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# COMPARATIVE LAW AND ECONOMICS

VOLUME III

Gerrit De Geest and Roger Van den Bergh

# Comparative Law and Economics Volume III

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# [1]

# Some Differences in Corporate Structure in Germany, Japan, and the United States

**Mark J. Roe**[†]

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† Professor, Columbia Law School. Theodor Baums, Bernard Black, Victor Brudney, Ronald Gilson, Victor Goldberg, Jeffrey Gordon, Robert Hamilton, Hideki Kanda, Klaus Hopt, Lou Lowenstein, Steve Kaplan, Fritz Kübler, Gerald Neuman, Hugh Patrick, J. Mark Ramseyer, Detlev Vagts, and Paul Windolf made useful comments. Douglas Cardwell, Stacy Cooper, Marco Geromin, Burkard Gopfert, Megumiko Ishida, Steven Lorenz, Martina Stoldt, Hans-Gert Vogel, and Jean-Claude Zerey assembled data, research, and translations of German and Japanese materials. The Bradley Foundation supported this research.

## Introduction

Ownership of the large public corporation in Germany and Japan differs markedly from that in the United States. Here, senior managers hold the reins of power; scattered individuals and institutions own the stock. American financial intermediaries only recently have begun to project power into corporate boardrooms; they have historically been dispersed, weak, and uninterested. In the German and Japanese large firm, in contrast, senior managers must share power with active intermediaries wielding the votes of large blocks of stock.

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These differences and the different law, history, and politics that helped produce them cast doubt on current thinking about the origin of the large American public firm. True, firms had to tap vast pools of capital to reach economies of scale and, as shareholders diversified, scattered ownership shifted power to managers. While this is the dominant economic paradigm, it omits a critical step: American shareholders could have diversified through powerful intermediaries, but they did not. Corporate functions could have become further specialized, with strong intermediaries sharing governance functions with managers, but they did not. Had such intermediaries developed in the United States, a flatter structure of shared power could have developed in the large American firm, as it did in Germany and Japan. Elsewhere I have argued that one must look beyond economics to explain the American results: America's politics of financial fragmentation, rooted in federalism, populism, and interest group pressures, pulverized American financial institutions, contributing heavily to the rise of the Berle-Means corporation.[1]

In Part I of this Article, I argue that even a brief comparison of corporate ownership structures between Germany and Japan on the one hand, and the United States on the other, poses problems for prevailing academic theories. The classical economic explanation for the public firm emphasizes scale economies, shareholder diversification, and the divergence of managerial goals from stockholder goals. The economic explanation would, if it were universal, tend to predict that nations with similar economies would have similar corporate structures. There is a best way to make steel, and presumably there is a best way to organize large steel firms. Thus, managerial incentive compensation schemes, proxy fights, conglomerates, takeovers, and boards of independent outsiders, all of which reduce (or reflect) the costs of organizing the large American public firm, should play a role in corporate governance in all three nations. At a minimum, the absence of these features in the flatter, shared authority structure prevalent in Germany and Japan poses a challenge, because it shows that there is more than one way to deal with the large firm's organizational problems. And the differences in corporate structure suggest that differing political histories, cultures, and paths of economic development must be added to the economic model to explain the differing structures. The economic model must be down-sized and considered to be the special case that arises if intermediaries are fragmented.

The classical economic model does not account for the German and Japanese corporate structure, whose basic features I present in Part II. Large financial intermediaries, usually banks, hold concentrated blocks of stock in many foreign firms, including the very largest. Bankers and managers interact

1. Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991) [hereinafter Roe, *Political Theory*]; Mark J. Roe, *Political and Legal Restraints on Ownership and Control of Public Companies*, 27 J. FIN. ECON. 7 (1990).

in structured settings, where power has been shared between firms and financiers, unlike in the United States, where the chief executive officer has historically controlled the firm from the top of a hierarchy, without significant accountability to financial intermediaries.

Comparison allows us to test the hypothesis that law and the politics that underlie it help determine corporate structure. If U.S. firms could readily adopt the German or Japanese structure under U.S. law, we would have a partial contradiction of the law and politics hypothesis. In fact, several laws bar U.S. banks from involvement in the governance of American firms. Most critically, the foreign banks have a national reach that would violate the McFadden Act; they are relatively much larger than U.S. banks, giving them the size needed to control large slices of large firms' capital structure. The Bank Holding Company Act of 1956, as usually interpreted, requires U.S. banks to be passive, but the foreign banks are not passive. The Glass-Steagall Act limits American banks' securities business.

German national banks enter boardrooms by combining votes from stock they own directly, stock in bank-controlled investment companies, and securities they vote for their brokerage customers. Combining banks, mutual funds, and brokers in this way would violate the McFadden Act, the Glass-Steagall Act, and the Bank Holding Company Act. Japanese banks are also active in corporate governance through truly national banks and, even though Japan has a Glass-Steagall Act (imposed by America after World War II) to separate commercial banks from investment banks, Japanese regulators effectively repealed it by forcing savings and corporate financing into Japanese banks.

These laws, necessary to fully understanding the American public firm, have been the San Andreas fault line in American corporate governance, historically severing America's largest financial institutions from its largest industrial firms. While we'll never know whether American-style fragmentation would have developed in the absence of legal roadblocks, American law would have been sufficient to block both German- and Japanese-style financial institutions from developing here.

In Part III, I examine whether the differences in corporate structure are only temporary because financial institutions in Germany and Japan are "behind" America and evolving without political pressure to resemble American institutions. There are contrary trends abroad—some point toward less concentration and less institutional voice, some point to more voice or to stability. And there are weak trends toward greater concentration and institutional voice here in the United States. The mixed facts indicate financial evolution is uneven; we are evolving to look (a little) like them and they are evolving to look (a little) like us.

Even if foreign financial institutions clearly were fragmenting and American institutions were concentrating, doubts about current corporate theories would persist. Foreign politics could have induced the foreign evolution. In Part IV, we see that today's foreign structures depend partly on the path they took from the foreign statist past, which militated toward financial concentration. Today political forces not all that different from those in America's past are weakening the intermediaries. In Germany, persistent popular pressure has led to Parliamentary proposals to reduce the power of banks over industrial stock. In Japan, efforts to transform credit-based financial power, which is weakening, to stock-based boardroom power, have not been fully successful yet, because the laws left by the post-World War II American occupation preclude such a transformation, and interest group conflict—mostly between bankers and brokers—tends to support the status quo. To transform their financial system, the Japanese must dismantle the American framework. They are beginning to do so, but they may fail.

In Part V, I analyze the common elements in the German and Japanese structural patterns and compare them to the U.S. structure in order to find theoretical explanations for their survival despite their obvious weaknesses. Institutional ownership discourages entrepreneurial leadership, risks conflicts of interest, and may make adaption to change more difficult. Moreover, agency problems may simply shift from the firm to the intermediary. Although a simple inquiry might try to find the better corporate structure and anoint it the preferred candidate, complications afflict such an inquiry. First, there isn't much evidence that the foreign structures contribute greatly to better performance. Second, a legal inquiry differs from an economic one. As long as institutional engagement in corporate governance advantages some firms, we have reason to regret some of our restrictions. Finding some value in the foreign structures, however, does not mean we should require them here; absent spillover effects, we should only allow firms that want them to adopt them. Third, even if we came to regret our restrictions, we might not necessarily demand their repeal or predict that their repeal would lead to rapid restructuring, because the path-dependent development of American financial institutions and corporate structures impedes change. Fourth, it might turn out that neither the American fragmentation nor foreign concentration is optimal, or it might turn out that any foreign successes are culturally dependent or embedded in institutions (like labor relations or the regulatory system) that are impossible to import. The comparative inquiry may just show that there are more possibilities than the American one. Fifth, product market competition in an internationalized economy is the best self-corrective. Whatever the source of the recent success of foreign firms—and I suspect corporate structure is tertiary—competition induces American firms to perform better.

What are the possible foreign strengths? Although a corporate law academic's first inquiry would likely be to see if the German and Japanese corporate structure controls managerial agency costs well, the competitive advantage of the foreign structure may lie not just in reducing what we think of as agency costs, but in (1) changing the environment of decisionmaking—bringing more individuals and organizations to the table when technologies and markets are changing too rapidly for a single CEO or a single firm to stay current; (2) improving the information flow to large stockholders in ways that a fragmented securities market cannot achieve; or (3) improving organizational performance by facilitating relation-specific investments without using a stultifying, large vertical organization and by providing a matrix for decisionmaking across related organizations. Even if future research shows none of these hypotheses about Germany and Japan to be true, or shows that the advantages of the true hypotheses are offset by their disadvantages, the study of the differences in corporate structure is worthwhile because it illustrates that the current American arrangements are not inevitable, but instead are highly dependent on the organization of financial intermediaries. We may never want to import foreign features, but once we see that corporate structure is variable, we may be more willing to reexamine our own system.

In Part VI, we see that in reexamining our system, we should not allow Germany and Japan to become blueprints for American financial institutions. The organization of banks is too important to be driven by debatable corporate governance concerns. Nor is it clear that legal change would induce structural change. The gains, if any, from change may be small and might fail to exceed the transaction costs of any change. Complex institutions are shaped by their own history, including their regulatory history; legal permission may not lead institutions to take the newly-opened opportunities, at least not immediately. Moreover, CEO's are embedded in several markets and organizational features beyond corporate governance relations with institutional shareholders. These other markets and organizational features may be strong enough to render any gains from corporate change small.

Finally, I conclude this review of corporate structures with a simple claim: How a nation organizes its financial institutions deeply determines its large firm corporate ownership structure. In America, a deep gap separates finance and industry; in Germany and Japan such a fault line does not yet fully separate intermediaries from managers. Neither ownership fragmentation due to scale economies nor the economic model can explain enough of the structural differences. Corporate ownership structure is highly sensitive to the organization of financial intermediaries, which in turn is highly sensitive to popular attitudes toward financial concentration and political fights.

## I. THE CLASSICAL ECONOMIC MODEL OF THE PUBLIC FIRM

Since Adolf Berle and Gardiner Means published *The Modern Corporation and Private Property*[2] in 1932, American corporate law academics' central task has been to understand the separation of ownership from control in the large American corporation. In the standard story, the rise of large-scale production technologies at the end of the nineteenth century demanded huge inputs of capital that could only be raised from far-flung investors who, demanding diversification and liquidity, were only able to buy small pieces of a firm's equity. Small holders distant from the enterprise lacked the information, skill, and incentive to monitor managers, who became relatively free from shareholder oversight.

This unwieldy structure yielded agency costs, described in the modern reformulation as the sum of (1) bonding costs, as managers tried to assure that they would do a good job; (2) monitoring costs, as shareholders tried to oversee managers; and (3) a residual loss that could not be eliminated.[3] Corporate law scholarship sought to understand these costs, to explain features of the firm as either aligning managers' interests with those of shareholders or as the residuum of unavoidable loss, and to recommend ways to further reduce these costs. In equilibrium, there would be no further costs to eliminate. Any observed costs would be either the bonding or monitoring costs, whose elimination would cost more in increased residual loss, or the residual loss, whose elimination would cost more in offsetting bonding or monitoring costs.

Corporate academics sought to perfect the independent director, who is not beholden to management. Other means to minimize agency costs have included managerial labor markets, incentive compensation tied to stock price, capital markets that denied bad managers access to capital, and high debt that heightened fear of bankruptcy. Conglomerates in their ideal form centralized information and checked managers;[4] in their pathological form, they built empires. In contractarian corporate thought, corporate law was a contract to minimize agency costs. State corporate law provided a standard form for most firms and allowed the remaining ones to tailor the contract to their specific situations.[5] Finally, some financial theorists explained shareholder powerlessness as efficient; stockholders should not influence firm decisions because their specialty was bearing risk, not decisionmaking.[6]

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2. ADOLF BERLE & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

3. The 1970's state-of-the-art was Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

4. OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 155-75 (1975).

5. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 34-35 (1991).

6. Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980).

By the 1980's, however, agency theorists were unsure whether America had achieved a long-run equilibrium in corporate structure in which the further reduction of agency costs had become unimportant. Many scholars argued that takeovers cured large, residual agency costs because managers who deviated too much from shareholders' interests risked a hostile takeover. Skeptics viewed some takeovers as resulting from the agency costs of errant managers expanding their empires, but others argued that even these costs would be eliminated in another wave of takeovers that would break up the empires.[7] Regardless of whether takeovers cured or exacerbated agency problems, many corporate law scholars viewed agency cost explanations as central to understanding the American corporation.[8]

Our classical economic model would imply that large firms in every economy would face similar problems. The organization of large-scale industry in the United States generated agency problems and solutions; large-scale industry elsewhere should tend to develop the same organization, problems, and solutions. As foreign industry "caught up" with American industry, economies of scale would require huge inputs of capital from far-flung investors who would let power shift to managers, leading to a similar fragmented ownership, afflicted with similar managerial agency costs. The alternatives to this prediction might be too horrible for corporate law scholars to imagine. Corporate structure might not matter. Or, different governance systems might yield different advantages and disadvantages, making it difficult for one system to dominate the other. Or, each system might be efficient in its own national context, indicating that there are several equally efficient ways to organize large-scale industry. Or, the U.S. governance system may have arisen and survived because U.S. laws and politics suppressed the obvious alternatives to the Berle-Means corporation.

The differences in corporate structure seem to contradict the classical economic model, at least in its most simple form. Elsewhere I have advanced an additional hypothesis to explain the development of the large public firm in America.[9] There is more than one way to move savings from households to industry. A securities market that produces fragmented ownership is only one way, and it is the prevailing way in America. But, funds could also move

7. Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597, 627-28 (1989).

8. For overviews of the agency theory literature, see Michael C. Jensen & Clifford W. Smith, *Stockholder, Manager, and Creditor Interests: Applications of Agency Theory*, *in* RECENT ADVANCES IN CORPORATE FINANCE 93 (Edward I. Altman & Marti G. Subrahmanyam eds., 1985) and Clifford W. Smith, *Agency Costs*, *in* THE NEW PALGRAVE: FINANCE (John Eatwell et al. eds., 1989).

9. Roe, *Political Theory*, *supra* note 1. For related discussions, see WILLIAM G. OUCHI, THE M-FORM SOCIETY: HOW AMERICA CAN RECAPTURE THE COMPETITIVE EDGE 82-90 (1984); LESTER C. THUROW, THE ZERO SUM SOLUTION 164-65 (1985); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990); Ronald J. Gilson & Reinier H. Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991); Joseph A. Grundfest, *Subordination of American Capital*, 27 J. FIN. ECON. 89 (1990); Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.-Oct. 1989, at 61.

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