1999

Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference

William Wilson Bratton

Joseph K. McCahery

Articles

Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference

WILLIAM W. BRATTON*
AND
JOSEPH A. MCCAHERY**

Professors Bratton and McCahery take up the main questions addressed by the literature on comparative corporate governance: whether national governance systems can be expected to converge in the near future, and whether the focal point of that convergence will be a new, hybrid governance system comprised of the best practices drawn from different systems. This Article advances the view that neither global convergence that eliminates systemic differences nor the emergence of a hybrid best practice safely can be projected because each national governance system is a system to a significant extent. Each system, rather than consisting of a loose collection of separable components, is tied together by a complex incentive structure. Interdependencies between each system's components and the incentives of its actors create significant barriers to cross reference to and from other systems. The cross reference hypothesis, in contrast, presupposes divisible corporate governance institutions—a world in which one system's

* Samuel Tyler Research Professor of Law, The George Washington University Law School. Our thanks to Richard Buxbaum, John C. Coffee, Jr., Abe de Jong, James Fanto, Gregory Mark, Larry Mitchell, Theo Raaijmakers, and Luc Renneboog for reading and commenting on earlier drafts of this Article.

** Associate Professor of Law, Katholieke Universiteit Brabant.

components can be adapted for use in the other system without significant frictions or perverse effects.

This Article draws on models of monitoring and blockholding articulated in the incomplete contracts theory of the firm. Under incomplete contracts theory, different governance systems have incentive structures that entail different trade-offs—trade-offs between ownership concentration and liquidity, between monitoring and management initiative, and between private rent-seeking and activity benefiting shareholders as a group. The trade-offs delimit opportunities for productive cross reference. More particularly, blockholder systems, such as those in Europe, subsidize monitoring by permitting blockholders to reap private benefits through self dealing and insider trading. Market systems, such as those in the United States and Britain, regulate such private rent-seeking toward the end of maintaining an institutional framework that supports diffuse share ownership and liquid trading markets. It follows that a legal framework conducive to blockholding may be ill equipped to foster dispersed equity ownership and thick trading markets, and that a legal framework conducive to liquid trading markets may have properties that discourage blockholding. This gives rise to questions for law reform agendas on both sides of the Atlantic. In the United States, proponents ask for deregulation of controls on institutional investors, looking to encourage blockholding and more effective monitoring. In Europe, proponents ask for stronger securities regulation, looking to encourage deeper trading markets. This Article suggests that each reform program may lead to disappointing results because neither assures conforming adjustments to the pertinent actors' incentives. Alternatively, strict reforms that materially change prevailing incentive patterns could perversely destabilize workable (if imperfect) arrangements without assuring the appearance of more effective alternatives.

INTRODUCTION

In these globalizing times, corporate law's leading question is whether there is a national corporate governance system (or component thereof) that possesses relative competitive advantage. The question arises in the wake of increased competition in international product markets. Such competition is intense enough to make it plausible to project that the different systems pursuant to which firms are managed and capitalized will become factors at the margin of competitive survival. If only the fittest practices can survive in the global market, it also becomes plausible to project that national governance systems will converge upon them and systemic differences will disappear. Related questions about competitive advantage and convergence to best practice come up in domestic policy discussions in many countries. Concerns about local firms' performance in international markets turn attention to alternative governance practices identified in international comparisons: if competitive advantage lies elsewhere, then domestic practice should be reformed to follow the international leader.

An extensive body of studies addresses these questions, identifying and evaluating national variations in management and financial practices, industrial organization, and corporate and securities laws. Unfortunately, even as these descriptions have become thicker and more cogent, answers to the bottom-line questions respecting competitive advantage have become more elusive and convergence predictions have become more qualified. Working hypotheses have changed rapidly, more in response to external events than to developments in the discourse. American observers early in the 1990s looked to Japanese governance practices for guidance for the reform of their domestic market governance system, then viewed to be in the throes of a productivity crisis.[1] Now American observers comment on their system's robust ability to self-

1. *See* W. Carl Kester, *Governance, Contracting, and Investment Horizons: A Look at Japan and Germany*, *in* STUDIES IN INTERNATIONAL CORPORATE FINANCE AND GOVERNANCE SYSTEMS: A COMPARISON OF THE U.S., JAPAN, & EUROPE 227, 227–28, 239–41 (Donald H. Chew ed., 1997) [hereinafter INT'L GOVERNANCE]; Michael E. Porter, *Capital Choices: Changing the Way America Invests in Industry*, *in* INT'L GOVERNANCE, *supra*, at 5, 6–8.

correct in the wake of external shocks[2] and wait for signs of American-style reform in Japan.[3] The change in view corresponds to the comings and goings of national economic distress: the United States started the 1990s in a severe recession that tested the resilience of its corporate institutions; Japan has experienced an intensifying economic and institutional crisis as the decade has progressed.[4] Views about the likelihood of convergence also have changed. Although some observers still project convergence as an imminent possibility,[5] many now offer reasons why convergence should not be expected.[6]

Comparative governance has this tentative, reactive quality because no one has any direct, empirical answers to its basic questions. It follows that the principal assertions made in comparative discussions—claims respecting relative competitive advantage, the appropriate course of national level law reform, and the likelihood and shape of systemic convergence—cannot be falsified. They can be evaluated only indirectly, through appraisal of the theories of the firm and of competitive evolution that support them. Unsurprisingly, the comparative governance literature holds out alternative theoretical frameworks that support conflicting hypotheses.

The theoretical approach commanding the widest acceptance looks at present national regimes and sees suboptimal performance

---

2. *See generally*, Ronald J. Gilson, *Reflections in a Distant Mirror: Japanese Corporate Governance through American Eyes*, 1998 COLUM. BUS. L. REV. 203, 205 (1998) (noting that American firms have learned Japanese lean production methods and that both Japanese cross-holding arrangements and shop floor arrangements have come under pressure); Arnoud W.A. Boot & Jonathan R. Macey, *Objectivity, Control and Adaptability in Corporate Governance, in* COLUMBIA LAW SCHOOL, CORPORATE GOVERNANCE TODAY 223, 232–34 (1998) [hereinafter COLUM. CORP. GOV.] (discussing American adjustments in the 1990s).

3. *See, e.g.*, Gilson, *supra* note 2, at 206.

4. There is also striking evidence of American corporate success in the 1990s. In 1992 Japanese companies had a 17.5% share of world profits and U.S. companies had 25%. By the third quarter of 1998 the Japanese share was 7% and the U.S. share was 38%. *See Is the Stock Market Too High?*, BUS. WK., Jan. 25, 1999, at 126.

5. *See, e.g.*, W. Carl Kester, *American and Japanese Corporate Governance: Convergence to Best Practice?, in* NATIONAL DIVERSITY AND GLOBAL CAPITALISM 107, 123–24 (Suzanne Berger & Ronald Dore eds., 1996) [hereinafter Kester, *Convergence*]; Kester, *supra* note 1, at 241–42; Porter, *supra* note 1, at 16–17 (expressing fear that signs of German and Japanese convergence toward American governance will chill reform of American system).

6. *See* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 238–39, 280–81 (1994) which took the lead in articulating this position in the corporate governance literature. There is an independent body of theory that points in the same direction. *See infra* notes 103–25 and accompanying text.

caused by the operation of political forces over time. It thereby dismisses the possibility of evolutionary efficiency in its account of the *status quo*.[7] But it nevertheless holds out a brighter future of productive cross reference between the two prevailing types of national systems: (*a*) "Market" systems, found mainly in English-speaking countries and characterized by widely-dispersed shareholding and thick, liquid trading markets; and (*b*) "Blockholder" systems, found with many variations in Europe, East Asia and most other capitalist economies, and characterized by control in insider coalitions or wealthy families and thin trading of non-controlling stakes.[8] The assertion is that each system can and should learn from the other: the failures of market systems can be ameliorated with devices from blockholder systems and devices from market systems can ameliorate the failures of blockholder systems.[9] Restated as a convergence projection, this cross reference hypothesis implies that global competition will cause the emergence of a hybrid best practice. It also suggests that we should assume in the meantime that the market and blockholder systems possess equal competitive fitness.[10]

---

7. *See, e.g.*, Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641, 643–62 (1996) (describing path dependent evolutionary patterns in general and corporate governance in particular).

8. Systemic differences manifest themselves starkly in statistics on shareholder types, with institutions being more prominent in blockholder countries. Germany and the Netherlands (blockholder) and Britain and the United States (market) compare as follows:

Distribution of share ownership, 1993:

Ownership of shares(%)	Germany	NL	UK	US
-households	16.6	20.0	17.7	50.2
-non-financial enterprises	38.8	9.6	3.1	14.1
-banks	14.2	0.7	0.6	0.0
-investment funds	7.6	1.5	9.7	5.7
-pension funds	1.9	7.9	34.2	20.1
-insurance companies	5.2	5.5	17.2	4.6
-government	3.4	0.0	1.3	0.0
-foreign share	12.2	54.8	16.3	5.4
-share of largest shareholder				
>25%	85	--	13	
>50%	57	22	6	--
>75%	22	--	1	--

CPB NETHERLANDS, NETHERLANDS BUREAU FOR ECONOMIC POLICY ANALYSIS, CHALLENGING NEIGHBOURS: RETHINKING GERMAN AND DUTCH INSTITUTIONS 357 tbl.10.3 (1997)

9. *See infra* notes 85–89 and accompanying text.

10. *See infra* notes 52–56 and accompanying text.

The leading opposition hypothesis proceeds in the neoclassical microeconomic mode to assert that market systems reflect the operation of efficient evolutionary processes. Here product market competition remains the causal mainspring but has a more powerful effect, supporting an assertion that the systemic differences identified as material in the cross reference hypothesis are irrelevant. It follows that countries with market systems should avoid borrowing from blockholder systems and stick to internally-generated governance reform agendas. Convergence is a certainty from this perspective, but takes the particular form of world-wide hegemony for market institutions.[11]

This Article advances a case for a third hypothesis. Under this view, which follows from current microeconomic theories of the firm, we cannot safely project either global convergence that eliminates systemic differences or the emergence of a hybrid best practice. This is because each national governance system is a *system* to a significant extent. Each system, rather than consisting of a loose collection of separable components, is tied together by a complex incentive structure. Interdependencies between each system's components and the incentives of its actors create significant barriers to cross reference to and from other systems. The cross reference hypothesis, in contrast, presupposes divisible corporate governance institutions—a world in which one system's components can be adapted for use in the other system without significant frictions or perverse effects.

As it makes this case, the Article makes two important contributions to theoretical learning in the comparative governance field. First, it draws on legal theory, economic theory, and the pertinent empirical studies to highlight assumptions and analytical infrastructure heretofore obscured in legal literature on comparative governance. This results in a taxonomy of comparative governance's leading assertions. Encapsulated as "the corporate governance matrix," this framework imports transparency to this increasingly complicated subject matter, facilitating a more neutral appraisal of its conflicting positions. Second, the Article draws on models of monitoring and blockholding articulated within the incomplete contracts theory of the firm, a body of economics not yet significantly reflected in the comparative legal literature. Under incomplete contracts theory, different governance systems have incentive structures that entail different trade-offs—trade-offs between ownership concentration and liquidity, between monitoring and

11. *See infra* notes 92–103 and accompanying text.

management initiative, and between private rent-seeking and activity benefiting shareholders as a group. The trade-offs delimit opportunities for productive cross reference. More particularly, blockholder systems subsidize monitoring by permitting blockholders to reap private benefits through self dealing and insider trading. Market systems, in contrast, regulate such private rent-seeking toward the end of maintaining an institutional framework that supports diffuse share ownership and liquid trading markets. It follows that a legal framework conducive to blockholding may be ill equipped to foster dispersed equity ownership and thick trading markets, and that a legal framework conducive to liquid trading markets may have properties that discourage blockholding.[12]

The Article's analysis raises important questions for law reform agendas on both sides of the Atlantic. In the United States proponents ask for deregulation of controls on institutional investors, looking to encourage blockholding and more effective monitoring. In Europe proponents ask for stronger securities regulation, looking to encourage deeper trading markets. This suggestion is that each reform program may lead to disappointing results because neither assures conforming adjustments to the pertinent actors' incentives. Alternatively, strict reforms that materially change prevailing incentive patterns could perversely destabilize workable (if imperfect) arrangements without assuring the appearance of more effective alternatives.

The analysis seconds the policy recommendations made in discussions in the United States by neoclassical critics of the cross reference hypothesis. But it does not simultaneously endorse their theoretical presuppositions. The incomplete contracts model should ultimately prove to be more compatible with the capacious framework of reference developed by those articulating the cross reference hypothesis. Both make second-best assumptions and recognize the salience of political events. The difference lies in the underlying theories of the firm. Proponents of cross reference assume that improvements in governance institutions would be within easy reach but for political barriers and historical path dependencies in the regulatory pattern. Our analysis of the incomplete contracts model challenges this diagnosis at the level of economic theory. Politics can indeed explain why a governance system has not evolved so as to be first best. But it cannot by itself show us how to improve that system.

12. We do not claim to be the first commentators to make this point. *See, e.g.*, Curtis J. Milhaupt, *Property Rights in Firms*, 84 VA. L. REV. 1145 (1998). But we believe this article to be the first sustained exercise in the legal literature of describing and confronting the economic theory supporting the point.

For that one needs an economic theory of the firm.[13] No economic theory yet articulated shows us how to splice blockholder components onto market systems so as to effect material improvement.

Part I of the Article recounts the results of the corporate governance comparison, describing the elements that distinguish market and blockholder systems.

Part II looks at comparative corporate governance's theoretical infrastructure. Here we compare assumptions and assertions basic to the cross reference hypothesis and the neoclassical critique. We also draw on the economics of systemic convergence to show the thin foundation underlying strong convergence predictions. Comparative governance emerges as a debate over two closely-related points. Participants make basic choices between (*a*) the strong and weak convergence perspectives, and (*b*) alternative descriptions of governance institutions as either divisible and fitted for cross reference or indivisible and not so fitted. We plot these four positions on a matrix that shows four contrasting perspectives and go on to consider the taxonomy's implications for corporate governance debates.

Part III lays foundations for our case against cross reference. Here we show how existing comparative studies confirm the salience of barriers to cross reference—such as the shareholder free rider problem in market systems and the provision of private benefits in blockholder systems—without offering any cogent suggestions as to how they might be overcome.

Part IV describes breakthrough applications of incomplete contracts theory and highlights their implications for legal policy. This theory teaches us that the market and blockholder systems' contrasting features do not imply unexploited complementarities. They instead should be read to follow from second-best choices in a world of complex trade-offs. The model tries to work through the trade-offs so as to show us what features we might see in an optimal hybrid system. But the incentive problems bound up in the trade-offs prove destabilizing to hybrid structures. Absent private benefits and the incentives they import toward block formation, we can never be sure that blocks will appear when monitoring is needed. Such blocks as they appear will be unstable and will tend to be larger than necessary, sacrificing liquidity even as they solve the monitoring problem. Allowance of private benefits through self dealing and insider trading solves these problems only to create new problems, for

13. Indeed, it needs to make reference to a theory of the firm to show that an evolved system is deficient in the first place.

there is no way to assure private benefits provision to an incentive-compatible degree. Finally, only a subset of firms will need block monitoring in the first place.

Part V concludes that a system must go one way or the other, either controlling access to private benefits for the purpose of protecting its liquid trading markets or not doing so in order to support blockholding. The theory of the firm holds out no solid middle ground. Accordingly, the primary message of comparative governance for domestic legal policy lies in an unsuspected quarter. Market systems depend on legal protections for outside investors. Blockholder systems lack these protections. Caution respecting their diminution is the indicated course.

I. THE CORPORATE GOVERNANCE COMPARISON

This Part sets out the results of the governance comparison, describing the interrelated strengths and weaknesses of the market and blockholder systems and reporting on empirical findings. Bottom line results turn out to be thin: We have no empirical basis for ascribing comparative advantage to either system, and most observers accordingly assume the systems to be equally competitively fit.

A. Elements of Market Systems

Market corporate governance systems are characterized by dispersed equity holding,[14] a portfolio orientation among equity holders, and a broad delegation to management of discretion to operate the business. Ownership and control are separated. This leads to two chronic productivity disadvantages.

The first disadvantage is the shareholder-management agency problem. Collective action problems prevent close monitoring of management performance by widely-dispersed shareholder owners holding small stakes. Imperfect performance incentives result for managers, who may rationally sacrifice shareholder value to pursue their own agendas. The classic case of this occurred with the American conglomerate firms of a generation ago: Managers built large empires by making investments that yielded uncompetitive returns and sacrificed shareholder value even as they caused the firm

14. In the case of some large firms, they are also characterized by dispersed debt holdings.

to grow.[15] Market systems provide three corrective mechanisms to address this management incentive problem and ameliorate the structural barrier to direct shareholder oversight. These are the hostile takeover, derivative lawsuits against management self dealing,[16] and the inclusion of outside monitors on boards of directors.[17]

The second productive disadvantage of the market system is a time-horizon cost that stems from the shareholders' tendency to rely on short-term performance numbers. This problem has been attributed to information asymmetries. Management has superior information respecting investment policy and the firm's prospects, but this information tends to be either soft or proprietary and therefore cannot credibly be communicated to actors in trading markets.[18] It has been said that management as a result is disinclined to make long-term capital investments necessary for international competitiveness. The problem becomes more severe as the takeover deterrent becomes more vigorous, causing managers to look for quick fixes to keep the shareholders satisfied.[19] To restate this point in more general terms, market systems fail to provide clear-cut protections to managers who

15. *See generally* Porter, *supra* note 1.

16. Different national systems emphasize different protections. The United States at present holds the derivative action for breach of fiduciary duty, whereas Britain holds out few incentives to plaintiffs but maintains a more robust takeover market. *See* Geoffrey P. Miller, *Political Structure and Corporate Governance: Some Points of Contrast between the United States and England*, 1998 COLUM. BUS. L. REV. 51, 52–53 (1998).

17. *See* Erik Berglöf, *Reforming Corporate Governance: Redirecting the European Agenda*, *in* ECONOMIC POLICY: A EUROPEAN FORUM 93, 97–99 (1997). Unsurprisingly, in both the United States and Britain, studies on governance focus on how to improve the operation of the board. *See* Stephen Woolcock, *Competition Among Forms of Corporate Governance in the European Community: The Case of Britain*, *in* NATIONAL DIVERSITY AND GLOBAL CAPITALISM, *supra* note 5, at 179, 183.

18. *See* Roe, *supra* note 7, at 649. Roe adds a third cost, an industrial organization cost stemming from American firms' tendency to resort to vertical integration as the solution for the commitment problems attending incomplete relational contracts with significant suppliers and customers. *See id.* Full vertical integration implies the incentive problems attending and deadweight costs of bureaucratized management. In the Japanese *keiretsu* (and to a lesser extent in Germany), cross-holdings of shares between the vertically related firms ameliorate the commitment problem without carrying the costs of full vertical integration. *See* Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 YALE L.J. 871, 882–88 (1993).

Roe suggests that in market systems, stronger financial intermediaries "might have linked related suppliers and customers with partial cross-ownership, but without tight (and sometimes costly) vertical organization." Roe, *supra* note 7, at 649. This pattern does not occur in Japan, where significant nonfinancial cross-ownership invariably accompanies financial ownership. *See* Kester, *supra* note 1, at 231 tbl.1. Nor would it appear to be implicated in bank holding and voting patterns in Germany. *See* ROE, *supra* note 6, at 171–77.

19. *See* Porter, *supra* note 1, at 6.

make firm-specific investments of human capital,[20] a failure due in part to the systems' reliance on takeovers, proxy fights, and boardroom *coups* to control agency costs.

Market systems have countervailing advantages. Their shareholders can cheaply reduce their risk through diversification. Relative to shareholders in blockholder systems, they receive high rates of return. The systems' deep trading markets facilitate greater shareholder liquidity. These capital markets also facilitate corporate finance, providing management with greater flexibility as to the type and sources of new capital than do markets in blockholder systems.[21] More generally, they provide an environment relatively more conducive to management entrepreneurship,[22] as reflected in increased investment in new technologies.[23] Finally, although market system shareholders and their outside-director agents cannot access full information about firm operations, their very distance from operations yields a countervailing benefit. Distance makes them relatively immune to capture by the management interest and assures objective evaluation of the information they do receive.[24] A practice of objective evaluation means relatively fewer barriers to disinvestment and related features of downside restructuring.[25]

B. Elements of Blockholder Systems

Blockholder systems are characterized by majority or near-majority holdings of stock held in the hands of one, two, or a small group of large investors.[26] In Europe, the largest block investors tend

20. *See* Boot & Macey, *supra* note 2, at 219–24.

21. *See* Berglöf, *supra* note 17, at 113.

22. This point is developed in the abstract in the incomplete contracts literature. The idea is that a more generous extension of discretion from capital to management promotes innovation, and contrariwise that there is such a thing as excessive monitoring. *See, e.g.*, Mike Burkart et al., *Large Shareholders, Monitoring, and the Value of the Firm*, 112 Q.J. ECON. 693, 693–94 (1997). For a discussion of this literature see *infra* notes 242–52 and accompanying text.

23. *See Is the Stock Market Too High?*, *supra* note 4, at 126 (attributing recent U.S. competitive success to corporate-led transition to an information-based economy).

24. *See* Boot & Macey, *supra* note 2, at 225.

25. *Cf.* Porter, *supra* note 1, at 5, 11–12; Roe, *supra* note 7, at 650; Gilson, *supra* note 2, at 216–17 (suggesting that the market system in the United States showed that it had the flexibility to restructure in the 1980s where the Japanese main bank system might lack aptitude to respond similarly).

26. In Germany, 64% of large firms have a majority owner, in France 59%. *See* Paul Windolf, *The Governance Structure of Large French Corporations: A Comparative Perspective*, *in* COLUM. CORP. GOV., *supra* note 2, 705, 725. *See also supra* note 8.

to be individuals or rich families, with nonfinancial firms and banks making a secondary appearance in some countries, particularly Germany and Sweden.[27] Other European control blocks result from cross-holding arrangements among groups of nonfinancial firms.[28] In the Japanese *keiretsu* system of blockholding, in contrast, individual and family holders are not prominent. There blockholding means aggregations of smaller blocks than in Europe, held by (*a*) clusters of banks having lending relationships with the issuer firm, and (*b*) clusters of other nonfinancial companies, in many cases in supplier or customer relationships[29] with the issuer. These corporate holders often belong to a formal *keiretsu* organization along with the issuer,

---

For a detailed report on blockholding patterns in Germany, see TIM JENKINSON & ALEXANDER LJUNGQVIST, HOSTILE STAKES AND THE ROLE OF BANKS IN GERMAN CORPORATE GOVERNANCE (Center for Economic Policy Research Discussion Paper No. 1695, London 1997). Following J. Zwiebel, *Block Investment and Partial Corporate Control*, 62 REV. ECON. STUD. 161 (1995), Jenkinson and Ljungqvist assume three types of firm: (*a*) firms with many small blocks but without a controlling block; (*b*) firms with one large block and many small blocks; and (*c*) firms with one very large block and no small blocks. Furthermore, there are five economically significant block sizes in Germany: (*a*) a 95% controlling party can compulsorily acquire minorities shares; (*b*) a 75% super-majority block; (*c*) a 50% block that gives management control of the company; (*d*) a 25% block that gives veto powers on corporate charter amendments and supervisory board changes; and (*e*) a block less than 25% that gives protection against other, larger blockholders. The study shows that just under three quarters of all German listed companies have a majority owner: 23.1% have blocks in excess of 90% of their equity capital; 18.4% are super-majority controlled; and 30.5% have a simple majority owner.

Only a quarter are not at least majority controlled by a blockholder. Taking a closer look at these 141 firms, they show that 86 of these firms have one or more blocking majority stakes, where two or three such stakes would amount to majority or super-majority control. The remaining 55 firms have no stakes in excess of 25%. 37 of these firms have one or more disclosed non-blocking stakes while only 18 firms are widely held. *See generally* JENKINSON & LJUNGQVIST.

27. *See* Berglöf, *supra* note 17, at 101 tbl.4. Financial advisors in France serve as proxies for financial advisors to controlling shareholders. They also figure into complex arrangements of cross-shareholdings among private French firms. *See generally* James A. Fanto, *The Role of Corporate Law in the Adaptation of French Enterprise*, 1998 COLUM. BUS. L. REV. 97, 107 (1998); James A. Fanto, *The Absence of Cross-Cultural Communication: SEC Mandatory Disclosure and Foreign Corporate Governance*, 17 NW. J. INT'L L. & BUS. 119, 184–85 (1996) (discussing French cross-shareholding practices in the context of U.S. disclosure requirements applied to foreign issuers).

28. *See* Michael Adams, *Cross Holdings in Germany*, 155 J. INSTITUTIONAL & THEORETICAL ECON. 80 (1999) (pointing out that corporate cross-holdings are widespread in Germany, that there is little information about the extent of the cross-holdings due to inadequate transparency and that disclosure rules which are easy to circumvent, and that such cross-holding promotes management entrenchment).

29. This is not necessarily true. *See* Kester, *supra* note 1, at 231 tbl.1, 234 tbl.2; Michael I. Gerlach, *Twilight of the Keiretsu? A Critical Assessment*, 18 J. JAP. STUD. 79 (1992) (stating that preferential trading patterns in Japanese industrial organization follow a probabilistic rather than deterministic model).

ameliorating collective action problems.[30]

Blockholder systems, like market systems, leave management in charge of the business plan and operations.[31] But large-block investments imply a closer level of shareholder monitoring.[32] In addition, the coalescence of voting power in a small number of hands means earlier, cheaper intervention in the case of management failure.[33] The systems' other primary benefit stems from the blockholders' ability to access information about operations. This lessened information asymmetry permits blockholders to invest more patiently.[34] The longer shareholder time-horizon in turn frees management to invest for the long-term and creates a more secure environment for firm-specific investments of human capital by the firm's managers.[35]

There are corresponding costs and limitations. Where the blockholders are firms, internal agency costs can constrain their

30. The Japanese system also is distinguished by close ties between financial intermediaries and government regulators. *See generally* Curtis J. Milhaupt & Geoffrey P. Miller, *Cooperation, Conflict, and Convergence in Japanese Finance: Evidence From the "Jusen" Problem*, 29 L. & POL'Y INT'L BUS. 1 (1997) (describing how regulatory cartels among government and private sector actors run according to informal norms and interlinked decisionmaking institutions).

Keiretsu cross-holdings are decreasing as a result of Japan's current economic crisis. At the beginning of the 1990s approximately two-thirds of the shares of Japan's listed companies were held via cross-holding networks; now the figure is around 50% and declining. Simply, their members have better uses for their capital at this time. *See* Brian Bremner, *Wanted: A New Economic Model*, BUS. WK., Nov. 30, 1998, at 44. If the system survives the crisis (and some will predict movement to the market model, *see infra* note 102 and accompanying text), the question will be whether the groups reform when prosperity returns.

31. In France and Germany the family owners employ professional technocrats to do the managing, but significant links between the managers and the owners persist. *See* Windolf, *supra* note 26, at 722.

32. The incomplete contracts models show this formally. *See infra* notes 202–06 and accompanying text. For empirical studies that support the assertion that ownership concentration can improve the control of management and therefore can increase the value of the firm, see Michael Hertzel & Richard Smith, *Market Discounts and Shareholder Gains for Placing Equity Privately*, 48 J. FIN. 459 (1993). *See also* Karen Wruck, *Equity Ownership Concentration and Firm Value: Evidence from Private Equity Financings*, 23 J. FIN. ECON. 3, 4 (1989) (studying transactions that change ownership and finding value increases provided that the level of concentration is less than 25% of the shares).

33. *See, e.g.*, Masahiko Aoki, *Toward an Economic Model of the Japanese Firm*, 28 J. ECON. LIT. 1, 14–17 (1990) (discussing Japanese financial systems); Gilson & Roe, *supra* note 18, at 880.

34. *Cf.* Porter, *supra* note 1, at 10–11.

35. More generally, there tends to be a closer relationship between management and all of the stakeholders. When problems come up, stakeholders raise their voices when difficulties arise, finding new managers instead of exiting. *See* Woolcock, *supra* note 17, at 183.

effectiveness as monitors.[36] Indeed, whatever the identity of the blockholder, its heightened oversight incentive does not appear in practice to result in sharp oversight of management investment policy.[37] Although closer proximity lessens the information asymmetry problem, there is an accompanying increase in management influence and loss of critical objectivity.[38] Freedom to make long-term investments thus often means pursuit of growth in market share at the cost of a suboptimal rate of return on equity investment.[39] Trading markets in blockholder countries tend to be thinner and less transparent than in market system countries,[40] and firms in search of financing encounter a more restricted range of alternatives.[41] Meanwhile, the blockholders themselves give up the benefits of diversification and, given thin trading markets, liquidity and the possibility of easy exit through sale.[42] Finally, there is a

---

36. *See* Roe, *supra* note 7, at 649.

37. The result is satisficing (as opposed to optimizing) behavior on the part of the managers, but satisficing relative to a higher frontier of production for a given level of inputs. *See* Kester, *Convergence, supra* note 5, at 122–23.

38. *See* Boot & Macey, *supra* note 2, at 225, 237–38 (making reference to sources in public choice and psychology).

39. *See* Porter, *supra* note 1, at 12–13. This implies that equity investors in firms in blockholder systems settle for lower rates of return than do equity investors in firms organized in market systems. In the case of corporate investors, the explanation is that offsetting advantages lie in long term business relationships with the issuer. *See* Kester, *supra* note 1, at 227.

40. The comparative figures for Europe show this starkly. The capitalization of the London equity market stays at 90 to 100% of gross domestic product; in Germany and France the figure is 20%, for Italy 16%. Britain has 2500 listed companies; Germany 600 (in 1991), France and Spain 300–400 each, and Italy 200. *See* Woolcock, *supra* note 17, at 185.

41. For a summary of these points in the context of bank lending, see Raghuram G. Rajan & Luigi Zingales, *Which Capitalism? Lessons from the East Asian Crisis*, 11 J. APPLIED CORP. FIN. 40 (1999). Rajan and Zingales compare relationship lending in East Asian countries to arm's length borrower-lender relationships in market systems. In developing economies, say Rajan and Zingales, relationships facilitate reputational enforcement—a necessity in the absence of reliable legal enforcement. The system discounts the importance of transparency, which in turn protects the participants from potential competition. The absence of competition and disclosure implies that few price signals exist. *See id.*

42. *See* Berglöf, *supra* note 17, at 96.

The parallel phenomenon in the banking sector is the loan at a below-market rate of interest. But Rajan and Zingales offer an interesting explanation of this phenomenon as an incident of a relational lending system in which loan terms result from negotiations rather than from price signals in a marketplace. Given negotiations, the costs a borrower may face result from the negotiations and may diverge from the lender's risk-adjusted cost. According to Rajan and Zingales, in a second-best world an imperfection in cost terms may not be such a bad thing. It may be that some firms are important and worth subsidizing because they create social value. The lender, meanwhile, takes a long-term view on return on investment. In a market system, in contrast, it is unlikely that a lender could make such a loan since it will be difficult for the lender to extract his investment from the firm in the long term so as to justify

shortage of loyalty. Blockholders, having sacrificed diversification and liquidity, extract a return in the form of private benefits yielded through self dealing or insider trading. Legal regimes in blockholder states facilitate this *quid pro quo* with lax protection of minority shareholder rights and lax securities market regulation.[43] This in turn chills the development of robust trading markets.

C. *Empirical Studies, Comparative Advantage, and Equal Competitive Fitness*

Which of the two systems, market or blockholder, has comparative advantage? Most comparative governance discussants decline to answer this question, preferring a working hypothesis of equal competitive fitness. In part, caution dictates this position. Relative productivity advantage is at bottom an empirical question. Although there is an impressive and growing body of empirical studies comparing different aspects of national governance systems, the studies have not yet attempted to compare productivity.[44] Instead the studies use comparative data to try to establish causal connections between shareholder protection practices and other structural aspects of governance and finance. For example, one line of inquiry tests national systems against a multipart checklist designed to measure the level of investor protection.[45] Items on the checklist include rules and practices respecting shareholder voting, legal protections against management self dealing, creditors' rights, accounting rules, and enforcement practices. Application of the test shows that: (*a*) common law countries provide the strongest protection for investors;

---

below-cost financing of the firm in the short term. Lenders in a relationship-based system, in contrast, are able to offer below-market loans since they are able to absorb short run losses by resorting to their monopoly power to extract above-market rates over the long run. Despite these beneficial effects, the fact that relationship-based systems have little regard for price signals makes them prone to the misallocation resources and severe economic problems. *See generally* Rajan & Zingales, *supra* note 41.

43. *See* Berglöf, *supra* note 17, at 96, 98.

44. It may be some time before we see such studies. State of the art work proceeds at a more general level. *Compare* Raghuram G. Rajan & Luigi Zingales, *Financial Dependence and Growth*, 88 AM. ECON. REV. 559 (1998) (studying the connection between growth rates and financial market development and finding that industrial sectors relatively more in need of external finance develop more quickly in countries with well-developed financial markets), *with* Ross Levine & Sara Zervos, *Stock Markets, Banks, and Economic Growth*, 88 AM. ECON. REV. 537 (1998) (showing that each of stock market activity and banking development positively predict growth, capital accumulation and productivity improvements, but that the size of stock market capitalization is not robustly linked with growth).

45. *See* RAPHAEL LA PORTA ET AL., LAW AND FINANCE 16–31 (National Bureau of Econ. Research Working Paper No. 5661, 1996).

(*b*) France and similar civil law countries provide the weakest level of protection; and (*c*) Germany and similar civil law countries provide an intermediate level of protection.[46] The legal systems, thus differentiated, are then sorted again in accordance with data respecting capital markets. There results a strong positive correlation between the level of legal investor protection on the one hand, and the size and depth of the national securities market and the prevalence of dispersed shareholding on the other.[47] Weak investor protection, in contrast, corresponds with blockholding.[48] Other studies show

46. *See id.* at 18. The study assumes that there are two broad traditions, civil and common law, and goes on to analyze the rights of investors in 49 countries that have publicly traded companies. It appears that relatively few countries have legal rules favoring outside shareholders: only 22% mandate one share one vote; only 16% allow cumulative voting; and only 22% allow voting by mail. *See id.* Creditors' rights present a more difficult picture. To summarize, common law countries simply offer better legal protection for creditors. Correspondingly, the French civil law countries treat creditors and shareholders poorly. *See id.* at 24–25.

47. *See* Raphael La Porta et al., *Legal Determinants of External Finance,* 52 J. FIN. 1131 (1997). The study confirms that common law countries have better access to equity finance than do civil law countries. The differences between Britain and France are particularly significant and strongly suggest that poor investor protection entails lower liquidity and smaller markets. *See id.* at 1137. Strong anti-director rights (as well as one share one vote) are also linked to higher liquidity markets. *See id.* at 1140. The level of legal enforcement and the origin of rules in common law are also correlated to valuation and depth of both equity and debt markets. Economic statistics, such as the total capitalization of equity held by outside shareholders, show that common law countries tend to have better stock markets. *See id.* at 1146–48. The authors assert that these data confirm the view that the nature of legal rules and their efficient enforcement are positively related to the size and depth of a country's capital market. *See also* Asli Demirguc-Kunt &Vosislav Maksimovic, *Law, Finance, and Firm Growth,* 53 J. FIN. 2107, 2134 (1998) (showing firms in countries with both an active stock market and a well-developed legal system are able to obtain external funds for faster growth).

48. The logic is straightforward: given weak legal protection, only voting control will protect against expropriation by other equity investors. *See* Raphael La Porta et al., *Corporate Ownership Around the World,* 54 J. FIN. 471, 510 (1999) [hereinafter La Porta et al., *Corporate Ownership Around the World*]. This study investigates the structure of the 20 largest corporations in 27 different countries, along with smaller firms (in order to maintain consistency of size across jurisdictions). Its authors have chosen to bias large corporations because it is these firms which are most likely to possess dispersed ownership patterns. Their research shows that, based on a data set which included the ten largest publicly traded non-financial companies in the sample of countries tested and assuming a 20% definition of control, that for large firms: (*a*) nearly 40% world-wide are widely held; (*b*) 30% are family controlled; (*c*) 18% are state controlled; and (*d*) the remaining fall into different categories of ownership. *See id.* at 491. The Berle and Means image of the firm with separation of ownership and control dominates in Japan, Britain and the United States, while in the rest of the world there are few firms that fit this description. In terms of firms with owners, the principal owner types, as noted, are families and the state. It follows that countries with poor shareholder protection have more concentrated shareholding (and vice versa). *See id.* at 496–97. The study also finds that bank control is not common, showing up in only Germany and Belgium. *See id.* at 502. Blockholding, however, is common, with blockholders employing control rights devices and other instruments to limit the power of minorities and typically participating in the management of the firm. *See id.* at 491. For an extension, see Raphael

analogous correlations. The level of shareholder protection has been shown to relate inversely to the size of the premium over the market price per share paid for a majority voting block—higher premiums are commanded in countries with weak protections.[49] A direct connection between strong shareholder protections and the volume of initial public offerings has also been shown.[50] In contrast, relationships between Japanese firms and their main banks have been shown to result in reduced pain and easier financing during periods of financial distress.[51]

What the studies tend to confirm, then, is the accuracy of the casual description of systemic differences, advantages, and disadvantages set out above. Subject to a couple of prominent exceptions, they do not purport to address the matter of comparative advantage among developed economies.[52] One exception is La Porta,

---

La Porta et al., *Trust in Large Organizations*, 87 AM. ECON. REV. 333 (1997) [hereinafter La Porta et al., *Trust in Large Organizations*]. This study starts with the proposition that trust is needed to support cooperation in large organizations and accepts an empirical measure of trust derived from a survey conducted worldwide. Trust is then connected to government effectiveness (measured by investor evaluations), civic participation (measured by participation rates) and firm size. *See id.* at 334. Statistically significant results obtain, with higher trust countries having higher levels of cooperative success. *See id.* The lowest levels of trust obtain in countries with high rates of membership in hierarchical religions. *See id.* at 336.

49. *See* Luigi Zingales, *The Value of the Voting Right: A Study of the Milan Stock Exchange Experience*, 7 REV. FIN. STUD. 125 (1994). Zingales shows a high (86%) premium for control blocks in companies listed on the Milan exchange, against a world average of 10 to 20%, and a United States average of 5.24%. *See id.*

50. *See id.*

51. *See* Takeo Hoshi et al., *Corporate Structure Liquidity and Investment: Evidence from Japanese Industrial Groups*, 106 Q. J. ECON. 33 (1991); Takeo Hoshi et al., *The Role of Banks in Reducing the Costs of Financial Distress in Japan*, 27 J. FIN. ECON. 67 (1990).

52. Their main normative message lies with developing economies lacking either institutions of legal protection or blockholding. For a similar evaluation, see Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance* 52 J. FIN. 769–73 (1997).

Jonathan Macey argues that the studies confirm market system superiority. *See* Jonathan Macey, *Measuring the Effectiveness of Different Corporate Governance Systems: Toward a More Scientific Approach*, 10 J. APPLIED CORP. FIN. 16 (1998). We strongly disagree. Macey cites results on control premiums and IPO activity, and also stresses the fact that market systems have hostile takeovers. This all means, he says, that market systems are superior in controlling agency costs. The problem with this argument is that it fails to confront the results of the comparative exercise. Takeovers, for example, mean that the market system has developed means to deal with the agency costs that result from dispersed ownership. The comparison asserts that blockholding tends to prevent these costs from occurring in the first place. The same comment can be made about the size of control premiums. These reflect the presence or absence of legal protection; blockholder systems are said to compensate for a lower level of shareholder protection by delimiting the agency costs of the separation of ownership and control. It may be that market systems are superior overall and that the results Macey cites are suggestive of that superiority. But that case has yet to be made as an empirical proposition. At present, the only available support is the lesser backup provided by a theory of the firm that privileges market institutions.

Lopez-de-Silanes, and Shleifer's finding of no significant relationship between per capita gross domestic product and the incidence of widely-held firms based on a study of twenty developed countries.[53] An inference of equal competitive fitness arises. The second exception is a famous body of work by Kaplan that looks at management replacement rates in the United States, Japan, and Germany. This finds no significant differences between the three countries and both of these studies can be taken to imply equal competitive fitness.[54] The respective systems' evolutionary survival in the context of national product markets is another fact that (albeit weakly) implies equal competitive fitness.[55]

The informal comparison, recounted above,[56] provides additional indirect support for the equal fitness hypothesis. Each system's weakness appears to be matched by a systemic strength on the other side, and vice versa, as the tables illustrate. Table 1 shows, broadly, that stepped up shareholder monitoring under the blockholder system comes at the cost of thick trading markets and associated benefits, and that thick trading markets exact a monitoring cost. Table 2 looks at management policy and shareholder information levels and highlights some points of tension in the comparison. Each system's investment minus is also its plus and each system's investment plus is also its minus. Thus the market system suffers from short-sightedness because it sacrifices long-term projects to the demand for present

53. *See* La Porta et al., *Corporate Ownership Around the World*, *supra* note 48, at 510.

54. *See* Steven N. Kaplan, *Top Executives, Turnover, and Firm Performance in Germany*, 10 J. L. ECON. & ORG. 142 (1994); Steven N. Kaplan, *Top Executive Rewards and Firm Performance: A Comparison of Japan and the U.S.*, 102 J. POL. ECON. 510 (1994). *See also* Steven N. Kaplan & Bernadette Minton, *Appointments of Outsiders to Japanese Boards: Determinants and Implications for Managers*, 36 J. FIN. ECON. 225 (1994). See also Colin Mayer et al., Who Disciplines Bad Management? (Tilburg University Working Paper 1998) (on file with author), which provides a complementary study of poorly performing firms in Britain, comparing the activity of four sets of interested parties—existing holders of large blocks of shares, investors acquiring new holdings, creditors, and non-executive directors. The study finds a high level of board turnover, which it attributes to the initiatives of creditors and the demands of providers of new equity capital. Outside directors perform a weak disciplinary function and large blocks have little influence, with the exception of holdings held by industrial companies.

55. European commentators point to this as a reproach to American suggestions of market system superiority. *See* Windolf, *supra* note 26, at 713–14. For additional evidence, see Demirguc-Kunt & Maksimovic, *supra* note 47, at 2120–23, which contradicts the conventional wisdom that market depth matters for comparative advantage. Their study shows that it is activity, or turnover, that matters in a comparison of developed and developing countries, rather than the market capitalization ratio. *See also* Raghuram Rajan & Luigi Zingales, *What Do We Know about Capital Structure? Some Evidence from International Data*, 50 J. FIN. 1421, 1422 (1995) (showing that debt equity rations are roughly equivalent across G-7 countries).

56. *See supra* notes 14–43 and accompanying text.

shareholder value; meanwhile, the ability to deliver present shareholder value is the market system's plus. In contrast, the block-

Table 1—Monitoring Versus Markets

	Market	Blockholder
Shareholder monitoring	Minus	Plus
Diversification	Plus	Minus
Liquidity	Plus	Minus
Shareholder legal rights	Plus	Minus
Thick trading markets	Plus	Minus

holder system suffers from an excessive growth focus because it does not concern itself with shareholder value; meanwhile, these suboptimal growth investments display the long-term time horizon

Table 2—Investment Policy/Information Asymmetry

	Market	Blockholder
Short-term focus	Minus	Plus
Shareholder value focus	Plus	Minus
Long-term focus	Minus	Plus
Growth focus	Plus	Minus
Shareholder information level	Minus	Plus
Shareholder objectivity	Plus	Minus

said to be its plus. A similar plus-is-minus relationship prevails with shareholder information. Blockholding ameliorates information asymmetries, but the proximity that opens this access implies susceptibility to capture by the management interest and a loss of objectivity. On the other hand, information asymmetries are more pronounced in market systems, but shareholders (and director representatives) at a distance from managers evaluate firm performance with a clearer eye.

The literature explores the implications of the equal fitness hypothesis in two frameworks. One framework looks to global-level effects of competitive interaction among firms in international product markets. The other looks to competitiveness in national contexts. Part II recounts and expands on these discussions.

II. FRAMEWORKS FOR COMPARING CORPORATE GOVERNANCE SYSTEMS—CONVERGENCE AND NONCONVERGENCE, CROSS REFERENCE AND INDIVISIBILITY

This Part proceeds as follows. Section A describes the theoretical frameworks that facilitate projections of global convergence as to the terms of governance systems. Contrasting scenarios emerge. Some project a process of international cross reference that leads to a new hybrid system composed of elements drawn from both market and blockholder systems. Others assert the primacy of product market discipline and dismiss comparative governance policy inquiry as irrelevant, even as they assert evolutionary superiority for the market system and project its eventual emergence in global competition. Section B describes a contrasting analytical framework that projects persistent variation in national institutions even in a global economy. This approach is informed by social theory and second-best economics and rejects the technological determinism that informs projections of a unitary, global capitalism. It acknowledges the possibility of convergence, but at the same time emphasizes matters that make convergence unlikely, such as the embeddedness of national systems of production and political barriers to governance reform. Under this weak convergence perspective, comparative governance exercises have their primary bearing in domestic policy contexts. In Section C, comparative governance emerges as a two course menu. Participants make basic choices between (*a*) the strong and weak convergence perspectives, and (*b*) alternative descriptions of governance institutions as either divisible and fitted for cross reference or indivisible and not so fitted. We plot the four possible selections on a matrix that shows four contrasting perspectives. We then discuss the taxonomy's descriptive and normative implications.

A. Comparative Analysis in a Global Framework: Strong Convergence and Irrelevance

Many argue that the globalization of production, finance, and trade is causing national economies to converge as to performance, and national economic institutions to converge as to form. Global competition will mean bigger markets calling for large and capital intensive (but specialized) producers and necessitating cross-border

collaboration among existing producing organizations.[57] These producers will access capital in financial markets uncoupled from national regulatory restraints.[58] Innovative production technologies, like capital, will rapidly diffuse to firms worldwide.[59] The same should follow for corporate governance institutions.

Many examples of movement toward corporate governance convergence support this prediction. Many of these follow from cross-border investment and finance, including mergers and acquisitions. For example, hundreds of firms from blockholder systems raise equity capital in securities markets in Britain and the United States and in consequence must conform to stricter accounting standards and incur ancillary regulatory costs.[60] Some of these firms have also experienced pressure for American-style governance reform upon the acquisition of significant ownership stakes by American investment institutions.[61] Contrariwise, American producers acquired by foreign firms have become subject to governance structures unique to blockholder systems.[62]

Additional evidence of convergence occurs within national systems as they change to take on other systems' characteristics. For example, European securities markets have increased in depth in recent years, partly due to the privatization of state-owned enterprises. In Italy, for example, privatization has meant a dramatic increase in the number of large-capitalization, widely-held corporations; between 1995 and 1997 the ratio of Italian stock market capitalization to gross

57. *See* Robert Boyer, *The Convergence Hypothesis Revisited: Globalization but Still the Century of Nations?*, *in* NATIONAL DIVERSITY AND GLOBAL CAPITALISM, *supra* note 5, at 47.

58. *See* Milhaupt, *supra* note 12, at 1186–87.

59. *See id.*

60. At the end of 1996 there were a total of 784 foreign issuers listed on NASDAQ, the NYSE and the Amex. *See* Amir Licht, *Regulatory Arbitrage for Real: International Securities Regulation in A World of Interacting Securities Markets*, 38 VA. J. INT'L L. 563, 566 (1998). The announcement of a dual listing tends to cause an increase in share value. *See id.* at 634–35.

61. *See* Lucian A. Bebchuk & Mark Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, *in* COLUM. CORP. GOV., *supra* note 2, 575, 580.

62. The most famous example is the German two-tier board that governs the combined Daimler Benz-Chrysler. *See* Chrysler Corp., Proxy Statement: For a Special Meeting of the Stockholders to be held on September 18, 1998, at 16–17 (Aug. 6, 1998) (on file with the SEC). *See also* Theodor Baums, *Corporate Contracting Around Defective Regulations: The Daimler-Chrysler Case*, 155 J. INSTITUTIONAL & THEORETICAL ECON. 119 (1999) (explaining the structure of the merger by reference to German law, in particular its constraints on both forward and reverse triangular mergers, and the practice in German corporate law of creating capital structures in order to protect firms from opportunistic dissenting shareholders).

domestic product rose from 19.3% to 31.3%.[63] One of these new large-capitalization Italian firms has even been the victim of a successful hostile takeover. Germany has seen a dramatic increase in the number of initial public offerings (IPOs) of privately-held firms. Its *Neuermarkt*, set up to attract start-up company listings in the manner of the NASDAQ,[64] will see 100 IPOs in 1999. At the same time, large capitalization German conglomerates are undergoing American-style unbundling, selling off holdings in subsidiaries and affiliates into the Frankfurt *Neuermarkt*.[65]

Meanwhile, governance reform by international cross reference also has become an everyday topic in corporate policy debates. The first prominent round of discussions on comparative governance occurred in the United States in the early 1990s, prompted by a perception that shortcomings in domestic practice had contributed to the failure of American firms in several key sectors to compete successfully against foreign rivals.[66] Systemic shortcomings were alleged—the market system had operated in the United States in the 1980s to favor short term increases in shareholder value and deter long-term investment in production processes. As a result, Japanese and German producers, which had invested more in search of growth, had a product market advantage. It was thought that America's short-term bias had arisen as a perverse result of widespread hostile takeover activity in the 1980s. Ironically, by the early 1990s, new legal controls constrained takeovers, constraints that also deprived the governance system of a principal disciplinary device. It was thought that America therefore needed to look abroad for additional means of agency cost control in order to reestablish a competitive position. It made sense to make reference to the systems whose firms were seen to be beating American firms in product markets—systems which had not evolved to rely on takeovers. Thus, European and Japanese practices of bank monitoring, cross holding, and blockholding presented themselves as simultaneous correctives for both short-term investment bias and the takeover's decline.[67]

---

63. *See* John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U.L. REV. 641, 665 (1999). This is still a small percentage. The figure for Britain in 1995 was 132% and for the United States it was nearly 87%. *See id.* at 663.

64. *See id.* at 664–65.

65. *See* Jack Ewing et al., *Enough Spin-Offs to Make You Dizzy*, BUS. WK. INT'L ED., May 10, 1999, at 68.

66. *See* Porter, *supra* note 1, at 5–8.

67. Policy debates respecting participation of institutional investors in governance in the United States provided an independent impetus. For discussion, see *infra* notes 144–62

Today's Europeans return the favor, looking to the corporate governance institutions of the United States to improve the quality of boardroom operations and enhance the depth and liquidity of their trading markets.[68] Toward this end, the Italian government

---

and accompanying text.

68. Three prominent committee reports demonstrate the trend: England's Cadbury Committee, the Netherlands' Peters Committee, and France's Vienot Committee. The best practices they recommend will be familiar to American observers.

(a) *England.* The Committee on the Financial Aspects of Corporate Governance, *Report of the Committee on the Financial Aspects of Corporate Governance* (Dec. 1992) [hereinafter Cadbury Committee Report] develops a Code of Best Practice based on a survey of the financial practices of 200 firms in Britain. The Code addresses the design, structure, and function of the corporate board. The Committee recommends, *inter alia*, (1) that if the same person holds the positions of the CEO and executive director, then the board should be balanced by the inclusion of a senior non-executive director substantially independent from the CEO/executive director; (2) that outside directors have an important place on the board, and should form and manage special committees on the executive director's compensation; (3) that the board form an audit committee including at least three non-executive directors.

The mechanism of a voluntary code, which presupposes that companies that do not comply disclose that fact, seems to have worked reasonably well in Britain. *See* Committee on Corporate Governance, *Final Report* (Jan. 1998) [hereinafter Hampel Committee Report] (established to review the operations of the Cadbury Committee's recommendations).

(b) *The Netherlands.* The Committee on Corporate Governance, *Corporate Governance in the Netherlands—Forty Recommendations* (June 1997) [hereinafter Peters Committee Report], sets out a list of forty recommendations for companies listed on the Amsterdam Stock Exchange. The report provides, *inter alia*, (1) that the Dutch supervisory board be given formal independence from the managing board in order to guarantee effectively that the duties to shareholders are upheld; (2) that executive compensation for supervisory board members should be linked to long-term investment in the firm and should not be tied to short-term results; (3) that supervisory board members not gain personally from their role on the board; (4) that, toward greater transparency, the annual report should contain information about backgrounds of board members, the number of shares held, and business relationships with the firm; (5) that an audit committee or the supervisory board should monitor the quality of external financial reports, ensure compliance with internal procedures, facilitate external communications with auditors, and establish high standards with regard to audits.

This code, like the British one, contemplates that if a firm decides not to adopt a recommendation, then it must explain its action. Moreover, the supervisory board is to assess whether the auditors should verify the reporting of implementation of the recommendations. Interestingly, a follow-up study prepared by an accounting firm shows that, although companies have welcomed the Peters Report with open arms, they have done very little in the way of adopting its recommendations. Meanwhile, the Dutch Minister of Finance has warned that mandatory rules may be in the offing.

(c) *France.* Le Conseil D'Administracion des Societes Cotees, *Raport du Groupe de Travail de l'Association Francaise des Entreprises Pricees et du Conseil National du Patronat Francais* (July 1995) [hereinafter Vienot Committee Report], like the British and Dutch reports, emanates from the financial community. More particularly, it was appointed by the Conseil National du Patronat Francais and the Association Francaise des Enterprises Privees. Here the express aim is to assist small investors by providing greater transparency and to assist foreign investors newly involved in the French stock market. The committee recommends, *inter alia,* (1) that the board produce a regular report on the activities of the firm; (2) that there be at least two outside directors per listed company; (3) that boards form committees to monitor the actions of management, select top executives, and set compensation.

promulgated a package of securities and corporate law reforms in 1998.[69] Japan has removed both process restrictions that inhibit shareholder derivative actions[70] and legal restrictions on share issuance that prevent issuers from including stock options in management compensation arrangements.[71] American-style shareholder activism is also spreading. For example, French shareholders have been forming associations, initiating inquiries, and questioning entrenched practices.[72]

The list of confirming examples, although impressive, does not tell us much about the degree, character, and speed of the convergence being projected. Cross-border stock listing and merger and acquisition activity, for example, can continue to increase in volume without entailing systemic convergence. The French or

---

For commentary, see Karel Lannoo, *A European Perspective on Corporate Governance*, 37 J. COMMON MKT. STUD. 269 (1999) (recognizing a contradiction between, on the one hand, the globalization of markets, and on the other hand, the insular nature of national corporate governance systems in the EU, but acknowledging that the recent, gradual convergence in corporate governance regimes, as reflected in the recommendations of the three semi-official national committees, Cadbury, Vienot and Peters, constitutes adaptation to globalization).

69. These include increased disclosure requirements and a requirement of a mandatory takeover bid by any person or group acquiring 30% or more of the shares of a publicly held company. *See* Coffee, *supra* note 63, at 665–66.

70. *See generally* Mark D. West, *The Pricing of Shareholder Derivative Actions in Japan and the United States*, 88 NW. U. L. REV. 1436 (1994).

71. *See* Milhaupt, *supra* note 12, at 1188–89.

Recent German reforms can also be cited. The Act on Control and Transparency of Enterprises (implemented on May 1, 1998) seeks to increase performance of supervisory boards, create greater transparency, and strengthen shareholder positions. The new legislation also facilitates performance pay (either through share buybacks or other schemes) for management. At the same time, the Act attempts to limit the influence of banks on voting. The Act provides that: (*a*) a bank must inform customers whose shares it administers that their shares can be exercised by a shareholder association or by the bank; (*b*) a bank must inform its clients when it holds 5% or more of the voting rights of a company or was involved with that firm recently as a member of an underwriting syndicate; (*c*) a bank must advise customers if any one of its managers or employees is a member of the management or supervisory board of a firm in which the client holds stock. In order to implement these changes, banks are required to take steps to ensure that their own interests do not influence the voting rights of their customers (that is, to appoint a compliance officer). More significantly, the Act, through new sec. 135Is 3 Aktg, provides that a bank may not exercise the voting rights of its customers in a corporation in which it holds 5% or more of the shares, unless it has obtained specific prior approval or does not exercise its own voting rights; amendments refer to the Stock Corporation Act. All of these changes could be denominated as movement in the direction of market system regulation. For discussion of this legislation, see THEODOR BAUMS, CORPORATE GOVERNANCE IN GERMANY: SYSTEM AND CURRENT DEVELOPMENTS 17–18 (University of Osnabruck Working Paper No. 70, 1998).

72. *See* Oliver Pastre, *Corporate Governance: The End of "L'exception Francaise"?*, 1998 COLUM. BUS. L. REV. 79, 86–88 (1998). There is also evidence that the Italian Parliament reacted to demands from foreign investors when it increased its disclosure standards in 1998. *See* Coffee, *supra* note 63, at 665–66.

German company that avails itself of the New York or London equity market remains rooted in its blockholder system of origin even as it makes some governance concessions. Indeed, such a firm's very resort to a cross-border transaction to raise equity capital demonstrates the continuing salience of systemic differences. A convergence event does occur when the firm consents to a change in its governing rules. But this is convergence on a company-specific basis rather than at the level of a national system. Managers of multinational firms have for decades been making reference to international sources and engineering changes in internal governance processes that similarly imply convergence. In all of these cases, the firm's home governance system continues unchanged. Note that convergence events such as these occur in the new global venue—in the world of transnational linkages generated by actors in the handful of international business centers that provide financial and corporate services on a global basis.[73] The vast majority of such linkages, to the extent they entail legal obligations, rely on conventional national systems to guarantee contract and property rights[74] and to create and define juridical corporations. Such global transactions and actors interact with and influence national systems but have not as yet fundamentally transformed them.

Other items on the list of confirming examples more directly signal possibilities for the convergence of national systems. Thickening trading markets and related law reform initiatives make the German and Italian blockholder systems more market-like; the United States' institutional investor movement seeks a more blockholder-like environment. Counter-anecdotes can be cited, however. The United States' institutional investor movement succeeded more in changing academic theory than in changing embedded market system practices. Europe-wide law reform in the form of EU directives related to insider-trading and disclosure of significant ownership stakes has been hobbled by slow implementation and indifferent compliance.[75]

To catalog anecdotes, then, is to collect evidence of both global convergence and persistent national differentials. The collected anecdotes provide little basis for projecting convergence's degree, character, and speed. To move beyond cataloging and

73. For a fuller description, see SASKIA SASSEN, GLOBALIZATION AND ITS DISCONTENTS 194–214 (1998)

74. *See id.* at 199.

75. For a description of the difficulties with the transparency directive, see Coffee, *supra* note 63, at 669–71. For a description of the difficulties with the insider trading directive, see *infra* note 176.

evaluate the anecdotes' meaning requires reference to a theoretical framework. To make that reference is to encounter three schools of thought, each supporting a different projection. The schools are: (*a*) a strong global perspective that posits a determinative causal link between corporate governance institutions and the competitive survival of firms in international product markets and stresses both the importance of governance reform and the possibility of successful systemic cross reference; (*b*) an irrelevance perspective that posits the same causal link but dismisses the importance of governance reform and the value of systemic cross reference; and (*c*) a weak convergence perspective that emphasizes impediments to the realization of at-the-margin competitive dynamics at the global level and questions the inevitability of institutional convergence. The strong convergence and irrelevance perspectives are discussed below. The weak convergence scenario and the closely related national framework of comparative corporate governance inquiry are discussed in Section B.

1. Strong Convergence and Productive Cross Reference

Strong globalization scenarios depict national economic systems as firms competing in a frictionless world market that brings national institutions to the margin that determines competitive success or failure. Such a market does not in fact occur in the real world, of course. But, citing growing international product competition, financial deregulation, and trade liberalization, many now hold this global, at-the-margin model to provide a plausible basis for making predictions about the future development of national economies.[76] A series of projections follow.[77] Under the law of a single price, each commodity should carry the same price throughout the world market and production costs should equalize world-wide. Given free trade and complete diffusion of technical knowledge, national productivity levels and growth rates should also converge, even assuming continued barriers to the movement of labor and capital.[78]

This model also projects that competition and emulation among producers will lead to homogenous institutional settings. Since coordination mechanisms, including corporate governance

76. *See, e.g.*, KENICHI OHMAE, THE BORDERLESS WORLD: POWER AND STRATEGY IN THE INTERLINKED ECONOMY x–xiv, 161–62 (1990) (contending that national borders will be smashed by a new world market lying beyond the capacity of national intervention).

77. For a description, see Gunther Teubner, *Legal Irritants: Good Faith in British Law or How Unifying Law Ends Up in New Divergences*, 61 MOD. L. REV. 11 (1998).

78. *See* Boyer, *supra* note 57, at 30–31.

arrangements, figure into production costs, the viability of the best arrangements and innovations will be tested and proved in product and factor markets. Rational actors responding to price competition will seek to design or emulate optimal arrangements.[79] Actors and firms that fail to adopt these superior organizational technologies will in the short run lose money and in the long run disappear.[80] Diffusion of knowledge respecting the best practices will follow as a practical matter from contacts among multinational managers, consultants, lawyers, government actors, and academics.[81] Accordingly, the only cognizable barrier to actual convergence to best practice comes from government controls[82] like trade barriers and corporate governance mandates. More generally, to the extent that convergence proves to be slow or uncertain, it must be that government actors or rent-seeking interest groups are using resources generated outside of markets to sustain distinctive national institutions.[83]

These predictions, if robust, imply a dividing point in the history of corporations. We come to a moment—whether in the immediate past, the present, or in the near future—at which intensifying competition in international product markets for the first time turns endowments derived from national governance systems into factors relevant to firms' competitive survival. Once this industrial divide is crossed, the identification of a material difference between two systems' governance practices gives rise to the possibility of, first, long-run relative competitive advantage for firms organized in one of the systems (and disadvantage for those in the other) and, second, a need to reform the system not presently endowed with the better practice.[84] This comparison facilitates a just-in-time intervention that gives the firm or system with a comparative disadvantage a chance to self-correct at an early stage in the history of the global market.

Note also that crossing the divide causes formerly irrelevant

79. *See generally id.* at 34, 54. Under post-war macroeconomic theory, given competitive markets and the availability in each country of the same technology, each country has the same growth rate. *See id.* at 34–35.

80. *See* Bebchuk & Roe, *supra* note 61, at 565, 568–69.

81. *See* Boyer, *supra* note 57, at 46.

82. *See* J. Mark Ramseyer, *Are Corporate Governance Systems Converging: The A-Contextual Logic to the Japanese Keiretsu*, *in* COLUM. CORP. GOV. *supra* note 2, at 537, 544.

83. *See* Suzanne Berger, *Introduction*, *in* NATIONAL DIVERSITY AND GLOBAL CAPITALISM, *supra* note 5, at 1.

84. These are not the only possibilities. The systems, although materially different, also could be equally competitively fit. *See supra* notes 53–54 and accompanying text.

differences in governance practice to start to bear on competitive fitness. To see this, continue to take a neoclassical, first-best view of the effects of product market competition, and assume further that governance institutions bear on product cost and that national product competition is keen, but that there is little or no international trade. It follows for any given nation that domestic firms following inferior governance practices have already disappeared or will do so forthwith. To the extent that all surviving firms within a given national system follow a common set of practices, the practices do not lie at the margin of competitive survival even if they are inferior to practices followed abroad. International product markets remain too thin to bring them to the margin.

If we now change the facts and interpose expanding international product markets, there follows a projection of a second round of competitive testing in the global venue for the governance institutions of firms organized within each national system. National practices theretofore irrelevant to competitive fitness become relevant. No inference of competitive advantage in the new international environment arises from the fact of national-level survival. Identification of a point of difference between national systems can as easily imply future competitive disadvantage as advantage for a given set of national firms.

In a Coasean world, each competing firm would restructure itself and the necessary adjustments would occur on an informal, decentralized basis. In the real world, in contrast, law and political processes will matter for the adjustment of corporate governance institutions in the new global venue. Law influences shareholder protection, agency cost control, and the investment behavior of financial intermediaries and blockholders, and thereby the form and relative effectiveness of governance arrangements of firms organized in a particular national framework. It follows that law reform can figure importantly in a given national system's adjustment process. Assuming no political barriers, it also follows that convergence to best practice can be projected not only for firms' internal arrangements, but for national corporate law regimes.[85]

These strong convergence projections presuppose a high degree of technological determinism. In the world they posit, all firms face the same optimizing problems and seize on the same solutions.[86] This adaptive dynamic depends on an assumption of

85. *See* Bebchuk & Roe, *supra* note 61, at 575.

86. Carrying this point out to its logical conclusion, the implicit assertion is that there is a single optimal way of organizing production among a possible multiplicity of local optima.

pervasive and high-powered incentives to innovate. This assumption, however, challenges the equal competitive fitness hypothesis, discussed above.[87] If the systems are equally fit, it could follow that their differences, even their most prominent differences, are irrelevant to productivity.[88] Consider the fact that the market and blockholder systems share an inability to reduce the agency costs of management to zero even as they treat these costs differently. By hypothesis, then, each system could be reducing the aggregate of agency and capital costs to roughly the same level at roughly the same cost. If all other systemic costs and benefits worked out roughly equally, then the differences among the systems would not impact on bottom line results, at least until a change in the prevailing economic context caused the situation of cost equality to change. In this scenario, incentives to invest in innovative governance technologies cannot be assumed: if nothing disturbs the equilibrium, corporate governance does not matter at the margin. It follows that the strong convergence proponent who subscribes to the equal competitive fitness view must articulate a plausible scenario that highlights a generative incentive to invest in governance reform.

The missing incentive lies encased in the prediction that competitive evolution will result in a new hybrid system that adopts the best practices on an international menu.[89] Proponents predict that, given imperfections in both present systems, there will likely ensue a process of borrowing and modification of components of existing systems. Certain features of certain national systems will come to be seen as possessing problem-solving advantages and come in for widespread adoption. The incentive to adopt follows from the ordinary stress to reduce costs felt by actors under competitive pressure.

This is plausible enough, but one further operative assumption needs to be highlighted. For governance cross reference to offer advantageous solutions in which business actors willingly invest, the existing systems must have divisible components. That is, a particular feature (or innovation) must be detachable from one system and adaptable to another.[90] If the systems are in fact divisible, then

---

See Boyer, *supra* note 57, at 47.

87. *See supra* notes 53–54 and accompanying text.

88. One can reach the same insight by juxtaposing the two systems and then viewing both from the point of view of an observer in a Third World country. That observer sees commonalties for the most part. *See* Shleifer & Vishny, *supra* note 52, at 737–38.

89. *See* Aoki, *supra* note 33, at 23–24. *See* ROE, *supra* note 6, at 187–94.

90. *See* Berger, *supra* note 83, at 12–14. For a speculation as to the components of a hybrid corporate governance regime, see Kester, *Convergence*, *supra* note 5, at 108–09.

the cross reference hypothesis emerges as robust. Policy discussion should anticipate the hybrid's likely composition so as to identify barriers to its realization. Moreover, assuming intense global product competition and no other significant frictions, the systems should indeed converge in their broad outlines over time.[91]

2. Irrelevance and Market Superiority

The connection just drawn between a strong convergence scenario and the cross reference hypothesis has been controverted by an irrelevance contention following from neoclassical microeconomic assumptions.

Chicago School critics suggest that governance reform by cross reference at best would be wasted effort and at worst could injure market systems.[92] They posit a global marketplace just as (and perhaps more) competitive than that posited in the strong convergence model. Here again product competition determines firm survival and any governance arrangement that hobbles a competitor with excess costs causes failure. But here it follows that firms not only must choose optimal governance arrangements in order to survive, but that governance problems take care of themselves in the long run. In that long run, therefore, corporate governance policy inquiries are irrelevant.[93] In the meantime, the differences between governance

---

Kester's hybrid, *inter alia*, preserves some of the shareholder protections and high powered incentives of present market systems, but contemplates informal ties among co-operating companies as in Japan.

91. It should be noted that the cross reference hypothesis can be restated in a weaker form so as to allow for the persistence of national level colorations. *See* Berger, *supra* note 83, at 18–19.

92. *Cf.* Merton H. Miller, *Is American Corporate Governance Fatally Flawed?*, *in* INT'L GOVERNANCE, *supra* note 1, at 44–45.

93. This irrelevance point can be combined in a unitary description with the irrelevance point made above, in the text accompanying *supra* note 88, despite their different emphases. For a first step, juxtapose the two stories: the first focuses on a structural feature of a first-best world; the second follows from the fortuitous possibility that systemic differences may have equivalent cost implications. The juxtaposition highlights the point that neither irrelevance story eliminates the possibility that systemic differences can have important cost consequences for competing firms and national economies. A cost difference has the greatest impact for a firm at the margin, where any cost disadvantage impairs its survival. Ironically, the margin is the base point for the first story's irrelevance claim, while under the second story it is the point of greatest relevance for governance difference. This is because what the first story makes irrelevant is less governance itself than governance policy talk. Talk matters least at the margin. There the uncompetitive firm runs out of room to maneuver, market practice identifies the most productive governance device, and no reference to theory is necessary.

Let us take a step way from the margin and introduce a small measure of room in which firms

systems highlighted in comparative discussions are immaterial. This is because blockholder systems' components and behavioral characteristics can be explained by reference to the same microeconomic model that explains the components and characteristics of market systems.[94] Convergence at a substantively significant level already has occurred. Differences obviously exist, but these always can be accounted for as adjustments to legal barriers.[95]

This two-sided irrelevance assertion is accompanied by the claim that the United States' market system is substantively sound and not in need of reform.[96] Proponents of cross reference, it is argued, overreacted when they claimed at the beginning of the 1990s that recent legal constraints on hostile takeovers created a need to look to blockholder systems for alternative arrangements to control agency costs.[97] Subsequent events have shown that the market system has adjusted very well: takeover activity again breaks volume records; new strategies for hostile tender offers have been developed; and institutional activism has become a governance constant.[98] In the alternative, it is admitted that the subset of *hostile* takeover activity

---

with different practices having positive cost implications can survive over an intermediate term. Here the relevance of the comparative exercise depends on the observer's point of view. An observer with an investment or citizenship stake in one of the competing systems might be quite interested to know whether it possesses the relatively inferior or relatively superior practice. But if one changes perspectives and looks at the competing systems from a general efficiency point of view, then the comparison loses its urgency once again. From this point of view, any needed corrections are assured in the long run, along with the concrete identification of the superior practice. Only if all systems produce deadweight losses due to some shared perverse feature does this point of view counsel intervention at the planning level.

94. Ramseyer illustrates this point with an historical explanation of the Japanese system couched solely in terms of rational, self-interested responses to the national economic and legal environment. *See* Ramseyer, *supra* note 82, at 537, 546–47, 555. Ramseyer admits that the explanation is incomplete because it does not explain cross-shareholdings held by nonfinancial *keiretsu* members who do not stand in a vertical supplier-customer relationship with the issuer. Since the blocks of stock held by these firms are small on a percentage basis—less than 5% of most *keiretsu* members—he dismisses the phenomenon as trivial or symbolic. *Id.* at 557.

Aoki provides a useful contrast to this analysis. Here the same microeconomic perspective is applied so as to highlight systemic differences. *See* Aoki, *supra* note 33, at 18–24.

95. *See* Frank H. Easterbrook, *International Corporate Differences: Markets or Law?*, 9 J. APPLIED CORP. FIN. 23, 29 (1997); Ramseyer, *supra* note 82, at 538.

96. *See* Ramseyer, *supra* note 82, at 540–41 (arguing that barriers to hostile bids do not reduce the diffusion of efficient governance strategies.). *Cf.* Jonathan R. Macey, *Italian Governance: One American's Perspective*, 1998 COLUM. BUS. L. REV. 121, 124–25 (1998) (describing evaluative standards under which the United States emerges as first best).

97. *See infra* notes 146–56 and accompanying text.

98. *See* Boot & Macey, *supra* note 2, at 232–33; Easterbrook, *supra* note 95, at 24–25.

has decreased in the 1990s, but it is argued that the decrease does not make much difference. A potential acquirer with a better governance strategy ends up taking over the target one way or the other. If regulation forecloses the option of a hostile takeover, then the acquirer will win over recalcitrant members of the defending board with side payments disguised as consulting agreements or as nonsubstantive high paying jobs. Hostile takeovers accordingly are not the only means to the end of bringing new governance strategies to the firms that need them. Friendly mergers and acquisitions can substitute for them, with the sole difference going to the pattern of distribution of merger gain.[99]

Some commentators in this vein go a step further to argue that market systems occupy a higher evolutionary plateau and are intrinsically superior to blockholder alternatives.[100] Nothing in

---

99. *See* Ramseyer, *supra* note 82, at 540–41.

100. *See, e.g.*, Miller, *supra* note 92, at 38–41; Easterbrook, *supra* note 95, at 26 (comparing Europe and East Asia to the United States in the late nineteenth century); Macey, *supra* note 96, at 123–29 (arguing that systemic performance can be gauged by reference to barriers against self dealing and robustness of securities markets). Macey argues that there is empirical support for this assertion. *See* Macey, *supra* note 96 at 124–25. We refute this claim in the text accompanying *supra* note 52.

Rajan and Zingales pursue the superiority argument on a more serious level, in connection with their discussion of the current East Asian crisis. As discussed, Rajan and Zingales describe misallocations of capital in the context of relational banking systems, hypothesizing that a relationship-based system works better in less developed economies where price signals are less effective. They note recent work on the performance of United States conglomerates abroad which appears to confirm the view that, despite resource misallocation within the firms, these large groups perform better in less developed markets such as India and South Africa. Rajan and Zingales attempt to develop a theoretical framework which provides a guide to the circumstances supporting the emergence of a relationship approach and the circumstances supporting an arm's length approach. Under this framework, a relationship-based system will emerge when there exists little investment capital and contractability is low. In contrast, an arm's-length system dominates when there exists abundant capital and high-quality projects. Both systems are equivalent when there is little available capital but high contractability. Rajan and Zingales posit that in this last situation, the arm's-length system will eventually replace the relationship based approach. *See supra* text accompanying note 41.

Rajan and Zingales employ their model to explain the recent crisis in East Asia. Until recently, East Asian economies have been dominated by the relationship-based model. Prior to the liberalization of capital, most East Asian markets lacked sufficient capital even though good investment projects were abundant. The opening of these markets saw a dramatic shift of capital flows toward East Asia. Yet, these systems had few well developed controls in place to monitor these loans properly. In effect, the East Asian economies reflected a combination of high sources of capital and low contractability, with the result that neither system could operate effectively. In response, Western investors took a short-term view in order to facilitate easy exit. The compromise was effective until the crisis emerged. The crisis led to a massive retreat of short-term capital from these markets, since there existed inadequate protection.

Rajan and Zingales argue that, while moral hazard and panic may have played a role, the crisis should be explained by reference to the unhappy encounter of arm's length and

economic theory makes this assertion untenable. It may be that the market system does have superior properties of competitive fitness and will achieve hegemony after a period of competitive struggle. The convergence events cataloged above also can be drawn on to support this view.[101] Firms that opt to list in London and New York in effect vote with their feet, seeking to lower their cost of capital by bringing themselves in a market system context. In so doing they resemble American firms that reincorporate in Delaware. Meanwhile, to the extent that firms in market systems have a lower cost of equity capital, they have a financing advantage in the emerging global takeover market. There results a projection of long run assimilation of firms from blockholder systems into multinational firms with market system parents.[102] As more and more firms from blockholder systems adopt market institutions by these transactional means, their systems of origin become less and less relevant. Presumably, such marginalization imports an impetus for adaption of market institutions through law reform. Arguably, we see the beginning of this in Europe today.

On this view, present policy discussion in market system venues should be directed to the preservation and enhancement of this advantage. It also must be noted, however, that nothing in economic theory guarantees the correctness of this evolutionary superiority claim. If the equal competitive fitness hypothesis turns out to be accurate, then the foregoing scenario does not work. All such assertions lie at the level of hypothesis, pending the appearance of a decisive empirical literature or the occurrence of the long run.

A point of tension between the evolutionary superiority claim and the irrelevance claim should also be noted. If policy choices respecting systemic structure are absolutely irrelevant, then, by hypothesis, the Anglo-Saxon market system cannot meaningfully be deemed to be evolutionarily superior. The systemic superiority claim implies not only relevance for policymaking but an emphatic policy agenda. Under this, the market system needs protection from forces of interest group rent-seeking, protection that should be secured in advance of the promotion of structural change inspired by reference to the more primitive systems of Japan and Germany.

---

relationship-based systems. The flight of arm's length capital was rational given the options available to investors. At the same time, Rajan and Zingales concede that East Asian countries may have made a strategic error in accepting such large flows of near term capital without developing adequate institutions to support the new financial environment. *See* Rajan & Zingales, *supra* note 41, at 44–45.

101. *See supra* notes 60–72 and accompanying text.

102. *See* La Porta et al., *Corporate Ownership Around the World*, *supra* note 48, at 512.

B. *Weak Convergence and Comparative Governance in a National Framework*

1. Barriers to Convergence and the Weak Convergence Perspective

A third body of theory controverts both strong convergence hypotheses described above, rejecting their technological determinism even while acknowledging the existence and importance of the emerging global markets.[103] This alternative approach also rejects the idea that a single production technology always must emerge as the winner.[104] It instead posits that there may be more than one way to solve a given technical problem. Expanding on this point, it also suggests that there can be more than one type of capitalism: not only may different national systems of production be functionally equivalent and equally fit, but national differences may persist indefinitely.[105]

This perspective draws on social as well as economic theory to depict national systems as tightly bundled packages of specific resources, institutions, and legacies. The perspective does not deny the possibility of convergence to best practice. But it asserts that when such convergence does occur, such convergence does not follow from the operation of a self-implementing mechanism like the at-the-margin adjustment process described in strong convergence

---

103. *See* Kester, *Convergence*, *supra* note 5, at 108–09.

104. For an example of this thinking, see BUSINESS SECTOR ADVISORY GROUP ON CORPORATE GOVERNANCE, ORGANIZATION FOR ECON. CO-OPERATION AND DEV., CORPORATE GOVERNANCE: IMPROVING COMPETITIVENESS AND ACCESS TO CAPITAL IN GLOBAL MARKETS—A REPORT TO THE OECD (1998) (rejecting a one-size-fits-all approach to corporate governance, opting for pluralism and adaptability of corporate governance, and recommending that nations adapt corporate governance rules suited to changing competitive markets, formulate minimum standards of corporate governance designed to promote fairness and transparency, issue voluntary best practices for boards to improve accountability, encourage common principles for disclosure, and emphasize the impact that corporate law rules have for private and public sector).

105. A related point of view that favors centralization also should be mentioned. If national-level sticking points will prevent convergence to best practice, then international-level coordination may be called for. *See* Paul Davies, Issues in Corporate Governance 14 (Presented at the Single Market and Company Law Conference, European Commission 1997) (on file with author) (addressing corporate governance in the European Community). Davies argues that, given the central role of the EC in generating the conditions for effective mobility of capital across borders, the EC should promote cross-community action by coordinating the corporate governance requirements of national stock markets. Under this approach, the articulation of common standards would be developed in a single EC instrument. *See id.*

theory.[106] Convergence instead occurs within limits set by national contexts. Accordingly, its effects are uncertain and varied, depending on precise configurations of markets, technical competencies,[107] property rights institutions, and related incentives.[108] Nor can we safely assume that a best practice will emerge and be adopted universally. A materially different national system can survive in a competitive global market by finding a niche suited to its particular endowments.[109] Alternatively, a national system may be disabled from adopting a productive technical innovation because the necessary implementing reform lacks political feasibility when mooted in the context of a tightly-fitted set of national institutions. Given barriers such as these, significant, context-breaking steps toward convergence are most likely to be taken during the political crisis that follows an external economic shock.[110]

This picture of intermittent movement toward convergence can be restated in the terms of second-best microeconomics. Movement is intermittent because competition operates imperfectly, hobbled by asymmetric information, contracting frictions, sunk costs, increasing returns to scale, and public goods problems.[111] Instead of a unique, global equilibrium, then, we should expect unstable, punctuated equilibria. Convergence can indeed occur—but so can autonomous evolution, partial catch-up followed by collapse, or catch-up followed by forging ahead. Strong convergence predictions,

106. There is accordingly no tension between this description and the contemporary movement toward partial integration of national systems in Europe and North America. The conventional view of harmonization initiatives such as that of the European Union is that mutually designed institutional structures facilitate the development of competitive techniques in a more open marketplace. The European movement toward harmonization assumes partial divergence, in that some countries will be slower in adapting common standards due to their relative starting points.

107. Technology is not a pure public good. Accordingly, its use depends on learning. It follows that different producers will be differentiated in respect of their ability to learn a new technology—accessibility may presuppose past experience, shutting out some producers. *See* Boyer, *supra* note 57, at 50.

108. *See id.* at 47.

109. *See id.* at 31. This point derives from the observation of national product markets, where the same product can be sold for different prices and domestic firms develop niches, with different niches possibly calling for specific organizational forms. *See id.* at 50.

110. *See* Berger, *supra* note 57, at 18–19, 21. This theory appeared in the 1970s in opposition to theories of technological determinism and strong convergence articulated in the 1950s and 1960s by both Marxists and liberals. *See id.* at 2–3.

111. Trade theory posits that free exchange causes factor incomes to converge without also asserting convergence as to the form of the institutional arrangements of trading nations. At the same time, international product competition can lead to several different equilibrium results, some of which do not include institutional convergence. *See* Boyer, *supra* note 57, at 51–53.

meanwhile, credibly can be made only if special conditions obtain, including costless availability of requisite technology, total divisibility of production institutions, and independent availability on the part of each such divisible, systemic component.[112]

This weak convergence perspective is supported by a body of comparative studies of production practices. These antedate the comparative governance literature by a generation, looking at the shop floor rather than the boardroom. They show that during the post-war era different capitalist economies developed fundamentally different firm organizations to produce the same products.[113] The different organizational patterns are accounted for as the product of domestic interactions between political and social interests and economic strategies.[114] These studies anticipated and paralleled the governance literature, articulating a set of distinctions between market-based production institutions in English-speaking countries and societal and state-coordinated systems of Germany and Japan.[115]

Additional support for the weak convergence view comes from the endogenous growth school of macroeconomic theory. This approach rejects earlier models of technologically-driven convergence of growth rates. It instead posits an endogenous model under which each country's equilibrium growth path depends on contextual factors such as past investments in research and development and education. According to this view, rates of productivity growth will vary from country to country[116] and movement toward convergence can only be expected given a base of similar educational endowments and technical policies.[117] Given similar economies, convergence

---

112. *See id.* at 31, 55–58.

113. For studies antedating the comparative corporate governance literature, see MARC MAURICE ET AL., THE SOCIAL FOUNDATIONS OF INDUSTRIAL POWER (1986); RONALD DORE, BRITISH FACTORY—JAPANESE FACTORY: THE ORIGINS OF NATIONAL DIVERSITY IN INDUSTRIAL RELATIONS (1973). For more recent contributions to this literature, see MICHEL ALBERT, CAPITALISM VS. CAPITALISM (1993); JAMES P. WOMACK ET AL., THE MACHINE THAT CHANGED THE WORLD: THE STORY OF LEAN PRODUCTION (1990).

114. *See* Boyer, *supra* note 57, at 45–46 (discussing differentials in the manifestation of Fordist production techniques as they diffused during the post-war period).

115. *See* Berger, *supra* note 83, at 4.

116. *See* Boyer, *supra* note 57, at 35.

117. It follows that underdeveloped countries can become trapped. *See generally* GROWTH, PRODUCTIVITY, UNEMPLOYMENT: ESSAYS TO CELEBRATE BOB SOLOW'S BIRTHDAY (Peter A. Diamond ed., 1990).

Empirical tests of convergence hypotheses focus on per capita measures of gross national product. These applications of per capita gross national product measures have been applied so as to yield productivity levels from the late nineteenth century to the present. The best work models the convergence of income across regions, taking into account the interplay of net migration pattern and economic growth. *See generally* Robert J. Barro & Xavier Sala-i-

respecting productivity growth rates, in fact, has been demonstrated empirically. But the rate is slow: given strong similarities, the underlying speed of convergence has been estimated at two percent per year, meaning that it takes 25 years for similar economies to reduce an initial productivity gap by 50%.[118]

Martin, *Convergence Across States and Regions*, 1 BROOKINGS PAPERS IN ECON. ACTIVITY 107 (1991); BART VERSPAGEN, UNEVEN GROWTH BETWEEN INTERDEPENDENT ECONOMIES (1993). The results support the proposition that convergence depends on similarity. *See* P. Bairoch, *Europe's Gross National Product: 1800–1975*, 5 J. EUR. ECON. HIST. 273 (1976) (showing divergence in Europe between 1830–80 when more than the top eight countries are tested, yet evidence of strong productivity convergence if only the top eight countries are tested); W. BAUMOL, S. BLACKMAN & E. WOLFF, PRODUCTIVITY AND AMERICAN LEADERSHIP: THE LONG VIEW (1989) (showing convergence among a select club of countries; divergence for less developed countries); J. Bradford Delong & Lawrence Summers, *Equipment Investment and Economic Growth*, 106 Q.J. ECON. 445 (1991) (looking at 61 countries and arguing that convergence occurs with significant investment, divergence where investment is too low); Bart Verspagen, *A New Empirical Approach to Catching Up or Falling Behind*, in 2 STRUCTURAL CHANGE & ECON. DYNAMICS 359 (1991) (looking at 114 countries and observing that if the technological gap is small enough, then there is convergence, but that there is divergence with a large initial gap).

The basic chronology that emerges from this research supports the proposition that strong convergence cannot be assumed as an historical constant. Boyer summarizes the research to show that there was significant divergence among countries until the end of the nineteenth century. At the beginning of the twentieth century there was some convergence, but this was disrupted in the 1930s. Significant reduction of productivity differences is a more recent phenomenon. From the 1950s to the present there has been convergence in productivity. On the other hand, in the post-1973 era many newly developing countries have fallen behind similarly-situated countries due to external shocks and other problems. *See* Boyer, *supra* note 78, at 42–43.

118. *See* Boyer, *supra* note 57, at 41. Barro and Sala-i-Martin show that the speed of convergence *within* the United States in terms of per capita income from 1880–1988 was around 2% per year (within and across four major regions). They also make similar estimates for the 1963–86 period and find the same estimated rate of convergence in Europe for the period 1950–85. The effect of net migration on convergence is found to have been quite small in the United States. A more complex impact is found for capital mobility, although Barro and Sala-i-Martin assume that greater mobility would not lead to higher rates of convergence. *See generally* Barry & Sala-i-Martin, *supra* note 117.

Blanchard challenges this simple convergence story. *See* Olivier Jean Blanchard, *Comments and Discussion*, 1 BROOKINGS PAPERS ON ECON. ACTIVITY 159 (1991). He acknowledges that Barro and Sala-i-Martin establish a robust convergence of incomes across regions. Yet he doubts their conclusion that convergence is the salient aspect of regional growth in the United States. He introduces a simple model of the United States in which he assumes there are 50 small economies, and looks for the effect of shocks, technology, and factor mobility. He challenges several assumptions of Barro and Sala-i-Martin: (*a*) he asserts that there is substantial evidence showing considerable regional specialization due to increasing returns of production; (*b*) he asserts that persistent regional specificities may explain why certain states and nations experience decreases in their terms of trade; (*c*) he focuses on the mobility of factors across jurisdictions; and (*d*) in contrast to the strong, neo-classical convergence model, he assumes that labor is immobile.

Blanchard offers two special cases to challenge the strong convergence hypothesis. His first case assumes that if (*a*) labor is immobile so that it is allocated evenly across states, (*b*) capital is mobile, and (*c*) there is an absence of shocks, then the economy will converge to equal per capita output per state. If, however, we change assumptions and introduce state-

The weak convergence view influences much recent commentary on comparative governance.[119] It now is accepted that large, successful firms do not operate at the razor-thin margin assumed in strong convergence scenarios. When a competitor's superior governance arrangements yield a product market advantage, the disadvantaged firms do not automatically go out of business. They can instead offset the disadvantage by cutting supply or other production costs, returning less to their equity investors, or, as a last resort, securing state subsidies.[120] More broadly, national systems hold out real and persistent barriers that can prevent the emergence of a hybrid corporate governance system, even a hybrid holding out productivity advantages (or, in the event of market system superiority, that can retard the diffusion of market institutions). Each of selective incentives,[121] cost barriers,[122] interest group politics,[123] and structural interconnections among systemic components[124] can contribute. It

---

specific shocks but retain labor immobility, the movement of capital causes the shocks to impact on output per capita, and over time will lead to divergence. The second case assumes that capital is immobile and labor is mobile. In this case the economy will exhibit convergence even when the shocks to technology and demand have a permanent aspect. But, given the stochastic nature of the shocks, the states do not converge to the same level. Eventually a stationary level is achieved, as labor adjusts in response to the shock.

Blanchard argues that although the economy in this model appears to exhibit signs of convergence, true convergence should not be implied. Blanchard contends that an innovation in personal income should lead to a permanent increase in the level of employment, as labor is attracted to a higher return. Based on this insight, he looks at the long-run elasticity of employment in the South and North-Central regions of the U.S. and finds effects of innovation in the South but none in the North-Central region. The conclusion is that there *appears* to be convergence of output across the United States, with labor mobility the crucial reason for this outcome. This is not a surprising result given the relative level of economic development among the states.

119. *See, e.g.*, Berglöf, *supra* note 17, at 104–11 (commenting on the limited amount of actual convergence among European governance systems). In Europe, he says, neither globalization nor increased institutional shareholding activism has prompted institutional changes that lead to more uniformity. *See id.*

120. *See* Bebchuk & Roe, *supra* note 61, at 584–85.

121. *See id.* at 575–78 (noting the possibility that blockholding could persist after securities market reforms so long as not accompanied by effective reform of fiduciary law causing value of private benefits to blockholders to exceed proceeds on public sale of block, and the possibility that dispersed shareholding could persist even though legal barriers to blockholding were removed due to resistance of managers seeking to retain positional advantage).

122. *See id.* at 572–74, 579–83 (describing several possible cost frictions, including sunk costs, along with the possibility that equal effectiveness denudes the reform movement of force).

123. *See id.* at 572–74, 577–78 (noting the possibility of interest group resistance); La Porta et al., *Corporate Ownership Around the World*, *supra* note 48, at 512 (noting that majority shareholders in blockholder countries tend to oppose law reform that would give rights to minority shareholders).

124. *See* Woolcock, *supra* note 17, at 181–82 (noting that each national system in

follows that the only safe projection is weak convergence—hybrid innovation that supplements existing systems without threatening vested interests or requiring law reform.[125]

2. Comparative Governance in a National Framework

The weak convergence perspective has negative implications for comparative governance analysis in a global framework. If convergence due to the operation of global market mechanisms is not a significant possibility, then there remains very little "globalized" corporate governance subject matter to discuss. But the weak convergence perspective does not thereby imply that comparative corporate governance exercises are irrelevant. They retain pertinence in national policy frameworks.[126]

At the national level, the question is whether alternative mechanisms identified in an international comparison can help domestic firms solve governance problems. Any such benefit need only be potential—an experimental possibility—in order to justify the comparative exercise.[127] Indeed, so long as different outside practices have cost implications, actors with a financial stake in a given national system should have an intrinsic interest in trying them. This is because the outside practices open an opportunity for domestic competitive advantage, provided they are productively superior and not culturally, technically, or geographically bound to the country of origin. This justification occurs even in the absence of international competition. In this scenario, competitive survival is exclusively a function of the operation of domestic markets. A new source of advantage always will be welcome, whatever its national origin.

The equal competitive fitness hypothesis holds out no negative implications for this domestic exercise. Even if neither the market nor the blockholder system has an overall advantage, it may remain possible to identify material productivity differences among the

---

Europe is made up of a set of linked policies, regulations, practices, and philosophies affecting capital markets, corporate structure, and industrial relations).

125. *Cf.* La Porta et al., *Corporate Ownership Around the World*, *supra* note 48, at 513 (expressing skepticism as to imminent convergence to market system separation of ownership and control); David Charny, *The German Corporate Governance System*, 1998 COLUM. BUS. L. REV. 145, 164 (1998) (projecting that Germany will see only convergence that does not depend on law reform, such as stepped up market pressures and the appearance of a subset of firms governed along American lines).

126. Or a regional framework as applies in the European Union.

127. *Cf.* ROE, *supra* note 6, at 187–209 (speculating on the possibility the U.S. intermediaries imitate German or Japanese banks).

systems' individual components. The fact that the systems' respective strengths and weaknesses tend to cancel each other out suggests potential complementarities. A plus factor in one system may yield a productivity advantage if transplanted to firms in the other system. This possibility is strengthened to the extent that the systems result from accidents of political history.[128] American observers dissatisfied with the amount and quality of shareholder monitoring in mature domestic firms thus have looked to the stockholding patterns and monitoring activities of financial institutions in Japan and Germany to support law reform directed to development of home grown institutional monitors. On the contrary, European observers, aware that firms in the United States and Britain have the advantage of a wider array of financing modes and sources due to deeper domestic securities markets, have been looking to governance reform to build investor confidence in domestic securities markets so as to promote their growth.

National-level comparison, then, is a cross reference exercise in which firms and regulators experiment with new, imported techniques—the same exercise carried out in the global framework under the rubric of convergence to best practice. The source of the competitive imperative differs in the national framework, however. On the global level, the incentive lies at the international level and implicates a near-term threat of serious competitive disadvantage for a given nation's producers as a whole.[129] On the national level, the incentive lies in the search for national-level advantage, with global advantage coming to bear as an additional but not essential factor. If, for example, institutional monitoring holds a productivity advantage for American firms, then some American firms presumably will want to try it—and will have an incentive to work toward the removal of

128. This is Roe's suggestion. *See* Roe, *supra* note 7, at 644–45.

129. There is at least one practice in corporate law's past to which we can look as an indirect source of historical support. This is the evolution of corporate codes and governance practices in the United States as it developed as a common market over the last 100 years. Famously, corporate law is generated at the state level, with each of the fifty states having its own code and body of cases, and its generation is at the same time subject to a competitive constraint. The states compete for rents flowing from corporate charters. The historical result of a century of practice is convergence in the outline of the states' corporate codes. Any state that fails to conform to this basic outline loses incorporation business to the market leader, Delaware. Although each statute varies in its terms to some extent, the variation is not thought to create sufficient incidental costs as to justify a national level harmonization movement. But, at the same time, the normative implications of the system are hotly controverted. The argument is that the terms of U.S. corporate law, although constrained by competition, remains subject to interest group influence. As a result, the state codes now constrain the field of operation of a mainstay of the American market control system, the hostile takeover. For discussion, see ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 52–84 (1993).

regulatory barriers—toward the end of gaining a cost advantage over domestic competitors. If no productivity advantage proves out, no one should be the worse off since the experiment can be abandoned quickly.

The national and global frameworks overlap in one other respect. Extensive national-level experimentation in cross reference could mean incidental steps in the direction of global convergence to a superior, hybrid governance system.[130] These converging stories stem from very different theoretical frameworks, however. In the national framework, convergence is only an incidental possibility. No deterministic vision of global economic evolution is asserted.

The national framework thus offers a more robust, less demanding base of assumptions than does the global. It implies no particular evolutionary projection. It requires no risky appraisals of systemic productivity. Yet it promises important contributions to domestic policy discussions about governance and productivity in many different countries.

But the national framework still makes a strong assumption when it commends domestic experimentation by cross reference. As noted above,[131] cross reference only works if the different systems have divisible components. To the extent that national systems resemble the tightly-fitted complexes of diverse elements depicted in the weak convergence view, divisibility may be an unsafe assumption. The pluses and minuses of the two systems depicted in Tables 1 and 2 do not necessarily imply complementarities. They also suggest the presence of internal dependencies. Each system may manifest interconnected trade-offs that strike an overall balance among the interests of its various participants. The balances thus struck may not be so easily adjusted.[132]

Questions accordingly arise as to the likely returns on investments in experiments in cross reference. If corporate governance institutions tend to be indivisible, returns may be nonexistent because frictions prevent experiments from being carried out in practice or because such experiments as are carried out fail to bring improvements. Alternatively, losses could result if

130. *See* Aoki, *supra* note 33, at 22–24; Berglöf, *supra* note 17, at 115–17 (presenting a reform agenda for European corporate governance centered on investor protection).

131. *See supra* text accompanying note 90.

132. *See* Coffee, *supra* note 63, at 659–60 (noting this problem and suggesting by way of example that an American monitoring board staffed by outsiders might not make sense in a firm in an Asian country in which all other firms in the industry were staffed with personnel close to government actors, or alternatively, nominated representatives of trading partners to their boards).

experimentation occurs but unforeseen interconnections among components within a given system lead to perverse effects. Parts III and IV take up these problems in detail.

C. *The Comparative Governance Matrix*

Stripped to its essentials, comparative corporate governance may be seen as a two-course menu that offers two choices in each course. One first chooses a convergence model, strong or weak. This choice has determinative implications for the framework in which comparison then proceeds. Strong convergence models imply that global competitive forces dominate national level evolution. Weak convergence implies determinative influence for national social and political institutions, but holds open a door for the homogenizing influence of competitive forces, whether domestic or global. The second menu item is divisibility. Here one decides whether it makes sense to view national governance systems as open to significant modification by cross reference to other systems' components. This choice determines the policy implications of the comparative exercise—whether it looks toward or looks away from the development of hybrid governance structures.

The menu implies four basic points of view respecting comparative governance. Table 3 plots out the possibilities.

Table 3—The Comparative Governance Matrix

	Divisible	**Indivisible**
Strong Convergence	(1) Global cross reference	(2) Chicago School
Weak Convergence	(3) National cross reference	(4) National embeddedness

Box (1). Strong convergence and divisibility combine to imply a projection of a hybrid but unitary governance system world wide.[133] Skepticism respecting near- or intermediate-term

133. *See, e.g.*, Kester, *Convergence*, *supra* note 5.

convergence possibilities makes this a minority point of view. Indeed, it is virtually absent from the legal literature.

Box (2). Strong convergence combined with indivisibility implies competitive struggle between entire systems, with one system winning in the end. This is the position advanced by Chicago School participants in both legal and economic discussions. A *caveat* needs to be entered about the binary characterization of the Chicago position, however. Presumably, a Chicago School observer would not object if a reforming blockholder system adopted market system components piecemeal, even while simultaneously warning of potential perverse effects for market systems from experiments in cross reference. Cross reference enters the Chicago story to this extent. But it does so only at an intermediate point in the time line. In the end, the superior properties of the market system overwhelm the blockholder antecedent and no hybrid appears. Such a market system triumph is most easily imagined in a crisis: economic distress leads to political disruption, the blockholder system cracks under the strain, and there follows root and branch reform designed to foster market institutions. Thus the Chicago School's strong evolutionary superiority claims imply a long run assertion of indivisibility. In the short run, however, cross reference is a productive possibility only if it goes one way.

Box (3). An observer who chooses weak convergence and divisible institutions makes reference to other governance systems as a means to the end of effecting domestic improvements. This perspective sees value in cross reference even as it abandons breathless projections of near-term international convergence. It is manifested both in leading American discussions of Japanese and European institutional investors and in European law reform initiatives directed to improving the depth of securities markets and in responsive economic discussions.[134] It fairly may be termed the international mainstream approach.

Box (4). The fourth and final perspective pairs weak convergence with indivisibility to emphasize barriers to both convergence and cross referenced governance reform at the national level. This perspective is reflected in the present literature on convergence,[135] but has shown up only sporadically in legal comparative governance discussions.[136] It is, however, a possibility

134. *See, e.g.*, Berglöf, *supra* note 17, at 115–17 (presenting a reform agenda for European corporate governance centered on investor protection).

135. *See* Boyer, *supra* note 57, at 45–58.

136. *See* Fanto, *supra* note 27, at 180–91; Woolcock, *supra* note 17, at 181–82; Gregory

explored in the economic literature,[137] and much implicated in the position articulated in Parts III and IV of this Article.

Reconsider now the two questions posed at the start of this Article in the context of the four perspectives in the matrix. The first question goes to the near-term possibility of significant convergence. We emerge less with an answer than with a range of possibilities. Strong convergence perspectives lie at one end of the range. These persist based on indirect empirical support and descriptive assumptions derived from microeconomic theory. The closer the attachment to the neoclassical model, the stronger the convergence claim. Even so, nothing in the literature permits us to dismiss these claims altogether. And, even if complete convergence is not imminent, the plethora of real world convergence events in recent years requires us to take seriously the possibility that the pace of convergence will accelerate. At the other end of the range lie weak convergence predictions made by theorists predisposed to seeing persistent structures amidst thick institutional descriptions. These appear to be safer on the state of the empirical studies.[138] But even the weakest convergence position remains subject to a *caveat* respecting radical change due to external shocks.

The second question, which concerns relative competitive fitness, now can be restated: Which of the four perspectives implies a strategy for governance policy best calculated to enhance the productivity of individual firms and national systems? Empirical evidence matters here too, but present results remain too thin to provide a basis for an educated guess. The only strong empirical result—that significant investment in firms by outside capital presupposes the rule of law—does not help us to distinguish among the systems in developed countries. There also is indirect but cogent empirical backing for the equal competitive fitness hypothesis.[139] But this does not help us choose a strategy either. We have seen that equal competitive fitness synchronizes well both with the global cross reference (Box (1)) and national cross reference (Box (3)) perspectives.[140] It is compatible with the national embeddedness view (Box (4)) for the same reasons. Equal competitive fitness becomes an

---

A. Mark, *Realms of Choice: Finance Capitalism and Corporate Governance*, 95 COLUM. L. REV. 969, 993–98 (1995) (reviewing ROE, *supra* note 6).

137. *See, e.g.*, Berglöf, *supra* note 17, at 113–16; Aoki, *supra* note 33, at 23–24.

138. *See supra* notes 44–55 and accompanying text.

139. *See supra* notes 53–56 and accompanying text.

140. *See supra* notes 86–89 and 126–29 and accompanying text.

issue[141] only with the Chicago School view of market superiority (Box (2)). Its indirect empirical backing provides a basis for arguing against the market superiority view, but does not suffice to falsify it.

We have, in short, no conclusive basis for assigning equal fitness to both systems, for assigning relative advantage to one system, or even for assigning equal or relative advantage to an internal component of either system. Nor can we falsify the assertions basic to any of the perspectives in the matrix. Each of the four points of view thus retains some vitality, leaving the literature as a whole in a speculative posture.

The existence of such a broad, active menu of possibilities underscores the determinative role that theory plays here. Recall, by way of example, that the cross reference hypothesis derives credibility from the assumption that cost savings accruing from improved governance lend an incentive to experiment to business actors. Yet absent hard numbers it remains difficult to appraise the magnitude of the incentive posited. If business actors are not operating at the margin, questions of the magnitude of the gain from experimentation will be critical in practice. If only modest or speculative gains are projected, then the actors could turn out to be rationally indifferent to cross reference possibilities. The cross reference hypothesis accordingly needs a cogent, albeit informal, description of the source and expected value of this gain. Such a specification can only be based on an economic theory of the firm.

More generally, differences identified in a governance comparison can be evaluated only by reference to antecedent theories of the firm. It follows that better information about available theoretical alternatives means better quality for the projections emerging.

III. COMPARATIVE RESULTS AND THE CASE FOR INDIVISIBILITY

The question as to the productivity advantages of different governance strategies devolves on the utility of cross reference: can it improve bottom line results for a given firm or system? Answers to this question turn on views as to divisibility. We have seen that positive projections of divisibility go together with positive predictions respecting cross reference in Boxes (1) and (3) on Table 3.[142] Boxes (2) and (4) share suspicion about divisibility and cross

141. *See supra* note 133 and accompanying text.

142. *See id.*

reference, but for different reasons. The Chicago School holds incidents of blockholding to be intrinsically inferior; accordingly, cross reference should only proceed in one direction whatever its technical feasibility. The Box (4) view, in contrast, sees national systems as embedded and asks whether cross reference is technically feasible in the first place.

The comparative literature suggests a number of factors that could operate to embed governance institutions. Significantly, different projections tend to follow depending on the factor emphasized. For example, leading contributions to the literature emphasize past and present political sticking points and assert that but for such points economic incentives would prompt cross referenced experiments.[143] The result is a straddle between Boxes (3) and (4), which puts the best gloss on the problematics of cross reference. But for the embedded acts of past legislatures and present public choice problems, a fitter hybrid would emerge.

This Part explores an alternative view, asserting that economic factors by themselves make governance systems resistant to cross reference. It states this case by reference to the results of the informal comparison described in Part I, showing how incentive structures built into the market and blockholder systems create barriers to cross reference. The implication is that even the qualified case for cross reference put forward in the legal literature has been overstated. Negative implications also follow for two leading law reform questions: (*a*) whether productive monitoring by institutions and blockholders will result from the removal of regulations controlling the holding practices of American institutional investors; and (*b*) whether equity trading markets on the European Continent will deepen as the result of enactment of regulation mandating transparency and barring insider trading. Part IV further develops this case by reference to leading exemplars of the incomplete contracts theory of the firm.

A. Comparative Governance and the Unsolved Free Rider Problem

A question arises when Boxes (3) and (4) on Table 3 are contrasted with the pluses and minuses juxtaposed on Tables 1 and 2:[144] does the mirror-image relationship of the systems' strengths and

143. *See supra* text accompanying notes 106–10.

144. *See supra* text accompanying note 56.

weaknesses suggest divisibility or indivisibility? They have suggested divisibility to many observers. But there also arises an inference of interdependence among elements within a given system and thus indivisibility. The results of comparative inquiries provide significant support for the latter reading.

The comparison's initial impetus came from within the United States, where observers were simultaneously dissatisfied with perverse effects displayed by the market system during the 1980s and concerned about anti-takeover legislation's impact on the system's capacity for agency cost control. The solution to both problems was thought to lie in newly activist institutional shareholders. Institutions had come to hold larger proportionate stakes of publicly-traded shares. Larger stakes per institution meant higher expected returns from costs incurred to monitor individual firms in the institution's portfolio. Even if the proportionate stakes of individual institutions remained below the threshold point at which investment in monitoring becomes cost beneficial, it was thought that coalitions of institutions could reach the threshold point by pooling their resources.[145] But regulatory reform would have to come first, said the proponents: politically-generated regulatory barriers were impeding the accumulation of large institutional holdings and deterring coalition formation.[146]

The difficulty for this theory of agency cost control lay in a free rider problem.[147] An institutional shareholder not participating in a coalition would get the same increased returns as a participating institution while saving the cost of monitoring. Accordingly, it was difficult to see how any given institution could have a financial

145. *See* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 524–25, 585–89 (1990).

146. *See id.* at 578. The targets are: (*a*) disclosure requirements imposed on holders of more than 5% of a class of securities under section 13(d) of the Williams Act, 15 U.S.C. § 78m(d) (1994); (*b*) liability of controlling persons for securities law violations of controlled persons under section 15 of the Securities Act, 15 U.S.C. § 77o (1994), and section 20(a) of the Exchange Act, 15 U.S.C. § 78(a) (1994); (*c*) short-swing liability for trading profits of 10% holders under section 16(b) of the Exchange Act, 15 U.S.C. § 78p(b) (1994); (*d*) restrictions on capital structures and incentive compensation for advisors of investment companies under sections 18(d) and 23 of the Investment Company Act, *see* 15 U.S.C. §§ 80a-18(d), 23(a), 23(b) (1994); and (*e*) portfolio diversification requirements under ERISA. *See* Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV.10, 26–27 (1991). For a more broadly based attack on American securities regulation, asserting that it sacrifices governance effectiveness for liquidity, see Amar Bhide, *The Hidden Costs of Stock Market Liquidity*, 34 J. FIN. ECON. 31, 33–45 (1993).

147. *See, e.g.*, Anat R. Admati et al., *Large Shareholder Activism, Risk Sharing, and Financial Market Equilibrium*, 102 J. POL. ECON. 1097, 1101 (1994); Steven Huddart, *The Effect of a Large Shareholder on Corporate Value*, 39 MGMT. SCI. 1407, 1407–08 (1993).

incentive to take the lead in investing in monitoring and coalition building.[148] At the same time, the financial benefits of cost-intensive relational investment remained underspecified. Underperforming companies appropriate for coalition intervention tended to be publicly identified in the ordinary course, and institutions already were informally (and cheaply) communicating their criticisms to their managers.[149]

The free rider problem and the gains specification problem had a disturbing implication in turn. Any institutional coalition building or block formation that actually occurred in practice carried a cognizable risk of perverse effects. The institutional monitor, rather than engaging in public-regarding monitoring and problem solving, rationally would look for compensation for its investment in information and intervention in the form of side payments from management. Since these by definition would not be shared with competing institutions in the shareholder group, they would solve the free rider problem as well as the returns specification problem.[150]

Comparative governance went to the leading edge of corporate law scholarship in the United States when proponents of delegated institutional monitoring and related law reform looked abroad for material with which to rebut these objections. It was hoped that practices in Germany and Japan would show that aggressive monitoring by investment institutions holding large equity stakes leads to financial rewards and need not be deterred by free riding.[151]

---

148. The explanation for such institutional activism as was seen in practice lay in selective incentives such as reputation. *See generally* Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 473–74 (1991).

149. *See* William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture and Corporate Self-Regulation*, 73 N.C. L. REV. 1861, 1905–06 (1995).

150. *See id.*

151. For a model of how to ameliorate the corporate free rider problem through the supply of screening and monitoring services, see Colin Mayer, *Financial Systems and Corporate Governance: A Review of International Evidence*, 154 J. INSTITUTIONAL & THEORETICAL ECON. 143, 154 (1998). For a basic theoretical work-up of bank monitoring, see generally Douglas W. Diamond, *Financial Intermediation and Delegated Monitoring*, 51 REV. ECON. STUD. 393 (1984). German banking practices expand on the basic borrower-lender model due to the banks' shareholding role. German banks have a large voting influence at shareholders' meetings, as a result of their equity shareholdings (direct or indirect via subsidiary investment funds) and their role as depositories for the bearer shares held by their individual clients. *See* JEREMY EDWARDS & KLAUS FISCHER, BANKS, FINANCE AND INVESTMENT IN GERMANY 178–95 (1994). This latter role is most prominent where, unusually for a German company, the shares are widely held.

For a formal model of the bank-firm relationship, see Ludwig von Thadden, *Long-Term Contracts, Short-Term Investment and Monitoring*, 62 REV. ECON. STUD. 557 (1995). This one-creditor model shows that relationship banking can reduce short-sightedness due to

The domestic agenda strongly influenced the shape of the comparative inquiry. Mark Roe's leading study of Germany looks not at the blockholders who tend to control German firms but at the investment and monitoring practices of Germany's large banks.[152] It finds significant bank shareholdings and governance input, but not the sort of institutional monitoring being envisioned for institutions in the United States.[153] German bank monitors, as it turned out, do not take an activist role in effecting investment and divestment policies keyed to shareholder value.[154] When they do monitor they tend to take a lender's point of view, intervening on the financial downside. Later studies question even this observation. It has been asserted, for example, that German banks do not actually take an active role in downside restructuring. More generally, the studies question whether German bank incentives lie on the side of shareholder value creation at all.[155]

---

economies of scale. The argument is that banks, which possess good technology for obtaining information about firms, can strategically use their informational advantage to select long-term welfare enhancing projects over short-term projects. The question, of course, is whether anything like this ever occurs in practice.

152. *See* ROE, *supra* note 6, at 171–77 (including shareholding statistics on banks only).

153. It should be noted, however, that the impact of bank monitoring in Germany has changed over time. *See* GARY GORTON & FRANK A. SCHMID, UNIVERSAL BANKING AND THE PERFORMANCE OF GERMAN FIRMS 6–9 (National Bureau of Econ. Research Working Paper No. 5453, 1996). Table 3 distinguishes the role of the German banks in the 1970s from their role in the 1980s. Using 1974 data on firm performance, Gorton and Schmid show that at that time firm performance did improve as a function of how much equity the banks owned, and that performance was unrelated to bank proxy voting and blockholding. Their 1985 data show reduced bank lending and equity holding and no longer support a positive connection between bank equity holding and firm performance. The 1985 data show blockholding to have become the most important factor affecting firm performance and also show that bank and nonbank blockholders were responsible for improved performance. *See id.*

154. Baums asserts that while it appears that banks have a significant position in the German system of corporate governance (for example, three banks hold 37 positions of about 231 positions reserved for stockholders on the supervisory boards of the 24 non-financial companies comprising the DAX 30), their actual influence is easily exaggerated. Their influence, says Baums, is limited by factors such as the co-determination regime and personal interlocks among all publicly held firms. Real influence, says Baums, tends to be concentrated in the hands of a small number of individuals (approximately 45) that control more than half the positions available for equity available on the boards of DAX 30 companies. It is unlikely that there will be sufficient incentives for these individuals to monitor each others' actions. *See generally* BAUMS, *supra* note 71.

155. A number of studies have yielded results that destabilize the received picture of productive relationship banking in Germany.

(a) *Borrower Dependence.* It appears that German firms are no longer as dependent on bank capital as was once the case. Today, they rely in the main on retained earnings financing. *See* GORTON & SCHMID, *supra* note 153, at 5, 42, n.10 (arguing that if statistical comparisons are made based on flows of funds, then German firms have similar levels of debt to those in stock market based economies). Indeed, new studies assert that German banks provide similar levels of finance to their domestic corporate sector as do Anglo-American banks. *See*

R.G. Rajan & Luigi Zingales, *What Do We Know About Capital Structure? Some Evidence from International Data*, 50 J. FIN. 1421 (1995); Jenny Corbett & Tim Jenkinson, *The Financing of Industry, 1970–1989: An International Comparison*, 10 J. JAP. & INT'L ECONS. 71 (1996).

(b) *Financial Distress.* The evidence shows that German banks do not get very involved in firm rescue efforts. There is little evidence to suggest that German banks "reduce the costs of financial distress and bankruptcy by close monitoring and control." EDWARDS & FISCHER, *supra* note 151, at 175. This is accounted for by reference to the facts that 80% of bank loans to firms are secured and banks tend only to be involved in restructuring efforts when a portion of the distressed firm's loans are unsecured. *See id.* at 171. The evidence points to limited capacity of banks to detect financial distress at companies at an early stage through enhanced monitoring. *See id.* at 175. There also is little evidence to show that bank presence on supervisory boards leads to heightened monitoring efforts. *See id.*

(c) *Proxy Voting.* There is no doubt that banks, acting as proxies, exercise voting control at supervisory board elections. *See* A. Gottschalk, *Der Stimmrechtseinfluß der Banken in den Aktionärsversammlungen der Großunternehmen*, 41 WSI-MITTEILUNGEN 294 (1988) (the Gottschalk Study) (looking at a list of 100 firms and showing that in 32 firms with equity capital of DM 29.5 billion, among them the 7 biggest in Germany, the average size of proxy votes and direct shareholdings held by the three largest banks was 45.2%, and that all the banks together on average represented more than four-fifths of all votes present at shareholder meetings and, with one exception, that they always had at least a majority of the votes). The question is whether they do so to productive effect. *See* M. Perlitz & F. Seger, Regarding the Particular Role of Universal Banks in German Corporate Governance (Mannheim Working Paper, 1994) (on file with author) (arguing that the control exercised by banks through boards and proxy votes has been detrimental to German firms). Edwards and Fischer suggest that collusion between the banks and the managers results, noting that the voting rights of blockholders can be restricted by an Aktiengesellschaft's (AG's) charter and that banks have tended to support managers who propose these limitations. Bank control in the form of proxy votes has been wielded defensively in the context of recent takeovers. *See* EDWARDS & FISCHER, *supra* note 151, at 192–93. Franks and Mayer report that in the recent case of Continental's defensive response to a bid by Pirelli, the banks strategically employed proxy votes to favor a management motion for a voting restriction on holders of 5% or greater. At the same time, they note that a predator firm can get around the banks by buying the shares in the open market and revoking the proxies. *See* Julian Franks & Colin Mayer, Ownership, Control and the Performance of German Corporations (London Business School and Oxford University Working Paper, 1997) (on file with author). Finally, Gorton and Schmid assert that a bank faces conflicting objectives depending on how much equity it owns, the value of that equity, and its ability to extract private benefits. They suggest that this is in effect the same trade-off that managers face. The upshot is that when German banks play this insider role they will tend to take actions which benefit themselves at the expense of other shareholders, subject to the constraint following from their equity and debt positions. In other words, the lower the level of the bank's equity holding the more likely the bank pursues a private maximization course of action, with firm value enhancement being more likely when the bank holds a high level of equity. *Cf.* GORTON & SCHMID, *supra* note 153, at 13–14.

Incidents of bank defection from the management interest also should be noted. Banks in a number of instances have assisted predators in hostile stake-building. The context is a very specific one, however. The subject firm has two or more large blockholders, none of which has a block large enough to effect control; the bank in effect assists in the development of a control block. *See* JENKINSON & LJUNGQVIST *supra* note 26. Note also that defection from the management interest in these cases does not by itself assure that the banks were pursuing value-creation for the shareholders as a whole.

(d) *Monitoring and Information.* It is often argued that the bank's equity stake in the borrowing firm improves the flow of information for the bank and reduces the problems of

The comparison with Japan led to similarly awkward results.[156] Like the German universal bank, the Japanese main bank engages in crisis monitoring from the lender's perspective and does not act like the idealized shareholder monitor.[157] For enhanced

---

asymmetric information. This proposition is doubtful in the case of German banks. For example, there is little evidence that banks use their representation on supervisory boards so as to assist in their loan decisions. *See* EDWARDS & FISCHER, *supra* note 151, at 231. Edwards and Fischer point out that while large banks tend to control proxy votes, there is little direct connection between their supervisory board representation, large control of proxy votes, and the incentive to monitor. Moreover, it appears that there is very little specialized skill within German banks to support sophisticated monitoring. The banks are highly specialized in transaction lending, and possess few incentives to acquire skills which could decrease their competitive position in the transaction lending market. *See* ARNOUD W.A. BOOT & ANJAN V. THAKOR, CAN RELATIONSHIP BANKING SURVIVE COMPETITION, (Center for Economic Policy Research Discussion Paper No. 1592, London 1997). *See also* FRANKLIN ALLEN & DOUGLAS GALE, A WELFARE COMPARISON OF THE GERMAN AND US FINANCIAL SYSTEMS (London School of Economics, Financial Markets Group Discussion Paper No. 191, 1994) (employing an industrial organization approach and asserting that bank-based systems may be more suited to traditional industries where there is some consensus about how the firms should be managed, while stock markets, with their ability to assimilate information quickly and assess diverse views, may be better suited to provide checks for dynamic industries).

156. This comparison looks to bank monitoring without telling us much about the wider organizational structure of Japanese industry. That, as described by Masahiko Aoki before Japan's present economic crisis, involves interdependencies between vertically-related nonfinancial firms, nonhierarchical management practices, and a highly-articulated employee incentive structure that includes a norm of lifetime employment. Aoki contends that Japanese successes stem from the combination of these elements. *See* Aoki, *supra* note 33, at 18–22. For a partial rejoinder that retells the story of the Japanese lifetime employment as an incident of the settlement of postwar social discord, see Ronald J. Gilson & Mark J. Roe, *Lifetime Employment in Japan: Labor Peace and the Evolution of Japanese Corporate Governance*, 99 COLUM. L. REV. 508 (1999).

157. *See generally* Hoshi et al., *supra* note 51 (showing that the bank governance system plays a key role in providing funds to firms (permitting investment plans to proceed with diminished sensitivity to internal cash flows) and noting that main banks can be depended on to intervene in the activities of a firm before there are financial difficulties); Kaplan & Minton, *supra* note 54 (same). *But cf.* Rajan & Zingales, *supra* note 41, at 43–44 (reinterpreting findings of Hoshi et al., as confirming that Japanese banks continue expansionary lending in the teeth of evidence of poor borrower cash flows and steady loss of corporate opportunities).

Evidence is mixed on the question of whether Japanese bank-borrower relationships enhance firm value. On the positive side, see Jun-Koo Kang, *The International Market for Corporate Control: Mergers and Acquisitions of US Firms by Japanese Firms*, 34 J. FIN. ECON. 345–71 (1993) (showing that firms with strong ties to Japanese banks are more likely to make more profitable acquisitions). For a study that questions whether the main bank system is superior, see JUN-KOO KANG & RENE M. STULZ, IS BANK-CENTERED CORPORATE GOVERNANCE WORTH IT? A CROSS-SECTIONAL ANALYSIS OF THE PERFORMANCE OF JAPANESE FIRMS DURING THE ASSET PRICE DEFLATION (Charles A. Ricke Center, Ohio State University Working Paper No. 97–6, 1997) (showing that for the 1990–93 period, firms which were more dependent on banks as a source of finance had poorer performance results than non-bank dependent firms, which is correlated with poor stock market performance for these firms during this period). *See also* David Weinstein & Yishay Yafeh, *On the Costs of a Bank-Centered Financial System: Evidence from the Changing Main Bank Relations in Japan*, 53 J. FIN. 635 (1998) (showing that *keiretsu* borrowers that have a close relationship with a bank may have

returns on their equity holdings, Japanese banks are said to look to captive lender-borrower relationships[158] and insider trading, rather than to public-regarding monitoring.[159] The comparative focus accordingly shifted to a different Japanese phenomenon—cross shareholding (and resulting monitoring) among nonfinancial firms in *keiretsu* organizations. But this did not fit the bill either.[160] These relationships came to be described as a means to the end of stabilizing long-term relational contracts among members of vertical production combines.[161] As such they had nothing to offer in the way of precedent for financial institutions in the United States.

The comparison, in sum, failed in its purpose of providing direct, cross referenced backing for United States law reform.[162] Germany and Japan held out no institutional practices suited to fill America's monitoring gap.

---

increased access to capital without enhanced profitability); Joe Peek & Eric Rosengren, *The International Transmission of Financial Shocks: The Case of Japan,* 87 AM. ECON. REV. 495 (1997) (showing that Japanese banks misallocate investment capital through study of real estate investment practice in the early 1990s showing heavy investment in deteriorating Japanese real estate and disinvestment from recovering real estate market in the United States). For general discussion of the pluses and minuses of relationship borrowing, see Raghuram G. Rajan, *Insiders and Outsiders: The Choice between Informed Relationship and Arm's Length Debt,* 47 J. FIN. 1367–1400 (1992) (detailing trade-offs, including U.S. evidence that a borrower's value is related to its bank's health).

158. This is changing in the context of Japan's current banking crisis. Today Japan's banks do not have the ability to raise foreign currencies to service their clients' needs. The clients are turning to foreign banks. *See* Jathon Sapsford, *Citibank Sets Big Credit Line for Japan Group: Assurance of $600 Million Reflects Emerging Role of Foreign Institutions,* WALL ST. J., Oct. 2, 1998, at C12.

159. *See* J. Mark Ramseyer, *Columbian Cartel Launches Bid for Japanese Firms,* 102 YALE L.J. 2005, 2013–14 (1993).

160. Roe dismisses cross-holding shareholders in Japan as tending to play a protective function, insulating the managers in the groups from takeovers. *See* ROE, *supra* note 6, at 181.

161. *See* Gilson & Roe, *supra* note 18, at 874–75. For criticism of this explanation, see Ramseyer, *supra* note 82, at 538–58 (arguing that this explanation covers only a subset of cross-holdings and deciding that most can be explained only in terms outside of a strict rational expectations framework).

162. Roe describes the participation of German and Japanese banks in terms of "power sharing," "interlock," and "Escher-like overlap":

> [A]n Escher-like staircase: while always walking downstairs, we wind up on top of the staircase from which we started. Banks own industry, but industry owns banks; managers direct employees; but employees sit on the supervisory board. The model resembles in some ways American political governance, with checks and balances. ROE, *supra* note 6, at 184–85.

Complex interconnections such as these imply indivisibility.

B. *Can Relational Engagement Emerge in a System Open to Hostile Takeovers?*

Barriers to cross reference result in part from internal dependencies within governance systems. This Section, by way of example, compares the patient, constructive engagement said to distinguish the relationship between blockholders and firm managers with the arm's length discipline of the market system's hostile takeover. The question is whether both modes of monitoring can be incorporated in a single governance system. Just such a result has been a central aspiration of American corporate governance in the 1990s. American proponents of delegated monitoring envisioned relational engagement among firms and institutional shareholders even as they joined the rest of the corporate law academy in disapproving state law constraints on hostile takeovers. The question whether the two objectives plausibly may be pursued simultaneously never came up in practice, because the states were no more ready to roll back their anti-takeover statutes than institutional investors were ready to make significant investments in monitoring. But it retains importance in the evaluation of the cross reference hypothesis.

Minimal hostile takeover activity may be a precondition of relational engagement between institutional shareholders and managers. If a hostile offeror holds out a significant premium over market price, institutional shareholders seeking good results for the year (and owing fiduciary duties to their clients) have an overwhelming incentive to defect from any relational commitments and accept the offer. An active possibility of defection in turn chills the managers' *ex ante* incentive to cooperate with the institutional shareholders. Control in a blockholder, in contrast, disables the hostile tender offer as we have known it in the United States. Indeed, stable Japanese cross-holdings have been accounted for as an anti-takeover device.[163]

This does not mean that blockholders cannot defect from a relational commitment to the firm's managers by selling out. Given an offer at a substantial premium, any holder, block or not, has a powerful incentive to defect from management's side. In a blockholder system, of course, such a control transfer probably would occur not through a tender offer made to the entire group of

163. See ROE, *supra* note 6, at 181, noting also isolated takeover activity in Japan. Unwinding of the blocks in the context of Japan's current economic crisis presents a different question. There have been reports of this occurring. *See Mitsubishi: The Diamonds Lose Their Sparkle*, ECONOMIST, May 9, 1998, at 67.

shareholders but through a private block sale.[164] To see this possibility, hypothesize a firm with three large blocks, none of them large enough to enable unilateral exercise of control. An entrepreneur could unilaterally negotiate the purchase of each of the blocks, take control, and replace the managers.[165] Were such control transfers to become an everyday event in a given blockholder system, the quality of the "relational engagement" between its managers and block shareholders presumably would deteriorate,[166] sacrificing some of the governance benefits of blockholding itself. Since such disruptive control transfers always are a theoretical possibility in a blockholder system, some stabilizing device would appear to be necessary. Side payments running from the firm to the blockholder nicely fit this bill.[167] The firm's managers in effect outbid the hypothetical offeror for the blockholder's loyalty, the bid (and the relational engagement) coming at the expense of small shareholders on the outside.

There arises a negative inference for the American case for delegated monitoring. If the institutional blockholder is disabled from collecting the payment, as it would be to an extent in the United States due to reputational[168] and legal constraints,[169] then a cross

164. For a discussion of the economics underlying this proposition, see *infra* text accompanying note 225.

165. For a description of friendly takeovers in Japan, see J. Mark Ramseyer, *Takeovers in Japan: Opportunism, Ideology, and Corporate Control*, 35 UCLA L. REV. 1, 21–26 (1987).

Looking at the small minority of German firms that are not in the control of a majority blockholder, JENKINSON & LJUNGQVIST, *supra* note 26, have isolated 17 cases of hostile stakebuilding. Several insights emerge: (*a*) stakebuilders tend to operate in the same industry; (*b*) a takeover via stakebuilding is likely to occur when an existing coalition of blockholders has broken down; (*c*) the emergence of a hostile stakebuilder often paves the way for the exit of a blockholder; and (*d*) banks often play a crucial role in assisting predators to gain stakes in these firms. In cases where a control transfer is achieved, the firm gaining control can enter into a control or profit transfer agreement whereby the profits from the target are transferred to the acquirer. It also appears that protection for small shareholders in these firms is weak, evidenced by losses being foisted onto them, group assets being sold at prices advantageous to the dominant shareholder, and later lowball offers for minority shares. Thus the ability to extract value from minority shareholders is one of the incentives that drives these transactions.

166. Significantly, JENKINSON & LJUNGQVIST, *supra* note 26, show that German banks take an active role in cases of behind-the-scenes hostile stakebuilding. For a description, *see supra* note 155.

167. *Cf.* Marco Pagano & Ailsa Röell, *The Choice of Stock Ownership Structure: Agency Costs, Monitoring, and the Decision to Go Public*, 113 Q.J. ECON. 187, 191 (1998) (finding that an entrepreneur choosing between outside finance from private blockholders and going public will be more likely to choose private finance if a blockholder can be paid off to monitor less at the expense of the other minority shareholders).

168. *See* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 817, 851, 855 (1992) (contending that transparency will prevent members of institutional coalitions from collecting side payments).

reference scenario looking to institutional monitoring lacks a plausible incentive base.[170] More generally, it appears that you can have a system in which a vigorous corporate control market imports discipline or a system in which relational engagement imports discipline, but not both. On this reading, the comparative exercise not only fails to yield positive results for the United States' domestic agenda, but has a strong negative implication for the case for delegated monitoring.

C. *Side Payments, Insider Trading, and the European Law Reform Agenda*

Relational engagement and side payments are closely linked, quite apart from the context of control transactions. As noted above,[171] blockholders do not sacrifice liquidity and invest in monitoring without extracting returns. To get these, they exploit their positions through insider trading and self dealing transactions.[172] It follows that the principle of pro rata treatment for equity holders as a group can play no significant role in a blockholder system's legal and normative environment. We note, however, that the pro rata principle does activate the investor protections identified in the economic literature as mainstays of market systems—majority-to-minority fiduciary duties, one share one vote, and the insider trading ban.[173] An inference of indivisibility arises.

It has been argued that pro rata treatment is not a necessary element of an environment conducive to dispersed equity ownership. According to a well-known precept of law and economics, non-controlling holders of shares of block-controlled firms who are excluded from gain made available to inside holders—whether in the form of side payments or premiums in the case of block trades—should not complain so long as shared governance benefits stemming

169. The legal constraint is the basic duty of loyalty. *See, e.g.*, DEL. CODE ANN. tit. 8, § 144 (1998). But the duty leaves open room to siphon rents to insiders under the guise of contracting. For descriptions of the deals, see Edward B. Rock, *Controlling the Dark Side of Relational Investing*, 15 CARDOZO L. REV. 987, 1004–06 (1994).

170. *See* Bratton & McCahery, *supra* note 149, at 1921–24. *But see* Ian Ayres & Peter Cramton, *Relational Investing and Agency Theory*, 15 CARDOZO L. REV. 1033, 1041, 1060–61 (1994) (suggesting that blockholders could play the role of distinguishing good from bad takeovers).

171. *See supra* text accompanying note 42.

172. *See supra* text accompanying note 43.

173. These protections show up on the lists devised to test the investor-friendliness of different national systems. *See supra* notes 45–46 and accompanying text.

from the insiders' arrangements exceed the costs of side payments in the long run.[174] The governance comparisons hold out a negative implication for this position, however. They show that conditions necessary for the realization of the hypothesized efficient result cannot be assumed to occur in the real world. The problem lies in the condition that the outsider shareholders be left in their *ex ante* position *ex post* the insider's extraction of private benefits. Outsider shareholders need substantive rights and process rules that provide a viable means to enforce this condition. Blockholder legal systems tend to fail to provide such minimal protections.[175]

The question as to the desirability of creating such a shareholder-protective legal regime is presently being debated in Europe's blockholder countries. The proponents look primarily to securities law reform as the means to the end of deeper equity trading markets, proposing regulations that would enhance transparency respecting both issuers and the markets on which their shares are traded.[176] The question is whether such disclosure and insider trading

174. Ironically, it is a prominent proponent of the market system superiority, Judge Frank Easterbrook, who has argued most forcefully for abandonment of the pro rata norm in American corporate law. *See* Easterbrook, *supra* note 95; Frank J. Easterbrook & Daniel Fischel, *Corporate Control Transactions*, 93 YALE L.J. 698, 703–15 (1982). The argument, made in the context of the law of cash out mergers, may not carry over to the broader governance context, however. With merger gain, increased returns that presuppose a non pro rata rule are on the table in the present or near term. In the institutional investor context we deal with monitoring over a longer term. The small shareholder is being asked to abandon a range of claims for pro rata treatment on faith that returns in the long run are enhanced due to heightened institutional or blockholder attention. The problem is that in a non pro rata regime, the small holders make the exchange without a guarantee as to a minimum rate of return. Once the ready yardstick of pro rata treatment is abandoned, nothing stops the blockholder from splitting the whole pie of enhanced value with management.

Easterbrook also took up the case of the block trade at a premium. His analysis is now seen to be incomplete. *See* Lucian Ayre Bebchuk, *Efficient and Inefficient Sales of Corporate Control,* 109 Q.J. ECON. 957 (1994); Marcel Kahan, *Sales of Corporate Control,* 9 J. L. ECON. & ORG. 368 (1993).

175. *See* Luca Enriques, The Law On Corporate Directors' Self Dealing: A Comparative Analysis 72–74 (Milan Working Paper, 1998) (on file with author), which provides a detailed comparison of the fiduciary law of France, Germany, and Italy with that of Britain and the U.S., and concludes that self dealing regulation is "less significant and less stringent" on the Continent. France has the most rigorous of the three continental regimes. But it tends to turn on shareholder ratification. *See id.* at 62–63, 67–69. In a world of blockholders and cross-holdings, shareholder ratification would appear to offer outside minority holders little practical protection. Enrique's survey of British fiduciary law provides a useful counterweight to the report in Miller, *supra* note 16, which understates its reach.

176. *See* EUROPEAN CORPORATE GOVERNANCE NETWORK, THE SEPARATION OF OWNERSHIP AND CONTROL: A SURVEY OF SEVEN EUROPEAN COUNTRIES (submitted to the European Commission on October 27, 1997), which asserts that European blockholders impose non-transparent constraints on the corporate strategies devised by corporate managers and recommends greater transparency for the protection of investors and minority shareholders. The report asserts that self regulation will not produce the optimal level of

rules would suffice by themselves to foster an environment conducive to dispersed shareholding. Self dealing transactions between blockholders and firms that do not involve purchases and sales of shares on securities exchanges[177] may independently discourage dispersed shareholding. Accordingly, discussants in countries like Germany, France, and the Netherlands have gone much farther and suggested corporate law reforms. This agenda features direct controls on blockholders, such as the one share, one vote rule,[178] self dealing

---

information and stresses a need for mandatory disclosure. It appears that firms presently avoid national disclosure mandates through the use of holding companies sited in third states which have no disclosure rules. The report also notes that European insider trading regulation at present imposes no significant costs on the holding and disposition of large blocks. Under the EU insider trading directive, large blockholders are not initially considered to be insiders because the directive does not provide any size thresholds. The national securities regulator bears the burden of showing that any holder, large or not, is using inside information while trading. The upshot is that, unlike United States law, the European directive has little impact on the distribution of large concentrations of shares.

177. The European Union already has promulgated insider trading rules. But insider trading remains on the table for discussion because serious doubts remain about the effectiveness of national-level enforcement of the EU directive. *See* Berglöf, *supra* note 17, at 107, 108.

The EU enacted its Directive on Insider Trading in 1989. *See* Council Directive 89/592 of 13 November 1989 Coordinating Regulations on Insider Trading 1989 O.J. (L 334) 30. The Directive stated that the aim of the regulation was to promote investor confidence by ensuring equal market opportunities for all investors. The Council of Ministers passed the unified Directive on the grounds that the harmonized provisions would eliminate the conflict between certain countries and provide the basis for cooperation and enhanced enforcement. *See id.* Like U.S. law, the Directive is concerned with the public disclosure of information that would have a significant effect on market-sensitive information. *See* Klaus Hopt, *The Insider Dealing Directive*, 27 COMMON MARKET L. REV. 51 (1990). Significantly, the directive ignores the fiduciary relationship between insider and firm and imposes liability on traders who possess inside information. The Directive was welcomed by most member states although Germany, due to domestic pressures from large banks which stood to lose, delayed implementing it until mid-1994. *See* Daniel James Standen, *Insider Trading Reforms Sweep Across Germany: Bracing for Cold Winds of Change*, 36 HARV. J. INT'L L. 177 (1995).

The enforcement problem is shared with other EU directives. While the EU monitors the implementation of directives into national law, directives are primarily enforced by member states, which make regulatory decisions within different institutional and political frameworks. In the case of the insider trading directive, member states are required to identify the regulatory agency designed to perform the task of enforcement and provide this body with the resources necessary to ensure the proper exercise of their functions. This institutional design could lead to lax enforcement, particularly where the governments have an incentive to minimize the goals of the directive. Furthermore, if this kind of decentralized enforcement is to be effective, then transparency is needed respecting each member states' regulations and their effects. A lack of transparency can undermine the level of trust required for the mutual recognition framework to function effectively.

Very different levels of enforcement are thought likely to prevail respecting insider trading. For example, it would appear that the passage of the Federal Securities Trading Act in Germany in 1994 has so far done little to alter the trading practices of insiders. *See Insider Dealing Law Comes into Force*, FIN. TIMES LIMITED, FIN. REG. REP., Dec. 1995, at 22–23. Dutch compliance also is thought to be wanting. *See* Berglöf, *supra* note 17, *passim*.

178. *See* La Porta et al., *Corporate Ownership Around the World*, *supra* note 48, at 512,

constraints to protect outside shareholders,[179] voting caps, and limits on the proportion of capital held by designated investors.[180]

Europe thus faces an intriguing choice implicating the connection between legal rules, corporate governance practice, and trading market depth. If the objective is deep national equity markets like those in London and New York, an analogy to the legal regimes of Britain and the United States suggests that stepped up disclosure and insider trading rules amount to only half of the needed loaf of law reform. Both Britain and the United States add rules against self dealing by managers and control shareholders, rules that contain insider opportunities to effect non pro rata distributions that reduce returns on outside equity contributions.

The problem is that meaningful reform following this lead could destabilize the incentives that sustain Europe's blockholder monitoring regime,[181] inadvertently causing the blocks to dissipate by cutting off the holders' sources of return. An experiment in cross reference intended to deepen the market thus could imply a larger (and unintended) move to a market system. In contrast, limited reform that does not include self dealing constraints may fail to deepen the markets significantly. Thus, the question as to divisiblity is joined. Significantly, the comparative governance literature offers no cogent advice on the likely outcome.[182]

IV. THE INCOMPLETE CONTRACTS THEORY OF THE FIRM AND THE CASE FOR INDIVISIBILTY

Economists working within the incomplete contracts theory of the firm have taken up the question raised upon the juxtaposition of systemic features of market and blockholder systems, as in Tables 1

(one share-one vote will be ineffective, taken alone, so long as blockholders maintain control through pyramiding arrangements).

179. *See id.*

180. *See* Enriques, *supra* note 175, at 93–94.

181. Indeed, these initiatives have a negative implication for blockholding because deeper equity markets presuppose larger proportions of widely-held equity. Berglöf suggests stepped up withdrawals from European exchanges in recent years may be linked to the appearance of greater investor participation. *See* Erik Berglöf, *Corporate Governance, in* THE EUROPEAN EQUITY MARKETS: THE STATE OF THE UNION AND AN AGENDA FOR THE MILLENNIUM 147, 173 (Benn Steil et al. eds., 1996).

182. For an extended discussion of the dangers for Europe of the importation of market system shareholder protection rules, see Berglöf, *supra* note 17, at 114–16.

and 2:[183] Do the systems' contrasting features imply unexploited complementarities or trade-offs? The inquiry results in an emphatic case for a trade-off description. The cumulated trade-offs imply indivisibility in turn.

One line of incomplete contracts inquiry poses a concentration and liquidity trade-off. This analysis begins with the standard assumption that blockholder control brings stepped up monitoring that makes the firm more valuable. It goes on to assert that liquidity also enhances firm value by lowering the cost of capital.[184] The trade-off results because concentration sacrifices liquidity even as it enhances monitoring; at the same time, dispersed ownership enhances liquidity even as it sacrifices monitoring. One of the basic assumptions of this trade-off analysis—that increased monitoring makes the firm more valuable—is scrutinized in turn in a second line of inquiry. This asserts that delegations of authority to managers have a positive impact on productivity because they import incentives to make productive investments. It follows that, although some monitoring may be a good thing, there can be such a thing as too much monitoring. There results a trade-off between monitoring and delegation: stepped up monitoring depresses management's incentives to make productive investments even as it imports productivity enhancing discipline.

By hypothesis, to the extent these analyses identify stable, optimal (albeit second-best) trade-off points, they provide the beginnings of a blueprint for a superior, hybrid governance structure. Conversely, to the extent these analyses show that structural factors or incidental frictions are likely to prevent the realization of optimal trade-offs, they hold out a negative implication for the cross reference hypothesis.

This Part shows that this theory's cumulative results lie on the negative side and support the case for indivisibility. Private benefits are the key. The models show that absent private benefits and the incentives they import toward block formation, we can never be sure of the appearance of blocks when monitoring is needed. Moreover,

183. *See supra* text accompanying note 56.

184. And, hence, raising the stock price, all other things being equal. *See* Patrick Bolton & Ernst-Ludwig von Thadden, *Liquidity and Control: A Dynamic Theory of Corporate Ownership Structure*, 154 J. INSTITUTIONAL & THEORETICAL ECON. 167, 173 (1998) [hereinafter Bolton & von Thadden, *Structure*]. Empirical support for this proposition can be found in studies showing that the liquidity of a stock increases with the firm's market capitalization. *See, e.g.*, Franklin Allen & Douglas Gale, *Limited Market Participation and Volatility of Asset Prices*, 102 AM. ECON. REV. 933 (1994); Marco Pagano, *Endogenous Market Thinness and Stock Rise Volatility*, 56 REV. ECON. STUD. 269 (1989).

absent private benefits, such blocks will be unstable and will tend to be suboptimally large. Once a system allows for private benefits, in contrast, there is no way to assure their provision to an incentive-compatible degree. Furthermore, only some firms will need block monitoring (and hence limited private benefits provision) in the first place. It follows that a system either controls access to private benefits for the purpose of protecting its liquid trading markets or does not control private benefits so as to nurture its blocks. The theory of the firm holds out no hospitable middle ground.

A. Incomplete Contracts Theory

The various versions of the incomplete contracts model[185] remit us to a second-best world, and there identify and explain barriers that prevent the evolution of first-best transaction structures.[186] This economic model holds, first, that transacting actors

185. For overviews of the literature, see BERNARD SALANIE, THE ECONOMICS OF CONTRACTS: A PRIMER 175–188 (1998); Bengt Holmstrom & John Roberts, *The Boundaries of the Firm Revisited*, 12 J. ECON. PERSP. 73, 75–79 (1998). For precedent treatments in the legal literature, see Avery Katz, *When Should an Offer Stick? The Economics of Promissory Estoppel in Preliminary Negotiations*, 105 YALE L.J. 1249, 1278–79 (1996); William W. Bratton, *Dividends, Noncontractibility, and Corporate Law*, 19 CARDOZO L. REV. 409 (1997); William W. Bratton et al., *Repeated Games, Social Norms, and Incomplete Corporate Contracts*, *in* ASPECTS OF FAIRNESS IN CONTRACT 161, 164–71 (Chris Willett ed., 1996); Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, 21 J. LEG. STUD. 271, 272–73 (1992); Oliver Hart, *An Economist's View of Fiduciary Duty*, 43 U. TORONTO L. REV. 299 (1993); Oliver Hart, *An Economist's Perspective on the Theory of the Firm*, 89 COLUM. L. REV. 1757 (1989).

186. Incomplete contracts theory should be distinguished from transaction costs theory. Both recognize that contracting actors cannot be expected to negotiate complete *ex ante* solutions to all problems. Transaction costs theory, however, turns on the notion that the institution of *ex ante* contracting, broadly conceived, supports efficient transactional relationships. It makes three assertions toward this end. First, actors who put capital at risk can be expected to design *ex ante* governance structures that minimize the costs of future uncertainty. Second, even though legal decisionmakers must assist the parties by filling in omitted terms *ex post*, those terms may be cast from an *ex ante* time perspective, and, indeed, should be so cast in order to guard against disruption of the parties' allocation of financial risk and to minimize future transaction costs. *See* Bratton et al., *supra* note 185, at 166–71. Third, and finally, there is a prediction: given proper containment of the agencies of state intervention, transacting actors can be expected to devise technologies that lower the transaction costs that cause incompleteness, thereby expanding the effective zone of contractual governance. Incomplete contracts theory places a greater stress on the *ex ante* impact of *ex post* problems of performance and enforcement than does the transaction costs approach. These three factors—computability, observability, and verifiability—intrinsically limit the operation of the institution of the *ex ante* contract. State intervention accordingly takes a place on its list of possible means to the end of improving suboptimal governance conditions. *See* Phillippe Aghion & Benjamin Hermalin, *Legal Restrictions on Private Contracts Can Enhance Efficiency*, 6 J. L. ECON. & ORG. 381 (1990).

can create producing institutions that will certainly evolve toward the first-best only to the extent that they deal with contractible subject matter. Second, it holds that contractibility cannot safely be assumed. Noncontractibility may occur because the requisite transactional technologies may not yet exist.[187] Alternatively, even where an *ex ante* contract term can be devised in theory, *ex ante* agreement on that contract term will not be feasible if in practice a party's future performance of the term will be either unobservable by the counterparty or unverifiable by the enforcing authority.[188]

Corporate capital structures provide second-best solutions to noncontractible governance problems.[189] Corporate contracts are famously empty at their cores, omitting important future variables due the difficulty or impossibility of *ex ante* description or *ex post*

187. Unlike most law and economics, which tends to include any voluntary economic relation within its notion of the *ex ante* contract, incomplete contracts theory restricts the reach of the *ex ante* contract to cases where actors make explicit specifications about the future. That is, to have "contract" terms that govern future states, those contingent states must be specified and the future outcomes must be computable. Since many future states of nature clearly are not computable, transacting parties as a result lack the technology necessary to enable the negotiation and composition of a contract term *ex ante*. *See* Luca Anderlini & Leonardo Felli, *Incomplete Written Contracts: Undescribable States of Nature*, 109 Q.J. ECON. 1085 (1994).

188. For contributions to the literature making this point, see Sanford Grossman & Oliver Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691 (1986); Oliver Hart & John Moore, *Incomplete Contracts and Renegotiation*, 56 ECONOMETRICA 755 (1988); Bengt Holmstrom & Paul R. Milgrom, *Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design*, 7 J.L. ECON. & ORG. 24 (1992) (showing that contracts that tie an agent's compensation to verifiable measures can divert effort and attention from other more important but less easily measured aspects of performance).

189. For a formal expression of this point, see OLIVER HART, FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE (1995). He notes that given managers who derive no private benefits from control of assets, first-best results easily can be achieved (in a taxless world) with an all equity capital structure and a simple incentive compensation system. In a two-period situation he would simply make the managers' compensation depend entirely on the dividend. That is, assuming investment at $t = 0$, and cash flows to be realized at $t = 1$ and $t = 2$, incentive compensation I should = $\pi(dt=1 + dt=2)$, where π is a small positive number. If the payment also covers liquidation proceeds, L at $t = 2$, then $I = \pi [dt=1 + (dt=2, L)]$, and the manager can be expected to make an optimal decision respecting liquidation at $t = 1$. If at $t = 1$, the expected L is greater than the cash flow expected at $t = 2$, the firm is liquidated at $t = 1$ and no indebtedness is needed in order to align management incentives.

But managers do derive private benefits from asset management, and in Hart's conception, the bribe π required to align their incentives with those of the outside security holders is unfeasibly large. Accordingly, a complex capital structure that includes control mandates must be interpolated. And, in a dynamic environment, a range of possibly optimal contractual formulas for setting the terms of that control transfer can be suggested; uncertainty makes it impossible to deem any one *ex ante* optimal. Restating this point, it is now the understanding that a simple one-period incentive contract that sets the firm's capital structure based upon a particular projection of the appropriate direction for the agents' activities will not be optimal for all future scenarios.

observation and verification. Shareholders, for example, contribute capital in the absence of terms governing such fundamental matters as investment policy, dividend payout rate, and management remuneration and tenure. Absent specific directives, outcomes respecting these matters must of necessity be determined *ex post*, either by renegotiation or by the specification of an empowered party. More particularly, the contracts making up the firm's capital structure deal with noncontractible future contingencies by providing open-ended processes that facilitate the allocation and reallocation of control.[190] These control transfer mechanisms are particularly important in bad performance states. They determine whether the shareholders vote out the managers; whether a blockholder emerges to put the managers under effective control; whether a tender offer occurs so as to effect needed change; and whether the bondholders take control of the assets in distress situations.[191]

These *ex post* outcomes follow neither from the consummation of transactions facilitated by price mechanisms nor from the operation of *ex ante* contractual specifications. They follow instead from the exercise of contingent powers to control the firm's assets,[192] powers in some cases vested by the basic terms of corporate law and in other cases vested by contract. Incomplete contracts theory asserts that with the diminution of space in which contractual specification is feasible, such power allocations play a progressively larger role in determining the firm's productivity.[193] It further asserts that some power allocations work better than others and goes on to try to identify the properties of the better arrangements. Toward this end, it models the impact of particular provisions for control transfer on *ex ante* incentives to make firm-specific investments of human and financial capital.

This approach is often referred to as the "property rights" theory of the firm because it isolates the collection of assets as the firm's defining characteristic and studies arrangements for the assets' ownership. Notably, "owner" is here specially defined as the party who has the right to control all aspects of the asset that have not been given over to contractual specification *ex ante*. Since ownership *is*

190. *See* Philippe Aghion & Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59 REV. ECON. STUDIES 473, 479 (1992).

191. There is disagreement within the incomplete contracts literature respecting the efficient location of control rights, in particular with respect to the debt/equity trade-off. *See* Raughuram U. Rajan & Luigi Zingales, *Power in a Theory of the Firm*, 113 Q.J. ECON. 387 (1998).

192. *See id.*

193. *See id.*

control under this definition, the two cannot be separated, although they can be shared.[194] This concept has a counter-intuitive aspect in a world still characterized by the Berle and Means separation of ownership and control. But the concept, as applied in exercises that articulate the characteristics of this "shared" ownership, easily accommodates the management-controlled firm as we know it in practice. Managers are seen to share control with the equity, retaining "effective" control in most states subject to displacement by the shareholders in exceptional situations.[195] As thus extended, incomplete contracts theory comes to bear on production-specific aspects of firm governance—for example, a manufacturer's decision to make or buy a component part[196]—in addition to control transfer events like takeovers, proxy contests, and insolvency receiverships. The subject matter for examination in these extensions is not "ownership" of assets *per se* but the grant of access to assets owned by others. Here again the emphasis is on the identification of arrangements that encourage firm specific investment.[197]

B. *The Liquidity and Concentrated Ownership Trade-Off and the Minimal Block Capital Structure*

Concentrated ownership sacrifices liquidity but enhances supervision, while dispersed ownership enhances liquidity but sacrifices supervision.[198] A theory of the optimal trade-off between the two should not, according to the economists Patrick Bolton and Ernst-Ludwig von Thadden, seek to determine whether concentrated or dispersed ownership is *per se* desirable. It instead should seek to determine how often and at what points in a firm's life cycle concentrated ownership leads to more productive results.[199] Bolton

194. *See* Grossman & Hart, *supra* note 188, at 695.

195. *See* Mike Burkart et al., *Large Shareholders, Monitoring, and the Value of the Firm,* 112 Q. J. ECON. 693, 696, 712 (1997).

196. *See* Rajan & Zingales, *supra* note 191, at 419–20.

197. *See id.* at 387–90.

198. *See* Shleifer & Vishny, *supra* note 52, at 754–55 (asserting that concentrated ownership solves the problem of shareholder disincentive to invest in monitoring that comes with high levels of diversification, but that the benefits of concentrated ownership must be assessed in terms of the significant costs, including loss of liquidity and private benefits extraction).

199. *See* Patrick Bolton & Ernst-Ludwig von Thadden, *Blocks, Liquidity, and Corporate Control,* 53 J. FIN. 1, 2 (1998) [hereinafter Bolton & von Thadden, *Blocks*]. The model appears in two versions. *See also* Bolton & von Thadden, *Structure*, *supra* note 184.

The Bolton-von Thadden model has a long ancestry. We can trace its origins to the classic

analysis of Armin Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972). That model looked into the incentive problems of team production and asked how the owners of the asset can induce the manager of the asset to cooperate. The model introduced two mechanisms to overcome the control problem—monetary incentives and a third party monitor—and assumed that the monitor could measure the agents' performance. Fama and Jensen later sharpened this story by centering on how the structure of ownership can be altered to limit externalities tied up with the incentive problems of joint production. More specifically, they argued that an ownership structure, such as a partnership, can be designed so as to produce an optimal outcome for the firm. The equilibrium result is asserted to follow from the role played by contractual constraints enforced by third parties. *See* Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327 (1983). For a new interpretation of these foundational models directed to the place occupied by constituency interests in the theory of the firm, see Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

The inquiry into the relationship between ownership structure, team production, and firm value took its next step forward when Bengt Holmstrom identified concentration of equity ownership as a critical factor. *See* Bengt Holmstrom, *Moral Hazard in Teams*, 13 BELL J. ECON. 324 (1982). Holmstrom's model is concerned with techniques for disciplining production team members. It emphasizes that, given problems in monitoring individual contributions to firm output, there is no sharing rule which can achieve an equilibrium outcome. This is because the team members will always have an incentive to collude so as to facilitate shirking and therefore cannot enforce a sharing agreement among themselves. Hence, there must always exist a principal to enforce penalties respecting shirking. More particularly, the moral hazard problem with agents calls for an incentive scheme which "breaks the firm's budget constraint." In other words, given bad news about team performance a budgeting authority must be in a position to cut off needed capital. Holmstrom suggests that shareholders with an ongoing contingent commitment to provide capital could perform this incentive function; with the occurrence of the contingency related to team performance they are released from their funding commitment. The problem left open for solution in the Holmstrom model, which relies on equity intervention, is the incentive that some owners have to free ride on other owners' efforts. From this monitoring perspective, then, it might be optimal to have a single owner. Thus the costs of independently monitoring the firm and pledging capital for financing give rise to a question respecting the optimal level of concentration of ownership.

Holmstrom identified at a theoretical level the problem on which today's comparative governance discussions devolve—the relationship between ownership concentration, liquidity, management agency costs, and investor incentives respecting governance. Holmstrom identified the problem and later discussants went on to confront the problems of the separation of ownership and control and blockholding. Shleifer and Vishny offered a model of an equity-financed firm in which there is one large shareholder and a number of small shareholders who free ride. In this model, firm value increases with the larger shareholder's presence. Consequently, in the model, the large shareholders are likely to have an incentive to retain their large shareholdings. The problem comes if the large shareholders ever get into a position to sell their shares anonymously in the trading market. Shleifer and Vishny found that would have every incentive to do so, sacrificing the benefit of their monitoring. *See* Andrei Shleifer & Robert Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461 (1986). *See also* Huddart, *supra* note 147, at 1408 (modeling the instability problem in a world where the blockholder's risk profile differs from that of the wider shareholder population).

A different perspective on the liquidity-control tradeoff can be found in Bengt Holmstrom & Jean Tirole, *Market Liquidity and Performance Monitoring*, 101 J. POL. ECON. 678 (1993). This paper assesses how a firm's ownership structure effects the value of managerial monitoring through the improved information content of the share price of the firm. Holmstrom and Tirole argue that the existing literature on managerial incentives poorly

and von Thadden, offer a model of the liquidity-concentration trade-off that bears importantly on evaluation of the cross reference hypothesis.

The Bolton-von Thadden model inquires into the conditions necessary for the formation of control blocks and into the concomitant costs in terms of reduced liquidity.[200] It assumes that blocks can coalesce in two ways: either (*a*) there is a large blockholder in place *ex ante* who stays put and removes unsuccessful managers, or (*b*) where ownership is dispersed *ex ante* and the managers later fail, an entrepreneur shows up to put a block together by purchasing shares in the market by tender offer.[201] The model further assumes a world where (*a*) blockholders can add to their returns through insider trading but commit no breaches of the duty of loyalty,[202] and (*b*) blockholders incur net private costs due to monitoring and other activities incident to the exercise of control. Taken together, these assumptions imply that block shares sell at a discount from nonblock shares on a per share basis, reflecting the monitoring cost.[203] This result contrasts with the real world experience of block shares trading at a substantial premium over market price, of course.[204] But the dose of unreality

---

understands how the stock market acts as a monitor of management: "the firm's ownership structure," they say, "influences the value of monitoring through its effect on market liquidity." *Id.* at 679. More particularly, they show that the informational benefits of listing and observing a quoted stock price are not well understood in terms of the costs and benefits of market monitoring.

In this highly stylized model, it is the presence of liquidity traders which produces the incentives for other traders to invest in information. The informed traders are able to profit since they choose the profit-maximizing route given the expected behavior of the other investors. Holmstrom and Tirole nonetheless argue that someone will have to pay the speculator for making investments in monitoring. The cost of such investments in monitoring are borne *ex ante* by insiders in the form of a lower initial share price. *See id.* at 696–97. Without the monitoring fee, liquidity would be hard to sustain. Market liquidity thus has its costs. Accordingly, say Holmstrom and Tirole, some degree of concentration of ownership is required. The Bolton-von Thadden model pick ups the problem at this point.

200. This cost-benefit analysis covers not only the blockholder but the shareholder population as a whole.

201. *See* Bolton & von Thadden, *Structure*, *supra* note 184, at 188.

202. *See* Bolton & von Thadden, *Blocks*, *supra* note 199, at 3. Here they proceed in contrast to many other incomplete contracts models of blockholding. For recent models that use insider trading and other private benefits as a permitted incentive to be traded off against gains from monitoring, see Ernst Maug, *Large Shareholders as Monitors: Is There a Trade-Off between Liquidity and Control?* 53 J. FIN. 65 (1998); Charles Kahn & Andrew Winton, *Ownership Structure, Speculation, and Shareholder Intervention*, 53 J. FIN. 99 (1998).

203. The implications of possibilities for gain through insider trading are examined in the model. *See infra* text accompanying note 221.

204. Extensive empirical literature documents this. *See, e.g.*, Michael Barclay & Clifford Holderness, *Private Benefits from Control of Public Corporations*, 25 J. FIN. ECON. 371 (1989). Bolton and von Thadden point out that the Barclay-Holderness study finds substantial premiums for blocks of greater than 25% and smaller premiums for blocks under

nonetheless enhances the model's heuristic value for comparative governance. In the real world, control premiums follow from the fact that control makes private benefits available absent a strict and perfectly-enforced regime of insider trading and fiduciary rules. The task for comparative governance, in contrast, is to test the proposition, put forward in American institutional investor literature, that public-regarding institutional monitoring is economically viable. If incentives for block monitoring can be shown to occur in a world entailing a liquidity trade-off but constraining private benefits, then the case for public-regarding monitoring emerges much enhanced. Such a result simultaneously would bolster the case for the coexistence of thick trading markets and effective blockholding in Europe.

1. The Optimal Block in a World of Trade-Offs

For Bolton and von Thadden, the optimal trade-off between concentration and liquidity depends on a number of factors. The factors include: (*a*) the degree of liquidity demand due to shareholder impatience or desire to consume, with lower demand and patience favoring concentration; (*b*) the transaction costs of ownership and transfer, with high costs favoring concentration; (*c*) the level of monitoring costs, with high costs favoring dispersal; and (*d*) the expected variance of returns, with high variance favoring concentration because uncertainty implies a need to accord more discretion to managers and thus an enhanced need for monitoring.[205] The location of the trade-off point varies from situation to situation. But a clear set of alternatives emerges at the bottom line, despite the complexity at the trade-off point. *If* the factors signal concentration, then an optimal capital structure: (*a*) contains no more than one block, since duplication of the block position reduces liquidity; (*b*) includes a block containing no more than the minimum number of shares necessary for the exercise of control, since a larger block reduces liquidity (the "Minimal Block" or "MB"); and (*c*) includes outside shareholders each of which holds only a minimal number of shares, since any shareholding larger than the minimum also reduces liquidity (the "Minimal Block Capital Structure" or "MBCS").[206]

25%. In effect, they say, their model contemplates blocks of 10% to 20% that nevertheless exert control power. *See* Bolton & von Thadden, *Blocks*, *supra* note 199, at 8–9.

205. *See* Bolton & von Thadden, *Structure*, *supra* note 184, at 191–93.

206. *See id.* at 190. In the model the minimum holding is one share. Substantial blocks smaller than the optimal size could carry the benefit of easing the cost of a tender offer, but

Under the model's assumptions, the MB will sell at a discount per share from intrinsic value because monitoring is costly and the cost cannot be passed on to the outside shareholders in the form of private benefits received by the blockholder. For the same reason, block formation through tender offer occurs only to the extent that the holder can buy the shares at a discount from intrinsic value. Under the model's set up, such purchases can be made only from impatient liquidity sellers who are willing to sell at a discount.[207] Relative numbers of liquidity sellers and patient investors (who only sell for intrinsic value) thus can have a significant governance impact.

We note some points at which the MBCS fails to synchronize with the main points on governance reform agendas. Since the MB must command control, it, of necessity, has to be comprised of a substantial percentage of shares, even recognizing that control can be maintained with considerably fewer than 51% of the shares.[208] The insistence on a control block follows from a central assertion of incomplete contracts—that absent enforceable contract terms, productivity and related incentives depend on control transfer allocations.[209] The American case for delegated institutional monitoring, in contrast, looks toward the lesser goal of ongoing participation in control through institutional coordination. The model accordingly raises a question as to whether the pursuit of a half a loaf is worth the cost. At the same time, however, it dovetails with a central point in the American case: monitoring requires much more concentration in institutional holdings than we presently see in the United States.

The MBCS model has the converse message for European blockholding practices. For Europe, the problem is not undersized but oversized blocks, for the blocks in place there are larger and more numerous than the MB model predicts.[210] The model also shows that the European blocks carry a liquidity cost that diminishes the depth of national securities markets. A clear implication arises for European law reform: trading market depth approaching that of Britain and the United States depends not merely on transparency but on the unwinding of some of the blocks. This presumably could occur

---

Bolton and von Thadden speculate that dispersion still will dominate due to liquidity benefits. *See* Bolton & von Thadden, *Blocks, supra* note 199, at 18.

207. *See* Bolton & von Thadden, *Blocks, supra* note 199, at 13.

208. This result would be especially easy to effect where the firm goes public with a block in place.

209. *See supra* text accompanying notes 191–92.

210. The implication is that private benefits figure prominently in blockholder-firm relationships. *See infra* notes 252–54 and accompanying text.

without a negative governance impact so long as each firm emerged with a MBCS.

2. Block Formation

The MBCS model allows for the coalescence of blocks for the purpose of effecting governance improvement at badly managed, publicly-held companies. But such block formation comes in the mode of the traditional tender offer rather than in the mode of delegated institutional monitoring. Block formation through tender offer depends in turn on the degree of uncertainty about the block's appearance. If a block's appearance is certain, no holder will sell into a tender offer for less than the firm's intrinsic value with a block in place. This kills the offer. Since monitoring is costly, the tender offeror must get the shares at a discount from intrinsic value so as to be compensated for the cost of the monitoring. This means that block formation can never be a sure thing: the tender offer proceeds only if a sufficient number of impatient liquidity sellers are willing to sell at the requisite discount.[211] Liquidity, which is enhanced by impatient selling, thus promotes block formation for a public company[212] even as the block's formation reduces liquidity. Contrariwise, if it were absolutely certain that no block ever would appear, all shares would be discounted to reflect that possibility. This in turn would create a perfect arbitrage opportunity for a potential tender offeror seeking to put together a block. The model thus posits an equilibrium

---

211. *See* Bolton & von Thadden, *Structure*, *supra* note 184, at 188.

212. *See also* Maug, *supra* note 202, at 66 (noting that in this sense there is no trade-off between liquidity and control).

Liquidity also can make block monitoring difficult to sustain. Whenever a closely held firm goes public while retaining a blockholder, the free rider problem arises. The holder, who reaps no private benefits, must spend to monitor but must share the proceeds with the shareholders as a whole. At the same time, the presence of the block depresses liquidity in the outside trading market. Not only are there fewer shares trading than otherwise would be the case, but, given anonymous trading, an information asymmetry arises between the blockholder and the outside shareholders—the blockholder could be secretly unwinding its position due to negative inside information and the outside shareholders might not realize it. *See* Bolton & von Thadden, *Structure*, *supra* note 184, at 178. The possibility that the block will be unwound independently depresses the value of the firm because it implies a reduced level of monitoring. That threat always is present to the extent the blockholder's wealth is constrained: limited wealth makes the holder vulnerable to liquidity shocks and the block unstable. Lower wealth levels thus favor concentration. *See id.* at 208.

Just as liquidity makes blocks unstable, so it facilitates takeovers. A deep market driven by impatient liquidity traders who do not hold out for the full, long term value of their shares is a market with minimal free-riding on monitoring gains yielded by a blockholder. Thus block formation by tender offer is favored. *See* Bolton & von Thadden, *Blocks*, *supra* note 199, at 3–4.

characterized by uncertainty about prospects for block formation by tender offer.[213]

The tender offeror only bids for shares on offer from impatient sellers because only these present an opportunity for an arbitrage profit. If all holders are impatient, the offeror will tender for as many of their shares as its level of wealth can sustain. The size of the emergent block thus very well can exceed that of the MB. Patient holders, in contrast, will demand a premium in exchange for giving up their free ride. As a result, if the process rules governing tender offers require the highest price offered to be shared with the entire group of offerees, then the bid fails whenever the offeror has to buy shares from patient shareholders in order to accumulate the minimum number of shares necessary in order to take control.[214]

There arises a negative implication for transparency regulations, such as section 13(d) of the Williams Act,[215] that tip off the holders as a group to the presence of a party interested in gathering a control block.[216] Interestingly, however, this negative implication does not extend to all regulations appearing on the target list put forward by U.S. proponents of delegated monitoring.[217] Regulations constraining the size of institutional holdings and the nature of institutional shareholdership, appear in a positive light in this context because they by definition promote liquidity.[218] The model thus echoes the Chicago School policy position: emphasis on law reform to promote larger proportionate institutional holdings may be misplaced, and primary emphasis should be placed on reversing state level constraints on tender offers. The underlying reasons are quite different, however. Here the point is not that the market system is intrinsically superior to the blockholding alternative. Nor is the point that market regulation is intrinsically costly.[219] Rather, the point is that the market system's underlying incentive structure favors control transfer by takeover.

213. Note also that uncertainty about block formation is the only equilibrium result absent legal restrictions. Bolton & von Thadden, *Structure, supra* note 184, at 194.

214. *See* Bolton & von Thadden, *Blocks, supra* note 199, at 14–17.

215. 15 U.S.C. § 78m(d) (1994).

216. *See* Bolton & von Thadden, *Blocks, supra* note 199, at 17.

217. *See supra* note 146.

218. *See* Bolton & von Thadden, *Blocks, supra* note 199, at 3–4.

219. Bolton and von Thadden's model implies a need for regulation at a crucial point. *See infra* text accompanying notes 224–25.

3. The Unwind Problem

The same factors that make block formation problematic make the MBCS unstable once in place. Assume that a privately-held firm goes public but simultaneously places a MB with a third party holder who receives no private benefits. We have an optimal trade-off between concentration and monitoring. But will the MB stay in place? If it is absolutely certain that the MB will remain in place, then the market price of the stock will be at a high level, reflecting the value of the MB holder's monitoring. But on this state of facts the MB holder has an overpowering incentive to sell its shares piecemeal into the market—it is not, after all, being compensated for its monitoring expenses under the model's assumptions. If the MB holder can sell into the market anonymously, the other shareholders never will be in a position to know whether or not the MB holder is unwinding its position. Given anonymity, then, the MB holder can exit at the higher price, recover its expenditures for monitoring, and leave the firm unmonitored and thus selling at a lower value. There results uncertainty respecting the stability of the block, a factor which will tend to depress the stock price.[220] Ironically, the more stable market actors believe the block to be, the more the MB holder has an incentive to unwind it. Intrinsic instability thus is a problem for blockholder systems, given anonymity respecting trading and changes in block positions.[221]

A very different result follows where the MB holder's ownership position and trades are made transparent. Given transparency, other shareholders will read the MB holder sales to

220. This problem can be viewed in different ways. Kahn and Winton, accepting that trading profits yielded by the inside position are an intrinsic part of a blockholder's incentives, work them in as a factor in a model directed to predicting types of firms in which a blockholder emerges in the first place. Trading profits, they find, are likely to loom larger where the firm is small, young, and not very well known. With mature, thickly-traded firms, other motives will predominate when a shareholder becomes active. *See* Kahn & Winton, *supra* note 202, at 101.

221. *See* Bolton & von Thadden, *Structure*, *supra* note 184, at 194–99. The unwind problem is discussed extensively in the literature. Others, somewhat implausibly, suggest that the firm lock in the blockholder with supermajority provisions in the charter. The idea is that the blockholder has to acquire the supermajority in order to get control in the first place. The supermajority holder is more likely to intervene and suffers a larger liquidity sacrifice, and thus has a heightened incentive to stay with the firm for the long term. *See* Maug, *supra* note 202, at 67. *See also* Kahn & Winton, *supra* note 202, at 102 (suggesting that firms place blocks of restricted shares); Admati et al., *supra* note 147, at 1100–01 (obtaining a first-best block equilibrium outcome assuming a Walrasian trading mechanism and blockholder commits to only one round of trading); Huddart, *supra* note 147, at 1408 (noting the commitment problem and suggesting that all purchases and sales by the blockholder be made on the basis of pro rata offers).

mean that either (*a*) the MB holder is unwinding because it has become impatient and wants to cash out, or (*b*) the MB holder is unwinding because it has adverse inside information about the prospects of the firm. Either way, the sales will depress the stock price, making it difficult for the MB holder to unwind in the first place. Transparency thus has a tendency to lock in the blockholder, making the block more stable and thus more effective as a governance tool.[222]

Bolton and von Thadden draw a regulatory conclusion from all of this. Just as transparency respecting blockholder purchases, such as that mandated by regulations like section 13(d) of the 1934 Act, decreases the likelihood of block formation, so mandated transparency respecting blockholder sales, such as that incident to section 16(b) of the 1934 Act,[223] imports stability to a block monitoring system by preventing the blockholder who has negative information about the firm's prospects from selling out on the sly.[224] Significantly, the MB holder is not absolutely locked in given transparency. If it encounters a need for liquidity it always can exit by selling its block as a whole. That sale will be at the MB holder's pro rata share of the value of the firm as block monitored net of monitoring cost, compensating the holder for its governance input if not depriving the other shareholders of their free ride.[225]

4. A First-Best Second-Best Hybrid Capital Structure

Can the MBCS be endorsed as an all-purpose optimal capital

---

222. *See also* Pagano & Röell, *supra* note 167, at 213–14 (finding that blockholders will have an incentive to alter their stakes through trading absent complete transparency in the trading market and that transparency imports a stable ownership structure). *Cf.* ERNST MAUG, INSIDER TRADING LEGISLATION AND CORPORATE GOVERNANCE (Duke University Economics Working Paper, 1999) (visited Oct. 27, 1999) <http://www.duke.edu/~Maug/research> (arguing that in a situation where insider trading is not monitored and dominant shareholders can monitor companies, managers will have an incentive to disclose private information early to induce large shareholders to sell rather than intervene whereas if insider trading is regulated, the interests of the dominant shareholder and small shareholder converge; noting also that EC Insider Trading Directive may not be very effective because it requires information to be precise which creates a gray zone where information cannot be easily classified as inside information).

223. 15 U.S.C. § 78p(b).

224. *See also* Pagano & Röell, *supra* note 167, at 208–09 (finding that mandatory disclosure that makes private benefit extraction easy to detect encourages public offerings to the extent that they lower the monitoring cost that otherwise would be incurred).

225. *See id.* at 197, 199, 207. The block is broken up in subsequent liquidity trading only if every holder becomes impatient. *See* Bolton & von Thadden, *Blocks*, *supra* note 199, at 11.

structure? As we have seen, a MB by definition leaves the largest possible number of shares available for trading and thus best combines the monitoring advantages of blockholding with the thick trading of market systems.[226] Generalizing from this point, Bolton and von Thadden assert that, given a number of nonblock shares "tending to infinity," blockholding will always dominate over dispersion. Otherwise the choice between dispersion and concentration depends on the full range of trade-off factors.[227]

Does this finding provide us a template for the optimal firm and a supporting hybrid governance system? No, since the number of shares outside of the block always is finite we remain stuck in a world of trade-offs. But it still plausibly can be suggested that real world trade-offs heavily favor the MBCS as a practical matter. If the optimal block was sufficiently small so that a very large number of dispersed shares were left in circulation, then a satisfactory level of liquidity could be maintained even as the holders benefited from the blockholders' monitoring. Bolton and von Thadden take pains to note that control can be maintained with a block of 10 or 20% of the shares.[228] With a large capitalization firm, the 80 or 90% remaining available for trading should more than suffice to support a deep market.

There emerges, then, a picture of first-best second-best capital structure, characterized by a 10–20% block with the remainder publicly traded. This MBCS seems better suited to conditions in Continental Europe than in Britain or the United States. Although 10 to 20% blockholders certainly have been known to exercise control in market systems, control does not inevitably attach to blocks of this size. The American experience has been that such a small blockholder is difficult to unseat if already in control of the board. But, at the same time, an outsider who newly acquires a 10 to 20% block has influence but will not necessarily possess unilateral control power.[229] Thus the MBCS picture seems tailored for Europe, where blocks larger than 10 or 20% and not identical with the management interest already in place.[230] Presumably, the blocks' size can be

226. This result previously has been commended in Amar Bhide, *The Hidden Costs of Stock Market Liquidity*, 34 J. FIN. ECON. 31 (1993).

227. *See* Bolton & von Thadden, *Blocks*, *supra* note 199, at 21–22.

228. *See id.* at 8–9.

229. This is the lesson of sale of control cases like *Essex Universal Corp. v. Yates*, 305 F.2d 572 (2d Cir. 1962), in which a 28.3% block implicates control.

230. Note that in the United States, where a corporation has a 10 to 50% blockholder or blockholders, there often is identity between the blockholder group and the firm's management group—as where a group of entrepreneurs builds a successful close corporation

reduced without materially disturbing existing control relationships. The United States, in contrast, lacks these existing blocks. Entrepreneurs would have to put the 10 to 20% blocks together through open market purchases. No control transfer would follow so long as management remained opposed, necessitating the further step of a proxy fight or a tender offer for a 51% block.

5. Implications of Indivisibility

Despite the problems, the MBCS model suggests a hybrid, block-based solution to the problem of optimal capital structure. It thus supports the cross reference hypothesis, but on an aspirational level. The model simultaneously offers incidental, but significant, support for a real world description of indivisibility. It does this at three points. First, it is fundamental to the model that, absent a number of shares tending to infinity and given substantial demand for liquidity, a MB may fail to emerge even though it is needed to maximize the value of the firm. Here the insight is that in a world where all investors are impatient, liquidity is valued above all even at the sacrifice of gains from monitoring. We note a more than passing resemblance to investors and markets in the United States.[231] Second, as the model's discussion of the incentives of the tender offeror shows, when such a control block does emerge in world where liquidity is highly valued, it likely will do so in the form of a suboptimally large block. Third, absent complete transparency in the trading market and private benefits, a MBCS will have a tendency to be unstable.

Given these results, the model can be read to predict not an

---

and later takes it public, continuing to run the business and retaining significant equity stakes. Such firms are not "blockholder" firms within the model, which contemplates separation in the identities of the blockholder and the manager. The importance of this distinction is dramatized in Pagano & Röell, *supra* note 167. This model shows that for an owner taking a firm public, completely dispersed shareholding maximizes returns even though entailing a suboptimally high level of monitoring. The owner avoids a capital structure entailing a higher level of monitoring because it chokes off her private benefits. *See id.* at 190. Interestingly, the model also predicts that private benefit extraction will not tend to be very wasteful for firms that do go public—otherwise monitoring would be highly beneficial and a close corporate structure with a large outside investor-monitor would make more sense. Similarly, strict disclosure rules encourage dispersed ownership by making monitoring from an outside point of view more effective. *See id.* at 191. *See also* Burkart et al., *supra* note 22 (predicting that concentrated ownership leads to high levels of monitoring and low management initiative).

231. No claim to originality accompanies the observation. *See generally* John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991).

ideal hybrid system, but a world in which we are likely to see: (*a*) given legal controls on private benefits, intervention respecting a poorly performing widely-held firm in the form of a tender offer for a majority or greater than majority stake, as in market systems; (*b*) the emergence of smaller, long-term control blocks only with the provision of returns through private benefits, as in blockholder systems, and (*c*) hostile takeovers for majority and supermajority stakes rather than optimal blockholding. The divergent results strikingly resemble the divergent characteristics of existing market and blockholder systems. The results are doubly noteworthy because they are yielded by a model devoted to predicting the shape of a superior hybrid.

C. *Institutional Monitoring and the Free Rider Problem*

Bolton and von Thadden model a world in which blockholding without self dealing is profitable, replicating a result basic to the American case for delegated monitoring.[232] Although they do not in terms address the subsidiary point respecting the formation of institutional coalitions, their model does not exclude the possibility. Indeed, elsewhere in the literature we learn that such shareholder cooperation presupposes two conditions: (*a*) stable interactions over time within the monitoring coalition,[233] and (*b*)

---

232. *See supra* notes 168–70 and accompanying text.

233. Pagano and Röell suggest that such a cooperative pattern may make possible monitoring by institutional coalition. *See* Pagano & Röell, *supra* note 167, at 210 *citing* Jean Tirole, *Collusion and the Theory of Organizations*, 2 ADVANCES IN ECONOMIC THEORY: SIXTH WORLD CONGRESS 151, 156 (Jean-Jacques Laffont ed., 1992). We are skeptical.

The problem facing all attempts at cooperative monitoring is how to enforce a noncontractible contract for monitoring. Pagano and Röell's solution is to suggest that even if there is no enforceable contract, the prospect of an equilibrium outcome is made possible by such mechanisms as reputation, which can facilitate long-run cooperative behavior. Following Tirole, *supra*, they propose relying on reputation as the foundation of enforceability of repeated interactions. The idea here is that given enough repeated interactions, trust will emerge and a party can invest without a contract. More specifically, the repeated game works as a self-enforcing arrangement so long as there is a high probability that each round will be followed by a succeeding round, which deters defection and induces cooperation in the current round. The reputation model makes a number of basic assumptions. A player will invest in his reputation and cooperate so long as that player values the returns from cooperation over time higher than the short-term gains of opportunistic behavior. The player's self-interest serves as a mechanism for overcoming the collective action problem. We should note, however, that in many infinitely repeated games there is a very large (possibly infinite) number of outcomes which are better than the non-cooperative outcome. *See* Bratton et al., *supra* note 185, at 177. These persistent multiple equilibria give rise to questions respecting the viability of the reputation effects model of cooperation. Quite simply, the number of equilibria predicted vastly outnumber the number

substantial shareholdings, since incentives to free ride diminish as stakes grow.[234] But these conditions only return us to the incentive problems bound up in the liquidity-control trade-off. Stable interactions and substantial positions will prevail only among investors who do not value liquidity highly. The shareholder free rider problem also comes to bear—the MBCS model never quite manages to make it go away. This could retard coalition formation among institutional investors even if coordination otherwise was desirable and investors had come to value liquidity less highly. Note also that, given the free rider problem, it is prospects for trading profits (as realized by a tender offeror in the MBCS model) that provide the incentive that brings a block into existence. But, since trading profits mean selling as well as buying, they turn out to provide an unstable incentive base for long-term monitoring, at least absent a regulatory device that prevents blockholder sales.

A model from Charles Kahn and Andrew Winton expands on this point. Kahn and Winton's set-up takes us a step closer to American practice. Here control transfer is not the only meaningful form of intervention: influence stemming from significant stakes can lead to productive changes in certain circumstances. More particularly, institutional ownership stakes below a critical level means that information about the firm developed by an institutional investor is most profitably used only for the purpose of speculative trading. Above the critical level, intervention in the firm's affairs is the more attractive alternative, but only if special conditions exist.[235] A large capitalization conglomerate in need of unbundling presents the archetypical attractive situation: it is informationally accessible, its stock has been bid down, the intervening institution knows what to do, and the intervention is quickly completed. In contrast, a firm where problems and solutions presuppose special knowledge, like a high technology firm, presents an unattractive case for intervention. Here the situation is opaque, intervention is more expensive, and turn

---

we would expect to observe in the real world. This creates the problem of predicting an outcome.

This approach is not without problems even on a practical level. If there is to be cooperative monitoring by a subset of shareholders, the level of cooperation sustained over time surely depends on the incentives of the parties. Institutional investors present a succession of different parties none of whom appears to be committed to maintaining a reputational interest in monitoring. Thus it appears that cooperation can be sustained only if it is possible to bind parties to the process by first persuading them that they have common interests. This is an heroic assumption no matter how large the stock of companies that wish to invest in monitoring.

234. *See* Pagano & Röell, *supra* note 167, at 210.

235. *See* Kahn & Winton, *supra* note 202, at 100–01.

around takes longer. Even an institution with a large stake resolves doubts in favor of selling in the event of bad news.[236] Given wealth limitations on institutions and the need to diversify, say Kahn and Winton, intervention will follow only in quick-fix situations where the critical level of ownership stakes is low.[237] Given this analysis, the economically sustainable pattern of institutional intervention already has appeared in American practice. It takes the form of discrete (as opposed to relational) intervention against mature, large capitalization firms that are manifestly ill-managed—actions like the "Just Vote No" campaign, the shareholder proposal against the poison pill, and the one-time, behind-the-scenes meeting between company executives and select institutional representatives. Incentives for more sustained delegated monitoring appear to be lacking.[238]

The MBCS model, as thus supplemented, challenges the cross reference hypothesis as applied to the United States: economic fundamentals rather than historical path dependencies may be the factor primarily responsible for the dearth of institutional monitoring. There follows an endorsement of the Chicago School's policy recommendation, albeit from a different base of assertions. Recall that Chicago simultaneously holds to market system superiority and strong convergence by asserting, (*a*) that substantive convergence already has occurred because the same set of microeconomic factors can be drawn on to explain all national systems, and (*b*) that persistent differences among the systems completely can be explained as the results of legal intervention.[239] Here, in contrast, we get an economic analysis compatible with the equal competitive fitness hypothesis. The analysis indicates that not only has substantive convergence not yet occurred, but that interdependent financial incentives may stand in its way. Persistent differences among national systems can be as plausibly accounted for as either the results of free choice in a world of trade-offs or the perverse effects of interest group legislation.

236. *See id.* at 119–21. The model has a strong regulatory implication. To the extent that quick institutional intervention can assist in company turn around, short-swing profit disgorgement under section 16(b) of the 1934 Act has an unproductive side effect. 15 U.S.C. § 78p(b).

237. *See id.* at 120.

238. For a description of the pattern seen in practice, see Bratton & McCahery, *supra* note 149, at 1906–18.

239. *See supra* text accompanying notes 94–99.

D. *The Monitoring and Initiative Trade-Off*

American analyses of blockholder systems have proceeded on the assumption, widespread in corporate law, that increases in a principal's effort to measure or verify an agent's performance necessarily induce better performance. The incomplete contracts literature reconsiders this proposition,[240] entering a caveat respecting monitoring. The caveat has powerful implications for both comparative governance and other exercises in incomplete contracts economics, including the MBCS. Even if it were safe to assume that control passes to a 10 to 20% blockholder, the MBCS model's signal of optimality cannot be taken as conclusive because it reflects only two factors, concentration and liquidity. Firm value may be sensitive to a wider range of governance variables.

The variable now in question is a trade-off incident to monitoring itself. The concession of decisional authority to an agent means a potentially costly loss of control over projects, but it also entails a benefit. The agent's incentive to acquire and develop information—increases along with the scope of the delegation of authority. It follows that reductions in monitoring activity can encourage initiative in the agent, increasing the principal's expected return.[241] The costs of monitoring however, can include a diminution in the value of firm-specific investments made by the firm's agents.[242] Just as stepped-up monitoring is a benefit of increased concentration in shareholdings, so is reduction in management initiative a cost of concentration.[243]

The trade-off implies a commitment problem. If management initiative is crucial for the firm's success, maximal shareholder value requires an *ex ante* commitment to leave control in the manager. Given concentrated shareholdings, that commitment may be difficult to make credibly. Matters such as investment and monitoring policy are noncontractible: the equity holder cannot credibly commit *ex ante* to refrain from using its control rights in situations where it deems the exercise to be optimal *ex post*.[244] The best available solution may be a

240. *See* Philippe Aghion & Jean Tirole, *Formal and Real Authority in Organizations*, 105 J. POL. ECON. 1, 10 (1997).

241. *See id.* at 11. The incentives of the agent, thus empowered, to communicate information back to the principal depend in turn on the alignment of incentives between the principal and the agent. *See id.* at 17–18.

242. *See* Burkart et al., *supra* note 195, at 694.

243. *See id.* at 701.

244. *See id.* at 700–01. At least, this statement is true according to the literature. A Corporations teacher at this point might make reference to the device of a shareholders'

reduction in concentration of shareholdings. The equity holder's incentive to monitor decreases as the level of holdings becomes dispersed. Cost and incentive barriers decrease the likelihood that dispersed shareholdings will coalesce into blocks *ex post.* Management's initiative to invest productively is enhanced as a result.[245]

The point for comparative governance is not that monitoring always is a bad thing and dispersed shareholding always superior to blockholding. This literature takes pains to stress that the optimal trade-off between initiative and concentration (and thus monitoring) may vary from firm to firm. For example, the trade-off point may vary depending on the availability of reliable means to measure agent performance. With a long-established, mature business, reliable measures of management performance may be found in conventional, short-term quantifications such as the stock price, the earnings results, the dividend payout pattern, or the performance pattern of the industry as a whole. Accordingly, strict incentive contracts may work well in tandem with limited monitoring and dispersed ownership. With a high-tech business engaged in a novel line of business, monetary incentives will be harder to design. Tighter control and concentrated ownership may be needed as a result.[246]

A warning for comparative governance emerges from this analysis: there may be such a thing as suboptimal overmonitoring. The warning gives rise to a question: does the intense blockholder engagement with management hypothesized in the comparative literature carry this risk of overmonitoring? The results of the informal governance comparison confirm the question's salience. American academics went abroad searching for vigorous institutional

---

agreement combined with an irrevocable proxy: assuming a small number of shareholders, complete delegation can be effected if either (*a*) the manager is given irrevocable control of the board, or (*b*) the board is abolished and a shareholders' agreement gives the manager the right to the Presidency and an irrevocable proxy to determine the results of shareholders' meetings. These arrangements do not solve the problem, however, because of the absolute nature of the delegation they entail. The more desirable middle ground of a continuing, conditional, and controlled delegation proves problematic because of the contractibility problem.

245. *See id.* at 694, 701.

246. *See* Aghion & Tirole, *supra* note 240; Burkart et al., *supra* note 195, at 718–19. We note an apparent tension between this line of inquiry and that of the Kahn-Winton model, discussed in the text accompanying *supra* note 237. Kahn and Winton intervene in the large capitalization firm and avoid intervention in the high-tech firm. Here we monitor the high-tech firm and rely on published data on the large capitalization firm. In fact, it is the same story. Kahn and Winton's intervention is a low cost event, initiated by institutional holders who presumably are relying on published data and would never invest in the monitoring contemplated by Aghion and Tirole, whose monitor is a blockholder.

monitors—banks that scrutinize investment policy with a clear eye for shareholder value.[247] But, as noted above, comparative inquiries report that the benefits of European and Japanese institutional investor monitoring lie in downside intervention.[248] These reports correspond directly with the basic assertion of the incomplete contracts models: investor-manager arrangements are more likely to look to the transfer of control to remedy manager failure than to ongoing active participation in management control as a prophylactic that prevents management failure from occurring in the first place.

In sum, we see an additional reason why control transfer trumps control sharing as a governance strategy for the equity interest—control sharing carries a risk of chilling management incentive.[249] We also must modify the vision of optimality bound up

247. *See supra* text accompanying note 151.

248. *See supra* text accompanying notes 152–62. The blockholders' inside access and reduced information asymmetries certainly create possibilities for constructive engagement on an ongoing basis. But comparative research has not yet yielded concrete evidence of such relationships.

249. The Aghion-Tirole model has prompted a series of inquiries into the problem of overmonitoring. The fact pattern posited depicts an owner considering taking her firm public, facing a choice between holding a control block and an otherwise dispersed shareholder group, and holding a control block and admitting another large holder and an otherwise dispersed shareholder group. The former situation carries a risk of undermonitoring, where the latter carries a risk of overmonitoring. Pagano and Röell explore the possibility of a cooperative solution to the latter problem: the controlling shareholder and the blockholder make a collusive contract in which they agree to an optimal level of monitoring activity. In the model, increasing returns to capital follow if the monitoring shareholders act together to set the level of monitoring activity. On the other hand, small shareholdings will be discouraged given the existence of the collusive contract between controlling and large shareholder. This means that small stakeholders are likely to meet heavy discounting of their share stakes in subsequent trading. *See* Pagano & Röell, *supra* note 167 at 209–13.

We have questions about Pagano and Roell's approach, based on insights developed in a new theoretical literature in industrial organization that tests the effects of enforceable side contracts within the firm. *See* Tirole, *supra* note 233; Jean-Jacques Laffont & David Martimort, *Collusion and Delegation*, 29 RAND J. ECON. 280 (1998). Jean-Jacques Laffont & David Martimort, *The Firm as a Multicontract Organization*, 6 J. ECON. & MGMT. STG. 201, 223–24 (1997) [hereinafter Laffont & Martimort, *Firm*] point out that side contracting is possible but may be costly. A tractable model must explain how bargaining takes place, which party has more bargaining power, and whether the parties bargain under asymmetric information. It is suggested that, in the context of the principal-agent models, the bargaining problems are further complicated by mechanism design difficulties. More specifically, it is pointed out that there may be several problems with the implementation of the contract offered by the principal (here the controlling shareholder). They stress that, in this regard, the modeler may have to make a choice between the assumption of a strongly collusion-proof allocation (which is robust to all equilibria in hidden games) versus a weakly collusion-proof allocation (that is responsive to just one equilibrium). *See id.* at 224. But they acknowledge that this distinction makes little sense when the agents bargain under symmetric information since they will, assuming joint rationality, bargain to the set of Pareto optimal outcomes. It follows that Pagano and Röell's collusive contract will emerge if the contracting parties are

in the MBCS: block capital structures are optimal only to the extent that the benefits of intense monitoring outweigh the costs of its negative effects on management initiative. More generally, the optimal capital structure may be asset specific. The question for comparative governance is accordingly one to be addressed separately and specifically to each different system world-wide: Is there any aspect of your practice or regulation that unnecessarily prevents given firms, viewed as collections of assets and incentive problems, from maximizing their value? The answers could involve either deregulation or regulation depending on the circumstances. Cross reference and hybridization would or would not result depending on the answers.

E. The Role of Private Benefits

The informal comparison, as we have seen, tells us that blockholders look to yields from insider trading and self dealing transactions[250] to recoup their investment in monitoring and sacrifice of liquidity. In contrast, leading models of the concentration-liquidity trade-off and the monitoring-initiative trade-off tend to assume a world with constraints on private benefits.[251] The assumption, while heroic, teaches an important lesson about the connection between private benefits and governance structures. The more closely we look at the dynamics of the MBCS model, the harder it is to imagine a MBCS in a world without private benefits. In the MBCS world, as posed by Bolton and von Thadden, blocks appear only occasionally.

---

narrowly rational and symmetrically informed. As a practical matter, however, parties are more likely to be imperfectly informed agents who, due to less than ideal conditions, bargain to less than efficient outcomes.

The problem of asymmetric information is yet another serious barrier to the emergence of an equilibrium side contract. Laffont and Martimort point out that the scope for a perfect Bayesian equilibrium in the game of coalition formation "depends on what happens in the status quo outcome when one agent refuses the coalitional agreement." Laffont & Martimort, *Firm*, at 224. In conventional Bayesian theory, it is the substitution of different beliefs from prior beliefs that ensures the emergence of an equilibrium side contract. As with the standard Bayesian dynamic games, problems of multiplicity arise also in the game of coalition formation. One potential solution is to assume an uninformed and benevolent third party that suggests side contracts to the parties which jointly maximize their collusive activity. Obviously this model is more appropriate to regulated industries where delegation to third parties dominates. From the perspective of corporate law, it is unlikely that this second-best solution can be achieved.

250. *See supra* note 42 and accompanying text.

251. *See* Bolton & von Thadden, *Structure*, *supra* note 184 and accompanying text. *See also* Burkart et al., *supra* note 195, at 697 (monitoring vs. managerial-initiative model).

Even then they are unstable so long as equity holders value liquidity highly and gains from monitoring are the only reason for block formation. Incentives for block formation diminish further once we interpolate the insight of the monitoring-initiative models: if block formation carries a cognizable risk of unproductive overmonitoring, a clear cut formation incentive emerges only in the case of control transfer due to poor management performance. We accordingly must make reference to private benefits if we are to account for the blocks that exist in practice (and dominate capital structures outside of English-speaking countries). Thus, these incomplete contracts models effectively refute the case for block monitoring based on a pure financial incentive.

This point is made affirmatively in a new model from Lucian Bebchuk.[252] Bebchuk interpolates private benefits so as to cause a volte face. Now it is dispersed ownership structures rather than blocks that are intrinsically unstable. The reason is straightforward. Absent effective anti-takeover devices and to the extent that private benefits are freely available to actors in control, a dispersed group of shares presents an intrinsically attractive opportunity for a takeover entrepreneur because the private benefit yield assures a payoff. Given this, there is no incentive for an insider to sell out by taking the firm public in the first place. Such a move sacrifices the value of the private benefits, detaching it from the insiders' control stake, only to leave it open for capture later by a tender offeror.[253]

An important lesson results for Europe. Clearly, private benefits must figure into the explanation of its existing blockholding pattern. Market liquidity comparable to that in Britain and the United States will come only with fewer and smaller blocks. One means to the end of reducing the blocks is a legal regime that effectively deters blockholder insider trading and self dealing and brings transparency to internal corporate affairs. The question is whether a partial regulatory package will suffice. More particularly, if self dealing is a mainstay of blockholder returns, then an effective insider trading ban

252. *See* LUCIAN AYRE BEBCHUK, A RENT-PROTECTION THEORY OF CORPORATE OWNERSHIP AND CONTROL (Harvard Law School, Center for Law, Economics, and Business Discussion Paper No. 260, 1999).

253. For a recent model that also considers the role of private benefits, see MIKE BURKART ET AL., BLOCK PREMIA IN TRANSFERS OF CORPORATE CONTROL (London School of Economics, Financial Markets Group Discussion Paper No. 1868, 1998). The assertion here is that tender offers are a preferable means of effecting control transfer to block transfers. Under this model, a controlling blockholder with a large stake internalizes more deadweight costs of extracting private benefits and thus gain less. To the extent that private benefits extraction decreases in the size of the block, tender offers are superior because they increase concentration and hence firm value.

will not suffice to bring high liquidity and present European reform initiatives could fail in their purpose. This appears to be a serious prospect: if substantial private benefits remain available, why should a blockholder give up its privileged position? But a tougher reform package that constrains self dealing transactions gives rise to the converse question: assuming (*a*) that a new regime discourages blockholding by regulating both self dealing and insider trading, and (*b*) that blockholder monitoring does import benefits and a MBCS should be the objective, how can it be assured that a single, optimally-sized block will remain in place in each firm? Unless some private benefits are reserved for this remaining blockholder, it remains in the same posture as the selling blockholders. In other words, the free rider problem shows up at exactly the same point where it presently determines results in market systems.

F. Summary—Private Benefits and Indivisibility

Let us suppose, with the American governance literature, that Bolton and von Thadden's model of the concentration-liquidity trade-off more closely approximates the problem for solution in the real world than do models of the concentration and initiative trade-off. Given this assumption, the problem for solution concerns the interface between the MBCS and private benefits provision. That is, we take the MBCS and relax the assumption about self dealing transactions. A number of problems identified by Bolton and von Thadden become solvable as a result. Given the right amount of private benefits, free riders and gain specification need not present a problem and a clear cut incentive to form a block and monitor readily can be hypothesized. The block, once formed, remains stable.

By hypothesis, then, an optimal trade-off between blockholding and ownership dispersal implies a subsidiary need to set an optimal level of self dealing and insider trading. That optimum could be variously defined as, (*a*) an amount costing the minority shareholders just less than their pro rata share of the gain to the firm as a whole from blockholder monitoring, (*b*) an amount just sufficient to cover the costs of blockholder monitoring but no greater, or (*c*) an amount falling between these two extremes resulting from negotiations between the inside and the outside interests.[254]

254. *Cf.* Lucian Ayre Bebchuk, *Efficient and Inefficient Sales of Corporate Control*, 109 Q. J. ECON. 957 (1994) (discussing the costs and benefits of equal opportunity and free transfer rules respecting transfers of corporate control); Marcel Kahan, *Sales of Corporate Control*, 9 J.L. ECON. & ORG. 368 (1993) (same).

A question then arises as to why we do not see real world governance systems directed to the achievement of this result. The answer must be that the subject matter is noncontractible. Neither the per period cost of monitoring nor the per period gain to the firm from monitoring is suited to advance specification. Nor, given the information asymmetry that prevails between blockholders and outside shareholders, do we have conditions favorable to *ex post* observation and verification.[255] It follows that a choice thus must be made between prohibiting or granting private benefits at a systemic level.[256] That choice can be seen in economic terms as turning on the relative value placed on monitoring and liquidity. It also legitimately can be described in political and historical terms. Either way, it appears to be fundamental and unavoidable.

V. CONCLUSION—IMPLICATIONS FOR THE UNITED STATES

We return to the corporate law system of the United States to offer a new view as to the message held out by corporate governance comparison. Certainly, there emerges no template for public-regarding delegated monitoring, as observers once hoped to find. We reserve judgment on the assertion of market system superiority, but with a comment. We wonder whether triumphal cries of market superiority heard from American observers reacting to the distress across the Pacific could prove closely tied to transient stock market averages and turns of business cycles. We instead perceive a warning from comparative governance.

The comparative exercise teaches again the old lesson that markets are only as deep as their legal foundations. Market systems have been built on foundations that compel transparency, prohibit

255. Once we confront the difficulty of setting the right amount, it would seem that we can re-characterize the monitoring incentive problem as a species of the economics of management compensation. But the re-characterization holds out no quick solutions to the basic agency problems under discussion. Oliver Hart has argued that the management and shareholder incentives can in theory be perfectly aligned in a world without private benefits by giving management a set cut of the dividend payout stream. The problem, says Hart, is that amount that would have to be paid over is too large as a practical matter. *See supra* note 189, for the formal presentation of this point. The same would appear to be the case for a blockholder in control. Moreover, given anything but completely effective regime of private benefits prohibition (which in turn presupposes complete transparency) the control-monitor on an optimal salary easily can double dip. *See also* Burkart et al., *supra* note 195, at 705–06 (arguing for an analytical distinction between employment contracts, which encourage productive behavior with monetary incentives, and monitoring, which discourages bad behavior).

256. In the alternative, contractually by individual firms within a given system.

insider trading, and police self dealing. Yet legal mandates that support these foundations have been questioned in the United States in recent years, with the questions following from the idea that deregulation means freer markets.[257] The comparison can be seen as a reproach to this line of reasoning. From this point of view, markets and legal investor protections go together in the real world. Where protections are absent, one-sided deals flourish and outside equity capital either becomes more expensive or dries up altogether. Of course, the comparison also shows us that self dealing can have incidental productive benefits when leavened with relational engagement. It can even be built into a system that is equally competitively fit. But the system that results is materially different from ours.

Furthermore, a nominally mandatory, market-protective legal system such as ours can be captured by the special interests that operate within. It can be manipulated for their benefit without simultaneous provision of processes adequate to facilitate corrective self-help by the injured interests. This is precisely what has happened in American corporate law during the past two decades. Management capture of the state-based system has led to anti-takeover regulations and enervated fiduciary rules, without provision of processes adequate to facilitate contractual adjustment by shareholders. Politics do matter, and, as Chicago School likes to remind us, it is not safe to assume that invulnerability follows automatically from the evolutionary survival of our system.

So whenever someone suggests that we unwind one of our system's legal supports, we need to ask whether we want to do so at the risk of pushing the system in the direction of a market-blockholder tipping point. Across that line, private benefit provision is so liberal as to make blockholding the only rational systemic alternative. The question, by virtue of its very existence, materially increases the burden on the deregulatory proponent.

257. *See, e.g.*, ROMANO, *supra note* 129, at 85–101 (arguing against the mandatory disclosure system).