LESS IS MORE—A CRITICAL VIEW OF FURTHER EU ACTION TOWARDS A HARMONIZED CORPORATE GOVERNANCE FRAMEWORK IN THE WAKE OF THE CRISIS

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ABSTRACT

Coming in the wake of the current financial crisis, European developments in corporate governance have received intensive attention, especially during a period when the market volatility of the European Union calls its future integrity into question. This paper seeks to contest further action from the European Union level towards establishing "a harmonized corporate governance framework" with reference to both its desirability and practical feasibility. Starting with a critical evaluation of the factors underpinning the legitimacy of integration, which questions the appeal of "more Europe" in the post-crisis context, the paper casts further doubt on the major harmonization methods of corporate governance, initially based on arguments grounded in the real world and then drawing on theoretical conundrums. Practically, it appears more feasible and desirable to aim for an improved variety of governance systems while leaving open the possibility of flexibility and national distinctions between practices.

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I. INTRODUCTION

A long-standing topic in the realm of corporate governance has been the likelihood of rival systems converging towards a single standard model. In conjunction with the increasingly globalized economy and notable improvements in technology, production, and trading patterns, corresponding improvements in the governance of corporations have been increasingly called for. Attention has intensified in both the economic and legal academic domains regarding the transportability of "best practices" of corporate governance.[1]

1. *See* MAURO F. GUILLÉN, MODELS OF MANAGEMENT: WORK, AUTHORITY, AND ORGANIZATION IN COMPARATIVE PERSPECTIVE (1994); Michael J. Rubach & Terrence C. Sebora, *Comparative Corporate Governance: Competitive Implications of an Emerging Convergence*, 33 J. WORLD BUS. 167 (1998) (providing a historic and comparative perspective of corporate governance systems and convergence of these systems in several countries); John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301 (2004) (arguing that corporate "gatekeepers" were a significant cause of financial distress in the early 2000s); Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001); Diane K. Denis & John J. McConnell, *International Corporate Governance*, 38 J. FIN. & QUANTITATIVE ANALYSIS 1 (2002); John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implications*, 93 NW. U. L. REV. 641 (1999)

In Europe, which currently has the most developed model of regional integration, a forward-looking harmonized approach to corporate governance has been a particular topic of interest. Europe has traditionally been an area consisting of a multitude of highly sophisticated national corporate governance systems. These systems have developed over time and overwhelmingly reflect a variety of distinguished nationally historical, cultural, and financial traditions.[2] The two ideal types of governance systems categorized in the orthodox taxonomy of corporate governance—the Anglo-American "outsider" system of the United Kingdom and the Continental "insider" system exemplified by Germany—can also be seen as forming the polar extremes of European corporate governance. Each type of framework is characterized by different ownership patterns, managerial strategies, and structural elements.[3]

In response to the fast expansion of the European internal market[4] and business transportability, corresponding measures controlling the creation of corporate bodies and their behavior have been solicited at the EU law level, with particular attention being devoted to the prospect of harmonization across countries.[5] Viewed on a broad spectrum, this

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[hereinafter Coffee, *The Future as History*] (discussing the history of corporate governance convergence and its likely adoption by global markets).

2. *See* THOMAS CLARKE, INTERNATIONAL CORPORATE GOVERNANCE: A COMPARATIVE APPROACH 170 (2007); Eur. Comm'n Reflection Group, *Report of the Reflection Group on the Future of EU Company Law* (Apr. 5, 2011) [hereinafter Eur. Comm'n Reflection Group], *available at* http://ec.europa.eu/internal_market/company/docs/ modern/reflectiongroup_report_en.pdf.

3. A large amount of literature has made considerable contributions to the development of these two corporate governance models. *See, e.g.*, Ruth V. Aguilera, Deborah E. Rupp, Cynthia A. Williams & Jyoti Ganapathi, *Putting the S Back in Corporate Social Responsibility: A Multi-level Theory of Social Changes in Organizations*, 32 ACAD. MGMT. REV. 836 (2007); Rafael La Porta, Florencio Lopez De Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999); Cynthia A. Williams & John M. Conley, *An Emerging Third Way? The Erosion of the Anglo-American Shareholder Value Construct*, 38 CORNELL INT'L L.J. 493 (2005). In these comparative studies, the Anglo-American model is alternatively labeled as the market-oriented model, common law model, shareholder-centered model, or liberal model. The Continental model is variously known as the bank-oriented model, civil law model, stakeholder-centered model, or coordinated model. *See* Ruth V. Aguilera & Gregory Jackson, *The Cross-National Diversity of Corporate Governance: Dimensions and Determinants*, 28 ACAD. MGMT. REV. 447, 447 n.1 (2003).

4. The original wording was "common market" in the Consolidated Version of the Treaty Establishing the European Community, Dec. 24, 2002, 2002 O.J. (C 325) 33, 40 [hereinafter EC Treaty], *available at* http://eur-lex.europa.eu/en/treaties/dat/12002E/pdf/12002E_EN.pdf. This term was replaced by "internal market" following the Amendments to the Treaty on European Union and to the Treaty Establishing the European Community, Dec. 17, 2007, 2007 O.J. (C 306) 10, 11, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2007:306:0010:0041:EN:PDF.

5. Michael J. Rubach & Terrence C. Sebora, *supra* note 1; John C. Coffee, Jr., *The Future as History*, *supra* note 1; Hanno Merkt, *European Company Law Reform: Struggling for a More Liberal Approach*, 1 EUR. CO. & FIN. L. REV. 3 (2004); Mathias M. Siems, *Convergence, Competition, Centros and Conflicts of Law: European Company Law in the 21st Century*, 27 EUR. L. REV. 47 (2002); Paul Omar, *In the Wake of the Companies Act 2006: An Assessment of the Potential Impact of*

constitutes an integral part of efforts to achieve the primary Union objective of "economic, social and territorial cohesion, and solidarity among Member States."[6] In the minds of the drafters of the original Treaty Establishing the European Economic Community ("EEC"), substantial harmonization of the rules and regulations governing companies' performance was essential in creating a level playing field for the free movement of companies and for the achievement of their primary goal: the harmonious development of economic activities within the common market.[7] Much of the opinion in the second half of the last century reached a consensus on the necessity of a high degree of sustainable convergence by means of "federal" (e.g. European Community ("EC") level) regulations[8] and a robust harmonization program consisting mainly of determinative directives initiated in the late 1960s, covering both company law and corporate governance. While this ambitious scheme lost much of its impetus in the 1990s due to forceful criticism from corporate scholarship and policy-makers in Member States,[9] the EU has not given up on the idea of forming a harmonized corporate governance framework; indeed, it has been singled out in particular as one of the Union's policy priorities.

In an acknowledgement of the difficulty of gaining political consensus for large-scale sweeping Union intervention following a seminal report from the High Level Group of Experts in 2002, the EU harmonization strategy has moved towards a less rigid form and has been marked by an

Reforms to Company Law, 20 INT'L COMPANY & COMM. L. REV. 44, 54 (2009); Eur. Comm'n, *Progress on Financial Services: Ninth Progress Report* (2003), *available at* http://ec.europa.eu/internal_market/finances/docs/actionplan/index/progress9_en.pdf.

6. Consolidated Version of the Treaty on European Union art. 3(3), Mar. 30, 2010, 2010 O.J. (C 83) 1, 10 [hereinafter TEU], *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:083:FULL:EN:PDF.

7. *See* Treaty Establishing the European Economic Community art. 2, Mar. 25, 1957 [hereinafter EEC], *available at* http://europa.eu/legislation_summaries/institutional_affairs/treaties/treaties_eec_en.htm (official treaty not published); *see also* EC Treaty, *supra* note 4, art. 2, at 10.

8. John Armour, *Who Should Make Corporate Law? EC Legislation Versus Regulatory Competition* 6 (Eur. Corporate Governance Inst., Working Paper No. 54/2005, 2005), *available at* http://www.cbr.cam.ac.uk/pdf/WP307.pdf (unofficial working paper source); CATHERINE BARNARD, THE SUBSTANTIVE LAW OF THE EU: THE FOUR FREEDOMS 6 (2004); *Report of 25 March 1998 on Progress towards Convergence*, COM (1999) 98 final (Mar. 25, 1998), *available at* http://aei.pitt.edu/4901/1/4901.pdf; VANESSA EDWARDS, EC COMPANY LAW 3–5 (1999).

9. It is believed that it is better to leave the main issues regarding company law to the different parties' discretion because of the astonishing rapidity of the modern business environment and the undeniable role of the markets. *See* PAUL L. DAVIES, SARAH WORTHINGTON, LAURENCE CECIL BARTLETT GOWER & EVA MICHELER, GOWER AND DAVIES' PRINCIPLES OF MODERN COMPANY LAW 132 (8th ed. 2008). For views on market efficiency, see FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1986); Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984).

increasingly broad use of alternative instruments in the form of national codes to enable flexibility and mutual recognition among Member States. Interestingly, it does not seem that the Union wishes to completely abandon its role as supranational legislator in the area of corporate governance. As well as the continuing (but much less frequent) formulation of directives setting up minimum rules in certain areas at the Community level,[10] a major harmonization initiative was a mandate requiring the application of national codes on a "comply-or-explain"[11] basis. For this reason, the EU move towards harmonization since 2002 has been termed "procedural harmonization."[12]

Recently, the legitimacy and utility of this procedural harmonization approach were again reconsidered in light of the recent economic and debt crises, which caused increased doubt about the EU integration process.[13] Since the onset of the worldwide recession three years ago, waves of economic and debt crises have not only threatened local and regional economies, but also brought the existence of the European Union itself—a unique regional, economic, and political partnership—to a critical point. In the search for a strategy to bring the EU back from the edge of collapse, future reforms of corporate governance, particularly those aimed at Union-wide harmony, have received renewed attention. The Commission is planning to put forward new initiatives regarding corporate governance in hope of reiterating its commitment to a "strong and successful single market."[14] These new initiatives are built on the premise that a harmonious framework at the European level will be crucial to ensure necessary transparency in governance structure as well as to revive investor

10. The most recent two were Directive 2010/76/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC in regards to capital requirements for the trading book and for re-securitizations and the supervisory review of remuneration policies and Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the Exercise of Certain Rights of Shareholders in Listed Companies. *See* Council Directive 2010/76, 2010 O.J. (L 329) 3, 3–35 (EU), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:329:0003:0035:en:PDF; Council Directive 2007/36, 2007 O.J. (L 184) 17, 17–24 (EC), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2007:184:0017:0024:EN:PDF.

11. For further discussions on the concept of comply-or-explain, see *infra* Part IV.C.II.

12. Armour, *supra* note 8, at 5; Simon Deakin, *Regulatory Competition versus Harmonization in European Company Law*, *in* REGULATORY COMPETITION AND ECONOMIC INTEGRATION 190–217 (Daniel C. Esty & Damien Geodin eds., 2001).

13. *See, e.g.*, Christian Andres & Erik Theissen, *Setting a Fox to Keep the Geese—Does the Comply-or-Explain Principle Work?*, 14 J. CORP. FIN. 289 (2008).

14. *Commission Green Paper on The EU Corporate Governance Framework*, at 2, COM (2011) 164 final (Apr. 15, 2011), *available at* http://ec.europa.eu/internal_market/company/docs/modern/com2011-164_en.pdf.

confidence and economic development.[15] Nevertheless, even with the rhetoric of an "even closer Union,"[16] the end goal of harmonization is not well defined or even agreed upon.[17] Responses from a wide range of professional representatives, citizens, and public authorities have also shown a generally hostile attitude towards the implementation of further governance measures at the EU level, which renders the prospect of further harmonization at the Union level unclear.[18]

At a time of heated discussion about the need for solidarity, this paper sets out to contest both the legitimacy and the practical feasibility of increased Union action towards a harmonized corporate governance framework. Following Part I, Part II of the article provides some history, offering an overview of the process of European integration. Part III examines the credibility of the factors thought to underpin the EU harmonization initiatives, thereby investigating whether a corporate governance framework driven by the EU as a "federal" legislator is indeed a necessity for the post-crisis environment. In Part IV of the article, the attainability of harmonization in corporate governance practices is critically discussed by applying close scrutiny to the competence of Union level actions. This article finds that neither the traditional top-down harmonizing approach, nor the current "procedural harmonization" approach characterized by "comply-or-explain," are likely to achieve a harmonized corporate governance framework, and long-standing national dynamics in corporate governance have managed to survive and will likely persist.

Finally, Part V draws insights from a theoretical perspective to explain the unfeasibility of European harmonization in the realm of corporate

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15. Matthew Sparkes, Matthew Holehouse, Andrew Trotman & Rachel Cooper, *Debt Crisis: As it Happened*, THE TELEGRAPH (Nov. 11, 2011) [hereinafter Comments from Jose Manuel Barroso], *available at* http://www.telegraph.co.uk/finance/financialcrisis/8887896/Debt-crisis-as-it-happened-November-11-2011.html (quoting Jose Manuel Barroso); *see also* Eur. Comm'n, Directorate-General for Econ. and Fin. Affairs, *Economic Crisis in Europe: Causes, Consequences and Responses*, 7 EUR. ECON. (2009) [hereinafter *Economic Crisis in Europe*], *available at* http://ec.europa.eu/economy_finance/publications/publication15887_en.pdf; Eur. Comm'n Reflection Group, *supra* note 2, at 11; Fraser Cameron, *The European Union as a Model for Regional Integration* (Working Paper for the Council on Foreign Relations' Int'l. Insts. & Global Governance Programme, 2010), *available at* http://www.cfr.org/eu/european-union-model-regional-integration/p22935.

16. The rhetoric of "an even closer Union" was put forward in the TEU as one of the key objectives. *See* TEU, *supra* note 6, art. 1.

17. JO STEINER & LOMA WOODS, EU LAW 20 (10th ed. 2009).

18. *See, e.g.*, Eur. Comm'n, *Summary of Responses to the Commission Green Paper on The EU Corporate Governance Framework* (2011) [hereinafter Eur. Comm'n, *Summary of Responses*], *available at* http://ec.europa.eu/internal_market/ company/docs/modern/20111115-feedback-statement_en.pdf; Giandomenico Majone, *Legitimacy and Effectiveness: A Response to Professor Michael Dougan's Review of Dilemmas of European Integration*, 32 EUR. L. REV. 70 (2007).

governance. This is not only attributable to the flexible nature and blurred boundaries of corporate governance as an evolving discipline,[19] but is also owed to the deeply-embedded unique identities and capabilities of national corporate governance systems across Europe.[20] Despite the urgency sensed by European legislators to consolidate the frontiers of the EU, rigorous theoretical viewpoints and flawed practices continue to oppose further Union legislative intervention towards a harmonized corporate governance framework.[21] It appears more desirable and practically feasible to envisage a continuing variety of governance systems, which leave open the possibility of flexibility and national distinctions between practices.

II. AN OVERVIEW OF EUROPEAN HARMONIZATION

Whereas most significant changes in Europe over the past sixty years were brought about by efforts towards integration, few would disagree with the importance of understanding the definition of European integration and the various strands of theories and practices characterizing the process.

Attempts at European unity can be traced back as early as 1464, when the Czech King George of Poděbrady proposed the formation of a league of Christian nations to King Louis XI of France.[22] Following the fall of Constantinople in 1453, the desire for peace and security in central Europe—"a traditional crossroads of all European conflicts"—predominantly inspired this proposal.[23] In 1693, an English philosopher, William Penn, took and further developed the idea of a United States of Europe in his important work *Essay towards the Present and Future Peace by the Establishment of an European Dyet, Parliament, or Estates*.[24] Though the intended effects of his essay of resolving state conflicts did not immediately come to fruition, its proposal for establishing a European Parliament had a significant influence on almost all European integration plans and proposals in the subsequent two centuries.

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19. *See infra* Part V.A.
20. *See infra* Part V.B.
21. *See infra* Parts V.B & VI.
22. Vaclay Havel, *Dreaming Aloud*, *in* THE CONSCIENCE OF EUROPE 89, 89–97 (John Coleman ed., 1999).
23. *Id.* at 95.
24. WILLIAM PENN, AN ESSAY TOWARDS THE PRESENT AND FUTURE PEACE OF EUROPE BY THE ESTABLISHMENT OF AN EUROPEAN DYET, PARLIAMENT OR ESTATES (1693, reprinted in 1983).

In the wake of the Second World War, the impetus towards creating a united Europe to eliminate the destructive forces of national chauvinism[25] saw the emergence of the Statute on the Council of Europe in 1949. The formation of the European Coal and Steel Community ("ECSC") followed soon after, signifying the beginning of contemporary Europeanization.[26] The ECSC went beyond intergovernmentalism and established a supranational authority whose independent institutions had the power to bind its constituent Member States.[27] Building on the success of the ECSC, the Treaty of Rome extended the integration to other economic sectors in 1957 with the creation of the European Economic Community ("EEC"). The initial decades of Europeanization were chiefly inspired by economic concerns, with the aim of removing barriers to trade and establishing a common market to enable the harmonious economic development of the Member States. It was not until 1992 that full-fledged integration efforts permeated the fields of defense and politics. The Treaty on European Union ("TEU"), also known as the Maastricht Treaty as it was signed in Maastricht on February 7, 1992, introduced the striking "three-pillar" structure, which developed the Common Foreign and Security Policy and enabled close cooperation in justice and home affairs.[28] As well as the directly applicable provisions of the Treaty regulating the four freedoms,[29] the harmonization of laws between Member States is viewed as a necessary instrument for achieving the primary Treaty objective of "economic, social and territorial cohesion, and solidarity among Member States."[30] The influence of the European Union

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25. EUR. UNIV. INST., DOCUMENTS OF THE HISTORY OF EUROPEAN INTEGRATION (Walter Lipgens ed., 1985); PAUL P. CRAIG & GRAINNE DE BÚRCA, EU LAW: TEXT, CASES, AND MATERIALS 4 (5th ed. 2011).

26. An early conceptualization of this term was offered by Ladrech, as "an incremental process of re-orienting the direction and shape of politics to the extent that EC political and economic dynamics becomes part of the organizational logic of national politics and policy making." *See* Robert Ladrech, *Europeanization of Domestic Politics and Institutions: The Case of France*, 32 J. COMMON MARKET STUD. 69, 69 (1994). Over the years, the implications of this term are increasingly expanding. *See* Johan P. Olsen, *The Many Faces of Europeanization*, 40 J. COMMON MARKET STUD. 921 (2002) (providing a comprehensive analysis of the term).

27. CRAIG & DE BÚRCA, *supra* note 25

28. The Maastricht Treaty creates the European Union and the so-called "three-pillar" structure, consisting of the European Communities, common foreign and security policy ("CFSP"), and police and judicial cooperation in criminal matters. *See Summaries of EU Legislation: Treaty of Maastricht on European Union*, EUROPA, *available at* http://europa.eu/legislation_summaries/institutional_affairs/treaties/treaties_maastricht_en.htm (last updated Oct. 15, 2010).

29. The "four freedoms" are the cornerstones of the European single market—the free movement of people, goods, services and capital. They are now fully enshrined in the EU Treaty. *See* TEU, *supra* note 6, tit. IV.

30. TEU, *supra* note 6; *see also* Piet Jan Slot, *Harmonization*, 21 EUR. L. REV. 378 (1996).

has now spread to almost every corner of the world with a momentous impact on Member States' developments in the economic, political, sociological, cultural, technological, and ecological domains.

Although the history of the European Union is characterized by its extensive harmonization program in numerous areas including social policy, company law, and environmental legislation, less attention is given to explaining the precise meaning of harmonization. Harmonization is used interchangeably with other terms—for instance, "approximation" in Article 114 of the TEU or "cohesion" in Article 174 of the TEU[31]—to denote the same concept. A useful starting point is acknowledging that harmonization does not simply mean unification. Unification refers to the complete replacement of the legal orders of a Member State with a new order adopted at the European level[32] and is primarily achieved through precise and meticulous regulations.[33] Harmonization, on the other hand, is normally aimed at the formation of a common set of rules, and it is characterized by directives designed to allow for differentiation by Member States contextualizing the Union-level legislative orders into their domestic practice, along with the possibility of opting out the program.

Observing the past six decades of European integration, one could contend that it has essentially been a convoluted process involving a search for the proper balance along the traditional dichotomy between supranationalism and intergovernmentalism.[34] Supranationalism suggests that an authority (in this case, the EU) that stands above the national states holds and yields the power and control to achieve harmonization in international organizations, and national states may be obliged to act against their preferences. In the process of harmonization, the authority takes "inter-state relation beyond cooperation into integration, and involves some loss of national sovereignty."[35] Intergovernmentalism, conversely, emphasizes the central role of Member States in an international and organizational context. Their national sovereignty

31. Walter van Gerven, *Harmonisation Within and Beyond*, *in* "FROM PARIS TO NICE"—FIFTY YEARS OF LEGAL INTEGRATION IN EUROPE 1 (Martijn van Empel ed., 2003).

32. STEINER & WOODS, *supra* note 17, at 362; D. Vignes, *The Harmonization of National Legislation and the EEC*, 15 EUR. L. REV. 358 (1990); van Gerven, *supra* note 31, at 1–15.

33. Piet Jan Slot, *supra* note 30, at 379.

34. These two competing approaches dominated the study of European integration. For a comprehensive discussion of the origin and implications of these two approaches, see IAN BACHE, STEPHEN GEORGE & SIMON BULMER, POLITICS IN THE EUROPEAN UNION ch. 1 (2011).

35. NEILL NUGENT, THE GOVERNMENT AND POLITICS OF THE EUROPEAN UNION 558 (6th ed. 2006).

generally remains intact. Integration occurs only when it is in the common interests of the states.[36]

Before the Maastricht Treaty, especially in the early days of the Community, supranationalism undoubtedly underpinned the European integration process. Many regulations were disguised in the form of directives, providing detailed obligations and leaving Member States with few powers to regulate at a national level and no room for diversity.[37] This trend is also seen in the fields of company law and corporate governance. In the opinion of the Commission, a sweeping harmonization of company law on the basis of Article 44(3) is necessary. It had to cover "all provisions concerning structure and organs of companies, formation and maintenance of its capital, the composition of the profit and loss account, the issue of securities, mergers, conversions, liquidations, guarantees required in cases of company concentrations, etc."[38] Inevitably, the loss of the autonomy of Member States triggered a huge outcry against the overarching influence of the Community. An important sign of opposing voices from Member States was *Brunner v. European Union Treaty*,[39] in which the German Federal Constitution Court refused to accept that EU law trumped Member States' constitutional guarantees and further highlighted the importance of preserving the quality of a sovereign state in its own right, even upon adherence to the Union Treaty. Not surprisingly, the full-fledged trend towards harmonization at the EU level gradually fell into decline after it lost favor with Member States.

Seeking to avoid stiff regulatory intervention from the Union, it was argued that the ultimate goal of harmonization should be "to strengthen the

36. *Id*.

37. van Gerven, *supra* note 31, at 1.

38. M. Berkhouwer présente son rapport, au nom de la commission du marché intérieur, sur la proposition de la Commission de la C.E.E. au Conseil (doc. 10/1964-1965) relative à une directive tendant à coordonner, pour les rendre équivalentes, les garanties qui sont exigées, dans les États membres, des sociétés au sens de l'article 58 alinéa 2 du traité pour protéger les intérêts tant des associés que des tiers (doc. 53). This is from the opinion of the Commission as given in the report drawn up by C. Berkhouwer on behalf of the Commission for the internal market regarding the proposal of the Commission of the EEC to the Council (document 10/1964–1965) for a directive concerning the coordination of the safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of Article 48(2) ex 58(2) of the Treaty with a view to making such safeguards equivalent. This is located in the European Parliament Session (in years 1966–1967) dated May 9, 1966, document 53 at 7, *translated and quoted in* Jan Wouters, *Corporate Law*, *in* "FROM PARIS TO NICE"—FIFTY YEARS OF LEGAL INTEGRATION IN EUROPE 33, 33–74 (Martijn van Empel ed., 2003).

39. Brunner v. The European Union Treaty, Entscheidungen des Bundesverfassungsgerichts [BVerfGE] [Federal Constitutional Court] Oct. 12, 1993, 89 BVerfGE 155, English translations at [1994] 1 C.M.L.R. 57 (Ger.) (unofficial English translation available at http://www.proyectos.cchs.csic .es/euroconstitution/library/Brunner_Sentence.pdf).

common legal heritage of Europe (and) not to strangle its diversity."[40] This view became relevant at the Union level after the *Cassis de Dijon* judgment[41] shed new light on national differences in the course of harmonization, especially on the construction of the mutual recognition principle for the free movement of goods. The TEU (the Maastricht Treaty)[42] evidenced the movement of EU harmonization efforts away from the traditional supranationalism of the Union with the introduction of the subsidiarity and proportionality principles. Today, these are enshrined in Article 5 of the TEU, prescribing that the Union does not enjoy full competence but may only act within a system of attributed competences and objectives.[43] From this point of view, Union harmonization may not go beyond what is necessary to achieve the objective of the Treaty. Where there is joint competence, the Community might only legislate "if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States, either at central level or at regional and local level, but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level."[44]

A number of contradictory views on the degree of leeway that Member States should enjoy have also led to the appearance of a variety of harmonization methods over the years, which confusingly do not follow a fixed pattern and further complicate the blueprint for a harmonious EU. Following Slot's influential taxonomy,[45] several major modes may be mapped out when examining the rules and standards at the Union level. These modes include: (1) Total Harmonization, where no derogation is allowed from Member States except for safeguard measures; (2) Optional Harmonization, where a directive provides an option to follow either the

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40. WALTER VAN GERVEN, JEREMY LEVER & PIERRE LAROUCHE, CASES, MATERIALS AND TEXT ON NATIONAL, SUPRANATIONAL AND INTERNATIONAL TORT LAW, at v (2d ed. 2000).

41. Communication from the Commission Concerning the Consequences of the Judgment Given by the Court of Justice on 20 February 1979 in Case 120/78 ('Casis de Dijon'), 1980 O.J. (C 256) 2, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:1980:256:0002:0003:EN: PDF.

42. Treaty on European Union, Feb. 7, 1992, 1992 O.J. (C 191) 1 (The Maastricht Treaty).

43. These two principles are fundamental to the functioning of the European Union and to the division of competences between the Union and the Member States. The first principle states:

> Under the principle of subsidiarity, in areas which do not fall within its exclusive competence, the Union shall act only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States, either at central level or at regional and local level, but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level.

TEU, *supra* note 6, art. 5(3)–(4). The second principle adds, "Under the principle of proportionality, the content and form of Union action shall not exceed what is necessary to achieve the objectives of the Treaties." *Id.*

44. TEU, *supra* note 6, art. 5(3).

45. Piet Jan Slot, *supra* note 30, at 380–83.

harmonized rules or the national rules; (3) Partial Harmonization, which employs two sets of rules and generally requires cross-border transactions to be subject to Union rules; (4) Minimum Harmonization, where minimum rules apply to all Member States, although they may individually or jointly implement more stringent rules; (5) Alternative Harmonization, where Member States are allowed to choose between alternative methods; and (6) Mutual Recognition, where Member States are required to recognize each other's rules and control.[46] As will be presented, the process of establishing a harmonized corporate governance framework has been complicated by the cumulative use of these methods, raising considerable doubts about the ambit and extent of necessary future regulatory changes.

III. CONTESTING THE LEGITIMACY OF EU CORPORATE GOVERNANCE HARMONIZATION: MOTIVATIONS UNDERLYING CONVERGENCE

A. *The Single Market and Corporate Mobility*

The history of corporate law and corporate governance demonstrates the predominance of two factors—economic needs and cycles of financial collapse—in stirring up public debate and developments in the field of corporate governance, with a major point of concern being the harmonization of governance models.[47] From a wider socio-economic perspective, pressure from globalization, mainly in the form of economic and financial integration and the development of international principles and codes, is driving institutions and nations to reconfigure their corporate governance systems to adapt to changes in the wider context and achieve convergence through commonly-recognized "best practices."[48] Meanwhile, a harmonized system of governance structures is also seen as essential to level the playing fields for businesses in light of growing economic and financial linkages and integrated market mechanisms among nations.[49]

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46. *Id.*; *see also* STEINER & WOODS, *supra* note 17, at 360–68.

47. *See* Klaus J. Hopt, *Modern Company Law and Capital Market Problems: Improving European Corporate Governance after Enron*, 3 J. CORP. L. STUD. 221 (2003); CLARKE, *supra* note 2.

48. Jeffrey G. Williamson, *Globalization, Convergence, and History*, 56 J. ECON. HISTORY 277 (1996); ORGANISATION FOR ECONOMIC CO-OPERATION DEVELOPMENT (OECD), PRINCIPLES OF CORPORATE GOVERNANCE 2 (2004), *available at* http://www.oecd.org/daf/ca/corporategovernance principles/31557724.pdf.

49. *See, e.g.*, WORLD BANK & OECD, CORPORATE GOVERNANCE: A FRAMEWORK FOR IMPLEMENTATION (1999), *available at* http://www.sovereignglobal.com/media/framework_for_impleme nation.pdf; IRE M. MILLSTEIN, MICHEL ALBERT, SIR ADRIAN CADBURY, ROBERT E. DENHAM, DIETER

In the complex landscape of European regional integration, a uniform governance framework for corporations has traditionally been at the center of the extensive harmonization program and is regarded as essential for the completion of the common market.[50] Community legislators have viewed harmonization as an essential means of filling the gaps between the directly applicable provisions of the Treaty pertinent to economic integration from the beginning. In all instances where diversities between national rules and regulations could affect the functioning of the common market, harmonization is deemed necessary and placed on the top of the agenda.[51] With the power vested under Articles 94 and 95 of the EC Treaty (now Article 114 of the TEU), an extensive body of law was developed by the Council for the approximation of laws, regulations, or administrative provisions of the Member States insofar as they directly affect the establishment or functioning of the common market. In the eyes of the original EC Treaty drafters, a substantive mandatory harmonization program across the realms of company law and corporate governance was indispensable in realizing their primary policy goal. The variety of national rules concerning corporate governance were presented as increased transaction costs and distorted trade and competition orders in cross-border activities, which impeded the process of establishing an integrated market.[52] A report of the European Commission found that "[h]armonisation of the rules relating to company law and corporate governance, as well as to accounting and auditing, is essential for creating a Single Market for Financial Services and products."[53]

In addition to the vision of establishing the common market, the basis of many company law directives is enshrined in Article 50(2)(g) of the TEU (previously Article 44(3)(g) of the EC Treaty). Article 50(2)(g) requires the Council and the Commission to attain freedom of establishment by "coordinating to the necessary extent the safeguards which, for the protection of the interests of members and others, are required by Member States of companies or firms within the meaning of the second paragraph of Article 54 (ex Article 48) with a view to making

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FEDDERSEN & NOBUO TATEISI, CORPORATE GOVERNANCE: IMPROVING COMPETITIVENESS AND ACCESS TO CAPITAL IN GLOBAL MARKETS: A REPORT TO THE OECD BY THE BUSINESS SECTOR ADVISORY GROUP ON CORPORATE GOVERNANCE 15 (1998), *available at* http://www.keepeek.com/Digital-Asset-Management/oecd/industry-and-services/corporate-governance-improving-competitiveness-and-access-to-capital-in-global-markets_9789264162709-en.

50. Armour, *supra* note 8, at 6; BARNARD, *supra* note 8.

51. Piet Jan Slot, *supra* note 30, at 379.

52. Armour, *supra* note 8, at 6; BARNARD, *supra* note 8.

53. *Company Law & Corporate Governance*, Eur. Comm'n, *available at* http://ec.europa.eu/internal_market/company/index_en.htm (last updated Feb. 11, 2013).

such safeguards equivalent throughout the Community."[54] It was hoped that regulatory harmonization in the field of company law would give rise to increasing corporate mobility and freedom of establishment so that companies based in one Member State could easily penetrate the markets of other Member States.[55]

Despite these ostensibly sound policy expectations, the reality is that little empirical evidence exists to demonstrate that Member States and others were suffering in the EU single market due to the lack of harmonized company laws and corporate governance rules.[56] This contradicts the arguments in favor of utilizing European corporate governance harmonization to establish and promote the single market. From a legal perspective, the presence of irreconcilable differences between the development of the internal market and limited progress towards corporate governance convergence further suggests that the impact of a harmonized corporate governance model on economic integration and corporate mobility might not be as overwhelming as convergence optimists imply. On the basis of Article 3 of the Treaty of the European Union and relevant articles in the Treaty on the Functioning of the European Union,[57] great achievements were seen on the basis of the single market program, particularly the impressive realization of a common market for goods.[58] In the company law field, the principal function of the internal market in terms of the free establishment of companies is largely attained in practice. The application sphere of the real-seat doctrine has been significantly constrained, particularly since the European Court of Justice ("ECJ") decision in *Centros*.[59] The freedom to choose the binding governance system by newly-formed corporations in the EU successfully facilitates easy incorporation and free establishment of companies. Recent ECJ cases after *Centros* further support the EU's inclination toward the freedom of movement of corporations by pressing Member States to recognize the legitimacy of companies chartered in other Member States.[60]

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54. TEU, *supra* note 6, art. 50(2)(g).

55. With regard to corporate mobility, the main provision of this source of law is contained in the Consolidated Version of the Treaty on the Functioning of the European Union art. 49, Mar. 30, 2010, 2010 O.J. (C 83) 47, 67 [hereinafter TFEU], *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:083:0047:0200:en:PDF.

56. DAVIES ET AL., *supra* note 9.

57. TFEU, arts. 21, 26, 28, 29, 114, 115.

58. Majone, *supra* note 18.

59. Case C-212/97, Centros Ltd. v. Erhvervs-og Selskabsstyrelsen, 1999 E.C.R. I-1459.

60. *See, e.g.*, Case C-208/00, Úberseering BV v. Nordic Construction Company Baumanagement GmbH, 2005 1 W.L.R. 315, 1 C.M.L.R. 1 (2005); Case C-167/01, Kamer van Koophandel en

Although legal and economic transitions have progressed to a relatively advanced level with regard to the development of the internal market and the achievement of free establishment of companies, there is still a highly fragmented landscape in the realm of corporate governance consisting of several tiers of integration.[61] Currently enacted EU company laws are characterized by their "salami" progression: a number of disparate areas are covered, most of which relate to security market regulations and issues facilitating cross-border businesses, such as capital maintenance,[62] the audit of accounts,[63] and the standardization of company registration.[64] However, core areas of corporate governance, such as company management and company structures, are either left untouched at the European level or failed to gain the necessary level of support. A typical example is the lack of uniformity in voting rights in publicly traded companies regardless of growth in cross-border business activities. Contradictory views taken by Member States, reflecting their long-standing diversified shareholding structures, could not be reconciled at the EU level, and eventually Commissioner McCreevy had to declare an abrupt end to the discussion of this issue.[65] An in-depth study also revealed that enacted company law harmonization initiatives have become highly autonomous; the emphases of many enacted directives are on legislative policy aims regarding equivalent protection for shareholders and creditors in the markets rather than making a direct contribution to the operation of the internal market.[66] In reality, one can best infer an indirect link between the realization of the freedom of establishment of companies

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Fabrieken voor Amsterdam v. Inspire Art Ltd., 2003 E.C.R. I-10155, 3 C.M.L.R. 34 (2005); Case C-411/03, Re Sevic Systems AG, [2006] 2 B.C.L.C. 510. For academic views supporting the convergence function of these case laws, see Martin Ebers, *Company Law in Member States against the Background of Legal Harmonization and Competition between Legal Systems*, 11 EUR. REV. PRIVATE L. 509, 511 (2003); Paul Rose, *EU Company Law Convergence Possibilities After Centros*, 11 TRANSNAT'L L. & CONTEMP. PROBS. 121, 129 (2001); Klaus Heine & Wolfgang Kerber, *European Corporate Laws, Regulatory Competition and Path Dependence*, 13 EUR. J.L. & ECON. 47, 48 (2002).

61. *See, e.g.*, MADS ANDENAS & FRANK WOOLDRIDGE, EUROPEAN COMPARATIVE COMPANY LAW 40 (2009); Stefan Grundmann, *The Structure of European Company Law: From Crisis to Boom*, 5 EUR. BUS. ORG. L. REV. 601 (2004); Cameron, *supra* note 15, at 2; Coffee, Jr., *The Future as History*, *supra* note 1, at 667–71.

62. *See* Second Council Directive 77/91, 1976 O.J. (L 26) 1 (EC), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:1977:026:0001:0013:EN:PDF.

63. Council Directive 2006/43, 2006 O.J. (L 157) 87 (EC), *available at* http://www.esma.europa.eu/system/files/dir_2006_43_EN.pdf.

64. *See* First Council Directive 68/151, 1968 O.J. SPEC. ED. (L 65) 41 (EC), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=DD:I:1968_I:31968L0151:EN:PDF.

65. For instance, one-share-one-vote is the standard structure in the UK; but many other Member States are accustomed to the rule of proportionality between capital and control. For further discussions, see BRENDA HANNIGAN, COMPANY LAW 43 (2d ed. 2009).

66. *See* Wouters, *supra* note 38, at 45.

and harmonization in corporate governance. In a recent report, the EU finally acknowledged the tenuous link between the operation of the internal market and the harmonization of corporate governance, which clearly undermines the necessity of future harmonization in this area based on the Union's Treaty foundation: "The different corporate governance systems of the Union should not be viewed as an obstacle to free enterprise within a single market, but as a treasure trove of different solutions to a wide variety of challenges that have been experienced and overcome."[67]

B. Cycles of Crises

Greater than the impact of changing perspectives in the internal market economy, concerns originating from the transmission of the financial crisis to the real economy tend to stimulate interest in the development of corporate governance systems. One well-known example is the Great Depression of the late 1920s, which led to the important Berle-Dodd debate on the objective of the corporation and the superiority of different corporate governance models.[68] In the new millennium, the collapse of Enron revived the stakeholder-end argument in the convergence debate, which was diametric to the shareholder-oriented convergence argument prevalent in the 1990s.[69] The recent and on-going financial turmoil has further renewed interest in the prospects of convergence in corporate governance in the immediate hope that a contingency model may be identified and used to predict future crises and achieve business success.[70]

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67. Eur. Comm'n Reflection Group, *supra* note 2, at 11.

68. Adolf A. Berle, *For Whom Corporate Managers Are Trustees*, 45 HARV. L. REV. 1365 (1932); E. Merrick Dodd, *For Whom are Corporate Managers Trustees*?, 45 HARV. L. REV 1145 (1932).

69. *See* THOMAS CLARKE, THEORIES OF CORPORATE GOVERNANCE 13 (2004); CORO STRANGBERG, THE CONVERGENCE OF CORPORATE GOVERNANCE AND CORPORATE SOCIAL RESPONSIBILITY: THOUGHT—LEADERS STUDY (2005), *available at* http://www.corostrandberg.com/pdfs/Corporate_Governance.pdf; Williams & Conley, *supra* note 3; Steen Thomsen, *The Convergence of Corporate Governance Systems and European and Anglo-American Standards*, 4 EUR. BUS. ORG. L. REV. 31 (2003); Lucian Cernat, *The Emerging European Corporate Governance Model: Anglo-Saxon, Continental, or Still the Century of Diversity?*, 11 J. EUR. PUB. POL'Y 147 (2004); Simon Deakin, *The Coming Transformation of Shareholder Value*, 13 CORP. GOVERNANCE INT'L REV. 11 (2005). For the convergence argument in the 1990s, see John C. Coffee, Jr., *Convergence and Its Critics: What are the Preconditions to the Separation of Ownership and Control*, *in* CORPORATE GOVERNANCE REGIMES: CONVERGENCE AND DIVERSITY 83 (2004); Hansmann & Kraakman, *supra* note 1; Denis & McConnell, *supra* note 1.

70. In relevant empirical research, promising results have been suggested regarding the positive link between corporate governance and corporate performance. *See* CLARKE, *supra* note 2, at 22;

Since the summer of 2007, the EU has slipped into and been in the midst of the deepest financial turmoil since the 1930s, involving banking systems, stock markets, and the flow of credit. As of the writing of this article, one of the most influential regional economies, the Eurozone, is facing its greatest challenge so far: the depth of the current debt crisis.[71] Confronting this catastrophic situation, EU legislators have once more decided to resort to the dubious remedy of a coordinated framework, which will predictably lead to even more strenuous efforts towards integration.[72] In particular, further legislative action at the EU level to develop a synchronized corporate governance framework is seen as crucial in achieving this policy priority.[73] Corporate governance plays a central role in running and regulating modern enterprises in globally integrated markets, and it is anticipated that a well-coordinated framework will overcome the current Eurozone contagion fear as well as create the necessary climate for investment and economic revival. As noted, a harmonious EU corporate governance framework will "inspire investor and lender confidence, spur both domestic and foreign investment, and improve corporate competitiveness."[74]

In light of theoretical conundrums plagued with disputes over the prospects of convergence, one cannot help but wonder whether the desired harmonized corporate governance framework can be achieved at all, let alone bring the suggested positive impact in curing the crisis. Although much work in the field of corporate governance has examined the prospect of convergence,[75] so far even convergence activists have failed to agree about the ends towards which convergence will likely achieve. In the 1990s, there was an overriding belief in the superiority of the market-based Anglo-American model that was established through extensive

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Rebecca Brown & Tue Gørgens, *Corporate Governance and Financial Performance in an Australian Context* 33–34 (Austl. Treasury Working Paper No. 2009-02, Mar. 2009).

71. *EU "Faces Its Greatest Challenge,"* BBC NEWS (Sep. 28, 2011), *available at* http://www.bbc.co.uk/news/world-europe-15087683 (quoting Jose Manuel Barroso).

72. Comments from Jose Manuel Barroso, *supra* note 15; Eur. Comm'n Reflection Group, *supra* note 2, at 8.

73. *Commission White Paper*, *supra* note 15.

74. For further discussion of the necessity of harmonizing EU corporate governance, see INT'L FIN. CORP. (IFC), THE EU APPROACH TO CORPORATE GOVERNANCE—ESSENTIALS AND RECENT DEVELOPMENTS 2 (2008), *available at* http://www1.ifc.org/wps/wcm/connect/f515ff804af4fc7da869b9b94e6f4d75/IFC_EUApproach_Final.pdf?MOD=AJPERES.

75. *See, e.g.*, Douglass C. North, *Economic Performance through Time*, 84 AM. ECON. REV. 359 (1994); Rubach & Sebora, *supra* note 1; L.G. Thomas & Geoffrey Waring, *Competing Capitalisms: Capital Investment in American, German, and Japanese Firms*, 20 STRATEGIC MGMT. J. 729 (1999); MARCO BECHT & COLIN MAYER, MARKET DISCIPLINE ACROSS COUNTRIES AND INDUSTRIES 255–69 (2004).

market integration and equity finance development during the 1970s and 1980s.[76] This was practically supported by the simultaneous sequence of dramatic events occurring in the insider business world, including the 1997–98 East Asian financial crisis, the burst of the Japanese economic bubble, and a series of German corporate scandals. All of these events seriously challenged the efficiency of Continental insider systems.[77] Based on these practical phenomena, neo-classical scholars advocated convergence toward the Anglo-American shareholder-oriented model, promoting the view that this model represents production efficiency, increased investment opportunities, and reduced transaction costs.[78] Therefore, when globalization and industry competition forces corporations in different countries to adopt "best practices" to maintain their competitive advantage, the Anglo-American system will eventually become the convergent point.[79]

Things took a dramatic turn, however, in the post-Enron era. Recurring corporate failures exposed the inherent instability of the Anglo-American system and the perspective of convergence based on a shareholder-oriented model of governance became a lot less convincing.[80] Based on these changes in governance practice, stakeholding proponents argue in favor of the Anglo-American system converging toward the Continental model.[81] The growing exercise of corporate social reporting, the

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76. Financial globalization, i.e. the integration of more and more countries into the international financial system and the expansion of international markets for money, capital and foreign exchange, took off in the 1970s. From the 1980s on, the increase in cross-border holdings of assets outpaced the increase in international trade, and financial integration accelerated once more in the 1990s. *See* Eur. Comm'n, The EU Economy 2005 Review: Rising International Economic Integration Opportunities and Challenges 19 (2005), *available at* http://ec.europa.eu/economy_finance/publications/publication433_en.pdf.

77. *See, e.g.*, Coffee, *The Future as History*, *supra* note 1, at 543; *Thomas Clarke*, *Cycles of Crisis and Regulation: The Enduring Agency and Stewardship Problems of Corporate Governance*, 12 CORP. GOVERNANCE INT'L REV. 153, 156–57 (2004).

78. One major argument supporting the efficiency of the Anglo-American regime is as follows: dispersed shareholdings mean that shareholders' wealth depends on more diversified portfolios of investments (held directly or through institutions such as pension funds and mutual funds) than shareholders in a closed regime with concentrated ownership. Since the risk of a diversified portfolio is lower than that of a concentrated one, shareholders require lower return in relation to the risk. This in turn lowers the cost of capital faced by corporations and makes capital for risky ventures more available, particularly in the circumstance of global capital market integration. *See* Raghuam G. Rajan & Luigi Zingales, *The Great Reversals: The Politics of Financial Development in the 20th Century*, 69 J. FIN. ECON. 5 (2003); Vihang Errunza & Etienne Losq, *International Asset Pricing Under Mild Segmentation: Theory and Test*, 40 J. FIN. 105 (1985); Hansmann & Kraakman, *supra* note 1.

79. Hansmann & Kraakman, *supra* note 1; *see also* MICHAEL C. JENSEN, A THEORY OF THE FIRM: GOVERNANCE, RESIDUAL CLAIMS, AND ORGANIZATIONAL FORMS (2000).

80. *See, e.g.*, Williams & Conley, *supra* note 3; Thomsen, *supra* note 69.

81. *See, e.g.*, Williams & Conley, *supra* note 3; Thomsen, *supra* note 69; Strangberg, *supra* note 69; Deakin, *supra* note 69. For differences between the Continental model and the Anglo-American

widespread adoption of executive stock options which reintegrate ownership and control,[82] and the rising significance of human capital[83] in Anglo-American corporate governance have all been suggested as indicating convergence away from the shareholder-oriented model and toward Continental pluralism.

Disputing both convergence points suggested above, the cross-reference hypothesis espouses the equal competitive advantages possessed by the two ideal models.[84] Proponents suggest that past business cycles provide evidence that neither model outperforms the other at all times.[85] It is argued that global and regional competition will give rise to the emergence of a hybrid model characterized by the competitive features of both systems—or, in simple terms, a coordinated system of "best practices." In practice, harmonization movements at the EU level have thus far attempted to shape a mutual pattern consisting of "best practices" from both the Anglo-American and Continental models.[86] Additionally, several multilateral bodies also encourage hybrid convergence by urging the adoption of common standards.[87] However, judging from previous theoretical developments, one begins to wonder whether this approach can withstand closer scrutiny on the grounds that currently recognized "best practices" are not able to embrace and predict all possible future variations. For example, although the meteoric rise in executive pay was explained and recommended during the 1990s as a reliable incentive scheme supported by the long-lived bull market,[88] in the wake of the crises

model, see *supra* note 3 and accompanying text.

82. Thomsen, *supra* note 69.

83. Sanford M. Jacoby, *Corporate Governance in Comparative Perspective: Prospects for Convergence*, 22 COMP. LAB. L. & POL'Y J. 5 (2001).

84. "[T]his cross reference hypothesis implies that global competition will cause the emergence of a hybrid best practice. It also suggests that we should assume in the meantime that the market and blockholder systems possess equal competitive fitness." William W. Bratton & Joseph A. McCahery, *Comparative Corporate Governance and the Theory of the Firm: the Case Against Global Cross Reference*, 38 COLUM. J. TRANSNAT'L L. 213, 218 (1999). For hybrid convergence arguments, see Steven N. Kaplan, *Top Executives, Turnover, and Firm Performance in Germany*, 10 J. L. ECON. & ORG. 142 (1994); Steven N. Kaplan, *Top Executive Rewards and Firm Performance: A Comparison of Japan and the U.S.*, 102 J. POL. ECON. 510 (1994).

85. Bratton & McCahery, *supra* note 84, at 218–19.

86. *E.g.*, Friedrich Kübler, *A Shifting Paradigm of European Company Law?*, 11 COLUM. J. EUR. L. 219 (2005); Cernat, *supra* note 69.

87. Tarun Khanna, Joe Kogan & Krishna Palepu, *Globalisation and Similarities in Corporate Governance: A Cross-Country Analysis*, 88 REV. ECON. & STAT. 69, 71 (2006); *see, e.g.*, OECD, CORPORATE GOVERNANCE IN OECD MEMBER COUNTRIES: RECENT DEVELOPMENTS AND TRENDS, DAFFE/CA/CG (2000), *available at* http://www.cgscenter.org/library/OECDStudiesonCorpGov/CG%20inOECD%20MemberCountries.pdf; WORLD BANK & OECD, *supra* note 49.

88. Lucian Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 OXFORD REV. ECON. POL'Y 283 (2005); CLARKE, *supra* note 2, at 77; Kevin Murphy, *Top Executives Are Worth Every*

over the past ten years, this strategy is now seen as extravagant and a major contributory factor in managers' excessive risk-taking practices and undue concentration on short-termism.[89] It is beyond argument that governance is more of a social creation than a natural occurrence. The astonishing rapidity of developments in the business world prevents one all-embracing governance approach because this would act to constrain future possibilities by current practices and insights.[90]

The best of all possible worlds, in the views of some commentators, would be an integrated system comprising core rules and values as an irreducible minimum, "but no more than can be justified as universally applicable."[91] This thought underpinned the EU minimum harmonization trend, which commenced with the Single European Act and remained particularly prevalent since Maastricht, with its advantages of allowing flexibility and diversity in the regulatory system.[92] From the point of view of strong opposing voices, however, one might argue that with the desired end result of harmonization still unclear in the field of corporate governance, even this minimum harmonization is not a task that can be achieved in the short-term. Furthermore, such a minimum standard-composed framework, within which none of the Member States may fall, is pragmatically equal to welcoming the continuation of diversified standards above a baseline. This, in turn, may end up undermining rather than reinforcing efforts towards harmonization.[93]

IV. PRACTICAL FEASIBILITY OF EUROPEAN CORPORATE GOVERNANCE HARMONIZATION

A. The Blurred Borders of Corporate Governance

Corporate governance, being a contextual construct, is strongly shaped by local forces and institutional embeddedness.[94] Notwithstanding the

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Nickel They Get, 64 HARV. BUS. REV. 125 (1986).

89. HOUSE OF COMMONS TREASURY COMM., BANKING CRISIS: REFORMING CORPORATE GOVERNANCE AND PAY IN THE CITY—NINTH REPORT OF SESSION 2008–09, at 10 (2009), *available at* http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/ 519.pdf; Christian Plath, *Corporate Governance in the Credit Crisis: Key Considerations for Investors*, MOODY'S INVESTOR SERV., at 3 (Nov. 20, 2008); ASS'N OF CHARTERED CERTIFIED ACCOUNTANTS, CLIMBING OUT OF THE CREDIT CRUNCH 4 (2008), *available at* http://www2.accaglo bal.com/pdfs/credit_crunch.pdf.

90. John Carver, *A Case for Global Convergence Theory: Practitioners Avoid It, Academics Narrow It, The World Needs It*, 18 CORP. GOVERNANCE INT'L REV. 149, 151 (2010).

91. *Id.*

92. STEINER & WOODS, *supra* note 17, at 368.

93. *Id.*

94. *E.g.*, Toru Yoshikawa & Abdul A. Rasheed, *Convergence of Corporate Governance: Critical*

growing attention paid to corporate governance issues, practical diversities among the developed capitalist economies have so far defied a common definition of corporate governance, further emphasizing the thorny process of harmonization. In its broadest sense, corporate governance is crucial to the realization of macro-economic and social goals and is seen as embracing both the internal governing structures of a corporation and the external forces affecting corporate practice.[95] One prominent example is the World Bank's definition of corporate governance as "the organizations and rules that affect expectations about the exercise of control of resources in firms."[96] However, under most business circumstances, especially in direct association in the business context, this term is commonly delineated in a narrow mode and refers to the internal structure and operation of a corporation's decision-making practices.[97] Ownership and control are commonly recognized as central themes of corporate governance. "Ownership" signals the legal allocation of cash flow rights, and "control" indicates the ways in which legal rules and social norms interact to establish and maintain the balance of power among constituency groups, including shareholders, creditors, and employees.[98]

Within the European Union, the understanding of corporate governance becomes more divergent on closer inspection, with differing interpretations influenced by the diverse purposes of corporations. At one polar extreme is the shareholder value orientation principle, which is honored by a number of Member States.[99] This approach requires a company to maximize the interests of its shareholders ahead of any other party who might have claims against the company.[100] Corporate

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Review and Future Directions, 17 CORP. GOVERNANCE INT'L REV. 388 (2009); CLARKE, *supra* note 2.

95. *See, e.g.*, WORLD BANK & OECD, *supra* note 49, at vi (The definition offered by Sir Cadbury in 2000: "Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. . . . The aim is to align as nearly as possible the interests of individuals, corporations and society.").

96. WORLD BANK, BUILDING INSTITUTIONS FOR MARKETS: WORLD BANK DEVELOPMENT REPORT 2002, at 55 (2002).

97. Jeswald Salacuse, *Corporate Governance in the New Century*, 25 COMPANY LAW 69 (2004).

98. *See* Simon Deakin, Richard Hobbs, Suzanne J. Konzelmann & Frank Wilkinson, *Anglo-American Corporate Governance and the Employment Relationship: A Case to Answer?*, 4 SOC.-ECON. REV. 155, 156 (2006).

99. The shareholder value principle is alternatively referred to as the shareholder primacy principle or the shareholder wealth maximization norm. *See* Andrew Keay, *Tackling the Issue of the Corporate Objective: An Analysis of the United Kingdom's "Enlightened Shareholder Value Approach,"* 29 SYDNEY L. REV. 577 (2009).

100. *Id.*; *see also* Stephen M. Bainbridge, *In Defence of the Shareholder Wealth Maximisation Norm: A Reply to Professor Green*, 50 WASH. & LEE. L. REV. 1423 (1993); Mark J. Roe, *The Shareholder Wealth Maximisation Norm and Industrial Organization*, 149 U. PA. L. REV. 2063 (2001).

governance systems in these countries, led by the United Kingdom, are arranged to focus on "deal[ing] with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment."[101] In the UK, the evolution of definitions of corporate governance has faithfully followed the shareholder-oriented route. The most influential concept of corporate governance in the UK, initially presented in the Cadbury Report, explicitly emphasizes the predominance of the principal-agent relationship between shareholders and directors and the ultimate objective of profit maximization.[102]

In stark contrast to these shareholder-oriented systems, the principal objective of corporate governance in Continental "insider" systems epitomized by Germany is "to ensure the continued existence of the enterprise and its sustainable creation of value in conformity with the principles of the social market economy (interest of the enterprise)."[103] Corporate governance is therefore defined with an emphasis on coordinating the interests of various corporate constituencies, such as "the structure of rights and responsibilities among the parties with a stake in the firm,"[104] or "the process by which corporations are made responsive to the rights and wishes of stakeholders."[105] The disputed boundaries of corporate governance demonstrate the difficulty of harmonization and further inspire controversy as to the best-suited regulatory method.

Over the past forty years of attempting to eliminate diversity among national corporate governance models, the EU has employed a wide range of harmonization efforts ranging across almost all fields that have an

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101. Andrei Shleifer & Rober Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737 (1997).

102. Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board included setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting. Comm. on the Fin. Aspects of Corp. Governance & Gee and Co., Report of the Committee on Financial Aspects of Corporate Governance, ¶ 2.5 (1992) [hereinafter COMM. ON CORP. GOVERNANCE REPORT], *available at* http://www.ecgi.org/codes/documents/cadbury.pdf. This definition was subsequently incorporated by the Department of Trade and Industry's 1998 paper and has had a significant impact on the main attitude of the Company Law Reform Steering Group in terms of the shareholder/stakeholder value dispute. *See* CO. LAW AND INVESTIGATIONS DIRECTORATE, MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY 9 (1998).

103. GOV. COMM'N, GERMAN CORPORATE GOVERNANCE CODE, as amended on May 15, 2012, at 1 (2012), *available at* http://www.corporate-governance-code.de/eng/download/kodex_2012/D_CorGov_final_May_2012_amendments.pdf.

104. M. AOKI, INFORMATION, CORPORATE GOVERNANCE, AND INSTITUTIONAL DIVERSITY: COMPETITIVENESS IN JAPAN, THE USA, AND THE TRANSNATIONAL ECONOMIES 11 (2000).

105. Ada Demb & F.-Friedrich Neubauer, *The Corporate Board: Confronting the Paradoxes*, 25 LONG RANGE PLANNING 9 (1992).

impact on corporate performance including company law,[106] capital market law,[107] securities regulation,[108] and even the rules governing industrial relations.[109] The process can be split roughly into the traditional substantive harmonization by way of EU regulations and directives on substantive law and recent procedural harmonization, characterized by EU-imposed directives mandating the way of enforcement of national codes of practice.[110] Four decades of Community action, however, do not seem to alter the fact that central themes of corporate governance remain divergent across Member States. In the following sections, the effects of EU harmonization action at different times for the completion of the corporate governance framework will be critically assessed, firstly grounded in the real world, and then according to a theoretical analysis.

B. Early Harmonization—Directives on Substantive Law

Corporate governance was not singled out during the early EU harmonizing process, and it remained an integral part of the Europeanization of national company laws, which could be traced back to the 1960s. This was because corporate governance did not evolve into an independent discipline in its own right until around two decades ago when it was conceptualized in response to waves of corporate collapses and crises.[111] In the initial stages of harmonization, meticulously-drafted directives were mainly employed with a view towards approximating the

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106. *E.g.*, the Regulation on the European Company attempt and First Council Directive 68/151, 1968 O.J. SPEC. ED. 151, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31968L0151:EN:HTML; Second Council Directive 77/91, 1977 O.J. (L 26) 1, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:1977:026:0001:0013:EN:PDF; Third Council Directive 78/855, 1978 O.J. (L 295) 36, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:1978:295:0036:0043:EN:PDF; Fourth Council Directive 78/660, 1978 O.J. (L 222) 11, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:1978:222:0011:0031:EN:PDF; *see infra* Part IV.B. for further discussions.

107. *See, e.g.*, Council Directive 72/156, 1972 O.J. (L 91) 13 (EC), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=DD:I:1972_I:31972L0156:EN:PDF; Council Directive 2002/47, 2002 O.J. (L 168) 43 (EC), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2002L0047:20090630:EN:PDF.

108. *E.g.*, Council Directive 2007/64, 2007 O.J. (L 319) 1 (EC), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2007:319:0001:0036:EN:PDF.

109. *E.g.*, Council Directive 2009/101, 2009 O.J. (L 258) 11 (EC), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:258:0011:0019:EN:PDF.

110. Wouters, *supra* note 38, at 33.

111. "Corporate governance has only recently emerged as a discipline in its own right, although the strands of political economy it embraces stretch back through centuries." WORLD BANK & OECD, *supra* note 49, at 1; *see also* CLARKE, *supra* note 2, at 8; HANNIGAN, *supra* note 65, at 41 ("Corporate governance is a term much in use in the past decade and it can mean different things depending on the context.").

national laws of Member States. This achieved impressive results by the end of the 1980s with nine discrete areas being covered by directives.[112] Two regulations were also developed around or shortly after this period, respectively the Regulation on European Economic Interest Groupings[113] and the Regulation on the European Company.[114] Until the decline of this sweeping harmonization trend in the 1990s, however, no substantive achievements were made in advancing the convergence of corporate governance frameworks. As discussed in the previous section, the EU has been attempting to achieve an integration of features from both governance models, but most directives were based in the legal systems of only a few Member States. Coupled with the fact that early directives were often determinative with no room for national derogation, processes of setting up Community-level standards on corporate governance with a view towards total harmonization has turned out to be extremely harsh and difficult in the face of opposing voices from Member States with different systems.

The depressing fate of the proposed Fifth Directive,[115] which was originally intended to have an astounding total harmonization of three essential areas of corporate governance (legal structure of public limited companies, involvement of employees, and potential liability of directors), indicates the difficulty of coordinating diverse corporate governance practices. The initial draft of the Directive showed considerable German influence, recommending the introduction of a compulsory two-tier board system.[116] Not surprisingly, this was immediately overwhelmed by stiff opposition from single-board-structured Member States.[117] Though the radical total harmonization method was incrementally supplanted by optional harmonization[118] through substantial compromises in revised

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112. These were the First Council Directive 68/151, 1968 O.J. SPEC. ED. 151; Second Council Directive 77/91, 1977 O.J. (L 26) 1; Third Council Directive 78/855, 1978 O.J. (L 295) 36; Fourth Council Directive 78/660, 1978 O.J. (L 222) 11; Sixth Council Directive 82/891, 1982 O.J. (L 378) 47; Seventh Council Directive 83/349, 1983 O.J. (L 193) 1; Eighth Council Directive 84/253, 1984 O.J. (L 126) 20; Eleventh Council Directive 89/666, 1989 O.J. (L 395) 36; and Twelfth Council Directive 89/667, 1989 O.J. (L 395) 40.

113. Council Regulation 85/2137/EEC, 1985 O.J. (L 199) 1, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31985R2137:en:HTML.

114. Council Regulation 2157/2001, 2001 O.J. (L 294) 1 (EC), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2001:294:0001:0021:en:PDF.

115. The Fifth Directive was first drafted in 1972 and subsequently revised in 1983 and 1989. *See* Cernat, *supra* note 69, at 157.

116. Janice Dine, *Implications for the United Kingdom of the EC Fifth Directive*, 38 INT'L COMP. L. Q. 547, 547 (1989).

117. *Id.* at 556.

118. *See supra* note 45 and accompanying text.

versions, e.g. permission to adopt a "one-tier" board system of management, the likely outcome of the Directive's intervention in key areas of corporate management still remained unacceptable to businesses and Member States, and it has never been enacted.[119] Although the board of directors is the central organ performing corporate governance, its structure and operation have never occupied the harmonization initiatives of the Commission since.

As was the case for the Fifth Directive, all progress to introduce a unique form of legal entity at the European level—the European Company (known by the Latin term "Societas Europaea" or SE)—was blocked for a long time,[120] and its final version made a significant compromise on the issue of board structures. Notwithstanding the fact that the SE regulation is intended to release companies from different national legal systems so that they might operate their business on a Community scale, there is hardly any indication of an overarching vision on this key corporate governance matter, and both single tier and two-tier structures are permitted for structuring and managing SEs.[121] Even with this significant leeway, this harmonizing measure to create a pan-European business form has so far proved to be very disappointing. It took almost forty years for the SE to become a business reality, and its influence in harmonizing domestic corporate practice is minimal; in the past decades only 1029 interests were registered within the whole European Union.[122] Deep-rooted diversities in values, traditions, and priorities among Member States have prevented their companies from adopting a singular form, and thus have further impeded the European Company Statute[123] in its attempt to challenge Member States' long-established traditions of corporate control. A recent survey reveals that only slightly more than 12% of UK companies would

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119. *See* Eur. Parliament, *Fact Sheets: Company Law* (Jan. 18, 2000), http://www.europarl.europa.eu/factsheets/3_4_2_en.htm ("Adoption of the third proposal for a fifth directive in 1991 on the structure of public limited liability companies and the powers and obligations of their bodies has been blocked because of its provisions on worker participation.").

120. Early European convergence effort in the realm of company law and corporate governance could be traced back to the early 1970s, when the EU attempted to create a harmonized corporate governance system above domestic regimes by enforcing the statute for a European Company. Memorandum from Gregory Jackson to RIETI Int'l Symp., Regional Integration and the Diversity of Corporate Governance: Some Lessons from European Integration 5 (Apr. 22–23, 2002), *available at* http://www.rieti.go.jp/jp/events/02042201/pdf/jackson_1.pdf.

121. Council Regulation 2157/2001, *supra* note 114, art. 38.

122. ETUI, *European Company (SE) Database*, http://ecdb.worker-participation.eu/ (last updated Jan. 6, 2012).

123. *See* Council Regulation 2157/2001, *supra* note 114.

even consider adopting the European Company model, let alone put it into action.[124]

Recognizing the difficulty of imposing strict, rigid rules, directives after the 1980s were increasingly designed to allow for greater flexibility at the national level.[125] Directives aiming for optional and minimal harmonization have since become major strands. Member States can choose to go beyond these directive standards in their domestic regulations, or they may opt out of provisions that conflict with their existing regulatory systems. From a different perspective, this also creates the possibility that key differences between the two distinct corporate governance models may continue to be preserved if Member States choose to opt out of relevant harmonizing provisions. It has subsequently become common practice in Member States for national regulators to develop their own systems to govern the internal affairs of companies, and European directives are only cautiously accepted when the regulators perceive the urgency of borrowing effective regulatory techniques to make their jurisdiction more competitive.[126]

To use the example of the Takeovers Directive,[127] despite the fact that the Directive only contains minimum requirements in the field, its implementation has been strongly opposed by Continental-system Member States, such as Germany, due to their desire to preserve their national characteristics.[128] A number of basic features of the German corporate governance system effectively impede the growth of takeover practices and the development of any framework enhancing them, including the concentrated ownership structure that greatly reduces the vulnerability of corporations to takeovers, undeveloped takeover markets, and well-structured employee participation in governance. The incompatibility of these national elements, therefore, became a major factor influencing the hostility of Germany towards the Directive. In 1995, under the requirement of integrating its national system into the European unified

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124. A. Bibby, *Trials of a European Trailblazer*, FIN. TIMES (Mar. 31, 2005), http://www.ft.com/cms/s/1/7f95f656-a13f-11d9-95e5-00000e2511c8.html#axzz27OGvOLoE.

125. Until the end of 1974, thirty out of a total of seventy acts involving harmonization of laws embodied total harmonization. Since then, total harmonization has been restricted to areas of product standards. Piet Jan Slot, *supra* note 30, at 381.

126. *See* Eddy Wymeersch, *Company Law in Turmoil and the Way to 'Global Company Practice*,*'* 3 J. CORP. L. STUD. 283, 291 (2003)**.**

127. Council Directive 2004/25, 2004 O.J. (L 142) 12 (EC), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:142:0012:0023:EN:PDF.

128. *See* Mathias M. Siems, *The Rules on Conflict of Laws in the European Takeover Directive*, 4 EUR. CO. & FIN. L. REV. 458, 460 (2004); *cf.* Scott Mitnick, *Cross-Border Mergers and Acquisitions in Europe: Reforming Barriers to Takeovers*, 2001 COLUM. BUS. L. REV. 683, 699 (2001).

takeover regime, a voluntary takeover code was implemented in Germany. Because of the lack of sanctioning power from the Takeover Commission, only 540 of the 933 listed companies participated in this Takeover Code.[129] On July 14, 2006, the Implementation Act amending the German Securities Acquisition and Takeover Act ("WpÜG") was put into force to implement Directive 2004/25/EC on Takeover Bids.[130] However, German listed companies are entitled to choose existing German rules rather than following the more restrictive European rules regarding mandatory bid and board neutrality.[131] The possibility of circumventing these key rules practically becomes the biggest poison pill of all and further demonstrates the Directive's disappointing influence on harmonization.[132]

The very nature of optional harmonization also raises inevitable doubts about the strength of these directives in approximating Member States' laws. After these directives eventually get the necessary level of support, the finalized versions are generally weak and compromised, which severely reduces their effectiveness with respect to their initial goals for harmonization. Again, take the implementation of the Takeovers Directive as an example. This was intended to introduce a hallmark of Anglo-American shareholder-oriented capitalism—takeover practice—into the European system.[133] Many of the principles recommended by the Directive, such as focusing on disciplining the management of listed companies and protecting shareholders' exclusive rights, have long been

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129. Gregory Jackson, *Regional Integration and the Diversity of Corporate Governance: Some Lessons from European Integration*, RIETI, at 9 (Apr. 22–23, 2002), http://www.rieti.go.jp/en/events/02042201/jackson_1.pdf.

130. HILDEGARD ZIEMONS, JOCHEN SCHLOTTER & KARSTEN HILMER, COMMON LEGAL FRAMEWORK FOR TAKEOVER BIDS IN EUROPE 164–89 (2010).

131. According to Article 12 of the Directive, Member States are offered the right not to require companies whose registered offices are in their territory to comply with Article 9 and Article 11, which enshrine the board neutrality and the mandatory bid principle. *See* Council Directive 2004/25, supra note 128. *See also* Vanessa Edwards, *The Directive on Takeover Bids – Not Worth the Paper It's Written on?*, 1 EUR. COMP. FIN. L. REV. 416, 435 (2004)

132. *See* G Maier-Reimer, *Protection against Hostile Takeovers in Germany: Banks and Limitations on Voting Rights*, *in* EUROPEAN TAKEOVERS: LAW AND PRACTICE 242 (1992); FRESHFIELDS BRUCKHAUS DERINGER, THE TAKEOVER DIRECTIVE: IMPLEMENTATION IN GERMANY (2006), *available at* http://www.freshfields.com/uploadedFiles/SiteWide/Knowledge/The%20Takeover%20Directive%20implementation%20in%20Germany.pdf.

133. It was suggested that the prevalence of family- and bank-controlled companies in many Continental countries was due to a lack of appropriate protection for minority shareholders and strong anti-takeover devices. *See* Cernat, *supra* note 69, at 160; La Porta et al., *supra* note 3. Takeover practice has been commonly agreed to be a significant contributor to shareholder value orientation by putting a floor under board performance. P. REDMOND, PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES INQUIRY INTO CORPORATE RESPONSIBILITY (2005); PAUL L. DAVIES, INTRODUCTION TO COMPANY LAW 212 (2002).

practiced in the UK where takeover activity has historically flourished.[134] The Directive, as it was originally proposed, attempted to enhance employee participation in takeover bids, which is strongly Continental in character. Of the fifteen amendments introduced by the EU regarding the Takeovers Directive, five were related to the introduction of participatory rights for workers in the takeover process.[135] Despite its ambitious aims, after more than ten years of debate and intense argument, the Directive eventually reached its final form as a product of political compromise between Member States. It is clear that the main aim of the Directive, i.e., to offer equal treatment to shareholders throughout the European Community, can be easily circumvented by Member States. In the Directive, Article 9, which requires the target company's board to remain neutral in the bid, and Article 11, which aims to break through various pre-bid obstacles to takeovers, are considered to be the key provisions—"the core of this Directive"[136]—offering shareholder protection by restricting the rights of the target company board to frustrate a bid without shareholder approval.[137] Nevertheless, according to Article 12 of the Directive, which was added as a last-minute political compromise,[138] Member States are offered the right not to require companies whose registered offices are in their territory to comply with Article 9 and Article 11. By empowering Member States to maintain their national takeover regulatory features and allowing them circumvent those two key provisions, the Directive lacks sufficient force to approximate laws and practices across Member States. In addition, the implementation of the minimum bid requirement in the Directive greatly increases the difficulty of launching a takeover bid under the Directive. This potentially restricts the Directive's intended result of increasing cross-border mergers and acquisitions, which were thought to be the main vehicle for diluting concentrated ownership in Continental Europe.[139]

Viewed from a broader perspective, this legal approximation practice in corporate governance also reveals the dark side of EU harmonization via the vertical imposition of laws—destructively cutting through areas of domestic law. Directives are notorious for their fragmentary nature; each

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134. *See, e.g.*, Siems, *supra* note 128; Edwards, *supra* note 133, at 439.

135. EUR. COUNCIL, AMENDED PROPOSAL FOR A COUNCIL REGULATION ON THE STATUTE FOR A EUROPEAN COMPANY—GUIDELINES FOR POLITICAL AGREEMENT (2000).

136. Siems, *supra* note 128, at 460.

137. Edwards, *supra* note 133, at 435.

138. Luca Enriques, *The Mandatory Bid Rule in the Takeover Directive: Harmonization without Foundation*, 1 EUR. COMP. FIN. L. REV. 440, 441 (2004).

139. Cernat, *supra* note 69, at 160.

only covers one particular topic and applies to restricted forms of businesses. Most would agree that harmonization through Community directives, even when smoothly implemented, can only influence the Member State's internal laws that fall within the Community jurisdiction, mainly cross-border issues, and must leave intact other areas of domestic law despite the fact that they are dealing with similar issues.[140] This undermines the goal of harmonization and will likely result in further diversity at the national level.

C. *Current Procedural Harmonization: The Code-based Approach and Comply-or-Explain*

1. *The Background of Procedural Harmonization*

Recognizing many Member States' calls for more flexibility, a combination of legislation and soft law enabling a "bottom-up" convergence and a broader use of alternative instruments to primary legislation have been stated as a main theme of EU action on corporate governance in the new millennium. It is suggested that a harmonized framework should be achieved over time via "a certain coordination" of national codes of practices based on "best practices," reflecting the tremendous growth in voluntary codes and guidelines in Member States during the past few decades.[141] Compared to traditional directives, which produced "a certain 'petrifaction'"[142] of corporate performances, these corporate governance codes are generally developed on a national basis and "bring a firm considerable legitimacy"[143] by reflecting what public or private organizations consider to be best practices. As described by the recent comprehensive EU report on corporate governance codes, "[t]he codes—together with market pressures—may serve as a converging force, by focusing attention and discussion on governance issues, articulating

140. *See* van Gerven, *supra* note 31, at 5.

141. WEIL, GOTSHAL & MANGES LLP, COMPARATIVE STUDY OF CORPORATE GOVERNANCE CODES RELEVANT TO THE EUROPEAN UNION AND ITS MEMBER STATES (2002), *available at* http://ec.europa.eu/internal_market/company/docs/corpgov/corp-gov-codes-rpt-part1_en.pdf; THE EU APPROACH TO CORPORATE GOVERNANCE—ESSENTIALS AND RECENT DEVELOPMENTS, *supra* note 52, at 4. Starting from the UK Cadbury Report in 1992, over forty codes have been introduced and adopted in Member States over the subsequent ten years. Clarke, *supra* note 2, at 189.

142. THE HIGH LEVEL GROUP OF CO. LAW EXPERTS, REPORT OF THE HIGH LEVEL GROUP OF COMPANY LAW EXPERTS ON A MODERN REGULATORY FRAMEWORK FOR COMPANY LAW IN EUROPE 31 (2002) [hereinafter THE HIGH LEVEL GROUP], *available at* http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf.

143. Yoshikawa & Rasheed, *supra* note 94, at 392.

best practice recommendations and encouraging companies to adopt them."[144]

When delineating the new code-based approach, sweeping uniform European corporate governance code was rejected on the grounds that the specificities of Member States' corporate governance systems are so influential that a common EU code would either be meaninglessly abstract, or would become a very complex document aiming to be inclusive of all contingencies arising from diverse local practices and rules, which would not bring significant changes to the current landscape.[145] This accords with the well-accepted idea that European integration would work best when it supports, rather than undermines, the idiosyncratic values of Member States. To put this in a broader context, one might suggest that this code-based approach is one of the many responses to the forceful academic criticism of the excessive supranationalism exhibited in early Union harmonization practice.[146] Indeed, few would now disagree that a positive interventionist role should only be assumed by the Union in a cautious fashion, when its superiority over national or local action can be demonstrated. The principles of subsidiarity and proportionality contained in Article 5 of TEU are precisely constructed to tackle this issue by acknowledging the necessity of penetrating Union intervention in certain areas.[147]

To facilitate the anticipated trend of bottom-up convergence, the European Commission turned its attention to positively harmonizing not the substance, but rather the enforcement mechanisms, which, as will become clear, has been a rather disappointing process. Two further moves were introduced by the European Commission to accompany the code-based harmonization efforts. These were the establishment of the European Corporate Governance Forum in 2004 and the enshrinement of the Comply-or-Explain approach as imposed by Directive 2006/46/EC.[148] Under Article 46(a) of the directive, it is compulsory for a listed company to include a corporate governance statement in its annual report with

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144. WEIL, GOTSHAL & MANGES LLP, *supra* note 141, at 74.

145. THE HIGH LEVEL GROUP, *supra* note 144, ch. III.6.; Klaus J. Hopt, Jose Garrido García, Jonathan Rickford, Guido Rossi, Jan Schans Christensen, Joelle Simon & Jaap Winter, *European Corporate Governance in Company Law and Codes*, ch. 1 (Oct. 18, 2004), *available at* http://www .ecgi.org/presidency/pre sentations/2004_thehague_final_report.pdf.

146. *E.g.*, Giandomenico Majone, *From the Positive to the Regulatory State: Causes and Consequences of Changes in the Mode of Governance*, 17 J. PUB. POL'Y 139 (1997).

147. *See* Michael Dougan, *And Some Fell on Stoney Ground—A Review of Giandomenico Majone's Dilemmas of European Integration*, 31 EUR. L. REV. 865 (2006).

148. Council Directive 2006/46/, 2006 O.J. (L 224) 1 (EC), *available at* http://eur-lex.europa.eu/ LexUriServ/LexUriServ.do?uri=OJ:L:2006:224:0001:0007:EN:PDF.

reference to the national corporate governance code to which the company is subject.[149] While directives and recommendations continue to be introduced in specific areas, the code-based approach supported by mandatory application of the comply-or-explain principle is now scholarly termed "procedural harmonization,"[150] and it operates as the major European approach to corporate governance.[151]

2. Doubts on Comply-or-Explain and Procedural Harmonization

The concept of comply-or-explain that underpins procedural harmonization initiatives first came to prominence in 1992 and is marked by the release of the Cadbury Report on the Financial Aspects of Corporate Governance.[152] It became mandatory in 2000 in the UK via the listing rules of the Financial Services Authority before it was introduced into the European corporate governance framework.[153] One impetus behind the EU espousal of this system was to relieve businesses from regulatory burdens and bureaucracy imposed by early efforts towards Europeanization.[154] Under Article 46(a) of Directive 2006/46/EC, companies are entitled to derogate from the principles explicated in the codes if clear explanations can be offered in annual reports for such derogation, which stands in sharp contrast to mandatory systems.[155] Compared with mandatory legislation, this comply-or-explain approach can better accommodate companies' individual circumstances, particularly the size and complexity of the company and the nature of the risks and challenges it faces.[156] Allowing consideration of the dynamic divergence

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149. *Id.* art. 46(a).

150. Armour, *supra* note 8, at 7; Deakin, *supra* note 12, at 190.

151. *See* RISKMETRICS GROUP, STUDY ON MONITORING AND ENFORCEMENT PRACTICES IN CORPORATE GOVERNANCE IN THE MEMBER STATES 11 (Sept. 23, 2009) [hereinafter RISKMETRICS GROUP], *available at* http://ec.europa.eu/internal_market/company/docs/ecgforum/studies/comply-or-explain-090923_en.pdf; WEIL, GOTSHAL & MANGES LLP, *supra* note 141, at 74.

152. COMM. ON CORP. GOVERNANCE REPORT, *supra* note 102.

153. RISKMETRICS GROUP, *supra* note 151, at 22.

154. The growing sense of regulatory fatigue among companies and other interested bodies was formally acknowledged by the European Commission in the 2006 Review of the Action Plan consultation. *See* Directorate General for Internal Market and Servs., Eur. Comm'n, *Consultation on Future Priorities for the Action Plan on Modernising Company Law and Enhancing Corporate Governance in the European Union* (2005), *available at* http://ec.europa.eu/internal_market/company/docs/consultation/consultation_en.pdf; THE EU APPROACH TO CORPORATE GOVERNANCE—ESSENTIALS AND RECENT DEVELOPMENTS, *supra* note 53.

155. Directive 2006/46, *supra* note 148, art. 46(a).

156. FIN. REPORTING COUNCIL, THE UK CORPORATE GOVERNANCE CODE 4–5 (2012) [hereinafter UK CORPORATE GOVERNANCE CODE], *available at* http://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-September-2012.aspx.

and complexity of corporate practices, justified non-compliance encourages directors to modify their governance strategies and approaches in the light of evolving circumstances, and the flow and quality of information provided in the explanation can assist shareholders in appreciating the soundness of managerial decisions and pressing for a strategic change if they are not satisfied.[157]

Taking account of the disappointing results of previous substantive harmonization measures, this soft approach has been preferred by EU regulators since 2002 because it "fits well with the differences between national legal and governance frameworks," as well as "the variety of situations of individual companies."[158] From a practical perspective, there is a mandatory rule to either comply or explain, but the alternative of explaining non-compliance turns the actual governance guidelines contained in the Codes into optional rules.[159] It was also hoped that a constant flow of information regarding corporate practices might be assured via the implementation of this approach, providing a foundation for further legislation at the EU level.[160] Contemplating its anticipated advantages in comparison with mandatory systems, it came to prominence as the foundation of the new flexible EU corporate governance framework and was seen as the key to attaining long-term harmonization in the field.[161]

The EU's experience with the comply-or-explain approach, however, again challenges the effectiveness of the Union's integration activities regarding corporate governance. It further proves the point that a good national rule for corporate governance does not necessarily work as efficiently at the European level. Before being adopted into the EU corporate governance framework, the comply-or-explain approach was known as "the trademark of corporate governance in the UK,"[162] and it has been in place since the beginning of voluntary codes. In the United Kingdom, where the comply-or-explain principle originated and has flourished, the approach has been well received by businesses and is

157. Sridhar Arcot, Valentina Bruno & Antoine Faure-Grimaud, *Corporate Governance in the UK: Is the Comply or Explain Approach Working?*, 30 INT'L REV. L. & ECON. 193, 193–95 (2010).

158. *See* Eur. Corp. Governance Forum, *Statement of the European Corporate Governance Forum on the Comply-or-explain Principle*, § 1 (2006) [hereinafter Eur. Corp. Governance Forum], *available at* http://ec.europa.eu/internal_market/company/docs/ecgforum/ecgf-comply-explain_en.pdf. After 2002, there were few mandatory directives in force in the field of corporate governance, the most substantial one being the adoption of Council Directive 2007/36, *supra* note 10.

159. DAVID KERSHAW, COMPANY LAW IN CONTEXT 238 (2009).

160. RISKMETRICS GROUP, *supra* note 151, at 22.

161. Eur. Corp. Governance Forum, *supra* note 158.

162. UK CORPORATE GOVERNANCE CODE, *supra* note 158, at 4–5.

highly praised for its flexibility.[163] Data also shows satisfactorily high rates of compliance with most provisions of the UK Corporate Governance Code by companies of all sizes.[164] When companies do deviate from the Code, most manage to clearly set out their reasons and the arrangements that they put in place to provide alternative safeguards.[165] The efficiency of the comply-or-explain principle has been nevertheless challenged ever since its arrival in European law. Recent studies described by the Green Paper cast doubt on its efficacy as an EU policy, referring to it as "reduc[ing] the efficiency of the EU's corporate governance framework and limit[ing] the system's usefulness."[166]

Much of the criticism so far has been pinpointed at the inherent flaws of comply-or-explain without challenging the unnecessary Union regulatory intervention. The flexible code-based system has been championed by the UK over the past fifteen years because of the prosperity of the UK's market-based economy and the strong role played by the London Stock Exchange as a self-regulatory body.[167] The comply-or-explain principle, reflecting its embedded environment, is principally based on the strong role played by the market in corporate control, primarily disciplining non-compliant companies by lowering their share prices.[168] This market-based economic background and self-regulatory tradition are not present in many of the other Member States, which calls into question the suitability of this approach in other nations. In practice, the sweeping implementation of comply-or-explain across Europe has had

163. *Id.*

164. FIN. REPORTING COUNCIL, DEVELOPMENTS IN CORPORATE GOVERNANCE 2011—THE IMPACT AND IMPLEMENTATION OF THE UK CORPORATE GOVERNANCE AND STEWARDSHIP CODES 11 (Dec. 2011), *available at* http://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Developments-in-Corporate-Governance-2011-The-impa.aspx.

165. In the 2011 annual survey of compliance of the UK Corporate Governance Code by FTSE 350 companies, 50% of companies claim full compliance with the Code. 80% comply with all but one or two of the Code's 48 provisions. *Id.*

166. *Commission Green Paper*, *supra* note 14, at 18.

167. Rules developed by the Stock Exchange are generally far more rigorous than their statutory counterparts, and compliance with those rules has been substantive owing to the reputation of the Stock Exchange and the UK's mature and liquid security markets. *See* R.C. MICHIE, THE LONDON STOCK EXCHANGE: A HISTORY 567 (2001); JAMES J. FISHMAN, THE TRANSFORMATION OF THREADNEEDLE STREET: THE DEREGULATION AND REREGULATION OF BRITAIN'S FINANCIAL SERVICES 24–26 (1993).

168. Iain MacNeil & Xiao Li, "*Comply or Explain": Market Discipline and Non-Compliance with the Combined Code*, 14 CORP. GOVERNANCE INT'L REV. 486, 487 (2006); FRANK H. EASTERBROOK AND DANIEL R. FISCHEL, *supra* note 9; Anita Anand, *Voluntary vs. Mandatory Corporate Governance: Towards an Optimal Regulatory Framework*, 31 DEL. J. CORP. L. 229 (2006). In the wake of the current crisis, the comply-or-explain approach may also appear less appealing to UK shareholders in terms of alleviating the principal-agent conflict because of the stronger role of the board under this approach than its counterpart under the default rules in UK company law.

a more disruptive effect on national enforcement systems, which were established and operated in a coherent manner before the community measure. In over 60% of deviations, the principle has been abused by companies failing to provide sufficient explanation when they chose not to apply recommendations from the codes; "they either simply stated that they had departed from a recommendation without any further explanation, or they provided only a general or limited explanation."[169] It was suspected that many companies supported the comply-or-explain concept merely because they could easily get away with deviations.[170] With regard to the requirement of the German Corporate Governance Code to disclose the remuneration of company executive directors on an individual basis, only a small minority of firms (10 out of 126 in a 2002 sample and 22 out of 146 in a 2003 sample) actually complied with the suggestion.[171]

The efficiency of the comply-or-explain principle in European harmonization becomes even more questionable because the EU mandates the implementation, yet fails to cater for the complementary need for proper monitoring and disciplining mechanisms. This issue, according to Article 60(a) of the directive, is tackled by way of "self-governance" in Member States, which generates a multifaceted picture.[172] A number of different schemes have so far been employed by Member States in applying the comply-or-explain idea, including: assimilating into the local listing rules,[173] self-embodiment in the codes,[174] or enshrining in a mixture of public and private regulations—the listing rules make reference to the code and the law, whilst securities regulation imposes the comply-or-explain approach.[175] To add to this complexity, national implementation methods are further differentiated by ambits of national codes customized for diverse company types. Currently, some Member States have specific corporate governance codes tailored to small and medium-sized listed

169. *Commission Green Paper*, *supra* note 14, at 18.

170. Although companies which fail to comply with the recommendations are expected to submit explanation of non-compliance, the overall level of "informative explanations" is rather low in the EU. Only thirty-nine percent of all explanations on the reference corporate governance code are classified as sufficiently "informative". *See* RISKMETRICS GROUP, *supra* note 151, at 13.

171. Christian Andres & Erik Theissen, *Setting a Fox to Keep the Geese—Does the Comply-or-Explain Principle Work?*, 14 J. CORP. FIN. 289 (2008).

172. Directive 2006/46, *supra* note 148, art. 60(a).

173. *E.g.*, Denmark, Ireland, and Romania.

174. *E.g.*, Cyprus, Estonia, Finland, Luxembourg, and Sweden.

175. *E.g.*, Austria, Bulgaria, Italy, Latvia, Lithuania, Poland, Slovakia, Slovenia, and the United Kingdom. *See* RISKMETRICS GROUP, *supra* note 151, at 24.

companies.[176] In other jurisdictions, however, codes are designed to apply to all listed companies, with specific provisions devoted to smaller companies.[177] Local differences in the application of the comply-or-explain approach inevitably lead to diverse enforcement results, and thereby contribute to the continuing fragmented landscape of European corporate governance.

This discrepancy in application resulting from the national filtering process is particularly evident in cases involving a company that is incorporated in one Member State but whose shares are listed in one or more other Member States. For example, in the case of the Netherlands, the obligation to adopt the comply-or-explain approach is embodied in company law and is applicable to all domestic companies listed in a regulated market relying on the criterion of place of incorporation (the statutory seat).[178] Conversely, the comply-or-explain regime in some other Member States (e.g. the United Kingdom) is found in the Listing Rules and applies to all companies listed in the jurisdiction, regardless of their places of incorporation.[179] This leads to the practical effect that a company may suffer a double blow from both the country of incorporation (the statutory seat) and the country in which it is listed. Likewise, the possibility exists that a company incorporated in one Member State that applies listing rules and listed in another that applies the comply-or-explain approach on the basis of incorporation may be bound by neither jurisdiction to apply the local code.[180] Although practice over the past few years suggests that only a limited number of such "forum shopping" situations exist, the likelihood of EU companies' ability to completely circumvent procedural harmonization largely undermines any efforts toward convergence.

So far, two suggestions to resolve the issues in complex listing situations have been proposed by the European Corporate Governance Forum. The suggestions are that a company with cross-border share listing should have the discretion as well as the obligation to choose which code it intends to apply in the light of its own particular circumstances. The

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176. *See, e.g.*, *Code de Gouvernement D'entreprise pour les Valeurs Moyennes et Petites*, MIDDLENEXT (Dec. 2009), http://www.middlenext.com/IMG/pdf/Code_de_gouvernance_site.pdf.

177. *E.g.*, UK Corporate Governance Code, *supra* note 158. In Austria, Ireland, Slovakia, or the United Kingdom, a different practical implementation of the code results in fewer applicable recommendations for smaller companies. *Commission Green Paper*, *supra* note 14, at 4; RISKMETRICS GROUP, *supra* note 151, at 25.

178. RISKMETRICS GROUP, *supra* note 151, at 29.

179. *Id.*; *see also* Eur. Corp. Governance Forum, *supra* note 158.

180. RISKMETRICS GROUP, *supra* note 151, at 29.

Member State whose code is not chosen can require the company to explain in what significant ways the actual corporate practices of that company deviate from those set out in that Member State's corporate governance codes.[181] These suggestions should resolve the difficulty of no rule being applicable to a company, although the choice would be left to the company, which potentially increases the risk of forum shopping. Meanwhile, it remains doubtful whether these suggestions will reduce the probability of double code application. According to the suggestions, a company may presumably still be disciplined for failing to explain areas of disobedience within the code it chooses not to apply, the result being the same as applying both codes simultaneously to the same company.

3. *Contesting Procedural Harmonization from a Practical Point of View—Continuing Diversities across Member States*

The inspiration behind the EU's push towards procedural harmonization, i.e. a harmonized framework via substantial integration of individual codes, can be traced back to the theory of regulatory competition put forward by "race to the top" advocates.[182] In their analysis, law can also be seen as a product in a market for regulatory regimes, and diverse systems of rules will eventually converge via a process of national legislatures competing to attract firms.[183] Reflecting business demands, moderate but not excessive competition among national laws and rules is seen as promoting regulatory innovations, accelerating the integration of European corporate laws towards an aggregation of best practices, and subsequently progressing towards a "bottom-up" convergence across the European Union.[184]

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181. Eur. Corp. Governance Forum, *supra* note 158. Another weakness of these suggestions, although it is not particularly relevant to the theme of EU harmonization, is that they are restricted to resolving the issue of complex listing situations from a European viewpoint, neglecting discrepancies between EU Member State and non-Member States.

182. For instance, it is argued that the *Centros* decision, Case C-212/97, Centros Ltd. v. Erhvervs-og Selskabsstyrelsen, 1999 E.C.R. I-1459, has contributed to European corporate governance development as it implies the possibility of regulatory competition within the European Union. *See, e.g.*, Klaus Heine & Wolfgang Kerber, *European Corporate Laws, Regulatory Competition and Path Dependence*, 13 EUR. J. L. ECON. 47, 50 (2002); *cf.* Janeen Carruthers & Charlotte Villiers, *Company Law in Europe—Condoning the Continental Drift?*, 11 EUR. BUS. L. REV. 91, 92 (2000). Carruthers and Villiers have pointed out that the question of mutual recognition was not approved by the ECJ in *Centros*, rather, "the reality is that the decision brings this debate to the forefront". *Id.*

183. Roberta Romano, *The States as Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 YALE J. ON REG. 209 (2006); Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J. L. ECON. & ORG. 225 (1985); Deakin, *supra* note 12, at 216–17.

184. Siems, *supra* note 5.

For the purposes of this article, we need not engage in seeking answers about the contentious topic of whether regulatory competition will occur.[185] What does need acknowledgment, however, is that the presumed convergence will occur as a by-product of competition between national legislatures, which aim to attract firms to become subject to their laws. In other words, convergence will be triggered by firms' preferences rather than by a vertical imposition of laws working towards unification. This renders the EU's imposition of the comply-or-explain principle—i.e. the mandatory application of national codes—largely redundant from a theoretical point of view. When the envisaged convergence rests entirely on the basis of voluntary modifications of laws, why do we need further Union mandates to complicate the picture?

From a practical point of view, observation of the regulatory integration status casts further doubt on procedural harmonization and even on the prospect of regulatory competition. In the US, where regulatory competition is thought to be common practice, there is conflicting evidence regarding the large-scale occurrence of regulatory competition and convergence.[186] In Europe, the practice in the years since the *Centros* decision[187] has proved that the anticipated "legislation shopping" that was feared as a result of increased corporate mobility has been largely overwhelmed by the persistence of Member States' domestic competitive advantages, including skilled workforces, infrastructure, and proximity to natural resources.[188] No significant sign has been found of national rules regarding corporate governance "competing and

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185. The arguments in favor of the "race to the top" idea are not without their challengers. In particular, the possibility remains that such regulation competition will also lead to the possibility of jurisdictions reducing the standards of regulation to a low and inefficient level via a progressive dismantling of regulations, i.e. the so-called "race to the bottom." *See, e.g.*, William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974); Lucian Arye Bebchuk & Aallen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168 (1999).

186. For example, some evidence suggests that firms are more likely to remain in their home state, even when this implies inefficient decisions. Armour, *supra* note 8, at 12; Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559, 1596–97 (2002); M. Kahan, *The Demand for Corporate Law: Statutory Flexibility, Judicial Quality, or Takeover Protection* (N.Y. Univ. L. & Econ., Working Paper No. 04-015, 2004).

187. Case C-212/97, Centros Ltd. v. Erhvervs-og Selskabsstyrelsen, 1999 E.C.R. I-1459. A necessary condition for the realization of regulatory competition is the free movement of companies. For further discussion, see Andrew Johnson & Phil Syrpis, *Regulatory Competition in European Company Law after Cartesio*, 34 EUR. L. REV. 378 (2009); Amit M. Sachdeva, *Regulatory Competition in European Company Law*, EUR. J. L & ECON. 137, 138 (2010); Armour, *supra* note 8.

188. *See* Mark J. Roe, *Delaware's Competition* (Harv. John M. Olin Ctr. for L., Econ., & Bus., Discussion Paper No. 432, 2003), *available at* http://www.law.harvard.edu/programs/olin_center/papers/pdf/432.pdf.

converging."[189] With regard to the central themes characterizing the dichotomous models of corporate governance—namely, ownership and control—fascinating diversities in terms of both structural and practical aspects are still exhibited in European countries, despite an emerging common understanding of the significance of corporate governance and various harmonizing efforts over the past decades. In particular, differences can be perceived in terms of the following three key aspects: differences in board performance and structure, the rights and composition of the shareholder body, and the allocation of power between shareholders and directors. This indicates the inefficiency of procedural harmonization and tentatively suggests the limited prospect of regulatory approximation arising out of competition between national codes.

a. Differences at Board Level

With regard to board functions, although the EU introduced a Recommendation to clarify the role of boards of directors and committees,[190] its implementation so far has been rather discouraging. After six years, some Member States have yet to include the main principles in their codes of practice, and a few other Member States have simply chosen not to accept the key provisions in the Recommendations.[191]

Board sizes and the criteria employed to assess directors' practices also vary greatly between different corporate governance frameworks, which to a degree depend on the presence of employee representatives on the board.[192] In Member States operating under the Anglo-American model, a board is seen as having sole responsibility and accountability towards the residual claimants of the company—the shareholders. The maximization of benefits for shareholders, usually measured by quarter earnings of companies, is the paramount criterion for evaluating directors' performance: "The sole common interest of all shareholders is the ongoing prosperity of the company. . . . By elevating environmental and social considerations to the same level as the creation of wealth the concept of

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189. A Triandafyllidou & A Fotiou, *Sustainability and Modernity in the European Union: A Frame Theory Approach to Policy-Making*, 3 SOC. RESEARCH ONLINE 6.2 (1998).

190. *Commission Recommendation on the Role of Non-executive or Supervisory Directors of Listed Companies and on the Committees of the (Supervisory) Board*, 2005 O.J. (L 52) 51, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2005:052:0051:0063:EN:PDF.

191. RISKMETRICS GROUP, *supra* note 151, at 32.

192. *Id.* at 31.

accountability is undermined."[193] In countries featuring the Continental system, the central concern of corporate governance is defined not by the rights of the shareholders in relation to the managers, but rather, by the rights of the community in relation to the corporation itself.[194] "Shareholders alone cannot make a firm—creditors, employees, managers, and even local governments often must make contributions in order for an enterprise to succeed."[195] By emphasizing the alignment of various stakeholders' interests in evaluation standards and the involvement of stakeholders in supervisory boards, managing directors in Continental countries focus on longer-term corporate development strategies.[196]

b. Shareholder Rights and Composition

The most substantial harmonization achievement has been the adoption of a Directive on shareholder rights (Directive 2007/36), prior to which the sphere of shareholder rights had long been dominated by diverse national rules.[197] Although, admittedly, the Directive singles out certain core rules to be adopted across Europe, e.g., requirements regarding transparency and the information disclosed by issuers, it is not sufficient (and not intended) to supersede national disparities in shareholder rights. The Directive only lays down the minimum rights of shareholders concerning voting at general meetings, such as the right to information and the right to ask questions, most of which are already commonly acknowledged and implemented by national rules, albeit in different forms. Issues that are less than completely agreed upon, such as the role of intermediaries in the voting process, the possibility and means of shareholders putting items on the agenda of the general meeting, and the voting rights of institutional investors, are either to be included in the form of voluntary recommendations introduced independently of the Directive or completely left out of the harmonizing process.[198] Even when enforcing the basic rules

193. Henry Bosch, *The Changing Face of Corporate Governance*, 25 U.N.S.W L. J. 270, 290 (2002).

194. BROOKINGS INST., EMPLOYEES AND CORPORATE GOVERNANCE 164 (Margaret M. Blair & Mark J. Roe eds., 1999).

195. Lynn A. Stout, *Bad and Not-so-bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1195 (2002), *available at* http://www-bcf.usc.edu/~usclrev/pdf/075504.pdf.

196. *See* Gary Gorton & Frank A. Schmid, *Capital, Labour, and the Firm: A Study of German Codetermination*, 2 J. EUR. ECON. ASS'N 863 (2004).

197. Council Directive 2007/36, *supra* note 10; see also HANNIGAN, *supra* note 65, at 42.

198. Eur. Comm'n, *Fostering an Appropriate Regime for Shareholders' Rights—Third Consultation Document of the Services of the Directorate General Internal Market and Services*, MARKT/ 30.04.2007, at 2 (2007), *available at* http://ec.europa.eu/internal_market/company/docs/shareholders/consultation3_en.pdf; Eur. Comm'n., *Synthesis of the Comments on the Third*

enshrined in the Directive, Member States are left with a wide margin of flexibility and maintain the scope to retain their own dynamics, e.g., the freedom of the Chairman to reject questions during the meeting and the delineation of detailed measures allowing shareholders to ask questions related to items on the agenda.

Key findings regarding the extent of share ownership among the populations of various countries also indicate different profiles of shareholders in corporate governance and the varying degrees of capital market influence in different national corporate governance contexts. In the UK, the primary representative of the Anglo-American system, the percentage of share owners among the adult population has remained steady at over 20 percent within the period 1997 to 2002, while the proportion of shareholders aged over fourteen within the German population in the same period was significantly lower—around 6–8 percent.[199]

c. Distribution of Power

Irreconcilable differences concerning the core feature of corporate control—the distribution of power—are revealed in European corporate governance despite decades of enforced reforms. At the shareholder-oriented extreme, e.g., in the United Kingdom, the core issues of corporate governance are not regulated by corporate laws, but are left to the discretion of company shareholders that decide in the form of articles of association, on the basis that this will allow more freedom for business management. Shareholders are free to choose as they see fit the size and the composition of the board and the extent of power allocation. Directors are supposedly "responsible for the management of the company's business,"[200] indicating that in terms of governing the company, the powers of directors in the UK are allocated by the shareholder body and are subject to subsequent shareholder control.[201] In contrast, systems at the other extreme, represented by German law, do not allow shareholders

Consultation Document of the Internal Market and Services Directorate-General, at 2 (2007), *available at* http://ec.europa.eu/internal_market/company/docs/shareholders/consultation3_report_en.pdf.

199. AUSTL. STOCK EXCHANGE, INTERNATIONAL SHARE OWNERSHIP 2 (2005), *available at* http://www.asx.com.au/documents/resources/international_share_ownership_summary_05.pdf.

200. The Companies (Model Articles) Regulations, 2009, S.I. 2008/3229, art. 3 (U.K.).

201. According to section 21 of the Companies Act 2006, Articles of Association can only be changed by shareholders by means of special resolution. Companies Act, 2006, c. 46, § 21 (U.K.), *available at* http://www.legislation.gov.uk/ukpga/2006/46/pdfs/ukpga_20060046_en.pdf.

significant room to devise governance strategies, nor do they have the ultimate power to do so. According to section 119 of the German Stock Corporation Act, the shareholder body can "only make management decisions when asked to do so by the management board," indicating that the controlling power of the board in Germany does not stem from shareholders' allocation, and shareholders do not have as much corporate control as their UK counterparts.[202]

Such diversity regarding the balance of power allocation leads to structural and behavioral distinctions between boards under distinct models of corporate governance as well. Narrow latitude is favored in Anglo-American practice, which uses internal mechanisms to ensure the company's accountability to shareholders and to harmonize "the relationship between shareholders and their companies."[203] A one-tier (or unitary) board composed of both executive and non-executive directors is the prevalent form of management under the Anglo-American system.[204] Directors' accountability to the shareholders depends heavily upon the ability of the shareholders to review the performance of the board and to make decisions if they think the performance has been inadequate.[205] On the other hand, the broader view adopted in Continental practice sees the function of the board as a means to coordinate the web of relationships within a company, including the relationships between the company and its extensive range of stakeholders.[206] In countries featuring the Continental system, for instance Germany, Austria, and the Netherlands, a two-tier (or dual) board structure composed of both supervisory and management boards is mandatory for large public companies. The supervisory board oversees the direction of the business, while the

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202. Aktiengesetz [AktG] [Stock Corporation Act], Sept. 6, 1965, BGBL. I at 1089, last amended by Restrukturierungsgesetz [German Restructuring Act], Dec 9, 2010, BGBL. I at 1900, art. 6 (Ger.).

203. R.A. DERWENT & J.M. JONES, THE CORPORATE GOVERNANCE HANDBOOK: SUPPLEMENT 1 ON OPERATING AND FINANCIAL REVIEW (1996).

204. *See, e.g.*, Lucian Cernat, *The Emerging European Corporate Governance Model: Anglo-Saxon, Continental, or Still the Century of Diversity?*, J. EUR. PUBLIC POL'Y 147, 150 (2004); Klaus J. Hopt & Patrick C. Leyens, *Board Models in Europe—Recent Development of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy*, 1 EUR. COMP. FIN. L. REV. 135 (2005); Carsten Jungmann, *The Effectiveness of Corporate Governance in One-Tier and Two-Tier Board Systems—Evidence from the UK and Germany*, 3 EUR. COMP. FIN. L. REV. 426 (2007).

205. For example, in the UK, shareholders have the right to appoint and remove directors. *See* Companies Act, 2006, c. 46, § 168 (U.K.), *available at* http://www.legislation.gov.uk/ukpga/2006/46/pdfs/ukpga_20060046_en.pdf (describing the dismissal of directors). There is no express provision as to how directors are appointed in the Companies Act 2006, but it is provided in the Model Articles (Companies Regulation 2008) that a director may be appointed by ordinary resolution of shareholders. DAVIES, WORTHINGTON, GOWER & MICHELER, *supra* note 9, at 411–12.

206. *See* JILL SOLOMON, CORPORATE GOVERNANCE AND ACCOUNTABILITY 12 (2d ed. 2007).

management board is responsible for the management of the business.[207] A co-determination system is often employed in this dual structure, in which employees, as a significant group of stakeholders, may have representation on the supervisory board. For instance, it is mandatory for most German public companies to have up to half the supervisory board members elected by employees.[208] After decades of extensive discussion, the superiority of the structure of the board still remains in dispute,[209] and the marked distinction between one-tier and two-tier boards is still demonstrated among Member States in spite of the EU's long-standing harmonization efforts. At the time of writing, nine Member States employ unitary structures, eight use dual structures, another eight employ both, and the remaining two, Italy and Hungary, allow so-called "hybrid" structures.[210]

V. CONTESTING THE FEASIBILITY OF EUROPEAN CORPORATE GOVERNANCE HARMONIZATION—THE THEORETICAL PERSPECTIVE

The foregoing discussions raise serious doubts about the effectiveness of EU legislative efforts to actively create a harmonized corporate governance framework. This section will attempt to further argue against the feasibility of European harmonization in the realm of corporate governance from a theoretical perspective. On these theoretical grounds, it seems better to leave corporate governance out of the harmonization scheme, leaving it to the governance of national rules and the "invisible hand" of markets.

207. CHRISTINE MALLIN, CORPORATE GOVERNANCE 122 (2d ed. 2007). In the two-tier board system, the term "board" is often used to refer to the supervisory board, while the term "key executives" refers to the management board. *See* OECD, CORPORATE GOVERNANCE: A SURVEY OF OECD COUNTRIES 15, 88 (2004), *available at* http://www.oecd.org/daf/ca/corporategovernance principles/21755678.pdf.

208. Under the German Co-Determination Act 1976, public companies and partnerships limited by shares with more than two thousand employees should have a supervisory board consisting of an even number of members (twelve, sixteen, or twenty, depending on the total number of employees), equally divided between shareholder and employee representatives. MitbestG [Co-Determination Act], May 4, 1976, BGBL. I at 1153.

209. *E.g.*, Paul L. Davies, *Board Structure in the UK and Germany: Convergence or Continuing Divergence?*, 2 INT'L & COMP. CORP. L. J. 423 (2000); GREGORY FRANCESCO MAASSEN, AN INTERNATIONAL COMPARISON OF CORPORATE GOVERNANCE MODELS, A STUDY ON THE FORMAL INDEPENDENCE AND CONVERGENCE OF ONE-TIER AND TWO-TIER CORPORATE BOARDS OF DIRECTORS IN THE UNITED STATES OF AMERICA, THE UNITED KINGDOM AND THE NETHERLANDS (2000), *available at* http://publishing.eur.nl/ir/repub/asset/8028/Maassen_9789090125916.pdf; Hopt, *supra* note 47.

210. "There is no formal obligation" in Lithuania to have a board of directors, although practice shows that both forms of boards are employed. RISKMETRICS GROUP, *supra* note 151, at 32.

A. Contractual Connections Underlying the Corporate Context

Viewed from an economic perspective, the flexibility and diversity of the contractual agreements underpinning different corporations, as will be presented below, causes problems for the harmonization of corporate governance mandated by EU-level actions. Over the thirty years that have elapsed since Easterbrook and Fischel advanced the idea originally proposed by aggregate activists,[211] this contractual nature of corporations is mostly employed in the long-standing corporate objective debate in the field of corporate governance to justify the predominance of shareholder value maximization,[212] though its implications for the convergence debate have been less examined.

Resting on the existence of contractual relationships among constituencies in corporate business, the concept of a "company," according to this theory, is a voluntary venture with complex arrangements among participants who are connected by contracts.[213] Corporate constituencies agree upon the terms by which they are prepared to supply the corporation with input and by which they expect to be compensated for so doing; hence, the company is also referred to as a "nexus of contracts."[214] The terms contained in relevant contracts shape the governance and compensation devices available in different firms, which differ in conjunction with the diversity of economic activity carried on within corporations and the varied identities of the constituencies.[215]

Regarding the rich diversity of corporate contracts, Easterbrook and Fischel wrote, to give succinct examples: "Corporations sometimes are organized as hierarchies, with the higher parts of the pyramid issuing commands; sometimes they are organized as dictatorships; sometimes they are organized as divisional profit centers with loose or missing hierarchy."[216] Processes of contracting are primarily carried out on the basis of party autonomy and coordinated by the "invisible hand." If investors, as well as employees and other interested parties, are of the view

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211. *See* ALAN DIGNAM & JOHN LOWRY, COMPANY LAW 376–88 (6th ed. 2010); Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989).

212. *E.g.*, CLARKE, *supra* note 2, at 149; Eugene Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); Andrew Keay, *supra* note 99; John Parkinson, *Models of the Company and the Employment Relationship*, 41 BRIT. J. INDUS. REL. 481 (2003).

213. Easterbrook & Fischel, *supra* note 211, at 1426.

214. Fama, *supra* note 212, at 290; Easterbrook & Fischel, *supra* note 211, at 1426; Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310 (1976).

215. Easterbrook & Fischel, *supra* note 211, at 1426.

216. *Id*. at 1426–27.

that the way entrepreneurs manage the potential investee company will reduce their expected returns, they will either purchase the shares after a corresponding reduction in share price is made, or they will simply invest in some other firm.[217] "In general, all the terms in corporate governance are contractual in the sense that they are fully priced in transactions among the interested parties,"[218] and they continue to change under rapid market variations. The integrated contractual nexus defines the flexible nature of corporate governance—the system by which companies are directed and controlled.[219] It requires acute commercial awareness and sufficient discretionary powers for company managers to reflect on the constantly evolving business reality and, accordingly, modify corporate governance terms in short time. Therefore, it is undesirable to restrict company managers through rigid legislative instruments seeking to harmonize corporate governance practices.[220] The role of regulations and laws in this field, in contrast to ones of a public nature, is best confined to filling gaps and balancing irregular bargaining powers so that parties can move closest to an ideal agreement, i.e. the agreement the parties would have reached with "full information and costless contracting."[221]

Although there remains some controversy as to what content and form the preferred rules should have, in practice, the relationships accruing to corporate governance under the Member States' laws are flexibly defined, which at least superficially accords with the theory. Upon the fulfillment of fundamental duties of care, skill, and diligence, great autonomy is granted to central management, which typically assumes the operations of the corporation; this is a characteristic of all large corporations and is exemplified in corporate governance practices across Member States.[222]

217. According to this argument, what distinguishes shareholders from other stakeholder groups is their identity as risk-bearers—once contracts are formed, all other stakeholders' returns are somehow guaranteed by contracts. Shareholders provide their capital for an open-ended return and the value of their claim varies depending on whatever is left over after all the other constituencies' interests have been fulfilled through contractual claims. It is only logical that shareholders should be the only residual claimant group in the company, and they should be rewarded with the entitlement to the entirety of any excess profit that the firm may generate. EASTERBROOK & FISCHEL, *supra* note 9; Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J. L & ECON. 425, 437 (1993).

218. Easterbrook & Fischel, *supra* note 211, at 1430.

219. Comm. on Corp. Governance Report, *supra* note 102.

220. For arguments against mandatory state intervention in corporate performance, see Henry N. Butler, *The Contractual Theory of the Corporation*, 11 GEO. MASON U. L. REV. 99 (1989); Jonathan R. Macey, *From Fairness to Contract: The New Direction of the Rules against Insider Trading*, 13 HOFSTRA L. REV. 9 (1984); Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STANFORD L. REV. 857 (1983).

221. Easterbrook & Fischel, *supra* note 211, at 1433.

222. *See* ANDREAS CAHN & DAVID C. DONALD, COMPARATIVE COMPANY LAW: TEXT AND

The scope of management discretion is even more extensive in Anglo-American system countries where market forces traditionally assume a strong role in corporate control. In the UK, ultimate corporate governance concerns, including the distribution of powers between the shareholder body and directors and the appointment and removal of directors, are entirely left to the discretion of shareholders in individual companies, rather than being statutorily governed by the comprehensive Companies Act 2006.[223] It is also a tradition to grant directors extensive discretion in corporate decision-making, and courts tend "not [to] judge directors with the wisdom of hindsight and do not 'second-guess' directors on commercial matters."[224] The flexible and diverse contractual relationships defining the nature of corporations effectively serve to explain the autonomy of parties in governance, which give rise to vastly different approaches to corporate governance and further hinder the possibility of harmonization pressed by the EU as a federal legislator.

B. Path Dependence and Complementarity

As stated by Yoshikawa and Rasheed, "A better understanding of the relative intransigence of national governance systems is not possible without an examination of the factors that impede convergence."[225] The goal of a harmonized framework, even from a long-term developmental perspective, is theoretically undermined by arguments related to path dependence and complementarity—two primary factors underpinning the persistence of contextual factors in domestic corporate governance

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CASES ON THE LAWS GOVERNING CORPORATIONS IN GERMANY, THE UK AND THE USA 10 (2010). It remains a matter of dispute as to who should have the ultimate power of control in a corporation and also whom a corporation should serve. For a rich collection of literature in these fields, see, e.g., R. EDWARD FREEMAN, STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH (1984); ALFRED D. CHANDLER, THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS (1977); Adolf A. Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931); Dodd, *supra* note 68; Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003). For the purpose of this article, those issues will not be explored.

223. Companies Act, 2006, c. 46 (U.K.).

224. Law Comm. and Scottish L. Comm., Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties, § 5.28 (1999), *available at* http://hb.betterregulation.com/external/Company%20Director.pdf. When assessing whether directors have breached the fiduciary duty of acting in the interest of the company, the English court will consider, in the opinion of the directors rather than in the Court's own opinion, whether directors acted in the *bona fide* interests of the company. BIRDS ET AL., *supra* note 78, at 615; DEREK FRENCH, STEPHEN W. MAYSON & CHRISTOPHER L. RYAN, MAYSON, FRENCH & RYAN ON COMPANY LAW 455 (24th ed. 2007); *see also In Re* Smith and Fawcett Ltd., [1942] EWHC (Ch) 304 (Eng.); Regentcrest plc v. Cohen, [2001] 2 B.C.L.C. 80.

225. Yoshikawa & Rasheed, *supra* note 94, at 392.

practices. Originating in the 1980s,[226] the concept of path dependence has been increasingly utilized in recent years by scholars in various disciplines, including economics,[227] corporate governance,[228] and law,[229] in explaining the persisting properties of their subjects.

The original definition of path dependence refers to a situation under which the current state of a system is determined and "locked in" not only by its initial conditions, but also by the evolutionary path it took.[230] In the field of corporate governance, this theory offers a convincing explanation for the persisting properties of differing national models by drawing on the influence of historical, political, cultural, and other contextual elements in various countries, thereby challenging the view that corporate governance systems in individual economies are likely to move towards the same end at a rapid pace.[231] In the case of the EU, persisting structural, economic, and political differences result in the emergence of gaps between coordination and institutional capacity in Member States which, being further exposed by the current economic and debt crisis, are likely to threaten of the harmonization of European corporate governance.[232]

The phenomenon of path dependence may arise from a number of aspects in practice. From the structurally-driven point of view,[233] sunk

226. The first known use of the term "path dependence" in reference to the feature of persistence was by David in his article "Clio and the Economics of QWERTY." P.A. David, *Clio and the Economics of QWERTY*, 75 AM. ECON. REV. 332 (1985); *see also* Shuangge Wen & Jingchen Zhao, *Exploring the Rationale of Enlightened Shareholder Value in the Realm of UK Company Law—The Path Dependence Perspective*, 14 INT'L TRADE & BUS. L. REV. 153, 162 (2011).

227. *E.g.*, DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE (1990); S.J. Liebowitz & Stephen E. Margolis, *Path Dependence, Lock-In, and History*, 11 J.L. ECON. & ORG. 205 (1995).

228. *E.g.*, Lucian Arye Bebchuk & Mark J Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127 (2000).

229. *E.g.*, Oona A. Hathaway, *Path Dependence in the Law: The Course and Pattern of Legal Change in a Common Law System*, 86 IOWA L. REV. 601 (2001); Clayton P. Gillette, *Lock-in Effects in Law and Norms*, 78 B.U. L. REV. 813 (1998).

230. DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE (1990); DOUGLASS C. NORTH, UNDERSTANDING THE PROCESS OF ECONOMIC CHANGE (2005); Yoshikawa & Rasheed, *supra* note 94, at 392; Reinhard H. Schmidt & Gerald Spindler, *Path Dependence, Corporate Governance and Complementarity*, 5 INT'L FIN. 311, 314–16 (2002).

231. *See* Schmidt & Spindler, *supra* note 230; Bebchuk & Roe, *supra* note 228; Liebowitz & Margolis, *supra* note 227; Yoshikawa & Rasheed, *supra* note 94.

232. According to recent research results, the major causes of the European debt crises vary by country. For instance, the crises in Ireland and Spain were mainly triggered by defaults in the private sector, while in Greece and Portugal, the cyclically adjusted structural deficit was among the major causes. *See* Jerome L. Stein, *The Diversity of Debt Crises in Europe*, 31 CATO J. 199 (2011), *available at* http://www.cato.org/pubs/journal/cj31n2/cj31n2-2.pdf.

233. Here we follow the categorization method put forward by Bebchuk and Roe: path dependence effects can be perceived from two major aspects, namely structural and rule-driven. *See* Bebchuk & Roe, *supra* note 228.

costs are a major impediment to national harmonizing adaptations, where improving any single element individually may actually reduce efficiency and make switching more costly.[234] One example is the long-standing dominance of the stakeholder-friendly philosophy in German corporate practices. The predominance of this characteristic was based upon and relies on the existence and support of a number of structural elements, including but not limited to: the comprehensive legal regime of co-determination, restrictions on the distribution of dividends, and corporate stock repurchases.[235] Structural path dependence can also be triggered by rent-seeking incentives or loss-averse concerns of relevant constituencies, which lead to their inclination towards persistence.[236] In Klausner's terms, the human capital of lawyers and judges is complementary to the existing national system governing corporations' behaviors and because adapting to the EU standard could potentially devalue their existing legal knowledge, they will be disinclined to support the adjustments.[237] Existing literature has also extended the reach of such rent-seeking behavior by demonstrating that resistance can come from a wide range of actors, including "labor unions, banks, controlling shareholders, lawyers."[238]

The rule-driven aspect of path dependence, which can be simplified as "history matters;"[239] or the idea of "lock-in by historical events"[240] alternatively focuses on the preserving effect of the evolutionary path a system took. Initial structures of legal systems, including corporate law, rules governing corporate governance, labor relations, and insolvency are found to have a vast influence on the formation of subsequent structures,

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234. *Id.*; Masahiko Aoki, *The Contingent Governance of Teams: Analysis of Institutional Complementarity*, 35 INT'L ECON. REV. 657 (1994); Khanna, Kogan & Palepu, *supra* note 87, at 71.

235. *See, e.g.*, Julian Franks & Colin Mayer, *Corporate Ownership and Control in the UK, Germany, and France*, 9 J. APPLIED CORP. FIN. 30 (1997); Simon Peck & Winfried Ruigrok, *Hiding behind the Flag? Prospects for Change in German Corporate Governance*, 4 EUR. MGMT J. 420 (2000).

236. Khanna, Kogan & Palepu, *supra* note 87, at 71; Yoshikawa & Rasheed, *supra* note 94, at 393.

237. Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995), *cited in* Heine & Kerber, *supra* note 60, at 59; *see also* Bruce H. Kobayashi & Larry E. Ribstein, *Evolution and Spontaneous Uniformity: Evidence from the Evolution of the Limited Liability Company*, 34 ECON. INQUIRY 464 (1996).

238. Yoshikawa & Rasheed, *supra* note 94, at 393; *see also* Coffee, *supra* note 1; Bebchuk & Roe, *supra* note 228; Khanna, Kogan & Palepu, *supra* note 87.

239. *See, e.g.*, Paul A. David, *Why Are Institutions the "Carriers of History"?: Path Dependence and the Evolution of Conventions, Organizations and Institutions*, 5 STRUCTURAL CHANGE ECON. DYNAMICS 205 (1994); Reinhard H. Schmidt & Gerald Spindler, *Path Dependence, Corporate Governance and Complementarity*, 5 INT'L FIN. 311, 315 (2002).

240. W. Brian Arthur, *Competing Technologies, Increasing Returns, and Lock-In by Historical Events*, 99 ECON. J. 116, 116 (1989).

which tend to assimilate and stabilize the essential elements of initial configurations.[241] For instance, "[t]he early development and high degree of industrialisation of the UK economy have . . . facilitated the predominance of shareholder value orientation" as the overriding corporate objective "in practice."[242] To date, these historical lock-ins have occurred even in governance systems characterized by voluntary measures,[243] which indicates that diverse national corporate governance elements will continue to exert effects on the process of European procedural harmonization.

Recent scholarship suggests institutional complementarities as a source of multiple optima, as well as support for national system persistence.[244] Broadly speaking, the entire national corporate governance system is complementary to other sets of governance systems, i.e. the whole corporate governance system of one country must fit with other national characteristics. In light of the fact that partial changes to individual elements will not properly fit with the rest of the complementary structural elements, the reformed system will resist such changes unless fundamental alterations can be made to "the different elements of an economic, social and legal system in which governance is embedded."[245]

As a significant external monitoring mechanism of corporate governance, the rich diversities among various Member States' stock market developments suggest robust complementary effects and the likely persistence of their individual corporate governance systems. The UK shareholder-oriented corporate governance system is found to be complementary with its liquid market mechanisms and its heavy reliance on equity capital. The "market for corporate control" has become "one of the most severe disciplinary mechanisms"[246] in the UK, exerting governance for corporate shareowners, mitigating the agency problem, and ensuring the accountability of management.[247] The emphasis of German

241. Yoshikawa & Rasheed, *supra* note 94, at 392.

242. Wen & Zhao, *supra* note 226, at 168. For support on the interconnection between industrialization and the corporate objective, see Neil Fligstein & Robert Freeland, *Theoretical and Comparative Perspectives on Corporate Governance*, 21 ANN. REV. SOC. 21 (1995).

243. Liebowitz & Margolis, *supra* note 227, at 205.

244. The concept of complementarity was initially used by Schmidt and Spindler in the field of corporate governance. This demonstrated that a national system could be usefully regarded as a collection of elements consistent with and complementary to other internal and external systematic configurations, including the distribution of ownership rights, the objectives of the firm, the general structure of corporate law and the role and function of the market, and others. Schmidt & Spindler, *supra* note 230; Khanna, Kogan & Palepu, *supra* note 87.

245. Schmidt & Spindler, *supra* note 230, at 327.

246. Clarke, *supra* note 2, at 98.

247. ANDREW BLACK, PHILIP WRIGHT, JE BACHMAN & JOHN DAVIES, IN SEARCH OF

corporations on creditors and employees' interests is compatible with that nation's economic reality—their stock market is both illiquid and volatile.[248] Undersized and undeveloped capital markets result in high dependence on debt and the long-term commitment of capital, which in turn brings about the primary position of banks that tend to play multiple stakeholder roles in the corporate context.[249]

Whereas the growth of stock markets in Europe has been subject to extensive Union legislative efforts, the pace of change towards eliminating the sharp contrasts between the two polar extremes of corporate governance is relatively static. Statistics recently published by Eurostat usefully illustrate the different sizes and performances of national stock markets and the varied importance of investor capital in different economies of scale by demonstrating the distinct degree of market capitalization of firms (in million Euros) in the bank-based Germany and the market-based UK. As shown in Chart 1,[250] which contains yearly figures over the period between 2001 and 2010, the market capitalization value in the UK has always been significantly higher than the corresponding value in Germany, in all years doubling or more than doubling the German value.

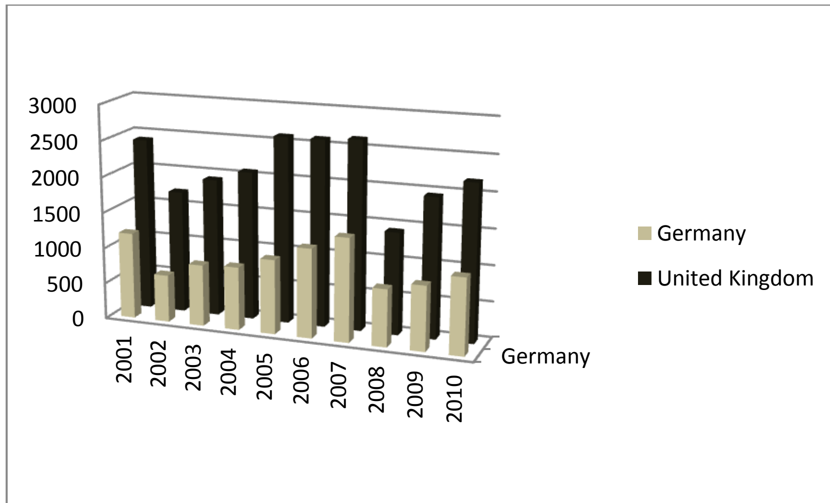
SHAREHOLDER VALUE: MANAGING THE DRIVERS OF PERFORMANCE 8 (1998); Denis & McConnell, *supra* note 1, at 4; Clarke, *supra* note 2, at 100–03.

248. Coffee, *supra* note 1, at 663; Jeffrey N. Gordon, *Deutsche Telekom, German Corporate Governance, and the Transition Costs of Capitalism*, 1998 COLUM. BUS. L. REV. 185, 200 (1998).

249. Aguilera & Jackson, *supra* note 3. In Germany, the role of the banks is not limited to being loan capital providers. The so-called "Universalbankensystem" allows an investing bank to act as a company's principal supplier of both debt and equity capital, with its representatives serving on the supervisory board of the company. *See* JONATHAN P. CHARKHAM, KEEPING GOOD COMPANY: A STUDY OF CORPORATE GOVERNANCE IN FIVE COUNTRIES 35 (1994); Robert Monks, *Relationship Investing* (Ctr. for L. & Econ. Stud., Paper for Conference on Relational Investing of Institutional Investor Project, 1993).

250. Data extracted from *Stock Market Capitalization*, EUROSTAT, http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=mny_stk_mcp_a&lang=en (last updated Feb. 22, 2013).

CHART I: COMPARISON OF MARKET CAPITALIZATION VALUE IN GERMANY AND THE UK (MILLION EUROS)



Statistics Source: Eurostat: EU Monetary and Other Financial Statistics—Stock Market Capitalization

Accounting for the relative economic importance of stock markets, the ratio of total stock market capitalization to gross domestic product (GDP) between Germany and the UK also demonstrates sharply disproportionate development paths. Typically, German stock market capitalization amounted to no more than a small percentage of the German GDP, [251] while the liquid equity trade and mature mechanisms in the UK contributed to its high market capitalization ratio. Although changes have been noted over the years as to the precise numbers, as will be seen from the chart below, the sharp contrast between the two countries persists, and this disparity seems to be on the rise. Chart 2 shows the total market capitalization of firms in the bank-based Germany and the market-based UK, taken as a proportion of GDP over the period 2006 to 2010.[252] In all cases, the UK ratios were more than double the comparative German values. These figures raise serious issues against Professor Coffee's convergence-favoring the argument that "securities markets [in Europe]

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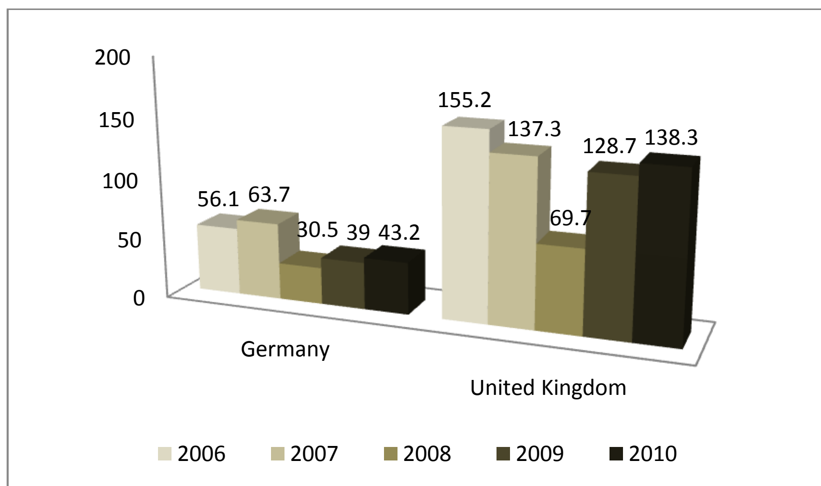
251. For 1995, German stock market capitalization was 23.9%, but the corresponding ratio was 130.7% in the United Kingdom. *See* EUROMONEY, THE 1996 GUIDE TO GERMANY 2, A4, tb1.1 (1996).

252. *Market Capitalisation of Listed Companies (% of GDP)*, WORLD BANK, http://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS (last visited Mar. 1, 2013) (data extracted from World Bank, Standard & Poor's, Global Stock Markets Factbook and supplemental S&P data).

are developing and convergence at this level is occurring" notwithstanding historical influences and institutional complementarities.[253] Instead, this evidence largely supports the arguments of path dependency theorists, who suggest that traditional national patterns, including those of markets, would suppress potential convergence stimuli and continue to resist substantive changes. To shed further light on the transformation of corporate governance systems in EU Member States, it follows that fundamental changes towards a harmonized end would not easily take place within different frameworks of corporate governance, owing to their inseparable systemic complementarities with domestic socio-economic factors.

CHART II: MARKET CAPITALIZATION OF LISTED COMPANIES (% OF GDP) IN GERMANY AND THE UNITED KINGDOM



Statistics Source: World Bank—Market Capitalization of Listed Companies (% of GDP).

VI. CONCLUDING REMARKS: THE LANDSCAPE IN THE WAKE OF THE CRISIS

The focus of long-standing theoretical and policy debates, the harmonization of corporate governance across Europe, continues to elicit public concern in the current climate of economic uncertainty. Reflecting on recent calls for further EU legislative moves towards a harmonized

253. *E.g.*, Coffee, *supra* note 1, at 667; *cf.* Bebchuk & Roe, *supra* note 228.

corporate governance framework, this paper contradicts the vision of further Union-level harmonization of corporate governance, reaching pessimistic conclusions regarding both its necessity and its feasibility in the post-crisis environment. Significantly, after a close scrutiny of the efficiency of harmonization efforts to date at the EU level, and of continuing differences in practice, it is clear that overall progress towards a single EU corporate governance framework has been sluggish.[254] This can partially be attributed to the flexible nature and blurred boundaries of corporate governance as an independent discipline. Although incremental changes brought about by legislative efforts are not to be denied in certain areas, the point to be considered here is that the extent and scope of these changes are not substantial enough to eliminate distinctions among national systems, and further EU action in the field of corporate governance is also likely to be substantively compromised by different national and business agendas and practices of corporate governance.

The ongoing crisis further complicates the plans for EU corporate governance harmonization. On the one hand, further EU action in corporate governance with the goal of establishing a harmonized framework is evidently seen at the Union level as essential for the revival of the economy.[255] As suggested by the Internal Market Commissioner Frits Bolkestein: "The more national corporate governance codes converge towards best practice, the easier it will be to restore confidence in capital markets in the wake of the scandals that have shaken trust in some European companies, including traditional 'blue chips.'"[256] Following the report on the responses to the Green Paper about the corporate governance framework for listed companies, the Commission has recently adopted an Action Plan outlining future initiatives in the areas of company law and corporate governance.[257]

Conversely, an increasing acknowledgement of the difficulties of eliminating national discrepancies has led scholars and practitioners to fight for more options and flexibility for Member States. "EU harmonization should respect the national corporate governance systems of the Member States and should strive to further the trend towards increased flexibility and freedom of choice in respect of company forms

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254. *See supra* Part IV.B & C.

255. *See Commission Green Paper*, *supra* note 14, at 2.

256. Eur. Comm'n, Corporate Governance: Commission Creates European Forum to Promote Convergence in Europe (2004), *available at* http://www.iasplus.com/en/binary/europe/0410corpgov.pdf.

257. Press Release, Eur. Comm'n, Commission Plans to Modernize European Company Law and Corporate Governance (Dec. 12, 2012), http://europa.eu/rapid/press-release_IP-12-1340_en.htm?locale =en.

and the internal distribution of powers."[258] Responses from a wide range of professional representatives, citizens, and public authorities also display a generally hostile attitude towards further governance measures at the EU level, which will severely impede the EU from gaining the necessary support for any further harmonization action.[259] With regard to certain core governance issues, including the power balance within boards and better governance of non-listed companies, many respondents opposed the need for any EU harmonizing action and maintained that they should be left to resolve issues at company level so as to reduce unnecessary costs associated with implementation and maintain the integrity and flexibility of businesses.[260]

To make the situation even worse, the continuing vulnerability of the Eurozone economies seriously challenges the established balance between various Member States in the economic and political partnership.[261] "[T]here is little public appetite for 'more Europe'" at this fragile time because of fears of one's own nation being dragged deeper into the crisis.[262] A reluctant attitude towards further integration can be seen from the recent UK government's pledge to hold an in/out referendum and renegotiate the nation's relationship with the EU.[263] The growing variation of health among Member State economies and their responses to the current crisis will understandably contribute to possible divergence in national corporate governance systems. Coupled with the inadequacy of existing Union-level approaches to harmonization and the long-standing national diversities contextualized by distinctive national structures, historical traditions, and value priorities, it appears more feasible and desirable in practical terms to envisage an improved variety of governance systems, allowing enough flexibility for differences among practices between individual Member States.

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258. Eur. Comm'n Reflection Group, *supra* note 2, at 11.

259. Eur. Comm'n, *Summary of Responses*, *supra* note 18.

260. *Id.* at 6–11.

261. Stephen Fidler, *An EU Currency Breakup Would Be Unlike Any Other*, WALL ST. J. (Dec. 2, 2011), http://online.wsj.com/article/SB10001424052970204012004577072340409590190.html; David Gow, *OECD: Euro Collapse Would Have "Highly Devastating Outcomes*,*"* THE GUARDIAN (Nov. 28, 2011), http://www.guardian.co.uk/business/2011/nov/28/oecd-eurozone-world-economy-warning.

262. Cameron, *supra* note 15, at 4.

263. "We will give the British people a referendum with a very simple in-or-out choice to stay in the EU on these new terms; or come out altogether." *David Cameron Promises In/Out Referendum on EU*, BBC (Jan. 23, 2013), http://www.bbc.co.uk/news/uk-politics-21148282.