Corporate Governance: Political and Legal Perspectives

Edited by
Mark J. Roe

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Corporate Governance in the New Global Economy **8**

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Mark J. Roe

Berg Professor of Corporate Law
Harvard Law School, USA

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Introduction
Political vs. Corporate Institutions as Explaining Western Securities Markets?

Mark J. Roe

The issue to explain in this literature is why some nations have deep securities markets, while others do not. The issue is not just academic, but embedded in the programs of the development agencies: since poorer nations tend to have poorer securities markets, are securities markets a road to wealth? Or are securities markets the results of wealth? The latter was perhaps the older feeling, while the former – securities markets as an instrument toward wealth – is perhaps the newer hope: build a securities market and industry will come.

In recent years two newer theories have emerged to help explain the presence or absence of strong securities markets: in one theory, corporate law propels securities markets, with, as a key corollary, common law systems especially as adept at developing the right corporate law. In the other theory, a nation's politics is more important than its common or civil law origin. Either legal system can construct good corporate law, if its policy wants it. More basic institutions than corporate law get the nation to the level of wealth in which securities markets with ownership separation could play a role. But once those basic institutions – many of them legal institutions available to either legal origin – are in place (property rights, enforceable contracts, low levels of corruption, effective macro policies), corporate law is (relative to getting good contract enforcement and strong property rights) easy. For those nations that have the basic institutional foundations, whether or not a nation has much securities development and ownership separation depends largely on something other than institutional capacity, but, so the second theory runs, depends largely on political currents inside that nation. If politics is supportive of corporate and securities institutions in nations where the basic property and contract institutions are functional, then that nation will get the corporate institutions.

Legal Origins

The Theory

The legal origins theory has been pushed forward most vigorously and most originally by La Porta, Silanes, Shleifer, and Vishny. In a series of articles they make the case that legal protection of minority stockholders is critical to ownership separation, with legal origin (civil law vs. common law) as the critical determinant of that protection (La Porta *et al.*, 1997, 1998, 1999, 2000). (The 1998 article is reproduced as Chapter 2, this volume.) Legal origins matter, their theory runs, because a) common law adeptly protects minority stockholders through common law's fiduciary duties, and b) civil law systems over-regulate. Data show a strong correlation between legal origins and ownership separation, as well as between legal origins and an index of legal protections.

On the former idea – the particular relevance of common law legal systems and their production of corporate law – Cheffins (2000), Coffee (2001), and Roe (2000) argue that the stock exchanges may have been more important initial engines of stockholder protection (however weak that protection was), and Miwa and Ramseyer (2002) and deLong (1991) argue that reputational institutions were key in Japan and the United States at the end of the nineteenth and the beginning of the twentieth centuries. On the latter idea – over-regulation as central – Coffee (2001) argues that civil law systems stifled self-regulatory organizations like stock exchanges. In Chapter 6, this volume, Roe (2004) argues that legal origin does not nicely explain the results: common law nations use civil law-type structures to regulate their corporations (via securities laws, which are heavily codified and primarily enforced by a regulator, not the judge). Equally importantly, he shows, fiduciary duties in the common law nations cover much less than they are usually understood to cover. Other institutions must be in play, he argues.

Bebchuk (1999) frees the corporate law theory from its legal origin specificity. He analyzes how weak minority shareholder protection weakens securities markets. As long as there are significant private benefits of control that a blockholder can garner, then diffuse ownership is unstable. If diffuse ownership should appear in a system that badly protects minority stockholders, then a blockholder will seek to enter the firm, take a block, and begin diverting the private benefits to himself or herself. Accordingly, the blockholder will not give up control if private benefits are high, and if he does, the diffusely owned structure is unstable. He does not theorize on how and why a nation gets good law to protect minority stockholders, but concludes that it is necessary for ownership to separate and for stock markets to develop.

Doubts about the Corporate Law Theory

The legal origins argument is not universally accepted. In one direct critique, Rajan and Zingales (2003, Chapter 3, this volume) present data that stock markets were developing nicely in most of the richer civil law nations at the end of the nineteenth and beginning of the twentieth centuries. While many of the firms that went public had blockholders, and ownership had not yet fully separated (as it had not in the United States), blockholders and dispersed stockholders lived together in the same firms in most civil law countries. Stock market capitalization in France and Germany rivaled that of the United States.

Rajan and Zingales thereby implicitly challenge the over-regulatory theory: in that theory (Coffee, 2001; La Porta, 1997), civil law systems are seen to over-regulate and to undermine private law institutions like stock markets. However, Rajan and Zingales' (2003a) findings suggest otherwise. Whatever 'excessive' regulation of stock exchanges existed in France and Germany, it was not so excessive as to destroy nascent stock markets in those nations. Rather, the trend lines for the nation-by-nation development of western securities markets suggest that the atrophy of civil law stock markets was a mid-twentieth-century phenomenon, rather than one tied to longstanding legal origins or the base level of regulation. Some nations' over-regulation may indeed have been sub-optimal, but it was not so excessive as to kill their nascent securities markets before World War I. It may well have been the political *sturm und drang* of the European early twentieth century that set securities markets back, and not its civil law mode of making law (Roe, 2005). The world wars had varying effects on the world's richest nations, and those varying effects – in destroying institutions and affecting post-war politics – nicely predict the strength of late-twentieth-century securities markets.

Other modern data also call into question the legal origins thesis: data that measure private benefits vary considerably from nation to nation, even among civil law nations (very high, as expected, in Italy, but low in Germany and Scandinavia; indeed at levels about that of the UK and the US) (Dyck and Zingales, 2004; Nenova, 2003; Franks and Mayer, 2001 (Germany)).

Roe (2004) in the last item in this volume offers an alternative conceptual account of legal origins. The common law system is 'low' in regulation; the civil law system is 'high'. The common law acts through judges interpreting in context via fiduciary duties; the civil law system operates through stiff codes and regulations. However, the principal protection for minority stockholders in the United States comes, Roe argues, through the securities laws and the SEC, which are *regulatory* institutions, not common law institutions. Roe argues that the base-line legal technology of *either* legal origin is not well suited to deal with securities markets; even if civil law would tend to over-regulate, common law would under-regulate. Each must adapt and the question he sees as primary, once a nation is rich enough to conceivably build securities markets, is whether the political will to do so is there.

Moreover, argues Roe (2002, 2003, 2004, 2005), vast portions of the corporate structure are effectively not regulated directly, and sometimes only weakly and indirectly, by corporate law. The American business judgment rule effectively has corporate law active in ferreting out thievery, but *not* in directly attacking mismanagement, but if managers mismanage the firm for stockholders, then ownership will tend not to separate and securities markets will tend to be weak. The institutions that keep managers aligned with shareholders are not primarily corporate law institutions.

Property Rights

For transitional and third-world nations especially, what is at stake might not be corporate law in particular, but the weakness of property rights in general. Mahoney (2001, Chapter 4, this volume) traces out the relationship – cf. Milhaupt (1998) (the state as retaining control rights over firms) and Gordon (2004) (the state as actor).

Let me offer a related account, one that builds on those cited in the prior paragraph, but that is not precisely theirs. If property rights are secure, then the economy will grow and large organizations will develop. Large organizations will then demand a good foundation of contract and even stronger property law. When we detect weak corporate law in the third-world and transitional nations, we are not, in this view of the institutional structure, detecting the primary basis for the weakness of securities markets and ownership separation. Rather we are detecting weak economies with little need yet for large business organizations. Weak corporate law is (simply?) derivative of those nations' weak property rights and ineffective contract law, not their weak corporate law. Corporate law would be the dessert, but they do not (yet) have the basic nutrition.

Once nations have developed strong property and contract institutions, they can grow, and some do. Once they grow and become richer, some will have the political will to develop diffuse ownership (more on that below). Those that do will get the corporate law that they need, as corporate law is a (relatively) 'simple', or at least not revolutionary, variant of its foundation of good property and contract law. Either this relatively 'simple' variant can develop through corporate law or, more often, through semi-private, self-regulatory organizations (Mahoney, 1997; Roe, 2001; Coffee, 2001). Today nations need not even have the developmental capacity; they can copy what works elsewhere, if they have both a) the foundational institutions and b) the political will to do so.

Thus, there are two separate questions to ask, and neither depends *solely*, or even primarily, on legal origins and the quality of corporate law. *First*, are property rights (and contract rights) sufficiently well protected that firms will grow and organizations become complex? If *no*, then corporate law is irrelevant (or its weakness just reflects the weakness of contract and property law). One strain in the current literature, while it lacks this precise emphasis, focuses on institutional quality, with that quality coming from sources other than legal origin (Acemoglu, Johnson and Robinson, 2002; Berkowitz, Pistor and Richard, 2003). (But cf. Beck, Demirgüç and Levine, 2003.)

If *yes*, then *second*, are political configurations favorable in the nation that has large organizations to securities markets and ownership separation? If *yes* to the second question, then that nation is probably not going to have much trouble building good corporate and securities law if it wishes to build it. In this vision, corporate law quality is not irrelevant, but a) it only comes into play in rich nations, once property rights are sufficiently strong, and b) once property is sufficiently strong, i) corporate law should not be hard to build and ii) political trends can undermine even good corporate law. Corporate law is an 'assist', not the primary determinant in either the poor or the rich setting.

Peace as Predicate

Roe (1994, 2003) presents two complementary theories on how politics can 'determine' the degree of ownership and the strength of securities markets in a nation that a) has a strong enough base of property and contract rights and b) is rich enough to have large firms. Some of this material is in this volume's first chapter.

First, 'populism' has propelled diffuse ownership by weakening financial institutions' role in large American firms and generally making financial control of large organizations harder (see Roe, 1990, 1994; Jensen, 1993). Second, social democratic, and closely related corporatist, polities have tended to hold back European securities market development and ownership separation.

The latter, the social democratic demeaning of securities markets and ownership separation, has occurred through two channels. The first channel has been inside the firm: managers in separated firms would not be as loyal to shareholders in social democratic polities as they would be in more conservative polities. Labor can make greater claims on the firm's cash flows, and there are, or have been, greater pressures emanating from the government in some nations, and less pressure in other nations, to expand employment to avoid down-sizing, etc. In some nations managers in diffusely owned firms would be more susceptible than in others to pressure to act in ways detrimental to shareholders. Even if the appropriate corporate law institutions were in place in those nations, the institutions would not be used if the difference in value to shareholders between close ownership (which keeps the managers from wandering too far from shareholder value) and diffuse ownership is too great. Roe (2001, 2002, 2003) shows data consistent with this.

The second channel is that social democratic polities have been less willing to provide the infrastructure that makes managers loyal to dispersed stockholders. They are sometimes less interested in transparency, usually stop hostile takeovers, and typically castigate high incentive pay even when it is functional. Insider trading has been seen as the wealthy maneuvering against the wealthy, an issue of limited public concern. These polities have generally not provided the pro-shareholder tools. In this view it is not so much that their legal origins have disabled them from providing the shareholder tools, but that their polities have had little interest in further fostering capitalist institutions. Securities markets in several of these nations were developing nicely at the end of the nineteenth and early twentieth century, including France and Germany, and most of the rest of the European civil law nations (Rajan and Zingales, 2003a). At that time those nations were conservative. The institutional structure was haphazard, the stock exchanges not modern, and so on, but then again the parallel organizations in the United States were also weak, at times corrupt (Coffee, 2001; Rock, 2001), and were not developed properly until later in the twentieth century.

The peace-as-predicate political perspective has a parallel in the property rights literature. Long ago Harold Demsetz organized thinking about property rights vs. the commons around the simple idea that 'the emergence of new property rights [read, for us: corporate law rights] takes place in response to the desires of the interacting persons [read, for us: dominant and diffuse stockholders] [to] adjust[] to new benefit-cost possibilities' (Demsetz, 1967, at p. 350). Where the benefits to dominant and diffuse shareholders of dispersion are limited (because rights to corporate cash flows and other benefits have not been strictly defined between shareholders and labor), then there has been little demand to define the rights of shareholders well (even when that institutional possibility is not especially costly, as it has not been in nations where the foundation of good property and contract rights has been laid down), because the benefits of doing so just are not there for the interacting parties, the diffuse and dominant shareholders.

The interesting question then is, if a nation has the basic institutional capacity, why does the demand not arise to develop corporate institutions? Roe (2001, 2003a) offers labor politics as an answer. Perotti and Von Thadden (2003) offer an analogous human capital explanation: if the median voter has few financial assets and high human capital, then that voter will demand a low risk corporate environment (cf. Pagano and Volpin, 2002). Rajan and Zingales (2003a, b) look at trade, protectionism, and incumbents who wish to protect their positions. In each view, the strength or weakness of corporate law is derivative of other, mostly political, currents in society.

Overall, a nation that impedes financial institutional involvement in large firms but promotes profit-making tends to get diffuse ownership. A nation that supports (or does not impede) financial involvement in large firms but that denigrates profit-making and shareholder wealth-maximizing institutions tends to get close ownership. (There is no clear, empirically confirmed welfare economics result. A common economics and corporate law perspective sees ownership separation as progress, and clearly separation gives some more capital-raising opportunities. However, it is seen by some to be ambiguous in welfare terms (see, e.g., Blair and Stout, 1999), and certainly many European assumptions have been, at least until recently, that pro-labor and go-slow is better (but cf. Hansmann and Kraakman, 2001, who detect change).)

Hansmann and Kraakman (2001) provide Chapter 5 in this volume. While they do not directly dispute either the corporate law or the political theory, their analysis provides a quite different perspective and, in effect, a challenge to both the legal and the political theories. The first challenge is in their claim that corporate law and corporate structures around the world have several deep similarities, such as limited liability and centralized management. They have these similarities because that is what works, and the shareholder-centered model has become so obviously more successful than its competitors that it will become the standard model around the world, if it has not already done so (cf. Salmon, 2002 for an analogous general analysis of national bench-marking). If law must change to accommodate the future, it will. Interest groups and incumbents impede reform, as emphasized by Bebchuk and Roe (2004) and Rajan and Zingales (2003a, 2003b), but the impediments will give way to the power of ideas that work, as key players, especially policymakers, in each nation see that progress and wealth depend on their adopting a shareholder-centered model for corporate law.

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Contents

[1]

Introduction

Before a nation can produce, it must achieve social peace. Factories that fail to produce because of internal turmoil or external upheaval are less valuable than those that produce smoothly. If conflict is expected, investors invest reluctantly, or not at all, and the factory is not built. Or investors search for the organizational form that minimizes the chances and costs of conflict. Dampening turmoil, or insulating the firm from it, can be a strong force in shaping firms' ownership and governance. Perhaps secondary in the United States, these considerations have historically often been primary in other nations.

Social peace has been reached in different nations by differing means, some of which have then been embedded in business firms, in corporate ownership patterns, and in corporate governance structures. The ways to achieve and maintain social peace vary, and that variety explains quite a bit of why corporate governance structures vary around the world.

Politics can affect a firm in many ways: it can determine who owns it, how big it can grow, what it can produce profitably, how it raises capital, who has the capital to invest, how managers or employees see themselves and one another, and how authority is distributed inside the firm. For concreteness I focus on one key variable: the degree to which ownership separates from control. This is in itself a key aspect of the modern corporation, and emphasizing it gives us the discipline of dealing with a single variable, one for which finance theory is well developed and about which data can be had to test, probe, and better understand how the firm's political environment affects it. Ownership will be our primary focus, but it reflects the bigger claim, that much of the firm's structure is affected, sometimes determined, by its political environment, and if we fail to scrutinize the political impact on a firm, we are unlikely to get the full story.

The large publicly held, diffusely owned firm dominates business in the United States despite its infirmities, namely the frequently fragile relations between stockholders and managers. Managers' agendas can differ from shareholders'; and tying managers' actions tightly to shareholders' goals has been central to American corporate governance. But in other economically advanced nations ownership is not diffuse but concentrated. The problem to explain is why ownership of large

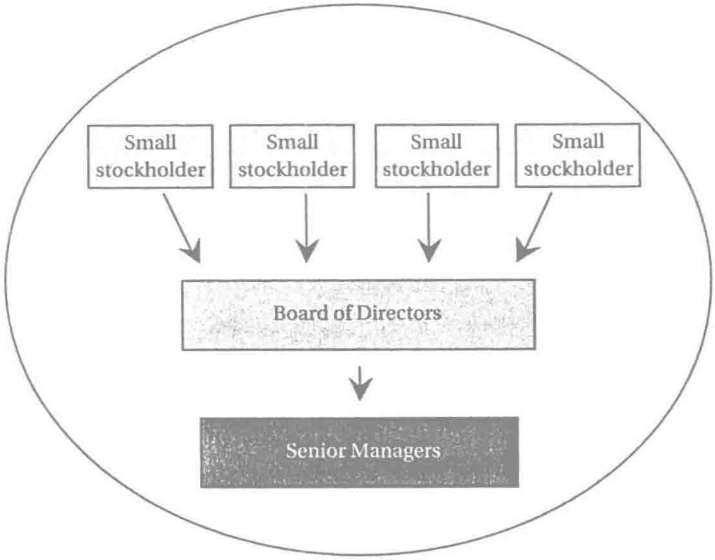

Fig. 1. Diffuse ownership

firms in the United States is diffuse, as depicted in Figure 1, while in so much of the rest of the wealthy West fewer firms go public at all, and of those that do, the firm's ownership is typically concentrated not diffuse, with a dominant stockholder as depicted in Figure 2. Although the American institutional investor has in recent years made the American stockholder less remote than it once was, even today ownership is much less concentrated in the United States than it is in the other nations in the wealthy West. It has been concentrated elsewhere in the wealthy West in no small measure because the delicate threads that tie managers to distant shareholders in the public firm fray easily in common political environments, such as those in the continental European social democracies.

Social democracies press managers to stabilize employment, to forgo some profit-maximizing but risky opportunities for the firm, and to use up capital in place rather than to downsize when markets no longer are aligned with the firm's production capabilities. Managers must have discretion in the diffusely-owned public firm, and how they use that discretion is crucial to stockholders, in that managers' actions produce the firm's profits. Social democratic pressures induce managers to stray further than otherwise from their shareholders' profit-maximizing goals: managers with discretion there are pushed away from being aligned with shareholders' typical profit-oriented goals. Moreover, the modern means that align managers with diffuse stockholders in the United States—incentive compensation, transparent accounting (whose recent failures highlight both its importance and its fragility), hostile takeovers, and strong shareholder-wealth maximization norms—have been weaker and sometimes denigrated by continental social democracies.

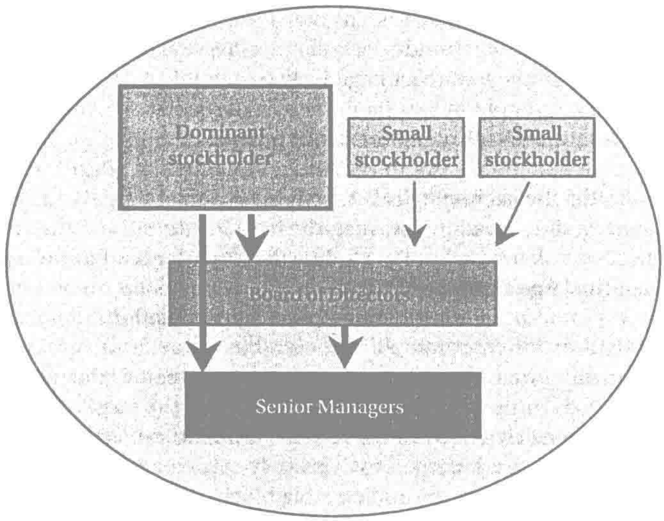

Fig. 2. Dominant stockholder in public firm

Hence, public firms there, all else equal, have had higher managerial agency costs, and large-block shareholding has persisted as shareholders' best remaining way to control those costs. Indeed, when we line up the world's richest nations on a left-right political continuum and then line them up on a close-to-diffuse ownership continuum, the two correlate powerfully.

True, the effects on total social welfare are ambiguous; social democracies may enhance total social welfare, but if they do, they do so with fewer public firms than less socially responsive nations. We thus uncover not only a political explanation for ownership concentration in Europe, but also a crucial political prerequisite to the rise of the public firm in the United States, namely the weakness of social democratic pressures on the American business firm.

* * *

That corporate governance structures around the world have differed is hardly contested. The very fact that many people talk today, at the beginning of the twenty-first century, about corporate convergence due to globalization tells us that people believe that corporate structures have sharply varied. The task here is to better explain why they varied. The thesis here is straightforward: prevailing explanations—based on the level of economic and technological development, on differing economic tasks, on random variation, and on the quality of technical corporate law—while important and not to be discarded, are incomplete. One big explanation is absent from the literature, namely that how social conflict has been settled powerfully affects how firms are owned and how authority is divided.

4 INTRODUCTION

Politics at times directly requires boardrooms and ownership structures to be a certain way. At other times it induces reactions, as, say, owners seek to mitigate political effects or employees react negatively to a political or economic result. At other times politics simply raises the costs of a particular structure, making that more costly structure less likely to arise and prosper.

No single explanation is going to dominate the others at all times: the level of economic wealth, the technological demands for large size, the institutions of capital-gathering, the prevailing tax rules, the legal institutions of the large firm are all important. My task here is hardly to refute the importance of these explanations for the rise of the large firm and the separation of ownership from control, but to focus on a deep, important, and missing political explanation.

I focus on two major corporate differences: the degree of separation of ownership from control, primarily and, secondarily, the degree of labor influence. The two are connected. In the United States ownership of the largest firms has been diffuse for quite some time; on the European continent, ownership has been concentrated, with even the largest firms privately-owned or, if their stock traded publicly, with a single owner controlling a big block of stock. In the United States, labor participates rarely in the core institutions of the firm's governance at the top, rarely owns significant stock directly, and even more rarely participates on the board. In France, a dynamic family and entrepreneurial sector challenged a government-dominated sector; public policy favored employees with jobs in place, and diffusely-owned firms were rare. In Germany labor still takes half of the seats of the supervisory board, in the most explicit manifestation of a political determinant of corporate governance. In Italy in the decades ending the twentieth century there were few public firms, social conflict in the largest firms spilled over into politics when the communist party in Italy was strong, and nominally conservative governments both denigrated the profit-oriented culture needed to make large firms' managers function well for shareholders and built up small businesses at the expense of large ones to deny fertile fields to the communist unions. In Japan, the firm was typically run at the top by a large board of insiders assured of lifetime employment. Banks have also been shareholders, and their loans induced them not to seek to maximize their wealth as shareholders. Some of these structures arose and prospered in Japan during times of intense social conflict. Similarly, the incidence of hostile takeovers, proxy fights, and incentive compensation mechanisms varies greatly around the world; sometimes used not at all, sometimes becoming central to corporate governance.

Those are nation-by-nation specifics. But we can generalize into a theory with predictions. Social democracies favor employees with jobs in place. They wedge open the gap between shareholders and managers by pressing managers to expand, to avoid downsizing, and to go slow in taking risks that would affect the work place. These are just the kinds of managerial agency costs that have been common at times in the large American firm: American managers when not strongly tied to shareholders' interests have *also* tended to expand, avoid, and go slow, despite the weaker political pressures here on managers to expand, avoid, and go slow. Moreover, social democracies denigrate the modern pro-shareholder tools—such