

# 1 Introduction: corporate governance after the ‘end of history’: investigating the new ‘great transformation’

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Over the last two decades, debates over the convergence or persistence of corporate governance systems have deeply engaged the energies of academics, regulators and investors. These debates have encompassed both the structural mechanisms of corporate decision-making, examining where decision-making authority should lie within the company and which groups should have power, as well as the more politically contested issue of whose interests should matter when corporate decisions are being made. How companies are organized, and what powers their constituents have to influence the corporate enterprise – the core questions of corporate governance – in turn influence capital markets and the investment decisions of managers of huge pools of capital. ‘Does the country have an equity culture’ is often the question asked by investors and asset managers before massive amounts of money are shifted into, or out of, a country at the click of a ‘mouse’.

Debates over the convergence or persistence of corporate governance systems take place in the shadow of at least four significant trends affecting operating companies.

First, there is increased global product market competition caused by improvements in information technology, transportation, standardization and supply chain management. These pressures have forced companies in every economy to cut costs, innovate, adopt new business strategies and develop new alliances. The intellectual habits of product and process innovation have also fuelled financial innovation towards similar goals: a search for yield and thus advantage.

Second, we see the transformation of the world’s largest corporations from primarily locally- or domestically-situated enterprises into global networks of supply chains and corporate parent/subsidiary relationships. Such enterprises, held together by webs of contracts, law and the interstitial glue of company history and norms, are subject to competing demands from far-flung regulators, consumers, investors,

non-governmental organizations and professionals such as lawyers, investment bankers and accountants.

Third, undergirding these developments are dramatically increased global capital market pressures throughout the developed and developing world. Newly-engaged market participants; new institutional investors and large pools of investible capital; increasing numbers of shareholders with activist agendas; and new types of financial innovation and complex financial engineering have accelerated the transition from industrial to finance capitalism in developed economies. Finance has come to be the dominant contributor to the economic output of such advanced democracies as the United States and Britain, and is of significant importance to the productive capacities of countries throughout the world.

Fourth, these trends are situated in a broader context, which is the emergence of the knowledge society, prompting a reconceptualization of public and private forms of governance. Both political and 'private' actors such as non-governmental organizations, corporations, collectives and individuals operate under conditions of extreme uncertainty, both in terms of procedural and institutional design as well as normative horizon. On the one hand, governments and governmental actors have become increasingly dependent on fragmented, societal knowledge, which leads to an important reconfiguration of the relations between political and civil society actors. The state, in its dependence on constantly updated information, is at the same time implicated in the production of that very information by creating rules and facilitating institutional growth for knowledge production and dissemination. On the other, corporations and other societal actors face pressing governance challenges that in many ways mirror those of contemporary political governing bodies. The dependence of management on expert knowledge, which is generated and communicated both in and outside of the firm, has grown in correlation with the expanding reach of business activities and their impact. With governments and corporations as knowledge actors, producers and consumers, the pressure on law to facilitate and to enable these processes has grown exponentially. No longer clearly situated in an exclusively public or private sphere, 'political', 'private', corporate actors are both authors and receivers of the rules that govern their behaviour.

Given these rapid changes in global operating conditions, it is understandable that there would be pressures on companies to adopt new governance mechanisms in response. Lengthening supply chains, emerging markets such as those in Eastern Europe, Latin America and China becoming part of global production, and increased competition

all require different managerial arrangements within the firm, at the least. And yet, we argue, the specific pressures to adopt corporate governance systems that prioritize shareholders' interests – pressures particularly salient in Europe – were as much a product of political ideology as changing economic requirements. In the enclosed chapters we examine those pressures and their effects, both within firms and within societies, evaluating the results of shareholder primacy in light of increasing financialization not only as a matter of theory, but also as a matter of fact.

### Thematic overview

The following collection addresses, from a historical and comparative perspective, the changing regulatory landscape for business corporations and financial institutions which has evolved in light of the increasing globalization of the markets and 'financialization' of economies. Taking their cue from political economy studies of national varieties of market regulation, going back to Karl Polanyi and Andrew Shonfield, the contributing authors explore the effect of integrating markets and converging policy strategies on corporate governance, finance and labour market regulation. The collection brings together authors from law, economics, sociology and political science from both North America and Europe to study the evolution of corporate, financial and labour regulation against the background of the continuing global economic – and regulatory – crisis.

Inspired by Sanford Jacoby's book *The Embedded Corporation*,<sup>1</sup> and by institutional and political economy accounts of corporate governance complementarities, the collected chapters bring a number of disciplinary perspectives to bear on the study of the regulatory evolution and relationship between firms, finance and labour in the transformation from industrial to finance capitalism. Part I of the book traces and evaluates this transformation, connecting it to the financial crisis that erupted in 2007. Contributions from Simon Deakin and Larry Mitchell provide a theoretical and historical framework for the book as a whole, discussing, respectively, the shift to shareholder primacy and the transformation to finance capitalism in the United States and United Kingdom. Contributions from William Allen, former Chancellor of the Chancery Court in Delaware, and historian Dalia Tsuk Mitchell analyse some of the implications of this transformation

<sup>1</sup> Sanford Jacoby, *The Embedded Corporation* (Princeton: Princeton University Press, 2005).

to finance capitalism on operating companies and their boards of directors, showing the political, historical and sociological forces at work. Fenner Stewart locates these developments within the theoretical debates of leading corporate law scholars today, while Peer Zumbansen provides a broader framework to evaluate the challenges facing both companies and governments within the global knowledge society. Zumbansen's chapter places Polanyi's work on embedded capitalism in the current context of both an intensified process of Europeanization and a global search for regulatory remedies against the dramatic market failures since 2007.

Part II looks more specifically at particular amalgamations of financial power that have formed as the transformation to finance capitalism gathered momentum; particular (and particularly destabilizing) financial instruments; and important regulatory and policy developments in Europe and within international financial institutions such as the World Bank as pressures mounted to adopt more shareholder friendly corporate governance systems. Stephen Diamond, a contrarian on the financialization theme, nonetheless evaluates and highlights the growing influence of private equity investors and hedge funds in the US market. Simon Archer traces changes in the composition, sources of funding and actions within the capital markets of the largest public pension funds in Canada, using that case study as a lens through which to scrutinize the economic role of public pension funds more generally. Janis Sarra discusses credit default swaps and analyses their destabilizing influence on both financial markets and bankruptcy proceedings, providing specific policy advice for regulators to use to address the problems these instruments have caused. Blainaid Clarke's contribution discusses the highly-contested European Takeover Directive, in which the European stakeholder vision of the corporation was supplanted by shareholder-centric rights and pride of place. Her chapter also shows how the political compromises in the Takeover Directive actually operate simultaneously to resist that shareholder perspective. Ruth Aguilera and Cynthia Williams critically evaluate the shareholder bias of noted finance theorists, Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny [commonly referred to as 'LLSV'] from the perspective of economic sociology, while recognizing the important influence on policy LLSV's theories have had at the World Bank. Collectively these authors bring a legal and political economy perspective to bear to carve out the implications of each of these developments for the balance of power within the firm and for the distributions of wealth and risk within developed economies.

There are a number of themes that emerge as we look at the transformation to finance capitalism in Parts I and II. One, which is not unexpected, is that within their different corporate governance structures, labour interests in Europe, the United Kingdom, the United States and Canada have responded to the shift towards finance capitalism in ways characteristic of their home countries' underlying political theories, alliances and power relationships. Thus, labour unions in the United States and Canada have used their pension capital as shareholder activists to advance the interests of their members by using their shareholder voting power, seeking transparency of voting records by their asset managers; board accountability through changes in voting rules; and involvement in limiting executive compensation through the use of shareholder proxy proposals. In these activist uses of pension fund voting power, the expressed corporate governance agenda of labour shareholders has little differed from the corporate governance agenda of shareholder activists generally, including promoting changes in companies' organizing documents that allow the market for corporate control to flourish. Indeed, in an irony little noted in the academic literature (but discussed by Jacoby in this collection), in the United States labour corporate governance activists have been shareholders' most consistent advocate. In Europe, labour has used their more integrated political position as recognized social partners to resist efforts to dismantle works councils and co-determination, but have also responded pragmatically in some cases, such as in Germany, as the economic bargains of the post-war era came under increasing pressure from the demands of finance capitalism. In Part III the contribution from Harry Arthurs and Claire Mummé discusses these differing uses of labour's shareholding power in North America and Europe, using a political economy analysis, while economist John Evans evaluates labour's voice in international public policy by examining the Trade Union's Advisory Council's position within the OECD.

One of the clearest implications of the shift to finance capitalism has been a corollary insistence that the interests of shareholders should predominate in both corporate governance theory and capital market regulation. A second theme of the book is that the underlying premise asserted in favour of the shareholder model of corporate governance, whereby such a shift would enhance social welfare, has not been proven. American legal academics Henry Hansmann of Yale University and Reinier Kraakman of Harvard University have been among the most succinct advocates for the view that there will be (and should be) convergence on the shareholder model of corporate governance, as argued in their iconic article from 2001, 'The End of

History for Corporate Law'.<sup>2</sup> In that article they posited that shareholder wealth maximizing views of the corporate governance relationship would ultimately predominate throughout the world, by virtue of 'the force of logic, the force of example, and the force of competition'.<sup>3</sup> As they put the argument in its strongest form, '[t]he point is simply that now, as a consequence of both logic and experience, there is convergence on a consensus that the best means to this end – the pursuit of aggregate social welfare – is to make corporate managers strongly accountable to shareholder interests and (at least in direct terms) only to those interests'.<sup>4</sup> Yet, the premise that shareholder capitalism enhances social welfare has not been seriously examined as an empirical matter by leading corporate law scholars in the United States. Rather, it has been accepted as an article of faith or has been demonstrated by virtue of high share prices.

In Parts III and IV the premise that shareholder capitalism enhances social welfare is, thus, examined empirically, and is found to be unsupported by the evidence. Contributions by leading labour scholars Sanford Jacoby and Harry Arthurs; by industrial relations economists Suzanne Konzelmann and Frank Wilkinson; and by labour economists William Lazonick and John Evans collectively show that pride of place to finance is correlated with increased economic insecurity and inequality; that shareholder capitalism is inconsistent with highly-productive industrial relations; and that investors' short-term demands, filtered through the stock market or through concentrated pools of investment capital, have often undermined companies' long-term planning and investments in research and development to meet future strategic and social challenges. While the Anglo-American venture capital markets permit rapid innovation, the pressures of finance, within shareholder wealth maximizing corporate governance norms, do not produce

<sup>2</sup> Henry Hansmann and Reinier Kraakman, 'The End of History for Corporate Law' (2001) 89 *Georgetown Law Journal* 439 ('End of History I'). Hansmann and Kraakman further elaborate in a related article, also entitled 'The End of History for Corporate Law', in Jeffrey Gordon and Mark Roe (eds.), *Convergence and Persistence in Corporate Governance* (Cambridge: Cambridge University Press, 2004) ('End of History II'). It is significant that Hansmann and Kraakman reiterated their views of the superiority of American-style shareholder-oriented corporate governance in that collection in 2004, notwithstanding the stock market bubble having burst in the United States, which occurred in 2001–2002, and notwithstanding the serious weaknesses of Enron, WorldCom and many other noted failures of corporate governance in the United States during 2001–2002.

<sup>3</sup> Hansmann and Kraakman, 'End of History I', p. 441.

<sup>4</sup> Hansmann and Kraakman, 'End of History II', pp. 42–43.

companies that show the same capacity for incremental innovation and learning as do European structures.<sup>5</sup>

The third theme of this book, then, engages with the debates over corporate governance systems. The explicit brief of many of these debates has been to determine whether companies are more efficient and countries more economically successful by prioritizing the interests of shareholders within *liberal* market economies, rather than balancing the claims of a broader range of stakeholders within *coordinated* market economies, using the categories introduced by Varieties of Capitalism scholars.<sup>6</sup> The implicit brief of these debates has challenged European countries and firms, where successful market economies are well-established, to adopt Anglo-American shareholder capitalism, even as advocates did their best to export American-style capitalism throughout the developing world. The contribution by Frank Jan De Graaf and Cynthia Williams in Part IV examines the underlying ideological commitments of liberal market corporate governance theory, and challenges Anglo-American theorists to think more carefully about the benefits of European systems, both for corporate governance arrangements and for capital market regulation. Mary Condon's contribution provides a political economy explanation for international securities regulators' attempts to have greater influence in transnational regulatory efforts after the global financial crisis by strategically deploying the concept of 'systemic risk', but also points out regulatory and definitional problems this concept creates. She also develops the point that securities regulators may need to revisit long-held understandings of the purpose and orientation of disclosure as the preferred regulatory strategy. Part IV concludes with Keith Johnson and Frank Jan De Graaf's recommendations for how understanding of pension funds' fiduciary duties must evolve to take account of the systemic influence these important market actors now have.

### Theoretical perspectives

As a general matter, the contributors to this book suggest that what could seem to be politically neutral or merely technical debates about the best systems of corporate governance as a means to the end of creating efficient, well-run companies and economically successful

<sup>5</sup> Jacoby, *Embedded Corporation*, p. 19.

<sup>6</sup> Peter Hall and David Soskice (eds.), *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford: Oxford University Press, 2001).

countries are masking, in fact, serious ideological disagreements. This observation should hardly be surprising, and indeed has been the basis for a respected analysis for why European countries have so far failed to create deep, liquid capital markets.<sup>7</sup> Nor should the resistance of countries encompassing stakeholder governance systems towards Anglo-American shareholder governance systems be surprising. Inspired by Karl Polanyi and Mark Granovetter as well as by the more recent revival of economic sociology, spearheaded by scholars such as Richard Swedberg and Jens Beckert, we find that two fundamental dynamics might well explain the persistence of corporate governance systems: the *embedded* nature of companies, corporate governance systems, and markets, as theorized by Granovetter; and the ‘double movement’ of market liberalization and resistance, as theorized by Polanyi, who himself is regularly associated with designing a theory of embedded capitalism.

In his article ‘Economic Action and Social Structure: The Problem of Embeddedness’,<sup>8</sup> Mark Granovetter brought a sociological and institutional perspective to bear on a fundamental observation: that markets are embedded within the social and political systems in which they arise. Thus, markets cannot be considered free-standing institutions outside of a society, as the ‘free market’ often had been, and still is in some contexts. Rather ‘the market’ must be understood as an embedded institution that manifests the social and political values of the society in which it is embedded, including the professional and transnational networks that affect the market, even as it develops its own logic and values. One implication of this view is that corporate governance reforms cannot be considered in isolation from a thorough understanding of the social and cultural context in which companies arise, and in conjunction with a thorough understanding of the complementarities between companies, corporate governance systems, and the political and institutional frameworks in which companies operate. Since stakeholder corporate governance systems are consistent with the social democratic traditions in the countries in which they’ve arisen – primarily in Northern and Central Europe, but also to some extent in Japan – it would be naïve to expect they would converge to Anglo-American shareholder capitalism smoothly. Even in the face of global product market competition and institutional investor pressure that will in theory privilege the most

<sup>7</sup> Mark Roe, ‘Modern Politics and Ownership Separation’, in Gordon and Roe, *Convergence and Persistence*, pp. 252–290.

<sup>8</sup> Mark Granovetter, ‘Economic Action and Social Structure: The Problem of Embeddedness’ (1985) 91 *American Journal of Sociology* 481–510.

efficient system of corporate organization<sup>9</sup> – believed by many American law professors to be theirs<sup>10</sup> – one would expect exactly the persistence of stakeholder systems that is observed, albeit under pressure.

Indeed, Karl Polanyi's work from 1944 on the double movement of market liberalization and resistance predicts this persistence. In *The Great Transformation* Polanyi argued that as markets expand, so do their undesirable side-effects: instability, monopoly and negative externalities, for instance, and that these side-effects cannot be solved by the market itself. Rather, market expansions are followed by social resistance to 'the pernicious effects of a market-controlled economy'. Polanyi called this the double movement: '[T]he action of two organizing principles in society ... economic liberalism, aiming at the establishment of a self-regulating market ... [and] the other was the principle of social protection aiming at the conservation of man and nature as well as productive organization.'<sup>11</sup>

The theme of the 'embedded firm' that lies at the core of this volume thus reaches back to a significant return of economic sociology since the 1980s, notably inspired by Granovetter's seminal article.<sup>12</sup> The significance of this reorientation in research lies in its distinct interdisciplinarity. In contrast to the rise in importance of economics in various fields in law, particularly tort, contract, property and corporate law,<sup>13</sup> the emerging field of economic sociology brings together administrative and regulatory studies in the tradition of Max Weber with scholarship in institutional and new institutional economics, such as that by Ronald Coase, Douglass North and Oliver Williamson.<sup>14</sup> Furthering and

<sup>9</sup> A number of academics have recognized that there can be different ways to organize efficient corporate organizations, and that there can be comparative economic advantage to different corporate governance systems. Jacoby, *Embedded Corporation*, pp. 170–171: 'The Japanese corporate system – governance, strategy, HR, and much besides – facilitates organizational learning and allows companies to specialize in products and processes that are difficult for other companies to imitate. By contrast, the U.S. emphases on flexibility and mobility require general, not firm-specific, skills to facilitate rapid allocation of resources to emergent industries.' Jeffrey Gordon and Mark Roe, 'Introduction', in Gordon and Roe, *Convergence and Persistence*, p. 5 (recognizing the possibility of various paths to efficient corporate organizations).

<sup>10</sup> Hansmann and Kraakman, 'End of History I', p. 441; Hansmann and Kraakman, 'End of History II', pp. 46–48.

<sup>11</sup> Karl Polanyi, *The Great Transformation: The Political and Economic Origins of Our Time* (New York: Farrar & Rinehart, 1944), p. 132.

<sup>12</sup> Granovetter, 'Economic Action and Social Structure'.

<sup>13</sup> See generally Richard Posner, *Economic Analysis of Law* (Boston: Little Brown, 1973), and subsequent editions; Robert Cooter and Thomas Ulen, *Law & Economics*, 4th edn (Boston: Pearson, 2004).

<sup>14</sup> Richard Swedberg, 'The Economic Sociology of Capitalism: An Introduction and Agenda', in Victor Nee and Richard Swedberg (eds.), *The Economic Sociology of Capitalism* (Princeton: Princeton University Press, 2005).

expanding the investigative scope of the law and economics agenda, economic sociology has contributed to an increasingly ambitious intellectual discourse about how to organize, govern and regulate corporations across societies.<sup>15</sup> We recognize this to be another illustration of an encompassing trend towards ‘governance studies’, which often have their starting point within the framework of a particular discipline but which unfold in an inherently border-crossing manner, drawing on a wealth of different disciplinary perspectives, theoretical foundations and empirical data.<sup>16</sup>

Reflecting on this context, much of the scholarship on comparative corporate governance has been dominated by a law and economics perspective.<sup>17</sup> Two volumes, one edited by John Armour and Joseph McCahery,<sup>18</sup> and the other edited by Jeffrey Gordon and Mark Roe,<sup>19</sup> have attracted considerable attention in enlarging the perspectives on the vivid debate over ‘convergence’ or ‘divergence’ in corporate governance principles. Central to all of these volumes, however, is a significantly biased perspective from which the policy and regulatory changes within differently observed countries are studied primarily with view to a very small set of established principles of economically theorized, allegedly technical or, ‘good’ corporate governance, including enhanced investor protection, capital markets disclosure as a primary regulatory mechanism, an absence of employee co-determination and a reduced interventionist role of the state. This credo is significantly captured in two landmark monographs, one by Mark Roe from 2003, and one from Kraakman *et al.* in 2004, that each received both explicit praise and criticism.<sup>20</sup>

<sup>15</sup> Ruth V. Aguilera and Gregory Jackson, ‘International and Comparative Corporate Governance’ (2010) 4 *Academy of Management Annals* 485–556.

<sup>16</sup> Peer Zumbansen, ‘The Conundrum of Order. The Concept of *Governance* from an Interdisciplinary Perspective’, in David Levi-Faur (ed.), *The Oxford Handbook of Governance* (Oxford: Oxford University Press, 2011 forthcoming).

<sup>17</sup> See here, above all the following volumes: Klaus J. Hopt, Hideki Kanda, Mark Roe, Eddy Wymeersch and Stefan Prigge (eds.), *Comparative Corporate Governance. The State of the Art and Emerging Research* (Oxford and New York: Oxford University Press, 1998); Klaus Gugler (ed.), *Corporate Governance and Economic Performance* (Oxford and New York: Oxford University Press, 2001); Joseph A. McCahery, Piet Moerland, Theo Raaijmakers and Luc Renneboog (eds.), *Corporate Governance Regimes. Convergence and Diversity* (Oxford and New York: Oxford University Press, 2002); Klaus J. Hopt and Eddy Wymeersch (eds.), *Capital Markets and Company Law* (Oxford and New York: Oxford University Press, 2003); Klaus J. Hopt *et al.* (eds.), *Corporate Governance in Context. Corporations, States and Markets in Europe, Japan and the US* (Oxford and New York: Oxford University Press, 2005).

<sup>18</sup> John Armour and Joseph McCahery (eds.), *After Enron. Improving Corporate Law and Modernising Securities Regulation in Europe and the US* (Oxford and Portland: Hart Publishing, 2006).

<sup>19</sup> Gordon and Roe, *Convergence and Persistence*.

<sup>20</sup> Mark Roe, *Political Determinants of Corporate Governance* (Oxford and New York: Oxford University Press, 2003); evaluated in Peter Gourevitch, ‘The Politics