THE TRANSFORMATION OF EUROPEAN CORPORATE GOVERNANCE: A CASE OF GERMANY AND FRANCE+

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Abstract

This paper provides insight into the evolving EU-wide corporate governance systems and discusses these changes within the context of the political-institutional, economic, legal and social features. In doing so, asking where are they, and where might they be headed? Specific attention is given to the comparison of the German and French system to the U.S. system. Moreover, this article also examines the evidence that varying legal and social traditions and rule of law directly impact corporate governance styles and efficiency. It is our contention that during the 1990s the EU nations experienced strong pressures to develop more effective corporate governance systems, tending toward the Anglo-Saxon model as applied in the U.S. and that this trends continues today especially among the large global multinationals.

Keywords: corporate governance, Germany, France, the USA

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"*[B]eing managers of other people's money than their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which partners in a private co-partner frequently watch over their own… Negligence and profusion therefore, must always prevail more or less in the management of affairs of a [joint stock] company*[1]*.*" (Adam Smith 1776)

Introduction

By the fall of 2001 global economic growth had measurably slowed and firms throughout the industrialized world faced falling demand for their products and services, this is occurring again in 2007-2008. Yet as they searched for ways to address the problem, the globalization[2] of competition continued to escalate, particularly in high-tech industries as, for example, information and biotechnology and in some service industries such as finance. Technical innovations, production efficiencies, low-cost capital, sophisticated managerial and labor skills and new markets continued to be as much in demand during the downturn as during the high-growth 1990s.

As measured by conventional macro-economic indicators such as growth, manufacturing productivity and unemployment, the European Union (EU) economies lagged behind the U.S. economy for almost all of the 1990s.[3] America's economy, except for one

[1] Smith, Adam, An Inquiry into the Nature and the Cause of the Wealth of Nations, London: Ward Lock, 1838, p.586.

[2] Globalization is interpreted in numerous different ways nowadays, ranging from the positive to the negative. As understood in this paper it is an economic process referring to the globalization of competition that takes place in an industry and is comprised of the evolving new patterns of cross-border activities of corporations based on trade, international investments and forms of cooperation. It involves the development of new technologies, products and production-processes, markets and marketing techniques and the sourcing of inputs such as raw materials, capital and labor.

[3] It has been a challenge to economists to explain the excellent performance of the U.S. economy during the 1990s. In time, explanations focused on the average annual productivity increase of

year, maintained an average annual growth rate of more than 3% while the average annual EU growth rate was less than that, except for one year. It should be noted that the recent 2007-2008 U.S. housing crisis and subsequent sub-prime mortgage financial losses have slowed the American economy, but many expect American dominance to continue once the economy recovers from this recent shock. Nonetheless, the long-established slower performance by European economies is usually explained in terms of the traditional European desire for economic stability and social safety as reflected by the widespread acceptance of the welfare states following World War II.[4] They are characterized by inflexible economic structures comprised of regulated product-service, capital and labor markets, high taxes, generous public spending and managerial systems that are risk averse. Over time, this had brought about a corporate governance system that sustains and, in turn, is sustained by such economic features and managerial practices.

Yet traditional European companies such as Siemens of Germany, Olivetti of Italy and Renault of France, too mention only a few, maintained a major presence throughout the world for many decades. They have and continue to offer high quality products effectively marketed, serviced and purchased by loyal customers. Eventually, these traditional companies were joined by other firms such as the cellular-phone manufacturers Nokia of Finland and Ericsson of Sweden that not only compete effectively but also took on the technological leadership of their industry. Moreover, jointly, they also obtained the largest global market-share in the industry (with Nokia dominating) ahead of America's second- placed Motorola[5]. Another example of a powerful emerging high-tech EU firm is the United Kingdom's Vodaphone that through mergers and acquisitions grew into the world's first or second largest network operator by the beginning of the 21st century.[6]

But such successful and globally competitive high-tech EU companies are still the exception rather than the rule. According to a report by the Economic Advisory Group of the EU Commission, of the 100 top companies in the broadly defined high-tech "New Economy" the EU nations are represented by only 6 firms, 3 of them Scandinavian.[7] Instead of fully restructuring during the 1990s to meet the challenges of the rapidly changing global marketplace, most EU companies tinkered at the edges of efficiency, cutting a few jobs here and selling a division there. As a result, measured by annual revenues earned during the 1990s, of the world's 50 largest high-tech companies 36 were American and only 4 European.[8] The strong performance of the American firms is usually ascribed to the flexible U.S. economy, liquid capital markets and the effective corporate governance system that is an integral part of it.[9] This trend continued until 2007 when the U.S. economy experienced its financial market shock.

Objective and Significance of the Analysis

It is the objective of this paper to provide insight into the evolving EU-wide corporate governance systems and the impact of that evolution on firm[10] competitiveness and to discuss changes in the internal management arrangements, while keeping the political-institutional, economic settings and changes in the relevant legal and social features in mind, that is, where are they, and where might they be headed. Specific attention is given to the comparison of the German and French system to the U.S. system. Moreover, this article will also briefly examine some evidence that varying legal traditions and rule of law directly impact corporate governance styles and efficiency, and the reaction of capital markets to the results of such systems will be measured in terms of firm efficiency and performance.

The changes discussed in this paper are of global importance, since it is our contention that corporate governance has an enormous impact on the competitive performance of a corporation. Currently, the 27 member EU produces over 30% of annual global output and has the world’s largest integrated single market[11] that carries out more than 60% of global trade inclusive of internal trade[12].

This is reemphasized by the fact that 10 Central and East European nations joined the EU on May 1, 2004, with two more following January 1, 2007. This raises the membership to 27 countries, enlarging the

2.5% and the contributions of the information technology industry to the rest of the economy. “ITC Driving U.S. Productivity Gains.” Press Release. U.S. Industrial Conference Board, October 29, 2001. The “Annual Economic Report of the President,” released in January 2002 made the same point. It should be pointed out, however, that during the 1990s a number of individual EU economies have done well not only in terms of the levels of productivity and GDP per capita, but also in terms of productivity growth. But these relatively successful performers were small states such as Ireland, which led the group. The large nations, generating over 80% of EU GDP as, for example, Germany, the United Kingdom, France, Italy and Spain did not do well.

[4] European welfare states provide a broad and deep social safety net that includes, among other things, relatively secure employment, generous unemployment and other benefits, regulated working conditions and extensive public pension system benefits, all financed through high taxes.

[5] Financial Times, Deutschland, October 2, 2001, p.4.

[6] See http://www.hoovers.com/free/search/mktg/csfs.xhtml?COID=47982&cm_ven=Paid&cm_cat=GGL& cm_pla=CSFS&cm_ite=vodafone

[7] Financial Times, February 20, 2002, p.15.

[8] The Economist, September 16, 2000, p. 77.

[9] Occasionally, the system breaks down, particularly the transparency, disclosure and monitoring aspects. Recent examples include Long-Term Capital Management in 1998 and the Enron Corporation in 2001- 2002.

[10] Throughout this paper the terms “firm”, “company” and “corporation” will be used interchangeably.

[11] The objectives of the Single Market are the free movement of products, services, capital and labor. To date, these goals have not been fully achieved. The Single Market is a successful work in progress.

[12] EU carries out approximately 20% of global trade exclusive of Intra-EU trade.

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size of the internal market to approximately 497 million people.[13]

Germany, with a population of 82.4 million and a $2.9 trillion GDP in 2006, representing 17% of the total population and 18% of the common GDP, is with out a doubt the EU's largest and most important economy.[14] Moreover, in contrast to other member nations as, for example, the United Kingdom, the Netherlands, Ireland or Spain, its economy continues strongly to reflect the traditional European welfare state features and values. Germany well illustrates the difficulties of restructuring economies and changing the extant corporate governance systems, thus its arrangements and experiences are frequently referred to throughout this paper. Additionally, given the importance of the French economic, trade and political influence in EU institutional affairs, its system of corporate governance is also frequently referred to throughout the paper. Furthermore, comparisons of the French and German systems are made regularly to the U.S. style of corporate governance throughout this paper, since many readers will be familiar with the US system.

The measure of the effectiveness of any system of governance is the degree to which the governed organization achieves its purpose. One must look at the purpose of the various systems, and ask the question, does the system achieve its purpose? Indeed, does the current global economic order perforce call for a change in the purpose?

The Literature

Although there is an extensive literature providing legal, economic and other definitions of governance systems[15], they mostly take a view only at a given point in time and/or a comparative view. This paper attempts to take a view on the evolution of European corporate governance and its current status less constrained by periods of time. As such, in this paper such systems are understood in a broader sense, consisting of a set of internal and external arrangements and processes that are shaped by the political, economic, legal and social characteristics and values of the societies in which they exist.

The internal arrangements comprise the type and structure of ownership, company objectives, the nature of the internal decision-making processes, the role of shareholders and other stakeholders, sources of financing, the monitoring, reporting requirements and the managerial incentive system.

The external arrangements consist of the political-institutional features such as the location and distribution of power and the nature of the decision-making processes. They also encompass the economic and, to some extent, the social structures, particularly the degree of competition and flexibility in the product, service, capital and labor markets and the extent of the social safety net that exists in the places that are home to the companies in question. Additional features are the legal traditions, rule of law, and regulatory requirements governing business activities.

Recent corporate governance literature[16], suggests that the most important cause of the

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[13] For a discussion of issues related to corporate governance developments in the transforming economies, see Dyck, Alexander. “Ownership Structure, Legal Protections and Corporate Governance,” Washington D.C.: The World Bank, April 2000.

[14] International Financial Statistics, Washington D.C.: International Monetary Fund, 2002.

[15] For example, Shleifer, Andrei, and Robert W. Vishny. “A Survey Of Corporate Governance,” *Journal of Finance,* 52, June 1997, pp.737-783; Shleifer, Andrei, and Robert W. Vishny. ‘‘Large Shareholders And Corporate Control.’’ *Journal of Political Economy,* 94, no. 3, pt. 1, June 1986, pp.461–488; La Porta, Rafael, Florencio Lopez-de-Silanes, and Andrei Shleifer. “Corporate Ownership Around The World.” *Journal of Finance*, 54, 1999, pp.471-517; La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny. “The Quality Of Government,” *Journal of Law, Economics, and Organization*, 1999, pp.; La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny. “Investor Protection And Corporate Governance.” *Journal of Financial Economics*, 58, 2000, pp.3-27; La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny. "Investor Protection And Corporate Valuation." *Journal of Finance*, 2002, pp.; Hart, Oliver. Firms, Contracts, And Financial Structure. London: Oxford Univ. Press, 1995; OECD. “Corporate Governance: Improving Competitiveness and Access to Capital Markets.” A Report to the OECD by the Business Sector Advisory Group on Corporate Governance, Paris: Organization for Economic Co-operation and Development (OECD), 1998; OECD. “OECD Principles of Corporate Governance,” Paris: OECD, 1999a; Hellwig, Martin. 'Banking, financial intermediation and corporate finance', in Albert Giovannini and Colin Mayer (eds), European Financial Integration, Cambridge; Cambridge University Press, 1991, pp. 35-63; Levine, Ross, and Sara Zervos. ‘‘Stock Markets, Banks, and Economic Growth.’’ *American Economic Review*, 88, June 1998, pp.537–558; Coffee, J.C. “The Future As History: The Prospects For Global Convergence In Corporate Governance And Its Implications.” Working Paper, Center for Law and Economic Studies, Columbia University, 1999; Demsetz, Harold, and Kenneth Lehn. ‘‘The Structure Of Corporate Ownership: Causes And Consequences.’’ *Journal of Political Economy*, 93, December 1985, pp. 1155–1177; Rajan, Raghuram G. “Insiders and outsiders: the choice between informed and arm's-length debt,” *Journal of Finance*, 47 (4) September 1992, pp.1367-1400; Borokhovich, K.A., R. Parrino, and T. Trapani. "Outside Directors And CEO Selection." *Journal of Financial and Quantitative Analysis*, 31, 1996, pp.337-355; Bradley, M., C.A. Schipani, A. Sundaram, and J.P. Walsh. “The Purposes And Accountability Of The Corporation In Contemporary Society: Corporate Governance At A Crossroads,” *Law and Contemporary Problems*, 62, 1999, pp9-86; Denis, D.K. "Twenty-five Years of Corporate Governance Research ... and Counting." *Review Of Financial Economics*, 10, 2001, pp.191-212; Khanna, T., J. Kogan, and K. Palepu. "Globalization And Corporate Governance Convergence? A Cross-Country Analysis." Working Paper, Harvard Business School, 2002; and. Cohen, Steven S. and Gavin Boyd, eds. Corporate Governance and Globalization: Long Range Planning Issues, Northampton, MA: Edward Elgar Publishing Inc., 2000.

[16] Andenas, Mads, and Kenyon-Slade, Stephen, eds. E.C. Financial Market Regulation and Company Law. London: Sweet and Maxwell, 1993; Coffee, J.C. “The Future As History: The Prospects For Global Convergence In Corporate Governance And Its Implications.” Working Paper, Center for Law and Economic Studies, Columbia University, 1999; David, Rene, and John Brierley, 1985, Major Legal Systems In The World Today, London: Stevens and Sons, 1985; Demsetz, Harold, and Kenneth Lehn,. ‘‘The Structure Of Corporate Ownership: Causes And Consequences.’’ *Journal of Political Economy*, 93, December 1985, pp. 1155–1177; Hay, Jonathan R., Andrei Shleifer, and Robert W. Vishny. ‘‘Toward A Theory Of Legal Reform.’’ *European Economic Review*, 40, April 1996, pp.559–67; Hart, Oliver. Firms, Contracts, And Financial Structure. London: Oxford Univ. Press,

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differences in various systems is the existence of distinct legal traditions (i.e. common or civil law traditions) across nations, since the legal system of a country molds investors' rights and protections insofar as their interactions with companies are concerned. Moreover, this literature states that the rule of law (among other things and most importantly, the extent to which contracts are legally enforced) also influences the effectiveness of corporate governance. Of course in most highly industrialized countries, no matter the genesis of their legal traditions, commercial law and the court systems are usually well developed, and contracts are generally respected and enforced to one degree or another.

Furthermore, few question the strong links between corporate governance, corporate finance and corporate performance as it is well documented in the literature[17]. Corporate governance in a very real sense molds the development of a nation's financial market as it provides the framework for the accord between investors and firms, which in turn influences the speed, amount of and method by which investors will receive adequate returns on their investments. Moreover, corporate governance styles and efficiency in management decision-making determine to a large degree the extent to which firms have access to outside financing, that is, whether outside investors are either willing to lend to firms or buy their securities. According to this line of research[18], a firm's ownership structure and its corresponding capital structure directly impact corporate performance. For example, if a firm does not generate enough confidence in outside investors, the firm's overall performance will suffer as it will have a difficult time growing or taking advantage of market opportunities due to its need to rely only on internal cash generation and accumulated financial resources. Moreover, corporate performance is further impacted by the availability of financing, i.e., a firm's performance can be negatively impacted if methods of available financing are limited due to either lack of financial sector development or to systemic rigidity. Accordingly, a firm's efficiency in terms of financial market access, costs, speed of transaction and available financial instruments has a direct impact on corporate performance.

In addition, according to the same type of literature,[19], the overall economic performance of a

1995; La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny. ''Law And Finance.'' NBER Working Paper no. 5661, Cambridge, Massachusetts, July 1996; La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny. "Legal Determinants Of External Finance," *Journal of Finance*, 52, 1997, pp.1131-1150; La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny. "Law And Finance," *Journal of Political Economy,* 106, 1998, pp.1113-1155; La Porta, Rafael, Florencio Lopez-de-Silanes, and Andrei Shleifer. "Corporate Ownership Around The World." *Journal of Finance*, 54, 1999, pp.471-517; La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny. "The Quality Of Government," *Journal of Law, Economics, and Organization*, 1999, pp.; La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny. "Investor Protection And Corporate Governance," *Journal of Financial Economics*, 58, 2000, pp.3-27; Levine, Ross. ''The Legal Environment, Banks, And Long-Run Economic Growth.'' *Journal of Money, Credit and Banking*, 30, no. 3, pt. 2, August 1998; Merryman, John H. The Civil Law Tradition: An Introduction To The Legal Systems Of Western Europe And Latin America, Stanford: Stanford University Press, 1969; Reynolds, Thomas, and Arturo Flores. Foreign Law; Current Sources Of Codes And Basic Legislation In Jurisdictions Of The World, Littleton, Colorado: Rothman and Co., 1989; Shleifer, Andrei, and Robert W. Vishny. ''Large Shareholders And Corporate Control.'' *Journal of Political Economy,* 94, no. 3, pt. 1, June 1986, pp.461–488; Wymeersch, E. ''Legal Determinants Of External Finance," *Journal of Finance,* 52, July 1997, pp.1131–1150; Vishny, Paul. Guide to International Commerce Law, New York: McGraw-Hill, 1994; Zweigert, Konrad, and Hein Kotz. An Introduction To Comparative Law. 2d rev., ed. Oxford: Clarendon, 1987;and Emmons, Willaim R. and Frank Schmid, "Corporate Governance and Corporate Performance", in Cohen, Stephen S. and Gavin Boyd, Corporate Governance and Globalization, Northampton, MA: Edward Elgar Publishing Inc., 2000.

[17] Shleifer, Andrei and Robert W. Vishny. "A Survey Of Corporate Governance," *Journal of Finance,* June 1997, pp,737-83; Hart, Oliver. Firms, Contracts, and Financial Structure, London: Oxford University Press, 1995; Hellwig, Martin. "Banking, Financial Intermediation And Corporate Finance," in Giovannini, Albert and Colin Mayer (eds), European Financial Integration, Cambridge: Cambridge University Press, 1991, pp.35-63; La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny), "Legal Determinants Of External Finance," *Journal of Finance*, 52, 1997, pp.1131-1150; Levine, Ross and Sara Zervos. "Stock Markets, Banks And Economic Growth," *American Economic Review*, 88, (3), June 1998, pp.537-558; OECD. "International Banking and Financial Market Development," Paris: OECD, 1999b; Rajan, Raghuram G. "Insiders And Outsiders: The Choice Between Informed And Arm's-Length Debt," *Journal of Finance*, 47 (4) (September 1992, pp.1367-1400; King, Robert G. and Ross Levine. ''Finance And Growth: Schumpeter Might Be Right.'' *Quarterly Journal of Economics*, 108, August 1993, pp.717–737; La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny. "Investor Protection And Corporate Valuation," *Journal of Finance*, 2002, pp.; Levy, Haim. ''Economic Evaluation Of Voting Power Of Common Stock,'' *Journal of Finance*, 38, March 1983, pp.79–93; Modigliani, Franco, and Merton H. Miller. ''The Cost Of Capital, Corporation Finance And The Theory Of Investment.'' *American Economic Review*, 48, June 1958, pp.261–297; Perotti, E.C. and E. von Thadden. "Will Capital Market Integration Force Convergence Of Corporate Governance?" *Journal of Financial and Quantitative Analysis*, 2003; and Wurgler, J. "Financial Markets And The Allocation Of Capital." *Journal of Financial Economics*, 58, 2000, pp.187-214.

[18] La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny. "Legal Determinants Of External Finance," *Journal of Finance,* 52, 1997, pp.1131-1150; Shleifer, Andrei and Robert W. Vishny. "A Survey Of Corporate Governance," *Journal of Finance,* June 1997, pp.737-783; Levine, Ross and Sara Zervos. "Stock Markets, Banks And Economic Growth," *American Economic Review,* 88, (3), June 1998, pp.537-558; Hart, Oliver. Firms, Contracts, and Financial Structure, London: Oxford University Press, 1995; Hellwig, Martin. "Banking, financial intermediation and corporate finance," in Giovannini, Albert and Colin Mayer (eds), European Financial Integration, Cambridge: Cambridge University Press, 1991, pp.35-63; Rajan, Raghuram G. "Insiders and outsiders: the choice between informed and arm's-length debt," *Journal of Finance,* 47, (4), September 1992, pp.1367-1400; OECD. "International Banking and Financial Market Development," Paris: OECD, 1999b; and Rajan, Raghuram G., and Luigi Zingales. ''What Do We Know About Capital Structure? Some Evidence From International Data.'' *Journal of Finance*, 50, December 1995, pp.1421–1460.

[19] Knack, Stephen, and Philip Keefer, ''Institutions And Economic Performance: Cross-Country Tests Using Alternative Institutional Measures.'' *Economics and Politics*, 7, November 1995, pp.207–227; Levine, Ross. "Financial Development And Economic Growth," *Journal of Economic Literature*, 1996, pp.; Levine, Ross,

country is also linked to these issues. It is clear that levels of economic development coupled with a nation's social and political heritage represent factors of crucial importance in the evolution of a country's corporate governance system. Accordingly, even among the more advanced nations, there exist substantial differences in corporate governance.

Nature, Type, and Objectives of Corporate Governance

Corporate governance can be viewed as the mechanism to minimize the loss of value occasioned by the separation of ownership from the management. Through the institution of the joint-stock company or listed company—as it is widely know in the UK--or publicly held corporation—as it is called in the US--investors are separated from management. While this separation provides benefits, such as the specialization of management functions and diversification of risk across the investor- stakeholder base, there are also significant costs (the foregone value) that arise due to this separation. However, effective corporate governance minimizes these costs[20]. Investors and other stakeholders use the governance systems to influence managers to take action that allows such stakeholders to realize their particular goals through effective monitoring and incentive systems that may be economic or social or a combination thereof. It is in this sense that corporate governance systems reflect social values. A corporation—the depositary of investor funds--must rely on the board of directors, and the management to watch out for its interests. Without safeguards, managers could use their position to siphon off economic benefits and thereby weaken long-term corporate performance, reducing investment values. The systematic enforcement of safeguards pertaining to corporate activities and governance issues is supposed to shape the business environment and the management ethos of companies. Ideally, managers are motivated to obtain financial and other resources on the best possible terms and to use them in the most efficient manner.

Under the universal concept of the formation and running of a corporation, fairly widely accepted throughout the world, it is through the various legal and economic arrangements and processes that investors and other stakeholders establish companies, select, monitor, reward and otherwise influence managers whom they hire to use, safeguard and augment their capital. It is the responsibility of governments to provide transparent political, legal and economic environments to protect individuals, firms and society against the misuse of corporate resources or from fraud.

The rapidly expanding globalization of competition and the growing diversity of investor ownership structures, financial products, and management methods together with the ongoing differences in how societies and economies are organized and managed, hinder the formulation of a generally accepted homogenous corporate governance system worldwide. Even so, international investors and expanding capital markets are gradually bringing about a degree of convergence. Flexibility, transparency and accountability, for example, are by now generally recognized as crucial governance features. But the political, economic, legal and social contexts still vary from country to country or region to region. In a general sense, in the American view, the primary purpose of the corporation is to make money and increase shareholder value. However, for the majority of the rest of the world, corporate governance has a much broader stakeholder[21] point of view. This view is reflected in the recent OECD report on corporate governance[22] In that report, the general objective of corporate governance is to align the interests of firms with those of society, to balance entrepreneurship with accountability and to enable companies to earn a rate of return on investment that generates additional capital.

In the narrow sense, corporate governance deals with the relationships among corporate management, the board of directors and the investors, or shareholders. But it can also concern itself with the relationship between the corporation and other stakeholders, in addition to investors. In a broader sense, corporate governance is formulated and disciplined by laws, regulations, stock market listing rules, commercial customs, and public opinion.[23] Differences exist from country to country as to how companies are governed, and the question "who do we govern the corporation for?" is answered differently in different countries. The corporate governance systems used throughout the world are generally rooted in either the stock-market based Anglo-Saxon (outsider)

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and Sara Zervos. ''Stock Markets, Banks, and Economic Growth.'' *American Economic Review*, 88, June 1998, pp.537–558; Levy, Haim. ''Economic Evaluation Of Voting Power Of Common Stock,'' *Journal of Finance*, 38, March 1983, pp.79–93; Modigliani, Franco, and Enrico Perotti. "Protection Of Minority Interest And Development Of Security Markets," Mimeo, MIT, 1996; Perotti, E.C. and E. von Thadden. "Will Capital Market Integration Force Convergence Of Corporate Governance?" *Journal of Financial and Quantitative Analysis*, 2003; Rajan, Raghuram, and Luigi Zingales. "Financial Dependence And Growth," NBER Working paper 5758, 1996; and Rajan, Raghuram G., and Luigi Zingales. "Financial Dependence And Growth." *American Economic Review*, 88, June 1998, pp.559-586.

[20] For a detailed discussion see "Corporate Governance: Improving Competitiveness and Access to Capital Markets," A Report to the OECD by the Business Sector Advisory Group on Corporate Governance, Paris: Organization for Economic Co-operation and Development, 1998.

[21] Stakeholder reflect the interests of all the major players associated with a firm i.e. shareholders, suppliers, customers, lenders, employees, trade unions, etc..

[22] "Corporate Governance: Improving Competitiveness and Access to Capital Markets." A Report to the OECD by the Business Sector Advisory Group on Corporate Governance, Paris: Organization for Economic Co-operation and Development, 1998. See also OECD Principles of Corporate Governance, 22 April 2004.

[23] Holly J. Gregory, "The Globalization of Corporate Governance", (Weil, Gotshal & Manges: New York 2003), law firm publication, p. 5.

or the more traditional bank-based (insider) European and Japanese governance systems.[24] At present, the Anglo-Saxon system is primarily used in the United States and, with modifications, in the United Kingdom and Ireland. The European system, with country-to-country variations, is practiced in the other EU nations while different versions of the Japanese system are used throughout the Pacific Basin Region.[25] Again it should be mentioned that the concept of corporate governance in the United States, or even in the United Kingdom, that is, in the Anglo-Saxon type of system, is considerably narrower than that in many other countries, especially that of Europe.

The main features of the Anglo-Saxon system are dispersed ownership and detailed legal provisions. The rights and responsibilities of investors and other stakeholders are defined by formal rules and applied through contracts relying on competitive and transparent market transactions. As already alluded to, the primary responsibility of management is to maximize shareholder value. With management compensation tied to profits and stock options, managers are under constant pressure to realize this goal. Failure to do so is quickly reflected by declining share prices in the deep and liquid capital markets. Thus failure is generally visible, and either the shareholders, through voting at the annual meeting, or the Board of Directors, by chastising or replacing management, attempt to correct problems as they arise. The major strengths of the system are its flexibility, transparency and accountability, enabling corporate managers rapidly to respond to competitive challenges and shareholder demands. Its disadvantage are the limited influence of stakeholders other than shareholders and the income and wealth gap between managers and workers on the one hand and shareholders and the rest of society on the other hand. Labor unions in particular clamor about this.[26]

The traditional European style corporate governance system has a desire for economic stability and social safety as reflected by the widespread acceptance of welfare states in continental Europe. European welfare states provide a broad and deep social safety net that includes, among other things, relatively secure employment, generous unemployment and other benefits, regulated working conditions and extensive public pension system benefits, all financed through high taxes. The system is characterized by inflexible economic structures comprised of regulated product-service, capital and labor markets, high taxes, generous public spending and managerial systems that are risk averse. Over time, this has brought about a corporate governance system that sustains and, in turn, is sustained by such economic features and managerial practices.[27]

The Japanese corporate governance system is bank- and stakeholder based with the "keiretsu," a unique form of industrial organization, playing a major role. A "keiretsu" is a network of businesses made up of a core company and/or a main bank and associated firms that maintain concentrated cross-ownership arrangements.[28] It represents a coalition of stakeholders without carefully delineated authority lines among, for example, suppliers, lenders, customers, shareholders holding a complex blend of senior, junior, short-term and long-term implicit and explicit claims against the firm. Its advantage is stability, however, this feature can turn into inflexibility, as seen in Japan since the early 1990s.

Implications of Legal Traditions and Rule of Law

A further factor important in the examination of the principles of corporate governance, and the very concept of the corporation itself lies in the system of law that a particular country adheres to. Although there are, of course, a variety of legal systems or families of laws, the two major systems that are accepted in the major trading and industrialized nations today are the Romano-Germanic family (commonly referred to as the Civil Law system) and the Common Law Family (commonly referred to as the Common Law system.) [29] Although other legal, religious and other quazi-legal traditions exist, they are primarily of rule-based systems of law – such as Hindu law, Canon law, Jewish law, and Muslim law[30], for the purpose of this study they are not considered as

[24] For more details see, Paul J.N. Halpern, " Systemic Perspectives on Corporate Governance Systems," in Steven S. Cohen and Gavin Boyd (editors) Corporate Governance and Globalization: Long Range Planning Issues (Northampton, MA,: Edward Elgar Publishing Inc., 2000) pp. 1-58.

[25] The dominant types of corporate government systems have been extensively discussed in the literature. See, for example, Schleifer, Andrei and Robert W. Vishny (1997) and Cohen and Boyd (2000) as cited previously. For a discussion of some of the changes in the Pacific Basin Region, see, "The End of Tycoons," The Economist, April 29, 2000, pp.67-69.

[26] See AFL-CIO Corporate Watch, for example at http://www.aflcio.org/corporatewatch

[27] See generally, Comparative Study of Corporate Governance Codes relevant to the European Union and its Member States, Comparative Study of Corporate Governance Codes relevant to the European Union and its Member States, 27 March 2002.

[28] In times of high economic growth and corporate profits (1970-1990) the system had worked well because it insured stability in all business relations. But in times of low growth and profits (1991-present,) requiring restructuring and other related corporate changes, the systems stability turns into rigidity. Consequently, the Japanese are currently reviewing the system as part of an overall examination of their economy. Changes, however, are slow in coming. Following the 1997-1998n financial crises, the same is true in the Republic of Korea and other Pacific Basin nations.

[29] Emmons, Willaim R. and Frank Schmid, "Corporate Governance And Corporate Performance", in Cohen, Stephen S. and Gavin Boyd, Corporate Governance And Globalization, 2000 and La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny), "Law And Finance," *Journal of Political Economy,* 106, 1998, pp.1113-1155. See also David, René and John E.C. Brierley, Major Legal Systems In The World Today, An Introduction To The Comparative Study Of Law, London: The Free Press, 1968.

[30] For an introduction to Islamic or Muslim law, see Perry, Frederick V. "Shari'ah, Islamic Law and Arab Business Ethics", Connecticut Journal of International Law, Volume 22, Issue 1, May 2007, forthcoming.

their importance in understanding the relationship between national investor protection and corporate governance is thought to be less important[31],[32].

The Common Law tradition is primarily found in the United States, United Kingdom, and Canada (and other English speaking nations and/or nations whose post-World War II development was heavily impacted by other English-speaking nations[33]. The Civil Law or Roman-Germanic tradition is primarily found in continental Europe (and other nations who where heavily influenced by continental Europeans, such as Latin America.) However, there are three main subdivisions within the civil-law tradition: the German[34], the French[35], and the Scandinavian[36] civil-law tradition[37]. Legal traditions are important as they are systematically related to the types of legal rights and protection provided to investors i.e. creditor rights and shareholder rights, respectively. These rights and protections, in turn affect the types and availability of financing to firms and determine which category of investors (banks, or non-financial institutions or individuals) are more active in the marketplace. Furthermore, legal rights of shareholders and creditors, for example, cash payments and/or participation in firm decision-making, are "necessary but not sufficient conditions for effective corporate governance. As such, a climate of respect for the rule of law is also needed."[38] In order to show that different types of corporate governance systems create variances in financial markets one could adopt the premise that the more superior a nation is on (a) shareholder rights, (b) creditor rights and the (c) rule of law, the more financially stable its financial markets are, which, in turn, positively influences corporate efficiency in terms of access and use of financial markets[39]. There are many studies[40] that have proven the relationships between the relative importance of debt and equity markets based on Common-law versus Civil-Law traditions for corporate governance systems. The overall picture that emerges from these studies is that Common Law nations have much larger markets for outside equity, and for some nations, also for corporate bonds[41] and that for most firms in Civil Law countries public equity and bond markets are relatively unimportant. In Civil Law nations, most external financing done by firms is in the form of banks loans. The smaller, more underdeveloped public equity and bonds markets in nations under the Civil Law tradition imply that the firms in these nations are restricted to insider (or "near-insider") financing consisting of owner-contributed funds, retained earnings or bank debt. The negative implications of theses restrictions i.e. lack of access to external financing, include fewer new firms (less competition and market growth); existing firms are smaller or more fragile; business cycles determine timing of financing; there are insufficient retrained earnings; banks have undue influence over firms; and ownerships is less diversified.

The EU Corporate Governance Systems

The corporate governance systems used throughout the EU nations vary. They are rooted in two broad European corporate law traditions; the company- and the enterprise-law based legal systems.[42] In the

[31] La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, "Law And Finance," *Journal of Political Economy,* 106, 1998.

[32] There are various good sources to gain an understanding of the Common Law and the Civil Law Systems as well as their impact on corporate governance and performance, for example, Merryman, John Henry. The Civil Law Tradition: An Introduction to the Legal Systems of Western Europe and Latin America, Second Edition, Stanford: Stanford University Press, 1990. See Fred, B. The German Civil Code, Littleton, Colorado: Rothman & Co, 1994; Peltzer, M., J. Doyle and E.A. Voight, German Commercial Code/Handelsgesetzbuch, 4th Revised Edition, Munich: Otto Schmidt Verlag, 2000; and West, Andrew, The French Legal System: An Introduction (German-English Text), London: Fourmalt, 1992. See Merriman, John Henry, Clark, David. S and Haley, John O., The Civil Law Tradition: Europe, Latin America, and East Asia, Cases and Materials, Lexis Nexis, Matthew Bender, Newark, New Jersey, 1994, p.948 and p. 951. Emmons, William R. and Frank Schmid, "Corporate governance and Corporate Performance", in Stephen S. Cohen and Gavin Boyd, Corporate Governance and Globalization, 2000, p.69 and Rafael La Porta, Florencio Lopez de Salinas, Andrei Shleifer and Robert Vishney. "Law and Finance," Journal of Political Economy, 106, 1998, pp.1113-1155.

[33] The common-law group includes all the English–speaking members of the OECD as well as former British colonies and protectorates. A sampling of these nations would include, among others, Australia, Ireland, New Zealand, Hong Kong, India, Israel, Pakistan, Kenya, Thailand and South Africa. Emmons, William R. and Frank Schmid, "Corporate governance and Corporate Performance", in Stephen S. Cohen and Gavin Boyd, Corporate Governance and Globalization, 2000.

[34] The German Commercial Code, written in 1987, includes in its subdivision, aside from Germany, a sampling of the following nations, among others: Austria, Japan, South Korea , Switzerland, Netherlands, and Taiwan.

[35] The French Commercial Code was written during the Napoleonic era, in 1807. It spread initially due to military conquests. Asides from France, a sampling of these nations would include, among others, Belgium, Greece, Italy, Mexico, Spain, Turkey, Argentina, Brazil, Chile, Indonesia, Jordan, Egypt, Philippines, and Venezuela.

[36] These nations include Denmark, Finland, Sweden and Norway.

[37] La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, "Law And Finance," *Journal of Political Economy,* 106, 1998 and Emmons, Willaim R. and Frank Schmid, "Corporate Governance and Corporate Performance", in Cohen, Stephen S. and Gavin Boyd, Corporate Governance and Globalization, 2000.

[38] La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, "Law And Finance," *Journal of Political Economy,* 106, 1998, p.74 and Emmons, Willaim R. and Frank Schmid, "Corporate Governance and Corporate Performance", in Cohen, Stephen S. and Gavin Boyd, Corporate Governance and Globalization, 2000, p.74.

[39] Emmons, Willaim R. and Frank Schmid, "Corporate Governance and Corporate Performance", in Cohen, Stephen S. and Gavin Boyd, Corporate Governance and Globalization, 2000.

[40] La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, 1998), (Shleifer and Vishny 1887), (Levine and Zervos 1998), (Hart 1995), (Hellwig, 1991), (Rajan 1992) and (OECD 199b).

[41] This does not imply that banks are not important in Common Law nations.

[42] For a more detailed discussion see, Wymeersch, E. "Elements of Comparative Corporate Governance in Western Europe," in Isaksson M. and R. Skog (editors,) Aspects of Corporate Governance, Stockholm: Juristforlaget, 1994. See also, Comparative Study of Corporate Governance Codes relevant to the European

company-based legal system (the Anglo-Saxon model) the emphasis is on the firm as a legal entity and the relationship between it and its investors. In the enterprise-law system the focus is on the enterprise as a real economic and social unit, which includes the role and relationships of its many stakeholders. The definition of investor or shareholder is an easy one. The term stakeholder is another matter, since a stakeholder can be anyone or anything with an interest, broadly defined, in the outcome of a corporation's activities, such as the environment, the community, vendors, employees, lenders, customers, the country as a whole, to name a few. In the EU, the company-based corporate legal system is used in the United Kingdom and Ireland; the enterprise based legal arrangements are applied primarily in Germany, the Netherlands and most other member nations.[43]

In continental Europe, in the enterprise system, concentrated ownership by banks or other firms and complicated stakeholder relations are common features throughout the region. Banks may be major equity owners and lenders at the same time, raising the specter of moral hazard through conflicts of interest. The banks however do not see it this way. They are privy to a great deal of information—many bankers are on the boards of corporations to which they are tied—and they are thus better able to ensure the health of their lending relationship, sometimes at the expense of their shareholdings. Labor unions and/or governments often influence management to achieve political and social goals such as stable employment, sometimes regardless of economic performance. The stakeholder-based, consensus decision-making process tends to be opaque and hard to penetrate for outsiders. The use of stock options and other financial incentives tied to profits are new phenomena and limited. Moreover, capital markets do not consistently sanction management for not maximizing shareholder value. The strength of the systems is that it focuses not only on shareholder interests but also considers the goals of other stakeholders. These may include the protection of jobs, a reasonably equitable income and wealth distribution and economic and social stability. Its weakness lies in its limited flexibility, limited transparency and limited accountability. Consequently, firms find it difficult quickly and decisively to respond to changing market conditions, particularly competitive challenges.

Selected Key Features

EU nations vary in size, legal systems, forms of industrial organization and social traditions. Some nations such as Germany, Italy, France, Belgium, Greece, Portugal and Austria reflect the traditional welfare state values. Others as, for example, the United Kingdom, Sweden, Denmark, Finland, the Netherlands, Ireland and Spain have already introduced more competition oriented economic policies that have reduced the scope of the welfare state. Ireland, for example, through sound economic policies has experienced almost 20 years of rapid growth, achieving a per capita GNP that is now even with that of the United Kingdom. The different national economies also dominate different industrial niches. Italy, for example, maintains large financial-industrial groups and clusters of family firms. Germany is characterized by mid-sized family owned and large engineering companies, while Sweden and Finland by high-tech communications multinational corporations.

As a consequence, the current EU corporate governance systems are a patchwork of arrangements.[44] At one end of the continuum are Germany, France and Italy with concentrated ownership, a bank oriented financing system, relatively illiquid capital markets and enterprise-based corporate laws that place moderate emphasis on the monitoring of corporate performance by stock-markets. At the other end are the United Kingdom and Ireland with their dispersed ownership, liquid capital markets and corporate laws that rely heavily on the stock market—and the value reflected thereby-- to monitor the performance of firms. The other member states are in between the two extremes.

Concentrated ownership is widespread, with reasons and structures differing from country to country. Except for the United Kingdom and Ireland, in most nations concentration is seen as supportive of long-term orientation that benefits all stakeholders, including society as a whole. In contrast, widely dispersed ownership is viewed as too focused on short-term objectives, such as shareholder value maximization. In Germany, for example, more than 80% of publicly listed companies have a single shareholder, owning more than 25% of equity.[45] Cross-ownership in unrelated companies is prevalent. Other nations with major ownership and voting blocks include Italy, Austria and Belgium. In France, domestic investors own large companies as a matter of government policy, a feature enhanced by the lack of institutional investors. In Italy, banks and holding companies own networks of firms through pyramids of cross-shareholdings. Elsewhere, as, for example, in Sweden several large companies are owned by business dynasties rooted in the late 19th or the early 20th centuries. It should be noted that in some countries disclosure laws are either not fully

Union and its Member States, European Commission Internal Market Directorate General, 27 March 2002.

[43] See generally Charkham, Johnathan. Keeping Good Company: A Study of Corporate Governance in Five Countries, (New York: Oxford University Press, 1994).

[44] Comparative Study of Corporate Governance Codes relevant to the European Union and its Member States
European Commission Internal Market Directorate General
27 March 2002.

[45] Rehman, Scheherazade and Peter Lauter, "Corporate Governance Developments In The European Union," *Hungarain Economic Forum*, University of Budapest, Hungary, Fall 2003 (interview with Dresdner Bank official, Frankfurt, Germany, September 26, 2001.)

developed or are still not working well, thus it is difficult to find out what real ownership structures are.

Other internal features also vary. The Netherlands shares elements of its corporate law with France but uses the two-tiered German corporate management structure that in firms with more than 500 employees comprises a supervisory board (*Aufsichtsrat)* and a management board (*Vorstand)* consisting of inside directors. The supervisory board is made up of outside directors and members elected by the employees and/or appointed by the labor unions, thereby realizing the objectives of "co-determination," i.e. the involvement of workers in management. The supervisory board appoints and oversees the management board that runs the day-to-day activities. The supervisory board is prohibited by law from taking part in the management of the corporation. Unlike under the one-tiered board structure used by French firms, German and Dutch companies thus practice a form of collective leadership. To emphasize this, German firms have "speakers of the boards" (*Sprecher*) rather than "chairmen" as in France. For a number of years, the EU Commission tried to introduce the German-Dutch system in all member countries. But most of them, in particular the United Kingdom and Ireland, strongly objected to the proposal; thus nothing came of it.

Germany

A closer look at the German system is warranted. Germany's cultural and social attitudes are based on cooperation rather than confrontation, the collective good, rather than the individualism so popular in the Anglo-Saxon system. Co-determination helps both to ensure and to interpret that attitude. Typically no one is concerned with short term accounts, certainly not more frequently than quarterly accounts, and the so-called "flash reports" often required by US-based multinationals of their German subsidiaries are viewed with xenophobic resentment and the feeling that the Americans are crazy.[46] Further, German management often thinks of its employees and customers first.[47]

Germans have long considered that there is already effective accountability in the governance of German corporations. However, the way in which this accountability system works is considerably different from what an observer in the United States or the United Kingdom would call adequate accountability. Because of the German penchant for cooperative action, the concept of accountability is rooted in the idea that all critical players already know what is going on: labor, the banks, management and the *Aufsichtsrat,* since they are all involved in decision making. Of course the shareholders, to the extent that they are not the bankers or labor, are relegated to a status of fair ignorance. The financial statements have typically been opaque; profitability is reported differently than in the Anglo-Saxon system. Excess profits have often been squirreled away for leaner times. Long term survival is more important than short term profits or mere growth. After all, the company has a duty to survive not simply for itself or its shareholders, but for workers and the larger community in which it operates.

Section 76 of the German *Aktiengesetz*, or Stock Corporation Code reflects the stakeholder/cooperative culture. Under that section of the law, management is given considerable latitude in directing "the company under its own responsibility", but at the same time, the law obliges management to take into account the interests of other stakeholders, to include employees, creditors, and the general public. There is no duty to maximize the value of shares.[48]

France

The French method of corporate governance, like that of other countries reflects its social and cultural values and its history. France, like Germany takes the social or enterprise view.[49] as in Germany, there is often more cooperation than confrontation. But in France, the cooperation is much broader and deeper than in Germany; it is also totally different than the Anglo-Saxon system. Even so, what we find in France is a bit of a conflicting paradox. In one sense, at least, the French system is somewhat similar to the American system, inasmuch as the person in charge is really in charge. The French typically give the *President Directeur-Général* (PDG) almost absolute power, much along the lines of the French tradition of strong and centralized leadership in the tradition of de Gaulle, Napoleon or Louis XIV. The state, or "*la France*" and the companies it sanctions, fosters and protects are often intertwined. It is similar to Germany inasmuch as the system, or the community—with a capital C—is very much taken into account. The difference is that, unlike in Germany, there is not much consulting and discussion with the various constituencies before a decision is reached. However, the government and the lending institutions it controls are involved, especially when things go wrong. So unlike the Anglo-Saxon system, or even the German system, there are no real checks and balances on the actions of the PDG. Often, however, the central

[46] During the 1990's the writer, Perry, often witnessed altercations between the US parent, where he worked, and its the German subisidiary over such matters.

[47] Charkham, Johnathan. Keeping Good Company: A Study of Corporate Governance in Five Countries, (New York: Oxford University Press, 1994), p.10.

[48] Akktiengesetz of September 6, 1965 (Bundesgesetzblatt) Section 76. The basic law on Stock Corporations is supplemented by further legislation such as the Codetermination Act, the Commercial Code, and the Security Trading Act. Further, the Justice Minister in September 2001, appointed a government commission to draft a German Corporate Governance Code, which was adopted on February 26, 2002. See the Electronic Federal Gazette at www.ebundesanzeiger.de.

[49] See, Recommandations sur le gouvernement d'entreprise, L'Association Française de la Gestion Financière (AFG), March 2004.

government, intervenes quickly, actively, and often behind the scenes, for example, the French Treasury often steps in to save companies in trouble, and a number of government organizations collect and disseminate credit and other types of information about companies. This is best illustrated by handling of the 2007 multi-billion trading scandal in which Societe Generale estimated losses exceeded $7 billion.

Few listed companies in France have widely dispersed shareholdings. The vast majority has major shareholders. This is generally so because they are subsidiaries of some other company, or because of institutional holdings or cross shareholdings. Often the original founder has retained a very large holding of company shares, or sometimes it is the state. Traditionally French companies have not favored going to the capital markets to raise money, preferring debt financing. But this has gradually changed.

The French believe in rule by the elite, and the elite are not simply the wealthy, rather they are the ones who are the intellectually superior, those who go to the top few schools. This "class" of elite goes from government to business and vice versa. [50] The connections which this phenomenon creates are made even tighter by the links of shareholdings of companies by the financial sector. There is complex web of interlocking company ownership.

In France, often financial intermediaries hold the shares for the true owners, and in those instances involving issues regarding dividends and the like, they must be contacted by the corporation, and they, in turn, communicate with the shareholders. National groups of shareholders, such as the Association National de Actionnaires Francais and the Fédération Nationale des Clubs have recently sprung up. The former attends shareholders meetings and voices general concerns, the latter represents shareholders in lawsuits. However, generally shareholders in France have a conservative view when it comes to expecting dividends. Big dividend payments are not, in their view, justified. If a company is not doing well, it cannot afford them; if it is doing well, it should guard its resources and invest them wisely[51].

France, like Germany, also introduced tax reforms. However, the French reforms were more limited, both in terms of magnitude and scope than the German changes.

European Governance Integration Trends from the 1990s Onward

During the 1990s the EU nations experienced strong pressures to develop more effective corporate governance systems, tending toward the Anglo-Saxon model as applied in the United States. There were several general reasons for this. First, the example set by the stellar performance of the U.S. economy and American companies. Second, as competition became more and more globalized and as capital moved across borders more freely, investors in general and large institutional investors in particular demanded more uniform and transparent corporate governance standards. To raise investment funds in the international capital markets firms had to meet Anglo-Saxon governance norms. Third, the good economic performance of the EU member states during the second half of the decade, the establishment of the EMU and the introduction of the euro in 12 countries had encouraged cross-border mergers, requiring transparent and flexible transactions. The continued expansion and deepening of the Single Market were additional factors that enhanced the process.

The EU nations' political and cultural establishments and even members of the business communities have frequently expressed reservations about some of the efficiency measures applied by American companies. The member states appear simultaneously to seek efficiency and competitiveness on the one hand and social and economic stability on the other hand. In 1999, Tony Blair, the Prime Minister of the United Kingdom, French Premier Lionel Jospin and German Chancellor Gerhard Schroeder even contemplated the development of a "Third Way" of structuring and managing economies that would differ from both the traditional European welfare and the American competition-based systems. Introduced with a great deal of fanfare, notions of such a "third way," however, quickly evaporated when they could not agree on what it meant. Nonetheless, when the U.S. economy began to slow, the prime ministers and the chancellor together with the other EU heads of state and governments blithely announced that their economies were sufficiently different from that of America so as not to be affected.

But soon they were forced to realize that the world economy was undergoing major changes and that the linkages among the world's industrial economies are tighter than they had assumed. While it is true that many of the EU member states' emerging economic problems could be ascribed to the global slowdown, quite a few of them were homemade. Whereas the American economy had been engaged in "***creative destruction***" for most of the 1990s, the EU economies displayed "***destructive caution***".[52] Most large companies in the EU were managed by well-educated and trained technocrats who had steadily risen through the ranks, but had a rather limited understanding of general management and marketing in the era of the globalization of competition. Well-managed companies bore up well before a myriad of

[50] This section is based on Charkham, Jonathan, Keeping Good Company: As study of Corporate Governance in Five Countries, New York: Oxford University Press, 1994 and Dellldin, Theodore, The French, London: Harvill, 1983.

[51] Charkham, Jonathan, Keeping Good Company: As study of Corporate Governance in Five Countries, New York: Oxford University Press, 1994 and Dellldin, Theodore, The French, London: Harvill, 1983.

[52] It was the Austrian-American economist Joseph Schumpeter who formulated the concept of "creative destruction" as a positive growth force in competition-based market economies.

laws, rules and regulations, while the poorly run firms were often saved at taxpayers' expense because of the employment implications. In time, consensus decision-making turned into a veto against change, and social and economic stability considerations turned into the maintenance of established structures. As the potential losses caused by change became politically less and less acceptable, even those who were willing to alter the status quo retreated.

The primarily technologically driven global competitive changes during the 1990s and the 2001-2002 global economic downturn combined with the skyrocketing costs of the traditional welfare states eventually had sobering effects on the political and business leaders throughout the region. They finally recognized that the frequently discussed but always delayed EU-level political-institutional and structural national economic reforms, including the development of more effective corporate governance systems, could no longer be postponed.[53] Undoubtedly, the slowdown of the global, U.S. and EU economies and corporate scandals in the United States somewhat reduced the pressures for change. Nonetheless, improving the flexibility and efficiency of the EU economies and revamping the corporate governance systems became major policy objectives of the member nations.

The change process, however, is slow and gradual. It requires a new worldview in general and a different economic value system in particular. Managerial philosophies, organizational structures, competitive strategies and, most of all, labor market structures and practices have to be altered.[54] Not surprisingly, across the EU, particularly in Germany and France, a palpable sense of unease has emerged over what is seen as an expanding American led process of the globalization of competition. This is partly due to a certain jingoism or xenophobia normal in any country, but also due in some measure to the realization that in order for some of those foreign managerial and governance philosophies seriously to take root, in order that national industry be able fully to compete on the world stage, some fairly thoroughgoing changes to the social and economic fabric of the national culture must also take place. That is very painful.

In the United States, the changes to the corporate governance system brought about by the collective outrage after Enron, Tyco and similar scandals was easy compared to what may be required in Germany and similar systems. Even though the Sarbanes-Oxley Act[55] has been touted as "the most important securities legislation enacted by Congress since the 1930's"[56] and "…the most significant changes to the regulation of public companies since Congress passed the Securities Act of 1933… and the Securities Exchange Act of 1934…"[57], in fact it barely changed the general concept of accountability and transparency, and what the relationship of the corporation to its shareholders/stakeholders is supposed to be. Of course it has seemingly taken away some of the CEO's kingship, and given more power to the board of directors, taking many things out of the traditional province of state law, and it has now made mandatory certain requirements for non-executive or outside directors.[58] However, in reality, it simply made the old system stricter and put in place more safeguards, duties and sanctions to ensure that management and boards of directors do now what everyone thought they should have been doing all along. The emphasis is still on financial disclosure. Germany, on the other hand will require a thoroughgoing transformation of the very concept of corporate accountability, ownership structure and the treatment of shareholders, if its companies are to be swathed in the flexibility and accountability of the Anglo-Saxon system.

While apprehensions over the specter of Anglo-American style changes are the strongest in Germany and France, other EU nations also express concerns. They believe that shorter working hours and more opportunities to enjoy life are more important than economic efficiency, a higher per capita GDP and a corporate governance system that focuses on shareholder value. Many in the political and cultural establishment believe that the change process threatens to spread American economic and social conditions and values such as pronounced income inequality, individualism and addiction to work, challenging the traditional European way of life. In almost every speech dealing with economic issues, prior German Chancellor Schroeder often emphasized that he did not want "…American conditions in Germany."

Such views, however, are by no means universal. Some politicians, opinion makers in the media, and

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[53] Various issues of the Economist. Financial Times, The Wall Street Journal and Business Week published during the years 1998, 1999 and 2000. The January 31, 2000 issue (pp. 81-87) of Business Week, contains a particularly informative article about the economic changes taking place in the EU nations. See, also EU Commission, Forward Studies Unit, Competition Advisory Group, "Sustainable Competitiveness: Report to the President of the Commission and the Heads of State and Government," Brussels: EU Commission, September 1999. Another insightful publication is a working paper by Jacquemin, Alexis. "European Competitiveness and Business," Brussels: EU Commission, Forward Studies Unit, 2000.

[54] Small- and medium-sized family-owned companies are also adjusting to the changing times.
The euro has increased pressures on them to obtain equity capital when expanding either domestically or
throughout the region, specially when banks reduce lending, as many have done in the recent past.

[55] The Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002)

[56] Greene, Edward F., Leslie N. Silverman, David M. Becker, Edward J. Rosen, Janet L. Fisher, Daniel A. Braverman, and Sebastian R. Sperber, The Sarbanes-Oxley Act: Analysis and Practice, New York: Aspen Publishers 2003, p.xiii.

[57] Romanec, Broc, Linda L. Griggs and Sandra Leung, "New Compliance Challenges Under the Sarbanes-Oxley Acto of 2002", *ACCA Docket,* November/December 2002, p. 23.

[58] See Howell, Joy and Stephen Hibbard, "Navigating the Changed Corporate Landscape," *Harvard Management Update*, December 2002, Cambridge, Massachusetts: Harvard Business School Publications 2002.

the majority of business executives argue that the members of the establishment of their respective countries are too self-satisfied and that they are not open to change coming from the outside world.[59] Others point out that the critical views primarily reflect concerns about the future of the traditional welfare states that for decades have provided a continually increasing standard of living together with economic and social stability.

Even so, some things in Germany are gradually changing, or at least there is a sense in many circles that things must change, and so there are attempts. In July of 2000, even before the major US scandals, the German Panel of Corporate Governance promulgated a paper entitled "Corporate Governance Rules for Quoted German Companies"[60] Unfortunately, the paper, in describing a "Code of best practice for German corporate governance", amounted basically to a group of cheerleaders extolling the German system, explaining how it equaled or exceeded the OECD Principles of Corporate Governance of May 1999.[61] The panel stated that:

> *"…The purpose of corporate governance is to achieve a responsible, value-oriented management and control of companies. Corporate governance rules promote and reinforce the confidence of current and future shareholders, lenders, employees, business partners and the general public in national and international markets. The Supervisory board, Management Board, and Executive Staff of the Company identify themselves with these Rules and are contractually bound by them. They are part of the general obligation to observe other interests related to the corporate activity*."[62]

In France the gradual restructuring of some industries that began a few years ago attracted billions of dollars in investment capital, much of it from U.S. and United Kingdom pension funds. This sparked a series of debates about the relationship between French cultural values and the demands of the international capital markets. French President Jacques Chirac was quoted as complaining that: " …French workers were being asked to sacrifice simply to safeguard the investment benefits of Scottish widows and California pensioners."[63]

Following the publication of the two so-called "Viénot Reports[64]" by the Mouvement des Enterprise de France along with the Association Francaise des Enterprise Privees, these associations have conducted and widely published such studies as "Transparence des Salaires et des Stock-Options : Initiative MEDEF-AFEP[65]." They are not ambivalent to either the demands of the capital markets nor the world press covering corporate scandals. French corporate and government leaders are also concerned with the issue of trust in the corporation, and for them:

> *"…In Addition to the moral imperative, this represents a key economic requirement for all developed economies, taken both collectively and individually. Ever more initiatives are being launched in both the United States and Europe, as each country understands that what is at stake is the competitiveness of its business and its financial markets.*
>
> *Recent events, particularly revelations of questionable accounting practices, have impacted global companies, ruined shareholders and employees and led to the disappearance of one of the leading audit firms. This has caused a severe breakdown of trust in the very essence of a market economy, namely the quality of corporate governance and the reliability of financial statements. The latter provide the link between the economic reality of each company and its shareholders, both institutional and individual."*[66]

The Viénot Reports did two things: they caused certain changes to be made to the French law, yet at the same time, they stood for the proposition that it is not so much the rule of law that makes for good governance, rather the spirit of the norms. The French believe that their system of corporate governance is far superior to the Anglo-Saxon system, or at least, certainly to that of the United States.[67] They smugly declare that unlike what they appear to consider the "cowboy system" in the United States, French law for example requires that "only the general meeting of the

[59] See, for example, Joffe, Joseph. "Agenda Deutschland," *Die Zeit,* March 7, 2002, p.1.

[60] "Corporate Governance Rules for Quoted German Companies," German Panel of Corporate Governance, Frankfurt am Main, July 2000. See www.ecgi.org/codes/country_documents/germany/code0700e.pdf

[61] OECD. "OECD Principles of Corporate Governance," Paris: OECD, 1999a.

[62] "Corporate Governance Rules for Quoted German Companies," German Panel of Corporate Governance, Frankfurt am Main, July 2000, p.1.

[63] The New York Times, January 9, 2000, p.10.

[64] "The Board of Directors of Listed Companies in France," July 10, 1995, hereafter Vienot #1, and "Recommendations of the Committee on Corporate Governance" Chaired by Mr. Marc Vienot, July 1999, hereinafter Vienot #2. Both reports were sponsored by the Association Francaise des Enterpises Privees and the Mouvement des Enterprises de France.

[65] Didier Pineau-Valencienne, alors président de l'AFEP, et Ernest-Antoine Seillière, président du MEDEF, ont présenté, en janvier 2000, une initiative conjointe en faveur de la transparence des rémunérations des dirigeants d'entreprises françaises.

[66] "Promoting Better Corporate Governance in Listed Companies", report of working group chaired by Daniel Bouton, President of Société Bank, September 2002, sponsored by Association Francaise des Enterprise Privees and Mouvement des Enterprises De France, herein referred to as the "Buonot Report," p.2.

[67] The general theme of the Buonot Report was that while the French system could stand some tinkering to make it better, it was in general pretty good, certainly better than that of the Americans, who clearly do not have it right as evidenced by history.

shareholders has the power to authorize the granting of options."[68]

The French believe that while certain core legislation is essential, the varied and precise rules for the governance of a corporation should be based on the general principles laid down by the two Viénot Reports and the Bouton Report, and that: "It is not so much the letter of the rules as their spirit, not standards but behavior. Though regulation is of course needed, formal rules and superficial compliance with them cannot be enough. The French student riots over proposed legislation in 2007 for "probationary periods" for first time job holders remind us that progress is slow.

Specific Trends

All EU nations, including Germany and even France, are acquiring an Anglo-Saxon corporate governance tinge, albeit to varying degrees and at a differing rates. Tougher disclosure laws or rules are gaining traction, shedding more light on ownership structures. Managers are paying increasing attention to shareholder value as a part of corporate strategies. Cross-border mergers and acquisitions are changing the industrial landscapes while companies switch to more sophisticated profit yardsticks such as " value added," a shareholder value related measure.[69] One of Germany's major banks, the Deutsche Bank has created a powerful new executive committee to streamline decision-making. This places a considerable amount of authority in the hands of the chief executive, an arrangement rather rare in Germany but the norm in US companies. Many of the industrial giants across the region have adopted international accounting standards and in most nations, executives are providing more information about their remuneration, including benefits. And there is a growing tendency to align the interests of top executives more closely with those of shareholders by making share options a part of income.

In view of such developments, Germany in 2002 introduced a new corporate governance code for publicly traded firms, albeit a voluntary one. It was developed by a committee of institutional and private investors, employee representatives, supervisory and management board members, business consultants and academics. Its objective is to make Germany more attractive to international and domestic investors by changing the traditional governance arrangements and practices, which had been strongly criticized by international investors. The new code provides more independence to supervisory boards, calls for increased corporate transparency, particularly in the case of hostile takeover attempts and strengthens the role of company auditors. It also proposes that companies regularly publish information concerning executive remuneration.

Referring to the collapse of America's Enron as a warning sign, the government emphasized that under a new law, publicly traded firms have to declare whether they intend to abide by the voluntary guidelines. While there are no formal sanctions for non-compliance, the government expects EU and international capital markets to pressure firms that choose to ignore the guidelines.

A nascent shareholder culture is also developing across the region. According to the German Shareholder Institute, 35% of Swedes, 33% of Spaniards, 31% of Danes, 30% of the Dutch and 23% of UK citizens, 21% of Greeks, 17% of Germans 13% of the Irish and around 10% of the French were shareholders – in comparison, only 25% of Americans and 9% of Japanese.

Conclusions

The eventual proposals of the EU's constitutional convention together with the number of countries admitted will have important implications for the current EU corporate governance systems already undergoing some changes. If the outcome is going to be a constitution i.e. a federal type EU political-administrative structure, it is likely that a new, unified and comprehensive EU corporate governance system would be established in the future. As mentioned in the introductory part of this paper, EU nations want to improve the efficiency of their economies in general and the global competitiveness of their firms in particular. They agree that to achieve these goals, they have to restructure their economies, that is, create more flexible product-service, capital and labor markets through, among other things, more privatization, deregulation, development of new technologies and the promotion of entrepreneurship.

To compete effectively, EU firms have to achieve sustained competitive advantages either through cost leadership, product/service differentiation or through the creation of a market niche in which they serve a particular market segment. Regardless of the specific competitive strategy or which combination thereof they choose, flexibility and the ability to respond quickly are of great importance.

Of the EU nations, Germany has the largest economy with the most internationally involved firms.

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[68] Buonot Report, "Promoting Better Corporate Governance in Listed Companies", report of working group chaired by Daniel Bouton, President of Société Bank, sponsored by Association Francaise des Enterprise Privees and Mouvement des Enterprises De France, September 2002.

[69] Most call it economic value added, or simply "EVA". In the 1970's and 1980's, American companies tended to measure there profitability and success by either return on equity, "ROE", or return on investment, "ROI", however, by the 1990's they realized that such measures did not give the full picture, since not all costs were taken into consideration. The idea of EVA as a measure holds that a company creates value when it derives revenues over and above all the costs incurred in generating those revenues. It must take into account the cost of capital, which often the older measurements did not do. See "Measuring and Managing Shareholder Value Creation", The American Institute of Certified Public Accountants, Management Accounting Guideline, September 4, 2002. See also, Armitage, Howard and Jog Vijay , "Economic Value Creation: What Every Management Accountant Should Know", *CMA Magazine,* October 1996, pp.21-24.

Yet, this powerful economy that is a major influence on the economies of the other member nations is still over-regulated and characterized by a cradle to grave social safety net and a traditionally structured corporate governance system based on consensus decision-making, involving a number of stakeholders.

It has become abundantly clear that if labor unions want to remain relevant, they must pursue flexible work skills and not simply collective political muscle as the key to job security. They also have to negotiate more constructively with management and governments, and instead of demanding job security at almost any cost, they must offer retraining and career services to their membership. They must be convinced that structural economic and institutional competitive reforms must be introduced in order to improve the overall performance of their economies and companies once the global economy recovers. Only then will EU corporate managers be able to take full advantage of their abundant scientific, technical and managerial skills, obtain funds through the most efficient channels of financing and formulate competitive strategies that can challenge the dominant global position of America's high-tech companies. One of the institutional reforms needed is a change in the EU nations' corporate government systems.

The laws respecting companies and their governance in the EU are in flux, for the time being. It seems that for every EU member nation that takes a step toward economic restructuring, another takes a step backward to protect traditional methods. Nonetheless, the gradual movement towards a common ground between the Anglo-Saxon shareholder-based and the European stakeholder-based corporate governance systems has started. While an international agreement on a single model of corporate governance rules is just as unlikely as it is unnecessary, it is clear, however, that the very influence of international capital markets and the globalization of competition will lead to a fair degree of convergence in governance practices. This is especially true given that the stock market continues to be the cheapest source of financing for global multinationals. Since London and New York stock markets dominate the global equities markets as they are larger, more efficient and accessible, and vastly more liquid then their Continental European or Asian counterparts, global multinationals will have to list themselves on these two Anglo Saxon style exchanges, in order to stay globally competitive. In doing so they must adhere to U.S. and U.K. style corporate governance systems, goals, and practices which entail, for example, accounting standards that mandate quarterly reporting, where both individual and institutional holders shun the long term, continuous market pressure for positive stock performance for shareholders that traditionally exhibit equity attention deficit disorder, and who buy and sell stock with the same frequency they buy their Starbucks coffee. Thus, it seems that this convergence favors the Anglo Saxon model at least for the global competitors.

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