

Expansive Retrenchment: The Regulatory Politics of Corporate Governance Reform and the Foundations of Finance Capitalism*

Chapter for *The State After Statism* (Jonah Levy, ed.)

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During the past decade both the U.S. and Germany have substantially reformed their corporate governance regimes to protect shareholder interests and foster the development of legitimacy of securities markets. Politicians and parties on the center-left in each country took advantage of changing policy preferences within the polity that favored reforms that protected shareholders and curtailed established managerial prerogatives. Policymakers overcame powerful institutional forces of path dependence in ways that have substantially expanded the scope and reach of the regulatory state. Corporate governance reform is central to an emerging paradigm of international finance capitalism, and indicates that new forms of regulatory intervention—not the withering of the state—accompany this form of political economic organization.

I. Introduction: After Enron

The collapse of the bubble economy of the 1990s in the United States and to a lesser extent in Europe, led to a wave of massive corporate finance scandals in the United States and stock market crashes around the world. The fall of the neo-liberal American economic and corporate governance model from international grace obscures the most important part of the story: a new form of international finance capitalism is emerging and the functioning of highly mobile private investment, securities markets and corporate governance regimes lie at its structural core. Consequently, the politics and institutions of corporate governance loom large in public debate and as a subject of public policy.

The increasing salience and reform of corporate governance reflects the rise of “*finance capitalism*” as an emerging paradigm of capitalism built on an expanding class of private

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investors, robust international capital markets, and sophisticated financial services.¹ These features of the economy have begun to take precedence over established institutional arrangements and practices that defined the post-war advanced industrial economies in all their variations. The emergence of finance capitalism, however, present a paradox: the development of financial markets and the increasing prevalence and import of market relations, so often linked to the diminution of state power and authority, have been accompanied by a substantial and ongoing *expansion* of law and prescriptive regulation governing the structure of and the conduct of parties within these markets and the steady centralization of regulatory authority at the national level. Further, though often neglected in theories of regulation, corporate governance law performs a crucial regulatory function by ordering the authority relationships, decision-making processes, and economic incentives of this most important and ubiquitous economic institution.

This chapter examines corporate governance reform in the United States and Germany during the past decade as an expansion of state capacity and as an indication of how changing social and economic conditions impose new demands on the state and offer state actors opportunities to develop new policies and instruments of state authority and power. To some degree, finance capitalism has begun to inform the public policies and economic structures of all the advanced industrial countries. This financially driven form of capitalism conforms to the long-established neo-liberal institutional structure and policy profile of the United States. Yet the same political push to develop capital markets and the increasing political and economic importance of corporate governance are seen—in more inchoate form—in neo-corporatist political economies such as Germany that have provided a comparative counterpoint to Anglo-American liberalism. This broad emergence of finance capitalism provides a vantage point from which to assess the competing theories of political economic convergence and path dependence that have preoccupied the field of comparative political economy since the early 1990s. Finance capitalism likewise poses difficult and important analytical problems of untangling the influence of economic efficiency in the reform of the foundational institutions of capitalism, more

¹ Although this new form of capitalism has also been referred to as shareholder capitalism, the restructuring of regulation, markets, and industries reflects changes that are far broader than narrow shareholder interests and reflect the growing structural power and influence of financial capital in all its forms. (See Cioffi 2002a, chap. 2) Thus, I use the more general term “finance capitalism.”

importantly the corporate firm and the markets for finance, and the role of power as channeled through political institutions. This chapter begins to frame and answer this central question.

A comparison of the developmental trajectories of the United States and Germany in the evolution and reform of their national corporate governance regimes, clarifies the common pressures favoring the reform of financial markets and corporate governance across national economies while revealing the political and structural features of the American and German political economies that have propelled them along separate paths of development. On the one hand, we live in an era frequently described as defined by globalization, deregulation, and retrenchment of state power as private actors, interests, and institutions predominate in the organization of the economy. Nowhere is this dynamic more frequently observed or invoked as in relation to the rise of international financial markets and the investors and corporations that utilize them. From this perspective, corporate governance usurps, or privatizes, politics and policy as private interests and institutions predominate in economic decision making and the state retreats under threat of capital flight. Indeed, in some ways the increasing importance of corporate governance as an area of policy and economic practice suggests the devolution of power from the state to the firm and market as the primary mechanisms of economic distribution, innovation, growth, and adjustment. On the other hand, much work in contemporary comparative political economy, particularly that associated with the “varieties of capitalism” literature, maintains that institutional differences among national economies are locked into place by the comparative economic advantages these arrangements confer on domestic firms. Neither description, however, recognizes the intensely political process by which corporate governance regimes are constructed and the state’s *substantially increased regulatory intervention* in the economy that accompanies substantial corporate governance reform.

Political elites in both the United States and Germany have expanded and centralized the regulatory state in the process of reforming corporate governance in order to protect shareholders and the interests of finance capital. These reforms served the interests of political elites by using capital market pressures channeled by corporate governance institutions to constrain managerial autonomy and (arguably) promote corporate restructuring as ways to increase corporate efficiency and improve aggregate economic performance. They reflect the capacity of state actors to take advantage of changing economic conditions and shifts in interest group preferences and public opinion by framing public policy debates and constructing interest group alliances to

overcome path dependence. Corporate governance reform belies theories of path dependence and neo-liberal convergence alike. The 1990s witnessed substantial change in institutional arrangements, policy preferences of important political actors, and economic relationships. Substantial reforms have swept through the securities law and regulation, company law, and increasingly in corporate practices and organization. Financial regulators and regulations exist where before there were none. Shareholder rights have developed rapidly in an era in which corporate managers were thought to be gaining power and influence over policy. In both the United States and Germany, regulatory power over corporate finance and governance has become more centralized, hierarchical, and formal as federal law supersedes state law, self-regulation, and unregulated markets. These are not the hallmarks of a stable political economic equilibrium. Nor do these developments herald the wholesale retreat of the state.

In the United States, the ascendance of corporate governance followed the long period of economic crisis during the 1970s and 1980s. American firms lagged behind foreign competitors in international competition. The rise of hostile takeovers, mergers and acquisitions, and financial engineering triggered intense struggles for power within both the public and private spheres by destabilizing established relations among managers, shareholders, and employees. More recently, following the collapse of the stock market in 2000 and of Enron in 2001, massive financial scandals exploding onto the headlines returned corporate governance to a central position in debates over economic policy and the proper role of the state in the economy. In Europe, increased interest of policymakers in corporate governance followed the large-scale privatization of publicly-owned enterprises that began in the 1980s and continued through the 1990s, the sluggish economic growth and innovation of European firms and national economies during the 1990s, and the transformation of financial systems as major financial institutions sought to develop more sophisticated financial services utilizing securities markets. Conditions of economic crisis thus prompted the emergence of corporate governance as a prominent policy area. And these governance policies and reforms constitute an important transformation of the state's role in fostering firm-level adaptation and adjustment to changing economic conditions. The reform corporate governance regimes triggered intense political and economic struggles

over power, autonomy, and wealth that were and are ultimately embodied in the structure of legal relations and institutional arrangements.²

The increasing prominence of the corporate firm and its governance in public policy entails a transformation in the role of the state and regulation in ordering economic relations. In place of state control over finance, public ownership of enterprise, or strong coordinating financial intermediaries, “[t]he use of law and regulation to structure markets and firms . . . is becoming an increasingly important, and perhaps dominant, mode of state intervention in the advanced industrial economies.” (Cioffi 2002c: 2) Corporate governance and its reform exemplify this intertwining of public and private. “The legal mechanisms of corporate governance do not *supplant* markets; they *restructure* both markets and the organizational hierarchies of the firm to accomplish policy goals.” (*Ibid.*)

The rise of corporate governance as a field of law and policy poses the questions of both *how* the state, through law and regulation, has come to restructure fundamental economic relationships, and *why* it has done so at this point in time. What drives the political demand for increased regulation of economic activities and institutions modes, and why does this expansion of regulation take the form it does? By examining the process of corporate governance reform in the United States, as the leading neo-liberal political economy, and Germany, as the leading neo-corporatist one, we can begin to see cross-national trends in reform efforts, how the role of the state in the economy has changed, how state actors allocated the costs of policy change and economic adjustment, and the relative trajectories of the German and American corporate governance regimes.

II. The Regulatory State, Public Law, and the Corporate Firm

Corporate governance regimes structure the allocation and exercise of power and decision-making authority among managers, shareholders, and employees— the principal groups involved in corporate affairs.³ A tripartite legal structure of company (or corporate) law, securities regulation, and labor relations law, defines the juridical relationships among these

² Cioffi 2002c: 2. For a political analysis of the history of the American case in comparative perspective, see Roe 1991, 1993, 1994.

³ Cioffi 2002a: 1; cf. Gerke 1998 (quoting Schmidt, 1997). This definition of the term corporate governance goes well beyond the narrow confines of the shareholder-manager (principal-agent) relationship that preoccupies the vast majority of scholarship in law and economics. This broader definition more accurately describes the function of corporate governance and its relationship to the broader political economy.

groups and thus establishes the core of national corporate governance regimes as a central feature of national political economies.⁴ This core structure of corporate governance differs substantially across different types of political economic organization. The cases of the United States and Germany demonstrate this variation. The two countries represent distinctive political economic models defined by neo-liberal and neo-corporatist institutional arrangements, respectively.⁵ These divergent political economies deployed very different national corporate governance regimes that configured of the corporate firm and power relations within it in very different ways. In each case, characteristic institutional structures and power relations are replicated at multiple levels of the state, market, and corporate firm. (See Tables 1 and 2 for the basic features of the post-war American and German governance models) Although numerous informal practices are associated with national corporate governance regimes, ranging from managerial compensation to the participation of employees in firm decision-making and implementation, these practices developed within and have been perpetuated by the formal legal and institutional structures of corporate governance. And these formal arrangements are the product of political forces.

The American economy has experienced waves of wrenching crisis and restructuring during the past twenty-five years. The Fordist model of mass production was based on large integrated and oligopolistic industrial firms, managerial autonomy from shareholders, long-planning horizons, stable sources of capital, and predictable product cycles in predictably expanding markets. This form of economic and corporate organization entered a prolonged period of crisis following the oil shocks and stagflation of the 1970s. Deindustrialization, erosion of domestic and export market shares, and the collapse of organized labor represented the collapse of the post-war economic order. In its place, the wave of hostile takeovers, mergers, and acquisitions during the 1980s signaled the arrival of a new, volatile, and financially driven form of economic organization that persisted and began to diffuse across many industrialized countries in the 1990s. Securities markets became more than simply another form of finance, they—or rather the

⁴ Cioffi 2002a: 1-2; 2002c. Although the interests of a wide variety of groups arguably may be encompassed within corporate governance (*e.g.*, creditors, customers, local communities, etc.), comparative analysis and a variety of practical considerations in framing a relatively parsimonious analytical framework indicate that a structural model of corporate governance should be limited to these three stakeholder groups and the bodies of law that define their status within the corporation. (See Cioffi 2002a, chaps. 1 & 2; 2002c)

⁵ For a classic expression of this typology of political economic types in the study of national financial systems, see Zysman, 1983. An updated analysis of national corporate governance regimes from this typological perspective is presented in Cioffi, 2000 and Cioffi and Cohen, 1999.

financial, legal, and other professional intermediaries involved in financial transactions—became the drivers of corporate and thus economic restructuring. The United States certainly had a head start in the development of this new paradigm of finance capitalism. Its securities markets were already the most developed and it had among highest rates of stock market capitalization and publicly listed firms in the world. Underlying this economic and financial structure was a well-developed legal and regulatory structure dating back to the New Deal that favored this reliance on markets. The legal and regulatory foundation of American finance capitalism was political in origin, as was its evolution during the past decade.

In Germany, a bank-centered financial system, strong labor unions and codetermination, networks of corporate cross-ownership and interlocking directorates, and consensual neo-corporatist policymaking stabilized economic relations and facilitated long-term skill acquisition, productivity growth, and innovation in production. These institutional arrangements allowed the German industrial economy to weather the crises of the post-1973 era better than its American counterpart. Throughout the 1970s and the 1980s, German firms maintained their comparative advantage in manufacturing by targeting high value-added products and market niches that could finance high wage and highly skilled labor. By the late 1980s, however, the German economy had begun to deteriorate in terms of unemployment, economic growth rates, and technological innovation. These macro-economic problems intensified throughout the 1990s following the reunification of East and West Germany as growth stagnated and unemployment surged to sustained levels of over 9%. This economic malaise fed the perception that Germany was no longer sufficiently economically innovative and dynamic, but that neo-corporatist institutional arrangements within national politics, finance, and the corporate firm now were blocking necessary adjustment and restructuring. Corporate governance reform in Germany is part of a broader and ongoing struggle over the future of these institutional structures. Before delving into the politics of reform, however, a brief sketch of the American and German financial and corporate governance regimes is needed.

Tables 1 and 2 here

A. The United States

The structure of American corporate governance encouraged reliance on rapidly shifting arm's length economic relationships over longer-term relational ties among management, capital, and labor. American law tends to preserve an expansive sphere of private organizational and managerial autonomy bounded by a highly developed regulatory framework and formal legal rights. American governance law and economic regulation maintained a relatively hands-off approach to the internal affairs of the corporation in American law and historically allowed managers great latitude in the private structuring of intra-corporate institutions and relationships. The absence of institutionalized representation of and negotiation among countervailing interest groups within the firm concentrates and centralizes of power in the hands of the CEO and other senior managers.

American corporate law is distinctive in that it has been the responsibility of state, not federal, law. State company laws function as general enabling statutes that create the bare minima of the corporate form— limited liability, the “corporate personality” (the capacity to enter into contracts and to sue and be sued), a board of directors, and basic fiduciary duties and shareholder rights. Otherwise, corporate law gives managers and directors wide discretion in how to structure the firm, its finances, and decision-making processes and gives shareholders comparatively few rights to vote on important corporate decisions. In fact, American proxy rules give *management* control over shareholder proxy votes. (See, e.g., Kübler, 1987: 215) In theory, the fiduciary duties of corporate directors and officers partially counterbalanced the resulting weakness of shareholders in corporate governance. These legal duties obligate them to run the corporation for the benefit of the shareholders in a loyal and reasonably attentive and competent fashion.⁶ In practice, however, the “business judgment rule” substantially dilutes fiduciary duties by exempting from liability those decisions taken in good faith in the ordinary course of business.⁷

⁶ Fiduciary duties in American corporate law are an enormously complex subject far beyond the scope of this chapter. For a leading treatise on the subject, see Block, Barton, and Radin, 1994. For an incisive overview and provocative theory of fiduciary duty law, see Allen, 1998.

⁷ Still, American law endows shareholders with unusually well developed substantive and procedural rights that has made the American regime highly litigious and has made the courts and attorneys important actors in corporate governance. Shareholders may enforce these rights through private lawsuits brought under a set of favorable procedural rules, including derivative suits, class actions, and contingency fee retainers. However, the business judgment rule reveals the structural inadequacy of fiduciary duties as a mechanism of governance. The potential liabilities of corporate fiduciaries are so enormous that no rational individual would agree to act as a director if not

American federalism's long-standing allocation of corporate lawmaking to the states and this concentration of power in corporate management increased the incentive for federal policymakers to use market-reinforcing securities market regulation as a principal means of constraining managers and protecting shareholders from fraud, misappropriation, and abuse. Accordingly, with the rise of the modern regulatory state in the 1930s, the American governance regime pioneered modern securities regulation and came to rely on the Securities and Exchange Commission—a strong centralized regulatory agency—to relieve information asymmetries and to improve the efficient functioning of securities markets. In short, the SEC's mission was to make the markets work—and it did so by using regulation to redress informational asymmetries that plague securities markets. The SEC was charged with drafting and enforcing elaborate and mandatory registration, disclosure, and securities fraud rules, and with overseeing the administration of stock exchanges (and their listing and disclosure rules). As a result of this institutionalization of securities regulation, the United States possesses comparatively strong transparency, disclosure, and insider trading laws and regulations designed to protect minority shareholders, facilitate market transactions, and buttress the perceived legitimacy of the country's securities markets. Within this regulatory framework, the "external" capital markets in the United States became among the most developed and liquid in the world with a high proportion of publicly traded firms, a sophisticated financial services industry, and an extraordinary range of debt and equity financing options.

Both the emphasis on transparency and disclosure regulation and weak institutional position of shareholders within the legal structure of the American corporation encouraged individual and institutional investors to respond to governance and management problems through exit by selling their stakes rather than participate more actively through voice in firm governance.⁸ There arose a mutually reinforcing relationship between the market-driven American financial system and a legalistic, transparency-based regulatory regime. The weakening of shareholders within firm-level structures of corporate governance through ownership fragmentation increased the importance of and reliance on prescriptive disclosure regulation to protect shareholder interests. This corporate governance and regulatory model

granted a very broad safe harbor from personal liability. Likewise, in the absence of a business judgment rule, insurers would refuse to write "directors' and officers'" insurance policies at acceptable rates.

⁸ See, e.g., Roe, 1991; Coffee, 1991. For the classic analysis of the use of exit and voice in governance relationships, see Hirschman, 1970.

formed an important underpinning of the Fordist model of production and the managerialism that defined American capitalism after the Second World War. When this disclosure and transparency regulation failed during the bubble market of the late 1990s, so did the broader system of corporate governance and finance.

Managerial dominance over corporate affairs subordinated both finance capital and labor. While American corporate governance law weakened shareholders within firm governance, it wholly excluded employees. No representational structures exist in American law at the state or federal levels to incorporate employees into firm decision making or provide for ongoing consultation processes, such as that provided by board representation or works council structures in Germany (*see infra*).⁹ American labor law strictly separates labor relations and firm management. In short, *labor law protects managerial prerogatives* from encroachment by collective bargaining or other forms of union power.¹⁰ Matters such as investment, marketing and production strategy, design and production plans, and financial strategies are considered within the “core of entrepreneurial control” and not subject to collectively bargaining,¹¹ although these issues may have decisive importance for the future of the workforce.

Together, the combination of corporate law managerialism, strong transparency and disclosure regulation under securities law, and labor marginalized through comparatively weak labor laws constitute the basic structural features of the American corporate governance regime. The American corporate governance regime also relied to a striking extent on the substantial use of highly formal and prescriptive regulation and formal litigious enforcement mechanisms. These legal-institutional arrangements encourage risk taking, organizational restructuring, and technological innovation, but at the cost of chronic “short-termism” that often elevates financial speculation and quick returns over long-term maintenance and growth of production and

⁹ In fact, labor law, as interpreted by the National Labor Relations Board and the federal courts, impedes the formation of *alternative* forms of employee representation under a broad prohibition of company unions that protects employee organization at the expense of organizational experimentation. These restrictions have led the NLRB and courts to hold that workplace committees dealing with safety and productivity issues are illegal. *See Electromation, Inc.*, 309 N.L.R.B. 990 (1992), enforced sub nom, *Electromation, Inc. v. NLRB*, 35 F.3d 1148 (7th Cir. 1994); *E.I. du Pont de Nemours & Co.*, 311 N.L.R.B. 893 (1993); *see also* Estreicher, 1994; Hyde, 1993; Summers, 1993. These rulings reinforced the sharp distinction between the spheres of state corporate law and federal labor law.

¹⁰ American labor law maintains this strict separation by limiting “mandatory subjects” of collective bargaining to a highly circumscribed range of “bread and butter” issues concerning the terms and conditions of employment. *NLRB v. Borg-Warner Corp.*, 356 U.S. 342 (1958); *Fibreboard Paper Prods. Corp. v. NLRB*, 379 U.S. 203 (1964); *see also First National Maintenance Corp. v. NLRB*, 452 U.S. 666 (1981).

¹¹ *Fibreboard Paper Prods. Corp. v. NLRB*, 379 U.S. 203, 223 (1964) (Stewart, J., concurring); *see also Ford Motor Co. v. NLRB*, 441 U.S. 488, 498 (1979) (quoting *Fibreboard*).

productivity. The American corporate governance regime reinforces both the comparative strengths of the American economy in terms of sophisticated financial services, high tech, and rapid corporate adjustment and reallocation of capital, and its systemic weaknesses: lagging competitiveness in production and manufacturing, a consistent failure to capitalize on technological innovations, and a combination of high levels of economic insecurity and inequality. As the varieties of capitalism literature accurately argues, these attributes are hallmarks of the liberal market economic model. Yet this legal framework pits managerialism against “shareholder primacy” (the principal that the maximization of shareholder value over any other stakeholder interests justifies managerial decisions) as the fundamental tension in corporate governance. During the 1980s and 1990s this tension would break out into increasingly bitter political conflict.

B. Germany

The post-war German political economy and corporate governance regime stands in sharp contrast to the neo-liberal American model. The German governance regime relied on law and regulation to structure the firm as a largely self-regulating entity situated within a consensus-based social market economy with its neo-corporatist interest representation, centralized wage bargaining, and networks of relational finance and corporate ownership. It led in the development of a stakeholder model of governance that incorporates and protects the interests of non-shareholder constituencies, particularly labor, within the corporation.¹² Like the United States, Germany is often described as highly legalistic country. However, German legalism more frequently uses law to fashion representational structures and institutional frameworks that channel opposing interests into negotiation rather than formal enforcement processes. The German political economy, in contrast to the United States, makes substantial use of centralized interest group representation in the formulation of policy. This ordering of opposing interests into long-term bargaining relationships replicated on the level of the firm and workplace through the distinctive institutionalization of German finance and labor codetermination.

The framework of German securities and company law corporate governance was the mirror image of the American structure. The American corporate governance regime was defined by centralized federal securities regulation and the dispersion of corporate law among

¹² For an early and classic article comparing the German and American corporate governance regimes and their legal and political histories, *see* Vagts, 1966. For more recent comparative treatments, *see, e.g.*, O’Sullivan, 2000; Roe, 1994, 1993b; Charkham, 1994.

the states. In Germany, a *uniform federal company law* and the *fragmentation of securities regulation* among the Länder (states) and local self-regulating exchanges defined the legal framework of German corporate governance until the mid-1990s. Disclosure regulations, and accounting rules remained weak and company finances opaque. Moreover, the law provided few effective avenues for private litigation to enforce shareholder rights.

In place of American-style transparency regulation, Germany's corporate governance regime long relied on mandatory rules to structure the corporation and its governance processes and on the power of large banks to monitor managers. Germany's bank-centered financial system defined a set of stable, interlocking ownership and governance relationships based on concentrated ownership, extensive cross-shareholding networks, and long-term relational finance ties between banks and corporate borrowers. These financial structures reinforced the stakeholder model. Relational finance by banks ameliorated pressures for maximizing short-term financial returns and encouraged the adoption of long-term adjustment and growth strategies by industrial enterprises that could balance the competing demands of capital and labor. The major banks' central role in securities underwriting, brokerage, and trading gave them significant power in corporate affairs. Large German "universal banks" combined the lending and securities services at the core of financial system. Consequently, these banks were simultaneously important lenders to and major shareholders in publicly traded firms. Further, under German law, the banks may vote "deposited share voting rights" ("DSVRs") if authorized by their brokerage clients.¹³ Bank representation on the supervisory board frequently cemented the combination of voting power with long-term relational lender and shareholding relationships. The corporate structure organized stakeholder interests into self-regulating relationships within firm governance. In theory, the banks' status as shareholders aligned their interests with those of other shareholders; and the banks' power within firm governance presumably protected these other investors. In fact, banks did not play the active monitoring role assumed by conventional wisdom and the contradictory status of the banks as lenders first and shareholders second generated conflicts of interest that law and regulation did not police or remedy. In the absence of strong shareholder protection or strong incentives for major banks to cultivate equity finance,

¹³ Thus, in addition to their own equity holdings, the banks wield disproportionate voting strength and substantial leverage when it comes to board nominations or influencing key strategic decisions. Charkham, 1994: 37-38; Vagts, 1966: 53-58. Even where German management attempts to maintain autonomy by diversifying sources of bank debt, Deeg, 1992: p. 208, banks have adopted a practice of designating a "lead bank" to monitor the corporation, vote their aggregate DSVRs, and maintain supervisory board representation. Vitols, 1995: p. 6.

relatively few German firms were publicly traded, equity was not an important form of finance, and securities markets remained far less developed than in the United States.

Under German company law, public corporations (*Aktiengesellschaft* or “AG”) have a dual board structure in which the supervisory board (analogous to the American board of directors) is completely separate from the management board (a more collegial version of the CEO and senior management of the American firm) with no overlapping membership between them. The supervisory board (“Aufsichtsrat”) appoints and supervises the managing board (“Vorstand”) and formulates (or at least approves) major corporate policies and strategies. German company law also gives the shareholders’ meeting (Annual General Meeting, or AGM) the right to receive relevant information and vote on a broad range of issues, including mergers, major acquisitions, capital increases, and major changes in business strategies.¹⁴ In the absence of stringent securities regulation designed to improve the efficiency and disciplinary function of stock markets, German company law relied on the internal corporate institutions, the board and AGM, to constrain managerial power. However, these institutional constraints were not designed to protect shareholders alone, as in the United States, but also to safeguard the interests of creditor banks and employees as important stakeholders of the firm.

Codetermination, the incorporation of employees into the firm’s governance processes, embodies the stakeholder vision of the corporation as an institutional and organizational entity.¹⁵ Company and labor relations law interpenetrate under codetermination to create “microcorporatist”¹⁶ structures that facilitate negotiation, compromise, cooperation, and consensus within firm governance. Supervisory board codetermination under the Codetermination Act of 1976, perhaps the most striking feature of German company law, requires most corporations with over 2,000 employees appoint equal number of shareholder and employee representatives to their supervisory boards.¹⁷ However, the chairman of the

¹⁴ Shareholders may bring a private action to nullify any corporate decision taken in violation of their informational and procedural rights. Because these decisions often concern important and time-sensitive strategic issues, managers usually seek to settle these suits quickly. Thus, German company law created a disclosure and transparency regime outside of securities regulation—though it functions only when an AGM is held, not continuously as under securities law. This litigation has also created all the problems allegedly excessive litigation and frivolous lawsuits that dodge the far more litigation prone American governance regime and legal system.

¹⁵ For discussions, see Katzenstein, 1987: Chap. 3; Wiedemann, 1980.

¹⁶ Cf. Assmann, 1990; Streeck, 1984 (use of the term “microcorporatism” in relation to firm structure and organization).

¹⁷ Wiedemann, 1980: 79. Firms with 500 to 2,000 employees must set aside only one-third of the board seats for employee representatives. Wiedemann, 1980: 80. “Montan” codetermination, the third (and original) variant, only

supervisory board is elected by the shareholders and wields a second tie-breaking vote.

(Wiedemann, 1980: 79; Charkham, 1994: 26) Thus, the structure of the board preserves shareholder formal (or managerial) dominance, but alters the bargaining dynamics on the board by allowing managers to ally with employee representatives to resist shareholder pressures for higher returns.¹⁸ Board codetermination has become enormously important as a symbol of the country's neo-corporatist and social democratic consensus-driven "social market economy." Works council codetermination provides a second and more important form employee representation in firm governance. The product of the center-right Adenauer government's 1952 attempt to break the unions' monopoly over representation of employees, works councils wield substantial influence within the workplace, and often over entire corporate groups, through their ability to use informational, consultation, and codetermination or codecision rights to substantially impede the implementation of managerial decisions and through their authority to demand compensation for economic injury caused by changes in corporate policy.¹⁹

This stakeholder system both legitimated the post-war capitalist order and conferred the comparative advantages of incremental innovations in industrial production that enabled German industry to focus on high quality and high value-added market niches that rationalized high wages and investment in skill formation. But these benefits came at an increasingly steep price during the 1990s, as export markets became increasingly unstable, international competition became fiercer, bank profits declined as the domestic market for corporate finance became increasingly saturated, and German reunification required more rapid and thoroughgoing restructuring of the country's corporate economy. By the early 1990s, these pressures and declining national economic performance made the need for structural reform ever more obvious. German politicians then faced the twin problems of what form the reforms should take and whether Germany's well-developed structure of interest representation would block them.

applies to firms in the coal, mining, and steel sectors employing more than 1,000 workers, provides for *full parity* of shareholder and employee representation. The decline of the mining and steel sectors in Germany has reduced the importance of Montan codetermination.

¹⁸ It does so, however, at the expense of well-defined fiduciary duties. Fiduciary duties under German company law protect the *corporation's* interests, rather than the interests of shareholders alone. Codetermination institutionalizes the recognition of the "interests of the corporation" as the interests of multiple stakeholder groups, including labor.

¹⁹ Wiedemann, 1980: 80-82. The Works Constitution Act of 1972 provides for the election of works councils in facilities or plants of business organizations with five or more permanent employees. Wiedemann, 1980: 80. However, many large firms voluntarily instituted enterprise (or *Konzern*) works councils covering an entire corporate group to ensure stable and cooperative labor relations. For general discussions of the political origins and impact of codetermination, *see, e.g.*, Vagts, 1966: 64-78; Streeck, 1984; Katzenstein, 1987: Chapter 3; Muller-Jentsch, 1995. For the role of works councils in German labor relations, *see* Thelen, 1991; *cf.* Turner, 1991.

III. Politics and Policy Reform

Corporate governance reform reflects systemic crises in both the American and German political economies and their approaches to economic policy. Declining national economic performance, the internationalization of financial markets, and fiercer competition within the financial sector spurred the pursuit of higher returns to capital by investors and financial institutions while policymakers sought ways to encourage corporate restructuring through market pressures. These changes increased the political and economic leverage of investors, investment banks, and institutional investors in the United States and of universal banks in Germany. Recurrent corporate financial scandals in each country also mobilized popular support for the reform of the corrupt insider-dominated dealings of corporate and financial elites—even as these elites shaped and benefited from the reforms of the past decade. (Cf. Moran, 1991)

However, financial scandals do not occur in a legal, institutional, or political vacuum and they alone do not produce far-reaching reforms. Scandal and economic crisis spread within a legal and institutional context that only trigger the political dynamics of reform. Crises and conflicts merely provide the necessary preconditions for substantial change in policy and institutional structures. Politics drives the reform process itself and predominates over market forces and economic logic. Crises, whether of economic performance or legitimacy, alter the balance of political power by strengthening and weakening interest groups, parties, and policy positions. Entrepreneurial politicians and political parties are presented with strategic opportunities to mobilize and cultivate supporters, alter interest group alignments, and take up issues that improve their prospects in electoral competition.

Significantly, the political proponents of reform in both the United States and Germany came from the center-left—the Democratic Party in the United States and the Social Democratic and Green Parties in Germany. The more conservative Republicans in the United States and the Christian Democrats (the CDU-CSU) in Germany were generally far more resistant to pro-shareholder reforms. The prospect of the political left advancing the cause of shareholders and finance capital appears counterintuitive. However, the politics of corporate governance indicates the power of finance capital and capital markets to destabilize and threaten the interests, power, and positions of established managerial elites represented by center-right parties and opened strategic political avenues to center-left parties.

First, under the pressures of economic crisis and an eroding working class base, center-left policymakers came to embrace corporate governance reform as a means of appealing to voters resentful of economic elites while claiming the banner of reform and economic modernization. The Democratic Party in the United States used the post-bubble scandals and the collapse of share prices to attack the Republican Party's most conservative and pro-manager leadership since the 1920s and as a well-placed appeal to middle class voters (with significant savings invested in stocks) who believed in free but *fair* markets. The German SPD government's corporate governance reforms satisfied left wing and populist constituencies by targeting managerial and (to some extent) banking elites and formed part of a strategy to lure political and electoral support from the middle class and financial sector by promoting policies that would encourage efficiency in capital allocation, higher rates of growth and innovation, and economic restructuring.²⁰

Second, in each case, scandal and crisis weakened opponents of reform. In the United States, managers, accounting firms, corporate attorneys, and anti-regulation conservative (of both parties) were almost completely sidelined from active political participation during policy debates over governance reform at the peak of the post-bubble scandals. German managers, and to some extent labor, reached a low point of their legitimacy in economic governance as stagnation and high unemployment wore on through the late 1990s. Bankers were already seeking a more market driven financial model and therefore largely (if quietly) supported the reforms and offered little resistance.

Third, in both the United States and Germany, governance reform fit surprisingly well within the contours of the center-left ideology. The Democratic Party and the SPD have both been committed to the development of the regulatory state as a counterweight to managerial power, concentrated corporate power, and market distortions. Both parties had a practical and ideological interest in shoring up the perceived fairness and equity of markets that absorbed increasing shares of working and middle class pension and retirement savings. Governance and securities law reform thus appealed to both the egalitarian and welfare state components of center-left ideology and policy agendas. This is a highly simplified sketch of complex inter-

²⁰ Governance reform also has the advantage of blame avoidance with respect to the inevitable economic pain inflicted on workers in the process of corporate restructuring. The state would not be directly responsible—market forces would. Further, the SPD has been careful to leave much of the welfare state intact to cushion the impact of restructuring to shore up support of its base constituencies and to insulate itself from criticism over the results of pro-finance and pro-shareholder policies.

party and intra-party dynamics in both countries. Yet the general point is valid. Corporate governance reform is largely a project of the political left—not the ostensibly pro-business or neo-liberal right.

These reforms do not fit into simple theories of convergence or path dependence. Although the resultant institutional developments display some important convergent tendencies, they also reveal substantial differences in structural and policy outcomes. In part, these reform trends indicate convergence on the American SEC transparency and disclosure model of securities regulation. (*See* Cioffi 2002c) More broadly, the current reform of corporate governance regimes reflects the ascendance of a new paradigm of finance capitalism defined by increasingly market-driven national and international financial systems. Because financial markets and financially driven firm strategies tend to produce spectacular market and governance failures—much in evidence in recent years, but not by any means a new historical phenomenon—finance capitalism requires a bulwark of strong legal rules and an institutional foundation of active regulatory authorities. Yet this broad rubric of finance capitalism does not erase national differences in institutional structures and economic practices, just as the broad contours of Fordist mass production admitted numerous institutional and regulatory variants during the post-war era.

A. The United States

The American governance regime contained a set of structural flaws that would together produce the systemic corporate governance crisis that peaked in 2000-2002.²¹ First, the transparency-based system of American securities regulation was weakened by the largely self-regulating character of the accounting industry (the intermediaries responsible for external corporate audits) that had long since come to treat auditing as a loss leader to sell more lucrative consulting services. The weaknesses of accounting and auditing as mechanisms of transparency were compounded by highly detailed, prescriptive, but loophole-riddled accounting rules (Generally Agreed Accounting Principles, or “US GAAP”) drafted by the Financial Accounting Standards Board (“FASB”), a private body comprised of accounting industry representatives. Second, American law virtually ensures management domination of the board of directors. State

²¹ This crisis continues to spread, most recently to the New York Stock Exchange and the mutual fund industry. Two central components of the American financial system are now ripe for substantially increased regulation displacing and self-regulatory model that has governed both for decades.

corporate law and federal proxy voting regulations together give managers almost complete control over the nomination and election of the directors who nominally monitor and oversee the firm's management. Within the single board structure of the American corporation, the CEO typically doubled as chairman of a board dominated by insider-managers. Consequently, CEOs and senior managers largely dominated the very governance institutions and processes that were supposed to render them accountable to shareholders. Third, institutional investors were not willing or able to fulfill the active governance monitoring role that many commentators, corporate governance activists, policymakers, and academic theorists envisioned for them—nor were many of them willing to become more active in corporate governance. Federal law had long segmented the financial services industry and *mandated* portfolio diversification that precluded the use of concentrated equity ownership as a means of checking the power of management.²² Federal regulation did not substantially depart from the *voluntarist* involvement in corporate governance advocated by even the most activist institutional investment funds and thus did not solve the fundamental collective action problems of monitoring by fragmented institutional shareholders.

These structural flaws were well known to commentators and policy makers prior to 2000 and some earnest attempts to address them failed politically. The post-bubble financial and governance scandals, beginning with the collapse of Enron and spreading to numerous other firms, Wall Street investment banks, and now to the New York Stock Exchange and the mutual fund industry, were the predictable result of these structural flaws and institutional weaknesses. Law and regulation left critical portions of the American corporate governance regime poorly regulated and subject to pervasive and substantial conflicts of interest among managers, boards, accountants, and financial institutions.

The failure to address these brewing problems politics grew out of a combination of fragmented governmental institutions imposing multiple veto points on policymaking, political polarization between the parties, and the influence of interest groups hostile to reform. At the same time, protection of shareholder interests remained the chief preoccupation of the SEC

²²The Glass-Steagall Act severed investment banking from commercial banking and traditional lending; the Investment Company Act of 1940 and the Employee Retirement Income Security Act of 1974 placed limits on the size of the stakes investment firms and funds could hold as a percentage of their own capital and of outstanding corporate equity. Under these market conditions, shareholders cannot solve the collective action problem of coordinating and defraying the costs of monitoring efforts. *See generally* See Roe, 1998, 1994, 1993b, 1991, 1990. These rules inadvertently strengthened managers by mandating fragmented ownership structures. In contrast, rules that mandate *institutional structures* within the firm deliberately modify power relations *by design*.

during the Clinton Administration and was backed by investment funds as well as public opinion. As a result, American corporate governance reform during the 1990s swerved between efforts to protect managerial interests and measures increasing shareholder protections. A Congress closely divided between Democrats and Republicans, established structures of federalism, and fragmented pluralist politics produced vacillation in public policy and would continue to discourage programmatic policy reform based on enduring interest group alignments and alliances. This political context precluded major systemic corporate governance reforms during the 1980s and 1990s even as problems of balance sheet manipulation, excessive CEO pay, excessive speculation and inflated stock prices, and inefficient and value-destroying merger and acquisition activity were clear to observers willing to see them.

The American corporate governance regime entered the 1990s still reeling from the legal and political upheaval caused by the hostile takeover wave of the 1980s. Managers had mobilized an ad hoc cross-class coalition with organized labor and grass-roots community groups to fight takeovers and effectively used the courts and state legislatures to erect a wide variety of anti-takeover defenses, ranging from judicially sanctioned “poison pill” defenses to a wide variety of anti-takeover statutes. Together, by the early 1990s, these legal changes had largely eliminated the market for corporate control²³ and effectively protected incumbent managers from hostile takeovers. The monumental legal and political battles over hostile takeovers gave way to a series of skirmishes over the proper limits of managerial power and how those limits should be imposed.

These conflicts pitted managerialist anti-regulation business groups, accountants, corporate lawyers, and anti-regulation politicians against pro-shareholder groups, pension funds, unions, regulators, and politicians more favorably disposed towards regulation. The SEC was caught between the opposing forces of managerial and pro-shareholder forces during the 1990s. As a consequence, the SEC suffered a series of political defeats in its attempts to protect shareholder interests. It failed in its efforts to address growing conflicts of interests in the accounting industry. Fearing (correctly as it turned out) that accounting firms acting simultaneously as consultants and auditors would compromise the integrity of their auditing in order to generate and keep lucrative consulting contracts, SEC Chairman Arthur Levitt, a Clinton

²³ There continued to be an extraordinarily vibrant *market for companies*—which reached its apogee during the 1990s boom and stock market bubble. However, the overwhelming majorities of mergers and acquisitions during the 1990s were friendly deals that often richly rewarded senior managers. (*See, e.g.*, Cioffi 2002a, chap. 4)

appointee, wanted to prohibit accounting firms from doing both auditing and consulting work for corporations. Accounting firms enlisted allies in Congress to fight on their behalf and bring legislative pressure on the SEC until the regulatory proposal was withdrawn.²⁴ Likewise, the SEC under Levitt failed in its attempt to require the expensing of stock options in corporate financial statements. In this case “new economy” technology firms dependent on options enlisted bipartisan congressional and executive branch support to quash the initiative.

The pro-shareholder forces were also split among themselves between those favoring expanded disclosure regulation and those seeking to encourage monitoring of management and corporate governance activism by institutional investors. The peculiar vacillations of SEC policy during the 1990s reflected this political and ideological conflict. From 1992 to 2000, the SEC under Levitt initiated a series of reforms to protect shareholders by improving managerial accountability and financial transparency that indicated this conflict over the means of regulation—with mixed political and practical success. In 1992, the SEC amended its proxy rules to encourage corporate governance activism by large institutional investors by making it easier to communicate with each other and with management.²⁵ In August 2000, the SEC shifted direction with the adoption of Regulation “Fair Disclosure” (“Regulation FD”). Regulation FD prohibited selective disclosure of material information by corporate managers to favored analysts, financial institutions, and institutional investors that is not released to the general public.²⁶ While addressing the problem of informational asymmetries that disadvantage small investors vis-à-vis large institutions, Regulation FD limited the ability of institutional investors to pursue corporate governance activism through their favored approach of private

²⁴ The regulation of accounting firms and their conflicts of interest became an especially important issue following a 1994 Supreme Court decision that largely abolished “aiding and abetting” liability under which accounting and law firms could be held liable for fraudulent statements and omissions by publicly traded corporate clients. *Central Bank of Denver v. First Interstate Bank of Denver*, 114 S.Ct. 1439 (1994). Without the threat of private litigation, SEC regulation was the only enforcement option remaining. Tort reform legislation in 1995 authorized aiding and abetting suits brought by the SEC, but not by private plaintiffs.

²⁵ The 1992 proxy rule changes appear to have encouraged greater governance activism by institutional investors, but at the expense of transparency in governance. Institutional investors, with some notable exceptions, preferred to voice their concerns and criticisms to management in private communications that would not become public. These communications thus became occasions for managers to disclose significant information to the representative of institutional investors and analysts associated with investment banks and brokerages.

²⁶ Another noteworthy feature of Regulation FD is that it expressly failed to create a private cause of action for its enforcement by shareholders. The 1992 proxy rule reforms are structural regulations that were undermined by the prescriptive (or prohibitive) rule of Regulation FD, while Regulation FD is a prescriptive rule without the established effective enforcement mechanism of private litigation.

communications with managers and board members.²⁷ This regulatory change ran contrary to both the pro-management stance of congressional Republicans and the SEC's own 1992 proxy reforms.

Moreover, in 1995 and 1998, congressional Republicans—strengthened by the 1994 mid-term elections—spearheaded “tort reform” legislation designed to reduce the incidence of securities litigation.²⁸ Securities litigation reform served a dual political purpose. It strengthened the position of managers, a predominantly Republican constituency, while attacking the financial base of a plaintiffs’ bar that overwhelmingly supported Democrats. These tort reform measures contained a grave deficiency: they provided for no alternative mechanisms to protect shareholders from fraud and financial abuses. The laws also had the unintended effect of centralizing corporate governance reform in federal hands. The 1998 law went so far as to preempt state securities fraud laws in order to impose a uniform set of more restrictive federal rules on the filing of securities suits.²⁹ Unwittingly, the efforts of Congressional conservatives to strengthen managers set the stage for a far-reaching reform and expansion of corporate governance and financial market regulation at the federal level.

The bursting of the stock market bubble and the collapse of the American equities markets in 2000 and the post-bubble corporate finance scandals of 2001-2002 unveiled the vast corruption and fraud that accompanied the economic and investment boom of the late-1990s. The massive corporate finance scandals at Enron, WorldCom, Global Crossing, Adelphia, and other major corporations, along with the loss of over \$7 trillion in stock market valuation, stoked popular resentment of corporate and financial elites. Scandal and the perception of systemic

²⁷ Transparency regulation and institutional activism have always been in tension. The 1992 proxy rule amendments presumed that more intensive communications between institutional investors and managers would benefit all shareholders. By the end of 2000, these two dominant paradigms of corporate governance regulation and reform had collided on the levels of politics, law, and investor relations.

²⁸ See Private Securities Litigation Reform Act of 1995 (“PSLRA”), Public Law: 104-67 (December 22, 1995), amending Title I of the Securities Act of 1933, 15 U.S.C. 77a *et seq.* Pub. L. No. 104-67, 109 Stat. 737 (1995) (passed over President Clinton’s veto, the PSLRA raised the pleading requirements and authorized the appointment of a “lead plaintiff” in securities fraud suits to curb the power of plaintiffs’ attorneys to bring frivolous and allegedly extortionate class actions).

²⁹ See Securities Law Uniform Standards Act of 1998 (“SLUSA”), Pub. L. No. 105-353, 112 Stat. 3227 (codified as interspersed subsections of 15 U.S.C. §§ 77-78). At a time when federalism formed a core part of the Republican Party platform, Republicans—with some Democratic allies—pushed through the SLUSA’s preemption provisions, which dramatically limited state authority and increased centralized federal control over securities regulation. This legislation had the strong support of some core Republican constituencies, such as corporate executives, the corporate bar, and financial services firms, and belies the notion that the economic conservatives in the United States are ideologically wed to deregulation, devolution, and decentralization of government authority.

crisis and dysfunction inflamed political support for more wide-ranging reform of the American corporate governance regime.

The most severe crisis (at least one of legitimacy) afflicting the American corporate governance and financial system since the Great Depression faced its disrupted the grip of a conservative coalition that had favored minimal regulation and blocked reform through the 1990s. The extraordinary scope, severity, and duration of these financial scandals allowed Democrats in Congress to mobilize support among the public and key interest groups for substantial corporate governance reform while it undermined the legitimacy of managerial and professional elites and their political allies who opposed it. Under these conditions, the Democratic leadership in the Senate, where the party held a short-lived majority prior to the 2002 midterm elections, overcame conservatives in their own party, the opposition of congressional Republicans, the Bush Administration, powerful vested managerial and accounting industry interests, and SEC Chairman Harvey Pitt (who's tenure did not survive the confrontation). Democrats in Congress outflanked and overrode the resistance to pro-shareholder reforms mounted by congressional Republicans and the White House, corporate managers, and accountants. Senate Democrats, although opposed by a Republican-controlled House and presidency, pushed through the most comprehensive corporate governance reform in the United States since the 1930s with the passage of the Sarbanes-Oxley Act of 2002.³⁰

The law was the product of a political struggle between Democrats using financial scandals against the Republicans, and Republicans seeking to dilute the legislation in keeping with their loyalty to corporate supporters and their anti-regulation policy agenda. Interest group politics were even more fractious. Corporate managers remained peripheral to the legislative process as result of their loss of prestige and influence in the wake of successive corporate scandals and the popular perception that they, as a class, had looted American corporations and their shareholders that comprised over 50% of American households.³¹ The development of

³⁰ Though named for both Democratic Senator Paul Sarbanes and Republican Representative Michael Oxley, Sarbanes was the law's chief architect and proponent. Oxley was the chief *opponent* of reform in the House and only signed onto the Sarbanes bill once it became clear that such opposition by Republicans was beginning to damage the GOP's public support as the corporate scandals continued to spread. Anonymous Interview, March 2003, Washington, DC.

³¹ The only issue managers fought fiercely was, perhaps revealingly but not surprisingly, the regulation and more stringent accounting treatment of stock options—the mechanism that was supposed to align the interests of managers and shareholders, but which became the most effective meaning of managerial rent-seeking and looting of the corporation ever devised.

securities markets, mass shareholding, and the growth and diversity of investment funds in the United States meant that financial interests were divided in their interests and preferences concerning the proper extent of corporate governance reform and government regulation of business and markets. Accounting firms, having perhaps the most to answer for and the most to lose, fought strenuously against the Sarbanes-Oxley reforms—even at the risk of further antagonizing public opinion—but were in no position to stem the tide of popular opinion and political pressures for reform. Financial institutions, such as investment banks, were split over the reforms. They are dependent on public faith in the integrity of the securities markets, but are also privileged insiders that benefited from the status quo and stood to lose from reform. Financial institutions and service providers were also weakened in the political process by their role in numerous scandals of their own—in addition to aiding and abetting dishonest corporate executives.

Institutional investors were a surprisingly impotent political force for reform. They were long committed to an essentially voluntaristic form of corporate governance activism, and the majority of them (particularly mutual funds) espoused a neo-liberal policy stance that was skeptical of, and often hostile to, increased regulation of their affairs. Further, because they are legally barred from contributing to political campaigns and cannot mobilize voters, institutional investors have less political influence than their economic power would predict. An important partial exception to the marginal political status of institutional investors was the active role played by union pension funds. These funds have long been the most activist investors in corporate governance, with ideological and strategic commitments to constraining imperious managers. They were also closely tied to the political operations of their founding unions and the AFL-CIO, which—despite the weakness of American organized labor—remain core contributors and voting constituencies of the Democratic Party.

Ironically, many in organized labor would have preferred that Congress pass no corporate governance reform bill prior to the 2002 mid-term election in order to keep the issue of financial scandal alive for Democratic candidates. By the summer of 2002, however, the politics of reform had taken on a life of its own beyond interest group control. Politicians of both parties scrambled to claim credit for reform or, just as important, to distance themselves from identification with a corrupt corporate elite and blame for the wave of scandals appearing daily

in the media. In the words of one organized labor representative involved in the legislative process, “We won Sarbanes-Oxley and lost the election.”³²

Sarbanes-Oxley imposed a host of new regulatory requirements and measures on publicly traded corporations, directors, corporate managers, accountants, and attorneys. Sarbanes-Oxley created an entirely new regulatory body appointed by and under the oversight of the SEC, the Public Company Accounting Oversight Board, to enforce a new set of prescriptive regulations governing accounting standards and the activities of accounting firms in auditing and consulting.³³ The reforms increased civil and criminal penalties for a host of securities law violations and also emphasized increased governmental investigation and enforcement actions rather than private civil suits that had long characterized securities law.

The second path-breaking aspect of the Sarbanes-Oxley Act is its intervention in the *internal* structure and affairs of the corporation. This represents the first time federal law and regulation has directly penetrated the traditional preserve of state corporation law. Similar to recent German reforms (discussed below), Sarbanes-Oxley strengthened the independence of the board and its auditing function. Public firms are now required to appoint an auditing committee comprised *entirely* of independent directors and at least one member must be qualified as a financial expert under new SEC rules. The audit committee now has direct responsibility for the appointment, compensation, and oversight of the outside auditors, and approval of all auditor services. The auditors must report directly to the board audit committee, which must resolve any disputes between management and the auditors concerning financial reporting. By encroaching on the traditional subjects of state corporate law, the Sarbanes-Oxley reforms continued the centralizing and federalizing tendencies of corporate governance reform. This unprecedented—and underreported—federalization of corporate law represents a sharp break with nearly two centuries of American federalism and suggests the growing policy import of corporate governance issues and the extraordinary political potency of the financial and governance scandals of 2001-2002. Together, these regulatory reforms represent not only a potentially vast

³² Anonymous interview, Washington, DC, March 2003.

³³ The Act also required the SEC, *inter alia*, to draft new regulations requiring heightened disclosure of the financial condition of corporations that included off-balance sheet transactions, codes of ethics (and their waiver by the board), the reconciliation of “pro forma” financial results with generally accepted accounting standards (US GAAP), limitations on non-audit services performed by the firm’s auditor, and real time disclosure of material financial information and developments.

expansion of federal regulatory power, but also a substantial centralization of regulatory authority displacing the self-regulating character of the accounting industry and firm governance.

Following the passage of Sarbanes-Oxley, the focus of regulatory politics moved from Congress to the SEC and its troubled ward, the Public Company Accounting Oversight Board. This reflects a longstanding tendency in American regulatory politics: the delegation of difficult and contentious policy problems to administrative agencies. Having resisted calls for reform, the SEC lost influence over the legislative process. In enacting the Sarbanes-Oxley Act, Congress substantially expanded the jurisdiction and powers of the SEC, but placed the agency in the middle of continuing and intense political conflicts among the Executive Branch, Congress, interest groups, and public opinion over the future of corporate governance reform. These conflicts remain unresolved. The scars of these battles still threatens to inflict long-term damage to the legitimacy, morale, and competence of the SEC. SEC Chairman Harvey Pitt, President Bush's appointee to head the SEC, had been a prominent securities lawyer on behalf of major accounting firms in private practice and his efforts to minimize the significance of the corporate scandals and to derail legislative reforms were regarded as suspicious and illegitimate by reformers and, increasingly, by the public at large. The struggle over accounting regulation and appointments to the Public Company Accounting Oversight Board ultimately resulted in the resignations of Pitt and the first Chairman of the Accounting Oversight Board, former FBI and CIA Director William Webster who was found to have been a director of a corporation charged with financial improprieties.

Yet the continuing disclosure of scandal within financial markets and institutions has raised the profile and importance of the SEC, under its new Chairman William Donaldson, to a degree unseen in decades. Recent governance and trading scandals involving the New York Stock Exchange and the mutual fund industry have increased the institutional leverage and authority of the SEC. The question is what the agency will do with this increased power. Already, the SEC is beginning to displace the traditional self-regulation of the stock exchanges and mutual funds with more direct oversight, formal regulation, and structural reform of these institutions. But the political conflicts over corporate governance reform persist. Their culmination may be the battle over reform of proxy voting regulations. Because structural regulation under Sarbanes-Oxley depends on improved functioning of boards, these regulatory amendments go to the very foundations of the recent reforms. However, the SEC's recent proxy

rule amendments to allow major shareholders such as institutional investors to more easily nominate and elect directors were modest and met with harsh criticism from shareholder advocates. The proposed rules only allow institutional investors access to corporate proxies mailed to all shareholders after substantial delays and under exceptional conditions. Even then the new rules allow dissident shareholders to elect no more than three directors in this fashion. This is almost certainly insufficient to substantially change the functioning of boards and suggests that corporate boards, however restructured, will remain rather pliant and ineffective as checks on managerial power and misconduct. The Sarbanes-Oxley Act's delegation of rulemaking authority to the SEC over the selection of American directors suggests that the reforms will have less impact than its partisans hoped and its detractors feared. The stage has been set for the next round of political conflict over corporate governance occasioned by the emergence of finance capitalism.

**Table 3: Major Changes in Financial Market Law and Regulation in the United States
(1990-2002) here**

Table 4: Major Changes in Company Law in the United States (1990-2000) here

B. Germany

The German case presents the rise of finance capitalism as the object of deliberate governmental policy and the product of sustained party and interest group politics. Securities law and corporate governance reform during the 1990s displays the trends of regulatory centralization, the steady expansion of formal prescriptive disclosure and transparency regulation, and the adoption of structural regulation even more clearly than its American counterpart.³⁴ By the late 1980s (and especially after the reunification of East and West Germany), Germany's neo-corporatist institutional arrangements could no longer maintain a high-growth, high-wage, and high-employment economy. During the 1990s this economic crisis intensified as growth slowed to less than 2% annually and unemployment hovered near 10%. Germany was widely regarded as a national laggard in reforming its financial market law and corporate governance regime when compared with other advanced industrial countries such as the United Kingdom and France.³⁵ By the late-1990s, large segments of the political elite and the German electorate began to lose faith in the social market economy at the same time they became beguiled by the booming stock market and high-tech sector in United States.

The substantial and comprehensive transformation of the German corporate governance regime reflects a shift in policy preferences and the formation of an enduring and effective political coalition favoring financial modernization dating back to the Kohl era. The EU's single market program of unifying capital and financial services markets contributed to this modernization program as the CDU leadership accepted some degree of liberalism and regulatory reform as the price of European unity. In the early 1990s, the Kohl government's

³⁴ For a more detailed description and analysis of the German reforms, see Cioffi 2002b.

³⁵ In many contemporary accounts, Germany is still regarded as lagging other countries in modernizing its financial and corporate governance systems. These criticisms neglect the substantial legal changes that have changed the foundations of the financial system. They also tend to focus on the perpetuation of codetermination and the low level of equity financing. Although codetermination has remained untouched, largely for political reasons, this has not appeared to affect investment behavior to a significant extent. Hostility to codetermination seems more rooted in ideology than practical economic considerations. The relative failure of Germany equity markets to develop following the reforms of the past decade is a more significant and complicated subject. Continued low levels of equity financing and IPOs suggests both the path dependence of established financial structures and practices, but also the simple fact that the booming German stock markets expansion late 1990s crashed along with the American markets and has not rebounded given the higher risk aversion of German investors. Under current conditions, securities markets do not appear as efficient or attractive to those making real world economic decisions to raise and invest capital. The German pension system remains largely state run, with far less savings flowing into pension funds and mutual funds invested in equities. As this system is reformed to relieve the unsustainable strain on public finances, a huge supply of capital may begin to flow into securities markets and aid in their growth—depending on what type of pensions and pension funds are encouraged by public policy. However, these issues are beyond the scope of this essay.

policy veered sharply in favor of capital market reform as part of the EU integration program to which it was committed as internationalists overcame the resistance of more localized domestic interests of the Länder governments, the Länder-based and regulated stock exchanges, and small firms and banks.

But corporate governance reform would not have gone nearly so far since the mid-1990s without substantial domestic support among powerful interest groups and political actors.³⁶ Declining profit margins caused by over saturation and excessive domestic competition in traditional bank lending along with and the increasing domestic market penetration by British and American investment banks in higher value-added financial services triggered a shift in business strategies and policy preferences of most large German banks.³⁷ The SPD's interest in pursuing an agenda of economic modernization and corporate governance reform coincided with and complemented the pursuit of financial system modernization and internationalization by many large banks. By the early 1990s, most large German universal banks began to appreciate financial system modernization and the cultivation of new financial services capacities as the route to higher profits, returns to equity, and more lucrative international markets. The elements of the new business model functioned together: more sophisticated market-based financial services would boost bank profits; higher profits would increase returns to equity; these higher returns would raise the price of shares that could then be used to make strategic acquisitions; and these acquisitions around the world would vault German banks into the "bulge bracket" of top international financial institutions. This shift in business strategies altered the banks' policy preferences and mobilized their peak association, the powerful and well-organized BDB, and its political allies in support of securities market and corporate governance reform. Likewise, the globalization of finance and financial markets also reinforced domestic political pressures for financial and corporate governance reform as Frankfurt sought to remain competitive in attracting international capital (and retaining German investment capital).

³⁶ Prior to the breakthrough of the Second Financial Market Promotion Act in 1994, the German government and financial elites were notorious for resisting EU directives requiring increased transparency, banning insider trading, and other regulatory reforms. With the exception of the fight against the neo-liberal Takeover Directive, this resistance has largely evaporated.

³⁷ For a more detailed discussion of the shift in the business strategies and policy preferences of large German banks, see Cioffi 2002b. The Schröder government's political strategy of allying with the banks in support of financial system reform in order to strengthen business support for the SPD and to weaken support for the CDU was confirmed in anonymous interviews conducted in Germany in July 2000 and July 2003.

Corporate managers and the leadership of organized labor were divided over corporate governance reform and the development of finance capitalism. Managers of many large German corporations, such as Daimler Benz and Siemens, backed much of the reform agenda. These firms now had global operations and were increasingly interested in tapping foreign credit and securities markets that were out of reach so long as the German financial and corporate governance model remained insular and dominated by domestic insiders.³⁸ Union leaders, including those of IG Metall, Germany's leading industrial union, realized that the German economy had slipped into a structural crisis requiring the adoption of reforms to increase growth by increasing restructuring and competitiveness. Despite some skepticism, labor leaders were largely willing to accept financial system and corporate governance reforms so long as they did not disturb codetermination and collective bargaining arrangements, and did not shift the costs of restructuring onto employees who would lose their jobs.³⁹

The reform of securities law and regulation quickly became a consensual policy among German political and economic elites and it has proceeded apace since the mid-1990s. The landmark Second Financial Market Promotion Act of 1994 transformed securities regulation in Germany.⁴⁰ The Act replaced the decentralized system of state-level exchange regulators and largely self-regulating stock exchanges with a centralized federal regulator, German Federal Securities Supervisory Office (*Bundesaufsichtsamt für den Wertpapierhandel*, or "BAWe"), for the first time in German history and transformed substantive securities law. The BAWe's creation represented an extraordinary change in the legal and institutional foundations of German finance. Over the remainder of the 1990s further legislation and regulatory rulemaking steadily expanded the agency's powers and jurisdiction and increased the stringency of disclosure rules and other regulatory standards. From late 1997 through 1998, another series of Financial Market Promotion Laws and other legislative changes markedly expanded the agency's role in regulating

³⁸ Shareholders, however, played virtually no political role in the reform of securities and company law—even though these reforms were ostensibly undertaken on their behalf. Quite simply, given Germany's historically undeveloped securities markets and lack of an equity culture of mass shareholding, shareholders were too few and too poorly organized to wield significant influence in policy debates. Reforms were almost entirely a top-down process.

³⁹ German welfare state policy has played a critical role in facilitating corporate restructuring despite countervailing union power. Organized labor has been accommodated by the extension of generous unemployment and early retirement pension benefits to ease the impact of restructuring on the workforce. Germany has effectively socialized the risk and costs of restructuring, but at increasingly enormous costs in terms of pension outlays and structural unemployment. (See Streeck 2003)

⁴⁰ Second Financial Market Promotion Act (Gesetz über den Wertpapierhandel und zur Änderung börsenrechtlicher und wertpapierrechtlicher Vorschriften, Zweites Finanzmarktförderungsgesetz) of 26 July 1994, Federal Law Gazette, Part I, p. 1749.

and policing German securities markets. The BAWe came to oversee the filing of prospectuses, the financial disclosure by public companies, insider trading, and the reporting of voting rights and ownership stakes. It now also supervises financial services providers, stock brokers, the stock exchanges, and cooperates with other national securities regulators. (See Cioffi, 2002b) In April 2002, following the election of Schröder's SPD-Green coalition in late 1998, the process of regulatory centralization reached its peak as the German Parliament consolidated all financial market and services regulation, including the regulation of securities markets, banking, and insurance, and folded the BAWe within one massive agency, the German Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, "BAFin").⁴¹ With this reform, Germany surpassed the United States in the centralization the administration of financial services regulation.

But consensus was far harder to find when policy debate turned to more contentious issues of company law reform and managerial power within the firm. The CDU-CSU led coalition balked at more substantial corporate governance reform. Corporate managers nestled within the protective network structure of the German economy were—and remain—both a core constituency of the center-right Christian Democrats and divided over corporate governance reform. Opposition was particularly intense among owners and managers of many small and medium sized firms within the *Mittelstand*, often referred to as the backbone of the German economy, who feared that financial system reforms would favor large publicly traded firms over their financial needs for stable sources of credit. Because they were tied to the CDU-CSU led coalition, the Free Democratic Party (FDP), was hamstrung on governance and financial system reform to which it was otherwise favorably disposed as Germany's sole liberal party with historically close relations to major banks and the financial sector.

This reform agenda was taken up by the center-left Social Democratic Party, first in opposition in the Bundestag and then as the governing party under Chancellor Gerhard Schröder, rather than by the recalcitrant political conservatives of the CDU under the Kohl government. Since the late 1990s, the SPD used corporate governance reform to claim economic modernization as the centerpiece of its own policy agenda to counter the traditional perception of

⁴¹ Law on Integrated Financial Services Supervision (Gesetz über die integrierte Finanzaufsicht ("FinDAG")), April 22, 2002 (effective May 1, 2002).

the CDU as the party of business and economic stewardship.⁴² Schröder's faction came to appreciate the reform of capital markets, securities law, and ultimately the entire corporate governance regime as a strategy to improve corporate and macroeconomic performance along with the party's electoral fortunes. Centrist SPD and Green Party leaders confronted resistance from more traditional left-wing members who were suspicious of Anglo-American "casino capitalism." However, Schröder's centrists were able to overcome these objections from segments of organized labor (particularly the rank-and-file) and traditionalist left-wing factions.⁴³ In part, the centrists prevailed because the corporate governance policy agenda appealed to long-standing ideological concerns of the German left. Both the SPD and Green parties have been antagonistic towards the traditional insularity of Germany's economic elite, with its associations with conservative hierarchy and corporatism.⁴⁴ The Greens, the SPD's coalition partners have revealed themselves to be economic liberals in many respects. Corporate governance reform as formulated by the SPD leadership appealed to the Greens' ideological preferences for economic decentralization and devolution—even as this necessitates regulatory centralization. By 2002, following the election of Schröder's SPD-Green coalition in late 1998, policymakers would thoroughly reformed the country's securities and company law to favor shareholder interests over those of incumbent managers and banks, and the development of securities markets in place of established bank-centered financial and ownership networks. (Cioffi, 2002b)

In 1998, the SPD took advantage of shifting policy preferences among interest groups to engineer the first major overhaul of company law since 1965. While still in the opposition, the Social Democrats' successful campaign for company law reform played upon popular resentment of "bank power" among their core constituents while casting themselves as business-friendly economic problem solvers.⁴⁵ The proposed legislation put the CDU on the defensive and forced the Kohl government to support a compromise version of the Control and Transparency Act ("KonTraG"), which moderated the anti-bank provisions while retaining more

⁴² See Cioffi 2002b; Höpner 2003. For an excellent account and analysis of the ways in which the Schröder government sought to create a shareholding culture in Germany during the late 1990s, see Ziegler, 2000.

⁴³ Indeed, Schröder's rise within the SPD and his victory in this policy debate indicates the decline of these traditional powers within German social democracy.

⁴⁴ For an excellent account of this ideological aspect of German social democracy in historical perspective, see Höpner 2003; see also Cioffi 2002b.

⁴⁵ For a detailed discussion of the SPD's pseudo-populist strategy to gain left-wing support for governance reform, see Cioffi 2002b.

important governance reforms.⁴⁶ This had been the SPD leadership’s strategy from the start: they could claim credit as modernizing reformers, maintain credibility with their left wing while painting the CDU as beholden to corporate interests, and still continue to cultivate closer relations with the financial sector.

The KonTraG complemented the prior massive overhaul of securities law by addressing issues of bank power, the function of the supervisory board, auditing, share voting rights, stock options, and litigation rules. The law sought to reduce the power of Germany’s universal banks in voting shares and supervisory board representation while strengthening their disclosure and fiduciary obligations to shareholders.⁴⁷ However, in the end, the law’s restrictions were measures acceptable to the large banks and fit with their emerging business strategies that diverged from the relational banking model of the past. The KonTraG also uses law to shift information and power to the supervisory board as a means of protecting shareholder interests. More than four years *before* the passage of the Sarbanes-Oxley Act, German law required the supervisory boards of listed firms to hire and oversee the external auditor instead of the management board.⁴⁸

An equally important regulatory reform introduced by the KonTraG mandated shareholder democracy through a “one share, one vote rule” that prohibits unequal voting rights and *abolished voting caps* among shares of common stock for the first time. In contrast to the general principle of one share-one vote, the KonTraG prohibits the voting of cross-shareholding stakes above 25% (a blocking minority under German company law) in supervisory board elections. This provision was designed to prevent managers from wresting control from

⁴⁶ Corporate Control and Transparency Act (*Gesetz zur Kontrolle und Transparenz im Unternehmensbereich*, “KonTraG”) of 27 April 1998, Federal Law Gazette, Part I, p. 786 (Gesetz vom 27.4.1998, BGBl. I, S. 786 vom 30.4.1998). For a political analysis of the KonTraG, see Cioffi 2002b.

⁴⁷ If the bank’s holdings in a listed firm exceed 5% of the corporation’s stock, it can vote their own equity stakes *or* vote the proxy votes of the shares deposited by its brokerage customers—but not both. The rules on the voting of shares by banks in corporate decision making were designed to use the traditional bank-centered proxy voting system while allowing alternative mechanisms of proxy voting to emerge (*e.g.*, shareholders’ associations). Policymakers feared that banks would make good on their threat to withdraw completely from the practice of voting depositors’ proxies if more onerous rules were imposed on them, resulting in fewer shares voted and managers even less constrained by this limited exercise in shareholder democracy. (See Cioffi 2002b) The KonTraG also imposes limited prescriptive rules on banks that require them to disclose all board mandates held by their representatives, their ownership stakes in firms, and alternative ways for their share depositors to exercise their votes. (*Ibid.*)

⁴⁸ The law contains additional auditing reforms to ensure the independence and reliability of auditors. An auditor may not auditing a firm if it has earned more than 30% of its revenues from the client over the past five years and must change the signatory of the audit if the same person has signed the report more than six times in ten years. The KonTraG also raised the limitation on auditor liability from 500,000 DM to 8 million DM for listed corporations (2 million DM for unlisted companies).

shareholders by engaging in reciprocal voting with the managers of other firms involved in cross-shareholding relationships. However, by weakening their defensive ownership structures, this new structure of voting rights exposes some German firms to unprecedented threats of hostile takeover—a fact underappreciated at the time but one that would soon prove politically contentious.⁴⁹

The modernization of securities markets took an additional leap forward in July 2000 when the Schröder government pushed through a major tax reform law (*Steuerreform*), over strenuous opposition from the Christian Democrats, that *abolished* capital gains taxes on the liquidation of cross-shareholdings. By seeking to encourage the unwinding of cross-shareholdings, the Social Democratic government deliberately chose to undermine the network ownership structure of corporate Germany that insulated German corporations from takeovers and to encourage the German financial sector to replace its bank-centered model that retarded the use of capital market financing with a market form of organization.⁵⁰ The reform was simultaneously a generous benefit to the financial services sector (which held a disproportionate share of these cross-shareholdings), a means to improve the liquidity of domestic stock markets (by increasing the proportion of shares actively traded—the “free float”), part of a longer-term strategy to subject firms to capital market pressures to restructure.

The takeover vulnerability created by these reforms, along with the fear instilled in managers by Vodafone’s hostile takeover of Mannesmann in early 2000, triggered a backlash against the further liberalization of German corporate governance.⁵¹ The growing domestic political conflict over takeovers spilled over into the EU’s attempt to adopt a EU Takeover Directive that would have liberalized Europe’s market for corporate control. Realizing that the

⁴⁹ The KonTraG also partially embraced Anglo-American financial practices and litigious enforcement mechanisms. The law allowed stock repurchases and the use of stock options as executive compensation for the first time (though with stricter limitations than in the United States to prevent excessive executive compensation and abuse). In the area of shareholder rights and enforcement mechanisms, the KonTraG contained modest reforms of shareholder litigation rules. However, the KonTraG did not alter the *substance* of fiduciary duties, nor did it otherwise alter the mechanisms and procedures for enforcing shareholder rights (*e.g.*, class actions, contingency fees) to make them more effective in practice. The German ambivalence towards litigation continues.

⁵⁰ In doing so, the tax reform of 2000 may become, in retrospect, the most important corporate governance reform in German history. (*See, e.g.*, Holloway, 2001)

⁵¹ One curious aspect of this backlash against takeovers is that the Mannesmann takeover *preceded* the enactment of the July 2000 tax reform law. At the time Mannesmann was taken over, corporate Germany appeared unruffled by it. Interviews conducted by the author, as well as journalistic accounts, indicate that the fears of German managers grew when they considered the combined effects of the KonTraG and the tax reform and the unequal playing field this might create against firms from countries that allowed more potent anti-takeover defenses—including, ironically, the United States. For an excellent analysis of the Mannesmann takeover, *see* Höpner and Jackson, 2001.

proposed EU directive would render German firms asymmetrically vulnerable to takeover by foreign corporations with stronger anti-takeover defenses, German managers, unionists, conservatives, and left-wing Social Democrats alike mobilized to block the directive in the European Parliament. They succeeded in blocking the directive in July 2001—the first major defeat ever suffered by the European Commission in its pursuit of a single EU market.⁵²

A week after the collapse of the EU Takeover Directive, the German Bundestag passed the Securities Acquisition and Takeover Act (the “Takeover Act”), which replaced a voluntary self-regulatory takeover “codex” widely derided as ignored and ineffective.⁵³ The domestic politics of takeover law were largely identical to the battle against the EU Directive. As originally drafted, the law was identical to the proposed EU Takeover Directive. Opponents of takeovers ranged across the political spectrum, from corporate managers backed by the CDU-CSU to the leaders of organized labor supported by the left-wing of the SPD. This disparate ad hoc coalition drove the government to appoint a nineteen member blue-ribbon commission comprised of corporate and financial institution managers, securities market officials, labor representatives, and leading legal academics. (*See Braude, 2000a, 2000b*) Through the appointment of the commission, the government simulated the interest group array of established neo-corporatist bargaining, while granting the government greater control over an increasingly divisive policy area. The government ultimately diffused the controversy surrounding the Takeover Act by diluting the liberal approach to takeovers and shareholder rights in the draft law. (*See Braude and Hong, 2001, Barbier, 2001*)

For the first time in Germany, the Takeover Act subjects takeover bids⁵⁴ to mandatory procedures and disclosure rules (under BAFin regulation and supervision) to facilitate and ensure the fairness of bids and takeovers.⁵⁵ More controversially, the Takeover Act also contains a general “duty of neutrality”—one of the most controversial features of the EU Takeover Directive—that prohibits the management board from taking action to frustrate a hostile bid. At

⁵² For an extended discussion of the relation between the politics of German corporate governance and the failure of the EU Takeover Directive, *see* Cioffi, 2002b.

⁵³ *See* Ashurst Morris Crisp, 2002 (translation); Strelow and Wildberger, 2002; Osborne & Clarke, 2002; Rissel, 2002; Zehetmeier-Mueller and Ufland, 2002; Williamson, 2001; BBC, July 11, 2001; Wood, 2001

⁵⁴ Offers by one or more parties acting in concert to acquire 30% or more of a public firm’s voting stock.

⁵⁵ The Takeover Act does not transform the core of the stakeholder corporate governance scheme. Codetermination and fiduciary obligations remain undisturbed. The law imposes a mandatory bid rule triggered when an ownership stake reaches a 30% threshold. The details of takeover bids and the offeror’s business plans must be fully disclosed in a filing with the BAFin.

the same time, however, the statute *expanded* the latitude of management to adopt defenses in advance and thereafter to deploy defensive tactics against a hostile takeover⁵⁶—similar to the reallocation of legal authority to the boards of American corporations during the 1980s.⁵⁷

In contrast to the American case, the Germany government sought to maintain the balance of stakeholder power within firm governance. First, rather than enshrining the primacy of shareholder interests in law, the Takeover Act does provide some protection for employee stakeholders. The Act obliges both the offeror and the target's management to disclose information to either the works council or directly to the employees concerning the terms of the offer and its implications for the firm, its employees, and their collective representation. Organized labor is also entitled to two representatives on the government's thirteen-member "advisory board" on takeovers created under the Act. Thus, the Takeover Act makes use of and may reinforce the institutions of works council codetermination even as it expands the supervisory board's power and liberalizes takeover law.⁵⁸ Second, codetermination legislation passed with government support in 2001 marginally expands the competence of works councils and makes them somewhat easier for employees to form. The legislation also had a political motivation: the Social Democratic government used it to compensate the unions and left-wing Social Democrats that had supported or acquiesced in the far more important and influential pro-business reforms of securities, company, tax, takeover, and pension laws.

This careful maintenance of stakeholder power, while seeking to increase shareholder protections, was displayed again as the government appointed two successive corporate governance commissions.⁵⁹ The first, under the Chairmanship of law professor Theodor Baums, was drawn from representatives of the major interest groups and charged with drafting a comprehensive code of best practices in German corporate governance. Baums successfully insisted that the politically explosive subject of codetermination be excluded from the commission's deliberations on the grounds that it would destroy the consensus required on other important issues. The formation of a second government commission on corporate governance

⁵⁶ Securities Acquisition and Takeover Act, § 33.1 & .2; *see also* Braude, 2001a

⁵⁷ However, "poison pill" defenses common in American practice remain illegal under German company law.

⁵⁸ Codetermination may have actually served a crucial legitimization function that made the pro-shareholder liberalizing elements of the Takeover Act palatable enough for passage. This hypothesis, however, remains speculative without further research.

⁵⁹ This narrative of the German corporate governance commissions is indebted to an interview with Theodor Baums, July 9, 2003, Frankfurt.

followed the release of the Baums Commission's report.⁶⁰ The standing Government Commission on Corporate Governance, once again selected from among the peak associations, major interest groups, respected attorneys, and legal academics. Known as the Cromme Commission, after its chairman Gerhard Cromme (the former chairman of Thyssen-Krupp), the commission made over 150 wide ranging recommendations (substantially following the Baums Commission's recommendations), many of them proposed legislative changes, that would improve disclosure and transparency; strengthen the role, obligations, and independence of corporate boards; improve external auditing; and modernize corporate finance rules. Most important was a proposed "comply or explain" rule (since enacted by Parliament⁶¹) that requires firms to comply with the Cromme Commission's Code of Best Practice or else explain in a public disclosure why it had not. Codetermination was the sole major subject conspicuously absent from the Commission report. The Commission's ground rules had placed supervisory board and works council codetermination outside the group's purview.

The works council reform and the refusal of the government's corporate governance commissions to alter existing forms of codetermination suggests the continued significance of labor relations issues in the country's corporate governance regime and the preservation of Germany's stakeholder model. At the same time, these most recent developments reflect two fundamentally important trends in the German political economy. First, they indicate the emergence of a stable political alliance among interest groups and political actors on the center-left to foster development of a market-based finance capitalism. Second, they suggest the increased importance of firm-level corporate governance as an important forum for economic adjustment and the negotiation of conflicts post-war neo-corporatist arrangements, sectoral collective bargaining, and the political and economic power of unions weaken and decline in significance.

⁶⁰ Baums Commission Report (*Bericht der Regierungskommission Corporate Governance*), July 10, 2001 (complete official German version available at www.otto-schmidt.de/corporate_governance.htm, English summary available at http://www.shearman.com/publications/cm_pubs.html); Cromme Commission (Government Commission of the German Corporate Governance Code), *German Corporate Governance Code*, adopted February 26, 2002, as amended May 21, 2003 (information and official German version and English translation available at <http://www.corporate-governance-code.de/index-e.html>).

⁶¹ See Transparency and Disclosure Act (TraPuG) (Gesetz zur weiteren Reform des Aktien- und Bilanzrechts, zu Transparenz und Publizität (Transparenz- und Publizitätsgesetz), v. July 19, 2002, BGBl. I S. 2681.

Table 5: Major Changes in Financial Market Law and Regulation in Germany (1990-2000)
here

Table 6: Major Changes in Company Law in Germany (1990-2000) here

IV. Politics of Regulatory Reform: Crises, Interests, and Political Actors

Although the logic of path dependence theories and varieties of capitalism scholarship predict the stability of political economics structures and institutional arrangements, developments in the law and policy of corporate governance show that regulatory intervention in the structure and operation of firms and financial markets has undergone remarkable change during the past decade. (See Tables 7 & 8) The narrative accounts of corporate governance reform detailed above highlight a number of important common structural trends in the United States and Germany: regulatory centralization and institutionalization, the displacement of self-regulation by formal prescriptive legal rules, the expansion of market facilitating disclosure and transparency regulation, and the restructuring of the corporate firm through structural regulation. These trends demonstrate not stability but a significant expansion of state power in the economy and its active reshaping of the private sphere.

In both the United States and Germany, institutional failures led to economic crises in both the neo-liberal and neo-corporatist corporate governance regimes and disrupted long settled interests and policy preferences within and among powerful interest groups. Significant changes in the interests of key economic actors, including corporate managers and financiers who play pivotal roles in domestic politics and economic life altered the configuration of interest group politics. Division and/or uncertainty over economic interests and policy preferences within interest groups or their loss of legitimacy under conditions of crisis or scandal prevent them from playing an influential role in the reform process.

Tables 7 and 8: Modified Governance Models and the Effects of Reform (1990 vs 2002)

This changed political context opened opportunities for entrepreneurial politicians and political parties and triggers changes in their strategic positioning and policy agendas. These changes in interest group policy orientations supply the preconditions for substantial regulatory reforms and institutional change. These conditions gave *political* actors greater autonomy in articulating and imposing their own policy preferences and opened politics to new regulatory approaches and mechanisms. Under such circumstances, political actors could more easily rearrange interest group alignments and alliances in order to engineer institutional change and regulatory innovation. Together, these changes in interests, political strategies, and institutional structures pose a threat to the institutional coherence and complementarities that have defined distinct national variants of advanced industrial capitalism and their comparative economic advantages. This implies that the development of finance capitalism, of which corporate governance reform is a part, portends an extraordinary period of political economic transition.

A. The American Case: The Politics of Punctuated Reform

The United States in some ways presents a puzzling case of reform. The country that developed modern securities regulation and shareholder capitalism fell victim to an enormously damaging speculative bubble, serious regulatory failures, corporate and accounting fraud on a vast scale, and systemic problems of poor governance and conflicts of interest throughout the American finance and corporate governance. The governance crisis that began in 2000 exposed the systemic deficiencies and contradictions of the American model in extravagant fashion. The very maturity of the American regulatory regime constrained the process of reform. Consequently, the unprecedented and wide-ranging American Sarbanes-Oxley reforms were intended to *reinforce* a faltering market-based financial system and corporate governance model.

Proponents of reform relied on public outrage over the scale and scope of the financial scandals of the late-1990s and its effect on the balance of interest group power in American politics and policymaking. The single most important feature of the reform politics of 2001-2002 was the virtual disappearance of corporate managers, accounting firms, and investment banks from the process. Tainted by scandal, these powerful actors and groups were weakened within the legislative process. Business and financial interests were also deeply divided over the reform effort. The blow to the prestige of business and the reputations of managers induced a significant number of leading figures, such as Warren Buffett, Paul Volcker, and Goldman Sachs' Henry Paulson among others, to publicly support legislative and regulatory reform. This

division was equally sharp, if not deeper on Wall Street. Leading investment firms understood the depth and seriousness of the scandals and crisis unleashed by the collapse of the bubble economy and they had an enormous stake in ensuring that it was contained—by regulatory reform if necessary.

Likewise, large public employee and union pension funds, long involved in a largely non-regulatory and voluntarist form of corporate governance activism, shifted their policy preferences dramatically in support of increased regulatory stringency and intervention in corporate governance. The increasingly pro-regulatory stance of pension funds highlighted another exceptional aspect of American reform process: organized labor was instrumental in the passage of the Sarbanes-Oxley reforms. The capacity of unions to raise money and mobilize voters gave them far more leverage in the political process than other funds that are constrained by law and by organizational form from political activity.⁶² Because of their control over pension funds of their own and their reliance on company funds outside their control, unions and the AFL-CIO were intensely interested in and supportive of governance reform. These policy preferences were driven by the reliance of American social welfare policy on private pensions—unlike Western Europe’s greater dependence on public retirement benefits. These institutional arrangements, so important to the emergence of finance capitalism in the United States, constituted private interests favoring its reinforcement and development.

The Democratic Party capitalized on these divisions among the economic elite and the public resentment of corporate managers and financial institutions and did so quickly in case the scandals subsided or public attention began to wane. The continued disclosures of corrupt and improper financial practices throughout 2001 and 2002 finally eroded Republican resistance as they sought to neutralize the scandals in advance of the 2002 November elections. The Sarbanes-Oxley reforms were certainly an exercise in political opportunism, damage control, and the rehabilitation of systemic legitimacy (usually referred to as “investor confidence”). But they are also a substantial step away from the managerial model of capitalism of the post-war era and

⁶² This strong support by organized labor gave a far more powerful voice to shareholder interests. The outrage of diffuse investors is unorganized and inarticulate in the policy process. Limits on campaign contributions and tenuous relations with beneficiaries (whom they cannot effectively urge to the polls) blunt the influence of institutional investors. Labor was comparatively strong in both respects. Although organized labor has not been able to achieve significant labor law reform, Sarbanes-Oxley illustrates its influence where conditions disfavor managers and political alliances are available.

towards a new form of finance capitalism, engineered by the center-left Democratic Party, that marks a new phase in American regulatory and corporate governance politics.

However, the Sarbanes-Oxley reforms were less systematic and more contested by interest groups and political factions than the far more thoroughgoing German reforms of the past decade. The Sarbanes-Oxley reforms reflect no elite consensus or coherent policy agenda. The political struggle over the Sarbanes-Oxley reforms reveals a policy marked by divisive party and interest group politics within a fragmented political structure that creates multiple veto points. This fragmented structure prevents coordination of complex policy and legislative initiatives, and empowers interest groups to block legislative and regulatory reforms in pursuit of their own narrow interests. When conditions propitious for legislative reform arrived, it had to be carried out quickly. The process was a sudden, reactive, and episodic response to scandal and popular outcry. Delay would likely have spelled the loss of the opportunity.

The fragmented American political system has also generated centrifugal forces in regulatory politics. Growing evidence of substantial enforcement failures by the SEC has led to a partial *reversal* of centralization of regulatory policymaking and enforcement. State regulators and attorneys general, led by New York State Attorney General Eliot Spitzer, filled a vacuum left by an under-resourced, overworked, and politically hobbled SEC and pursued aggressive investigations and enforcement actions targeting investment banks, firms and managers, and—most recently—mutual funds. These countervailing forces of decentralization and centralization are the product of a federalist structure that allows states substantial concurrent regulatory powers with the federal government. Duplicative institutions and overlapping law enforcement jurisdiction allow decentralization even as the national (and increasingly international) scope of financial markets, recent scandals, and reforms alike has increased pressures for regulatory centralization.

However, powerful political and economic forces favor the restoration of regulatory centralization. The SEC, under its new Chairman William Donaldson, has asked for and received the largest budget increases in its history to buttress enforcement capacities. Centralization is also likely to be reinforced by the flood of rulemaking the SEC is now engaged in as required by the Sarbanes-Oxley Act. The SEC is now in the midst of adopting some of the most important rules in its history, including more stringent regulation of executive stock options, the strengthening of accounting and disclosure regulations, and board independence and

qualification rules. The agency is also now considering increased direct regulation and oversight of mutual funds and stock exchanges. Each of these initiatives both expands and centralizes regulatory authority and power in the SEC's hands. In addition, the opponents of regulation and the Sarbanes-Oxley reforms in particular have already begun to attack the Act and related SEC rulemaking as excessively costly and damaging to American business. If history is any guide, American managers will not accept significant governmental limitations of their autonomy and a sustained backlash against corporate governance reform is gathering force.⁶³ Managers, financial institutions, and political conservatives are already seeking to use federal legislation to centralize regulatory power—if only to achieve a uniform rollback of reform and curtailment of enforcement activities by the states.⁶⁴ The American case is not one of punctuated equilibrium—at least not yet. Reform has redrawn the political battle lines over regulation and corporate power in the United States; it has not brought a truce.

B. Germany and the Logic of Systemic Reform

In Germany, the reforms necessary to develop a more market based financial system required a thoroughgoing overhaul of corporate governance law. As in the United States, the corporate governance reform reveals the political effects of divisions among business interests and elites in policy debates and outcomes. Institutional change on the order of magnitude of the 1990s corporate governance reforms entails fierce political and economic conflict among elites and social groups, and *within* the business community itself. As already seen in the American case, “business” is not a homogenous collective entity.⁶⁵ Numerous conflicts and cleavages the pit business interests against one another. In Germany, the most fundamental division is that between the financial sector and the rest of business. Corporate governance reform implicates the inevitable conflict between these two groups over corporate rents and the autonomy of corporate managers. While managers of financial firms may be ambivalent about rules that enhance their accountability to shareholders, the financial sector also benefits from the

⁶³ See, e.g., PriceWaterhouseCoopers, “Senior Executives Less Favorable On Sarbanes-Oxley, PriceWaterhouseCoopers Finds,” *Management Barometer*, July 23, 2003, available online at <http://www.barometersurveys.com>; Michaels, Adrian, “US Reforms Lose Support of Business Leaders,” *Financial Times*, July 27 2003.

⁶⁴ See Chaffin, Joshua and Adrian Michaels, “Donaldson Warns Against Turf Wars,” *Financial Times*, September 9, 2003; Masters, Brooke A., “States' Role In Doubt on Wall Street: House to Vote Soon on Bill to Affirm Ultimate Power of SEC,” *Washington Post*, Wednesday, July 23, 2003; Page E01; Masters, Brooke A. and Ben White, “Donaldson Backs SEC Supremacy Bill,” *Washington Post*, Wednesday, July 16, 2003; Page E01.

⁶⁵ Nor does the business community necessarily have a political or ideological “center of gravity” that represents its aggregate political positions and policy preferences.

development of securities markets these rules are designed to promote. The managers of the German universal banks generally supported corporate governance reform, often over the opposition of many other corporate managers. A second politically salient division within business opened between large public corporations with international operations and smaller, mostly privately held, firms far more reliant on domestic markets. The former have an interest in developing securities markets as part of a global financial strategy. In contrast, smaller and family-owned firms, such as those comprising the German Mittelstand, may have an interest in maintaining a bank-based financial system of long-term relational lending. The realignment of interests and alliances among large banks and publicly listed industrial firms fundamentally altered the political terrain in favor of reform and the development of an infrastructure for finance capitalism in Germany.

The SPD took advantage of the opportunity presented by these shifting interests to claim a strategic centrist policy position on financial system and corporate governance reform. The party's realignment of its political support to include major financial institutions created the political foundation of corporate governance reform. This placed the conservative CDU-CSU and their neo-liberal allies in the Free Democratic Party in a difficult position. They have long relied upon the support of business and financial elites, but now these elites and interest groups were splitting over financial market and corporate governance reform. The SPD outflanked the CDU-CSU and cast the conservative alliance as the defender of managerial interests and Germany's economic aristocracy who ran an economic model that had become outmoded and increasingly dysfunctional. The conservative and liberal parties had to follow the SPD lead—but at a distance to avoid alienating prominent managers who were antagonistic towards neo-liberal reforms.

Ultimately, the SPD-Green coalition has been forced to confront its own political constraints and was caught in a dilemma similar to that previously faced by the CDU as their union and more left-wing supporters became hostile towards further liberalization of corporate governance policies. In the domain of corporate governance policy and extending to those of labor relations, pension, and social welfare reform, the Schröder government has been fighting an increasingly tense two-front battle, not only against the CDU and FDP opposition parties, but also against the left wing of its own SPD and industrial unions hostile to reforms designed to promote the development of German finance capitalism along Anglo-American lines. In the area

of takeover law, the perceived threats to German corporate and socio-economic interests produced both greater unity among managers and political alliances with labor and the opponents of neo-liberal reform prevailed. Concern over the social and political legitimacy of the emerging corporate governance regime led the Schröder government and the SPD to maintain the balance of power between shareholders and employees within the firm and even buttress the existing institutions of the stakeholder model. Intra-party politics constrained policymakers to leave supervisory board codetermination untouched and to modestly strengthen works council codetermination. In the area of securities regulation, where these conflicts over economic power did not exist, pro-market regulatory expansion and centralization proceeded with astonishing speed to exceed that of the United States in some respects.

The conflicts generated by the reform agenda and chronic deadlocks within the established neo-corporatist bargaining processes led not only to regulatory centralization, but also to political centralization of the policy making process. The SPD government has relied increasingly on the use of expert commissions to formulate policies and frame legislative initiatives. Once it attained power and began pursuing a reform agenda that often antagonized the left wing of the SPD, the unions, and many German corporate managers, the Schröder government deliberately and shrewdly manipulated neo-corporatist policy processes to push through regulatory reforms while avoiding bargaining impasses.⁶⁶ The Schröder government has used this technique of political governance to appropriate (or manipulate) the existing framework of neo-corporatist interest representation by handpicking a groups of representatives from peak organizations as well as experts, academics, and professionals likely to reach a consensus on a given policy area close to the government's own position. As a result, party and interest group realignments and extant institutional arrangements permitted sustained systemic and systematic reforms. This "neo-corporatism by commission" thus allows the government to increase its control over policy processes and outcomes, by circumventing traditional neo-corporatist bargaining that increasingly tended to produce not consensus but impasse.⁶⁷ However, this style

⁶⁶ In contrast to corporate governance policy, the German Constitution circumscribes governmental intrusion into negotiations among the "social partners" in the area of labor relations. Accordingly, the government could not circumvent neo-corporatist gridlock through commissions or the tripartite negotiations under the Alliance for Jobs (Bündis für Arbeit). (See Streeck 2003)

⁶⁷ For discussions of the German government's increasing use of commissions as a means of formulating policy, forging consensus, and avoiding deadlock among interest group and peak associations, see *The Economist*, "German Reform and Democracy: The Exhausting Grind of Consensus," *The Economist*, August 28, 2003; Baums, Theodor, "Reforming German Corporate Governance: Inside a Law Making Process of a Very New Nature, Interview with

of governance contains a potentially damaging contradiction: it relies on neo-corporatist organizations for representational legitimacy while cutting them out of actual policy discussions. Neo-corporatism and the entrenchment of well institutionalized peak associations made the use of expert commissions possible, but this policymaking ultimately may cause peak associations to wither as their real influence and representational function wanes.

V. Conclusion: The Regulatory Politics of Corporate Governance and the Implications of Structural Change

The comparison of the American and German cases suggests that the neo-liberal American model has remained more resilient than the Germany's neo-corporatist arrangements. Sarbanes-Oxley does not represent a fundamental break with the established institutional arrangements and power relations of American corporate governance (as did the New Deal reforms of the 1930s). In comparison, the series of securities, company, and tax law reforms in Germany do represent a critical juncture in corporate governance and finance. The German reforms constitute a major episode of institution building and structural change that reflects a fundamental realignment of domestic political forces. The prospect of labor market, pension, and social welfare reforms in Germany further reinforce the impression that the German social market economy is now at a critical juncture that will substantially recast the economy and polity. These differences in the significance of reforms in the United States and Germany stemmed from the very different political motivations underlying them and the two countries' different starting points. German elites sought to systematically restructure their financial and company law systems in order to address pressing economic problems. American politicians had no such systemic reform agenda and merely sought an immediate response to the political and economic threats posed by pervasive corporate scandals. As the politics of reform differed, so did the policy outcomes and their significance.

Professor Dr. Theodor Baums," *German Law Journal*, vol. 2, no. 12 (16 July 2001); Zumbansen, Peer, "The Privatization of Corporate Law? Corporate Governance Codes and Commercial Self-Regulation," unpublished paper, July 2003 (on file with the author); cf. Heinze, Rolf G., and Christoph Strünck, "Contracting out Corporatism: The Making of a Sustainable Social Model in Germany," paper delivered at the Progressive Governance Conference, Hilton London Metropole, July 11–13, 2003. More controversially, some critics have accused the government of using expert commissions to circumvent Parliament in the process of policy formation. Government defenders counter, accurately, that Parliament still must pass all legislation and that the commissions have not impaired democratic lawmaking. See *The Economist*, "German Reform and Democracy," *op cit.*; Baums, *German Law Journal*, 2001, *op cit.*

More broadly, the market-driven American corporate governance model is more consistent with the growth and integration of transnational markets for finance and financial services, and arguably with the emerging paradigm of finance capitalism. Accordingly, the political and economic implications of corporate governance reform and finance capitalism are very different in United States and Germany. Corporate governance reform raises the possibility of more far-reaching and potentially destabilizing structural political economic change. State actors' deployment of new modes and mechanisms of regulation alters the institutional environment that defines the institutional complementarities that link financiers, managers, and employees. It follows that alteration of one element of a complex institutionally complementary system without corresponding changes to the other institutional elements will produce systemic dysfunction and intensified political and economic conflict. The vaunted institutional complementarities of the German model—high-skill, high-wage, high-value added production financed by supplies of “patient capital”—and the comparative economic advantages they confer may be fatally disrupted by the reform of the financial system and by tensions between this new market-driven financial system and the established labor relations system and the conflicts these tensions may generate within the firm.

In the corporate governance area, these conflicts come in two general variants. First, intensifying conflicts may arise between interest groups and state. Legalistic prescriptive regulation encourages more intensive lobbying of state actors and adversarial regulatory relations than self-regulation and consultative or neo-corporatist policymaking.⁶⁸ Second, regulatory reform may spark greater conflict among interest groups. Consensual, cooperative, and negotiated policymaking is displaced by more formal, and contentious policy processes mediated by the state through lobbying legislatures and agencies rather than negotiations among and within private groups. Neo-corporatist bargaining tends to screen out zero-sum policy outcomes, at the expense of slowing or preventing reform. The expansion of regulation and the channeling of lobbying directly towards state actors in place of sectoral and peak association bargaining encourage more pluralistic interest group fragmentation that makes consensus among interest groups harder to achieve. The paradoxical increase in the centrality of the state in neo-liberal regulation allows reform to proceed by striking divisive political bargains during moments of crisis, setting the stage for a new round of political and economic conflicts. In both the

⁶⁸ See generally Kagan, 2001, 1997.

American and German cases, corporate governance reform favors the displacement of relational governance practices by shorter-term contractual arrangements and arm's length economic transactions that sharpen conflict, reduce trust, and increase economic insecurity.

The incorporation of American-style securities regulation and corporate law principles poses a potentially substantial threat to the consensual German neo-corporatist system and social market economy. Over the medium to long-term, Germany's adoption of transparency regulation and company law rules favoring shareholder interests may sharpen conflicts among managers, shareholders, employees, and other stakeholders that the post-war political economy ameliorated by institutional design. The corporate firm is becoming a more important institutional forum for the negotiated adjustment of economic conflict as these functions devolve from the levels of sectoral governance and peak associations. Hence, the most striking difference between the American and German corporate governance regimes, the powerful position of labor and employees within politics and firm governance in Germany in contrast with the virtual exclusion of employees and labor interests from the American structure, has become an even more important institutional feature of the German political economy.

In contrast, the United States is more likely to absorb the regulatory innovations of the Sarbanes-Oxley Act without destabilizing the established market-driven corporate governance system. However, unintended consequences may flow from the recent American reforms. Congress may have crossed a threshold that makes further federal incursions into the traditional sphere of state corporate law more likely over time. Yet, as a general matter, shareholders historically have been the beneficiaries of federal legislation, as opposed to managers, labor, or other stakeholder interests. The Sarbanes-Oxley reforms fit comfortably within this historical pattern. The new federal politics of corporate governance reinforce the shareholder-centered character of the American model rather than dilute it. Even if a managerial and conservative backlash against corporate governance reform and Sarbanes-Oxley intensifies, as seems likely, the fragmented and veto-ridden American political system will also likely constrain attempts to deregulate corporate governance.

Finally, corporate governance and its reform have increasingly clear international repercussions. In the wake of the scandals that laid bare the structural flaws of the American corporate governance regime, the American model appears less efficient, less appealing, and thus less influential in informing policy overseas than at any time in decades. International and

domestic confidence in American capital markets and corporate governance has plummeted along with the public's regard for federal regulatory efficacy. If the 1990s was the decade of speculative booms and faith in neo-liberal financial markets, this decade has ushered in a new and more sober era of regulatory politics. Finance capitalism is already a reality in many respects, both at the national and international levels, but it is less likely than ever to take a single homogenizing form. Instead, this new paradigm of capitalism is developing in nationally distinctive ways, driven by varying political forces, and embodied in national regulatory structures generated through national political and legal institutions.

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