirely of independent directors.[134] At the same time, it mandated the introduction of shareholder decision rights in relation to executive compensation, by providing for an advisory 'say on pay' vote.[135]

Our other core jurisdictions have relied less heavily on the rewards strategy. Thus, there is less linkage between executive pay and corporate performance outside the U.S., even in jurisdictions where ownership is similarly dispersed such as Japan and the UK. In the UK, shareholder decision rights have traditionally been stronger, meaning that there has been

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[128] See *supra* text preceding note 21.

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

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

[131] Internal Revenue Code § 162(m).

[132] See John C. Coffee, *A Theory of Corporate Scandals: Why the USA and Europe Differ*, 21 OXFORD REVIEW OF ECONOMIC POLICY 198, at 202 (2005).

[133] See chapter 6 and especially 6.2.2.1.

[134] Dodd-Frank Act of 2010, § 952. The SOX had previously introduced modest controls on executive compensation: see §§ 304 (mandating disgorgement of CEO/CFO incentive compensation received following a financial misstatement); 402 (banning corporate loans to senior executives to use for exercising options).

[135] Dodd-Frank Act of 2010, § 951.

less need for the reward strategy.[136] In Japan, while recent policy discussions suggest increased favor for the reward strategy, the emphasis has traditionally been on creating a sense of unity between management and employees, which clearly makes the reward strategy an unlikely fit.[137] And in other jurisdictions, the common presence of a controlling shareholder is associated with significantly lower CEO compensation, [138] presumably because the controlling shareholder can rely on his own decision rights both to ensure good performance from managers and to curb excessive pay.

These differences in the use of the rewards strategy also track differences in the legal framework as regards the discretion of the board (as opposed to shareholders) to set pay. This is nicely illustrated by comparing the roughly contemporaneous Delaware civil litigation against Michael Eisner (Disney, Inc.'s former CEO) and other Disney directors over a termination payment that awarded $140 million to Disney's President[139] with the criminal prosecution of Josef Ackermann, at the time Deutsche Bank's CEO and a Mannesmann AG director, and two other members of Mannesmann supervisory board, for paying Mannesmann's CEO and members of his executive team 'appreciation awards' (of approximately $20 million in the case of the CEO) for having extracted an extraordinarily high premium from a hostile acquirer (Vodafone) after a drawn-out takeover battle.[140]

The two cases differed importantly on their facts. In *Disney*, the amount in issue was contractually fixed ex ante, and the dispute turned on whether Disney's directors had been so grossly negligent as to have acted in bad faith, either in negotiating the original contract or in not contesting a 'no fault termination clause' that triggered the $140 million payment to Disney's ex-President. In *Mannesmann*, the payments at issue were gratuitous (*ex post* bonuses granted by Ackermann and one other member of the compensation committee), but made with the full approval of Vodafone—which, by the time of the payout, held 98.66 per cent of Mannesmann's shares.

Despite these factual differences, the differing outcomes of the two cases are revealing. The Delaware court deployed the business judgment rule to exonerate Eisner and the Disney board from civil liability despite evidence of negligence and an odor of conflict of interest (the discharged President had been a close personal friend of the CEO). By contrast, the German Supreme Court (BGH), ruled that Ackermann might be criminally liable for breach of

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[136] See Martin J. Conyon and Kevin J. Murphy, *The Prince and the Pauper? CEO Pay in the United States and United Kingdom*, 110 ECONOMIC JOURNAL 467 (2002). The greater performance-sensitivity in the U.S. means executives there bear more firm-specific risk, which pushes upward the size of overall awards: Martin J. Conyon, John E. Core and Wayne R. Guay, *Are U.S. CEOs Paid More than U.K. CEOs? Inferences from Risk-Adjusted Pay*, 24 REVIEW OF FINANCIAL STUDIES 402 (2011).

[137] See Robert J. Jackson, Jr. and Curtis J. Milhaupt, *Corporate Governance and Executive Compensation: Evidence from Japan*, 2014 COLUMBIA BUSINESS LAW JOURNAL 111.

[138] See Martin J. Conyon et al., *The Executive Compensation Controversy: A Transatlantic Analysis* 55, Working Paper (2011); Marcos Barbosa Pinto and Ricardo Pereira Câmara Leal, *Ownership Concentration, Top Management and Board Compensation*, 17 REVISTA DE ADMINISTRAÇÃO CONTEMPORÂNEA 304 (2013) (finding a negative correlation between the levels of ownership concentration and executive compensation in Brazil).

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

[140] See e.g. Curtis J. Milhaupt and Katharina Pistor, LAW AND CAPITALISM 69–86 (2008).

trust in the form of dissipating corporate assets.[141] From the perspective of Delaware law, it is nearly inconceivable that a disinterested director (Ackermann) would face civil liability for approving a gratuitous bonus ratified by a 98 per cent disinterested shareholder, let alone a criminal penalty.[142] Delaware has long permitted disinterested boards to reward departing executives with compensation in excess of their contractual entitlements.[143] For the BGH, criminal liability followed as a matter of course from the penal code, the fact that Mannesmann's independent existence was ending, and the absence of a pre-negotiated golden parachute.[144]

While the U.S. has traditionally constrained managerial pay less than elsewhere, signs of convergence are emerging. As we have noted, the U.S. has now introduced limited shareholder ratification of executive compensation, in the form of 'say on pay'. At the same time, the mandatory disclosure of individual directors' pay and global competition for executives have driven overall compensation upwards even in Germany, where the pattern of reliance on rewards has been even more pronounced in the financial industry and in sectors most exposed to international competition.[145]

3.4 Legal Constraints and Affiliation Rights

Legal constraints and affiliation rights play an important role in the structure of corporate governance by protecting the interests of shareholders as a class. All managerial and board decisions are constrained by general fiduciary norms, such as the duties of loyalty and care. Moreover, affiliation rights in the form of mandatory disclosure inform both shareholders and boards of directors by providing a metric for evaluating managerial performance in the form of well-informed share prices.[146] And, of course, the right to exit by freely

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[141] BGH, Decision of 21 December 2005, 3 StR 470/04. Unlike the lower court, the BGH relied on criminal law alone (§ 266 Strafgesetzbuch (Criminal Code)), and did not pin its holding to § 87 AktG, which requires managerial compensation to be reasonable.

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

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

[144] The Mannesmann decision is thought to be wrong by a clear majority of German commentators. The Mannesmann court remanded the case to the lower instance that was courageous enough to drop the criminal case. The main consequence of the Mannesmann case was that many corporations introduced a clause in the directors' contracts allowing such rewards. See also *infra* 8.2.3.5.

[145] Francesca Fabbri and Dalia Marin, *What Explains the Rise in CEO Pay in Germany? A Panel Data Analysis for 1977-2009*, IZA Discussion Paper No 6420 (2012). See also Alex Barker, *Germany Overtakes UK in Corporate Executive Pay Stakes*, FINANCIAL TIMES, 5 January 2015. On the recent legal reform of managerial compensation in Germany see *infra* 6.2.2.1.

[146] See Gordon, *supra* note 122. See also *infra* 9.1.1.

selling shares underpins the market for corporate control, an essential component of governance in dispersed ownership firms that we discuss in Chapter 8. By contrast, exit rights by means of withdrawal of one's investment in the firm are made available less frequently in general corporate governance. Corporate law makes use of them only in special circumstances, detailed in later chapters: for example, as a remedy for minority shareholder abuse (chapter 6) or as a check on certain fundamental transactions such as mergers (chapter 7).

3.4.1 The constraints strategy

Both hard-edged rules and fiduciary standards would seem to be of little use, if not counterproductive, to protect the interests of shareholders. After all, shareholders who can appoint and remove managers should have no need to hobble managerial discretion with legal constraints—except, perhaps, in the context of related party transactions, which we address in Chapter 6. Yet, all of our core jurisdictions impose a very broad duty on corporate directors and officers to take reasonable care in the exercise of their offices—the duty of care. This duty is a non-trivial component of the wider corporate governance system: in some jurisdictions there is a real risk of being held liable for its breach; in jurisdictions where this is not the case, compliance with other sets of legal obligations, such as disclosure requirements, will implicitly force directors to exercise due care in a number of situations, lest their disclosures prove wanting.[147]

It is tempting to view violations of the director's or officer's duty of care as a kind of corporate 'malpractice', analogous to malpractice committed by other professionals such as doctors. But the analogy is weak because defining 'reasonable care' is far more difficult for directors than for doctors: business decisions are even more idiosyncratic than medical decisions.[148] This is why courts in all jurisdictions display at least some deference to corporate directors' decisionmaking.

At the very least, most of them will refrain from second-guessing business decisions on their merits.[149] Yet courts will usually review the process by which a given decision has been made, inquiring whether directors were sufficiently informed and took reasonable steps, such as obtaining appropriate advice, to reach their decision. This is the case in continental Europe, where some jurisdictions explicitly articulate a duty to

[147] See Robert B. Thompson and Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VANDERBILT LAW REVIEW 859 (2003).

[148] See e.g. Holger Spamann, Monetary Liability for Breach of the Duty of Care? 18–19, Harvard Law School John M. Olin Center Discussion Paper No. 835 (2015) (available at ssrn.com); see also *Re Barings plc (No 5)* [2000]1 BUTTERWORTHS COMPANY LAW REPORTS 523 at 536 (rejecting analogy with medical malpractice and declining admissibility of expert evidence).

[149] Even in Japan, where this is not the case, courts will only review decisions based on whether they are 'extremely unreasonable': Supreme Court of Japan, July 15, 2010, 2091 HANREI JIHO 90. For details of this case, see Dan W. Puchniak and Masafumi Nakahigashi, *Comment*, in *Business Law in Japan – Cases and Comments* (Moritz Bälz et al. eds., 2012).

make well-informed decisions.[150] For example, under the German law on public corporations, management board members shall not be deemed to have violated their duty of care if they prove that, at the time of taking a business decision, they had 'good reason to assume that they were acting on the basis of adequate information for the benefit of the company,' a provision that goes under the name of 'business judgment rule' in that jurisdiction but the exculpatory reach of which the case law has restricted.[151] A post-crisis surge in liability suits (and criminal prosecutions) against directors, especially at banks, is testing the wisdom of granting courts such wide-ranging discretion in reviewing business decisions.[152]

Unsurprisingly, the jurisdiction that is traditionally most open to private enforcement of corporate law via shareholder litigation, the U.S., is also the one that has gone furthest in insulating managers from legal challenges of business decisions taken in good faith (that is, in the honest belief that they would benefit the company's business). Combined with ancillary institutions such as the (ubiquitously exercised) power to introduce charter provisions waiving directors' liability for good faith breaches of duty [153] and comprehensive D&O insurance, the U.S. business judgment rule significantly reduces the likelihood of a director ever having to make a payment in relation to a duty of care suit.[154]

By contrast, other jurisdictions, including the UK, do proclaim an objective negligence standard for directors' duty of care, without a business judgment rule or any power to modify the duty by amendment of the company's articles of association.[155] However, these have been combined with procedural obstacles to enforcement such that, outside bankruptcy, directors are rarely sued.[156]

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[150] Art. 2381 Civil Code (Italy); § 93 AktG (Germany). For a comparative discussion of the scope and contours of the business judgment rule in Brazil, see Mariana Pargendler, *Responsabilidade Civil dos Administradores e Business Judgment Rule no Direito Brasileiro*, 953 REVISTA DOS TRIBUNAIS 51 (2015).

[151] § 93 AktG (Germany). See Klaus J. Hopt and Markus Roth, *Sorgfaltspflicht und Verantwortlichkeit der Vorstandsmitglieder,* in AKTIENGESETZ, GROSSKOMMENTAR (Heribert Hirte et al. eds., 5th ed. 2015), § 93 comments 61-131; Klaus J. Hopt, *Die Verantwortlichkeit von Vorstand und Aufsichtsrat,* ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT 2013, 1793.

[152] Klaus J. Hopt, *Responsibility of Banks and Their Directors, Including Liability and Enforcement*, in FUNCTIONAL OR DYSFUNCTIONAL – THE LAW AS A CURE?, 159 (Lars Gorton, Jan Kleineman and Hans Wibom eds., 2014).

[153] DGCL § 102(b)(7).

[154] See Bernard Black, Brian Cheffins and Michael Klausner, *Outside Director Liability*, 58 STANFORD LAW REVIEW 1055 (2006).

[155] UK Companies Act 2006 ss 174, 232. Art. 2381 and 2392, Civil Code (Italy). For France, see Bruno Dondero, *Chronique de jurisprudence de droit des sociétés*, GAZETTE DU PALAIS, 12 May 2015, No. 132, 19.

[156] Practically no shareholder lawsuits are launched against directors of UK publicly-traded companies (John Armour, Bernard Black, Brian Cheffins and Richard Nolan, *Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States*, 6 JOURNAL OF EMPIRICAL LEGAL STUDIES 687 (2009)). This likely reflects both procedural obstacles to litigation and the usefulness of shareholders' governance rights. In any event, UK courts have discretion to grant relief for breach of duty where directors acted 'honestly and reasonably' (UK Companies Act 2006 s 1157). The UK reformed its law relating to derivative actions in 2008, making it easier for shareholders to challenge duty of care

The law's deference to corporate decision-making has two main justifications. The first, already hinted at, is that judges are poorly equipped to evaluate highly contextual business decisions. In particular, absent clear standards, hindsight bias can make even the most reasonable managerial decision seem reckless *ex post*. The second is that, given hazy standards and hindsight bias, the risk of legal error associated with aggressively enforcing the duty of care might lead corporate decision-makers to prefer safe projects with lower returns over risky projects with higher expected returns.[157] Ultimately, shareholders may stand to lose more from such 'defensive management' than they stand to gain from deterring occasional negligence.[158]

The general duty of care applies—as far as it goes—to all functions of the board. As the monitoring role of the board has grown, a natural step has been to develop the duty of care as regards oversight, which plays into corporate governance and serves in part to protect shareholder interests. For example, case law in Delaware and the UK holds that the duty of care extends to creating 'information and reporting systems' that can allow the board to assess corporate compliance with applicable laws.[159] Similarly, in the EU and Japan the law tasks supervisory boards, audit committees, and statutory auditors with ensuring that publicly traded companies have adequate auditing checks and risk management controls in place.[160] And SOX Section

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violations. If this ever results in high levels of litigation, it is to be expected that there will be pressure to dilute the standard of care.

[157] See, e.g., *Gagliardi v. Trifoods International, Inc.* 683 ATLANTIC REPORTER 2d 1049 at 1052-3 (Del. Ch. 1996).

[158] In the U.S., the rare cases in which courts hold directors personally liable for gross negligence in decision-making tend to involve unusual circumstances, such as a merger or sale of the entire company or the onset of insolvency. See *infra* 5.3.1.1. Moreover, even in these cases, the courts often hint at something more than negligence—bad faith or a conflict of interest that is difficult to prove—as the real basis for liability. The famous Delaware example is *Smith v. Van Gorkom*, 488 ATLANTIC REPORTER 2d 858 (Del. 1985), in which the Delaware Supreme Court clearly believed that a retiring CEO had a strong personal interest in selling his company, which added an element of disloyalty to the arguably negligent process followed by the board in consummating the sale.

[159] See *In re Caremark Int'l Inc. Derivative Litigation*, 698 ATLANTIC REPORTER 2d. 959 (Del. Ch. 1996), reaffirmed by the Del. Supreme Court in *In re Citigroup Inc. S'holder Derivative Litig.*, 964 ATLANTIC REPORTER 2d 106 (Del. Ch. 2009). Breach of this duty entails that the corporation had in place no information and reporting system whatsoever or that directors *knew* of its inadequacy. German law is less deferential. See LG München, decision of 10 December 2013 (5 HKO 1387/10 – *Neubürger*), ZIP 2014, 570 (management board member held liable for having failed to implement a comprehensive compliance system to detect unlawful activities). The UK adopts a straightforward negligence standard: see *Re Barings plc (No.5)*, *supra* note 148, especially at 486–9, and Companies Act 2006 s 174.

[160] See FSA Disclosure Rules and Transparency Rules DTR 7.1 (UK); § 91(2) AktG (Germany); Art. L. 225–235 Code de Commerce (France); Art. 149 Consolidated Act on Financial intermediation (Italy). For Japan, see Arts. 362(4)(iv), 390(2), 399-2(3), 399-13(1), 404(2) and 416(1) of the Companies Act, and Arts. 24–4–4(1) and 193–2(2) of the Financial Instruments and Exchange Act. The EU directive on statutory audits (Directive 2006/43/EC, 2006 O.J. (L 157) 87) requires companies to have an audit committee (comprised of directors or established as a separate body under national law) that shall, *inter alia*, 'monitor the effectiveness of the [company's] internal quality control and risk management systems and, where applicable, its internal audit, regarding the financial reporting of the audited entity'. Art. 39(6)(c).

404, a milder version of which was adopted in the EU, requires CEOs and CFOs of U.S. firms to report on the effectiveness of their firms' internal financial control.[161] Such provisions are mainly enforced by outside auditor attestation.[162]

3.4.2 Corporate governance-related disclosure

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

All our core jurisdictions mandate extensive public disclosure as a condition for allowing companies into the public markets. That is the focus of Chapter 9. There is considerable convergence in disclosure obligations, including on aspects of continuing disclosure that are governance-related. For example, all of our core jurisdictions require firms to disclose their ownership structure (significant shareholdings and voting agreements), executive compensation, and the details of board composition and functioning.[163]

It is quite plausible that such extensive disclosure obligations make both a direct contribution to the quality of corporate governance, by informing shareholders, and an indirect contribution, by enlisting market prices in evaluating the performance of corporate insiders.[164] In particular, by making stock prices more informative, mandatory disclosure makes hostile takeovers less risky. Arguably the comprehensive nature of U.S. proxy statements, and the large potential liability that attaches to misrepresentations, builds on this assumption.

Even continental European jurisdictions, which have no such strong tradition of mandatory disclosures, attach serious consequences to a company's withholding of material information bearing on a shareholder vote. Shareholder litigation aimed at voiding shareholder resolutions taken on the basis of incomplete or misleading disclosure is particularly common in

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[161] SOX § 404. See Art. 24–4–4 Financial Instruments and Exchange Act (Japan). In the EU, the directive on company reporting (Art. 20(1)(c) Directive 2013/34/EU, 2013 O.J. (L 182) 19) requires listed companies to include in their annual corporate governance statement 'a description of the main features of the [their] internal control and risk management systems in relation to the financial reporting process'.

[162] SOX § 404(b). Art. 193–2(2) Financial Instruments and Exchange Act (Japan). In the EU the external auditor has to report to the audit committee 'on any significant deficiencies in the audited entity's […] internal financial control system, and/or in the accounting system'. Art. 11(2)(j) Regulation (EU) 537/2014, 2014 O.J. (L 158) 77.

[163] For ownership and compensation disclosure requirements, see *infra* 6.2.1.1.U.S. Regulation S-K, 17 C.F.R. Part 229 Item 601(b)(3)(i)-(ii), requires filing the corporate charter and bylaws in financial reports. In addition, any voting trust agreement and corporate code of ethics must be filed in Form 10Q. See Item 601(b) Exhibit Table. Disclosure of voting agreements is also required by the EC Takeover Bids Directive (Art. 10 Directive 2004/25/EC, 2004 O.J. (L 142) 12). For board structure, see European Commission, Recommendation 2014/208/EU on the Quality of Corporate Governance Reporting, 2014 O.J. (L 109) 43.

[164] See generally John Armour, *Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment*, in RATIONALITY IN COMPANY LAW 71, at 102-4 (John Armour and Jennifer Payne eds., 2009); Gordon, *supra* note 122.

Germany, where courts take such matters very seriously, both in publicly traded and privately-held companies.[165]

3.5 Explaining Jurisdictional Variation

A review of major jurisdictions reveals that they often use the same strategies to shape corporate governance in fundamentally similar ways. For example, all our sample jurisdictions mandate that shareholders elect directors (or a voting majority of them) and all require a shareholder majority to approve fundamental changes, such as mergers and charter amendments. As highlighted in section 3.3.1, each of our jurisdictions has adopted the trusteeship strategy as part of the now-global norms of good corporate governance. Alongside universal reliance on independent directors, all major jurisdictions also rely on mandatory disclosure to enlist the market as a monitor of the performance of public companies and aid disaggregated shareholders in exercising their appointment, decision, and exit rights.

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

If we were to array our seven core jurisdictions on a spectrum from the most to the least empowering for shareholders vis-à-vis managers in publicly traded companies, we would most likely put Brazil and the UK at one extreme. However, while both these countries lean heavily toward shareholder power, the similarities end there.

In the UK, the corporate governance environment fully accords with the shareholder-friendly legal framework: despite the fact that shareholdings are diffuse, UK governance is heavily influenced by institutional shareholders, who are well equipped to represent the interests of shareholders as a class.[166]

Brazil has much more in common with continental European countries such as Italy and France than with the UK. As in those countries, dominant shareholders, or stable coalitions of blockholders, are prevalent in Brazilian companies.[167] This ownership structure largely neutralizes the management-shareholder agency conflict. Large blockholders, like traditional business principals, hire and fire as they wish; they do not need, and probably do not want, anything more than appointment, removal, and decision rights to protect their interests. It seems natural, then, that jurisdictions dominated by large-block shareholders should have company laws that empower shareholders as a class. This is exactly what the law does in France, Italy, and especially Brazil. Each accords shareholders significant rights, such as the non-

[165] See e.g.Ulrick Noack and Dirk Zetzsche, *Corporate Governance Reform in Germany: The Second Decade*, 15 EUROPEAN BUSINESS LAW REVIEW 1033, 1044 (2005).

[166] See *supra* text accompanying note 80.

[167] See, e.g., Julian Franks, Colin Mayer, Paolo Volpin and Hannes F. Wagner, *The Life Cycle of Family Ownership: International Evidence*, 25 REVIEW OF FINANCIAL STUDIES 1675 (2012) (controlled ownership structures appear stable over time in our core jurisdictions).

waivable minority rights to initiate a shareholders' meeting, to initiate a resolution to amend the corporate charter, to place board nominees on the agenda of shareholders' meeting, and the right to remove directors without cause by majority vote. Each of these powers, which correspondingly constrain managerial discretion, require a shareholders' meeting resolution, the outcome of which dominant shareholders will be able to determine. As a byproduct, governance at the few listed companies in those countries with no dominant shareholder will also be heavily tilted in the direction of shareholder power. That, in turn, helps make such companies a rarity, because strong shareholder power makes dispersed ownership companies more prone to hostile takeovers.

The second way in which the governance landscape shifts shifts in continental Europe and in Brazil is that, to a greater degree than in the U.S. or UK, corporate governance is a three-party game that revolves around more than the interests of shareholders and managers. In Italy, France, and Brazil, the third party is the state, which is simultaneously an intrusive regulator, a major shareholder,[168] and a defender of 'national champions', in which it may or may not hold an equity stake.[169] In France there is a well-travelled career track between elite state bureaucracies and the corporate headquarters of France's largest companies.[170] In Brazil, not only is the state the controlling shareholder in numerous listed firms, but the main institutional investors in the country—the pension funds of state-owned enterprises and the development bank—are themselves under government control.[171]

The role of the state in corporate governance reinforces both shareholder-friendly governance law and concentrated ownership in these jurisdictions—though strengthening the power of the state as a controlling shareholder does not necessarily serve the interests of minority shareholders.[172] On the one hand, the politicians and civil servants who

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[168] See Mariana Pargendler, *State Ownership and Corporate Governance*, 80 FORDHAM LAW REVIEW 2917 (2012). For instance, as of May 2016, the Italian Government controlled Italian companies representing almost 30 per cent of the total capitalization of the blue chips index (S&P Mib) (source: authors' elaboration, based on Consob data).

[169] A good example is the French state's failed attempt to prevent General Electric from taking over Alstom's electricity generation business. In 2014, the French government opposed such proposed acquisition, mainly out of concern for its effects on Alstom's rail transport activities and on employment. For that purpose, it issued a decree granting itself a veto over takeovers of companies in the energy supply, water, transport, telecommunications and public health sectors (Decree No. 2014-479 of 14 May 2014). The French government also encouraged Siemens to make a rival bid. In the end, however, GE secured the deal after making a number of commitments with the French government regarding the exercise of voting rights and director positions. See David Jolly and Jack Ewing, *G.E.'s Bid for Alstom Is Blessed by France*, NEW YORK TIMES, 21 June 2014, at B1). In Brazil, the development bank has made generous debt and minority equity investments to support the creation of national champions.

[170] See, e.g., William Lazonick, CORPORATE GOVERNANCE, INNOVATIVE ENTERPRISE AND ECONOMIC DEVELOPMENT, 49–56 (2006) (describing the elite education and civil service experience of typical French CEOs).

[171] See, e.g., Mariana Pargendler, *Governing State Capitalism: The Case of Brazil*, *in* REGULATING THE VISIBLE HAND? THE INSTITUTIONAL IMPLICATIONS OF CHINESE STATE CAPITALISM 377, 385-8 (Benjamin Liebman and Curtis J. Milhaupt eds., 2015).

[172] See Pargendler, *supra* note 168.

control the state shareholdings in these jurisdictions have a natural incentive to favor strong shareholder rights, both because they represent the state as a shareholder and because they can discreetly act through other large-block shareholders to ensure that corporate policies reflect the state's priorities. On the other hand, well-connected blockholders can be an economic asset for firms in a politicized environment, to the extent that these 'owners' have more legitimacy and resources to protect their companies from political intervention than mere managers backed by dispersed shareholders could muster.[173] Thus, an interventionist state, concentrated ownership, and shareholder-friendly law may be mutually reinforcing, especially when the state holds large blocks of stock in its own right.[174]

Germany's corporate law is similar to other continental European ones in terms of shareholder powers, but with two important qualifications. First, board members' insulation from shareholder pressures is greater, thanks to lengthier terms of office and less shareholder-friendly removal rules. Second, the codetermination statute mandates labor directors on the board with interests that tend to be opposed to those of the shareholder class. As an outcome, German law for companies without a dominant shareholder appears to be more manager-oriented than in other countries with a prevalence of concentrated ownership.[175]

In contrast to Italy, France and Brazil, the third actor in German corporate governance is not the state but labor. As discussed further in Chapter 4, German law provides for quasi-parity codetermination**,** in which employees and union representatives fill half of the seats on the supervisory boards of large firms.[176] Of course, labor directors, like shareholder directors, have a fiduciary obligation to further the interests of 'the company' rather than those of their own constituency. Nevertheless, labor's interests have significantly less in common with those of large-block German shareholders than the state's interests might have with those of blockholders in France and Italy, especially at a time when their governments are experiencing public budgets constraints, which make their financial interest qua shareholders more salient. In addition, state intervention in corporate governance is likely to be sporadic, while labor directors continuously monitor German firms. We suspect (and we are not the first to do so[177]) that the net effect of Germany's closely-divided supervisory board is to enhance the power of top managers—that is, of the management board—relative to that of shareholders (or even

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[173] This observation tracks Mark Roe's similar point that strong labor favors strong capital, in the form of controlling shareholders. See Mark J. Roe, *Legal Origin, Politics, and the Modern Stock Market*, 120 HARVARD LAW REVIEW 460 (2006).

[174] See generally, Pargendler, *supra* note 171; Ben Ross Schneider, HIERARCHICAL CAPITALISM IN LATIN AMERICA (2013); Aldo Musacchio and Sergio G. Lazzarini, LEVIATHAN IN BUSINESS: VARIETIES OF STATE CAPITALISM AND THEIR IMPLICATIONS FOR ECONOMIC PERFORMANCE (2014).

[175] Perhaps relatedly, the ownership structure of the largest German companies is now much more similar to that in the U.S. and the UK than has for long been the case. See Ringe, *supra* note 76, 507–09.

[176] See *infra* 4.2.1.

[177] See Katharina Pistor, *Codetermination: A Sociopolitical Model with Governance Externalities* in EMPLOYEES AND CORPORATE GOVERNANCE 171 (Margaret M. Blair and Mark J. Roe eds., 1999).

labor). Put differently, the average large German company is likely to be more managerialist than a similar firm in a large blockholder jurisdiction such as Italy or France.[178]

U.S. corporate law is harder to encapsulate. While Delaware law has traditionally been viewed as board-centric, the shift toward shareholder empowerment that has taken place in the last couple of decades[179] has occurred with very little change in state law and only in part due to federal law reforms. In other words, changes in the relative power of shareholders and managers following the reconcentration of shares in institutional investors' hands led to changes in corporate governance practices that flexible existing laws could accommodate and corporate law reforms have mainly followed. As an outcome, the U.S. is nowadays much less of a poster child for managerialist corporate law than in the past.

Finally, Japanese corporate law also has a plausible claim to shareholder-friendly law on the basis of its short director terms and easy removal rights. But in Japan the gap in spirit between a shareholder-friendly corporate law and the reality of Japanese corporate governance appears to be larger than in any other core jurisdiction. Japan is a dispersed-shareholder jurisdiction, like the U.S. and UK,[180] but its shareholders are weak, and its managers are strong, even compared to the U.S. Moreover, although there are hints of change in response to recent reforms, Japanese boards remain overwhelmingly dominated by inside directors. So how can Japanese governance practice entrench managers while its corporate law empowers shareholders? A number of factors help explain this puzzle, including the dispersion of Japanese shareholdings since World War II, a statutory law derived from early—and shareholder-friendly—German law, the role of the state in mobilizing Japanese recovery after the war, a strong reliance on debt rather than equity financing, and the continuous increase in Japanese share prices for four decades after the war.[181]

But there is another partial answer that seems especially salient today. Japan has a tradition of stable friendly shareholdings among operating firms (*kabushiki mochiai* or cross-shareholdings) that cement business relationships

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[178] It can hardly be otherwise if Germany's two-tier board structure functions in part to insulate companies' business decisions from dissension on their supervisory boards by assigning these decisions to their management boards. A revealing indication of the power of the management board is that often in widely held companies the management board itself, rather than the supervisory board, informally nominates the company's shareholder nominees to the supervisory board. See *supra* note 11.

[179] See e.g. Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 UNIVERSITY OF PENNSYLVANIA LAW REVIEW 1907, 1917–26 (2013).

[180] One recent study finds that listed companies in the UK and Japan have the most dispersed ownership structures in the world, while the U.S. trails some distance behind. See Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 REVIEW OF FINANCIAL STUDIES 1377 (2009).

[181] See Masahiko Aoki, *Toward an Economic Model of the Japanese Firm*, 28 JOURNAL OF ECONOMIC LITERATURE 1 (1990); Ronald J. Gilson and Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 YALE LAW JOURNAL 871 (1993); Steven Kaplan, *Top Executive Rewards and Firm Performance: A Comparison of Japan and the U.S.*, 102 JOURNAL OF POLITICAL ECONOMY 510 (1994).

and insulate top managers from challenge. These business-to-business holdings are numerous but generally not large, and they are frequently not even reciprocal. But the important point is that they are stable and management-friendly. [182] In prior decades these 'captive' shareholders accounted for a much higher percentage of the outstanding shares of Japanese listed companies than they do today, when they represent around one-third of outstanding shares—only slightly more than the share percentage held by foreign investors in Japanese firms.[183] While U.S.-style hedge fund activism against Japanese companies in the 2000s has been largely unsuccessful, mostly because of cross-shareholdings, [184] this change in shareholder identity, as well as the stagnant economy since the 1990s, has made large listed companies and the Japanese government more sensitive to investors' demands. [185] At the same time, once cross-shareholdings are unwound, the legislator may deem existing Japanese law corporate law too shareholder-friendly and make it less so.

A final puzzle that we have encountered in this chapter is why a single model of best practices (independent directors and a tripartite committee structure) increasingly dominates governance reform in all core jurisdictions when the agency problem that gave rise to this model—managerial opportunism vis-à-vis the shareholder class—is paramount only in diffuse shareholding jurisdictions such as the U.S. and UK.

The obvious question with respect to best practices is: why should one size fit all, given the dramatic differences in ownership structure across our target jurisdictions? One plausible explanation is the wide-spectrum prophylactic hypothesis: [186] the *same* global good governance recipe of independent directors and independent committees somehow responds effectively to the various agency problems: not only the problem of managerial opportunism, but also the conflict between majority shareholders on one hand, and minority shareholders or non-shareholder constituencies on the other. We explore this issue in Chapter 4. In essence, this must imply that the formula means different things in different contexts. For example, adding independent directors may empower Japanese shareholders and reinforce

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[182] See Julian Franks, Colin Mayer and Hideaki Miyajima, *The Ownership of Japanese Corporations in the 20th Century*, 27 REVIEW OF FINANCIAL STUDIES 2580 (2014). We take no position on the continuing debate about the importance of the *Keiretsu*, or networks of companies bound by cross shareholding and relations with a 'main bank'. Compare Curtis Milhaupt and Mark D. West, ECONOMIC ORGANIZATIONS AND CORPORATE GOVERNANCE IN JAPAN: THE IMPACT OF FORMAL AND INFORMAL RULES (2004) with J. Mark Ramseyer and Yoshiro Miwa, THE FABLE OF THE KEIRETSU, URBAN LEGENDS OF THE JAPANESE ECONOMY, Ch. 2 (2006).

[183] As of 1986, manager-friendly business companies, banks, and insurance companies together held more than 60 per cent of market capitalization. This ratio fell to slightly more than 30 per cent in 2012. On the other hand, holdings by foreign investors rose from 5 per cent in 1986 to 28 per cent in 2012. Note, however, that this unwinding of cross-shareholding relationships is taking place mostly in large public companies and less in small and medium-sized listed ones. See Goto, *supra* note 23, at 144-146.

[184] See Goto, *supra* note 23, at 140-144. Whether U.S.-style hedge fund activists will come back to Japan making the most of its shareholder-friendly law remains to be seen.

[185] An example of such attitude by the government is the adoption of the Stewardship Code and the Corporate Governance Code. See, *supra* notes 90 and 115.

[186] See section 3.3.1.

shareholder dominance in the UK, while it traditionally served to justify allocating power to the board rather than shareholders in the U.S. The question, then, is whether convergence on the substance of best governance practices is true functional convergence or mere stylistic convergence that hides persistent differences in the actual structure of corporate governance across jurisdictions.[187]

However, a second plausible explanation is that international best practices are largely ornamental in blockholder jurisdictions, since dominant shareholder coalitions retain the power to hire and fire the entire board, including its nominally independent directors. On this account, controlling blockholders may not lose much in terms of real power, while their controlled corporations will display all the features that institutional investors expect. More puzzling perhaps is why investors should accord any significance to such compliance. Here we simply note that the coordination costs investors face in the domestic environment are multiplied many times over when they invest overseas. Even activist investors, whom we saw earlier to be the most willing to invest in gathering firm-specific governance information, do significantly worse in their cross-border interventions than in their domestic engagements.[188]

[187] Formal convergence that obscures substantive divergence in corporate law is the natural converse of formal divergence that obscures functional convergence. See Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AMERICAN JOURNAL OF COMPARATIVE LAW 329 (2001).

[188] Becht et al, *supra* note 18.

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