CONVERGENCE VERSUS DIVERGENCE, GLOBAL CORPORATE GOVERNANCE AT THE CROSSROADS: GOVERNANCE NORMS, CAPITAL MARKETS & OECD PRINCIPLES FOR CORPORATE GOVERNANCE

Janis Sarra†

There is growing debate as to whether international corporate governance practices can or should converge. Effective corporate governance has been linked to the ability of corporations to compete in global capital markets. Corporations operating in diverse economies have capital structures that are the result of public and private choices, and the corporate governance issues that arise reflect these structures. There is market pressure for convergence of corporate governance norms. The OECD has formulated Principles aimed at setting standards for corporations as they seek to attract capital. While the shareholder protections proposed are helpful in articulating norms that will attract long-term investment capital, the Principles fail to fully appreciate some of the current tensions between shareholder rights and obligations of corporate officers. Moreover, while the Principles suggest that corporations comply with laws regarding obligations to stakeholders, they fail to adequately discuss why shareholder rights are elevated to a universal norm, whereas accountability to other parties implicated in the corporation, such as creditors and workers, is not.

La possibilité et la pertinence d'une convergence des pratiques en matière de la régie des entreprises internationales font l'objet d'un débat croissant. La gestion efficace est reliée au pouvoir concurrentiel des entreprises sur le marché mondial des capitaux. Les entreprises opérant dans des milieux économiques divers ont des structures financières qui résultent des choix des secteurs public et privé, et le style de gouvernement reflète ces structures. Des pressions s'exercent sur le marché pour une normalisation de la régie des entreprises. L'OCDE a formulé des Principes en ce sens pour les entreprises qui cherchent à attirer des capitaux. Bien que les protections prévues à l'égard des actionnaires soient utiles pour l'élaboration de normes favorisant l'investissement de capitaux à long terme, les Principes ne prennent pas pleinement en ligne de compte certaines des tensions actuelles entre les droits des actionnaires et les obligations des dirigeants d'entreprises. De plus, bien que les Principes suggèrent aux entreprises de se conformer aux lois édictant les obligations envers les actionnaires, ils n'expliquent pas clairement pourquoi les droits des actionnaires sont élevés au rang d'une norme universelle, alors que la responsabilité envers les autres parties participant à une entreprise, par exemple les créanciers et les employés, ne le sont pas.

† Professor of corporate law and insolvency, Faculty of Law, University of British Columbia. My thanks to Paule Stewart, law student UBC Faculty of Law, for her research assistance, and to R. B. Davis of the Ontario Bar for his helpful comments on a draft of this paper. Any errors are my own.

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I. INTRODUCTION

Effective corporate governance has become a key consideration with the growth of global capital markets. Corporations must enhance their governance systems if international capital is to invest in their enterprises, particularly corporations in those jurisdictions with developing or transitional economies. There is, however, considerable debate as to whether there is a convergence of corporate governance principles and practice as corporations compete in global capital, labour and products markets, and whether such convergence should be a policy objective.

This article discusses two aspects of this debate. First, it explores whether such a convergence is likely to occur either through regulatory change or by operation of private law. The debate regarding optimal corporate governance principles, when applied to diverse capital structures implicated in international corporate activity, is at a nascent stage. The debate is accompanied by private law and capital market pressure for convergence. It is far from clear that "efficiency" in corporate governance can be achieved through unquestioning reproduction of the Anglo-American governance model throughout the world. The Anglo-American model and its various features were a response to highly diversified ownership and the correspondingly strong role of managers in governance, giving rise to agency theory. Other market economies, such as Japan and Germany, have different capital and governance structures, and are informed by different normative notions of efficiency.While some convergence is occurring due to market pressure, there is also countervailing pressure from the diverse economic, social and political systems in which corporations operate.

Second, the Organization for Economic Co-operation and Development (OECD) has sought to articulate global corporate governance principles. While the principles are an important contribution to the governance debate, shareholder rights are underdeveloped as a normative principle, particularly as they are applied to bank-centred economies and more generally, in respect of principles enhancing shareholder activism. This article also suggests that notwithstanding the existence of successful models of corporate governance that incorporate other investors in the firm, such as workers and creditors, the discourse has been dominated by a shareholder rights paradigm. While enhanced shareholder rights are an important aspect of international governance regimes, the narrow focus of the debate fails to fully explore other key capital structures and their resultant governance models. The OECD Principles give only a cursory nod to this set of issues, and as a result, the principles are helpful but not fully developed.

Part I very briefly introduces the OECD Principles as background to the discussion that follows on approaches to corporate governance in diverse economies. It then briefly examines theoretical approaches to governance, including Anglo-American notions of efficiency. Part II analyses the link between capital markets and effective corporate governance. Part III describes corporate governance schemes in different economic systems and discusses how the symptoms of ineffective corporate governance manifest themselves in each. This discussion assumes that effective corporate governance is represented by the market-centred and bank-centred models that dominate internationally. A discussion as to whether these models represent an optimal economic model is beyond the scope of this paper. Part IV describes the market pressure for convergence of corporate governance practices, suggesting that governance practice has converged to some extent where corporations are seeking capital in Anglo-American securities markets. Part V then suggests that the OECD Principles make a positive contribution to the governance debate. However, based on the discussion earlier in the paper, it offers a critique of those aspects of shareholder rights and stakeholder protection that are absent, arguing that such considerations should be part of any further development of universal norms. Part VI concludes that the diversity of capital and corporate structures does not preclude a convergence of principles that would enhance corporate governance and ultimately access to global capital markets. However, it requires a willingness to move beyond Anglo-American governance norms to explore the benefits and risks of other governance structures.

A. *OECD Principles for Corporate Governance – A Brief Introduction*

In 1999, the OECD developed non-binding Principles for Corporate Governance (the Principles).[1] Application of the Principles could arguably enhance the protection of equity investors, allow for equitable treatment of minority and foreign shareholders, and facilitate the movement of capital internationally. The Principles are ostensibly aimed at recognizing the different legal regimes that corporations operate under globally and at assisting governments in their efforts to improve the regulatory framework for corporate governance. They focus primarily on publicly traded corporations, but also apply to privately held and state-owned enterprises. The Principles are discussed at length in Part V. However, it is helpful to note here, for purposes of the discussion that follows, that they are organized around four key principles: shareholder rights and equitable treatment of shareholders, disclosure and transparency to enhance accountability, the role of other stakeholders, and the responsibility of corporate boards.

The OECD Principles recommend that the corporate governance framework should provide basic shareholder protections regarding transfer of shares, ensure timely and accurate disclosure on all material matters regarding the corporation, including the financial situation and operating results, corporate objectives, performance, ownership structure and voting rights, membership of the board, key executives and their remuneration, governance structure and policies of the corporation. The Principles suggest that the corporate governance framework should "recognize the rights of stakeholders as established by law" and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises. They recommend that boards should fulfil key functions such as reviewing and guiding corporate strategy, risk policy, annual budgets and business plans. The corporate board should also set performance objectives, monitor corporate and managerial performance, oversee major capital expenditures, and engage in strategic planning. These are, at first glance, all intuitively appealing principles. Transparency, basic protection of property rights, effective boards and stakeholder

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[1] The OECD is a multilateral organization with 29 member countries and numerous non-member countries who "share the common values of pluralistic democracy and market economy." OECD, Ad Hock Task Force on Corporate Governance, *OECD Principles for Corporate Governance*, Doc. No. OCDE/SG/CG(99)5 (April 1999), online: OECD <http://www.oecd.org/pdf/M00008000/M00008299.pdf> (last modified: May 1999) [hereinafter *Principles*].

collaboration are key to attracting capital and generating wealth. However, as the discussion that follows indicates, they are thin on their analysis when applied to diverse economic systems and their capital and governance structures. They are essentially a reproduction of Anglo-American governance norms with only very cursory acknowledgement of both the challenges and benefits of other governance structures.

B. *Theoretical Approaches to Governance*

Corporate governance includes both the internal governance mechanisms of the corporation and the broader public regulatory framework in which corporations operate. It is a set of legal tensions and relationships, and the structure by which corporate decisions are made such that capital can be raised at a cost-effective price, assets utilized in efficient generation of wealth, and corporate officers are held accountable to those investing in the firm.[2] While a distinction can be drawn between public regulatory law and the private governance activities internal to the corporation, internal governance is itself a function of both private decisions regarding optimal management of the corporation, as well as public law notions of director and officer responsibilities. Both are aimed at ensuring the efficient operation of the corporation and the generation of economic activity while reducing agency costs. Debate regarding optimal corporate governance structures has centred around two broad theoretical approaches that can be loosely classified as contractarian and communitarian, although there is a broad range of views among these theorists.

The contractarian approach to corporate governance suggests that contracts are the mechanism by which stakeholders, those having both implicit and explicit contracts with the corporation and its managers, exercise control over managers in order to protect their interests.[3] The dominant normative paradigm for contractarian scholarship is that the only residual claimants (after payment of all debts) to the firm's assets are the equity capital investors, based on long-standing and powerful notions of property rights that inform most of private law.[4] The goals that flow from these notions are shareholder wealth maximization, aimed at an optimal return on investment of equity capital. Thus, much of this scholarship focuses on why it is efficient to have corporate officers accountable primarily or solely to shareholders and why shareholders are the parties with the greatest incentive to monitor.[5] Agency theory seeks to reduce inefficiency in the nexus of contractual relations' structure of the firm, by advocating structural

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[2] G. Visentini, "Compatability and Competition between European and American Corporate Governance: Which Model of Capitalism?" (1998) 33 Brook. J. Int'l L. 833 at 835; F. Barca, "Alternative Models of Control: Efficiency, Accessibility and Market Failures" in J.E.Roemer, ed., *Property Relations, Incentives and Welfare* (London: MacMillan Press, 1997) at 195.

[3] M.C. Jensen & W.H. Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" (1976) 3 J. Fin. Econ. 305 at 305-315 [hereinafter "Theory of the Firm"].

[4] J. Braithwaite & P. Drahos, *Global Business Regulation* (Cambridge: Cambridge University Press, 2000).

[5] F.H. Easterbrook & D. Fischel, *The Economic Structure of Corporate Law* (Cambridge: Cambridge University Press, 2000) at 36-38.

measures and incentives that align the interests of corporate directors and officers with those of shareholders.[6] Agency theory distinguishes between decision rights on business decisions exercised by managers; monitoring and ratification/reward rights given to directors; and default control, fundamental change decision rights and monitoring rights given to shareholders.[7] Shareholders, particularly minority shareholders and shareholders in widely held corporations, suffer from information asymmetries, free-rider problems, lack of incentives to invest in the acquisition of expertise and the costs of monitoring, in part due to the limited liability regime. Efficient governance mechanisms include the co-location of decision making power, incentives and specific knowledge to make effective decisions, while creating incentives to monitor and hence reduce agency costs.[8]

However, the contractarian model poses difficulties as a complete answer to corporate governance. There is no consensus on whether shareholder wealth maximization is short or long-term, and there continues to be high transaction costs associated with this tension in terms of shareholder disputes and litigation. Control of agency costs does not necessarily create accountability of managers to shareholders. Contractarians have argued that market responses to poor governance i.e., exit and price reductions, will ultimately result in replacement of managers or shifts in governance. Yet exit by investors can send uncertain and untimely signals to managers through imperfect markets.[9]

Contractarianism, based on the notion that redistribution constitutes interference, does not acknowledge that current market models were based on a particular distribution of property, and that the governance systems they generate have redistributional effects that continue to shift value to property owners. A shareholder wealth maximization paradigm thus has distributional consequences that are made invisible using a purely contractarian analysis. Another operating assumption of contractarians is that corporations are free to externalize numerous costs by having others bear the costs of decisions that create production or market efficiencies for the corporation, but may have negative economic and social consequences for the environment and/or communities. The pressure to be globally competitive and resulting secondary and contingent labour markets, "labour shedding," and the search for cheaper labour markets are viewed as efficiency enhancing because the harm caused by these structural changes does not have to be accounted for by the corporation. Yet the logic of a contractarian approach should be to recognize, value and account for all implicit and express contracts and thus for all costs associated with particular governance decisions. If there is to be accurate accounting of such externalities, the question is why those bearing the risk of loss and actual losses do not have their interests routinely accounted for in corporate decision making. Yet for this approach, capital markets are enhanced when public law facilitates liquid markets rather than imposing rigid standards on corporate behaviour.

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[6] "Theory of the Firm", *supra* note 3.

[7] E.F. Fama & M.C. Jensen, "Separation of Ownership and Control" (1983) 26 J. L. & Econ. 301.

[8] "Theory of the Firm", *supra* note 3.

[9] L.L. Dallas, "The Relational Board: Three Theories of Corporate Boards of Directors" (1996) 22 J. Corp. L. 1 at 42.

A second theoretical approach is that of communitarian scholars who generally suggest that corporate governance should be aimed at ensuring that the corporation as a legal personality is a responsible member of society. In generating wealth, governance should ensure that the corporation is accountable to the communities in which it operates, and is advancing public policy in terms of investor protection, environmental protection and employment standards. This scholarship views corporate governance as the mechanism by which the corporation and its decision makers are held accountable to all of the stakeholders of the corporation. The objective is still generally shareholder wealth maximization, but tempered by an objective of good corporate citizenship.[10] This view reflects the notion that long-term shareholder wealth maximization creates stable supply and consumer markets, lower turnover in employees, enhances productivity and thus value of the corporation to its shareholders and to society. A challenge of the model, however, is to develop an acceptable method to determine what are socially optimal goals and to respond to the question of why corporate officers are better situated than public policy makers to determine what those goals are.

Lynne Dallas has responded to this problem by proposing relational corporate boards situated within power coalition theory. This theory suggests that the corporation is an institution whose activities result from a contest for control among power coalitions of stakeholders: shareholders, creditors and employees.[11] The behaviour of the corporation is influenced by contracting, but also by formal and informal co-opting, and the process of absorbing new elements into the decision- making structure of the corporation, in order to avert threats to the stability of the firm. It focuses on three spheres of accountability for ensuring that corporate officers act responsibly: voice or exit, markets, and judicial intervention.[12] Dallas points to empirical data that suggests that a corporate board representing diverse interests is an effective means of acquiring resources, reducing environmental uncertainty, making optimal use of skills of diverse participants, and ensuring that decision making takes account of the context in which the corporation operates.

The gap between contractarians and communitarians reflects different normative understandings and assumptions regarding the role of the corporation. However, both theoretical approaches have made contributions to the governance debate. The contractarian view allows for ease of accountability given that corporate officers are accountable only to shareholders and given its single equity capital maximizing objective. It does, however, have weaknesses in terms of discerning shareholder wealth maximization given the diversity of investors and different risk

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[10] M.A. O'Connor, "The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labour-Management Co-operation" (1993) 78 Cornell L. Rev. at 958 [hereinafter "Human Capital Era"]; L. E. Mitchell, "Co-operation and Constraint in the Modern Corporation: An Inquiry into the Causes of Corporate Morality" (1995) 73 Tex. L. Rev. 477 at 501-2; M. O'Connor, "Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers" (1991) 69 N.C.L. Rev. 1189 at 1195; D. Millan, "Communitarianism in Corporate Law: Foundations and Law Reform Strategies" in L.E. Mitchell, ed., *Progressive Corporate Law* (Boulder: Westview Press, 1995).

[11] L.L. Dallas, "Two Models of Corporate Governance: Beyond Berle and Means" (1988) 22 U. Mich. J. L. Ref. 19 at 85.

[12] *Ibid.*

capabilities and investment timelines. Moreover, the narrow focus of contractarian theory results in the creation of externalities and an artificial distinction between costs of firm activity that are accounted for within the corporation and those that are not. It fails to acknowledge that the initial distribution of property, economic rights and political rights then determines the scope of possible economic and political outcomes when looking at market allocations of resources, goods and services.[13] Market theory fails to account for this initial distribution and its impact on cost/benefit analysis. Communitarian theory may provide a more fulsome analysis of corporate transactions in that it would account for the costs of corporate transactions that are considered externalities under the contractarian model. However, its inability to articulate who decides priorities, and on what basis, leaves the model highly vulnerable to corporate decision making that is accountable to no one.

C. *Rethinking Efficiency and Governance*

The dominant Anglo-American approaches to corporate governance explain and reinforce a notion of maximization of share value as the singular and optimal goal of corporate decision making.[14] According to this theoretical approach, any rights of creditors or employees ought to be strictly limited to contractual and statutory rights.[15] These traditional views of corporate governance have been buttressed by statutory and judicial support for the notion that the objective of the corporation is shareholder wealth maximization, with judicial deference to business judgements that accomplish that end.[16] Shareholder wealth maximization or the "shareholder primacy norm" had its origins in cases involving disputes between minority and majority shareholders, prior to enactment of oppression remedies, where the courts held that corporate officers were to act in the best interests of all shareholders.[17] These cases did not address situations in which the interests of other stakeholders were affected. Nevertheless, they were quickly embraced as supporting shareholder primacy, to the exclusion of other interests in the firm. Theory and practice thus converged to create and legitimize a narrowly cast view of corporate governance that requires directors and officers to take account only of shareholder interests.

Concepts of property, maximization of shareholder wealth, and efficiency goals are deeply embedded normative concepts and are the underpinnings of current Anglo-American theories of corporate governance. Yet their normative invisibility does not render their normative content non-existent. Efficiency generally means the allocation of financial and other corporate resources, to put assets to their highest use while

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[13] B.A. White, "Feminist Foundations for the Law of Business: One Law and Economics Scholar's Survey and Re(view)" (1999) 10 UCLA Women's L. J. 39 at 42, 51, 74.

[14] M. Kessel, "International Aspects of Corporate Governance, A United States Perspective" (Canadian Bar Association Conference on Corporate Governance, Vancouver, 1997) (Ottawa: Canadian Bar Association, 1997) 1 at 2.

[15] J. Macey & G. Miller, "Corporate Stakeholders: A Contractual Perspective" (1993) 43 U.T.L.J. 401 at 427.

[16] R.J. Daniels, "Must Boards Go Overboard? An Economic Analysis of the Effects of Burgeoning Statutory Liability on the Role of Directors in Corporate Governance" (1995) 24 Can. Bus. L.J. 229 at 231.

[17] D.G. Smith, "The Shareholder Primacy Norm" (1998) 23 J. Corp. L. 277 at 279.

controlling transaction costs. Hence legal rules should be constructed to ensure resources are allocated to their optimal use, which will ultimately benefit society as a whole because of the economic activity and wealth it will generate.[18] Optimal use, however, is normatively defined as maximizing equity value. Although there are a number of pricing mechanisms, efficiency is frequently measured by present share value as the measure of shareholder confidence in managers and the market's overall assessment of the governance of the corporation.[19] Failures in the market's ability to accurately price are generally attributed to information asymmetries, the solution being to create greater transparency in governance and corporate transactions in order for investors to monitor and respond.

Creditors are assumed to have bargained a risk premium in the cost of credit. However, this ignores the complexity and diversity of creditors. The more senior the creditor, the more likely it is to have bargained a risk premium and secured its interest against the assets of the corporation. Thus, while secured creditors will not benefit from upside gains of a shareholder driven concept of efficiency, losses will have been controlled. However, thousands of creditors are unsecured and unable to either diversify risk or bargain a risk premium. They include small trade suppliers, repair persons, employees, pension fund beneficiaries, local governments to whom payment for taxes and utilities is owed, claimants harmed by environmental or consumer torts. These creditors are considered fixed or contingent claimants, and thus corporate decision making is not required to take account of their interests in maximizing value. Thus efficiency, as currently normatively defined, allows for corporate decisions that shift assets away from creditors, often expropriating value that could be used to satisfy these claims, unless the shift is excessive enough to render the corporation insolvent. The difficulty is that at this point, unsecured creditors are likely to receive no value or only a severely discounted value for their claims, given the hierarchy of credit realization in bankruptcy. Yet the decision making has occurred at a point very much prior and these interests, which may be the most severely prejudiced by particular corporate transactions, need not be accounted for in determinations of efficiency.

The discourse assumes as a normative starting point that the owners of capital are free to externalize the costs of injury from their negligence or costs of adjustment from restructuring. Efficiency, as it is currently understood, is measured by wealth generation for the exclusive benefit of shareholders. Thus, it is almost always efficient in the short term to seek out the lowest wages, engage in environmentally risky practices, and to externalize adjustment costs. The current efficiency debate ignores the initial distribution of wealth both domestically and internationally. Current markets do not price the complex costs associated with production of a good, including environmental harm, long-term sustainability and employment loss. These costs are externalized or not costed at all.

Doug Kysar suggests that the current theoretical underpinnings of macroeconomics developed when the world contained four billion fewer people and use

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[18] L. Kaplow & S. Shavell, "Should Legal Rules Favour the Poor? Clarifying the Role of Legal Rules and the Income Tax in Redistributing Income" (2000) 29 J. Legal Stud. 821.

[19] E.F. Fama, "Market Efficiency, Long-Term Returns and Behavioural Finance" (1998) 49 J. Fin. Econ. 283.

of resources in productive activity and the waste produced were considered costless because of the apparently limitless capacity to absorb both use and waste.[20] He suggests that GNP and GDP do not measure sustainable economic activity, quality of economic growth, or economic growth as measured by its impact on particular countries. The failure to integrate these notions often results in employment practices and environmental issues being traded off from shareholder return, without a more fulsome understanding of the objectives of efficient generation of economic activity.

Thus while few would take issue with the idea that resources should be utilized optimally, how the objectives or benchmarks of optimal use are measured and defined is key. Accuracy of costing may require tempering traditional efficiency measures to encompass maximizing value by having regard to diverse investments in the firm.[21] This expands the debate regarding objectives of short versus long-term shareholder wealth maximization, to consider triple bottom lines including sustainability and recognition of diverse inputs into productive activity. Rather than seeking the "most efficient" course of action, traditionally normatively defined as shareholder wealth maximization, corporate decision-making ought to encompass a choice between competing efficient decisions, having regard to competing investor interests. This would lead to a more even-handed approach both to efficiency and risk in terms of key stakeholders in the firm. The starting point of measuring efficiency could be to consider what interests and investments are at stake in the corporation, and to acknowledge that there are competing efficient decisions. Such decision making could make Pareto improvements <u>if</u> costs are fully accounted for, including those complex costs such as harm to long-term sustainability and the social and economic costs of adjustments in employment markets. In this sense, the model draws from the best attributes of contractarian and communitarian theorists.

The debate regarding optimal governance norms becomes more immediate when one considers the move to global capital markets and the need for governance practices to become more transparent, more cross-border and cross-corporate culture in their nature.

II. The Link Between Capital Markets and Corporate Governance

Corporate governance is only one aspect of the larger framework of macroeconomic policies, competition and tax policy, global capital, products and labour markets, cultural norms and ethics, and diverse state regulatory systems. The growth of global capital markets has created the potential for greater access to a larger investor pool. Key to the attraction of long-term "patient capital," whether it is domestic or international, is the ability to offer corporate governance systems that are clearly articulated and adhered to, within regulatory and legal frameworks that support

[20] D. Kysar, "Sustainability, Distribution and the Macroeconomic Analysis of Law" (April 2001) at 71, 73, 76 [unpublished, archived with author, cited with permission]. Kysar suggests that a distinction must be made between accidental "environmental tragedies" and a continuing pattern of externalizing costs that seriously undermines the potential for sustained economic activity.

[21] J. Sarra, "Corporate Governance Reform: Recognition of Workers' Equitable Investments in the Firm" (1999) 32 Can. Bus. L.J. 384 at 386-392.

contractual and ownership rights.[22] Articulation of these objectives by the OECD, as will be evident in Part V, are the most valuable contribution that the OECD principles make to the governance debate. However, with the emergence of global capital markets, the governance debate continues to situate itself as a purely property based regime, with private property viewed as a key means by which resources are used efficiently. Discussion regarding global capital markets focuses on the need to protect those property rights under vastly differing legal and political regimes, correlating shareholder protection and developed external capital markets.[23] State regulatory systems that protect private property rights are aimed at creating accountability to owners of capital and to creating a "market" for efficient governance. Studies have indicated that there is a direct relationship between effective corporate governance and investor confidence in capital markets.[24]

Capital markets are key to economic development. Emerging or transitional economies need foreign capital to make the investments necessary to generate wealth. Developed market economies also require additional capital to meet product and other market changes, and to ensure that they are globally competitive. However, the globalization of capital markets should not assume that free markets will function effectively absent an adequate regulatory and governance framework. The financial market failures in Russia and Asia in the late 1990s are classic examples of this need.

The link between capital markets and corporate governance is important, but is underdeveloped as a concept and thus does not reflect interests that are not defined as traditional property rights. It simultaneously contains the language of free market, while advocating state regulatory control to protect private property. The link manifests itself in a variety of ways. For example, emerging and transitional economies are frequently plagued by underdeveloped securities markets, inadequate regulatory frameworks to recognize and protect investments, inadequate exit mechanisms, in some cases corruption, and a judicial system unable to adequately respond to and provide timely and effective remedies for these issues.[25] However, even in developed market economies, there have been some notable failures in the ability of shareholders, the market or securities regulators to detect managerial misconduct.[26] Depending on the

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[22] I. Millstein, "Address" (Global Conference on Corporate Governance, Southern Connecticut State University, 10 July 2000), online: Global Corporate Governance Forum <http://www.gcgf.org/library/speeches/Millstein710.doc> (date accessed: 23 October 2001); *Principles, supra* note 1.

[23] R. LaPorta *et al.*, "Corporate Ownership Around the World" (1998), online: National Bureau of Economic Research <http://netec.wustl.edu/WoPEc/data/Papers/nbrnberwo6625.html> (last modified: 24 October 2001).

[24] See *e.g.* Toronto Stock Exchange Committee on Corporate Governance in Canada, *Where Were the Directors? Guidelines for Improved Corporate Governance in Canada* (Toronto: Toronto Stock Exchange, 1994).

[25] I. Millstein, "A Private Sector Perspective on Corporate Governance" (Latin American Corporate Governance Roundtable, Sao Paulo, 26 April 2000) at 3, online: OECD <http://www.oecd.org/pdf/M00015000/M00015382.pdf> (last modified: 26 April 2000).

[26] The RT Capital and Bre-X scandals in Canada are good examples of this. See *e.g. Re RT Management Capital Inc. et al.* (20 July 2000), online: Ontario Securities Commission <http://www.osc.gov.on.ca/en/Enforcement/Decisions/rtcapitaletal_20000720.html> (last

capital structures of these economies, controlling shareholders, corporate boards, banks and other institutional lenders were thought to be carefully monitoring corporate decision makers. The shift to global capital structures squarely raises the issue of whether there should be a convergence in corporate governance norms such that investors can appropriately assess where to invest capital and under what conditions. It should be kept in mind that factors such as the legal and regulatory regime also influence the ability of capital markets to act as an effective tool for channelling investments efficiently.

A. *National Historical Development and Public Regulation of Corporate Activity*

In most developed market economies, a public regulatory framework supports and respects property ownership, shareholder rights, and other public policy standards that create and delimit the role of the legal personality and its decision makers. Governance is also affected by the existence or absence of numerous constraints on corporate activity, such as controls on transfer or disposition of shares.[27] Domestic laws on accountability play a powerful role in the protection of investors. Corporate governance is shaped by public laws that recognize, to varying degrees, the interests of shareholders, creditors, workers and others in terms of director and officer liability for contract enforcement, employment standards, gender and race discrimination laws, and environmental protection. Public regulation to protect property rights is increasing while there is simultaneously a move toward fewer standards regulating corporate conduct in respect of environmental protections and employment standards. While corporations and the economic systems in which they operate continue to diverge internationally, some principles of corporate governance and the role of public regulation may be slowly converging in order to facilitate cross-border economic activity and to protect some key interests in the corporation.

Anglo-American capital markets have developed in a regulatory framework aimed at protecting diverse equity investors. This "investor consumer" protection sets standards for disclosure, creates regulated forums for securities transactions, imposes prohibitions on insider trading, and creates other measures designed to facilitate access to capital while affording basic protections to minority shareholders. The Anglo-American system has also generated strong notions of fiduciary obligations of corporate officers, now codified in statutes. The system has made public policy choices regarding how the costs of corporate activity can be externalized, both in tax policy and in regard to legislation as to who bears the costs of restructuring, downsizing and other corporate transactions. Generally, other than limited notice, severance provisions and tax remittance obligations of corporations, workers and communities bear the costs of restructuring and the enormous human costs in terms of disruption to communities and

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modified: 20 July 2000); J.G. MacIntosh, "Lessons of Bre-X (?) Some Comments" (1999) 32 Can. Bus. L.J. 223; J.N. Gordon, "Pathways to Corporate Convergence? Two Steps on the Road to Shareholder Capitalism in Germany" (1999) 5 Colum. J. Eur. L. 219 at 221.

[27] M. Becht, "Strong Blockholders, Weak Owners and the Need for European Mandatory Disclosure" (European Corporate Governance Network Executive Report, Bruxelles, 27 October 1997) at 35-36, online: European Corporate Governance Network <http://www.ecgn.org/ecgn/docs/pdf/eu.pdf> (last modified: 27 October 1997).

loss of human capital investment. Yet, in addition to the wage/labour bargain contained in economics literature, human capital should be broadly defined to include worker loyalty, foregone employment opportunities when younger, training and retraining costs (both direct and opportunity costs), investment in the social and productive health of the corporation, and decisions that have affected family life. These are costs and contributions of workers not accounted for in assessing the effectiveness of public regulation in creating efficient markets.

Once one moves beyond the Anglo-American corporate paradigm, the issues differ somewhat. For example, some continental European countries, with different historical development and civil law traditions, have frequently accorded greater economic equality in the workplace. In part, this was facilitated by the bank-centred capital structure and governance model that moved corporations away from a pure shareholder wealth maximization norm. In contrast to the U.S., which used public laws to severely restrict the activities of banks, banks in Germany and other continental European economies were allowed to obtain ownership stakes and to offer securities trading services to customers. This made the role of the bank as intermediary between investors and the corporation key to governance structures. Public regulation thus facilitated banks acting as direct equity owners, creditors and blockholders with a strong governance role.[28] These regulatory choices resulted in the underdevelopment of securities markets, because capitalization did not require liquid securities markets and oversight was exercised by banks and other blockholders performing a key governance role. The monitoring role of banks also resulted in a model of corporate governance with greater focus on the value of human capital contributions in addition to share wealth maximization. Public regulatory choices have also been made in EU countries in terms of the recognition of a role for employees in corporate governance, and the laws regarding the cost of corporate activity that negatively impacts on employees and other stakeholders. For example, the EU Acquired Rights Directive, adopted as legislation in several EU member states, limits the ability of an acquiring bidder to lay off excess employees in the immediate wake of a takeover.[29] This protects employees and tempers the takeover market in these economies.

As an example, German co-determination is a function of complex post-war history regarding the appropriate role of corporation. In turn, these national historical developments have tempered pressure to move to a purely shareholder wealth maximization measurement of effective corporate governance, influenced also by limited labour mobility and a resultant strong interest in governance by employees.[30] Moreover, national wage adjustment programs, legislated co-determination structures, national retraining programs and public policy that mandates the corporation to consider workers' interests, shifts the governance focus and has resulted in a more comprehensive means of addressing structural changes to corporations. With the high risk of expropriation of their human capital investments removed, workers in turn developed

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[28] Visentini, *supra* note 2 at 849.

[29] *European Union Acquired Rights Directive, Eur. Rep.* (9 January, 1999), online: LEXIS (library.curnws).

[30] L.A. Bebchuk & M.J. Roe, "A Theory of Path Dependence in Corporate Ownership and Governance" (1999) 52 Stan. L. Rev. 127.

more co-operative production models, acquired higher firm loyalty, and interacted with managers to create more productive work practices.

The link between capital markets and corporate governance has been described as either path dependent or a function of markets. Some scholars have argued that governance models are path dependent in that corporations reflect the historical, legal and political frameworks in which they operate. Bebchuk and Roe observe, for example, that the Anglo-American governance norm is a function of path dependence rather than a natural evolution towards efficiency, and that these norms have developed in response to widely dispersed capital structures and protections and limits placed on corporations under U.S. political and social institutions.[31] They suggest that there is unlikely to be a convergence of corporate governance norms because of the strong historical framework that operates to determine governance practice, including a history of adversarial bargaining with workers, enormous power inequities, and laws that prohibit unions from acquiring a governance role in the corporation.[32] Arguably, strong political, economic and social norms will act as a barrier to any fundamental changes in corporate governance norms absent legislative intervention. While there may be a good business case to be made for long-term shareholder or enterprise wealth maximization, it is unlikely to occur without intervention in the "market." This is because the transaction costs of accomplishing this may be viewed as too high, and the benefits of a redistributive nature as too great a challenge to existing property norms, to be acceptable to many shareholders.

In contrast, other scholars suggest that global capital markets will create convergence notwithstanding political and historical influences.[33] The mobility of capital, the merger or cross-listing initiatives of international stock exchanges, the global transfer of both debt and equity will result in convergence of corporate governance norms. Visentini observes that when the allocation of economic resources takes place only as a function of an efficiency drive, markets may overrule domestic legislation and there is a danger that global companies will not be adequately regulated in any jurisdiction.[34] Path dependence and market convergence theory both have merit and are not mutually exclusive. Historical economic and political structures set strong normative and regulatory frameworks in which corporate governance practice is determined. Convergence pressure is therefore likely to result in alteration of these regulatory frameworks, but not a complete merger or immersion in capital markets.

B. *The Role of Ownership and Capital Structures*

A sizeable number of the world's corporations continue to be closely, domestically held (including family owned and state owned enterprises), or part of an intricate set of cross-holdings. Governance of corporations is shaped by their internal capital, share and management structures. For example, for Anglo-American

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[31] *Ibid.* See also C. Milhaupt, "Property Rights in Firms" (1998) 84 Va. L. Rev. 1145; J. Coffee, "The Future as History: Prospects for Global Corporate Governance and its Implications" (1999) 93 Nw. U.L. Rev. 641.

[32] "Human Capital Era", *supra* note 10 at 947.

[33] Coffee, *supra* note 31 at 642.

[34] Visentini, *supra* note 2.

corporations with widely held share ownership, corporate governance mechanisms are usually aimed at controlling opportunistic behaviour by powerful managers in order to protect dispersed shareholders who lack the resources, information and incentive to effectively monitor their activities. In contrast, the governance challenge in closely held, cross-held or block-held corporate structures such as in Germany, Italy, Japan and parts of Asia, has been to protect the interests of minority shareholders from powerful controlling shareholders or blockholders.[35]

The ownership structure is, in part, a determinant of differences in attitude to risk and resultant incentives to monitor. Ralph Heinrich has suggested that increased concentration of ownership creates a higher incentive to monitor and thus reduces information asymmetries, however it also creates a concurrent risk aversion that can impact on managers' decision making.[36] If the corporation takes a higher portion of debt, this effect is mitigated because the risk is shifted to creditors who do not have to share any upside benefits. Thus equity owners will tolerate higher levels of risk. This may explain why block-held firm sor many mergers and acquisitions are highly leveraged. Heinrich observes that the countervailing effects of changes in ownership create a role for capital structures as an additional complementary governance instrument. Thus the broadly accepted link between concentrated ownership and level of monitoring needs to be qualified to account for leveraging. Although there are higher agency costs of debt, an ownership structure that shifts risk to creditors can mitigate these costs in order to achieve higher monitoring.

While leveraging thus reduces shareholder risks, the costs are transferred to creditors. As noted above, however, the difficulty with shifting the risk to creditors is that it assumes that creditors have bargained a risk premium and have the ability to diversify risk. Many creditors are unsecured lenders, and except for a few statutorily preferred claims, this shift in risk creates a distributive transfer in value from equity to debt investors, the latter of whom are in no better position to protect themselves from managerial opportunism or shirking than are small investors. Thus excessive risk taking behaviour by managers disproportionately shifts the cost of that behaviour away from equity holders to unsecured creditors, not to senior secured lenders who have the information and bargaining power to protect their investments. Anglo-American governance theory is therefore grounded not only in property norms, but in a preconceived hierarchy of property that is to be protected. Property claims by unsecured creditors are not properly accounted for, or protected, in the period where a corporation is solvent but the officers engage in excessive risk taking. Hence capital structures heavily influence governance and who bears the costs of corporate decisions.

There are both private and public law issues in the role of ownership and the governance structures generated. The ownership structure of the corporation both shapes the internal mechanisms that ensure effective oversight and planning and

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[35] See M.J. Roe, *Strong Managers, Weak Owners, The Political Roots of American Corporate Finance* (Princeton: Princeton University Press, 1994). See also Becht, *supra* note 27.

[36] R. Heinrich, *Complementarities in Corporate Governance: Ownership Structure, Capital Structure, Monitoring and Pecuniary Incentives* (Duesternbrooker, Germany: Kiel Institute of World Economics, 2000) at 3, 10.

responds to the regulatory regime that sets the climate for capital investment.[37] In North America and Europe, complex securities and corporations regulatory frameworks have developed to deal with particular ownership structures and to encourage economic activity, while simultaneously creating varying degrees of accountability to investors. Becht has observed that in global capital markets, investors are likely to participate in liquid markets so that they can spread their risks more widely and exit easily if dissatisfied with corporate performance.[38] In turn, corporations that attract many investors and have a liquid market in their shares benefit from lower cost capital and are thus more competitive.[39] Governance choices are driven largely by access to capital. Diversification of ownership creates accountability problems between managers and dispersed shareholders, whereas concentration of ownership reduces potential for liquidity, a main advantage of dispersed ownership, but such ownership allows for lower-cost monitoring. Yet concentrated voting power creates a risk of blockholder/managerial collusion to the detriment of small shareholders.[40] The move towards more liquid capital markets presents these investors with the benefits of easier exit but also the problem of reduced ability to monitor managers. Thus ownership and governance structures influence and reflect one another.

The growth of multinational corporations and increase in mergers and acquisitions has also necessitated the need to merge ownership and corporate governance mechanisms that function in different economic systems. The impact of cross-border ownership and cross-corporate culture has not yet been fully explored. The assumption has been that more active capital markets will lead to unquestioning adoption of Anglo-American models of ownership and corporate governance that are characteristic of liquid capital markets. There is some evidence to support this. However, it is equally plausible that new hybrid models of governance will emerge to reflect more complex capital structures. A corporation owned and registered in one country will be required to comply with domestic law of another, but also required to comply with foreign public laws in terms of governance, consumer protection, anti-discrimination laws, officer liability and credit systems; thus creating governance models that cross boundaries and systems.[41] A deeper understanding of how different capital structures and economic systems raise different governance issues is necessary in order to appreciate the convergence debate.

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[37] M.C. Jensen, "The Modern Industrial Revolution, Exit and the Failure of Internal Control Systems" (1993) 48 J. Finance 831 at 863-65. See also H.G. Manne, "Mergers and the Market for Corporate Control" (1965) 73 J. Polit. Economy. 110. See also W.J. Carney, "The Legacy of the 'Market for Corporate Control' and the Origins of the Theory of the Firm" (1999) 50 Case W. R. L. Rev. 215.

[38] *Supra* note 27 at 23.

[39] *Ibid.*

[40] *Ibid.*

[41] One example is the recent merger of Daimler-Chrysler, with its head office in Germany, ownership primarily in Germany and the United States, and trading on the New York Stock Exchange (NYSE) in the years prior to the merger. See D.E. Logue & J.K. Seward, "Anatomy of a Governance Transformation: The Case of Daimler-Benz" (1999) 62:3 Law & Contemp. Probs. 87.

III. How the Symptoms of Ineffective Corporate Governance Manifest Themselves: Divergent Systems, Different Challenges

At the heart of the governance debate is the question of how to allow corporate officers to make effective decisions and create wealth, while ensuring that they are accountable to investors.[42] While it may seem convenient to global capital investors, it may be impracticable to expect that North American norms of governance will be imported wholesale into corporations operating in diverse systems. Equally, however, investors will be hesitant to invest their capital in jurisdictions where there is legitimate concern over fundamental notions such as property rights, shareholder remedies, and accountability by corporate decision makers for their governance decisions. The discussion below is designed to summarize some of the key differences among several divergent economic systems and corporate control structures in order to try and identify some of the signs of ineffective governance in each.[43] These signs must be recognized in order to appreciate the convergence debate: to assess whether there can be divergent systems but more universal principles for corporate governance, and if so, what they should include.

A. *Anglo-American Corporations: Dispersed Ownership, Liquid Markets*

The Anglo-American model of corporate governance is a function of widely held corporations. The capitalization of U.S. corporations was accomplished by equity investments of numerous widely dispersed shareholders. The result was the predominance of corporate structures whereby strong managers controlled the corporation, and dispersed shareholders lacked the information or resources to effectively monitor these managers.[44] This power vested with those with little equity stake and little direct accountability, created conditions for opportunistic behaviour, shirking, and failure to effectively enhance shareholder value. Berle and Means described the concentration of economic activity, dispersed ownership and powerful managers as a "separation of ownership and control," posing questions for governance that continue to occupy American legal scholars and regulators today.[45] They also discussed whether governance should include accountability to diverse stakeholders, a part of their dialogue that is largely lost; this issue is explored below.

Under Anglo-American corporate structures, shareholders must incur additional agency costs in monitoring managerial behaviour, and in attempting to better align the interests of managers with those of shareholders. The regulatory system responded to the governance problems resulting from widely dispersed ownership through securities

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[42] I define investors as all those who invest in the corporation in terms of equity capital, debt and human capital.

[43] Readers should refer to the extensive literature for a comprehensive understanding of these capital structures.

[44] A. A. Berle & G.C. Means, *The Modern Corporation and Private Property* (New York: Commerce Clearing House, 1932) at 355-56.

[45] *Ibid.* at 71.

regulation, consumer protection laws, and corporations laws apportioning responsibility and liability among the corporate legal personality and directors and officers in their fiduciary capacity. Within this regulatory system, corporations are left with a variety of options for public and private financing, and particularly, with choices regarding stock exchanges with varying levels of disclosure and standards. Dispersed ownership is viewed as optimal because the resulting liquid capital markets ensure an objective mechanism for monitoring and assessing managerial performance. Dispersed ownership encourages risk-taking and ultimately reduces the cost of capital.[46] Both statutory and common law codification of fiduciary obligation have created a benchmark against which the activities of corporate managers are measured. The benchmark of "in the best interests of the corporation" is broadly worded but normatively narrowly defined as shareholder wealth maximization.

However, the ownership structure of Anglo-American corporations has been changing and shares are no longer uniformly and widely dispersed. Even though the majority of shares continue to be widely held, there is frequently concentration of ownership by large investors, either pre-initial public offering owners or institutional investors. Under this model, equity investors can acquire additional blocks of shares and an active market exists for partial control changes.[47] As a result, governance in Anglo-American corporations is not static, and changing capital structures reflect that corporations have not yet found the optimal mix of accountability and officer discretion to make decisions that maximize value. Anglo-American governance norms have been accompanied by private law initiatives such as shareholder agreements and share purchase rights plans in corporate charter documents. These developments have created new tensions in accountability and governance. For example, mechanisms to influence the market for corporate control, such as poison pills and break-up fees, have a tendency to entrench managers.[48] This, combined with jurisprudence according high deference to business judgments, has worked in some instances to diminish accountability. Current initiatives to reform U.S. securities regulation, through overly rigid interpretation of the ordinary business exception, have extended a trend toward diminishing shareholder participation and thus the ability of institutional and other shareholders to hold managers accountable.[49] For example, Ayotte suggests that the courts, upholding the SEC's elimination of shareholder participation regarding social policies, have further aggravated the issue of separation and control, instead of enhancing corporate democracy.[50]

There has been a substantial increase in institutional shareholder activism aimed at enhancing corporate accountability. This has taken the form of "voice", in

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[46] N. Georgakopoulos, "Corporate Defense Law for Dispersed Ownership" (Canadian Law and Economics Association Annual Conference, Toronto, Canada, September 2000) at 53, 54 [unpublished, archived with author, cited with permission].

[47] See C. Mayer, "Ownership Matters" (Inaugural Lecture of the Leo Goldschmidt Chair in Corporate Governance, Université Libre de Bruxelles, 10 February 2000), online: European Corporate Governance Network <http://www.ecgn.ulb.ac.be/ecgn/speeches/htm> (last modified: 11 February 2000).

[48] *Ibid.*

[49] C.L. Ayotte, "Re-evaluating the Shareholder Proposal Rule in the Wake of *Cracker Barrel* and the Era of Institutional Investors" (1999) 48 Cath. U. L. Rev. 511 at 539.

[50] *Ibid.* at 512, 541-43, 551.

the sense of informal influences on corporate officers, and a more direct intervention in the form of board seats and shareholder proposals. Institutional investors have the resources and information to monitor managers. Moreover, while the prospect of exit affords these investors bargaining power, other regulatory restrictions hinder exit, thus leaving voice as the *de facto* option. In some cases of U.S. pension funds and Canadian labour-sponsored investment funds (LSIFs), the exercise of shareholder voice has been aimed at more communitarian goals, in terms of measuring effective governance by assessing performance in employment and safety standards and environmental sustainability. This creates a new set of tensions in terms of the shareholder wealth maximization paradigm.

While the Anglo-American dispersed ownership model generated a regulatory framework aimed at holding managers accountable through disclosure standards, transparency of securities markets and prohibitions on particular types of self-dealing transactions, there continues to be serious issues of accountability. Shareholders have attempted to reduce agency problems and align managers' interests with those of equity investors by compensation practices that give equity or options. However, this can also create non-alignment of interests in a widely held corporation, because the lack of diversification of managers' holdings may discourage risk taking, contrary to the interests of diversified equity holders. These attempts at the reduction of agency costs may actually result in increased conflicts in governance priorities. Moreover, a constant challenge in this capital market is to ensure that the conduct of investment advisors and securities professionals, who act as intermediaries in liquid securities markets, do not create another layer of unaccountability for equity investors. Rather than enhance shareholder participation, governance reform has been aimed at disclosure and transparency of corporate transactions and decision making. The premise is that investors will exit if dissatisfied with corporate performance, thus causing securities markets and the resultant market for corporate control to influence and ultimately enhance corporate governance. Exit is the only means of exercizing preferences. The Anglo-American regime has been less effective in enhancing shareholder participation rights and thus in creating accountability though "voice," as opposed to "exit". It is premised on the fact that shareholders have no incentive to monitor where exit is easier. If investors exit in sufficient numbers, the market sends a message to the corporation to change its managers or its governance practices.[51] While this focus strengthens capital markets, it is unclear as to whether it enhances long-term governance of the corporation.

The system thus fails to address a more active voice in governance, whereby investors articulate their governance priorities and preferences. The "right to influence the corporation" is viewed as participation at general shareholder meetings, board elections and voting on fundamental transactions. Shareholders do not vote on economic and operational issues that directly impact on sustainability, long term return on equity investments, workers, or the communities in which they are situated; nor do they act as an accountability check on managers who do have carriage of such

[51] See F.H. Easterbrook & D.R. Fischel, "Voting in Corporate Law" (1983) 26 J. L. Econ. 395.

decisions.[52] Although shareholders should be able to bring forward proposals, there is often a pre-condition of a specified number of shares and a broad discretion by managers to prevent the proposals being placed on the agenda. These restrictions are aimed at preventing frivolous shareholder proposals, however, they also make a normative choice regarding which kinds of shareholders will have participation rights, i.e. institutional shareholders, blockholders and controlling shareholders, many of whom already influence corporate decision making.

This in turn may have distributional consequences. It does not allow individual investors to bring forward proposals because they do not have the resources and information to adequately monitor or to solicit support from across a broad range of shareholders. When shareholders do make proposals they can be excluded for a variety of reasons, under ordinary business exceptions or under the prohibitions in corporations statutes on shareholder proposals aimed at social issues.[53] While shareholder proposals are of a non-binding nature, permitting their circulation and a shareholder voice would provide normative guidance to corporate officers, even if they decided to act otherwise. Further, a greater use of technology in shareholder voting could facilitate a new era of shareholder participation in governance, yet the Anglo-American system is resistant to greater investor activism.

With the recent tragic events in the United States and the resulting economic shock and capital market reaction, we do not yet have the data to assess the different ways in which economic systems and corporate governance structures deal with such economic shocks. It is evident that the economic consequences for workers, trade suppliers and small investors needs further study. In particular, the issue of how current governance, regulatory and market mechanisms apportion such economic shock among the stakeholders in the firm, and whether the resulting apportionment appropriately distributes the costs, deserves further investigation.

B. *German Corporations: Concentrated Ownership and Control, Nascent Securities Markets, and Co-Determination*

In contrast to the Anglo-American model, the central European model of corporate governance is a function of closely held or block-held domestic capital structures, and public policy choices about the role of multiple stakeholders, such as creditors and workers. For example, 80% of the top 170 firms listed on French and German stock exchanges have a single shareholder who owns more than 25% of shares.[54] In Germany there are large "blockholders" who own or control large blocks

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[52] See L. Dallas, "The Control and Conflict of Interest in Voting Systems" (1992) 71 N. C. L. Rev. 1.

[53] An example was section 137(5) of the *Canada Business Corporations Act*, R.S.C. 1985, c. C-44, as am. by S.C. 2001, c. 14, which until November 2001 expressly prohibited proposals promoting general economic, social or political causes. It now requires the proposal to relate in a significant way to the business or affairs of the corporation.

[54] E. Boehmer, *Business Groups, Bank Control and Large Shareholders: An Analysis of German Takeovers* (Bonn, Germany: Deutsche Forschungsgemeinschaft, 1998) at 6.

of shares, primarily banks and other corporations.[55] Generally, the influence of banks, as large blockholders, varies depending on whether the power is over debt or equity markets.[56] For example, in Belgium, France and Sweden, banks are an integral part of links between different business groups, and thus their monitoring is manifested through that means.[57] For closely held corporations or those with complex cross-holdings, block-holding or pyramid structures, governance problems are created by alignment of the interests of managers with controlling shareholders or blockholders. This is frequently to the detriment of minority shareholders and foreign shareholders, because their interests are disregarded or control premiums are extracted through self-dealing transactions.

German corporations are more highly leveraged, and thus debt, as well as the equity that banks vote on behalf of investors' deposits, plays a strong governance role. This capital structure and governance role of banks historically resulted in little need for developed securities markets and thus there was little impetus to develop strong protections for minority shareholder interests. This was further influenced by public policy that recognizes the importance of lending institutions and employees within the governance structure of the corporation. The result is a governance structure with less pressure to maximize short-term shareholder value, and more attention to other stakeholders. While capital is less liquid, corporations are also less subject to the wide fluctuations that accompany rapid changes in investor confidence. For example, rapid capital market changes do not result in immediate labour shedding and thus the negative impact on employees is generally less extreme. More recently, as Germany has sought to attract international capital to remain competitive globally, there are more active securities markets, although these are still ancillary to the banks as the primary source of capital. While these securities markets allow corporations to diversify their capital structures, securities trading services are most often offered by the banks.[58] Thus, while there is greater access to a mix of debt and equity, and some competition between the two, both are still largely available through the banks. Only recently have there been changes to governance structures to enhance minority shareholder accountability, such as new insider trading rules, in part a result of greater competition for capital.

Corporate governance objectives in Germany have also been mandated by the statutory framework. Governance has been aimed at encouraging the boards to manage for the good of the enterprise, including both equity investors and the public welfare. This is reflected in the co-determination model, a two-tiered corporate board structure

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[55] M.J. Roe, "Some Differences in Corporate Structure in Germany, Japan and the United States" (1993) 102 Yale L. J. 1927 at 1929. Banks vote equity left on deposit, unless instructed otherwise by the equity owner.

[56] See R. Romano, "Comment of La Porta, Lopez-de-Silanes & Shleifer, Corporate Ownership Around the World" (1998), online: European Corporate Governance Network <http://www.ecgn.org/ecgn/conference98/roberta_romano_comments.htm> (last modified: 29 April 1999).

[57] Becht, *supra* note 27 at 37. In Italy, before implementation of the EC Second Directive on Banking, commercial banks could not hold shares directly, but could hold shares in investment banks which in turn held shares in industrial corporations; Visentini, *supra* note 2 at 838.

[58] Visentini, *ibid* at 840-41.

in which workers and shareholders participate on a supervisory board and daily decision making is undertaken by a separate managerial board. Co-determination is strongly supported by stakeholders and public policy, and thus involves some sharing of power and militates against corporate opportunism. Co-determination has translated itself in the workplace in the form of works councils. Works councils are essentially collaborative processes to enhance production, workers' voice in strategic planning, and stronger commitments to retraining and health and safety. Corporate officers, through a series of collaborative strategies, pursue both shareholder wealth maximization and the economic and social health of the enterprise and its workers.

However, the two-tier board structure, while designed to reflect different stakeholder interests, has created a different kind of accountability concern. While the supervisory boards of the largest corporations are comprised of equal numbers of employees and shareholders, the Board Chair is always a shareholder and has the casting vote. Moreover, for smaller corporations, employees comprise a much smaller percentage of board membership. "Employee" membership on the board includes supervisors, professionals and unionized workers, whose interests frequently diverge. Board oversight is undermined by infrequent board meetings, unduly large and unwieldy board size, and untimely and inadequate disclosure to board members. There is also a problem of managers bypassing the supervisory board and thus exacerbating accountability problems.[59] The banks participate both as equity holders on the supervisory board and as blockholders intervening directly with managers. The latter raises concern regarding any control premiums that they may be extracting. Moreover, German law allows for a broader scope of shareholder participation at general meetings, a role employed by banks.[60] Thus concerns about shareholder rights are those faced by minority shareholders in light of "strong blockholders and weak owners."[61]

Within corporations with a high concentration of shareholding, there is considerable difference in controlling shareholder voting, with the U. K. dominated by institutional investors such as life insurance companies and financial institutions, whereas Austrian, Italian and French ownership is dominated by family, individual and non-financial companies.[62] Many corporations in these jurisdictions are a complex arrangement of pyramid holdings, block-holdings and cross-holdings, where a few shareholders or blockholders exert considerable influence over corporate decision making.[63] Lack of disclosure of ownership holdings, voting control and transactions that may benefit particular blocks of shareholdings also creates potential for abuse and risk of extraction of control premiums. Lack of transparency in both ownership and material foreseeable risk hinders outside investors' ability to assess the stewardship of the corporation. Thus the governance issues differ from those presented by dispersed

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[59] V. Dinh, "Co-determination and Corporate Governance in a Multinational Business Enterprise" (1999) 24 J. Corp. Law 975 at 981-83.

[60] Visentini, *supra* note 2 at 844.

[61] Becht, *supra* note 27 at 4.

[62] See C. Mayer, "Firm Control" (Inaugural Lecture, Oxford University, 18 February 1999), online: European Corporate Governance Network <http://www.ecgn.ulb.ac.be/ecgn/docs/EUcontrolproject/inaugural%20lecture.pdf> (date accessed: 28 November 2001).

[63] *Ibid.* at 11. See also L. Zingales, "The Value of the Voting Right: A Study of the Milan Stock Exchange Experience" (1994) 7 Rev. Finan. Stud. 125.

ownership. Much of the governance debate centres around the separation of ownership and control, however, within this debate there are complex issues of the meaning of control, be it formal voting power, influence or monitoring power, the influence of cross-shareholding, and degrees of separation.[64]

The move to global capital markets has created different kinds of convergence pressures, discussed in part IV. Even prior to the events of fall 2001 and the subsequent market reaction, recessionary trends in the United States and Asia have resulted in decreased capital spending. There have been economic consequences for Germany and other EU states that rely on these markets for their consumer goods. The slowdown in economic activity globally has resulted in some labour shedding by German based corporations, although these appear to involve facilities outside of Germany, where Anglo-American type cost cutting is a more acceptable norm. Continued economic decline may place pressure on these corporations to make adjustments domestically, which would create considerable tensions with existing norms regarding governance.

C. *Japanese Corporations: Cross-Holdings, Under-Developed Securities Markets and "Lifetime Employment"*

Japanese corporations are characterized by a system of cross-holdings, with *Keiretsus* structured both vertically, where suppliers play a direct governance role in terms of their relations with the corporation, and horizontally, in which there may be one bank and a number of member firms.[65] Generally, banks as debt holders are also the largest equity holders, and thus corporate governance structures emerged to utilize this pattern of ownership, debt and control.[66] While the capital structures thus differ from continental Europe, Japanese securities markets are also underdeveloped. The structure of ownership and debt historically resulted in little dependence on capital markets, low liquidity because of the size and complexity of cross-holdings, and underdevelopment of securities regulation.

Japan has been characterized by a single board structure of corporate governance, with the banks as a dominant influence. There are other powerful social and cultural structures, such as suppliers' clubs and presidents' clubs, that exert a strong normative influence on the activities of corporate managers.[67] Non-bank shareholders have not been powerful and thus banks have acted as a temper on the pure shareholder wealth maximization model. For example, the bank-centred model ensures that implicit contracts with workers are respected, giving rise to norms that are characterized as "lifelong employment" by Japanese legal scholars.[68] Thus capital structure has a powerful influence on how workers and other interests are accounted for in the firm.

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[64] Mayer, *supra* note 62 at 9.

[65] M. Fukao, *Financial Integration, Corporate Governance and the Performance of Multinational Corporations* (Washington, D.C.: Brookings Institution, 1999) at 100-101.

[66] S.D. Prowse, "The Structure of Corporate Ownership in Japan" (1992) 47 J. Fin. 1121 at 1126.

[67] Roe, *supra* note 55 at 101.

[68] M. Nakahigashi, "Corporate Governance in Japan in the 21st Century: A Comment on Nottage" (April, 2000) at 3 [unpublished, archived with author, cited with permission].

Japan's corporate governance system, like Germany's, has a somewhat communitarian focus. Corporate governance has emphasized protection of employee and creditor interests, which are considered at least as important as shareholder interests.[69] The governance structure harmonizes relationships among corporate officers, shareholders and workers.[70] This stakeholder model arises out of a complex post-war economic and political history, in which long-term employment evolved in response to massive labour unrest and production takeover strikes. The illiquidity of Japanese labour and capital markets created a higher incentive to invest in workers over the long-term, in turn creating corporate structures and cultures that were stable and resulted in highly productive collaboration.[71] The regime did not evolve from express policy decisions recognizing and valuing human capital, but rather is a complex development of worker activism, its structural response, and a governance system that now strongly recognizes and values team production, collaboration and co-operative dispute resolution. In turn, corporate structures and the workplace climate generated have more easily adapted to competitive pressures of global capital markets, technological changes and the need to design new competitive work processes.[72] This stakeholder model has been buttressed by judicial decisions that have protected workers' human capital investments.[73]

Unlike Germany, where employee board membership arises out of representation by constituency (workers or shareholders), Japanese workers' representation on corporate boards is accomplished through employees being promoted to inside directors as a function of their contributions to the firm. This acquisition of voice in corporate decision-making protects against expropriation of their firm specific human capital investments, and has allowed corporations to acquire market flexibility.[74] This is not worker representation in terms of a concerted labour voice.[75] However, employees are promoted to director status from all hierarchical levels of the corporation, and thus reflect voices from all parts of the corporate structure.[76] Thus Japanese capital and governance structures have worked to create a wealth maximization model not aimed purely at shareholder wealth maximization. It includes a normative conception of long-time employment and incentives to invest in industry and firm specific human capital. It turn, this has resulted in high loyalty and buy-in to the objectives of

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[69] Roe, *supra* note 55 at 101.

[70] M. Aoki, "Toward an Economic Model of the Japanese Firm" (1990) 28 J. Econ. Lit. 1 [hereinafter "Economic Model"].

[71] R.J. Gilson & M. J. Roe, "Lifetime Employment: Labour Peace and the Evolution of Japanese Corporate Governance" (1999) 99 Colum. L. Rev. 508 at 531.

[72] See "Economic Model", *supra* note 70. See also *supra* note 71 at 537. The model may also be a function of variable incentive-based wages, which developed incentives for firms to engage in human capital skills training without fear of employee or competitor opportunism.

[73] Gibson & Roe, *ibid.* at 526. The authors point out that court decisions have protected employees by requiring employers to show economic need in order to downsize, worker consultation and exhausted alternatives to layoffs.

[74] M. Aoki, "The Participatory Generation of Information Rents and the Theory of the Firm" in M. Aoki *et al*, eds., *The Firm as a Nexus of Treaties* (London: Sage Publications, 1990) at 26-28.

[75] Although unions are tied to corporate enterprises and thus tend to develop collaborative as opposed to adversarial relations in their representation of workers.

[76] Interview with M. Nakahigashi (30 March 2001).

enhancing productivity and internal labour markets, in terms of employee and shareholder wealth maximization. Advancement in the corporation is frequently measured by contributions to the team process, as opposed to individual contributions.

However, this has also been a highly gendered view of the recognition of employees' contributions to the firm, and thus Japanese governance structures, while communitarian in focus, suffer from inconsistencies. Women are not given access to many jobs that provide long-term employment assurances, because there continues to be deeply imbedded norms that women must make a choice between career and marriage/child bearing.[77] Recent equal opportunity laws may begin to address these issues, but they inadequately address broad equitable remedies and more systemic change. Interestingly, the value structure of Japanese corporations, such as collaboration and non-adversarial resolution of disputes through social relations, are structures that require enormous time commitments outside of working hours, thus conflicting with women's caregiving obligations. While these changes are slowly being addressed, they highlight the fact that non-aggressive and more co-operative models do not necessarily include all stakeholder voices.

Concentrated ownership in Japan has also led to the underdevelopment of minority shareholder protection, and the risk of extraction of greater control premiums. While shareholders have access to derivative type suits, there are no oppression remedies available. The emphasis on employee protection rather than on an exclusive shareholder wealth maximization objective, has resulted in Japan being less competitive in attracting capital in global markets. This has changed somewhat in the past ten years, as Japan has increasingly looked to international capital markets to raise additional capital and reduce reliance on the banks. A number of firms are now listing on Anglo-American stock exchanges. In turn, this has required Japanese firms to comply with disclosure and other Anglo-American securities requirements, thus imposing greater transparency requirements on Japanese corporations.[78] This is also creating enormous pressure on Japanese corporations to move away from their communitarian focus.

Japan is now facing considerable convergence pressure because of an economic slowdown. There has been pressure to revamp securities regulation, to merge exchanges, to shift the structure of some exchanges to stock corporations, and to create a higher measure of transparency. There is also some pressure from international investors to move to an Anglo-American style governance, although the vast majority of Japanese corporations continue to retain their governance structures and norms. The Nissan Corporation is one of the very few examples wherein massive cost cutting and labour shedding has occurred. However, even in this case, there is a blend of Japanese and American governance norms, rather than a wholesale adoption of the Anglo-American

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[77] J.S. Fan, "From Office Ladies to Women Warriors? The Effect of the EEOL on Japanese Women" (1999) 10 UCLA Women's L.J 103 at 105-09, 116. See also R. Yamakawa, "We've Only Just Begun: The Law of Sexual Harassment in Japan" (1999) 22 Hastings Int'l & Comp. L. Rev. 523 at 527.

[78] See M. Aoki, "The Japanese Firm as a System of Attributes: A Survey and Research Agenda" in M. Aoki & R. Dore, eds., *The Japanese Firm: The Sources of Competitive Strength* (Oxford: Oxford University Press, 1994).

approach.[79] There continues to be substantial resistance to move towards Anglo-American norms, such as the *Keidanren* (Japanese Federation of Economic Organizations) resistance to a current legislative proposal requiring every large corporation to have at least one outside director on its board. Moreover, even within a restructuring climate, the interests of employees as key stakeholders continues to be a priority, thus generating a search for more efficient structures that account for these interests and costs.

D. *The Intersection of Diverse Governance Models and Capital Markets: "Voice" or "Exit"*

The evaluation of Japan and Germany's corporate governance systems against Anglo-American norms warrants several observations. First, these systems are characterized by their under-developed securities markets and thus lack of competitiveness in global capital markets. As these countries seek international capital, much of which is grounded in Anglo-American securities regimes, they will be required to move towards a system of enhanced protection of shareholder interests, to the possible detriment of other corporate investors and community members. The high leverage characteristics of these systems also raises concerns regarding the ability to finance technology-based firms, start-ups and other aspects of the new economy, because to date these have been largely funded by equity investments, particularly venture capital financing. Thus, these economies may be at some disadvantage in the competition for capital. These are legitimate issues, but they are not the only considerations.

The concern about liquid capital markets is key, but also masks a number of problems that Anglo-American investors face. Concurrent with the growing competition for capital is the need for capital to find new markets. Given the colossal failures in emerging and transitional economies, central European and Japanese markets are more desirable. Yet capital investors have difficulty not only with weaknesses in minority shareholder rights, but also with the more communitarian norms reflective of corporate governance in these countries. This concern is cast as an efficiency debate. In Germany, co-determination is attacked as inefficient because of worker participation on corporate boards, and because blockholders and controlling shareholders bypass that structure and influence managers directly. It is also "inefficient" because shareholder wealth maximization is not paramount as a corporate objective. It has been argued that correlation exists between co-determination and under-development of deep securities markets because of the tendency of blockholders to bypass the board and directly influence managerial decision-making.[80] While there is little doubt that Germany's model of governance has created accountability problems, it is much less clear that this is a function of co-determination. Even without employee representation on supervisory boards, minority and foreign shareholders would have great difficulty in keeping managers accountable. This is because the structure of decision-making has enshrined infrequent meetings, information asymmetries, unwieldy board size, and rent-seeking

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[79] Nakahigashi, *supra* note 76.

[80] M. Roe, "German Co-determination and German Securities Markets" (1999) 5 Colum. J. Eur. L. 199 at 201.

behaviour by blockholders and controlling shareholders. Rather than cast the debate in terms of pressure to eliminate the role of workers, one should more carefully consider the structural and normative governance problems associated with centralized ownership and control structures, and how the governance role of debt has been underplayed in this analysis. One could adopt more explicit models with particular rights and accountability attached to co-determination.

Co-determination potentially allows for alliances between workers and minority shareholders in terms of maximizing wealth of the enterprise. Both could arguably benefit from enhanced monitoring of managers on the shop floor and at the board level. A co-determination model that situated information, decisions and accountability within the supervisory board could address many of the shareholder concerns raised. One would then be left with the one issue where there is truly normative disagreement, specifically that under German and similar governance models, corporations are managed in the interests of broader numbers of stakeholders. It is this disagreement that needs to be made transparent in the governance debate, because it challenges the Anglo-American shareholder wealth maximization paradigm.

The difficulty with scholarship on comparative corporate governance is that it frequently assumes that efficiency, broadly defined as shareholder wealth maximization and externalization of numerous costs, is the single goal of corporate governance. Only rarely is this narrow concept of efficiency challenged in Anglo-American economies. Thus, governance is measured from this model, and does not take account of other normative policy goals that create optimal wealth maximization, with the costs measured differently.

Ron Gilson has suggested that the cost of stability created by the bank-centred governance model is less adaptive efficiency.[81] He suggests that competitive success will require both "commitment" in terms of stability for workers and other investors, and "adaptability" to changing technology and markets. Yet these are often traded off in the search for efficiency. The governance challenge is to craft a model that balances these institutional considerations in order to achieve optimal governance strategies. As well, there are specific issues arising in emerging and transitional economies; in particular, complex issues regarding capital markets and relationships between these economies and developed nations and international lenders. These issues are too complex and diverse to be given adequate treatment here.

Thus, divergence within corporate systems creates different kinds of governance issues. What is common to a variety of structures, however, is that the interests of managers can diverge considerably from those of investors, where an investor is broadly defined as all those with an interest in the activities of the corporation. The outside investor frequently suffers from information asymmetries and inadequate resources to effectively monitor corporate activity. There is also a free-rider effect, where some shareholders benefit from others incurring the costs of monitoring. Too large a free-rider problem can result in inadequate monitoring of corporate decision-makers. Where there are poor regulatory practices, this creates potential for wealth expropriation by managers and controlling shareholders. Similarly, information

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[81] R.J. Gilson, "Corporate Governance and Economic Efficiency: When do Institutions Matter?" (1996) 74 Wash. U.L.Q. 327 at 341.

asymmetries prevent community members from properly monitoring for risk of environmental or consumer harms, or, in the case where harm has already been imposed, from successfully pursuing claims in tort against the actual decision-makers.

More recently, institutional investors, who are faced with less liquidity, have sought to exercise voice and vote in the governance of the corporation. This is most prevalent in the United States, but is increasing in Europe as domestic laws have freed up the ability of institutional investors to enter global capital markets.[82] Evidence of the rise in institutional investors in E.U. markets and a decrease in the percentage of holdings of the large banks means that these shifts in capital structures are likely to also result in shifts in governance structure.[83] The interests in corporate governance diverge not only within differing economies but also among the stakeholders in the corporation. Shareholders have differing investment timelines, different risk capabilities and different resources and information to engage in monitoring. Creditors, particularly senior lenders, have different kinds of governance concerns. Arguably, they have the bargaining power to extract both information and a risk premium in their negotiations for lending capital. However, this assumes that there is a regulatory and judicial framework in place to enforce contractual or securities violations.

The governance debate has resulted in considerable convergence towards a conceptual understanding of corporate governance as necessary to enhancing corporate performance, effectively monitoring activities of managers, and protecting shareholder rights. This debate and the resulting framework, however, have been largely situated within a structure of widely-dispersed share ownership that continues to characterize U.S. corporations. The governance debate has also been situated in the context of clear regulatory rules under securities and corporations legislation, comprehensive mechanisms for enforcement, an independent judiciary to enforce shareholder remedies, and a strong common law tradition of fiduciary obligation. Thus, much of Anglo-American scholarship focuses on the private law aspects of corporate governance because the relatively well-developed regulatory framework and strong independent judicial system is an operating assumption. Anglo-American scholars take for granted a well-defined system of ownership registration and property protection. Although there have been some notable failures in the North American governance regime, for the most part, corporations operate within a regulatory regime that minimizes the risk of such failures, and the regime has in place an infrastructure that will generally respond to the discovery of regulatory failures.[84] In such cases, the state will intervene and collaborate with the private sector to respond to the particular regulatory deficiency.

A key issue is whether other jurisdictions ought to import Anglo-American corporate governance norms and practices in a bid to attract global capital, and whether

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[82] Sarra, *supra* note 21at 386-94.

[83] For example, the merger of Daimler-Chrysler reduced holdings of the Deutsche Bank by 10% and increased the level of dispersed ownership, online: Daimler Chrysler <http://www.daimlerchrysler.com/index_e.htm?/investor/meeting2000/hvglossar_e.htm> (date accessed: 13 November 2001).

[84] For example, in response to the Bre-X scandal in Canada, a joint Toronto Stock Exchange/Ontario Securities Commission Task Force addressed Standards for listing mining sector corporations; Ontario, Toronto Stock Exchange/Ontario Securities Commission, *Setting New Standards: Recommendations for Public Mineral Exploration and Mining Companies* (Toronto: TSE/OSC, 1999).

capital investors will require such standards. For example, it has been suggested that developing and transitional economies should be allowed to shape their own governance systems for their emerging markets.[85] There is political and social resistance to wholesale importation of Anglo-American norms, and this resistance may or may not counter market pressure for convergence. Moreover, importing these norms and practices may not be effective in dealing with problems of corporate governance that differ from those to which the Anglo-American model responds. Nevertheless, pressure to adopt these norms may be applied by investors who will be reluctant to invest in corporations whose governance norms are unfamiliar.

IV. MARKET PRESSURES FOR CONVERGENCE

Path dependence theorists have explained why there will not easily be convergence in regulatory systems that influence capital markets and corporate governance. However, market pressure is creating a countervailing force, particularly for those economies seeking access to global capital markets. Convergence has been defined as the movement towards a common understanding and endorsement of the basic elements of effective corporate governance, including a legal framework that protects shareholder rights.[86] While the economic systems themselves may not closely converge, there is broader acceptance of the notion that there are key principles for effective governance that need to be adopted by nation states and their domestic corporations if they are to expect the enhanced flow of capital investment to their economies. Romano has observed that if domestic firms require capital, and additional debt is not an option, the global market for equity capital may produce a convergence in corporate law rules because outside investors will demand adequate protection of their investment in advance of investing capital.[87]

To date, convergence is taking the form of a movement towards market-based models. This is not, however, a purely market-based trend. While there are public regulatory changes to facilitate the development of securities markets in bank-centred economies, there have not been concurrent regulatory changes to facilitate the movement of foreign banks into the United States or other market economies. Thus, the current arena for competition for capital will be Europe and other economies where banks have played a significant role in governance.[88] The decisions by market economies to not allow freer competition in terms of laws regarding banks are clearly political and cultural choices that reflect a particular normative view of both securities and banking regulation. The current shifts in securities markets outside of North America should thus not be taken as pure market decisions in terms of efficient and fully competing

[85] J. Allen, "Code Convergence in Asia: Smoke or Fire?" (2000) Corp.Governance Int'l at 1, online: Global Corporate Governance Forum <http://www.gcgf.org/library/speeches/allenAsiaCnvrg.doc> (date accessed: 28 October 2001). Allen is the Secretary General of the Asian Corporate Governance Association (AGCA), founded in 1999 by business leaders of seven Asian economies.

[86] Millstein, *supra* note 22 at 4.

[87] *Supra* note 56 at 2.

[88] Visentini, *supra* note 2 at 848.

capital structures. Capital markets continue to be shaped by political choices.

For emerging and transitional economies, the need for global capital has created considerable market pressure for convergence of corporate norms. A recent Russell 20-20 survey of investor confidence in several Latin American countries revealed that the future flow of foreign capital into corporations in these countries is likely to be constrained until there are both state regulatory initiatives to enhance investor confidence and private sector initiatives to develop corporate governance practices that more closely converge with international norms.[89] These norms include protection of foreign shareholder rights, greater financial disclosure, regulated securities and lending markets, effective director oversight, and judicial systems that enforce these rights.

Thus, while regulatory change may be very slow, markets are creating some pressure for convergence of private property protection. The market pressure for convergence of corporate governance norms is most acute where there is risk of expropriation of investors' capital within economic systems with poor regulatory protection. It does not exist in the same way where there are serious concerns about oppressive labour practices or serious environmental harm. For example, in efforts to attract capital investment, Asian and other companies have listed on Anglo-American stock exchanges, and in doing so have been required to conform to the more rigorous disclosure requirements of these exchanges. In Asia, numerous states have also moved towards transparency measures, including independent board members and international auditing standards, as a means of regaining investor confidence.[90] Japan's 1998 Code of Best Practices addresses board size and function and an enhanced role for institutional shareholders. These are responses to the capital market, not to the need for a more integrated approach to global capital and labour markets.

The pressure for convergence will not necessarily result in the unquestioning adoption of Anglo-American governance norms. While some scholars suggest that convergence towards Anglo-American norms will enhance Japanese capital markets, Japanese legal scholars have suggested that the pressure for convergence is unlikely to lead to a wholesale adoption of the Anglo-American corporate governance model. Masafumi Nakahigashi observes that while there is a need to attract foreign capital to Japanese markets and thus to adjust the corporate law regime to meet international standards, there is a rigorous debate in Japan as to whether those standards should be American standards.[91] He suggests that Japanese corporate governance norms, such as lifelong employment and enhancing employee firm-specific skills, are still highly valued. Moreover, there is an increasing flow of American and other capital into Japanese markets with the knowledge that these structures and norms continue to be the operating paradigm in Japanese corporate governance. Thus, Nakahigashi suggests that

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[89] The Russell 20-20 is a non-profit group of 20 pension funds and 20 major money management organizations, investing US $1 trillion in capital, online: Dean LeBaron <http://www.deanlebaron.com/articles/yafei.html> (last modified: 4 October 2001).

[90] J. Allen, "Building Stronger Boards and Companies in Asia: A Concise Report on Corporate Governance Policies and Practices" (Asian Corporate Governance Association, H.G., China, January 2000), online: Global Corporate Governance Forum <http://www.gcgf.org/library.htm> (date accessed: 28 November 2001).

[91] *Supra* note 76.

the corporate governance and securities law reforms expected in the next two years are more likely to craft governance norms that respond to global capital markets, while continuing to promote existing norms that value workers' contributions and collaborative decision-making structures.

There may be market convergence in another sense. While Anglo-American scholars tend to be disparaging of the control exercised by banks in continental Europe, there are arguably efficiency gains in the monitoring of corporate managers. The Anglo-American corporation is facing a similar challenge in the growth of institutional investor activism, generally recognized as a positive trend in U.S. corporate governance. Like blockholders in bank-centred regimes, the institutional investor is an intermediary, in terms of being entrusted with the savings or equity investments of large numbers of people. Like banks, they have the information, resources and capacity to develop expertise to monitor corporate activity. Thus, in both Anglo-American and continental European regimes, concentrated investment provides both the incentives and the capacity to monitor performance. However, what is largely absent from the Anglo-American debate regarding institutional investor activism, is the issue of whether there is also some future risk of these investors extracting a control premium that is ultimately a risk to minority shareholders. While institutional investor activism is viewed as helpful in dealing with Anglo-American agency problems, there has been inadequate consideration of why this model is more desirable or efficient than reasonably successful bank-centred models in central Europe. Issues of risk capacity, agency costs and control premiums in this respect require further comparative study. Moreover, while institutional investors offer enormous potential to use their economic power to press for fundamental change in governance, to date, the activism has been aimed at more traditional governance reform.

While there is growing recognition that certain regulatory systems must be in place to facilitate movement of capital and provide exit mechanisms on firm failure, there are concurrent normative pressures to dismantle other regulatory frameworks in terms of environmental standards and social safety nets.[92] This is a deeply contested debate among scholars and policy-makers. There is also debate as to how market convergence will affect protections for stakeholders such as employees. Within this debate, workers are usually viewed as fixed capital claimants, with no interest in the corporation beyond wages and benefits owing. Thus, Anglo-American governance theory is pre-occupied with potential rent-seeking by employees and with the distributional effects of any governance structures that recognize and value workers as human capital investors. In part, this is because human capital investments are not properly accounted for in valuing inputs to corporate economic activity. Moreover, there is a normative assumption that competitive markets can externalize third party harms and do not need to take account of this in costing and making efficiency determinations. These assumptions have become key to the Anglo-American shareholder wealth maximization paradigm. Given increasing pressure to compete for global capital, much of it coming from Anglo-American investors, there is pressure on countries such as Germany, France and Italy to move toward the Anglo-American model, and as such, to rethink their recognition and protection of employees and other

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[92] Sarra, *supra* note 21at 385.

stakeholders.

It is no surprise, given the self-interest of capital investors, that market pressure for convergence of corporate governance norms has not been accompanied by concurrent market pressure to protect employees, small creditors or other stakeholders in these jurisdictions. The dismantling of regulatory barriers has accompanied the globalization of capital, product and labour markets in order to enhance the flow of capital. With the reduction in regulatory barriers, there are legitimate concerns regarding effects on other stakeholders.

V. THE OECD PRINCIPLES FOR CORPORATE GOVERNANCE

As noted in Part I, the OECD Principles for corporate governance are aimed at assisting governments in their efforts to improve the regulatory framework for corporate governance. They are organized around four key principles: shareholder rights and equitable treatment of shareholders; disclosure and transparency to enhance accountability; the role of other stakeholders; and the responsibility of corporate boards. The Principles make a compelling case for disclosure and basic shareholder rights, but fail to adequately address some of the key questions regarding shareholder activism, diverse shareholder interests and governance norms discussed above. While the Principles recognize the value of other stakeholder contributions, such as creditors and workers, and urge corporations to comply with stakeholder rights as recognized by law, they fail to articulate the reasons why these rights should be subject only to domestic laws while shareholder rights are paramount. The practical need to attract capital and the strong normative paradigm of shareholder wealth maximization combine to raise shareholder rights and remedies to universal principles of governance, without consideration of other models.

A. *Protection of Shareholder Rights and Equitable Treatment of Shareholders*

The OECD Principles expressly recognize the ownership of private property as a key means by which resources are used efficiently, and the need to protect those property rights under differing legal and political regimes.[93] They specify that basic shareholder rights include: the right to secure methods of ownership registration and the ability to convey or transfer shares; the right to obtain relevant corporate information on a timely and regular basis; the right to participate and vote in general shareholder meetings in person, by proxy, or other forms of voting in absentia; and, the right to elect board members and share in the profits of the corporation. This includes the right to be sufficiently informed and participate in decisions regarding fundamental corporate changes, such as amendments to corporate charter documents, authorization of additional shares, and extraordinary transactions. Shareholders should be given the opportunity to ask questions and place items on the agenda at general meetings, subject to reasonable limitations.[94] La Porta *et al.* have found a correlation between shareholder

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[93] Including the right to buy, sell and transfer shares, participate in profits, limit liability and some voting and disclosure rights, *ibid.* at 8.

[94] *Ibid.*

protection and developed external capital markets.[95] Mayer has observed that basic shareholder rights are preconditions for efficient financial markets in Europe because they encourage equity trading and the efficient running of corporations.[96] The Principles reflect these norms and practices.

The OECD Principles also suggest that markets for corporate control should be allowed to function in a transparent manner. Rules and procedures that govern the acquisition of corporate control in capital markets should be clearly articulated so that investors can make informed decisions based on their rights and remedies. Shareholders should be able to obtain information regarding voting rights attached to all classes of shares prior to purchasing shares, and changes to voting rights should be subject to shareholder vote. Insider trading and abusive self-dealing should be prohibited and those prohibitions enforced because such acts involve manipulation of capital markets. Directors and officers should be required to disclose any material interest in matters affecting the corporation. Transactions should occur at transparent prices and under fair conditions that protect the rights of all shareholders according to their class. Anti-takeover devices should not be utilized to shield managers from accountability or to impede the functioning of the market for corporate control.

The OECD Principles reflect norms that are self-evident in Anglo-American systems. To date, the shareholder rights paradigm that has dominated the discourse in Anglo-American market-based economies has not been universally applied. Part II identified some of the problems occurring internationally with basic shareholder rights, including regulatory failures, extraction of control premiums and limited minority shareholder ability to influence corporate decision-making. While markets for capital and for corporate control will create incentives for managers to improve corporate efficiency, codifying basic shareholder rights will reduce investment risk and transaction costs. The Principles call for equitable treatment of all shareholders, including minority and foreign shareholders. An important determinant of the degree to which shareholder rights are protected is the existence of cost effective legal mechanisms for dispute resolution and remedies. This is balanced with numerous devices to protect corporate officers from excessive litigation, particularly deference to business judgments.

The Principles thus enshrine important basic shareholder rights. However, they may fail to fully appreciate the diverse nature of shareholder interests, as discussed above. Controlling shareholders and blockholders do not face the same kinds of issues as minority shareholders regarding protection of their investments. The move to more liquid capital markets presents these investors with the problem of dilution of their equity and reduced ability to monitor managers. For widely dispersed shareholders, a concern is basic access to information and mechanisms for exit, since they are unlikely to have the information or resources to influence governance. Another operating assumption is that workers and small investors are mutually exclusive categories. Yet workers, other than those in contingent and secondary labour markets, are increasingly small equity investors, either through employee share ownership plans (ESOPs),

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[95] R. La Porta, F. Lopez-de-Silane & A. Shleifer, "Corporate Ownership Around the World" (1999) 54 J. of Fin. 471, online: National Bureau of Economic Research <http://papers.nber.org/papers/W6625> (date accessed: 28 October 2001).

[96] *Supra* note 47 at 3.

individual investments, and as contributors to pension funds. Workers investing in their own firm are more vulnerable to loss of both human capital and equity capital investments, and have less ability to diversify their risks. Investors with sizeable shareholdings such as institutional investors, face uncertain delineation of their rights when considering investment in other jurisdictions. Becht points out that "enhancing shareholder value" has different meanings depending on the context; shareholder value in the European context means maximizing value for minority and foreign shareholders, frequently contrary to the will of strong controlling blockholders, whereas shareholder value in the U.S. context means accountability by strong managers to weak shareholders.[97] While these values are addressed at the margin, the Principles do not suggest any structural changes that would better accommodate this diversity of interest, nor do they address what values are or should be key, given the range of equity investor interest and capacity for risk and return.

While the Principles endorse limited shareholder participation, they fail to promote a more active voice in governance, whereby investors articulate their governance priorities and preferences. The "right to influence the corporation" is essentially viewed as including default rights, such as participation at general shareholder meetings, board elections and voting on fundamental transactions. The Principles caution that, as a practical matter, corporations cannot be managed by shareholder referendum, and that managers should be left to exercise their business decisions without shareholder interference.[98] Although the Principles recognize that shareholders should be able to bring forward proposals, they recommend a pre-condition of a specified number of shares and then broad discretion by managers to prevent the proposals from being placed on the agenda. This latter restriction is aimed at preventing frivolous shareholder proposals. However, it also makes a normative choice regarding which kinds of shareholders will have participation rights; for example, institutional shareholders, blockholders and controlling shareholders, many of whom already influence corporate decision making. This in turn may have distributional consequences. It does not allow individual investors to bring forward proposals because they do not have the resources and information to adequately monitor or to solicit support from across a broad range of shareholders. For corporations with blockholding or controlling shareholders, the Principles add little to these shareholder rights, other than transparency, and they do not address the problem of such shareholders extracting a control premium.

Investor protection is an important public policy goal, even more so now that technological developments allow small investors to participate over the Internet in rapidly changing securities markets. The Principles do not really address the impact of such change on global capital markets or the protections that may be required for these investors. Interestingly, the Principles do recommend greater use of technology in shareholder voting as an aid to foreign shareholders. While this recommendation would assist with transparency, it is not reconciled with the retention of tight controls over the scope of shareholder participation that are advocated by the Principles. Although there are practical barriers to shareholder activism, its potential merits further study. While managerial accountability is measured by shareholder value, the role of shareholders is

[97] *Supra* note 27 at 12.

[98] OECD, *supra* note 1 at 12.

limited in the Principles. Shareholder activism is increasingly an issue in the United States and Europe, conflicting with traditional deference to business judgment. Shareholder proposals tend to be related to managerial performance, social and environmental issues, and are generally an expression of choices regarding governance of the corporation.[99] For example, in Germany, there is an increase in shareholder proposals and counter-proposals filed in opposition to management initiatives, aimed primarily at ensuring that the corporation is a "good global citizen" in the manner in which it accounts for environmental protection and labour standards, in addition to long-term shareholder wealth maximization.[100] In the U.S., there has been considerable growth in institutional shareholder activism, in which pensions and other funds have intervened directly in governance.[101] In Canada, Labour Sponsored Investment Funds conduct occupational health and safety, environmental and human rights audits prior to investing, and monitor corporate decisions on these matters on an ongoing basis. These reflect shareholder preferences, and such preferences may vary considerably given the source of equity funds, any political or social direction given by the constituting documents and the control structure of the institutional investor. While the Principles address shareholder rights issues in terms of traditional governance structures and unaccountable managers, they do not address current issues raised by investor activism. It would have been helpful to consider the tension between the separate legal personality of the corporation and new activism by shareholders.

The share-related rights in the Principles also do not squarely address many of the above-cited problems in market economies, specifically, the problems faced by minority shareholders confronted by controlling shareholders or blockholders. While this can in part be remedied by effective corporate boards, the Principles do not address the issue of blockholder or controlling shareholder control of board seats and board decision making. If boards are structured in such a manner as to act in the best interests of the corporation, and they include truly independent directors, then it is likely that the rights of minority shareholders enshrined in the corporation's charter documents will be somewhat protected, and that issues such as fundamental change will be brought to shareholders for approval. Such independence would help to prevent controlling shareholder or insider self-dealing transactions that harm the equity holdings of shareholders.

The OECD Principles conclude that optimal capital structure is best determined by officers and the board, and all that is required is disclosure of the structure. Yet there continues to be considerable debate globally about the efficacy of dual class and other voting shares, characteristic of closely-held corporations, where capital is needed but existing equity owners wish to retain control. There are diverse kinds of shares with different kinds of voting power, based on straight allocation of voting rights or on rights that are activated on particular control transactions. They have enormous implications

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[99] State of Connecticut, Office of the Treasurer, *Global Proxy Voting Policies* (Connecticut: Office of the Treasurer, 2000) at 36, online: State of Connecticut <http://www.state.ct.us/ott/proxyvoting/globalvotingpolicies.PDF> (date accessed: 1 November 2001).

[100] *Ibid.* at 36-39.

[101] See *e.g.* California Public Employees' Retirement System, online: CalPERS <http://www.calpers.ca.gov/default.htm> (date accessed: 13 November 2001).

for the protection of equity capital investors, and distributional effects in terms of the exercise of voting power in favour of controlling interests to the detriment of minority shareholders. Yet the Principles miss a valuable opportunity to engage in a debate regarding the relative merits and risks of various share structures. Similarly, the Principles are silent on the question of pre-emptive rights, again only requiring disclosure. With pre-emptive rights, on the issuance of new stock, existing shareholders are given the first opportunity to purchase additional shares in proportion to the amount of shareholdings they have. They protect existing investors, but act as a deterrent on control change and, in particular, as a barrier to foreign investors influencing governance. Again, the failure of the Principles to engage in a risk/benefit analysis of such mechanisms leave them thin on shareholder rights.

Thus, the Principles advocate basic shareholder rights that largely reflect Anglo-American governance norms. While these will facilitate access to global capital and the development of deeper and more liquid securities markets, they are thin in their analysis of very timely concerns about shareholder activism and rights within diverse economic systems. They also do not fully account for more bank-centred models of governance or hybrid models that may require a more complex understanding of shareholder rights. As is evident in section C below, they also fail to explore the intersection between shareholder interests and those of other stakeholders with investments in the corporation.

B. *Disclosure and Transparency of Financial and Non-Financial Information*

A key issue for global capital is how to assess risk and potential return when the corporation is operating in another country with different regulatory and cultural norms. The disclosure problem squarely raises the issue of the extent to which managers and controlling shareholders should be accountable to minority and foreign investors. Transparency was historically less of a concern in closely-held corporations because controlling shareholders monitored managers. However, with the growing diversity of capital structures, there are new risks in terms of accountability. Thus, disclosure is key to monitoring. The most valuable contribution made by the Principles to the governance debate is in terms of their disclosure and transparency recommendations.

The OECD Principles recommend that the corporate governance framework should ensure timely and accurate disclosure on all material matters regarding the corporation, including the financial situation and operating results, corporate objectives, performance, ownership structure and voting rights, membership of the board, key executives and their remuneration, governance structure and policies of the corporation. The Principles also recommend that this disclosure include material foreseeable risk factors, as well as material issues regarding employees and other stakeholders. This is to facilitate investors' assessment of the stewardship of the corporation. Transparency includes the disclosure of information such as self-interested transactions and cross-shareholdings, where there is potential for conflicts of interest. Information preparation should be undertaken by independent auditors in accordance with international accounting standards. The Principles recommend that there be channels for fair, timely and cost-efficient dissemination of information.[102]

Disclosure is a key feature of liquid capital markets, allowing corporations to attract and retain capital, and allowing investors to influence corporate behaviour by exit. The OECD suggests that disclosure of corporate objectives should include policies relating to business ethics, environmental and other public policy commitments, allowing investors to evaluate the relationship of the corporation with the communities in which they operate.[103] Such disclosure is important to investors concerned with "ethical investing", although it only facilitates exit, not voice. It is difficult to influence such corporate policies solely through exit, because the market will respond to unethical practices only if the practices seriously detract from shareholder value and only if managers perceive that such exit is linked to shareholder dissatisfaction with particular practices.

Disclosure and transparency requirements allow shareholders to monitor the use of their equity capital, enhancing board accountability mechanisms. As noted above, many shareholders do not have the resources to use the information to effectively monitor their investments. However, institutional investors, such as pension funds, are increasingly likely to use these transparency guarantees to monitor performance, and then influence corporate governance by voice or exit, signalling to other investors failures in governance. Pension funds now hold more than 25% of equity in U.S. corporations.[104] The interests of pension funds may align with small shareholders because they represent the interests of many individuals and thus are likely to press for good governance.[105] Mutual funds and other institutional investors are likely to take advantage of reduced barriers to information exchange through the internet. As a result, transparency and disclosure may be necessary to effectively compete in global capital markets. As noted in Part III, there is already some market convergence in this respect.

Notwithstanding the valuable contribution the Principles make to the transparency debate, there are further disclosure issues not addressed by the Principles that need to be developed. For example, current investor education is aimed at the prevention of fraud and enhancement of investing skills, with little or no attention to skills that would allow investors to assess, invest or act (through exit or voice) based on their own social and political preferences.[106] James Fanto argues that institutional investors could join forces with individual investors to promote corporate morality and agent morality. Disclosure norms and fiduciary obligations rarely address normative issues such as treatment of employees or tort claimants, thus, education is needed so that investors can understand the importance of business and governance norms and can appreciate collective action possibilities.[107] To this, I would add that investor education is required in terms of appreciating the distributional consequences of particular

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[102] OECD, *supra* note 1 at 8.

[103] *Ibid.* at 20.

[104] S. Nesbitt, "Long-Term Rewards From Shareholder Activism: A Study of the CalPERS Effect" (1994) 6 J. Applied Corp. Fin. at 75.

[105] Becht, *supra* note 27 at 61.

[106] J.A. Fanto, "Investor Education, Securities Disclosure and the Creation and Enforcement of Corporate Governance and Firm Norms" (1998) 48 Cath. U. L. Rev. 15 at 17.

[107] *Ibid.* at 25.

governance models. The Anglo-American paradigm suggests that consideration of stakeholder interests has distributional consequences that detract from shareholder wealth maximization. While this is true, it ignores the fact that Anglo-American governance also makes continual distributional decisions in terms of diverse shareholders and in terms of externalities. Investor education in this respect would facilitate more informed investment choices and might ensure that market pressures more accurately reflect diverse investor preference regarding governance practice.

"Exit" can send uncertain messages through imperfect markets to managers, particularly in regard to issues of social responsibility or environmental harms resulting from corporate actions.[108] Shareholder voting could provide shareholders with an opportunity for a wider range of expression of preferences and ultimately make managers more accountable. In this context, voting on social responsibility issues is preferable to exit and may provide a more effective means of communicating investor preferences. One possibility suggested by Dallas is development of a system of voting rights based on the concept of constituency.[109] Where voice instead of exit is effectively used, the power imbalances between investors and managers would shift.

C. *The Role of Stakeholders in Corporate Governance*

The Principles suggest that the corporate governance framework should "... recognize the rights of stakeholders as established by law and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises."[110] The Principles acknowledge that corporate governance is concerned not only with the flow of external capital to the corporation, but also with encouraging stakeholders to "... undertake socially efficient levels of investment in firm-specific human and physical capital."[111] The Principles suggest that creditors play an important role in some governance systems, and that employees contribute to long-term success of the corporation, acknowledging that this role varies considerably among nations due to laws, practices and market forces.

However, the Principles do not contain any analysis as to why these interests should only be recognized where laws require such protection. While the Principles ostensibly recognize corporate governance systems in which workers and other stakeholder interests are more highly valued and protected, they are assessed largely in terms of disclosure to equity investors to enhance their ability to make investment decisions. Stakeholders can be broadly defined as those with an interest in the corporation, including creditors, employees, suppliers, consumers, and local governments. Yet the Principles do not analyze the nature of governance structures that would best enhance stakeholders' firm specific investments. Performance incentives for employees are applauded with no concomitant rights attaching to their human capital investments. While participatory mechanisms such as worker representation on boards, employee stock ownership programs (ESOPs) or other profit-sharing strategies vary, there is no endorsement of any principles except to suggest disclosure where such

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[108] Dallas, *supra* note 9 at 23.
[109] *Ibid.* at 24.
[110] *Supra* note 1 at 18.
[111] *Ibid.*

stakeholders are allowed to participate. This can be contrasted with the more careful analysis of protection of shareholder interests in the Principles.

There are highly divergent approaches to workers as investors in the corporation. The Anglo-American paradigm has been that employees do not have investments in the corporation greater than the wage/effort bargain, and thus corporate decision-makers should not be accountable to them. Only more recently is there some recognition that the nature of human capital investment may be specialized or beyond fixed capital claims such that their interests need to be accounted for in governance of the corporation.[112] In countries with co-determination models of corporate governance, such as Germany, human capital contributions are recognized and valued. German works councils situated at the production level and joint supervisory boards exercising corporate oversight both have the stated objectives of working collectively for the good of both the enterprise and the employees, imposing a collaborative model.[113] While another view of this model is that employees continually engage in rent-seeking at the supervisory board level, such that managers merely align their interests with controlling shareholders and bypass the influence of workers on boards, there appears to be inadequate data to support the conclusion that such rent-seeking is the operating paradigm. Co-determination as a conceptual model thus requires further study, in order to be able to draw on elements of collaboration that may assist in protecting the interests of stakeholders in the governance of the corporation, and may be amenable to adapting to change in rapidly evolving markets. The Principles fail to address this.

Similarly, the analysis of the governance role of creditors is seriously under-developed. As noted in Part II, there are both advantages and disadvantages to this role. Failure to articulate principles that would encourage an effective governance role for creditors is a major weakness in the Principles. Moreover, the governance role of creditors is significant not only for German and Japanese governance models, but also in the insolvency context in Anglo-American markets. When a corporation is financially distressed, Anglo-American courts have held that corporate officers acquire a fiduciary obligation to consider creditors' interests as residual claimants to the value of the corporation's assets.[114] If the corporation has the potential to become viable, banks and other senior lenders are key players in the corporate restructuring. Often they acquire board membership or extract other governance change to allow for monitoring in exchange for their support of the workout. The Principles fail to address these aspects of governance in terms of the role of stakeholders, in this case, creditors of the insolvent corporation. Given the unprecedented number of firm failures internationally in the past decade, this was another missed opportunity to advance the governance debate.

Moreover, the Principles underplay the powerful role of financial institutions

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[112] Sarra, *supra* note 21 at 418-429; M.M. Blair, *Ownership and Control: Rethinking Corporate Governance For the Twenty-First Century* (Washington, D.C.: The Brookings Institute, 1995).

[113] *Mitbestimmungsgesetz*, 1996, 5 Commercial Laws of Europe 483-91(1982); *Betriebsverfassungsgesetz* (Works Constitution Act), as am. February 2001, 87 ff, 94-96 ff, 111ff, Germany.

[114] J. Sarra & R. Davis, *Director and Officer Liability in Corporate Insolvency* (Toronto: Butterworths) [forthcoming in 2001].

in shaping corporate governance policy in a globally integrated economy. This is particularly the case with respect to the role of international monetary funds and centralized financial institutions in emerging or transitional economies.[115] These institutions have had a powerful influence on the debate regarding when and where state regulatory intervention is necessary or beneficial, and where it "interferes" with the free flow of capital. It has shaped the debate regarding protection of equity capital as a fundamental principle, to the exclusion of consideration of other kinds of investments, and has an enormous distributional impact on economic wealth.[116]

Some scholars have observed that corporate limited liability specifies a division of value between shareholders and other claim holders such as tort claimants, consumers, suppliers and other creditors. Limited liability can induce agency costs between capital and other claim holders, which in turn can induce insiders to make sub-optimal investment choices regarding the welfare of all claim holders.[117] This point is key to the stakeholder debate.

Even within the Anglo-American governance paradigm, there has been some small recognition of stakeholder interest. In the United States, more than 25 states have enacted "constituency statutes," which allow corporate officers to consider the interests of non-shareholding constituencies such as workers, suppliers, and communities in which the corporation is located. This has sparked rigorous debate among legal scholars, based on concerns about the lack of accountability of managers and the inefficient decision-making. While these statutes have accorded directors and officers discretion to consider these interests, they do not accord any substantive or procedural rights to the stakeholders that the statutes are aimed at.[118] Scholars have observed that such statutes have not altered what corporate officers already do in decision making, specifically, to consider the interests of other stakeholders when pursuing shareholder wealth maximization.[119] While this may be a valid observation, it does not address the accountability issues that arise with this discretion and the lack of enforceable rights under such statutes. Corporate officers are left to determine what are externalities, without according rights or remedies to those who bear the costs of these decisions.

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[115] J. Wolfensohn, "A Proposal for a Comprehensive Development Framework (A Discussion Draft)" (1999), online: World Bank <http://www.worldbank.org/cdf/cdf-text.htm> (date accessed: 2 November 2001); World Bank, *World Development Report 1997: The State In a Changing World* (New York: Oxford University Press for the World Bank, 1997); J.E. Stiglitz, "More Instruments and Broader Goals: Moving Toward the Post-Washington Consensus" (United Nations University World Institute for Development Economics Research (UNU/WIDER) Annual Lectures 2, Assembly House of the Estates (Säätytalo), 7 January 1998), online: UNU/WIDER <http://www.wider.unu.edu/publications/publications.htm> (date accessed: 2 November 2001).

[116] United Nations Development Program, *Human Development Report* (1999), online: UNDP <http://www.undp.org/hdro/99.htm> (date accessed: 28 November 2001).

[117] K. John & L. Senbet, "Corporate Governance and Board Effectiveness" (1998) 22 J. Bank. Fin. 371 at 398. They suggest research is needed into the design of internal governance mechanisms that reduce managerial, debt agency and social agency costs.

[118] *Ibid.*

[119] D.G. Smith, "The Shareholder Primacy Norm" (1998) J. Corp. L. 277 at 290; W.J. Carney, "Does Defining Constituency Matter?" (1990) 59 U. Cin. L. Rev. 385; E.W. Orts, "Beyond Shareholders: Interpreting Corporate Constituency Statutes" (1992) 61 Geo. Wash. L. Rev. 14.

The Deputy Secretary General of the OECD recently urged transitional economies to reform their corporate governance mechanisms to create flexible labour markets that allow corporate restructuring, arguing that such strategies should be accompanied by a commitment to efficient social safety nets, educational opportunities, and strategies that take into consideration employees.[120] The statement ignores a global trend towards privatization and the dismantling of regulatory safeguards and social safety nets. Neither government nor private corporate actors have done a particularly effective job in North America of creating effective safety nets, or of recognizing the inputs made by workers and creditors in the corporation.[121] Corporations have not been required to account for externalities. As this capital moves outward, there is pressure to adopt this "shareholder wealth maximization/disregard externalities" approach. With the increase in global capital markets, there is increasing pressure to externalize costs of restructuring and environmental sustainability.

Thus, another missed opportunity in the Principles is the failure to consider optimal governance structures that would allow for fuller recognition of different investments in the firm. There is a lack of empirical data on the contributions that workers currently make to governance. Legal scholars frequently assume that shareholders and employees always have competing claims, such that managers will exploit their differences, forming alliances with one group or the other. Yet there has been little study of how one might craft an optimal structure in which worker and shareholder interests align.

Corporate initiatives in establishing worker participation models also present a double-sided dilemma. On the one hand, with diverse views given a governance role, decision-making can be enhanced and productivity gains made. However, such problems can also act to undermine workers' investments in the firm: either by sanctioning those workers whose skill sets do not include innovation; or because the energy, ideas and co-operation is extracted based on a deferred compensation scheme, and then managerial opportunism acts to expropriate the value- added in terms of layoffs during restructuring. Equity investments by workers has the potential to reduce some risk of harm if workers have a meaningful decision-making role, but this must include a recasting of corporate goals so that shareholder wealth maximization is only one objective of corporate activity. For example, in one Canadian corporation, the corporate constituting documents contain an express direction to corporate officers to: "make as top priority, the creation of an organization that is dedicated to economic security and empowerment of employees and to continuing improvements in productivity and quality."[122] By this recasting of the definition of "in the best interests of the corporation," corporate decision-making that simultaneously advances these objectives (so often treated as irreconcilable in corporate decision-making) will be compatible with the fiduciary obligations of the directors. This definition also gives express normative direction to corporate decision-makers, articulating a clear benchmark against which to

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[120] S. Kondo, "Address" (First Meeting of the Latin American Corporate Governance Roundtable, Sao Paulo, Brazil, 26-28 April 2000), online: OECD <http://www.oecd.org/pdf/M00015000/M00015378.pdf> (date accessed: 2 November 2001).

[121] Sarra, *supra* note 21 at 386-91.

[122] *Ibid.* at 429.

assess their actions.

Berle and Means, as early as 1932, raised the issue of who a corporation should be run for, suggesting that the modern corporation should serve society as a whole, not merely owners and managers.[123] Berle argued that corporate decision makers should be responsible for satisfying the needs of investors, workers and the aggregated community. He cautioned, however, that the emphasis on corporations existing for the sole purpose of shareholder profit could not be abandoned until there was a "... clear and reasonably enforceable scheme of responsibilities to someone else."[124] Dodd argued that corporations are the backbone of the organization of economic power and that they have corresponding public responsibilities.[125] Sixty years later, we continue to have an ill-defined scheme of corporate responsibility in regard to such stakeholders.

The Principles, based on the manager/shareholder paradigm of governance, have failed to recognize that many parties, in addition to shareholders, have an interest in the success of a corporation. Creditors and workers have firm-specific investments and varying degrees of claims, both fixed and residual, depending on their arrangements with the firm and its solvency. Employees, in particular, contribute human capital to the enterprise, as well as any additional equity capital they may have invested through share purchase or pension plan investments. Traditional governance mechanisms provide inadequate protection against the expropriation of these investments.

As discussed above, efficiency needs to be recast to encompass maximizing firm efficiency having regard to diverse investments in the firm. Rather than seeking the "most efficient" course of action, traditionally and normatively defined as shareholder wealth, corporate decision-making ought to encompass a choice between competing efficient decisions, having regard to competing investor interests. Thus, efficiency can be defined in the context of corporate goals, with those goals being recast. This would lead to a more even-handed approach to both efficiency and risk in terms of key stakeholders in the firm. This redefinition would recognize that the starting point of measuring efficiency is to consider what interests and investments are at stake in the corporation, and to acknowledge that there are competing efficient decisions that value and protect those investments.

Crucial to the redefinition of the goals of corporate governance is the recognition that the current Anglo-American governance model of wealth maximization is founded on assumptions that are normative choices. Once the normative underpinnings of this model are exposed, then the decision to exclude human capital and other stakeholder investments becomes much less compelling. Governance norms could include a requirement that directors and officers act in the best interests of the corporation to maximize enterprise wealth, having regard to all contributors of equity capital, debt and human capital.[126]

This redefined duty would require managers to consider alternatives in

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[123] A.A. Berle & G.C. Means, *The Modern Corporation and Private Property* (New York: Commerce Clearing House, 1932) at 355-56.

[124] A.A. Berle, "For Whom Corporate Managers *Are* Trustees: A Note" (1932) 45 Harv. L. Rev. 1365 at 1367, 1372.

[125] E.M. Dodd, "For Whom Are Corporate Managers Trustees?" (1932) 45 Harv. L. Rev. 1145 at 1149.

[126] *Ibid.*

decision-making which might enhance a broader set of interests. It would assist in the enforcement of implicit employment contracts by making managers less vulnerable to challenge by short-sighted shareholders. Just as trustees in a fiduciary relationship are required to be even-handed in their decision-making regarding apportioning costs and benefits amongst beneficiaries, so too would managers be required to be even-handed in their decision-making with respect to diverse stakeholders as the beneficiaries of the duty, and to consider the effects on all investors, not just equity investors. Access by diverse stakeholders to oppression remedies and the ability to bring derivative actions on behalf of the corporation would increase the accountability of corporate officers. As with cases currently brought by minority shareholders, the courts only grant remedies under these provisions where corporate officers have acted in an oppressive or unfairly prejudicial manner, or where circumstances warrant approving a shareholder derivative action on behalf of the corporation. Thus, the combination of enforceable rights and judicial deference to business judgments would allow a measure of freedom in decision-making but protect against expropriation of equity, debt and human capital investments or the infliction of harms that are unfairly prejudicial to those interests. The Principles fail to address these issues, notwithstanding the existence of models among its member states that include some of these normative choices.

The Principles also do not address the intersection of shareholder interests with those of other investors such as workers. Investors can adopt governance strategies that align with the interests of these stakeholders where possible. For example, the State of Connecticut, in adopting its Global Proxy Voting Policy, has concluded that it will vote for shareholder proposals that create good corporate citizens while enhancing long-term shareholder value; and it is in favour of non-strategic disclosure, particularly where it appears that the corporation has not adequately considered the impact of a particular action on shareholders' social and environmental concerns.[127] The following factors will be considered in determining support for a proposal: the impact on short and long term share value; the percentage of earnings and assets affected; the reputational issues and vulnerability to boycott; the negative impact on workers and communities; whether government action is more appropriate; whether the company has already attempted to address the particular issue; industry norms; and, whether the matter is more appropriately left to the board. Thus while the threshold for support of such shareholder proposals appears relatively high, it nevertheless indicates that there can be principles that guide decision-making and allow for alignment of interests with other stakeholders. While the Policy recognizes that there may be some job losses due to efficiency gains, particularly with mergers or acquisitions, it will not support transactions that unnecessarily eradicate employment and economically harm communities. Equally, it will not support cross-border mergers that diminish basic labour standards.[128]

Recognition of such a model for corporate governance in the Anglo-American context may be slow given the dominance of the shareholder wealth maximization model. However, the OECD member countries already have different governance models that potentially could encompass a duty to take into account the interests of <u>all</u> investors. It is disappointing that the OECD restricted the Principles to merely

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[127] *Supra* note 98 at 36.
[128] *Ibid.* at 22.

recognizing their existence, rather than recommending the adoption of a broader duty to investors beyond shareholder wealth maximization.

D. *Responsibilities of the Board of Directors*

The OECD Principles stop short of addressing key issues such as the factors that would require corporate boards to take into account the interests of all investors and the existence of problems in corporate governance outside of the classic weak owners/strong managers paradigm of Anglo-American ownership structures. Although the Principles acknowledge that in some countries corporate boards are required to act in the best interests of the corporation, taking into account shareholders, employees and the public good, they fail to endorse such models or to fully explore their contribution to effective capital markets.

Agency cost theory seeks to ensure that managers do not abuse the power they have acquired as the result of separation of ownership and control.[129] Agency theory dominates the Anglo-American governance debate and is reflected in the Principles. Corporate governance is aimed at controlling managerial abuse while minimizing agency costs associated with this, such as monitoring and prevention.[130] Agency cost theory relies on markets to determine board composition and to discipline managers, and the board's role is to improve financial performance for shareholders through reduction of agency costs. The aims are primarily the protection and promotion of shareholder rights, reduction of information asymmetries, cost-effective monitoring, and encouragement of better governance through the market for corporate control.[131]

The Principles recommend that boards should fulfil key functions such as reviewing and guiding corporate strategy, risk policy, annual budgets and business plans. Boards should also set performance objectives, monitor corporate and managerial performance, oversee major capital expenditures, be engaged in the recruitment and selection of key executives, and overall succession planning. Boards should monitor a number of functions, including: board remuneration practices; board nomination process; potential conflicts of interest of managers, board members and shareholders; integrity of the corporation's accounting, financial and audit reporting systems; the process of disclosure and communications; and effectiveness of the governance practices. These are important reforms to boards that recognize their contribution to effective governance. They are also reflective of the governance changes that have occurred in Anglo-American systems in the past decade.

In a further attempt to deal with perceived agency problems, the Principles recommend that the boards be able to exercise objective judgement on corporate affairs independent of managers. Recognition of power imbalances between managers, inside directors and outside directors, requires reduction of information asymmetries, time allowed for their responsibilities, and sufficient independence of non-executive board

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[129] E.F. Fama & M.C. Jensen, "Separation of Ownership and Control" (1983) 26 J. L. & Econ. 301 at 315; O. Hart, "An Economist's View of Fiduciary Duty" (1993) 43 U.T.L.J. 299 at 303.

[130] Blair, *supra* note 112 at 97-98; A. Belcher, "The Invention, Innovation and Diffusion of Self-Regulation in Corporate Governance" (1996) N. Ir. L. Q. 322 at 325.

[131] Mayer, *supra* note 47 at 6.

members to allow for independent judgement. This recommendation flows from widespread acceptance of the notion that independent or outside directors enhance board performance.[132] Although there appears to be some question as to whether boards with a majority of independent directors actually enhance corporate governance, studies have indicated that having a moderate number of inside directors on a largely independent board can enhance profitability and create a more optimal balance of skills, information and knowledge.[133]

However, the Principles do not offer any resolution of the "strong blockholders, weak managers" paradigm that exists in some of the OECD countries, discussed in Part II above. In particular, the they are silent on the subject of fiduciary obligation of directors. Common law jurisdictions generally have well-developed notions of fiduciary obligation by corporate directors and officers, developed to fulfil incomplete contracts between shareholders and the corporation.[134] The combination of the common law, and its subsequent codification in statutes, acts as another check on the activities of corporate officers. In contrast, European and other civil law countries do not have a developed notion of fiduciary obligation, in part because obligations were already codified, and in part because of the strong monitoring influence of blockholders and controlling shareholders. For example, in Germany, there has been little development of the notion of fiduciary obligation toward minority shareholders. As a result, there are few limits on the ability of controlling shareholders to act to the detriment of minority shareholders, and minority shareholders lack effective remedies.[135] Scholars have suggested that it is important to have mandatory fiduciary obligations under corporate law.[136] Yet the Principles fail to take the opportunity to explore this debate, or to assess the relative merits or problems associated with imposition of such obligations.

Anglo-American theorists suggest that diverse shareholders are vulnerable to co-determination boards because they are worker-dominated and create managerial opportunism in bypassing the board. However, what has not really been explored is the fact that the powerful alliance of blockholders and managers pre-dates statutorily imposed co-determination, and that worker participation on boards was a structural response to this alliance. The fact that there has not been a shift in the power balance does not necessarily mean that the model could not effectively respond to concerns regarding effective board oversight, perhaps in combination with the development of a fiduciary responsibility of directors and officers towards shareholders and other investors. The OECD Principles present an underdeveloped conceptualization of board theory.

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[132] L. Lin, "The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence" (1996) NW. U. L. Rev. 898 at 915.

[133] S. Bhagat & B. Black, "The Uncertain Relationship Between Board Composition and Firm Performance" (1999) 54 Bus. Law. 921 at 922, 950.

[134] R.J. Daniels & E.J. Waitzer, "Challenges to the Citadel: A Brief Overview of Recent Trends in Canadian Corporate Governance" (1994) 23 Can. Bus. L. J. 23 at 28.

[135] R. La Porta *et al.*, "Legal Determinants of External Finance" (1997) 52 J. of Fin. 1131.

[136] J.N. Gordon, "The Mandatory Structure of Corporate Law" (1989) 89 Colum. L. Rev. 1549 at 1555.

VI. CONCLUSION

The debate regarding optimal corporate governance principles, when applied to the diverse economic, capital and management structures implicated in international corporate activity, is at a nascent stage. It is accompanied by private law and capital market pressure for convergence. However, it is far from clear that "efficiency" in corporate governance can be achieved through an unquestioning reproduction of the Anglo-American governance model throughout the world. There are two reasons for this lack of clarity. First, the Anglo-American model suffers from its own problems internally. Within the model there is no agreement on whether "efficient" shareholder wealth maximization is short or long term, and it sanctions the creation of "externalities", for example, costs of corporate activity imposed on those outside of the corporation. In turn, these externalities raise a question as to why those bearing the costs do not have their interests considered in these corporate decisions.

Second, the model and its various features were a response to highly diversified share ownership and the correspondingly strong role played by managers in corporate governance. Other economies have very different ownership structures, with many corporations being controlled by alliances of strong blockholders and weak managers, leaving minority shareholders vulnerable to other shareholders' actions. While Anglo-American corporate governance is primarily concerned with controlling the agency costs of having managers act on behalf of diverse shareholders, that of other countries may be more concerned with managers acting even-handedly towards all shareholders and not favouring the interests of strong blockholders. While the Principles refer to this issue under the shareholder recommendations, they fail to consider governance structures that would ensure this shift in emphasis from agency costs to even-handed treatment.

They do highlight the debate regarding the reconciliation of diverse corporate structures and activities with growing global capital markets. The principles of transparency, accountability, fairness and responsibility appear to have wide application. From the viewpoint of an observer situated in North America, many of the principles seem to be self-evident and necessary components of a well-regulated corporate system that encourages and enhances investment. Yet as is discussed here, while they provide a useful starting point, there remains a considerable gap in our understanding of how these principles would translate into the diverse governance structures that currently exist. Equally, while the OECD has suggested that it has resisted endorsement of one type of corporate governance structure, the Principles are remarkably close to those that shape Anglo-American governance structures and theory. That this reflects the dominant market economy model is no surprise. While the Principles purport to recognize the divergence of corporate structures and diverse economies, the normative pressure for convergence is based largely on an assumption that the convergence will reflect the Anglo-American model as the most highly developed regulatory framework for capital markets. At the same time, they fail to fully account for trends such as shareholder activism.

The Principles recognize that there are both public law and private law aspects to corporate governance. This is an important contribution to the debate and makes more explicit a number of the operating assumptions in Anglo-American regulation of securities and protection of equity capital investors. However, within that recognition, the Principles do not really address the inherent tension between the public and private law aspects. For example, on the one hand, regulatory reforms are sought to facilitate the global movement of capital by ensuring protection of equity interests, particularly foreign capital and minority investors, in terms of recognition and enforcement of property rights. Regulation is also sought in terms of importing international accounting and auditing standards to enhance protection of financial institutions and other investors. On the other hand, deregulation is sought to "free up" labour markets, to encourage free trade and generally discourage regulation that inhibits investment. Thus, regulation is sought to facilitate the global movement of equity capital while the same considerations are not part of the debate for human capital investors. These inherent tensions, and the failure of the OECD principles to address them, stem from the underlying assumptions that the optimal approach to a globally integrated economy is to maximize efficiency by facilitating the ability of corporations, investors and lenders to compete in global capital markets. While there is no doubt that such competition is an essential prerequisite for continued economic growth, it may cast the paradigm too narrowly. This is illustrated by the definition of efficiency discussed above and the operating assumption that efficiency is enhanced by externalizing costs wherever possible. Thus only costs internal to the corporation are measured in determining efficiency, primarily through the measure of return to shareholders. Yet a model that suggests that capital, if given free movement and protection of property rights will move to the highest use, ignores a number of market and other realities. It completely bypasses the debate regarding why property in this context is a higher-valued commodity than human capital or other investments. These are deeply embedded normative notions that have distributional consequences without ever being explicitly acknowledged. Moreover, those with the resources and interest in promotion of market economies have the resources to champion the debate.

The international debate regarding optimal corporate governance practices seems to be leading to its own convergence of opinion that no one system of governance is optimal, because of the diversity and complexity of ownership structures. However, within that consensus there continues to be a divergence of opinion regarding what action is required by private parties to enhance governance, and whether market convergence will pre-empt policy debate on principles for corporate governance. It may be that any convergence of corporate governance regimes should be a two-way movement, rather than the adoption of the norms and principles of only one of the dominant governance models.