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Globalization has led to a remarkable resurgence in the study of comparative corporate governance. This area of scholarship had been largely the domain of taxonomists, intent on cataloguing the central characteristics of national corporate governance systems, and then classifying different systems based on the specified attributes. The result was an interesting, if perhaps somewhat dry, enterprise. We learned that national corporate governance systems differed dramatically along a number of seemingly important dimensions. Some corporate governance systems, notably those of the United States and other Anglo Saxon countries, are built on the foundation of a stock market-centered capital market. Other systems, like those of Germany and Japan, rest on a bank-centered capital market. Some systems are characterized by large groupings of related corporations, like the Japanese keiretsu, Korean chaebol, or European holding company structures. Still others are notable for concentrated family control of large businesses, including Canada, Italy and, notably, Germany.[1] Management styles also differ across national systems.

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[1] Marco Becht & Ekkehart Boehmer, Ownership and Voting Power in Germany, in The Control of Corporate Europe (Fabrizio Barca & Marco Becht, eds.),

In the United States and France, managerial power is concentrated, by practice in the U.S. and with statutory support in France, in an imperial-style American chief executive officer or French presidente directeur generale.[2]

The explosive decompression of trade barriers that gave rise to global competition also had an impact on academics. We learned that the institutions of all national systems were shaped not only by efficiency, but also by history and politics. In the United States, for example, the limited role of financial institutions in corporate governance – in effect, the Berle-Means separation of ownership and control – was the artifact not just of economics, but also of populist politics operating in a federal system.[3] Similarly, lifetime employment in Japan, said to be central to Japanese corporate governance, reflected not an effort to encourage investment in worker human capital, as commonly treated in the economics literature but, rather, grew out of a post-World War II political deal intended to rationalize work force levels and restore management control of production.[4]

Once different national governance systems were understood as more than just way stations on the road to convergence, comparative scholars began to treat institutional differences as having competitive consequences. Competition was not just between products, but also between governance systems. For example, Masahiko Aoki argued that Japanese lean production was inextricably linked to the Japanese

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preliminary version, available at www.ecgn.ulb.ac.be/book/ (visited April 20, 2000); Julian Franks and Colin Mayer, Ownership, Control and the Performance of German Corporations, Working Paper, Jan. 1997; Ekkehart Böehmer, Who Controls Germany? An Exploratory Analysis (working paper, Univeritat Osnabrük Arbeitspapiere Nr. 71, Oct. 15, 1998); Rafael La Porta, Florencio Lopez-de-Silanos, Andrei Shliefer & Robert Vishny, Corporate Ownership Around the World, 54 J.Fin. 471 (1999)

[2] CCH Int'l , French Law on Commercial Companies 5-6 (2d. ed. 1988).

[3] Mark J. Roe, Strong Managers, Weak Owners (1994); Miguel Cantillo Simon, The Rise and Fall of Bank Control in the United States, 88 Am.Econ. Rev. 1077, 1078-79 (1998). Some scholars have taken issue with this " political" theory. See note 22 infra.

[4] Ronald J. Gilson and Mark J. Roe, Lifetime Employment: Labor Peace and the Evolution of Japanese Corporate Governance, 99 Col. L. Rev. 508 (1999).

governance system, in which main bank contingent monitoring and cross-shareholdings protected the promise of lifetime employment by shielding managers and workers from shareholder demands, but disciplined both groups in the event of poor performance.[5] Others argued that the vertical keiretsu structure provided an important means of mutual monitoring.[6] Michael Porter argued that the bank centered capital markets of Germany and Japan allowed executives to manage in the long run while U.S. managers invested myopically out of fear that, unless catered to by a sharp focus on quarter to quarter earnings growth, the stock market's fickleness would be enforced by the market for corporate control.[7] At the same time, other commentators extolled the American system because its openness to external monitoring through a stock market-centered capital market allowed it to respond quickly to changes in the economic environment.[8] Finally, an important literature developed that ties the distribution of shareholdings within a country and the nature of its capital market to the quality of the country's legal and governance system.[9] Whichever side of the issue one took, the corporate

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[5] See, e.g., Masahiko Aoki, Toward an Economic Model of the Japanese Firm, 27 J.Econ. Lit. 1 (1990); Masahiko Aoki, The Japanese Firm as a System of Attributes: A Survey and Research Agenda, in The Japanese Firm: The Sources of Competitive Strength 11 (Masahiko Aoki & Ronald Dore eds. 1994).

[6] Ronald J. Gilson and Mark J. Roe, Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization, 102 Yale L.J. 271 (1993); Eric Bergloff & Enrico Peroti, The Governance Structure of the Japanese Financial Keiretsu, 36 J. Fin. Econ. 259 (1994).

[7] Michael Porter, Capital Disadvantages: America's Failing Capital Investment System, Harv. Bus. Rev., Sept.-Oct. 1992.

[8] See, e.g., Ronald J. Gilson, The Political Ecology of Takeovers: Thoughts on Harmonizing the European Corporate Governance Environment, 61 Fordham L. Rev. 161 (1992); Ronald J. Gilson, Corporate Governance and Economic Efficiency: When do Institutions Matter?, 74 Wash. U.L.Q. 327 (1996).

[9] See, e.g., La Porta,et. al., supra note 1; Rafael La Porta, Florencio Lopez-de-Silanos, Andrei Shliefer & Robert Vishny, Legal Determinants of Outside Finance, 52 J. Fin. 1131 (1997); Rafael La Porta, Florencio Lopez-de-Silanos, Andrei Shliefer & Robert Vishny, Law and Finance, 106 J.Pol. Econ. 1113 (1998); Rafael LaPorta, Florencio Lopez-de-Silanos, Andrei Shleifer & Robert Vishny, Investor Protection and Corporate Governance (working paper, Oct. 1999). This paper is

governance debate came to turn on arguments about the link between particular national governance institutions and competitiveness: Is this institution efficient?

From this point, it was no great leap to predictions of convergence: The force of competition would lead national systems to adopt a single efficient form. To be sure, the form on which systems would converge differed depending on which national system appeared most successful at the time of the prediction. Before the bursting of the Japanese "bubble economy," the main bank system represented the future; this array of complementary governance institutions was necessary to support lean manufacturing, the emerging standard of efficient production.[10] Not long thereafter, the Japanese bubble burst and the American economy boomed – sustained growth, low unemployment and, most surprisingly, low inflation – due to its rapid response to global competition, stock market-centered capital market, and the external monitoring to which stock markets are complementary. The American system then became the apparent end point of corporate governance evolution, a consensus that appears clearly from the IMF and the World Bank's response to the 1997-1998 East Asian financial crisis. In addition to these agencies' traditional emphasis on macroeconomic matters like government deficit reduction, countries accepting financial assistance also had to commit to fundamental reform of their corporate governance system, in the direction of the American model.[11]

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available on the Social Science Research Network Electronic Library at: http://papers.ssrn.com/sol3/paper.taf?ABSTRACT_ID=192549.

[10] A good example is a collection of articles holding out the main bank system as a model for emerging nations that came out of a World Bank financed study. See Mashiko Aoki & Hugh Patrick, eds., The Japanese Main Bank System: Its Relevance for Developing and Transforming Economies (1994).

[11] See, e.g., Timothy Lane, et. al., IMF- Supported Programs in Indonesia, Korea, and Thailand 72-73 (Int'l Monetary Fund Occasional Paper No. 178, 1999); Asia Pacific Talks Vow Tough Action on Economic Crisis, N.Y. Times, Nov. 26, 1997, p.A1; William A. Bratton & Joseph A. McCahery, Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference, 38 J. Col. J.Transnat'l L. 213, 236 and 236n.68 (1999), catalogs European proposals of U.S. style corporate governance reform proposals. Ronald Dore recounts the same influence of U.S. influence in Japan:

> What …all these slogans [concerning Japanese capital market reform] add up to is a general belief that (1) the principles according to which

These predictions of governance convergence had a more serious problem than the conflict in their prophecies. National governance systems turned out to be more adaptive in function, and therefore more persistent in form, than the prophets of convergence expected. For example, it was thought that Japanese lean production, supported both by employees rendered cooperative and inventive by lifetime employment, and by close, long-term ties to suppliers, could not be matched without dramatic changes in U.S. governance institutions. In fact, American manufacturers adopted lean production, but adapted lean production to fit their governance institutions, rather than adapting their institutions to lean production. As Charles Sabel has perceptively stressed, the link between institutional form and production technology was less tight than had been assumed.[12] The American system's functional adaptivity proved to be greater than expected, leaving institutional form largely intact. Thus, the debate over convergence is not quite joined. Are we expecting a formal convergence of legal rules, as Henry Hansmann and Reinier Kraakman argue has largely been achieved,[13] or merely functional convergence that operates behind a façade of local institutions?

> the typical neoclassical economics textbooks say the economy works are a priori correct principles, (2) those principles are best exemplified in the American economy, (3) the rightness of those principles is further confirmed by American success, and (4) Japan's present plight is not just a cyclical phenomenon and a debt-deflation hangover from the bubble; it is the natural and wholly just retribution visited on Japan for not following these principles.

Ronald Dore, Japan's Reform Debate: Patriotic Concern or Class Interest? Or Both?, 25 J. Japanese Stud. 65, 66 (1999). Annelise Riles reports that "[p]opular conversation in Tokyo today" refers to the shift toward an American approach to financial market structure as a "second occupation," referring to the influx of American ideas that accompanied the post-World War II occupation of Japan. Annelise Riles, The Transnational Appeal of Formalism: The Case of Japan's Netting Law (working paper, Feb. 2000).

[12] Charles Sabel, Ungoverned Production: An American View of the Novel Universalism of Japanese Production Methods, Law and Economics Center Working Paper, Columbia Law School (Feb. 1996); Susan Helper, John MacDuffie & Charles Sabel, The Boundaries of the Firm as a Design Problem, Law and Economics Center Working Paper, Columbia Law School (Feb. 1997).

[13] Henry Hansmann & Reinier Kraakman, The End of History for Corporate Law, in Are Corporate Governance Systems Converging (Jeffrey Gordon & Mark J. Roe, eds., forthcoming 2000).

In this article I want to examine the interplay of functional adaptivity on the one hand, and institutional persistence or path dependency on the other, that will influence whether such corporate governance convergence as we observe will be formal or functional.[14] Part I maps the intersection of adaptivity and path dependency where institutional form and function collide. I then consider a range of different outcomes that may result from the encounter. Part II describes two settings, one historical and one speculative, where convergence has been or would be functional rather than formal: removing poorly performing senior management, and disarming German co-determination. Part III takes up an example of the instrumental use of formal tools to catalyze the breakdown of path dependent barriers to functional convergence of German cross-holding and block-holding patterns. Part IV considers a setting where efforts at securing functional convergence without formal convergence have

[14] For present purposes, my concern is to clarify the terms of the discussion. I am not trying to resolve the debate over the extent to which changing economic forces are sufficient to drive formally and functionally divergent systems together. On this issue, Mark Roe and Lucian Bebchuk recently argued that path dependencies driven by "sunk adaptive costs, complimentarities, network externalities, endowment effects, and multiple optima" on the one hand, and by the self-interest of those who benefit from existing structures on the other, may freeze the institutions of particular countries in a noncompetitive pose. Lucian Ayre Bebchuk & Mark J. Roe, A Theory of Path Dependence in Corporate Ownership and Governance, 52 Stan. L. Rev. 127, 169 (1999). The self-interested fork of this argument tracks Mancur Olson's assessment that interest groups with a stake in current institutions will support policies that shrink the size of the pie if they protect the size of the groups' pieces. Mancur Olson, The Rise and Decline of Nations (1982). Alternatively, others lament that the relentless drive of competition has already compromised the diversity of capitalist systems that allowed the state to buffer individuals and local institutions from the forces of competition. "[A]cclerated technological change, renewed price competition and the globalization of financial markets have combined to produce a world economy in which a premium seems to be placed on speed of reaction: on rapid product change and an ability to cut costs fast. …The destruction or devaluation of national state capacity under globalization discriminates against national economies that are socially governed by politics at the national level." Colin Crouch & Wolfgang Streek, Introduction: The Future of Capitalist Diversity, in Political Economy of Modern Capitalism: Mapping Convergence and Diversity 1 (Colin Crouch & Wolfgang Streek eds. 1997). As will be apparent from the balance of my discussion, I expect the outcome to be a mixed bag of formal, functional and hybrid convergence, with the particular outcome quite sensitive to local conditions.

proven more difficult: the persistent relation between venture capital markets and stock market-centered capital markets. Part V takes up the potential for careful transaction design to help bridge the gap between formal and functional convergence through what I call convergence by contract. Two techniques are developed. The first provides accountability to investors through private governance mechanisms imbedded in the design of the security rather than through traditional public governance mechanisms such as investor voting or capital market surveillance. The second picks up John Coffee's recent analysis of convergence through a particular contract – the stock exchange listing agreement by which a foreign issuer submits to U.S. stock exchange governance rules and, more important, elements of U.S. securities regulation.[15] Convergence by contract may have particular saliency in those European countries whose governance structures use techniques, like super-voting stock to preserve family control, which American institutional investors find objectionable. Finally, Part VI takes up a form of convergence that operates through a hybrid of private and public ordering: The opportunity for individual companies to choose their corporate governance structure by selecting from the statutes offered by competing jurisdictions – the U.S. race to the top/race to the bottom form of regulatory competition that may have been introduced to the European Community by the European Court of Justice decision in *Centros*.[16]

I. The Interaction of Adaptivity and Path Dependency.

The institutional characteristics of national corporate governance institutions exhibit path dependency. Initial conditions, determined by the accident of history or the design of politics, can set an economy down a particular path. For example, the weakness of American financial intermediaries, and important characteristics of Japanese corporate governance including lifetime employment and

[15] John C. Coffee, Jr., The Future as History; The Prospects for Global Convergence in Corporate Governance and It's Implications, 93 Nov. U.L. Rev. 641 (1999).

[16] European Court of Justice, March 9, 1999, C. 21/297.

main bank relationships, find their origins not in considerations of efficiency, but in the interplay of populism and federalism in the case of the United States,[17] and in the World War II and immediate post-war experience in the case of Japan.[18] Indeed, the same outcome is possible even within a single economy. The trajectories of two high-technology industrial districts -- the continued success of California's Silicon Valley and the relative decline of Massachusetts' Route 128 -- owe much to the serendipitous presence of legal rules adopted in California following statehood that became important 100 years later.[19] From those initial positions, efficiency considerations favor the addition of new institutions whose contribution to the system reflects not just their own incremental addition to output, but also the resulting increase in output of existing institutions to which the new institutions are complementary.[20] For example, barriers to financial intermediary participation in corporate governance find a complement in legal rules and institutions that protect small shareholders who, in the absence of large financial intermediaries, must provide an

[17] Roe, supra note 3; see Simon, supra note 3.

[18] See, e.g., Gilson & Roe, Lifetime Employment, supra note 4; Masahiko Aoki, Unintended Fit: Organizational Evolution and Government Design of Institutions in Japan, Center for Economic Policy Research Working Paper No. 434, Stanford University (1994); Takeo Hoshi, Cleaning-up the Balance Sheets: Japanese Experience in the Post-War Reconstruction Period, in Corporate Governance in Transitional Economies: Insider Control and the Role of Banks 303 (Masahiko Aoki & Hyung-Ki Kim, eds. 1995); Tetsuji Okazaki The Japanese Firm under the Wartime Planned Economy, 7 J.Jap. & Intn'l Econ. 175 (1993).

[19] Ronald J. Gilson, The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not to Compete, 74, N.Y.U.L. Rev. 595 (1999).

[20] This increasing return characteristic is referred to as "supermodularity". See Paul Milgrom & John Roberts, Complementarities and Systems: Understanding Japanese Economic Organization, 9 Estudios Econ⌧micos 3 (1994). Milgrom and Roberts develop their analysis of how multi-attribute systems develop from an initial starting point in Paul Milgrom & John Roberts, Complementarities and Fit: Strategy, Structure and Organizational Change in Manufacturing, 19 J. Acct'g & Econ. 179 (1995); Paul Milgrom & John Roberts, The Economics of Modern Manufacturing: Technology, Strategy and Organization, 80 Am. Econ. Rev. 511 (1990).

economy's investment.[21] Similarly, the inability to protect trade secrets embedded in human capital finds a complement in a labor market characterized by extreme employee mobility.[22] Such increasing return characteristics shape the development path at each stage by favoring the selection of new institutions that increase the output of preexisting institutions, at the expense of alternatives that lack this attribute. Thus, the corporate governance system's development is driven, domino-like, by the linking of complementary institutions.[23]

In this system of institutional complementarity, institutional form is still constrained by the initial starting point, which under some

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[21] The reader will note that this formulation finesses an important current debate between my colleagues Professors John Coffee and Mark Roe. Noting that recent empirical work by financial economists has linked the existence of strong stock markets not to U.S. populist politics as argued by Mark Roe, but to strong legal protections for minority shareholders, Professor Coffee has put forward a "legal theory" of capital market development that he contends better fits the evidence than Professor Roe's political theory. Thus, Professor Coffee states that "[t]he most convincing explanation for this sharp disparity [between the importance of equity markets in the U.S. and in France, Germany and Italy] is that only those legal systems that provide significant protections for minority investors can develop active equity markets. … But once this explanation is accepted, it amounts to a rejection of the 'political theory' offered by Professor Roe and others." Coffee, supra n. 15, at 644 (1999). See John C. Coffee, Jr., Privatization and Corporate Governance: The Lessons from Securities Market Failure 25 J. Corp. L. 1 (1999). Formulating the issue in terms of complementarity-driven institutional evolution allows an important role for both politics and law. The difficulty with Professor Coffee's analysis is that it treats law as exogenous. If, as Professor Roe argues, the absence of financial intermediaries was driven by politics, then the resulting increased role for securities markets and individual investors creates a demand for complementary protective law that would not be present in a system with large financial intermediaries. From this prospective, law is important, but its character – protective of minority shareholders or not – is shaped by politics, a result consistent with the reported correlation between protective legal rules and developed securities markets. Put differently, political conditions create the demand for protective law, a combination that turns out subsequently to be efficient. Cf. Gilson & Roe, Lifetime Employment, supra note 3 (lifetime employment was politically dictated but then calls forth efficient complementary institutions). For Professor Roe's analysis of Professor Coffee's criticism, see Mark J. Roe, Political Preconditions to Separating Ownership from Control (working paper, September 1999). For the empirical literature that provides the foundation of Professor Coffee's analysis, see the sources listed in note 9 supra.

[22] See Gilson, High Technology Industrial Districts, supra note 19.

[23] Milgrom & Roberts, Complementarities and Systems, supra note 20.

circumstances may cause problems. A complementary system is difficult to change piecemeal; like leverage, complementarity has an ominous downside. When external economic changes counsel altering one institutional attribute, the change may cause the productivity of the entire system to decline dramatically because other attributes were selected to make good use of the now altered attribute.[24] The structure of the U.S. capital market, for example, represents the efficiency driven development of complementary institutions given the politically imposed initial condition. However, these same institutions represent a barrier to change if altered economic conditions reduce the resulting system's efficiency.

Path dependency, however, is not the only force influencing the shape of corporate governance institutions. Existing institutions are subject to powerful environmental selection mechanisms. If existing institutions cannot compete with differently organized competitors, ultimately they will not survive. Path dependent formal characteristics of national governance institutions confront the discipline of the operative selection mechanisms that encourage functional convergence to the more efficient structure and, failing that, formal convergence as well. National institutions are thus shaped by what I have elsewhere called "corporate governance plate tectonics, in which the demands of current circumstances grind against the influence of initial conditions."[25] From this perspective, functional convergence, in which the barriers to formal institutional change are avoided, comes first. Formal convergence, which can involve ripple like costs – including political costs – of changing complementary institutions with their own economic and political constituencies, comes as a last resort.[26]

[24] Id.

[25] Gilson, Corporate Governance and Economic Efficiency, supra note 8, at 332.

[26] Of course, convergence of any sort may fail in the face of institutions too inflexible for functional convergence and political institutions too responsive to the blocking efforts of interest groups protecting existing arrangements for formal convergence. Early 20th century Argentina appears to be such a failure, a then first world country that devolved significantly beginning in the 1930s. See Mark J. Roe, Backlash, 98 Col. L. Rev. 217 (1998).

II. Functional but not Formal Convergence: Replacing Senior Management

Recent empirical research concerning the German, Japanese and American corporate governance systems illustrates the occurrence of functional but not formal convergence.[27] German and Japanese corporate governance is said to be long-term oriented, so that managers can ignore short-term swings in stock prices and accounting profits in choosing projects.[28] The long-term, multi-dimensional relationship between banks and corporations in Germany and Japan may provide the suppliers of capital better information concerning corporate performance than stock price and accounting measures.[29] In contrast, the American stock market centered system is said to measure performance based largely on short-term oriented stock price and accounting reports, so that managers must invest in projects that provide short-term results clearly observable by one dimensional stock market investors who have no other source of information.[30]

The institutional characteristics of all three systems – strong financial intermediaries in the German and Japanese systems and weak intermediaries in the American system – are path dependent.[31] Little formal convergence has occurred. But whether there has been functional convergence, that is, whether the formal differences any longer affect performance, is empirically testable. Any successful system must find a way to replace poorly performing senior managers. If formal institutional characteristics matter, then the

[27] This section elaborates on Gilson, Corporate Governance and Economic Efficiency, supra note 8.

[28] See, e.g., Porter, supra note 7.

[29] Jeremy Edwards & Klaus Fisher, Banks, Finance and Investment in Germany, Ch. 2, sets out the argument.

[30] Jeremy C. Stein, Takeover Threats and Managerial Myopia, 96 J. Pol. Econ. 61, 64-78 (1988), models such a process.

[31] On this point, Professors Roe and Coffee appear to agree. Formal institutional characteristics – for Roe, legislative barriers to the growth of financial intermediaries, and for Coffee, legal rules that protect minority shareholders – dictate the structure of capital markets. See Coffee, supra note 15, and Roe, supra note 3.

monitoring of managers should be dictated by the information made available by the two systems. Because one can manage only what one can measure, the tenure of American senior managers should be more sensitive to short-term changes in stock price and accounting earnings than that of German and Japanese managers; only short-term results are said to be observable to U.S. capital providers, while German and Japanese bank monitors receive sufficient information to evaluate longer-run strategies.

Empirical studies demonstrate functional but not formal convergence. Despite the striking differences in institutional form that still remain among the three governance systems, we do not observe the predicted differences among the three systems of monitoring management. Rather, we observe functional convergence. Regardless of whether the capital market is bank or stock market centered, the tenure of senior management in all three countries is equally sensitive to poor performance, whether measured by stock market returns or accounting earnings.[32] This functional convergence is driven by selection: A system that allows poor managers to remain in control will not succeed. We do not observe formal convergence because each system's governance institutions have sufficient flexibility to find a solution within their path dependent limits. In the United States, stock market information and external pressure drives the solution; in Japan, main bank contingent monitoring is triggered by poor performance;[33] and in Germany, bank voting control and access to internal information through supervisory board membership,[34] are the

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[32] See Steven Kaplan, Top Executive Rewards and Firm Performance: A Comparison of Japan and the U.S., 102 J Pol. Econ. 510 (1994); Steven Kaplan, Top Executive Turnover and Firm Performance in Germany, 10 J. L.Econ.& Org. 142 (1994); Jun-Koo Kang & Anil Shivdasani, Firm Performance, Corporate Governance, and Top Executive Turnover in Japan, 38 J. Fin. Econ. 29 (1995); Steven Kaplan & Bernadette Minton, Appointments of Outsiders to Japanese Boards: Determinants and Implications for Managers, 36 J. Fin. Econ. 225 (1994).

[33] Masahiko Aoki, Monitoring Characteristics of the Main Bank System: An Analytical and Developmental View, in The Japanese Main Bank System: Its Relevance for Developing and Transforming Economies (Masahiko Aoki & Hugh Patrick, eds. 1994).

[34] See, e.g., Helmut M. Dietl, Capital Markets and Corporate Governance in Japan, Germany, and the United States 122-26 (1998).

active forces. In each case, we do not observe convergence of institutional form. Rather, each system's particular response to the problem of replacing poorly performing managers is, in evolutionary theorist's Stephen J. Gould's terms, "jury-rigged from a limited set of available components"[35] supplied by the system's particular history.

This analysis suggests a pattern: Functional convergence is likely the first response to competitive pressure because changing the form of existing institutions is costly. New institutions require new investment, and existing institutions will have developed related interest groups that render more difficult any necessary political action.

Moreover, the threat of partial change to interest groups organized around existing institutions is exacerbated by complementarity. Mancur Olson stresses that focused interest group politics motivated by protecting group welfare can block change that would be welfare increasing for society at large, a phenomenon he argues importantly influences the relative growth rate of nations.[36] Changing the form of an institution, in order to enhance its own efficiency in response to changing economic conditions, initially may result in a reduction, not an increase, in overall system productivity. The new form may not be complementary to the other institutions that make up the system, which can result in a reduction in the performance of even those institutions whose form remains unchanged. In a system characterized by complementarity, it may be necessary to alter all remaining complementary institutions before alteration of the first will improve things.[37] The result, among other things, is to multiply the number of interest groups with rents to protect. Functional changes in existing institutions – in Gould's terms again, "a contraption not a

[35] Stephen J. Gould, The Panda's Thumb: More Reflections in Natural History 20 (1980). Steven Kaplan & Mark Ramseyer, Those Japanese Firms with Their Disdain for Shareholders: Another Fable for the Academy, 74 Wash. U.L.Q. 403 (1996), also stress the Japanese system's capacity for functional convergence.

[36] Olson, supra note 14.

[37] Milgrom & Roberts, Complementarities and Systems, supra note 20.

lovely contrivance"[38] – will often be the least cost means to respond to economic change.[39]

A second example of functional change, as opposed to more politically difficult formal change, involves the problem of reforming labor participation on the supervisory boards of large German corporations.[40] Suppose one concludes that co-determination restricts the ability of German corporations to adapt to global competition and protects existing jobholders at the expense of higher unemployment.[41] Further suppose that the political barriers to formal change – legislative amendment of the relevant statute – are prohibitive at least in the short to medium run. In this setting, one can imagine a functional end run around the barriers to formal convergence, disarming rather than eliminating co-determination.

Under existing legislation, shareholder selected supervisory members, with the aid of the tie breaking vote cast by the chairman, command a majority of the board.[42] Thus, labor influence in the face of a shareholder selected board majority may reflect a coalition between inside managers and labor representatives unchallenged by passive shareholder selected board members.[43] A functional response to the problem might involve a shift in the character of the shareholder

[38] Gould, supra note 35, at 24.

[39] The text frames the problem in terms of blocking efficiency inducing change. However, interest groups also can seek self-serving affirmative change. The emphasis on blocking action reflects an assumption, which I will not pause to justify here, that blocking action requires less political power than causing action to be taken, and therefore is the more pervasive problem.

[40] This discussion reflects conversations with Mats Isaksson.

[41] Katharina Pistor, Co-determination in Germany: A Socio-Political Model with Governance Externalities, in Corporate Governance Today 387 (Columbia Law School/Sloan Foundation Project on Corporate Governance, 1998), analyzes the political origins of co-determination and assesses the governance externalities inadvertently created.

[42] See Dietl, supra note 34, at 113; Mark J. Roe, German Codeterminations and German Securities Markets, in Corporate Governance Today 745 (Columbia/Sloan Foundation Project on Corporate Governance, 1998)

[43] Cf. John C. Coffee, Unstable Coalitions: Corporate Governance as a Multi-Player Game, 78 Geo. L.J. 1495 (1990).

selected supervisory board members. Should the large German banks conclude that the inflexibility created by the blocking alliance was too costly, they might respond by reinventing shareholder selected supervisory board members so that more active shareholder members can disarm the blocking coalition.[44] To be sure, labor may respond by seeking further formal protection, but securing affirmative legislative action is likely more difficult than blocking actions that would result in formal convergence.

III. The Interaction of Formal and Functional Convergence

In some circumstances, path dependency reinforced by formal rules presents a barrier to functional convergence. Large German banks and insurance companies hold large stakes in other publicly held German corporations and in each other.[45] For example, Figure 1 shows the pattern of cross-holdings among shareholders of Daimler-Benz.

[Figure One Here]

More generally, studies report substantial block holders in a very high percentage of German public companies.[46] Now suppose that the economic environment changes in a fashion that requires a systemic response that can best be affected through a stock market centered capital market, rather than a bank centered capital market characterized by large block holdings.[47] While formal corporate law

[44] Cf. Ronald J. Gilson & Reinier Kraakman, Reinventing the Outside Director: An Agenda for Institutional Investors, 43 Stan. L. Rev. 863 (1991). A similar strategy relies on the use of supervisory board committees on which labor representatives do not sit. Pistor, supra note 41, surveys this strategy.

[45] See the sources cited in note 1 supra.

[46] Tim Jenkinson & Alexander Ljungquist, Hostile Stakes and the Role of Banks in German Corporate Governance (CEPR Working Paper no, 1969); Michael Adams, Cross Holdings in Germany, 155 J. Institutional & Theo. Econ, 80 (1999).

creates no barriers to the holders of large blocks reducing the size of their positions, German tax law creates a substantial path dependency. Sale of these stakes are subject to a 42 percent capital gains tax (rate effective January 1, 2000) that enforces the path dependent character of German concentrated ownership by imposing a substantial tax on a redistribution of ownership.

In December 1999, German Chancellor Gerhard Schroeder proposed eliminating the capital gains tax on sales by German corporations of stock in other German corporations, with the explicit goal of eliminating barriers to dissipating concentrated cross-holdings.[48] This change in tax rules represents an interesting interaction between formal and functional convergence. The proposed tax cut – revenue neutral to the extent that the tax induced path dependency prevented sales from ever being made – only eliminates the institutional shadow of a low basis. Determination of the most efficient distribution of shareholdings then is left largely to functional convergence, affected by the institutions' sales of their block-holdings and cross-holdings.

IV. The Failure of Functional Convergence: Venture Capital and the Structure of Capital Markets[49]

Comparisons of the United State's capital market with those of Japan and Germany focus on the different roles of banks and stock markets. The United States has a large number of comparatively small

[47] Gilson, Political Ecology, supra n.8; Gilson, Corporate Governance and Economic Efficiency, supra n. 8.

[48] Edmund Andrews, Germany Proposes Some Tax-Free Stock Sales, Lifting Market, N.Y. Times, Dec. 24, 1999, P. C1; Cecilie Rohwedder, Key German Party Backs Plan to Drop Capital-Gains Tax, Wall St.J., Dec. 29, 1999, P. A11; Edmund Andrews, German Stock-Sale Plan Stirs Only Limited Opposition, N.Y. Times, Dec. 30, 1999, P. C4. While the effective date of the capital gains exclusion has been delayed by a year, the reform is reported to be going forward. Emund Andrewes, German Stock-Sale Plan is Delayed a Year, N.Y. Times, Feb. 18, 2000, P. C4.

[49] This section draws on Ronald Gilson & Bernard Black, Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets, 47 J.Fin.Econ. 47 (1998).

banks that for practical purposes play no role in corporate governance, and an advanced stock market that supports an active market for corporate control catalyzed by the mechanism of hostile takeovers. Japanese and German banks are few in number, but larger in size relative to each nation's industrial firms, and are said to play an important governance role by monitoring corporate management.[50] Neither country has an active market for corporate control.

Less attention is paid to an additional systematic difference between bank and stock market-centered capital markets: the existence of a much stronger venture capital industry in stock market centered systems.[51] Because an active venture capital market is said to be critical to encouraging innovation, many countries have sought to replicate the United States' success. The failure of bank-centered systems to develop comparable venture capital markets demonstrates both the failure of functional convergence – banks have not been able to alter their functions in a fashion that would duplicate the stock market's role in venture capital – and the difficulty of implementing the systemic formal change necessary to the adaption of complementary systems.

In another article, Bernard Black and I have explored the link between stock markets and venture capital markets. The ability to liquidate a portfolio company investment – to "exit" − is crucial to venture capital investors. Their contribution to portfolio companies consists of both cash and non-cash contributions, such as managerial services, intensive monitoring and reputation, that are linked by economies of scope. Once a portfolio company succeeds to the point that the venture capitalist's non-cash contributions are of reduced

[50] See, e.g., Aoki, Monitoring Characteristics of the Main Bank System, supra note 33; Edwards & Fischer, supra note 30; Roe, supra note 3.

[51] Gilson & Black, supra note 49, surveys the empirical evidence on the size of national venture capital markets. See also Leslie Jeng & Phillipe Wells, The Determinants of Venture Capital Funding: Evidence Across Countries (working paper, May 1998). This paper is available on the Social Science Research Network Electronic Library at http://papers.ssrn.com/paper.taf?ABSTRACT_ID=103948. Curtis Milhaupt, The Market for Innovation in the United States and Japan: Venture Capital and the Comparative Corporate Governance Debate, 91 Nw. L. Rev. 865 (1997), provides an excellent account of the Japanese experience with venture capital.

value, efficiency dictates recycling those inputs so they can be invested in companies at a stage that requires them. However, the economies of scope associated with linking cash and non-cash contributions dictate recycling the cash contributions at the same time. Hence the importance of exit.[52]

The particular type of exit is crucial to the entrepreneur and to the terms of the contract between the venture capitalist and the entrepreneur. When exit occurs through an initial public offering, available only in a stock market-centered capital market, the entrepreneur typically regains the disproportionate amount of control that was shifted to the venture capitalist at the time of its investment, even if, as is typically the case, the venture capitalist does not then dispose of its entire investment. In contrast, when exit occurs by the portfolio company's sale to a third party, an exit route that *is* available in bank-centered capital markets, the entrepreneur not only forfeits the control ceded to the venture capitalist, but loses as well the elements of control he had retained. The critical impact of the opportunity to exit through an initial public offering is that, at the time of the initial investment, the parties can enter into an implicit contract that, in effect, gives the entrepreneur a call option on control exercisable on the company's success and reflected in the transaction by the release of the venture capitalist's formal levers of control on the occurrence of a public offering. Because the incentive properties of this implicit contract go to the heart of the entrepreneurial process – that is, the entrepreneur's dealings in control -- its availability only in a stock market-centered capital market helps explain the absence of vigorous venture capital markets in countries with bank-centered capital markets.[53]

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[52] Gilson & Black, supra note 49, at 252-55.

[53] Id. at 257-64. The recent experience in the internet industry, where the make/buy decision has leaned of late toward buy, may alter this pattern. Start-ups where the goal is to provide a part of someone else's business plan by being acquired may confront a very different incentive structure. See, e.g., Scott Thrum, Under Cisco's System Mergers Usually Work; That Defies the Odds, Wall St.J., March 1, 2000, p. 1 (Cisco uses acquisitions to reshape itself and plug holes in its product line; 51 acquisitions in past 6 _ years, 21 in past 12 months alone).

Bank-centered systems could respond to this competitive disadvantage through functional convergence: retain the structure of the capital market but provide funding of innovation through bank financing of start-up companies or internalization of the entrepreneurial process by large companies. If these alternative institutions yield the same functional performance as the United States' stock market linked venture capital market, then adaption will have occurred through functional convergence without the need for more costly formal convergence.

The empirical evidence needed to assess the existence of functionally equivalent financing of innovation in bank-centered systems is not available, but anecdotal evidence supports a skeptical view. The United States has become a world leader in precisely those industries, notably biotechnology and computer related high technology, in which venture capital markets played a central role. Moreover, large American and European pharmaceutical companies are responding to innovation in biotechnology not by direct funding of entrepreneurs, but by providing later stage financing and partnering to entrepreneurial companies, mostly U.S. based and originally financed through venture capital.[54]

A number of European countries have recognized the apparent failure of functional convergence, and have made efforts at formal convergence, notably by starting special stock exchange segments for newer, smaller companies. The limited success to date highlights the difficulty of piecemeal change of a system made up of complementary institutions.

France and Germany first tried to create small company stock markets during the 1980s; by the 1990s these projects had been closed or marginalized.[55] Current efforts include the Alternative

[54] Id. Debt financing of high technology start up companies by banks is simply not feasible. Because of the high risk and negative cash flow characteristics of such companies, the debt instrument would have to be something like a very high coupon zero coupon bond. In functional terms, the instrument would be the equivalent of equity.

[55] Sebastian Rasch. Special Stock Market Segments for Small Company Shares in Europe – What Went Wrong?, Center for European Economic Research Discussion Paper No. 93-13 (1994).

Investment Market of the London Stock Exchange; Euro NM, a consortium of the French Le Noveau March☺, the German Neur Markt, and the Belgian New Market; and EASDAQ, an exchange explicitly patterned after the U.S. NASDAQ, of which the NASD, NASDAQ's operator, is a part owner. The number of recent initial public offerings, especially on the Neur Markt, is evidence of the increasing acceptance of this institutional innovation.[56] Recognition of the importance of complementarity, however, suggests that merely creating a stock market will be insufficient to provide the institutional infrastructure necessary to support a venture capital market. Also missing are the complementary institutions that developed from the presence of stock markets in the United States: venture capital organizations, the limited partner investment vehicle, investment bankers experienced in taking early-stage companies public and, most important, a supply of entrepreneurs which the availability of venture capital financing elicits in the first place.

[56] See, e.g., Exchanges Broaden Their Global Appeal, Fin. Times, June 11, 1999, p. 6; Stewart Fleming, The Neur Markt'sWild Ride, Inst'l Investor, April, 1999, at 76, 77, 180.

One approach to the complementarity driven problem of creating multiple institutions more or less simultaneously is made available by the globalization of the capital market. As Bernard Black and I have suggested, companies with bank-centered systems can piggyback on another country's existing institutions. In particular, U.S. venture capital institutions – NASDAQ and its institutional infrastructure, including venture capital investors, investment bankers with experience in venture capital-backed IPOs, and experienced lawyers and accountants – are available to European start-ups. Access to these substitute institutions can facilitate adaption during the period that local institutions develop to achieve formal convergence.[57]

V. Convergence by Contract

Having examined situations where functional convergence has succeeded and, alternatively, where formal convergence appears necessary, the survey is extended by looking at a third situation that I will call convergence by contract.[58] Here I have in mind convergence in a situation where existing institutions lack the flexibility to achieve functional convergence, but where the costs, especially the political costs, of changing existing institutions make formal convergence difficult. I take up first the possibility of convergence through security design. I then consider convergence through the contract associated with a foreign company's listing its shares on a U.S. stock exchange.

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[57] Gilson & Black, supra note 49, at 271-73. Israel provides the best example of this phenomenon. According to recent estimates, more than 100 Israeli corporations are listed on U.S. securities exchanges, including in excess of 70 high technology companies. See Ira M. Greenstein & Lloyd Hamretz, U.S.-Israel Transactions Present Unique Issue, N.Y.L.J., April 28, 1998, at S2; Richard Rappaport, Beating Their Swords in to IPO Shares, Forbes ASAP, June 1, 1998, at 93. The adaption process in Eurpoe appears to be accelerating. While early stage ventures received only 10.2 percent of European private equity money in 1998, investment in 1999 is said to have shifted toward early stage financing. Europe's Start-up Stampede, The Economist, Jan. 15-21 2000, p.63.

[58] This discussion has benefited from conversations with participants at a Swedish Corporate Governance Forum meeting, including Karl-Adam Bonnier, Raulf Gonec, Mats Isaksson, Michael Jensen, Gunnar Nord, and Robert Ohlsson.

A. Convergence Through Security Design.

American investors, especially large pension funds and other institutional investors, now own substantial stakes in European publicly traded corporations. For example, the California Public Employees Retirement System ("CalPERS"), the largest U.S. public retirement fund, holds nearly $20 billion in foreign equities, representing almost 20 percent of its total investment in equity.[59] Anglo-Saxon institutional investment of this sort translates into a significant percentage of the outstanding shares in particular countries: on average, 35 percent of the outstanding shares of the 40 largest companies on the Paris stock exchange are held by American and British institutional investors and pension funds.[60] The figure rises to 41 percent of Dutch companies.[61]

With significant foreign investment has come demand for change in European corporate governance systems. In Netherlands, France, and Sweden, for example, substantial deviation from the Anglo-Saxon one share-one vote model can protect incumbent managers from monitoring by the capital market. Confronted with corporate governance systems that appear to lack mechanisms for external monitoring, U.S. institutional investors have begun to urge that European companies make significant changes in their formal governance institutions to more closely resemble U.S. style governance. Leading the movement, CalPERS has announced a set of general principles − its six General Principles including director accountability to shareholders and a one share-one vote capital structure. The General Principles were followed with the issuance of specific standards for the United Kingdom, France, Germany and Japan.[62]

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[59] Sara Webb, Calpers Sees New Targets Overseas, Wall St. J., Oct. 20, 1997, p.C1, col. 6.

[60] John Tagliabue, Resisting those Ugly Americans, N.Y. Times, Jan. 9, 2000, Sec. 3, p. 1, 10.

[61] Joel Chernoff & Patrick Farnon, Governance Codes Vary by Market, Pensions & Investments, Sept. 16, 1997, p. 16.

[62] These Principles may be accessed at http://www.calpers-governance.org/principles/international.

Formal convergence of continental corporate governance to the U.S. model can be expected to be very difficult, especially when it comes to matters of corporate control. Unequal voting regimes are designed to protect family control (and in the Netherlands foundation control); broadly weakening that control by amending the corporate statute to restrict unequal voting would face formidable political barriers. Some potential for finding a way out of the conflict between the institutional investors' demand for formal mechanisms of accountability, and the Europeans' sensitivity to relinquishing formal elements of control, arises from a kind of convergence that has taken place in the United States. The simple fact is that U.S. institutional investors do not always demand the same formal governance structure from all entities in which they invest. Such investors, including CalPERS, happily place billions of dollars annually in entities that lack the governance mechanisms traditionally found in U.S. public corporations. These investments go into the private equity market through the vehicle of a limited partnership in which the investors give up traditional governance mechanisms in return for securing the specialized services of the general partner in making investments in non-publicly traded securities.[63]

Investors in such vehicles as venture capital limited partnerships and leveraged buyout funds are not, however, left unprotected from the familiar host of agency problems against which traditional corporate governance techniques are directed. Rather, they are protected by quite different mechanisms that are created by contract.[64] While tracing the overall governance structure of these investment

[63] For example, on average pension funds supply over 40 percent of the annual commitments to U.S. venture capital funds. See Gilson & Black, supra note 49.

[64] For an overview of the standard contract between an investor and the general partner of a venture capital limited partnership, see Gilson & Black, supra note 49; William A. Sahlman, The Structure and Governance of Venture-Capital Organizations, 27 J.Fin.Econ. 473 (1990); Theodor Baums & Ronald J. Gilson, Comparative Venture Capital Contracting: Replicating the U.S. Template in Germany (Working Paper, May, 2000). Paul Gompers and Joshua Lerner, The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements, 39 J.L.& Econ. 463 (1996), provide empirical evidence of the use of covenant protection in venture capital limited partnerships. For an overview of the structure of a leveraged buyout limited partnership, See Michael Jensen, The Eclipse of the Public Corporation, Harv. Bus. Rev. 61 (Sept.-Oct. 1989).

vehicles is not my purpose here, examination of one feature is illustrative.

A standard private equity limited partnership has a fixed life, typically ten years, after which the partnership must be liquidated and its assets returned to investors. This fixed termination serves a number of important purposes. Most important, it balances the general partner's need for discretion in making illiquid investments characterized by enormous uncertainty, with the investors need for a mechanism of accountability. In publicly held corporations misuse of free cash flow is policed internally by the board of directors, and externally through shareholder action either through voting or through the control market, in all cases illuminated by performance information provided through stock market prices. In private equity limited partnerships, the free cash flow problem is addressed by a requirement that the general partner distribute the proceeds of investments that become liquid, and by the requirement that the partnership terminate and the assets be returned to investors at the end of the partnership term. These features assure that the general partner will not retain indefinitely capital which it cannot invest profitably.

The need to liquidate the partnership's assets to facilitate distribution also provides an observable measure against which to weigh the general partner's performance. Prior to that point, a market measure of the value of the limited partnership's portfolio is not available because its private equity investments are not liquid.

Finally, forced liquidation operates to hold the general partner accountable for its performance. At the end of the partnership term, the investor has the opportunity to choose whether to allow the general partner to continue managing its money by choosing whether to invest in a new limited partnership formed by the general partner. The general partner then must compete with other managers for the opportunity to manage the money of investors in the liquidated partnership, with its prior performance being the central influence on the outcome.

In countries where the cost of formal convergence would be high because of family and other concentrated holdings, accountability to investors might still be achieved by use of these private equity investment techniques. While designing a security by which this could be accomplished is well beyond my ambitions here, imagine that a European company with dual class voting in which a family controls the super voting shares, desires to raise equity capital from U.S. institutional investors. The family, however, is unwilling unilaterally to cede its control to the public float by eliminating the dual class structure.

An institutional investor might well be reluctant to invest when the dual class capital structure blocks any external monitoring of the performance of the management chosen by the controlling shareholder. Suppose instead the institutional investor is offered an equity security that provides accountability by mimicking the fixed term of a private equity investment, a correspondence that makes sense because both publicly traded corporations with dual class capital structures and private equity limited partnerships lack traditional corporate governance accountability mechanisms.

The structure of the security could take a number of forms. For example, the institutional investor could be sold low voting stock which, at the end of specified periods, would become super voting if the company's performance did not meet a specified standard, perhaps a designated percentile among a group of peer companies. If the voting shift were triggered, family designated management would have to compete for the opportunity to continue to manage the company. Depending on the size of the investment, actual control of the company might shift. Alternatively, the security might provide put rights that guaranteed the investor a return keyed to peer group performance; the need to raise capital to fund performance of a put-triggered redemption would have the same disciplining effect.

This short account provides not even a checklist of the provisions such a security would require, nor even a thoughtful canvas of what types of securities might be devised.[65] For now, the task is much more limited. I mean only to sketch the outlines of an intermediate

[65] For example, the architect of the security would have to confront management's incentive to take on too much risk in the later years of the security's term if performance is lagging. On a more mundane level, a means would be necessary to update the group of peer companies against whose performance the issuing company's would be measured.

contractual approach to convergence that might be appropriate when existing governance institutions lack the flexibility necessary for functional convergence and the mutability necessary for formal convergence.

B. Convergence Through Stock Exchange Listing.

John Coffee has developed a second example of convergence by contract, less speculative than the arbitrage between private and public organizational forms developed in Section V.A., and with the advantage of being already visible.[66] In this case, the contract is the listing agreement executed when a non-U.S. corporation lists its securities on a U.S. securities exchange, together with those U.S. securities laws to which the act of listing subjects a foreign corporation.

The listing agreement itself imposes a set of governance obligations including a minimum number of independent directors, an audit committee, and an equal opportunity rule with respect to tender offers. In turn, by listing on a U.S. stock exchange, the foreign company is obligated to register under Section 12(b) of the Securities Exchange Act of 1934, thereby voluntarily subjecting itself to a host of U.S. securities regulations that have corporate governance implications.

For example, by listing on a U.S. exchange a foreign company accepts the obligation under Section 13(d) of the Securities Exchange Act of 1934 to disclose holders of more than five percent of its outstanding stock, a significantly more stringent trigger than the 10 percent threshold required by the European Union Transparency Directive. The company also accepts the rules under Section 14(d) governing the procedural and substantive aspects of tender offers, those under Section 13(e) governing going private transactions, and those under Section 13(b) governing the making of "questionable payments." To be sure, the SEC has allowed some exemptive relief for foreign issuers when the detail of a particular requirement is inconsistent with the law of a foreign company's home jurisdiction,[67] but the scope of governance rules adopted by the act of listing and the resulting application of the Securities Exchange Act is significant.

[66] Coffee, supra note 15.

[67] Id. at 688-89.

VI. Hybrid Convergence through Regulatory Competition

Convergence by contract through foreign companies voluntarily listing their securities on U.S. exchanges is made possible by a form of regulatory competition. By choosing a U.S. listing, a foreign company selects a significant element of U.S. governance rules in preference to those of its own jurisdiction. A similar convergence mechanism has always been available in the United States with respect to corporate law. Because in the United States a corporation's internal affairs (including especially its corporate governance) is governed by its state of incorporation without regard to its principal place of business, a U.S. corporation can choose the state corporate law that governs its affairs by choosing its state of incorporation.[68] The aggregated choices of a majority of publicly traded U.S. corporations have resulted in a convergence on the Delaware General Corporation Law as a de facto national corporate law.

Historically, convergence through regulatory competition was not available in Europe because the widespread application of the "real seat" doctrine dictated that the corporate law of the country in which the corporation's principal place of business was located governed its internal affairs regardless of the country of incorporation, a mandatory coincidence of a company's primary business location and the corporate law covering its governance.[69] At the margin, differences in corporate governance simply did not outweigh the real economic differences that grew our of a business' location, especially before the single market initiative. As a result, Europe has supported a wide variety of corporate law regimes, ranging from the U.K.'s Anglo-Saxon system to the German dual board, and codetermined system.

On March 9, 1999, this equilibrium of diverse corporate regimes was fundamentally destabilized. In its *Centros* decision[70], the

[68] Roberta Romano, The Genius of American Corporate Law (1993) develops the role of regulatory competition in American corporate law.

[69] See, e.g., Richard M. Buxbaum & Klaus J. Hopt, Legal Harmonization and the Business Entreprise 68-79, 227-28 (1988).

[70] European Court of Justice, March 9, 1999, C.21/297.

European Court of Justice introduced regulatory competition – a hybrid between formal and functional convergence – into the European Union.

In *Centros*, Danish residents seeking to organize a corporation to do business in Denmark attempted to avoid the 200,000 Danish Crown (approximately $27,000) minimum capital requirement by organizing a U.K. corporation. English corporate law was attractive because it did not impose a minimum capital requirement for private corporations.[71] The newly formed U.K. corporation, which did not, and was never intended to do business in the U.K., then applied for registration (i.e., qualification to do business in U.S. terms) in Denmark.

The Danish Registry Office refused registration, concluding, quite accurately, that the U.K. incorporation was merely a means to avoid the Danish minimum capital requirement.[72] The European Court of Justice, however, relying upon the rights of establishment in Articles 52 and 58 of the Treaty, protected forum shopping for favorable corporate law by decoupling the choice of where to incorporate from the choice of where to locate the corporation's business operations:

> [T]he fact that a national of a Member State who wishes to set up a company chooses to form it in the Member State whose rules of company law seem to him the least restrictive and to set up branches in other Member States cannot, in itself, constitute an abuse of the right of establishment. The right to form a company in accordance with the law of a Member State and to set up branches in other Member States is inherent in the exercise, in a single market, of the freedom of establishment guaranteed by the Treaty.[73]

[71] Eddy Wymeersch, Centros: A Landmark Decision in European Company Law, in Festschrift for Richard M. Buxbaum (T. Baums ed., forthcoming 2000).

[72] That the motive of the U.K. incorporation was to avoid the minimum capital requirements of Danish corporate law was simply assumed by the Court. See *Centros*, §14.

Understandably, *Centros* created "great waves of unrest on the continent."[74] But it also created a hybrid mechanism of convergence – formal in the sense that what is at issue is the selection of binding rules of corporate law, but functional in the sense that, as a result of the European Court of Justice's decision, European Community law is sufficiently flexible to allow at least newly formed companies to adapt their governance structures in response to changing economic conditions.

The hybrid of formal and functional convergence *Centros* makes possible can be illustrated by the choices facing a venture capitalist and a German entrepreneur seeking to make use of German engineering and scientific talent to organize a high technology start-up company.

Formal German corporate law presents two particular problems for the standard venture capital contract used to finance early-stage high technology businesses.[75] Central to the relationship between the investor and the entrepreneur is that, during the period prior to the investors' exit, the investor receives a level of control disproportionate to its equity ownership. In particular, representatives of the venture capitalist often will control a majority of the board of directors even if the VC puts up less than a majority of the equity. Moreover, the board, controlled or significantly influenced by the venture capitalist, can remove senior management, including the founding entrepreneur, essentially at will.[76] German

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[73] *Centros*, at §27. The court's full holding is as follows: "It is contrary to Articles 52 and 58 of the EC Treaty for a member state to refuse to register a branch of a company formed in accordance with the law of another Member State in which it has its registered office but in which it conducts no business where the branch is intended to enable the company in question to carry on its entire business in the State in which the branch is to be created, while avoiding the need to form a company there, thus evading application of the rules governing the formalities of companies which, in that State, are more restrictive as regards the paying up of a minimum share capital."

[74] Wymeersch, supra note 61.

[75]Baums & Gilson, supra note 64, develops the differences between the environment of venture capital contracting in the U.S. and Germany.

[76] Id. See Gilson & Black, supra note 49 *;* Sahlman, supra n.45.

corporate law – in particular co-determination and the rules governing removal of management board members – present a barrier to giving the venture capitalist the control dictated by the nature of early-stage high technology financing.

First, fast-growing high technology companies can reach 500 employees very quickly, thereby triggering the full co-determination requirement that one-half the supervisory board be composed of labor representatives.[77] Since the entrepreneur can be expected to require at least some supervisory board representation, co-determination makes majority control by the venture capital investors impossible. Second, the requirement of a dual board structure further attenuates venture capitalist control. Under German corporate law, the management board is made up of full-time company employees, who cannot be removed except for cause short of their five-year term.[78] As a result, the formal legal rule interferes with central features of the control allocation critical to early-stage high technology financing.

Centros invites German venture capitalists and entrepreneurs to select a jurisdiction whose corporate law is more favorable to venture capital contracting – say, the U.K. – and then register the newly formed corporation in Germany. The ability to choose a different law allows functional convergence without altering formal German corporate law by, in effect, making optional the undesirable features of German law.

To be sure, the extent to which *Centros* actually announces a regimen of regulatory competition is more complicated than to this point I have allowed. First, some European lawyers have read *Centros* narrowly, "merely referring to a case of abuse, without general significance."[79] From the perspective of an American, and therefore of an amateur at parsing the opinions of the European Court of Justice, so narrow an interpretation seems like wishful thinking. For better or worse, the Court explicitly ruled that denying branch registration to a company whose foreign incorporation has the sole

[77] See Dietl, supra note 34, at 113-14.

[78] See Julian Frank & Colin Mayer, Capital Markets and Corporate Control, 10 Econ. Pol'y 184, 206 (1990).

[79] Wymeersch, supra note 71, at 3.

purpose of “evading application of the rules governing the formation of companies” in the nation in which the company’s principal place of business will be located, “is contrary to Articles 52 and 58.”[80] Rather than responding to a case of abuse by a member state, the ECJ seems self-consciously to invite avoidance by those organizing businesses.[81]

Second, the effect of *Centros* may be attenuated by responsive efforts by EC member states to impose restrictions in ways that cannot be avoided by instrumental choice of where to incorporate. *Centros* quite clearly limits its application to “rules governing the formation of companies;” it does not apply to more general rules “concerning the carrying out of certain trades, professions or businesses.”[82] Put differently, rules of general application, which do not depend for their application on the member state under whose laws a corporation was organized, would seem to be unaffected by *Centros*. So, for example, *Centros* would allow a newly formed UK corporation with a principal place of business in Germany to avoid co-determination, but would not affect the application of German legislation imposing workers councils on all companies. Thus, the European Court of Justice has left open to EC members the strategy of replacing worker participation in decision making imposed by corporate law through the formal structure of the corporation, like co-determination and protection of management board tenure, with legislation requiring worker participation before specified actions, like plant closings, can be taken – a mandate framed as a matter of labor relations, not corporate law.

At least in the high technology area, however, there is reason to doubt whether EC member states, and especially Germany, will take up the Court’s suggestions for crafting a way around *Centros*. First, *Centros* shifts the burden of going forward with reform through the

[80] *Centros*, ruling paragraph.

[81] “[T]he fact that a national of a Member State who wishes to set up a company chooses to form it in a Member State whose rules of company law seem to him the least restrictive and to set up branches in other Member States cannot, in itself, constitute an abuse of the right of establishment.” *Centros*, §27.

[82] *Centros* at §26.

political system from those who favor reducing worker involvement to those who wish to preserve it. Accomplishing change is more difficult than merely having to protect the status quo.[83] Second, there is reason to believe that practical limits on the breadth of *Centros*' application will persuade the labor movement that the game of legislative reform to avoid the decision's impact is not worth the candle.

As written, *Centros* applies only to newly formed corporations – quite literally, it affects the allocation of decision-making between capital and labor only at the margin. It is not farfetched to imagine that labor, anxious to increase German penetration of the high technology industries and, hence, German employment, might not object to a reduced governance role for labor in new companies in high technology industries, especially if labors' governance role in established German industry remains unchanged.[84]

But what of efforts by existing large German companies to take advantage of *Centros*? Suppose an existing company sought to relieve itself of its two-tier board structure and co-determination by merging into a newly formed U.K. subsidiary.[85] Would *Centros* require Germany to register the new UK company, thereby extending *Centros* to any company willing to reincorporate abroad, including established German companies, and likely inciting a political response by labor if it is to retain any formal corporate governance role?

At least for now, two barriers – one based in corporate law and the other in tax law -- make it unlikely that the ECJ will extend *Centros* to Germany's traditional industrial base. The corporate law barrier

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[83] n example from San Francisco, where I live, illustrates the point. For years, many residents sought to have the Embarcadero Freeway, a two level concrete abomination that separated downtown San Francisco from the waterfront, demolished. While this group was likely a majority, a concentrated minority whose businesses the freeway benefited was successful in blocking demolition. The 1989 earthquake, operating as a mechanism of natural urban renewal, inflicted sufficient damage that the freeway had to be torn down. Thereafter, the freeway proponents were unable to muster the political influence to have it rebuilt.

[84] For an indication that German unions are becoming more flexible, see Unions' Union, in Survey of European Business, The Economist, April 29-May 5, 2000, p. 16.

[85] This is the typical transaction form by which a U.S. companies reincorporated in another state.

concerns the merger: under German corporate law, a German corporation cannot merge with a non-German corporation. The convoluted structure of the recent Daimler-Benz/Chrysler combination was necessitated to avoid just this barrier.[86] To be sure, one can readily craft an argument that legal rules which prevent the migration of companies from one member state to another also violate the Treaty's right of establishment. But that holding would require a substantial expansion of *Centros*, in practical effect from a decision allowing functional convergence at the margins of a member state's economy, to one that contemplates regulatory competition as a means of securing uniformity fully parallel to the Treaty based harmonization through directive.[87]

Even were the ECJ to expand the reach of *Centros*, a significant tax barrier would remain. Under German tax law, shifting nation of incorporation is treated as a liquidation, thus triggering corporate level capital gains tax on the appreciation in corporate assets. For large German corporations, it is difficult to imagine that the value of the more attractive governance features of the corporate law of another EC member state would be worth the tax cost of the shift.[88]

V. Conclusion

In this essay, I have surveyed three kinds of corporate governance convergence: *functional convergence*, when existing governance

[86] Theodor Baums, Corporate Contracting Around Defective Regulations: The Daimler-Chrysler Case, 155 J.Instit. & Theo. Econ. 119, 122 (1999).

[87] This point is emphasized by the fact that in 1998 the European Commission prepared a draft 14th directive that set out how shift in country of incorporation could be effected. Wymeersch, supra note 71, at 16. Additionally, the European Court of Justice's decision in the Daily Mail case, C. 81/87 [1988] ERC 5483, involving the transfer of the registered office of a company from one state to another, is said to stand for the proposition "that articles 52 and 58 do not allow companies to transfer their seat… ." Id. at 18. Interestingly, Daily Mail is not cited by the Court in *Centros*.

[88] One might suppose that the European Court of Justice could extend *Centros* to prohibit imposing a tax penalty on the decision to shift nation of incorporation, but here the boundaries of the argument begins to expand exponentially.

institutions are flexible enough to respond to the demands of changed circumstances without altering the institutions' formal characteristics; *formal convergence*, when an effective response requires legislative action to alter the basic structure of existing governance institutions; and *contractual convergence*, where the response takes the form of contract because existing governance institutions lack the flexibility to respond without formal change, and political barriers restrict the capacity for formal institutional change. Additionally, two forms of hybrid convergence, involving voluntary selection of different formal rules offered by other jurisdictions both within and without the European Union, were considered. The diversity of circumstances suggests that there can be no general prediction of the mode that convergence of national corporate governance institutions may take. Because the flexibility of governance and political institutions will differ not only between countries, but within individual countries based on the particular response called for by changed conditions, the most we can predict is substantial variation both across and within different national systems, what Stephen J. Gould called "a contraption not a lovely contrivance."[89]

[89] Gould, supra note 33, at 24.