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"Changes of Governance in Europe, Japan, and the U.S."
Report on the international and interdisciplinary conference held in Berlin from September 9 to 11, 2004

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From September 9 to September 11, 2004, the Max Planck Institute for Foreign Private and Private International Law, Hamburg, and the Japanese-German Center Berlin held a conference on "Changes of Governance in Europe, Japan, and the U.S.: Corporations, State, Markets, and Intermediaries" at the Center's Berlin premises. Economists and lawyers from Japan, the U.S., and Europe participated in the conference, which focused on issues that are currently highly relevant in all of the jurisdictions represented. Corporate governance was used as a starter for a broader discussion of governance in general, with a closer look at the various institutions and actors in the field of both general and corporate governance. Because of this focus, the conference was divided into five parts, each of which consisted of three presentations and three commenting presentations. The conference was complemented by a cultural program which gave the participants the opportunity to get to know one another and to further exchange views. A conference volume edited by *Klaus J. Hopt*, *Harald Baum et al.* is under preparation.

I. CHANGE OF GOVERNANCE IN HISTORIC PERSPECTIVE: FROM STATE TO MARKET – PATHWAYS OF CHANGE IN THE 20TH CENTURY

The first part of the conference was devoted to the historic development in Europe, Japan, and the U.S. It started with the presentation of the historical German perspective (as part of the larger European framework) by *Dr. Harald Baum* from the Max Planck Institute. Baum gave a historical overview of the changing perceptions of the role of the state and the proper scope of government in Germany, with special emphasis on the legal developments in corporate law and securities regulation. He divided this historical development into three stages: the time of liberalism in the 19th century; the modern welfare state which began under Chancellor Bismarck as its first prominent representative and which led to more and more state intervention; and the crisis of the welfare state that we can observe today. Concluding his presentation, he discussed the essential structures of the corporatist German governance model and a possible (cautious) shift toward a more market-based regime.

In his comment on Baum's presentation, *Professor Guido Ferrarini* from the Universita di Genova presented the Italian development in the 20th century, with special attention to the legal developments in the field of corporate law and securities regulation. He divided this development into four stages, beginning with the age of liberalism in the second half of the 19th century which was characterized by a very limited role of the state. The following period was the mixed economy – covering about 30 years from Fascism to the new Republican Constitution in 1948 – which was characterized by state dirigism and an increasing role of public ownership of enterprises. The third period lasted until the 1970s and was characterized by the creation of the welfare state and the major role of public enterprises. The fourth stage coincided with what Baum defined as the crisis of the welfare state, and included changes in governance and regulation broadly converging with those found in other European states, primarily due to the influence of the European Union.

Professor Curtis J. Milhaupt from Columbia Law School concentrated on the Japanese reforms of corporate law. After giving a historical overview of the pertinent legal developments, he focused on the concept of choice that was introduced into Japanese corporate law by the reform of 2002: large firms are now allowed to adopt a U.S.-style "committee system" for corporate governance. By drawing from the early experience with the reform and looking for possible explanations for a company's decision to adopt the board/committee structure, he tried to assess what could be learned about the strategies of choice and discussed various possible explanations for the adoption of the new structure. Finally, he evaluated the implications and limitations of Japan's novel experiment with choice-based corporate governance. In this respect he saw only formal convergence with the U.S. system, for Japan has transplanted only some visible components of a U.S.-style board committee structure but not the complementary institutions that increase the functionality of the committee system in the U.S.

In his comment, *Professor Yoshiro Miwa* from the University of Tokyo rebutted the conventional wisdom about Japan being a state-dominated economy and only now shifting toward a more efficient market-oriented corporate governance system. First, Miwa pointed out that the spectacular economic growth of the Japanese economy during the last 130 years contradicts any notion of badly governed firms, especially as that growth took place in the private sector. Moreover, in his view the post-war government only minimally intervened in the Japanese economy, and Japanese firms always maintained market-based governance. Thus, they constantly faced the discipline of the stock market which prevented them from maintaining systematically inappropriate governance structures. Finally, Miwa claimed, the recession of the 1990s was not a result of a gap in governance created by the deregulation in the 1980s. The government had no substantial regulatory program to dismantle, nor could a decline in main-bank governance be the cause because main banks had never seriously governed any firms.

The third presentation was given by *Professor Jonathan Macey* from Yale Law School. Macey focused on the recent actions by New York State Attorney General

Elliot Spitzer to begin prosecuting several financial firms, thereby taking over tasks usually performed by the SEC, a trend Macey has labeled as an example of crisis-driven regulation. According to Macey, the process of "taking over" can be divided into four stages. First, there was a massive displacement of power from the states to the federal government. Second, Spitzer moved onto the scene and began carrying out tasks of the SEC. Third, he usurped the SEC's agenda completely. In the aftermath, Macey contended, three different developments are possible: (1) a long-term weakening of the SEC as an institution; (2) further preemption of the states' regulation of the U.S. securities markets; or (3) the SEC searching for a new constituency – shifting away from taking care of the needs of the average shareholder to serving special groups of investors such as institutional investors.

In his comment, *Professor Gerald Spindler* from the University of Göttingen compared Macey's thesis of crisis-driven regulation to the European market. There, however, he found long-term waves of regulation, such as the development of a European Civil Code. He also looked for parallels to the capture of agencies in Europe. In this respect, the situation in Europe is unique: on the one hand, the influence of market participants is channeled through the governments of the member states; on the other hand, interest groups can influence the regulatory process directly due to the European comitology approach to regulation. Competition between agencies of different member states, however, would be quite unlikely in Europe, as the country-of-origin principle would hinder such competition. Moreover, the agencies of the member states cooperate, and inside rule-setting committees such as CESR also impede competition.

II. CORPORATIONS: CHANGING MODELS OF CORPORATE GOVERNANCE

The second part, which was devoted to corporations, focused on the changing models of corporate governance and looked at various new or prospective laws in the different jurisdictions. The segment began with a presentation of the EU Action Plan by *Professor Klaus J. Hopt* from the Max Planck Institute. The Action Plan will probably provide a major impetus for the harmonization of European company laws. The objectives of the Action Plan are to strengthen shareholders' rights and the protection of employees, creditors, and other parties with whom companies deal, and to foster efficiency and competitiveness of business. Thus, the Action Plan covers five major areas: corporate governance, raising and maintenance of legal capital, groups of companies, restructuring and new company forms, and other enterprise and foundation forms. To put the Action Plan into perspective, Hopt discussed recent European attempts to harmonize certain fields of company law (including various directives and the Financial Market Action Plan) and the problems of subsidiarity and regulatory competition within the EU.

Commenting on Hopt, *Professor Jonathan Rickford* from The British Institute of International and Comparative Law in London discussed disclosure-based corporate

governance models in the EU and the UK. He questioned the EU approach regarding disclosure as a means of regulation, maintaining that it should rather be seen as a tool to enable regulation by other means. He then turned to the disclosure-based model of the European corporate governance codes. They combine best-practice norms with the principle of comply-or-explain, thereby introducing a mandatory element to ensure that market participants get information that they can react to. Because the effectiveness of the comply-or-explain approach to corporate governance regulation in the UK was grounded on the existing preconditions in the UK, he questioned whether such an approach could be transplanted into EC law, for the general legal regime in which a corporate governance system is embedded would be crucial.

The second presentation was given by *Mr. Gary Brown, Esq.*, a U.S. practitioner who has been actively involved in the political process of making the Sarbanes-Oxley Act. After briefly discussing the Enron scandal as the main cause for the legislative activities leading to the Sarbanes-Oxley Act, Brown gave an overview of its rules and effects. According to Brown, the Act has raised the level of awareness of duties and responsibilities. Overall, a paradigm shift can be perceived – power has shifted away from the executive level to the board of directors. However, the Act mostly reintroduced already-known duties. For example, according to the Act, board members can protect themselves from personal liability suits by maintaining an effective compliance program. That had been the law since before the Caremark decision (Delaware case law). In Brown's view, the SEC's "new" requirements for "disclosure controls and procedures" are remarkably similar to the requirements of Caremark.

Commenting on Brown, *Professor Paul Davies* from the London School of Economics and Political Science discussed the impact of Enron on law reforms in Europe. According to Davies, the economic impact of Enron in Europe was small, but the fear in EU jurisdictions that similar things could happen has led to legal action. Thus, Enron was unique in being a foreign scandal that led to law reforms in Europe. With respect to the use of legal strategies, however, Enron was less significant. The reason: at the heart of Enron there was a conflict of interest, and thus established analyses and techniques could be used. Therefore, alternative analyses remained marginal for policy making. Finally, Davies noted that Enron promoted the global audit dialogue because of the negative reputational effect suffered by US-GAAP.

Professor Misao Tatsuta from Doshisha University in Kyoto focused on company law reform in Japan with a special emphasis on the upcoming major reform of 2005. The 2005 bill will combine the dispersed company law provisions and create a comprehensive company law. An important part of the bill will be the fusion of the legal type of limited liability company with that of the closely held stock corporation by creating a new subcategory of the latter. Shareholders then can choose either a structure similar to today's closely held corporation, which has a board of directors as a monitoring body, or a structure similar to the former limited liability company, which had no separate monitoring body. With respect to large corporations, the choice between different types

of governance structures introduced with the 2002 reform will be carried over into the 2005 bill. Additionally, there will be changes in various other areas of company law, such as changes in the provisions of minimum stated capital.

In his comment, *Professor John O. Haley* from Washington University in St. Louis discussed aspects that make Japan distinctive with respect to corporate governance. First, in East Asia, Japan remains unique as the only country with large publicly held corporations with diffuse shareholding and professional managerial control. With the increase of foreign shareholding in recent years, the introduction of American shareholder practices has become more likely. The second important feature is that Japan has an inflexible labor market, and thus workers cannot "exit" because they usually remain with the same firm until their retirement. Hence, workers and managers depend highly on the success of their firm. Risk-taking is, therefore, very dangerous, with the result that Japanese firms tend to be risk-averse. In non-competitive parts of the industry, this leads to a lack of innovation. In competitive parts, however, firms are forced to innovate, a fact that explains the huge differences of success of Japanese firms in different industries.

III. BUREAUCRACY AND REGULATION

The third part of the conference looked more closely at the role of the state and its regulation. For a general classification of countries, *Professor Katharina Pistor* from Columbia Law School proposed distinguishing between so-called "Liberal Market Economies" (LMEs) and "Coordinated Market Economies" (CMEs), the difference being the role of the state in the economy. The issue is not one of the scale of state interference, but one of scope: the nature of the state in LMEs and CMEs differs – mainly with respect to the allocation of control rights. This difference is reflected in the legal tradition, namely in so-called substantive rules (which allocate the power to determine the meaning and content of an agreement among private parties) and procedural "default rules" (which assign the power of review). According to Pistor's scheme, common law countries usually classify as LMEs, whereas civil law countries classify as CMEs.

In his comment, *Professor Emeritus Horst Siebert* from the Kiel Institute for World Economics maintained that Pistor's distinction might miss the crucial point. Different economic systems should be distinguished by asking who has the decision rights, and to what extent markets, i.e., decentralized decision rights, would be substituted by norm-setting rights of social groups, i.e., by a corporatist approach. According to this criterion, Germany would qualify as a "restrained market economy" – which would also be at the root of the current high unemployment rates and poor growth. Aspects of the German economy which are particularly corporatist are the institutional set-up of the labor markets as well as co-determination and the central position of banks as financing institutions in corporate governance. Co-determination might arguably have some posi-

tive impact in the case of marginal technical innovation. However, in an environment of technological leap-frogging co-determination seriously impedes economic development.

In the second presentation, *Professor Anthony I. Ogus* from the University of Manchester addressed the issue of regulatory paternalism. Ogus proposed a "rational delegation approach" to paternalism: social psychology literature has spawned behavioral law and economics literature, all of which have emphasized the inherent limitations of individuals in decision-making, claiming that individuals are bound to be rational. In regulatory theory, this would require some deviations from neoclassical economics. Individuals who are aware of their own limitations in decision-making might empower government to decide for them in situations where they know their own decisions to be deficient. As possible justifications for paternalistic regulation interpreted in this manner, Ogus mentioned the status quo bias, the availability heuristics, excessive discounting of the future, a tendency toward short-term decision-making, selective optimism and control, and social pressure.

In his comment, *Professor Thomas B. Ginsburg* from the University of Illinois College of Law focused on the regulation of regulation from a comparative administrative law perspective. First, he discussed the risks of regulation: paternalism, regulatory capture, arbitrary application of regulations, and overregulation. Then he looked more closely at the convergence and divergence of systems of controlling regulation. While he saw a lot of convergence in standards and goals of regulation from a global perspective, he saw continuing divergence in the systems of regulating regulation. He also analyzed the role of judicial review of regulations. Overall, he saw substantial convergence in the core elements of administrative law despite continuing doctrinal divergences.

Giving a second comment on Ogus, *Dr. Luke Nottage* from the University of Sydney looked at the current regulatory development in Japan. According to Nottage, Japan is moving toward a more straightforward form of liberal law-making and law enforcement. In his view, Japan should now redefine and redirect its multi-level governance system to include a new external dimension in the form of a regional arrangement similar to the EU. To make that proposal more plausible, he tied it to broader "neo-proceduralist" models of law paralleling "re-regulation" patterns observed worldwide since the 1990s. As a practical example for his proposal, he discussed the regulation of mad cow disease (BSE) in Japan and the necessity of a regional-level arrangement in that context.

Professor Christian Kirchner from Humboldt University in Berlin introduced the theory of New Institutional Economics (NIE) as a proper concept for an analysis of what could justify regulatory intervention. NIE rests on the foundation of neoclassical economics, but has introduced some modifications. The NIE approach models citizens as principals in a principal-agent relationship, with public agencies as their agents. The general assumptions made by the NIE approach are the scarcity of resources, methodological individualism, bounded rationality, incomplete information, and positive transaction costs. The NIE approach equally takes into account deficiencies in the law-

making process and deficiencies in public governance structures and enforcement. Applying his theoretical insights to practice, Kirchner advocated general competition law to replace sector-specific regulation in the long run. However, the experience gained in the UK during the liberalization of telecommunications suggests that sector-specific regulation would be superior to competition law in a first phase in which monopolies are broken up. The problem would be to determine when all the bottlenecks had disappeared, indicating that the first phase had ended.

In his comment, *Professor Emeritus Kahei Rokumoto* from the University of Tokyo presented the Japanese reform of the judicial system, which is part of a more general law reform intended to reduce regulation. The aim of the reform of the judicial system is to shift power from the government and the bureaucracy to the judiciary. It is a response to the globalization of the economy, because in Japan the law in theory and the law in practice have increasingly drifted apart. It is also intended to open the Japanese lawyers' market, to allow foreign lawyers to work in Japan, and to radically increase the number of lawyers. Moreover, the recently introduced law school system was reformed along the lines of the U.S. system, albeit with some modifications, as Japan keeps its undergraduate legal education.

IV. MARKETS: CREATION, RISKS, SAFEGUARDS

In the fourth part, the conference turned to the role of markets in the governance debate, singling out the financial market, the market for corporate control, and the special situation of public undertakings.

Professor Emeritus Ernst-Joachim Mestmäcker from the Max Planck Institute dedicated his presentation to the special situation of public undertakings under EC law. EC law respects the existence of public undertakings but requires strictly equal treatment of private and public undertakings under community law. The influence of public authorities on their undertakings and the ability of these undertakings to disregard economic considerations because of their access to public revenues justifies and demands special rules and obligations to be imposed on public undertakings. Undertakings with exclusive or special rights also have to maintain separate accounts for their different lines of activity in order to hinder cross-subsidization from privileged sectors to competitive activities which are unlawful under general competition law rules.

In his commenting presentation, *Professor Fumio Sensui* from Kobe University explained that Japanese law did not recognize general state aid rules, or provisions that regulate the relationship between public undertakings and the state and impose a general principle of equality of private and public undertakings. However, Japanese law deals with these problems in a somewhat similar way through sector-specific regulations and general antimonopoly law.

Professor Martin Hellwig from the Max Planck Institute for Research on Collective Goods in Bonn introduced his presentation by analyzing the term “market discipline” in the context of markets and banking regulation. In his opinion, “market discipline” is an obscure concept that has more emotional appeal than analytical rigor. He then discussed the functioning of financial markets and in what sense they perform such functions differently from other institutions, such as banks. Drawing on recent economic analyses, he focused especially on the specifics of information processing in different institutions. Looking at the influence of stock prices – which reflect information about a company– on the behavior of corporations, Hellwig discussed the workability of incentive provisions. Overall, he found that none of the mechanisms that he had discussed by which information would be useful involved outright “discipline” in the sense of market participants exerting control over companies.

Professor Joseph A. McCahery from the Katholieke Universiteit Brabandt gave a presentation on the topic of self-dealing transactions and beneficial ownership. He commenced with presenting the factual situation regarding ownership and control in the U.S. and Western Europe, where he found huge differences between Continental Europe and the U.S. and the UK. Turning to the legal situation, he discussed the duty to disclose beneficial ownership in the new European regulatory framework, focusing especially on the European Transparency Directive and Takeover Directive. He then turned to the special case of the disclosure of ownership of closely held vehicles and the current regulatory responses. The final part of his presentation was devoted to the regulation of related party transactions in various European countries, especially the regulatory instruments of mandatory disclosure, requiring board approval or shareholder voting, and fiduciary duties.

In his comment, *Professor Stefan Grundmann* from Humboldt University in Berlin focused on the European takeover regulation. He found several constituting elements of the European regulatory model. The first element was the duty of neutrality, which would shift the power for assessing the efficiency of takeovers to the shareholder meeting, an outcome favored by Grundmann because of the self-interest of the board. He compared the duty of neutrality under German law with the one under EC law, which allows member states to opt out but requires them to enable companies to opt in again. Another element of the European regulatory model is the duty of loyalty, which becomes especially important with regard to defensive measures by the board before the bidding phase. A further element are the transparency and disclosure rules in the EC directive that aim at systematically informing interested investors about the potential for preventing a takeover bid and thus also about the chances that such a bid would occur.

V. INTERMEDIARIES: FUNCTIONS AND RESPONSIBILITY

In the fifth part of the conference, the participants focused on intermediaries and their specific functions in the field of corporate governance. It was begun by a presentation by *Professor Reinhard H. Schmidt* from Johann Wolfgang Goethe University in Frankfurt and *Dr. Marcel Tyrell* from the University of Trier. They focused on intermediaries and their relevance in the context of corporate governance. Intermediaries play a decisive role in the generation and processing of information, and their importance or unimportance is reflected in the different corporate governance structures. The informational features of different corporate governance systems create the need for different intermediaries to participate in corporate governance, thus shaping the different models of corporate governance in the different countries. In an insider-controlled system such as Germany, where banks are dominant players, information is internalized, meaning it is only available to a limited number of internal agents. In an outsider-controlled system such as the UK, the (outside) shareholders are the only target group, and thus information is externalized.

As an example for how Schmidt's and Tyrell's theory could be implemented by lawyers, *Professor Gérard Hertig* from the ETH Zürich pointed to the new rating procedure of credit risks that will be introduced by Basel II. Hertig explained that Basel II will offer a choice between an internal rating-based approach (IRB) and external ratings. As there are no incentives for lenders to disclose internal ratings voluntarily, Hertig pondered the possibility of requiring lenders to do so and assessed the costs and benefits of internal rating disclosures. Overall, Basel II will lead to lower borrowing costs for unlisted firms and the overall risk will decrease.

In his presentation, *Professor J. Mark Ramseyer* from Harvard Law School focused on the economic situation in Japan after World War II. His main thesis was that the conventional wisdom about Japan and its economic development after World War II is misleading. According to Ramseyer, Japan's political economy was not so very different from other existing systems as had always been believed. In his view, the "fairy tale" of Japan's uniqueness had its origins in the 1950s and 1960s when Marxists dominated the economics departments in Japan. Moreover, Western economists could hardly speak Japanese and thus the reception of Japanese material went through the hands of more left-oriented Western sociologists who were able to understand Japanese. Since left-leaning groups wanted to find a third alternative to the models of the East and West, neither of which they liked, they tried to establish Japan as a different economic model – not capitalist, but highly successful nonetheless.

In his comment, *Professor Hideki Kanda* from the University of Tokyo discussed examples of the somewhat unique bank behavior found in Japan and the "main bank" concept. Japanese companies usually establish long-term contractual relationships with more than one bank, with one of those serving as the "main bank" and taking on a strong legal position. Pointing to the research on the "main bank" concept, Kanda said

there is little to show how legal rules affect the main bank's behavior. In the case of insolvency of firms, the bank's behavior should not be explained with a hypothetical contract between the main bank and other creditors, but by the bank's interest in taking control of the whole organizational process of the company once it gets into trouble. Turning to the Japanese bureaucracy and its role in the economy, Kanda pointed out that the MITI did not have the power to intervene directly in the economy. However, by setting up a specific institution that prepares legislation, it became able to influence the economy indirectly.

The last presentation was given by *Professor John C. Coffee, Jr.* from Columbia Law School. According to Coffee, the accounting and financial reporting irregularities that surfaced in the U.S. in 2001/2002, when many financial reports were restated, show that gatekeepers – namely auditors and securities analysts – failed. The specific problem of gatekeepers is that they serve investors but are paid by others who are self-interested. With respect to securities analysts, Coffee proposed a new regulatory approach. They – or at least one "objective" analyst – should be paid by the stock exchanges, not by their respective firm. This could solve the conflict of interests of securities analysts as it would completely redesign the principal-agent relationship. Merely improving Chinese walls, however, would not help, as it would not change the incentives of the analysts.

In his comment on Coffee, *Professor Hiroshi Oda* from the University of London presented the reform of the law regulating certified public accountants (CPAs) in Japan. The aim of the reform was to dissolve concerns that Japanese accounting standards were insufficient because they enabled certifying results that did not reflect the true financial state of companies. An important part of the reform was the securing of independence of the CPAs. Similar to the Sarbanes-Oxley Act, the Japanese CPA law now prohibits simultaneous provision of audit and non-audit services. The length of time a CPA can audit a firm was reduced to seven years. An auditor who has recently audited a company is not allowed to become a director of that company. Additionally, large companies cannot be audited by only one single CPA. Moreover, there are several new provisions that strengthen governmental supervision. Overall the law has led to a stricter approach by CPAs, who have declined to give opinions in considerably more cases than before.