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FOREWORD

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This issue of *Law and Contemporary Problems* is the culmination of a four-year project undertaken by the authors to investigate the purposes and accountability of the modern corporation. The project, generously funded by the Alfred P. Sloan Foundation, consisted of four phases. The first phase involved an extensive review of the literature of corporate governance across the fields of law, economics, finance, and management, with a view toward identifying unifying themes, common perspectives, and relevant issues. This exercise produced an extensive bibliography of the most important work on corporate governance in each of these four disciplines.

We then sponsored a fourteen-week seminar series at the University of Michigan Business School in 1997. The intent was to provide a forum for pre-eminent individuals from the scholarly world and the world of practice to meet each week to discuss and debate emerging questions about the purposes and accountability of the firm. Nearly 150 faculty and graduate students from Michigan's Business and Law Schools attended these seminars. Each session explored the relationships between theory and practice. Taken as a whole, the series was relentlessly interdisciplinary. We would like to acknowledge the following people for their contributions to this seminar series:

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After first reading and discussing the broad interdisciplinary governance literature and then creating and participating in the seminar series, we articulated both the issues and our points of view about them in a series of articles. The first article in this issue, *The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at a Crossroads*, represents the third phase of our project. We begin the article by identifying five forces of change that have profound implications for corporate governance in contemporary society. These forces of change involve the nature of work, the nature of the capital market, the nature of the product market, the evolution of organizational forms, and the nature of the regulatory environment. These changes implicate every corporate constituency. They also challenge the current legal and practical systems for the exercise of power and control in the conduct of the business corporation.

Having identified the major forces of change, we turn to an examination of their implications for corporate governance. We begin our inquiry with a review of the traditional empirical literature that relates different aspects of corporate governance to different measures of corporate performance. We conclude that this cross-sectional approach is of limited value in analyzing the fundamental changes that we have identified. Much of this literature consists of so-called event studies, which cannot possibly capture the dynamics of the corporate governance process, because, by design, they assume that the existing institutional framework is taken as given. To analyze the implications of these changes for corporate governance, we turn to the two most popular paradigms of the public corporation: contractarianism and communitarianism. We describe these two views of the public corporation and examine how each addresses the forces of change we have identified.

We tentatively conclude that in a world of change, the contractarian view best orients a public policy position toward the large-scale, public corporation. While we recognize the limitations of the contractarian view (for example, third-party effects and ill-defined property rights), we believe that allowing individuals to engage freely in mutually beneficial contracting is the most efficient way of adapting to the changes we identified. We spend some time interpreting the debate surrounding the American Law Institute's Restatement on Corporate Governance as an attempt by members of the business community to inject certain communitarian views into an essentially contractarian environment. We note that although the Restatement contains some language that might be read as an affirmation of the communitarian perspective, the final document clearly asserts that shareholder-wealth maximization is the primary purpose of the business corporation, the fundamental tenet of the contractarian perspective. Finally, we examine governance structures in Japan and Germany to determine whether these alternative governance systems provide any blueprint for adapting to change. We find that the governance structures of these two countries are certainly more communitarian than the structure of U.S. corporations. We conclude, however, that this more communitarian perspective impedes the ability of corporations in these countries to adapt to an ever-changing global economy. We provide examples of corporations in these countries that have expanded internationally and, coincidentally, have adopted certain characteristics of the contractarian or Anglo-American model (for example, Siemens, Deutsche Bank, Hoerst, and Daimler-Benz). We also provide evidence that the governance practices and procedures in these countries are moving toward an Anglo-American model.

Our conjecture that the world is evolving along the lines of the contractarian model is an important and unique conclusion of our work. Most who have written on the subject to date have concluded that there is no "optimal" governance structure and that both the Japanese and German systems are sustainable. We disagree. We believe that there is sufficient theory and evidence to support our assertion that public corporations around the world are moving toward a more contractarian structure. Moreover, we believe that this move-

ment is, in large part, a response to the fundamental changes we have identified.

We do not conclude the article in a state of contractarian euphoria, however. We note that institutions should be developed to reduce the two major defects of a purely contractarian system. First, contracts cannot be written when property rights are ill-defined or the terms of contract cannot be enforced. Therefore, we call for the establishment of international standards and rules of law that would facilitate free contracting across borders. Second, we recognize the potential abuses of third parties and advocate that, whenever possible, externalities be internalized.

This issue of *Law and Contemporary Problems* represents the fourth and final phase of this project. We are indebted to the Editorial Board for giving us the opportunity to invite a broader discussion of these issues and ideas. This issue embodies the three hallmarks of our overall project. First, the authors represent a broad range of academic disciplines. Second, some articles lead from a consideration of theory, while others find their rationale in the world of business or regulatory practice. And, finally, it presents the opportunity to hear even more debate about these important issues.

In the second article of this issue, entitled *Anatomy of a Governance Transformation: The Case of Daimler-Benz*, Professors Dennis E. Logue and James K. Seward provide a compelling case study that supports our thesis that many European corporations are moving away from their communitarian heritage toward a more contractarian structure. Professors Logue and Seward chronicle the changes that have occurred during the past decade in the largest industrial corporation in one of the most communitarian economies in the world: Daimler-Benz—now DaimlerChrysler—of Germany. Burdened by the constraints imposed by the German system, particularly the required focus on employees and creditors, Daimler was forced to confront the imperative of remaining competitive in global product and capital markets in a global industry, the automotive industry. To convince foreign investors that “it was not simply raising capital so that it might continue to conform to German corporate governance standards,” the company transformed itself into a company conscious of shareholder value.¹ The first move was to list its shares, actually its American Depository Receipts on the New York Stock Exchange (“NYSE”) in 1993. The listing requirements of the NYSE mandated that the company restate its financial conditions to comply with the standards of U.S. generally accepted accounting practices (“GAAP”), which are much more exacting than German accounting standards. Subsequently, the company made a series of restructuring changes, including removing its chief executive officer, selling off unrelated businesses, reducing the equity ownership of the *hausbank*, and increasing the equity ownership of non-German shareholders. Additionally, in bold moves for any German corporation, it introduced stock and stock options as a part of

1. Dennis E. Logue & James K. Seward, *Anatomy of a Governance Transformation: The Case of Daimler-Benz*, 62 LAW & CONTEMP. PROBS. 87, 108 (Summer 1999).

its management compensation structure and tailored the performance evaluation of its divisions to a return-on-equity metric. The transformation into a more Anglo-American style corporation culminated in Daimler's merger with the U.S. automotive firm, Chrysler, and in its name change to "DaimlerChrysler" in 1998. The authors trace the specifics of these changes and present empirical evidence showing that they have had a positive effect on Daimler's financial performance. The authors conclude by predicting that Daimler is merely the first of several German firms that will undertake such a transformation. Moreover, they conclude that "[a]s more German firms follow, this trend will hasten the demise of the communitarian form of corporate governance, at least in Germany."²

A critical aspect in the transformation from a communitarian to a contractarian style of governance is the role of disclosure. In the third article, we learn that the relatively more communitarian systems of governance, such as those in Germany and Japan, have disclosure obligations that are substantially more lax than those in more contractarian systems, such as those in the United States. In *Required Disclosure and Corporate Governance*, Professor Merritt B. Fox explores the specific facets through which required disclosure affects the governance process. Professor Fox defines required disclosure as "any legal obligation that requires an issuer's management to provide, on a regular basis, information that it otherwise might not be inclined to provide."³ The article identifies four specific means by which such disclosure helps to ensure better governance: by assisting shareholders to exercise their voting franchise; by assisting shareholders in their quest to force managers to perform their fiduciary obligations; by forcing managers "to become more aware of reality"; and, indirectly, by making the firm more transparent so that market-based forces of discipline—the market for corporate control, the market for external financing, and stock-based compensation plans—can do their work. Professor Fox argues that required disclosure reduces the deviation between incumbent management decisionmaking and results that would impel a potential acquirer to maximize shareholder value. Similarly, required disclosure helps to reduce the disincentive to choose internal over external finance, thereby increasing the disciplinary role of external capital markets. Finally, he argues that mandatory disclosure rules in the United States make it easier to monitor corporate officials because disgruntled stockholders need only demonstrate the absence of disclosure to establish liability without knowing the details of the undisclosed transaction or transgression.

In the fourth article of this issue, *Corporate Governance in a Market with Morality*, Professor Thomas W. Dunfee challenges the contention that the contractarian model of the firm is, or should be, considered superior to a communitarian view. He begins by noting that even in the most contractarian system,

2. *Id.*

3. Merritt B. Fox, *Required Disclosure and Corporate Governance*, 62 LAW & CONTEMP. PROBS. 113, 114 (Summer 1999).

“[m]oral desires are embodied in markets.”⁴ He presents two intriguing examples. First, he points out that many consumers are willing to pay higher prices for “morally superior” goods. For example, consumers are willing to pay higher prices for tuna fish from companies that employ inefficient methods of fishing in order to protect the welfare of dolphins. Second, he points out that consumers often boycott the products of companies that are not perceived to be moral. The boycott of Exxon products in the wake of the Valdez oil spill can be seen as an example of such a phenomenon. It is undeniable that corporate managers must anticipate and respond to this degree of market morality. However, Professor Dunfee goes further. In an admittedly normative analysis, he argues that while maximizing shareholder value is a corporate manager’s first duty, they must do this within a consistent set of “hypernorms.” Professor Dunfee offers a detailed set of criteria that could be used to identify hypernorms.

Professor Dunfee’s article can be thought of as an elaboration of the postscript of Milton Friedman’s contractarian view that “a corporate executive . . . has direct responsibility . . . to make as much money as possible *while conforming to the basic rules of society, both those embodied in law and those embodied in ethical custom.*”⁵ Professor Dunfee offers a normative prescription as to how to think about the important qualification attached to Friedman’s proclamation. He writes in the tradition of those who argue that individuals, as well as corporations, have engaged in a grand social contract to interact with one another in a moral fashion.

Former Commissioner of the Securities and Exchange Commission, A.A. Sommer, provides a brief critique of Professor Dunfee’s article. Any disagreement that Mr. Sommer has with Professor Dunfee’s treatise is a matter of degree rather than of kind. Both recognize that a certain amount of moral behavior is expected, indeed required, on the part of corporate officers and directors. However, unlike Professor Dunfee, Mr. Sommer is unwilling to jeopardize the basic tenets of the contractarian structure by allowing corporate managers to stray too far from the principle of profit maximization under the guise of moral purpose or appropriate social behavior.

The contribution by Professor Timothy L. Fort and Mr. James J. Noone, *Banded Contracts, Mediating Institutions, and Corporate Governance: A Naturalist Analysis of Contractual Theories of the Firm*, is a critique of both our pro-contractarian stance as well as the more communitarian position taken by Professor Dunfee. The authors cleverly describe both theories as being based on an unrealistic notion of contracting.

The agency theory of contracting is ultimately unpersuasive because it fails to take into account adequately the cultural embeddedness of rationality and choice. Agency contractarians concentrate on a one-sided, dark notion of human nature and do not

4. Thomas W. Dunfee, *Corporate Governance in a Market with Morality*, 62 LAW & CONTEMP. PROBS. 129, 129 (Summer 1999).

5. Milton Friedman, *The Social Responsibility of Business is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970 (Magazine), at 33.

account adequately for the coercion necessary to sustain the choice that supposedly validates their approach. Similarly, social contractarians provide virtually no account of human nature and also miss the embeddedness problem. By not fully linking contracts to a transcendent reality, social contractarians provide no real reason to choose social contracting over agency contracting.⁶

The authors also quarrel with the basic assumption of both models, an assumption asserting that human behavior is motivated purely by self-interested desires. In essence, the authors argue that the individual is the inappropriate unit of analysis. Rather, any theory of social organization must specifically account for the interpersonal relations that occur within groups and institutions. The authors rely on a “mediating institutions” approach, which locates the importance of these relationships in small groups rather than following the traditional communitarian reliance on large-scale organizations. What emerges from this critical analysis of the scholarly literature on corporate governance is what the authors describe as “a constructive model . . . that takes the best features of social contracting and agency contracting and blends them with a naturalist-based communitarianism.”⁷

In the next contribution, Professor Robert M. Thompson examines the encroachment of the federal government into the affairs of public corporations. Long the province of the various states, recently enacted federal statutes have shifted the balance of power over corporate governance issues toward Washington D.C. In *Preemption and Federalism in Corporate Governance: Protecting Shareholder Rights to Vote, Sell, and Sue*, Professor Thompson argues that there has been a change in the federal/state law matrix regarding issues of corporate governance as a result of three new statutes regulating securities. These statutes include the National Securities Markets Improvement Act of 1996, the Securities Litigation Uniform Standards Act of 1998, and the Private Securities Litigation Reform Act of 1995. Before the enactment of these statutes, state and federal law concerning issues of disclosure generally existed side-by-side. However, with the enactment of these statutes, Congress set out to preempt state law in significant respects. The 1996 legislation preempts state law with respect to registration of securities. The 1998 legislation blocks state law anti-fraud class actions involving the largest American corporations, with some limited carve-outs preserving state law in certain instances. The 1995 legislation imported limits on class actions brought under Rule 10b-5.

Professor Thompson concludes that the results have been significant. Corporate governance is now a shared function between state and federal governments. Some shareholder functions are protected by both federal and state law; some receive protection from one but not the other; and some receive little protection from either. He finds that if Congress had any real concern about federalism, it could have preserved the states' control over shareholder func-

6. Timothy L. Fort & James J. Noone, *Banded Contracts, Mediating Institutions, and Corporate Governance: A Naturalist Analysis of Contractual Theories of the Firm*, 62 LAW & CONTEMP. PROBS. 163, 165 (Summer 1999).

7. *Id.* at 166.

tions. He believes that the division between state and federal regulation depends on what Congress wants rather than a determination of which corporate functions are best served by federal law as opposed to state law. He concludes that the real focus of the 1998 Act was to prevent alternate state rules that might be more favorable to shareholders. As a result, we have moved a bit further toward a federal corporate law.

Professor Deborah A. DeMott's contribution anchors this issue on corporate governance. She identifies an important distinction between British and American corporate law. As suggested by her title, *The Figure in the Landscape: A Comparative Sketch of Directors' Self-Interested Transactions*, Professor DeMott explains the important role played by so-called disinterested or independent directors in the American system of corporate governance. Interestingly, there is no role or even such a distinction in the British system. In the United States, disinterested directors play a pivotal role in monitoring corporate activity that may be tainted by self-interest. Examples of such activity include determining compensation plans, deciding on control transactions, or determining whether the firm should take up a derivative stockholder suit. In contrast, U.K. corporate law prohibits many self-interested transactions outright or requires the assent of shareholders. The United Kingdom may presuppose a greater role for direct monitoring by shareholders, while the United States has long relied on the judgment and integrity of outside directors, the figures in the landscape. She ties these distinctions to historical differences in patterns of shareholdings, as well as to institutional differences, chief among them the U.S. tradition of mandating disclosure and greater ease with which problematic transactions may be tested by litigation. Professor DeMott's analysis reveals that there are significant differences in the details of what might be seen as very similar governance structures. She reminds us that the Anglo-American system of governance embodies some very real Anglo and American differences. Notwithstanding our impulse to provide robust guidance to a myriad of firms in a wide range of countries, we must be careful about our generalizations. This wise counsel appropriately concludes this issue of the journal.