PART I

SHAREHOLDER ORIENTATION IN THE COMMON-LAW WORLD

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1 Introduction and Overview

The global financial and economic crisis that arose in 2007 has led to widespread debate regarding the adequacy of decision-making processes in financial and nonfinancial firms alike. Lawmakers and regulators, in particular, have asked whether corporate boards of directors ought to be more directly answerable to their shareholders, rendering comparative study of differing regulatory approaches to corporate governance a matter of vital public interest. This book presents a theory explaining the varying degrees of shareholder orientation historically exhibited by corporate governance systems in the common-law world – including Australia, Canada, the United Kingdom, and the United States – and explores the theory's practical ramifications for contemporary law and public policy.

The comparative literature tends to place corporate governance systems[1] in one of two broad categories. Throughout most of the world, the stock of large companies is generally concentrated in the hands of controlling families, banks, corporate groups, or governments. In such countries, the corporate governance system typically aims to balance the competing claims of various "stakeholders" in the corporate enterprise – notably, shareholders and employees. In common-law countries, conversely, publicly traded stocks are often held by widely dispersed, passive investors, and the corporate governance system typically places greater emphasis on their interests – a shareholder-centric approach to corporate governance often described as uniquely "Anglo-American," "Anglo-Saxon," or "common-law" in orientation.[2]

[1] Although definitions vary considerably – see, e.g., PETER ALEXIS GOUREVITCH & JAMES J. SHINN, POLITICAL POWER AND CORPORATE CONTROL: THE NEW GLOBAL POLITICS OF CORPORATE GOVERNANCE 293–95 (2005) – I use the term "corporate governance" to describe the rules that govern decision making in public corporations, whether arising from corporate law, securities regulation, exchange listing rules, or elsewhere.

[2] *See, e.g.*, Ruth V. Aguilera, *Corporate Governance and Director Accountability: an Institutional Comparative Perspective*, 16 BRIT. J. MGMT. S39, S41–S49 (2005) (contrasting "Anglo-Saxon"

Common-law jurisdictions – so called because they trace their legal origins to English judge-made "common law"[3] – undoubtedly exhibit substantial similarities in their business cultures, financial structures, and corporate governance systems.[4] Generalizations regarding the "Anglo-American model," however, tend to obscure the truly substantial differences exhibited by corporate governance systems in the common-law world – differences of great theoretical and practical significance. Simply put, shareholders in the United Kingdom and jurisdictions following its lead are far more powerful and far more central to the aims of the corporation than are shareholders in the United States. This central divergence – observable both in law and in market practice – has embarrassed all previous efforts of which I am aware to devise a comprehensive theory of corporate governance in widely held public corporations of the sort that predominate in common-law jurisdictions.

In this book I survey the vastly differing positions occupied by shareholders in public companies across a category of corporate governance systems too often lumped together in the comparative literature.[5] I then explore the political factors leading these otherwise similar legal and business cultures to part ways on the governance role of shareholders, and trace the consequences of this divergence for corporate governance theory and practice. I argue that external regulatory structures affecting the interests and welfare of other stakeholders in public corporations – notably the form and degree of social welfare protections available to employees – have had a decisive impact on the degree of shareholder orientation exhibited by corporate governance systems in the common-law world. Specifically, stronger stakeholder-oriented social welfare policies and legal structures have permitted the U.K. corporate governance

and "non Anglo-Saxon" corporate governance contexts, while acknowledging distinctions within the former category); John W. Cioffi, Public Law and Private Power: Corporate Governance Reform in the Age of Finance Capitalism 192 (2010) (describing German "ambivalence toward the Anglo-American variant of finance capitalism" following the financial crisis); Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. Fin. 1131, 1142 (1997) ("[C]ivil law families have much smaller stock markets than those in common law countries, presumably because of inferior investor protections."); Jean Tirole, *Corporate Governance*, 69 Econometrica 1, 3 (2001) ("The popularity of the shareholder value concept is much higher in Anglo-Saxon countries . . . .").

[3] *See, e.g.*, Black's Law Dictionary 276–77 (6th ed. 1990).

[4] *See, e.g.*, John Armour & David A. Skeel, Jr., *Who Writes the Rules for Hostile Takeovers, and Why? – The Peculiar Divergence of U.S. and U.K. Takeover Regulation*, 95 Geo. L.J. 1727, 1751 (2007); Geoffrey Miller, *Some Points of Contrast between the United States and England*, 1998 Colum. Bus. L. Rev. 51, 51 (1998).

[5] *See, e.g.*, Ruth V. Aguilera et al., *Corporate Governance and Social Responsibility: A Comparative Analysis of the UK and the US*, 14 Corp. Governance: Int'l Rev. 147, 147 (2006) (observing that "[l]ess attention has been paid to differences in corporate governance within the 'Anglo-American' system").

system to focus more intently on shareholders without giving rise to political backlash. The same generally holds true, I argue, in other common-law jurisdictions including Australia and Canada, which pursue broadly similar policies both in their corporate governance systems and in the provision of state-based social welfare protections. Conversely, weaker stakeholder-oriented social welfare policies and legal structures have inhibited the U.S. corporate governance system from doing the same, resulting in a starkly different balance of power between boards and shareholders.

I begin with a discussion of methodological problems encountered in comparative study of corporate governance, problems widely ignored in the extant literature. The challenge, explored in Chapter 2, is to avoid two extreme postures, each of which effectively undercuts the utility of comparative study – strict functionalism on the one hand and strict contextualism on the other. By "functionalism" I mean an analytic approach that assumes that corporate governance regimes have been crafted to manage identical, or at least very similar, sets of broadly defined problems. This approach often animates economic theories of corporate governance, which accordingly style corporate governance as chiefly concerned with the minimization of agency costs. This assumption obscures very real differences in how various systems function, and diverts attention from the possibility that differing degrees of shareholder orientation reflect more deep-seated differences in social views and market structures. At the same time, however, excessive "contextualism" threatens to render meaningful comparison impossible by focusing heavily or exclusively on idiosyncrasies of history, culture, and politics. I aim to steer a middle course between strict functionalism and strict contextualism by selecting the prevailing politics of social welfare as my explanatory variable. In this manner, I effectively assume the common necessity in each country to achieve some form of broader political compromise addressing employee interests, while highlighting the potential for strikingly different forms of political equilibrium to emerge in various countries – with divergent impacts on their respective corporate governance systems.

Chapter 3 provides an overview of significant differences between the principal corporate governance models in the common-law world, emphasizing the far greater power and centrality of shareholders in Australia, Canada, and the United Kingdom relative to their counterparts in the United States. For example, whereas shareholders in the United Kingdom possess unqualified legal power and practical capacity to remove public company directors without cause and to accept hostile takeovers without board interference, U.S. shareholders – including in Delaware, the principal jurisdiction of incorporation for U.S. public companies – possess neither. Similarly, U.K. company law focuses quite intently on maximizing return to shareholders, defining this by statute to be the overriding purpose of the U.K. corporation. U.S. corporate law, by contrast, has long remained ambivalent regarding the degree to which shareholders' interests proxy for the larger public interest, adhering to an ambiguous formulation of fiduciary duties owed simultaneously to "the corporation and its stockholders," and giving boards substantial discretion to favor the interests of other stakeholders in responding to hostile takeover attempts. The practical upshot is that shareholders loom much larger in U.K. boardrooms than in U.S. boardrooms. Although U.S. shareholders undoubtedly possess far greater capacity to sue after the fact for breaches of fiduciary duty, the considerable corporate governance authority possessed by shareholders in Australia, Canada, and the United Kingdom permits more direct and substantial shareholder influence over corporate affairs than one finds in the United States.

The book then turns to the prevailing economic and political theories of comparative corporate governance, examining in some detail their strengths and weaknesses, and endeavoring in particular to expose the limits of their respective explanatory domains. Economic theories, explored in Part A of Chapter 4, tend to focus on minimization of "agency costs" arising from misalignment of the board's and shareholders' interests. The corporation is often depicted as a "nexus of contracts," with corporate law tending toward those rules that rational shareholders, employees, and other stakeholders would agree upon in a hypothetical *ex ante* negotiation. In these respects, such theories reflect an inherent functionalism grounded in the scientific pretensions of the "law and economics" movement, a tendency contributing to a convergence bias – an expectation that rational actors grappling with the same (or substantially similar) problems in different countries will eventually converge on the optimal regulatory response. This, I argue, is contradicted by enduring differences in levels of shareholder orientation across common-law jurisdictions, and particularly by the fact that the corporate governance system of the United States – the world's predominant capital market – has remained a consistent outlier in this respect for several decades.

The turn to politics, I argue, is inevitable, given the shortcomings of economic theories of corporate governance. However, while I acknowledge the relevance of certain institutional factors identified in the extant comparative literature – notably the earlier rise to power of U.K. institutional investors, and their greater proximity and homogeneity in the London marketplace – in Part B of Chapter 4 I explore the inability of prevailing political theories of corporate governance to provide a complete explanation for the core divergence that I identify. Theorists emphasizing historical origins – for example, common-law versus civil-law orientation – find themselves unable to explain variations within a given category of countries, let alone why a given system might remain politically stable, or change, over time.[6] More generally, theorists purporting to identify a consistent political trend across both concentrated and dispersed ownership systems effectively sacrifice nuance for parsimony, finding themselves unable to explain the differing impacts of politics on corporate governance in these radically different settings. Mark Roe's "social democracy" theory[7] – perhaps the preeminent comparative political theory of corporate governance – is representative, associating ownership concentration and stakeholder-orientation with stronger social democracy (e.g., Germany), while associating ownership dispersal and shareholder-orientation with weaker social democracy (e.g., the United Kingdom or the United States). This approach would appear to have considerable explanatory power at the global level and is certainly capable of explaining the position of either the United Kingdom or the United States vis-à-vis numerous other countries. It cannot, however, explain the position of the United Kingdom and the United States vis-à-vis each other – because the United Kingdom (like Australia and Canada) simultaneously exhibits both greater shareholder-centrism in corporate governance and a greater commitment to social democracy in its prevailing politics than does the United States. My discussion of this and other prevailing political theories of corporate governance[8] exposes the inability of each to account for this striking divergence between the United States and other capital market-based corporate governance systems.

In Chapter 5, then, I analyze the varying approaches to social welfare policy embraced by the common-law jurisdictions in question, presenting evidence that the degree of shareholder orientation exhibited by the corporate governance system, on the one hand, and the degree of external "welfare state" protections,[9] on the other, reflect a single, broader political equilibrium

[6] *See infra* Chapter 4.B.i. (discussing the "law matters" theory built on the work of economists Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny).

[7] *See infra* Chapter 4.B.ii.

[8] *See infra* Chapter 4.B.iii–vii. (discussing John Armour and David Skeel's work on the role of institutional shareholders, the "Varieties of Capitalism" literature pioneered by Peter Hall and David Soskice, Alan Dignam, and Michael Galanis's work on macroeconomic context, Peter Gourevitch and James Shinn's work on coalition formation, John Cioffi and Martin Höpner's work on party politics, Pepper Culpepper's work on political salience, and Martin Gelter's work on the impact of employment protections).

[9] By "welfare state" I refer generally to a baseline set of protections relating to income, health insurance, employment insurance, and various other "social services." *See* Sanford Levinson, *The Welfare State*, *in* A COMPANION TO PHILOSOPHY OF LAW AND LEGAL THEORY 553, 555 (Dennis Patterson ed., 1996); Allan Cochrane et al., *Comparing Welfare States*, *in* COMPARING WELFARE STATES 1, 5–7, 12–14 (Allan Cochrane et al. eds., 2nd ed. 2001).

within each country. In the United States, social welfare protections – notably including access to health care – have historically been linked to employment status, whereas the British welfare state has, since the late 1940s, provided such protections primarily through government programs. These structures, I argue, have impacted the trajectory of each country's corporate governance system in profound ways. For example, the emergence of a shareholder-centric takeover regime in the United Kingdom – where board interference with hostile takeovers is prohibited, absent shareholder approval – reflects confidence among Labour leaders in the 1960s that the welfare state could mitigate the effects of job loss on employees. Conversely, in the United States, the emergence of a stakeholder-centric takeover regime in the 1980s – giving target boards substantial discretion to deploy potent defenses, regardless of shareholder wishes – reflects a powerful alignment of manager and labor interests, drawing substantial force from larger political concerns regarding the welfare of employees vulnerable to the loss of health care and other benefits linked with their jobs.

These political dynamics, I argue, remain as powerful in each country today as in decades past, and their relationship is further reflected in Australia and Canada, which have adopted social welfare models and struck larger social and political equilibria broadly resembling those in the United Kingdom, even if each has arrived there by its own path because of unique legal, economic, historical, and cultural factors. In Australia, for example, courts responded to the advent of hostile takeovers in the 1970s and 1980s in a manner resembling the approach taken in the United States, giving managers substantial latitude to deploy defenses. This reflects the fact that moves toward state-based social welfare remained hotly contested and incomplete during this period. Since the 1990s, however, Australia has adopted a far more shareholder-centric position on hostile takeovers, sharply limiting defensive tactics in a manner strongly resembling the approach taken in the United Kingdom – a move that was not inhibited by the social concerns of prior decades because by the mid-1990s Australia's state-based social welfare programs were firmly established. In Canada, however, a relatively substantial state-based social welfare system predated the major efforts to modernize its corporate laws in the late 1960s and 1970s, constituting part of the background social and political conditions before which corporate legal reforms took place. Canada's adoption of a social and political equilibrium resembling that in the United Kingdom remains remarkable, however, insofar as it required overcoming the substantial influence that U.S. models exerted because of the cultural, commercial, and geographic proximity of the United States.

The remainder of the book addresses limits to the theory's explanatory domain and explores various factors that the theory suggests will be likely to reinforce stability, or bring about change, in these corporate governance systems moving forward. My claim that social democracy correlates with shareholder orientation will naturally prompt critics to ask why, then, we observe less shareholder-centrism in continental European systems, rather than more. In Chapter 6 I take this potential objection as an opportunity to reiterate and explain further my theory's focus on the common-law world. Returning to the political theories explored in Part B of Chapter 4, I explain how the impact of politics on corporate governance differs between the concentrated ownership systems prevailing on the continent (and elsewhere around the world), on the one hand, and dispersed ownership systems such as those in the United Kingdom and the United States on the other. In countries with concentrated share ownership, as I explore in Part A of Chapter 6 principally by reference to Germany's bank-dominated system, the key regulatory aim of corporate governance is to constrain the innate power of controlling shareholders in order to bring corporate affairs into focus with the perceived needs of other stakeholders. One consequence in Germany has been substantial employee participation on the boards of large companies – so-called codetermination. Conversely, in countries with dispersed share ownership, the principal regulatory aim is to protect minority shareholders in order to incentivize the development of deep, liquid equity markets – hence the relatively greater emphasis on shareholder interests in U.K. and U.S. corporate governance. My analysis, however, suggests that the process of ownership dispersal – which unfolded over the course of decades in both U.K. and U.S. capital markets – requires a constant recalibration of emergent shareholder and stakeholder protections to balance shareholders' comfort with minority status and stakeholders' comfort with shareholder-centric corporate governance rules. Again, stronger stakeholder protections outside the corporate governance system allow it to focus more exclusively on the shareholders' interests by blunting political resistance, whereas weaker stakeholder protections outside the corporate governance system permit political opposition to arise, inhibiting the emergence of strong shareholder-centrism in favor of maintaining some flexibility to accommodate stakeholders' interests within corporate governance itself.

I then test the descriptive power of this binary distinction through examination of borderline cases. China, the Netherlands, and Japan, for example, arguably exhibit high levels of private share ownership dispersal, yet have not straightforwardly exhibited the traits that I associate with dispersed ownership systems. In each case, however, de facto control has been considerably more concentrated than it appears at first blush, because of substantial government control in China, the separation of control from cash-flow rights in the Netherlands through the placement of stock in "trust offices" (rather than with investors directly), and the *keiretsu* system of cross-shareholding in Japan. Over recent years, however, Japan has moved toward genuine share ownership dispersal, giving rise to a natural experiment. As long-term, stable shareholdings have unwound since the mid-1990s, a nascent market for corporate control has arisen, effectively requiring Japanese lawmakers to evaluate the U.K. and U.S. takeover regimes. As explored in Part A of Chapter 6, Japan's adoption of an approach to takeover defenses resembling that of Delaware – rather than that of the United Kingdom – reflects the fact that Japan's employer-based approach to social welfare provision more strongly resembles the approach historically taken in the United States, resulting in a similar need to buffer employees from the risks of job loss following the advent of hostile takeovers.

In contrast with China, the Netherlands, and Japan, which have exhibited high levels of private share ownership dispersal, yet have not straightforwardly exhibited the traits that I associate with dispersed ownership systems, Australia and Canada appear to present the opposite conundrum – each exhibiting somewhat higher levels of ownership concentration than the United Kingdom and the United States do, yet similarly exhibiting strong shareholder orientation. This suggests that the political factors that I describe may be impacted by other dynamics – including cultural, commercial, and geographic proximity to influential foreign regulatory models. In the case of Canada, as previously noted, what is truly remarkable is the degree to which reformers deviated from influential U.S. models, further suggesting that Canada struck the social and political equilibrium that it did because of social welfare–oriented dynamics resembling those at work in the United Kingdom. With respect to Australia, then, crude assertions of "path dependence" on U.K. models are flatly contradicted by Australia's unique approach to social welfare provision, long based on a national wage arbitration system, as well as the fact that its approach to corporate governance has evolved considerably over the course of recent decades – in a manner mapping quite coherently onto the evolution of its social welfare environment. Ironically, Australia arrived at a social and political equilibrium resembling the U.K. approach only following a long and complex process of domestic policy evolution – in multiple regulatory fields – that in fact bore little resemblance to the U.K. experience prior to the new millennium.

The remainder of Chapter 6 further tests the descriptive power of my theory by examining recent events potentially altering the fundamental conditions giving rise to the dynamics that I identify. Part B of Chapter 6 investigates the impact of changes in the composition of the shareholder base. In the United